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Valuations for Tax Purposes*

BY GEORGE E. FRAZER

There will always be a considerable difference of opinion in each profession as to the proper jurisdiction of that profession. This problem of jurisdiction has been constantly before each of the learned professions in all the eras of their development. Centuries ago when Francis Bacon, Lord Verulam, was chancellor of the exchequer a young nobleman ventured to elope with the chancellor's daughter. The chancellor, oblivious of his duties to the royal conscience, so far forgot his own jurisdiction as to surround himself with an armed band of retainers and start in hot pursuit. Whereupon many of the royal army officers and royal navy officers so far forgot their duties to their sovereign as to rally to the support of the elopers. A pitched battle would have developed if a prelate had not so far forgotten his jurisdiction as to marry the young people illegally. In the tight little island of England this long series of illegal acts by the most prominent people of the realm naturally resulted in litigation during the course of which the learned justices delivered themselves of the legal axiom, "It hath been our experience that professions do constantly tend to enlarge their own jurisdictions."

While I can not vouch for the historical accuracy of this legal aphorism, it does contain a large grain of truth and that grain might well be meat to our own profession. The physician does tend to become the dictator of public-health laws, the lawyer does tend to become a counsellor in economics, the engineer does tend to deliver himself of accounting opinions, the dentist becomes an oral surgeon and the men of the church involve themselves in public policies and politics. Whether because of his native modesty or, God save the mark, because of his limited education, the professional accountant has tended to limit his profession rather than to enlarge its jurisdiction.

Nowhere is this tendency of the professional accountant to deny his own salt more evident than in the exceedingly important

* An address before a regional meeting of the American Institute of Accountants, Indianapolis, November 16, 1925.

field of valuations for tax purposes. Far from attempting to enlarge his jurisdiction, the professional accountant seems to be needlessly anxious to give away ground that properly is his.

A striking illustration is found in the field of inheritance taxation. In October, I was a member of the committee that arranged the programme of the regional meeting of the American Institute at Chicago. The chairman of the committee very wisely decided that our programme should include a discussion of the relation of the public accountant to inheritance-tax returns and, perhaps unfortunately, delegated to myself the duty of interviewing a well known firm of lawyers in Chicago, prominent in inheritance-tax work, with the request that a member of that firm address our regional meeting. The members of this firm gave my invitation attentive audience and asked for a period of three weeks in which to consider the invitation to furnish such a speaker. At the end of three weeks I was informed that this firm had reviewed its extensive practice in the field of inheritance taxation and could not discover that there was any relation existing between the professional accountant and the field of inheritance taxation. This led me to make inquiries among my own professional brethren and I discovered, to my surprise and rather to my chagrin, that inheritance-tax returns, and particularly inheritance-tax valuations had not occupied a very large part of the attention of several of the more learned of Chicago's professional accountants.

Any sort of consideration of the problems raised by federal and state inheritance taxation discloses at once that the most serious problems in inheritance-tax administration have to do with the valuation of the different assets and liabilities that are exhibited in the estate. Certain of these assets can well be valued by practical business men. For example, real estate, real-estate leases and real-estate mortgages may be, and are properly, the subject of appraisal by real-estate men and/or professional engineers. Buildings and fixtures, as well as many kinds of machinery, are properly appraised by professional engineers. Choses in action may properly be appraised by attorneys, particularly when the choses are in litigation, or likely to suffer litigation before their final determination. All the other items comprising any estate are items requiring for their valuation the education, professional training and professional experience of the practising professional accountant.

Let us take for purposes of illustration securities such as bonds and stocks.

When the securities are actively dealt in on the market, the average price for a reasonable period before and after death is the best measure of value (*Matter of Crary*, 31 Misc. 72; 64 Supp. 566; *Matter of Proctor*, 41 Misc. 79; *Matter of Chambers*, 155 Supp. 153).

In New York the statute requires this basis of appraisal (see decedents' estate law, 122).

