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VALUATION OF PROPERTY FOR TAX PURPOSES

Library Research Project

Master of Accountancy Program

By Lloyd Sampson

THE GRADUATE SCHOOL
UNIVERSITY OF NORTH DAKOTA

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Outline of Independent Study X Thesis ____ Dissertation ____ Project Design ____

Student Lloyd Sampson Date ____

Title Proposed Valuation of Property for Tax Purposes

Anticipated Date of Graduation May of 1985

Brief Outline:

Through a library search of periodicals, treatises, court decisions, statutes, and regulations, I intend to compile a paper on the valuation of property for income, gift and estate tax purposes. I intend to cover the various topics discussed below:

Chapter 1 Introduction. What the paper will cover; the need to understand how property is valued for tax purposes, and the differences between valuation for income tax and gift-estate tax.

Chapter 2 The Market Used covers the type of market value (wholesale or retail) to use for the base value of the property, and whether broker commissions can be deducted.

Chapter 3 Methods of Determining Value (Appraisal) covers various appraisal methods including comparative value, reproduction value, and present value of future income, taking into account prestige value and functional obsolesence.

Chapter 4 Discounts and Premiums for blockage, minority interests, restrictions, unmarketability, and control are discussed.

Chapter 5 Special Use Valuation covers special statutory regulations on valuation of farm land and small businesses.

Chapter 6 Conclusion is the summary of what has been said. It includes problem areas, and how they should be avoided or decided. It also contains application of tax valuation to other areas.

Signatures of approval as specified in the "Degree Requirements" section of the Graduate Bulletin:

____ [signature]

____ [signature], Dept Rep

____

THIS OUTLINE MUST BE FILED IN THE GRADUATE SCHOOL OFFICE BEFORE ADVANCEMENT TO CANDIDACY

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Chapter 1

INTRODUCTION

One of the most important considerations in US Federal tax law is determining the value of the property being transferred when the property is other than cash. When property is received as compensation, or given to charitable institutions, the property must be valued for income tax purposes. When property is given to a non-charitable entity, it must be valued for gift tax purposes. When property is bequested or inherited upon the death of an individual, it must be valued for both estate tax purposes and income tax purposes (establish a new basis). Indeed, the English verb, "to tax," is derived from the Latin, "taxare," meaning to value or to estimate.1

Most estates are composed primarily of property other than cash and many gifts are of other than cash while in contrast most taxable income is received in cash. Therefore, the vast majority of circumstances wherein valuation becomes a consideration are in the gift and estate tax areas. As a result, the emphasis in this paper is on the valuation rules primarily in the estate, and secondly the gift tax areas. However, it should be noted that

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1.) Websters Third International Dictionary (1976)

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the rules in the gift tax area largely echo the estate tax rules[2] and that the income tax valuation rules also generally follow the estate and gift tax rules with a few exceptions, such as family attribution rules and special use valuation.[3]

Despite the pervasive importance of valuation in all three areas of federal tax; income, gift and estate; the Internal Revenue Code has almost nothing to say about the criteria to be used in valuation of property. For example, the main estate tax provision relating to valuing property merely refers to the fact that the value of the decedent's gross estate must be determined.[4] The equivalent provision of the gift tax law also simply refers to the value of the gift as being the amount of the gift.[5] The comparable provision of the income tax law does not even refer to the value of property, but instead merely states that compensation for services is includable in gross income.[6] There are a few detailed provisions, but they deal only with a few specialized situations, such as 2032A dealing with special use valuation. Therefore, typically the rules in the area of valuation for tax purposes come from the vast uncoordinated and sometimes inconsistent body of case law, administrative rulings

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2.) Bittker, Boris, "Federal Taxation of Income, Estates, and Gifts", 1984, vol 5, p 132-4.

3.) Bittker, Boris and Elias Clark, "Federal estate and Gift Taxation", (Little, Brown & Co.,1984), p 505.

4.) I.R.C. Section 2031.

5.) I.R.C. Section 2512.

6.) I.R.C. Section 61a.

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and IRS regulations.7

This paper will describe and explain the major rules out of this vast body of case law, rulings and regulations, and generally describe how property is required to be valued for tax purposes.

In the next chapter, the general valuation standard and the market place to be used for pricing will be outlined. In the third chapter, the appraisal methods for determining the value will be explained and evaluated. The following chapter will discuss the discounts and premiums that are often applied to adjust the appraised value. Finally, the fifth chapter will describe the special provisions in the IRC that provides an alternative and sometimes a very favorable method for valuing farm land and small business, before concluding.

7.) Bittker, Boris, "Federal Taxation of Income, Estates, and Gifts", (1984), vol 5, p132-4.

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Chapter 2

VALUATION STANDARD

The general rule for valuing property for tax purposes is to value it at "Fair market value." This has been defined and generally accepted by the courts 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.8

Although this classic definition appears clear enough at first glance, further inquiry reveals a number of questions; such as should retail or wholesale value be used, are selling expenses deductible, should cash sale or credit sale price be used, can forced sale prices be used, to what extent should knowledge of fact be assumed, to what extent should the price be "fair," and should sentimental or other individualized value apply? In the reminder of this chapter each of these questions will be addressed in turn.

A. RETAIL OR WHOLESALE MARKET

The standard definition of fair market value does not state

8.) Treas. Regs. Sections 20.2031-1(b) (estate tax), 25.2512-1 (gift tax), and 1.170(c)(1) (income tax- charitable contribution deduction).

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where or in what forum the sale between the willing buyer and willing seller is to take place. In other words, it does not state whether the model sale is a retail sale with a consumer purchaser or a wholesale purchase with a merchant, or both. However, the estate and gift tax regulations clarify this question by prescribing the forum where the hypothetical sale takes place as the market "in which the item [to be valued] is most commonly sold to the public."9 Therefore, items that are generally sold to the public in the retail market are to be valued at the retail price. For example, a used automobile should be valued at the price which a comparable car could be purchased by the general public (a car dealer's price), not the price that would be paid by a used car dealer.10

Occasionally wholesale prices control. For example, the tax court held that the market in which unset gemstones were most commonly sold to the public consisted of jewelers because they rather than retail customers were typically the ultimate consumers. Therefore, wholesale prices applied.11 Wholesale prices also control in valuing merchants' inventory, but, on the other hand, retail prices are used to value collections and accumulations owned by non-dealers.12

9.) Treas. Regs. Sections 20.2031-1(b) and 25.2512-1.

10.) Bittker, Boris "Federal Taxation of Income, Estates and Gifts",(1984), vol 5, p 132-15.

11.) Anselmo v. CIR, 80 TC 872,881 (1983).

12.) Research Institute of America, "Estate Planning and Taxation Coordinator",(1988),p 82,053.

There is, however, ways an ordinary taxpayer can dodge this retail merchant rule. According to one treatise, it is at least arguable for that members of the public resort to auctions, garage sales and classified advertising to acquire secondhand furniture and other secondhand personal goods so frequently that these sources rather than regular secondhand dealers constitute the market in which such goods are most commonly sold to the public.13 In any case, an ordinary taxpayer is allowed to value goods at classified ad or auction prices if the actual goods are sold in such manner. In other words, the goods may then be valued at their actual sales price.14 In this way an estate may circumvent the IRS retail sales rule.