This is so even though the estate holds large blocks of stock which might depress the price if sold all at once.

In discussing this question, the Illinois court says in *Walker v. People* (192 Ill. 106, at page 110; 61 N. E. 489):

> "Fair market value has never been construed to mean the selling price of property at a forced or involuntary sale. The very fact that the market would be depressed by forcing such large blocks of stock to sale indicates that such sale is not a proper test of the fair cash value of the stock. . . . The quotations of the stock exchange may be temporarily uncertain and untrustworthy if the sales thereon are suddenly affected for speculative purposes or by the forcing upon the market and to sale of large blocks of stocks in an extraordinary manner with no explanation of such action and when the purpose of it is left to the conjecture of those dealing in the stocks; but such a quotation may be a fair and safe guide when they are taken for a reasonable period of sales made in the usual and ordinary course of business."

However, in the case of securities actively traded in on the New York stock exchange the market value at the time of death may not be a proper valuation because the amount of the securities held by the particular estate may be either so large or so small that sale on a given date on the stock exchange would in itself create a different market value than the prevailing ticker quotations. Thus the court said in *Matter of Gould* (19 App. Div. 352; 156 N. Y. 423, 51 N. E. 287):

> "It is claimed, however, that the rule should be construed that when the value of large blocks of stock is involved, only the purchase and sale in markets of correspondingly large blocks of stock should be considered, upon the theory that such large blocks would necessarily sell at lower rates than small quantities of stock sold separately, and that throwing large blocks of stock upon the market all at once would have a tendency to produce a break in the market and perhaps an inability to get more than a mere nominal price offered for that stock. Under the construction contended for the securities involved in this proceeding might have been shown to be of little or no value."

Continuing our illustration, let us give some thought to inactive securities and their valuation. In the preparation of capital-stock-tax returns professional accountants have become thoroughly acquainted with the difficulties of giving proper valuations to securities of corporations where the securities are closely controlled, or where the corporation is small, or where the securities

represent a minority interest in a subsidiary corporation. It is interesting to note that it was recently held in California that:

> "The fact that minority stock was converted into majority stock by its transfer from the deceased to the beneficiary, who was also a large stockholder, did not affect the appraised value. This must be determined, as in other cases of closely held stock, by the value of the property of the corporation which the shares of stock transferred represented."—(*Felton's estate*, 176 Cal. 663; 169 Pac. 392.)

In the case of inactive securities the prevailing rule of valuation for inheritance-tax purposes is that the intrinsic value from the assets and debts must be ascertained (*Matter of Achelis*, N. Y., L. J., March 9, 1912).

While the practice varies as between federal inheritance-tax administration and state inheritance-tax administration and varies again as between the various states, the usual practice seems to be for an appraiser to be appointed to make a valuation of inactive securities. Naturally, the appraiser refers to the books of account of the corporation showing the securities and to similar kinds of evidence in making the appraisal. Often the appraiser discovers some very interesting conditions in corporate practice. While I do not wish unduly to lengthen this discussion, I am tempted to quote the remarks of the learned surrogate in *Matter of Pancost* (89 Misc. 110, 152 Supp. 724):

> "This appeal by the executor of decedent's estate brings up for review the finding of the appraiser as to the value of the shares of stock in the Jersey City Galvanizing Company held by the decedent at the time of his death. It is conceded by the executor that the statement of assets and liabilities of the company which is attached to the appraiser's report is a correct transcript from the books of the company. If the valuations contained in this statement were correct, the book value of the stock would be about $186.00 a share. The president of the company testified, however, that the value of the assets as entered on the books of the company was not correct, that the values were 25% to 50% higher than the actual values, and that they were retained on the books for the purpose of assisting the company in obtaining credit.
>
> "When the corporation wishes to obtain credit, it refers to its books which show net assets of $149,022.00, or a value of $186.00 a share. When the state attempts to assess a tax upon the interest of a stockholder in the company, the president of the company testifies that the actual value of the assets is about 50% of the book value, and that the value of the stock is only about $50.00 a share. I regret to say that in law little credence can be given to the evidence of persons who make such admissions of deliberate misrepresentation. There may be extenuating facts not presented of record. It is difficult for the surrogate to reconcile the conflicting statements of value and, therefore, it is practically impossible to arrive at a valuation that is more than approximately correct. The testimony in regard to alleged sales of stock is not conclusive, as such sales were not made in the open market, and the price at which the sales were made five years after the death of the decedent can not be taken into consideration in a proceeding to ascertain their value at the date of his death. I can not, therefore, find from the evidence in this matter that the appraiser's

valuation of $125.00 a share is excessive. The order fixing tax will be affirmed." *

It is not my present intention to enter into a discussion of the legal aspects of valuations for inheritance-tax purposes. My purpose here is to suggest to the profession that such valuations as are required for tax purposes should be made by the professional men whose training and experience best qualify them for such judgment. The real-estate man is the proper appraiser of real-estate values, the engineer is the proper appraiser of fixed assets, the lawyer is the proper appraiser of the probable results of litigation, the accountant is the proper appraiser of all assets and liabilities whose appraisal must be determined from the inspection of records of accounts.

Take the matter of the valuation of inventories. An important aspect of inventory valuation is the classification of the items of the inventory as between (a) active, (b) inactive, and (c) obsolete items. The distinctions in this classification are judgments arising from the actual records in the business relative to the turnover of the items in inventory. This certainly is a matter strictly within the jurisdiction of professional accountancy. Similarly, the counting of quantities of a large inventory is a matter involving records and internal audits, and the determination of what shall constitute price is an economic determination which should be left to the profession of applied economics, i.e., the accounting profession. Were I addressing laymen I might need to illustrate this question of price, as many of the laity, including in this respect attorneys and even judges, fall into the fallacy of assuming that price is readily ascertained for any given date. Professional accountants need no instruction as to the extremely technical character of the work required to determine the price as at a given date of the items comprising finished goods ready for the market. And when one essays the task of fixing price on work in process and on raw materials in stores there are few partners in the most important of professional accounting firms who will not admit that such work requires the utmost of their professional judgment and skill.

Let us pause then to consider how inventories are valued for inheritance-tax purposes. These values are largely made by lawyers learned in the law, or by mechanical engineers trained in the stress and strain coördinates, or even by real-estate men whose

* This matter of the valuation of inactive securities for inheritance-tax purposes is ably discussed in *Inheritance Taxation and the Federal Estate and Gift Taxes* by Gleason and Otis. (Matthew Bender & Co., New York, 1925.)

boast is sometimes that they have not been educated at all. Obviously, the professional accountant should exercise jurisdiction in the valuation of inventories for inheritance-tax purposes.

In the case of inventories there may be a very small margin of reason for valuations by professional engineers, particularly where the professional engineers can claim a working knowledge of the principles of cost accounting. There is not even this margin of reason for valuations other than by accountants in such estate items as goodwill, accounts receivable, notes receivable, funds held in trust and the whole list of payables and reserves. All of these items of value, positive and negative in the determination of the net estate, are items whose intrinsic worth must be determined from the professional inspection of accounts and records.

The whole matter seems so plain from the standpoint of the professional accountant that the question may well be raised why the valuation of estates is not normally and almost automatically turned over to the professional accountants in America as it has been to a large extent in Great Britain. One suggested answer is that trust companies often administer estates and have their own professional accountants within their organization, or perhaps are unwilling that professional accountants should share in the large fees that the trust companies enjoy. This suggested answer might also apply to prominent attorneys who have a good reputation in the administration of estates and see no particular reason why they should share fees with professional accountants. I do not myself believe that the trust companies and attorneys have any particular anxiety to keep professional accountants out of this business. It is rather my conviction that professional accountants in America have not in most cases justified themselves to the trust companies and to the attorneys as capable professionals in valuations.