B. SELLING EXPENSE

A related question under the fair market value rule is whether or not selling expenses may be deducted in arriving at the value of a piece of property. Since, as stated above, the fair market value of property is the <u>price</u> at which the property would change hands between a willing buyer and a willing seller, expenses incurred by the hypothetical seller to effect the sale are disregarded.15 From the seller's point of view, according to

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13.) Bittker, Boris "Federal Taxation of Income, Estates and Gifts",(1984), vol 5, p 132-15.

14.) Research Institute of America, "Estate Planning and Taxation Coordinator",(1988), p 82,054.

15.) Rohmer v. CIR, 21 TC 1099, 1104-1106 (1956); Smith's Est. v. CIR, 57 TC 650, 659 (1972), aff'd on another issue, 510 F.2d 479 (2d Cir.).

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the tax court, value is what could be <u>received</u>, not what is <u>retained</u> from a hypothetical sale.16 Therefore, real estate commissions and brokers' fees are not deducted in arriving at a fair market value.

It should be noted, however, that actual selling expenses if the property is actually sold by an estate, may be deductible as administrative expenses.

C. CASH SALE

Another possible area of contention is whether or not credit sale prices, or only cash sale prices, may be used to indicate fair market value. As any good businessman knows, a higher price than the regular cash price can be obtained for property if attractive financing is offered to help sell the property. This situation has been recognized by the courts and generally they have agreed that fair market value is the <u>cash</u> price that can be obtained for a property, not the higher financed price.17 Therefore, credit sales must be converted to what an all cash price would have been if they are to be used for comparison (in determining fair market value)".18

D. FORCED SALE

16.) Smith's Est. v. CIR, supra note 8 at 659.

17.) Research Institute of America, "Estate Planning & Taxation Coordinator",(1988), p 82,055.

18.) see for example: Folk's Estate v. CIR, par.82043 P-H Memo TC (1982).

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A fourth possible issue is whether or not a forced sale price would indicate the value of the property. As stated above, fair market value is the value at which the property would change hands between a willing buyer and a willing seller. In order to be willing, the seller must be free of compulsion. Thus, the fair market value standard implies that a "forced sale" would not establish the property's fair market value.19 This implication is accepted by both the regulations and the case law.20 Therefore, a bankruptcy sale, foreclosure sale, tax lien sale, or sale by a bank or bankruptcy trustee would probably be a forced sale, and, therefore, the sale price would be less than fair market value.

E. KNOWLEDGE OF FACTS

The standard definition of fair market value presupposes that the buyer and seller both have "reasonable knowledge of relevant facts," as stated at the beginning of this chapter. There have been cases that have held this definition to mean that the open market price was not the fair market price since the market participants did not have knowledge about some material flaw, or the participants were in some way unsophisticated or

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19.) Bittker, Boris "Federal Taxation of Income, Estates and Gifts", (1984), vol 5, p 132-7.

20.) id at 132-7, note #20.

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ignorant.21 However, it is generally agreed by the courts that this view is incorrect. The market cannot be second-guessed. A number of cases have held that the quoted market prices were the fair market value even though there was some undiscovered facts, such as a serious embezzlement because that was the price the property could have been sold for at that time.22

The knowledge of facts assumption could in valuing certain property, such as a closely held business, imply the presumption of the discovery of negative facts, such as embezzlement, inventory shortage, etc... if they would have been discovered in the course of a normal investigation by a prudent buyer. This type of situation would result in the arrival of a lower valuation due to this assumption.23

F. FAIR PRICE

Another possible areas of confusion with the fair market value standard is over the use of the word, "fair," and whether this requires the market price to be "fair" in order to indicate a property's value. Just because housing prices in California are ridiculously high, or because Soviet paintings are extremely inexpensive due to being out of fashion, legal authorities agree

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21.) Downer v. CIR, 48 TC 86,94 (1967); Strong v. Rogers, 14 AFTR 1207,1224 (D.NJ. 1983),aff'd, 72 F,2d 455 (3d Cir.); Dees v. CIR, par.62,153 P-H Memo TC (1962).

22.) Bittker, Boris "Federal Taxation of Income, Estates and Gifts", (1984), vol 5, p 132-10.

23.) id at 132-10.

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that does not mean that the houses or the paintings are not worth what they would fetch in the open market. What is sought is not the property's fair or inherent value, but rather its fair market value with emphasis on "market." Fair means no more than representative or typical.24 Thus, it is irrelevant what an authority believes a property should have been worth. Instead what is relevant is what a property is worth.

G: SENTIMENTAL VALUE AND VALUE TO PARTICULAR INDIVIDUALS

A final potential area of questions in regards to the application of the fair market value standard is whether a willing buyer should include individuals with a unique interest in the property that is to be valued. For example, an individual might be willing to pay more than anyone else for a particular rocking chair because the chair was his mother's favorite chair, or a family's heirloom, and, thus, has sentimental value. Another example is an individual may be willing to pay a premium for a few shares of stock that would give only him control of a corporation, or pay a premium for farmland that fits in well with the farmland he already owns. In all of these examples a particular individual is willing to pay more for the property than an ordinary buyer. Then the question is should the value he would pay be the value of the property?

The general rule is that the willing buyer in the fair

24.) Bittker, Boris "Federal Taxation of Income, Estates and Gifts", (1984), vol 5, p 132-13

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market standard is a disembodied actor free from passion or any unusual desire toward the property to be valued.25 Therefore, sentimental value, potential control premium, etc... are not considered in valuing the property for estate tax purposes.

Unfortunately, there is, however, some inconsistent case law in this area. For example, in one case the court considered the value of an isolated parcel of land to a particular developer who was seeking to assemble a larger tract.26

Another related question is the area of gift tax. Gift tax is on the value of the property given, not on the value of the property received. Therefore, when a majority interest in a company is broken up and given to a number of individuals, the gift tax is still on the value as a majority interest.

Therefore, the completed standard used for valuing property for tax purposes is: A particular piece of property's value is the cash price (without deducting selling expenses) at which the property would change hands between a willing member of the public as the buyer and a willing seller with the sale taking place in the market place in which that type of item is most commonly sold to the public, and when the seller is not being forced to sell and the buyer does not have any unusual interest in the property, and both buyer and seller have reasonable or

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25.) Whittmore v. Fitzpatrick, 127 F>SUpp. 710, 716 (D.Conn. 1954).

26.) Frieders' Est. v. CIR, 687 F.2d 224, 227(7th Cir. 1982)

expected knowledge of the relevant facts.

This standard is then applied to the appraisal process by appraisers, IRS and the courts in order to determine what the fair market value of a particular piece of property. This appraisal process is described in the next two chapters.

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Chapter 3

METHOD OF DETERMINING VALUE

The value of a particular piece of property for tax purposes is generally determined in a two-stage process although frequently the stages are blurred together.27 The first and main step is to arrive at a preliminary figure for value through an appraisal process. After arriving at this preliminary figure, the second step is applied. This second step is the application of discounts and occasionally premiums. In this chapter the first step, the appraisal process is described. First, the importance of the appraisal process will be discussed, followed by a discussion on the various appraisal methods including market comparison approach, capitalization of income approach, replacement cost, and historical cost.

A. IMPORTANCE OF APPRAISAL PROCESS

A good starting point with any transfer of property that is subject to gift tax, estate tax or income tax, or that may later be sold and then subject to income tax is to have an expert valuation done. There are several reasons for this.

First, often an appraisal is required. For example, if a

27.) Cooper, George "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance", Columbia Law Review,1977, p 196.

decedent had articles having a marked artistic or intrinsic value of greater than $3,000.00 then the executor shall file an appraisal of the property with the Federal estate tax return.28 Artistic and intrinsic property includes jewelry, furs, silverware, paintings, antiques, books, oriental rugs, and coin and stamp collections.