The second suggested explanation of the dearth of this work among accountants may well lie in the distaste that the accountants themselves have for work involving appearance as witnesses, subject to examination and cross-examination. Many accountants have unhappy recollections of their experiences on the witness stand and some of them may therefore refrain from giving opinions on values which are subject to examination and cross-examination.

At this point I should like to say that accountants, as professional men, should become more expert in giving evidence and particu-

larly in the preparation of evidence. It is a familiar rule of law that, subject to certain limitations, there are many occasions when original entries in books of account are best evidence. Unfortunately, most of the decisions of courts of last resort in this particular have to do with such simple forms of books of original entry as the now obsolete day-book and journal. The accountant realizes that the books of original entry today in any large corporation are exceedingly complex in character, including as they do loose-leaf records, card records, adding-machine tapes, columnar distribution records, tabulating cards, hectograph factory tickets, etc.

The problem of giving evidence based on books of original entry is difficult even as to the simple series of transactions, say with respect to the cost under a single cost-plus contract. The accountant may well view with some concern the possibility of giving an opinion subject to cross-examination when the opinion is to be based upon the accountant's professional knowledge of thousands of original entries recorded in dozens of different ways.

The accountant must meet this problem of giving evidence if he is to perform his full duty to his own clientele. The problem of the accountant in this respect is by no means as difficult as the problem of the physician. For half a century the medical journals have carried departments of medical jurisprudence and all the class A-1 medical schools have required courses in that subject. The accountant must study the law of evidence and learn how to prepare himself as a competent witness on values that properly fall within the scope of his own profession.

One is tempted to say something about the lack of skill on the part of attorneys in putting questions to accountants. Many an accountant on the witness stand has failed to give creditable evidence because of the asinine questions put to him by learned counsel. The accountant is not altogether free from blame in this regard. He has not studied the law of evidence as he should study it. The accountant should carefully prepare his evidence with the attorneys to the end that the client may be well served both by intelligent questions asked by counsel and intelligent replies returned thereto by the accountant on the witness stand.

In illustrating the theme here, reference has been made to valuations for inheritance-tax purposes. Those who have followed the discussion thus far will already have in their minds the scope of work on valuations to be introduced in evidence by the

professional accountant before the board of tax appeals and, indeed, before each of the government officers and clerks having to do with the administration of income taxation.

Whether the accountant will meet this problem or not is to my mind a fairly serious question. Accountants have not produced any considerable literature on the problems of valuations involved in the administration of the federal capital-stock tax or in the administration of the corporation-franchise-tax laws already existent in many of the states. Some accountants seem to be content to make annual audits and income-tax returns and to leave to bookkeepers and clerks employed within corporations the more intricate professional problems arising out of city, county and state tax reports. Perhaps if the accountant met more squarely the problems of city, county and state tax reports for his clients we would find a greater tendency on the part of banks, trust companies and attorneys to turn to the accountant as the proper person to appraise all current assets and liabilities, whether for inheritance-tax purposes or for income-tax purposes, or even for the purpose of distribution in bankruptcy.

The opportunities of the professional accountant in the preparation of evidence are very great, no matter for what purposes the evidence is finally to be used. The professional accountant, by his education and experience, should be competent in the preparation of evidence and he should undertake to educate his own clients so that they will recognize this competence on the part of their accounting advisor. Year after year as he goes over the closing entries of a corporation client, for example, the professional accountant should view such closing entries from the standpoint of their future use as evidence. This implies that the professional accountant should be engaged, at least annually, in the organization of evidence for future use, and this implication refers to each of the clients whom he serves. Then the accountant can expect to be called upon whenever evidence is required for valuation purposes, whether for inheritance-tax purposes, or for income-tax purposes, or for state-franchise-tax purposes, or for corporate-financing purposes, or for contract settlements, or for any other purpose in which competent evidence is likely to be required. In this respect, the professional accountant may well adopt the rule which Lincoln made the basis for his own life:

"I will work hard, I will study and prepare myself and when my opportunity comes I shall be ready for it."