A second reason for getting an appraisal is that the burden of proving the correctness of a claimed valuation is on the taxpayer.29 If the IRS contests a taxpayer's valuation, and the taxpayer has nothing to back up his valuation, the taxpayer will lose. However, the taxpayer armed with a well-documented appraisal may actually have an advantage with the IRS due to the Tax Courts increasing impatience with valuation disputes.30

A third possible reason for obtaining an immediate appraisal is that immediate income or gift taxes can result from an improper valuation before entering into a transaction with a related entity. Many of these potential problems can be avoided if the value of the property can be determined with some certainty.31

A fourth reason for obtaining an immediate appraisal is that

28.) Link & Soderquist, "Law of Federal Estate and Gift Taxation", (1981), ch 11, p 12.

29.) Research Institute of America, "Estate Planning and Taxation Coordinator",(1988), par 82,077.

30.) Schlenger, Jacques and Harold Nussenfeld, "Valuing Closely Held Business Interests and Planning the Buy Sell Agreements", 44th Annual NYU Institute, 1987, p52-4.

31.) id at 52-4.

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determining the present value of an asset (particularly a business) years hence will be infinitely more difficult then determining its value immediately.32

On the other hand, the taxpayer must weigh the negative facets of an immediate appraisal. The main negative facet is cost. Investment bankers, appraisers and other professionals demand substantial fees for their services.

In addition, if the taxpayer waits until the IRS makes a determination of value, then under I.R.C. Sec. 7517-1(a) the taxpayer can demand a statement from the IRS specifying what it bases its valuation on including computations and copies of any appraisals made for the IRS. Then based on this statement, the taxpayer can decide whether or not to accept, fight or compromise with the IRS.33

Therefore, although the personal representative, or taxpayer, may postpone the appraisal process until there is a material valuation dispute or may avoid the appraisal process entirely if either they are not subject to tax, or they accept the IRS valuation, more often than not in the case of large transactions, appraisals are unavoidable.34 Typically they can

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32.) Schlenger, Jacques and Harold Nussenfeld, "Valuing Closely Held Business Interests and Planning the Buy Sell Agreement", 44th Annual NYU Institute, 1987, p 52-4.

33.) Research Institute of America, "Estate Planning and Taxation Coordinator", (1988), par 82,078.

34.) Schlenger, J. and H. Nussenfeld, "Valuing Closely Held Business Interests and Planning the Buy Sell Agreements", 44th Annual NYU Institute, (1987),p 52-4.

save much more in tax savings than they cost.

In the remainder of this chapter the various methods that the experts use in the appraisals will be discussed.

B. MARKET COMPARISON APPROACH

The most widely used approach to valuing property is the market comparison approach, also known as the market approach or comparable sales approach. Under this method the sale prices of recently sold properties, as physically similar as possible to the one being appraised, where the sales were for cash or its equivalent, not forced and within a reasonable time of the date of the appraisal, are compared. Since no two properties are identical, the sales prices are adjusted up or down for the differences in prices, and the adjusted prices are compared to arrive at a fair market value for the subject property.35

The primary problems with this approach are: First, whether or not the comparative sales were arm's length transactions between a willing buyer and a willing seller without any unusual attitude toward the property. Second, whether or not the comparative sales were so few in number or distant in time that they have little or no probative value. Third, whether or not the purportedly similar properties have characteristics that diverge too greatly from the subject property, or whether or not the differentiating characteristics themselves were valued

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35.) Wolfsen Land & Cattle v. CIR, 72 TC 1,19 (1979).

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properly for the adjustments.36

As might be expected, there are times when this approach cannot be used with any degree of accuracy, such as when there have been no comparable sales for an extended period of time, or where the property is so unique that there are no similar properties to be sold. Then the courts must rely on the other methods of determining value.

Before discussing these other methods, it should be noted that often in determining value, courts will consider another method that is similar to the comparable sales approach, namely the liquidation value or net asset method.37 Under this approach the property is valued at the amount that would be obtained if the property was completely liquidated in pieces. This amount is determined by comparable sales for each individual asset. This method is typically used on corporations and closely held businesses that do not have a market price for their ownership interests (stock) and are generating less profit than a typical low risk investment. (Thus, the capitalization of income method discussed below would not work.) For business in financial trouble this method is justified by arguing that a purchaser of the business would most likely liquidate it.38

36.) Bittker, Boris "Federal Taxation of Income, Estates and Gifts", (1984), vol 5, p 132-21.

37.) see PH par. 120,312.9(30).

38.) Research Institute of America, "Estate Planning and Taxation Coordinator", (1988), par 82,294.

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C. CAPITALIZATION OF INCOME

The second most popular method of valuing properties and the most popular method of valuing businesses is the capitalization of income approach or the estimated future earnings method. This method is based on the idea that assets are rights to a particular future income. Under this method the appraiser looks at past earnings of the asset and adjusts them for events that are likely to occur or reoccur and for items that were not taken into account. The "corrected" historical income is then projected into the future. This projected future income is then capitalized at a particular rate to come up with the value of the asset.39

The capitalization or discount rate that is used varies depending on the sum of two factors. These factors are the riskless rate of return, typically the Federal short term savings bond rate, and a factor for risk of investing in the particular piece of property.40 The total rate then varies from between about 5% and 25% depending on interest rates and risk.

A second method for determining the capitalization rate is based on a comparison between the subject property and similar properties that are in the same industry in the same general geographical area and have recently been sold in an arm's length transaction. The sale price of the similar property is compared

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39.) Bittker, Boris, "Federal Taxation of Income, Estates and Gifts", (1984), vol 5, p 132-25.

40.) id. at 132-25.

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to its income, and a discount rate is calculated that when applied to its income would result in the sales price. This is the discount rate that is then used on the subject property.41

This method is exceptionally good for determining a business' goodwill. In fact, the IRS regulations require that it be applied to determine if there is any goodwill in a particular business.42 Under these regulations if a non-risky business earns more than 8% return on the value of its tangible asset, there is goodwill. The income beyond 8% is capitalized at 15% to determine the value of this goodwill. If the business is risky, then the percentages used are changed from 8% to 10%, and 15% to 20%. This somewhat arbitrary formula has been accepted by some courts and rejected by others, particularly when other evidence indicates that goodwill does not exist.43

It should be noted that in applying this formula for goodwill, the income of a business can be reduced by the reasonable value of the owner's services before the formula is applied.44 This is also the situation when the capitalization of income approach is used to value the entire business. A related concept is that prior to capitalizing a property's income stream,

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41.) Research Institute of America, "Estate Planning and Taxation Coordinator", (1988), par 82,280.

42.) Rev. Rul. 68-609 C.B. 1968-2,327.

43.) Rabkin, Jacob and Mark Johnson, "Federal Income, Gift and Estate Taxation, (1988), vol 4, p 5295a.

44.) Rabkin, J. and M. Johnson, "Federal Income, Gift and estate Taxation", (1988), vol 4, p 5295b.

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the income stream should be adjusted to include the salvage value for the property when it is finally sold.45

Another valuation method that is occasionally used and is similar to the capitalization of income method is the capitalization of dividends method. This method is identical to capitalization of income except the projected dividend stream is capitalized instead of the projected income stream. Although this approach is an unreliable indicator of value because the amount of dividends declared is artificially determined by the corporate owners, it is still occasionally considered by a court because dividend payment is certainly a consideration to a potential purchaser.46

Although the capitalization of income approach to valuation is one of the most popular approaches to valuing property, there are problems in relying on it in certain situations. Some properties have value beyond their income production. For example, in the much quoted case of Matter of Seagrams & Sons v. Tax Comm., the court found that there was significant value in the Seagrams Tower skyscraper in New York City beyond its potential income stream.47 This value the court referred to as "prestige value." A corporation would pay a premium for the

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45.) Bittker, Boris, "Federal Taxation of Income, Estates and Gifts", (1984), vol 5, p 132-24.

46.) Schlenger, J. and H. Nussenfeld, "Valuing Closely Held Business Interests and Planning the Buy Sell Agreement", 44th Annual NYU Institute, 1987, p52-15.

47.) Matter of Seagrams & Sons v. Tax Comm., 18 AD.2d 109.

building because it stood out and was a noted landmark. There apparently is a lot of advertizing value in having your name on a large well-known skyscraper.

This same sort of situation is apparent even on the local scale. As a realtor, the author noted that newer houses have a value beyond what they can be rented out for. This value is sometimes referred to locally as a luxury value. People apparently are willing to pay a premium to own their own house so they can do what they want with it rather than rent a house.

Furthermore, certain types of property cannot be valued at all by the capitalization of income method. For example, works of art, gold and antiques, even though they often increase in value, do not themselves generate income. Therefore, income capitalization cannot be used to value them. In these situations one or more of the other valuation techniques must be used to determine the property's value.

D. REPLACEMENT COST

The third major method for appraising property is the replacement cost method or the reproduction cost method. Under this method the appraiser calculates the cost to replace the property at present construction costs. From this value the appraiser deducts amounts for functional and economic obsolescence in order to arrive at a value that is the fair market value of the property.

Economic obsolescence is actual physical depreciation or

deterioration that the property has suffered.48 The appraiser typically estimates this amount by estimating the decrease in value from a newly replaced comparable property to the subject property for wear and tear.

Functional obsolescence is the loss of operating efficiency a piece of property has suffered.49 This would include items, such as doors or hallways that go nowhere, lack of closet space, awkward shaped rooms, poor floor plans, zoning or circumstances that restricts the properties highest and best use, etc...Again the appraiser attempts to estimate the decrease in value from a newly constructed comparable property that is designed and zoned properly for its highest and best use to the subject property.

The estimates the appraiser makes for economic and functional obsolescence can be very unreliable since they are just educated guesses, especially the older and more obsolete the property gets.50 For example, the court in Ingram-Richard Inc v. CIR likened obsolete machinery to a herd of white elephants and stated nobody wants them.51 They are a liability so replacement cost is not relevant.

The difficulty in fixing a proper allowance for depreciation

48.) Helin v. Grosse Point Twp., 329 Mich 396, 45 N.W.2d 238 (1951).

49.) Onondaga County Water Dist v. Bd. of Assessors of the Town of Minetto,(NY. 1976) 350 N.E.2d 390.

50.) Bittker, Boris, "Federal Taxation of Income, Estates and Gifts", (1984), vol 5, p 132-28.

51.) Ingram-Richard Inc. v. CIR, par 72,157 P-H Memo TC 1972.

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and obsolescence in many situations may make reproduction costs more suitable as a limit on the amounts obtained by applying other valuation methods then as a reliable measure of value in isolation.52 Many cases have held that replacement cost sets the upper limit of a property's value by reasoning that if somebody tried to get more than replacement cost for a property, a purchaser would merely have the property built himself.53

E. BOOK VALUE

The final appraisal method that is commonly used to value properties is book value or historical cost. Under this method the amount the taxpayer paid for the property, or the amount for which his donee sold the property, is considered as indicating the value of the property. If the subject property was bought or sold in an arm's length transaction at or about the valuation date, the price paid is ordinarily the best evidence of the property's fair market value.54 This method is generally reliable only if the purchase or sale of the subject property by the taxpayer or his donee is close to the tax date. The further away, the less reliable. If a number of years have passed since the purchase, then the book value or historical cost bears little

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52.) Bittker, Boris, "Federal Taxation of Income, Estates and Gifts",(1984), vol 5, p 132-28.

53.) Rosbroc Assoc. v. Assessor and Bd. of Review of City of New Rochelle, (NY.1976) New York Law Journal.

54.) Bittker, Boris, "Federal Taxation of Income, Estates and Gifts", (1984), vol 5, p 132-17.

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relation to the fair market value of the asset. This is particularly true in inflationary times, or with equipment that gets obsolete rapidly.55

As it has been shown in valuing a particular piece of property, typically one or more of the possible methods of appraisal cannot be used or are inaccurate for that situation. Also typically the independent use of various methods will result in different values for fair market value. Therefore, the courts and even the IRS usually wants to review a combination of methods in order to determine market value. For example, in valuing a closely held corporation, Rev. Rul. 59-60 requires that a number of factors be considered in valuation cases including book value, income, dividends, comparable sales, market price and a number of factors that would indicate a discount should apply.56

After a property has been appraised and a value derived, the resulting amount may be subject to an adjustment (a discount or premium) as discussed in the next chapter. It is after this second step in the valuation process that a final fair market value is determined, except in the unique situation of special use valuation which is discussed in chapter 5.

55.) Schlenger, J. and H. Nussenfeld, "Valuing Closely Held Business Interests and Planning the Buy Sell Agreement", 44th Annual NYU Institute, 1987, p 52-15.

56.) Rev. Rul. 59-60 1959-1 CB 237 Sec 4.01.

Chapter 4

DISCOUNTS AND PREMIUMS

After a preliminary value is determined for the property being valued, as described in the previous chapters, the second step of the valuation process is applied. This second step is the application of discounts and occasionally premiums. Discounts or premiums are adjustments to the preliminary value to reflect a variety of special factors, such as the difficulty of selling a minority interest in a closely held company or the impact of a formula price fixed by a buy-sell agreement. These discounts apply most often to interests in corporations, partnerships, and other businesses, but they can also apply to other property as well.

In the rest of this chapter a number of these types of discounts will be discussed, one at a time. Among them are blockage, lack of marketability, unregistered stock discount, minority discount, control premium, fractional interest discount, discount for lack of diversification, loss of keyman discount, discount for unrecognized capital gains, and other tax liabilities, discounts for easements and restrictions on use, and finally discounts for restrictions on sale.

A. BLOCKAGE DISCOUNT

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One of the few discounts that is actually recognized in the regulations is the blockage discount. This discount came about because courts and even grudgingly the IRS have realized that it may be difficult to market a large block of corporate stock without depressing the market. The regulations states:

> If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual markets, as through an underwriter, may be a more accurate indication of value than market quotations.57

This discount primarily is applied to stock that is publicly traded in a stock exchange or over-the-counter. It does not usually apply to stock in closely held corporations.58 They can get a discount for unmarketability instead. However, blockage discounts have also been allowed in valuing large blocks, parcels and collection of other types of property, such as works of art and real estate. For example, in Folks' Estate,59 the court gave a 20% discount in value for blockage to five lumber yards owned by the decedent because they were in the same general area and could not easily be converted to other uses.

Another example is in Smith's Estate v. CIR,60 the court granted a blockage discount for 425 pieces of art work that were

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57.) Tres. Regs. 20.2031-2(e) (1974) (estate tax), 25-2512-2(e) (gift tax).

58.) Rev. Rul. 59-60 402(g).

59.) 51 T.C.M. (P-H) 82,093 (1982).

60.) 57 T.C. 650 (1972) (Acq.).

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created and retained by the decedent, a distinguished artist. The tax court stated, "Each willing buyer in the retail art market would take into account in determining the price he would be willing to pay for any given item the fact that 424 other items were being offered for sale at the same time." Thus, the blockage rules applicable to securities "furnish a useful analogy."

According to the regulation, a blockage discount is applied only when the sale of the stock or property could not be accomplished in a "reasonable time" without depressing the market. This has been strictly defined by the courts. In one case the tax court did not permit a blockage discount where the decedent owned a block of 32,000 shares, and there was an average of 10,000 shares of that type of stock traded per month. The court stated that "32,000 shares was far below the total number of shares traded in a year."61

In another case the tax court granted a 10% blockage discount where the decedent owned a block of 159,000 shares and about 15,000 shares of that type of stock were traded each month.62 Therefore, a "reasonable time" for stocks would appear to be one year.

Finally, one unexpected twist is that for estate tax valuation blockage is determined by looking at the entire estate. However, for gift tax valuation the regulations require that

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61.) Wheeler T.C.Memo 1978-208(i).

62.) Estate of Brownell, T.C.Memo 1982-632(e).

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blockage be determined by looking at each separate gift by itself.63 This means that a donor who makes simultaneous gifts to a number of donees may be denied a blockage discount that would have been allowed if the entire block had been given to a single donee or held until death and then devised to a number of donees. The fifth circuit and the tax court have upheld the IRS on this point,64 but the tenth circuit in a case that was decided before the present regs, ruled that all the gifts made at the same time must be looked at together to determine blockage65 so there may still be a debatable issue on this point.

Unlike the blockage discount, the remaining discounts apply to closely held corporations and smaller property holdings.

B. DISCOUNTS FOR LACK OF MARKETABILITY

Frequently a court will grant a discount in valuation for an interest held in a closely held corporation or partnership due to the lack of a market for its shares. As stated by the court of claims:

> It seems clear that an unlisted stock of a corporation, such as Heekin, in which trading is infrequent and which, therefore, lacks marketability is less attractive than a similar stock which is listed on an exchange and has ready access to the investing public.66

Although there is no official authorization for this

63.) Treas. Regs. 25-2512-2(e).

64.) P.H. 82237.

65.) Maytag v. Com (1951 10th Cir) 187 F2d 962).

66.) Central Trust Co. 305 F2d 393, 405 (ct. cls. 1962).

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discount in the regulations or revenue rulings, the IRS has conceded that there should be a discount for lack of marketability in the appropriate situation.67

When and to what extent this discount is applied varies from case to case. It should apply to companies where there has been no trading in their securities, but it can also be applied when there is sporadic trading.68

Frequently it is lumped with other discounts, especially the minority discount (discussed in part D below) because usually when an interest in a corporation is a minority interest, it is less marketable.69 In fact, if the only reason a minority interest is less marketable than a majority interest is because it is a minority interest, then no discount for unmarketability is permitted.70 A majority interest can, of course, be discounted for a lack of marketability.71

Sometimes it is argued that the granting of a discount for lack of marketability of an ownership interest in a closely held business does not make sense when the underlying assets of the corporation are readily marketable. A buyer could buy the shares

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67.) O'Connell's Est. v. CIR 78191 P.H. Memo T.C. (1978) (20% discount conceded by IRS raised to 30% on basis of facts), rev. on another issue, 640 F.2d 249 (9th Cir. 1981).

68.) Schnorbach v. Kavanagh 102 F.Supp. 828 (D.C. Mich, 1951).

69.) Harwood Estate v. CIR 82 T.C.239 (1984).

70.) Martiani Frozen Foods, Inc. 81 T.C. 448 (1983).

71.) Estate Tax Planning and Taxation 9T 82291.

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and then liquidate the corporation, thus getting at the marketable assets within. This is what the court ruled in O"Connel's Estate v. CIR,72 where the closely held corporation held a ranch as its main asset. The ranch could easily be sold.

There are, however, three main problems with this argument. First, the buyer must be able to buy a large enough percentage of the corporation to force liquidation. (2/3 vote is needed in North Dakota.) Second, even if a buyer does acquire sufficient voice to force liquidation, he has a fiduciary duty to watch out for the interests of the minority stockholders. If it is not in their interest, he still cannot do it. Finally, a buyer with liquidation in mind would still want to buy for less than the value of the underlying assets in order to make the liquidation worth his time and trouble. The court in Estate of Piper v. CIR73 recognized this and granted a discount for lack of marketability on the value of a holding company that contained nothing but marketable shares of stock and a little real estate under long term lease.

Although the discount for unmarketability usually is applied to interests in closely held businesses, it can also apply to other property. However, the fact that a particular type of property, such as real estate, generally cannot be sold instantly, not like wheat, oil and listed securities, does not mean that it lacks marketability. Generally the discount is

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72.) 640 F2d 249 9th Cir, 1981).

73.) 72 T.C. 1063 (1980).

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applied when the property being valued is harder to sell than otherwise comparable property.74 This is sure to become better defined through future litigation.

C. UNREGISTERED STOCK DISCOUNT

This discount is often given in place of a discount for lack of marketability because the court believes that the lack of marketability could be corrected by floating a private underwriting or secondary distribution. The court will then decrease the value of the stock by the estimated expense of underwriting a public issue of the shares.75

Occasionally this discount is granted along with an overriding discount for lack of marketability. This was the result in Estate of Piper v. CIR,76 where the decedent had a controlling number of shares of Piper Aircraft Company, which is a New York Stock Exchange Company, held in a personal holding company. The tax court granted a discount for expenses of registering the Piper Aircraft shares because it was a control block and, in addition, granted a discount for lack of marketability of the personal holding company shares.

D. MINORITY DISCOUNTS AND CONTROL PREMIUMS

74.) Bittker, Federal Taxation of Income, Estates and Gifts, (1984) vol. 5, 132.3.2.

75.) Krahmer and Henderer, Valuation of Shares of Closely Held Corporations, 221 T.M. A49.

76.) 72 T.C. 1062 (1980).

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The estate and gift tax regulations state that if a block of stock that "represents a controlling interest either actual or effective in a going business is being valued, the price at which it changes hands may have little relation to its true value."77 This means that the controlling block may have a higher per share value, a premium, than an otherwise comparable non-control share.

Although it is not specifically stated in the regulations, it follows that the non-controlling blocks must be adjusted downward to reflect a lower value due to the lack of control.78

A number of reasons for putting a premium on control are often given by the courts. First, the minority stockholders in the absence of a special agreement granting them greater power, do not have the power to influence corporate policy or management, compel the payment of dividends, force liquidation, or convert corporate assets into cash.

Secondly, the holders of controlling shares can, and usually do, elect themselves or members of their families as directors and officers, thus enabling them to draw earnings out of the corporations as salaries. They can also buy goods from companies affiliated with them at slightly higher prices and sell goods to companies affiliated with them at slightly lower prices than otherwise, thus drawing off still more corporate earnings.

As pointed out in many court decisions, such as Curry's

77.) Treas. Regs. 20.2031-2(e) (estate) and 25-2512-2(e) (gift tax).

78.) Bittker, Federal Taxation of Income, Estates and Gifts, (1984) vol. 5, 132.3.4.

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Estate,79 this practice is a breach of fiduciary duty to the minority stockholders and, therefore, is illegal. As long as the controlling stockholder does not go too extreme, there is nothing the minority stockholder can do. This is due to the high cost and hazards of litigation, the difficulty in uncovering the facts (such as, determining the true fair market value of the goods), and the reluctance to second-guess corporate managers.80

Therefore, often the courts will grant either a minority discount or a control premium. The problem, however, is in determining when they should apply. There are two main issues in determining this: 1. Should the transferred block be added to either, or both, the transferor's or the transferee's other holdings in determining control? 2. Should the transferor's spouse's and other relatives' holdings be added to the transferor's holdings in determining control? (family attribution rule)

First, as to whether the other holdings of either, or both, the transferor and transferee should be added to the transferred block for determining control, the general rule for estate tax is the block of stock in the estate is treated as being owned by an independent third person. Therefore, the transferee's interest are not added to it. However, it should be noted there

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79.) 706 F.2d 1424 (7th Cir. 1983).

80.) Bittker, Federal Taxation of Income, Estates and Gifts, vol. 5, 132.3.4.

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is the possibility of an additional "bargaining premium" being added to the transferred block for estate tax valuation if the block could swing control of the corporation.81

The rule for gift tax is on the value transferred, not on the value received.82 Therefore, the shares are valued with control premium if the giver had and is giving up control of the corporation, and the shares are valued with a minority discount if the giver owed a minority interest in the closely held corporation prior to his gift.

Second, as to whether the ownership interests of related parties should be attributed to the transferor is presently a major issue. They would be, of course, for income tax purposes.83 However, they probably are not for estate and gift taxes. The tax court has held that the family attribution rules do not apply to estate and gift taxes for many years.84 The IRS has disagreed with them for equally as long. Then in 1981 in the landmark case, Estate of Bright,85 the 5th Circuit, who were sitting en banc (all 23 judges present), ruled that the family attribution rules do not apply to estate taxation. The 9th Circuit in Popstra v. U.S.86 soon followed. Although the IRS

81.) Bright's Estate 617 F2d 407 (5th Cir. 1981).

82.) Bittker Tax cite from Sup. 132-3, several cases.

83.) 318 of IRC.

84.) P.H. 82,297.

85.) 658 F.2d 999.

86.) 680 F.2d 1248 (1982).

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still does not agree, it appears that the attribution rules will not be applied in estate and gift taxes. Therefore, transferor's and transferee's interests are considered by themselves in determining if a minority discount or control premium are applicable.

A final added twist to this area is when a corporation has both voting and non-voting shares, and a control premium is to be added to the stock value, the courts will often add it to only the voting shares. The value of the accompanying non-voting shares are left unadjusted or changed only minimally.87 Other courts add it to the value of all the shares transferred.88 Therefore, this area is yet unresolved and will become better defined through further litigation.

E. FRACTIONAL INTEREST DISCOUNT

Similar to the minority discount is the fractional interest discount. The fractional interest discount is usually applied when the decedent or donee holds an undivided fractional interest in property other than a business company. It is most often applied when someone is a tenant-in-common in real estate.

For example, in Estate of Herter,89 the court gave a 15% discount to the value of the decedent's 29% interest in a New

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87.) See Ahmanson Foundation v. U.S. 674 F.2d 761 (9th Cir. 1981).

88.) See Estate of Curry v. U.S., 706 F.2d 1424 (7th Cir. 1983).

89.) T.C. Memo 3/31/54e.

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York City reality.

This discount is justified on the grounds that a buyer of the interest would not pay full value for it because he would either have to work with the other tenants-in-common or bring a partition suit, which is costly and uncertain. In either case, it could be a headache for a buyer.

One of the big issues in the area is whether the fractional interest discount should be applied to undivided interests of 50% or more. The IRS in a technical advice memorandum has ruled that it should not. They reasoned that Congress in 2040 of the IRC (dealing with spousal joint interests) has clearly indicated that where property is held by two individuals as co-tenants, no discount is to be allowed with respect to one's interest.90

The courts, however, have disagreed. In the main case in the area, Postra v. U.S.,91 the court allowed a 15% discount in the value of a decedent's undivided one-half interest in real estate held as community property. The tax court in Estate of Quinn92 allowed a 12.5% discount for the value of the decedent's one-half interest in Nebraska farm land; and in Knapp,93 the IRS was even arguing for a discount on property owned by two brothers since they were donating it, thus getting a charitable deduction.

90.) IRS Letter Ruling 8034005.

91.) 680 F.2d 1248 (9th Cir. 1982).

92.) T.C.Memo 1982-32.

93.) T.C. Memo 1977-389.

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As pointed out by Bitther in his treatise,94 "These disadvantages [suits for partition, etc...] are inherent characteristics of any undivided interest burdening the owner of a 99% interest in Blackacre, as well as the owner of the remaining 1%." Therefore, a fractional interest discount should be allowed any time an undivided interest in property is to be valued.

It should be pointed out, however, that a larger discount might be permitted where there actually is litigation or disagreement between the co-tenants.95

It should also be mentioned that it is possible for a fractional interest, instead of being discounted to actually be valued with a premium or more than its fractional percentage due to its "nuisance value." A majority owner may be willing to pay a fractional interest premium in order to avoid the headaches that a fractional interest owner could create with, for example, a partition suit, demand for accounting, etc...96 This has been argued on occasion by both taxpayers for charitable contributions and the IRS for gifts and estate taxation.

F. DISCOUNT FOR LACK OF DIVERSIFICATION

Although it is not officially sanctioned by the IRS through a revenue ruling or a regulation, it may be possible to cut the

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94.) Bittker, Federal Taxation of Income, Estates and Gifts (1984) vol. 5, 132.3.4.5.

95.) Estate Planning and Taxation 82141.

96.) RIA Estate Planning and Taxation Coordinator.

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value of stock in a closely held corporation with a discount for lack of diversification in the corporation's operations.

This discount is justified on the grounds that often publicly traded companies will be traded at a lower price if they are undiversified.97 The less diversified, the greater the risk, and investors pay more for investments with less risk.

This discount has traditionally been applied to closely held manufacturing companies that manufacture only one type of product.98

Lately it has also been applied to closely held investment companies, such as Piper's Estate v. CIR.99 In this case the court allowed a 17% discount from total asset value of a personal holding company that contained nothing but Piper Aircraft Company stock and a little real estate under long term lease. As can be seen, this could be a good tax planning tool.

A related form of this discount, when there is an undiversified management, is discussed in the next section on loss of keyman discount.

G. LOSS OF KEYMAN DISCOUNT

If an enterprise is heavily dependent on the talents, expertise, business relationships or personality of a so-called

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97.) Bittker, Federal Taxation of Income, Estates and Gifts, vol. 5 132.3.6.

98.) See Estate of Cookson T.C. Memo 1965-319, and Bardahl T.C. Memo 1965-158 (discount of 10% for lack of diversification).

99.) 72 T.C. 1062, 1082-1084 (1980).

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key person, that individual's death, retirement or resignation may lower the value of the company's stock. This point was acknowledged by the IRS in Rev. Rul. 59-60, which states, "The loss of the manager of a so-called one-man business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise" (from either inside or outside the company). The ruling further points out that in some types of business the loss of the keyman does not really impair the business or is made up for by life insurance proceeds.

This discount is most frequently involved when the key person's own shares are being valued for estate tax purposes. That is the key person has died so the value of the shares in the corporation is lower.100 However, this would also apply to other stockholders' stock upon the loss of the keyman.

However, in order to invoke a form of this discount the keyman does not have to die or retire. All that is required is the probability that if the keyman did die, retire or resign, the stock of the company would go down significantly in value. This can also be thought of as a discount for non-diversified management because a buyer would pay less for the stock if there was a large risk of loss of key management.101

100.) See Estate of Folks T.C. Memo 1982-43.

101.) O'Connel's Estate v. CIR 640 F.2d 249, 253 (9th Cir. 1981).

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H. DISCOUNT FOR UNRECOGNIZED CAPITAL GAINS AND OTHER TAX LIABILITIES

This discount, or premium, recognizes that a buyer may be willing to pay more, or less, for a corporation due to its hidden tax advantages or disadvantages. Presumably a buyer would pay more for a corporation with high basis assets or an operating loss carry forward, and less for a corporation with low basis assets (built in capital gain) or one that is subject to the personal holding company tax.102

This discount comes up most frequently with family holding companies. The estate of the decedent argues that this discount should be granted because the value of the stock held by the holding company has greatly increased in value since the holding company was organized and the stock investment acquired. Sometimes the discount is permitted, such as in Obermer v. U.S.103 However, more frequently it is not permitted, as in Estate of Piper v. CIR.104

This split in opinion can be explained by the fact that in Obermer the taxpayer showed that sales of stock held by the holding company took place periodically while in Piper the holding company held only Piper Air Craft Company stock, which it

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102.) Bittker, Federal Taxation of Income, Estates and Gifts, vol. 5 132.3.8.

103.) 238 F.Supp.29 (D. Hawaii 1964).

104.) 72 T.C. 1062 (1980).

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never sold. In the words of the court, "There is no evidence that a liquidation of the company's investments was planned."105 If there is never a sale, then there is never any reason to recognize the capital gain. Furthermore, as the court in Piper pointed out, the holding company could have been liquidated, and its basis (stepped up at the taxpayer's death) could be transferred to the stock it held. Therefore, unless the taxpayer can show that taxable sales of corporate assets are reasonably likely, and there is no intention or it is impossible to liquidate the corporation (no voting control), this discount probably will not be permitted.

I. DISCOUNTS FOR EASEMENTS AND RESTRICTIONS ON USE

This discount is applied when there is some type of restriction on the use of property that is being valued. This discount comes about because generally property is supposed to be valued at its highest and best use.106 When there is a restriction that prevents this best use, it lowers the value of the property.

The types of restrictions that can bring out this discount vary greatly, but one of the most common recently has been the open space or scenic easement. This is where an easement is given to charitable organization that bars or limits construction or development of the taxpayer's land or prevents removal of

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105.) Id. at 1087.

106.) 20.2.31(b).

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trees, etc... The taxpayer gets a charitable donation deduction and a reduction in the value of his land. This is ideal if the taxpayer does not want the land to ever be developed.107

Other restrictions that might bring out this discount include long term leases on the property that are now lower than fair market value, corporate loan agreements restricting or forbidding the payment of dividends until the loan is paid off, and irrevocable proxies.108

Generally the amount of this type of discount is determined on the basis of a before and after approach. The property is valued at its highest and best use before the restriction (or without the restrictions) and valued then with the restriction. The difference between the two values is the amount of the discount.

This difference can be substantial, such as in Flammon,109 where the tax court found that the granting of a scenic easement had by preventing the use of the land for residential development, reduced its value by 20% on one parcel and 40% on the other, thus granting discount on value in these amounts.

Other times the amount of the discount is determined to be minimal, such as in Todd,110 where the taxpayer was granted a mere $20,800 deduction (He had claimed a $353,000 deduction) for

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107.) See Thayer, T.C. Memo 1977-370.

108.) Voluntary Tax Cooper.

109.) Flammon Jr., Chester T.C. Memo 1986-572(i) (from RIA).

110.) Todd, Burtk v. U.S. (1985, D.C.PA) 617 F. Supp.253.

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the charitable contribution of a scenic easement on his country estate. The court ruled that the highest and best use of the property was as a country estate and, therefore, the granting of the easement did not effect the value of the property much. This resulted in a minimal value for the easement under the before and after approach.

In the next section the related discount for restrictions on disposition of stock or partnership interest is discussed.

J. RESTRICTIONS ON DISPOSITION DISCOUNTS

Frequently in closely held corporations there are limitations or restrictions on the disposition of stock. The unrestricted power to dispose of stock, particularly to sell it to the highest bidder, is a natural incident of ownership. Therefore, when this power is restricted, buyers are discouraged, and the market value of the stock goes down.

Restrictive agreements can take on many forms and result in innumerable different effects on the value of the stock. In addition, the effect of the restrictions for valuation may vary depending on which of the three taxes; income, estate, or gift; is being applied. Therefore, a complete analysis of this discount would require 30 pages or more so simply an overview will be given.

There are five main types of restrictions on sales. They

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are:[111]

1.) Absolute Prohibitions against Transfer - This type of restriction is usually valid under local law if limited to a reasonable period, but invalid as a restraint upon alienation if unlimited in duration.

2.) Consent - These restrictions require consent of the other shareholders or the corporation before a sale may be made.

3.) First Refusal Rights - These restrictions require shares that are for sale, first to be offered to other stockholders or the corporation at the proposed sale price.

4.) Option Buy-Sell Agreement - This restriction gives the corporation or other stockholders the right to purchase a retiring stockholder's stock at a predetermined price (often book value).

5.) Manditory Buy-Sell Agreement - This requires the corporation to buy up the stock of a retiring or deceased stockholder at a fixed or predetermined price (often book value).

The effect that each of these five types of restrictions have on value, of course, varies with the facts, but some types have a much greater effect on stock value than others. For example, a manditory buy-sell agreement might almost dictate the value of the stock while a first refusal right restriction might

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111.) Krahmer and Henderer, Valuation of Closely Held Corporations, 221 T.M.

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have very little effect on value.112

In any case in order for a restriction on disposition to have any effect on valuation for estate tax purposes, a number of tests must be met.

First, the restriction on disposition must be a bona fide business arrangement, not just a device to pass the decedent's shares to the natural objects of his bounty for less than full consideration.113

Second, the restriction on disposition must have been in effect and followed during the life of the decedent, not just at his death.114

Third, the restriction on disposition must not violate state law because then it is void and of no effect.115

Finally, the decedent could not have had enough voting control to amend the corporate by-laws and revoke the restriction or disposition any time he desired because then the restriction would have been illusory.

If these conditions are met, then the restriction will probably have an effect on value. A court would then probably permit a discount for restriction on disposition.

112.) P.H. 31298 (20).

113.) Rev. Rul. 59-60.

114.) Treas. Regs. 20.2031 2(h).

115. Quinn's Estate v. CIR, T.C. Memo 1982 (Oral agreement violated the statute of frauds.)

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K. POTENTIAL TAX PLANNING USES OF DISCOUNTS

As has been shown, the use of these discounts can greatly reduce the value of property for tax purposes. Because of this, discounts provide a good opportunity for tax planning. Through minimal effort many of these discounts can be brought into effect.

The key for tax planning with discounts appears to be to make the property worth a smaller amount to an outside purchaser, but a the same time worth the same to the taxpayer. For example, adding a "right of first refusal" restriction on sales to a small corporation's by-laws probably would not make the stock worth any less to the owners, but it may discourage outside buyers, thus resulting in a discount. Another example is granting an open space easement in a lake property. As long as the taxpayer wants to leave the lake property in the same condition as it is now, this would not hurt him. However, it will probably decrease the value to potential buyers, thus resulting in a discount.

Another way to take advantage of the discounts is to form a corporation. Family investment corporations consistently appear to be valued less for tax purposes than the value of the assets they contain. This is due to the lack of marketability and minority interest discounts they almost automatically receive. (Refer to family attribution.)

The only potential problem with this scheme is a run-in problem with the Personal Holding Company Tax. However, this could be avoided by forming a family investment partnership

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instead of a corporation. A well-drafted partnership agreement would probably cause the partnership to be treated the same as a corporation for the purposes of discounts. In Harwood v. CIR,116 a family partnership interest was allowed a discount of 50% for minority interest, unmarketability and a restrictive agreement. Therefore, it appears that partnerships may be the way of the future for passive investment business entities.

Although the use of discounts can result in significant reduction in appraised value, and thus typically significant tax savings, there is one additional important method whose use may result in even greater savings than discounts. This method, special use valuation, is discussed in the next chapter.

116.) Harwood v. CIR, 82 T.C. 239 (1984).

CHAPTER 5

SPECIAL USE VALUATION

As previously shown, the standard rule for valuing property for tax purposes is to value the property at fair market value. However, there is one major exception to this rule and that is the statutorily created rule for estate taxation referred to as "special use valuation." Under this rule qualifying properties can be valued based on their earnings rather than on fair market value. The remainder of this chapter discusses this rule in greater depth.

Special use valuation was enacted as IRC Sec. 2032A. The legislative intent behind the statute was to encourage the continued operation of family farms and other family businesses. The congressional committee report noted that typically the fair market value of farmland and other family businesses does not bear a reasonable relationship to its earning capacity. Instead typically its fair market value is higher than its income value due to large amount of "speculative value." This is particularly the case where the highest or best use of the property was other than the current family business.117 For example, with farmland located on the edge of an expanding city,

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117.) The Report of the House Ways and Means Committee, H. Rep. No. 94-1380 (1976).

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the developmental value is far more than its farming value.

Therefore, Congress enacted IRC Sec. 2032A in order to permit the family business to be valued at its income producing value rather than full fair market value for estate tax purposes, thus easing the estate tax burden on the typical family business or farm.

In order to qualify for special use valuation the farm or closely held business must be at least 50% of the decedent's gross estate before deducting mortgages, and the real property subject to the special use must be at least 25% of the adjusted gross estate after deducting mortgages. Furthermore, during the past five years the decedent or a member of his family must have materially participated in the operation of the farm or business. In addition, the business must pass to a qualified heir, which includes a grandparent, parent, sibling child, grandchild, spouse or nephew.118

The intent of Congress was to encourage the continued existence of the family business, not permit the heirs to use this provision to save on estate taxes and then a short time later realize the additional speculative value of the property by selling it. Therefore, as part of the provision, the heirs must continue the business and not sell the property for a period of at least ten years, or they will be subject to paying the estate tax they saved by using special use and paying an additional

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118.) Internal Revenue Code Sec. 2032A.

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penalty.[119]

Sec. 2032A(e)7 specifies the procedure to be used for determining the value of farmland when special use valuation is elected for estate tax purposes. Under special use the full fair market value of the farmland is reduced by the percentage that average annual gross cash rent for similar land in the same locality would be,[120] over the Federal Land Bank's new loan interest rate on the fair market value of the land. For example, if the fair market value of farmland was $750/acre, and cash rent was $40/acre, and the Federal Land Bank loan rule was 11%, then the $750.00 value would be reduced to:

[$40/(.11 x $750.00)] x $750.00 = $363.6/acre.

As can be seen, the use of special use can result in major estate tax savings. Sec. 2032A(e)8 describes a similar procedure for valuing a family business other than farmland by merely stating that their income be capitalized to determine their special use valuation.

Finally, it should be noted, Congress intended special use to help the small family business. Thus, Congress enacted as part of the statute a limit on how much an estate could save under special use.[121] Under this provision the reduction in value cannot exceed $750,000.00. Although limited, the limit is

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119.) Bittker, Boris and Elias Clark "Federal Estate and Gift Taxation" (Little Brown & Company, 1984), p 537.

120.) (over a 5 year period.)

121.) Report of the House Ways and Means Committee, H. Rep. No. 94-1480 (1976).

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so large that this provision is still an important exception to the general tax rule that properties be valued at fair market value.

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CHAPTER 6

CONCLUSION

As it has been shown, the consideration of valuation by the estate planner or other tax strategist can be one of the most important strategies possible to use. Since estate and gift taxes are levied on the value assigned to property, the art of valuation lies at the heart of any estate planning. The accomplished estate planner must develop strategies for passing on more value than meets the taxable eye in a transfer.122 This can be done by understanding and using to advantage the general valuation standards and appraisal methods. This can also be done by planning for and using to the largest extent possible, the various discounts, such as unmarketability and buy-sell agreements and by using whenever possible special use valuation.

Although the tax professional wants to state the lowest justifiable value on estate and gift tax returns and the highest justifiable value for charitable contributions on income tax returns, the professional should keep in mind two possible pitfalls.

First, Congress has enacted two penalty statutes creating

122.) Schlenger, J. and H. Nussenfeld "Valuing Closing Held Business Interest and Planning the Buy Sell Agreement", 44th Annual NYU Institute, 1987, p 52-3

stiff penalties for overvaluing charitable contributions 123 and undervaluing estate and gift property.124 The intent of these penalties was to encourage taxpayers to state reasonable values so these penalties probably will not be enforced if the taxpayer acts in good faith and has qualified appraisals to backup his valuations.125

The second possible pitfall is the tax court's increasingly intolerant attitude toward valuation disputes. The court in one case stated, "that the existing record reeks of stubbornness rather than flexibility on the part of both parties ...apparently the parties expect the court to reach a middle of the road compromise (so both parties have tried to come up with the most extreme valuation in their favor that they can.)" The court then went on to find entirely one side's valuation without any compromise.126 The tax court has since done the same procedure in several other cases.127 Therefore, the potential pitfall in

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123.) IRC Sec. 6659 states penalties for certain over valuations as follows:
10% penalty for 150 - 200% overvaluation
20% penalty for 200 - 250% overvaluation
30% penalty for more than 250%

124.) IRC Section 6660 states penalties for undervaluations as follows:
10% penalty for 50% to 66% of true value
20% penalty for 40% to 50% of true value
30% penalty for less than 40% of true value.

125.) Boyle, Ladson, "New Sharper Teeth in an Old Mouth: Valuation Penalties",1 Probate and Property May-June 1987, p 47.

126.) Buffalo Tool and Die Mfg v. CIR, 74 TC 441,451 (1980)

127.) Bittker, Boris "Federal Taxation of Income, Estates and Gifts" (1984), vol 5, p 132-95.

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this situation is that if the taxpayer is too extreme in his valuation, the court may rule entirely for the IRS with a resulting large tax assessment and possibly even the assessment of the penalties previously mentioned.

Finally, it should be noted that, as stated previously, the intention of the tax law is to value property at true fair market value. This is also the intention in many other areas of the law and business. Therefore, the methods used in valuation of property for Federal tax purposes are also commonly applied to valuation in bankruptcy disputes, property tax disputes, property damage disputes, and eminent domain disputes to name a few. In addition, the same general concepts are often used by individuals and corporation in deciding whether to purchase a particular property or invest in a particular business at a particular price. Also, because of these similarities between valuation for Federal tax purposes and valuation for other purposes, a good tax expert could probably convince a court to use or consider a new valuation technique that was derived or is being used in another area.

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