

Some Thoughts on the Valuation of Closely Held Business Interests[†]

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Very few problems encompassed within the task of the valuation of property for the purpose of the determination of tax liability partake more of the nature of guesstimates than those relating to the valuation of closely held business interests. Yet, we find that the valuation of these interests is a matter of constant concern and that an error in such valuation may well spell disaster to those subjected to the tax burden and, possibly, ruin to the business to which the valuation relates.

How should stock in a closely held corporation or the interest in a partnership or other business venture in which more than one individual is concerned be valued? Would it be equitable to adopt the formula suggested by Professor Rice¹ a few years ago which in its essence was an allocation of net assets with some provision for a formula for valuation of good will? In some respects this is the method provided in section 783 of the California inheritance tax regulations.² Should we determine that each of the factors suggested in the regulations of the Commissioner of Internal Revenue³ or those promulgated by the Inheritance Tax Department of the State of California⁴ constitute the perfect method of answering the problem? Or, would we be just as well off if we simply worked out a comparison with the stock of similar businesses listed on the exchanges, used the capitalization of earnings or took any one or two of the factors which have been considered by the regulations or in the cases?

Surely no one engaged in the field of appraisal of property is prepared unequivocally to stand on the position that any method which has been suggested or which is now in use is completely adequate, or that any method administers with uniformity and equity the provisions of the various laws

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¹ Rice, *The Valuation of Close Held Stocks; a Lottery in Federal Taxation*, 98 U. PA. L. REV. 367 (1950).

² CAL. ADMIN. CODE tit. 18, § 783 provides, in part: "The value of shares of closely held stock is usually arrived at by first ascertaining the net worth (the excess of the assets, including good will, if any, over liabilities) of the corporation as a going business, and then assigning to each share its proportion of such worth." Statutes of other states are substantially in accord with that of California.

³ See U. S. Treas. Reg. 105, § 81.10 (1944).

⁴ See CAL. ADMIN. CODE tit. 18, § 783.

relating to valuation of property. Assuredly, I do not have an answer which will bring about Utopia. It is my proposal merely to consider some aspects of the problem in the light of recent case law, and, secondly, to discuss the very special problem of the valuation of business interests where the disposition is subject to restrictions. It is in this latter situation that we have at least a possible standard which has some elements of certainty. At least one question to consider is whether that certainty is equitable both to the taxpayer and to the governmental unit collecting the taxes.

I

GENERAL CONSIDERATIONS

Section 13,402 of the inheritance tax sections of the Revenue and Taxation Code of the State of California uses language which is common to many inheritance tax laws and not substantially different from the methods provided statutorily for the valuation of property for property tax purposes. Section 13,402 states that "The tax is computed upon the clear market value of the property transferred . . ." Perhaps when our forebears enacted this law they were better equipped to interpret it than most of us, although from an examination of the early cases I find no evidence to that end.

Just as full cash value for property tax purposes means what the assessor decides it to mean, with some over-all restrictions, so clear market value for inheritance tax purposes, with minor exceptions, means simply what the appraiser says it means in each particular instance. I think I am not doing an injustice to appraisal generally to say that there is no more than lip service paid to any uniform set of standards, if, indeed, any such standards can be found. This lack of definite criteria is not unique to California; I believe it is the pattern in the federal service and in the operations in other states. It may be that such lack of definition is inherent not only in the statutory language used but in the very nature of property valuation itself.

Although in recent years the federal courts have tended to provide more explanation as to the items they believe necessary for valuation, they have in fact been no more definite. I think the same can be properly said of the state courts. The opinions of the Tax Court are illustrative of the general theme which appears to govern the valuation procedure in federal estate and gift tax matters, namely: a large number of factors are relevant in any particular case, no specific factor being controlling. Your guess is as good as mine as to which of the factors will get the gold ring in the merry-go-round of valuation of a property interest on any particular ride. In one case the emphasis will be on earnings,⁵ in another on net worth,⁶ and "cases

⁵ *Commissioner v. Johnson*, 51 F.2d 1075 (6th Cir. 1931).

⁶ *In re Nathan's Estate*, 166 F.2d 422 (9th Cir. 1948).

can be found in which primary or exclusive emphasis has been properly placed upon one or the other of almost every factor which the regulations state are to be considered in the determination of fair market value."⁷ The result of this lack of any basic set of standards which can be applied to the valuation of business interests is that the law as to value of closely held business interests is in fact made by the courts, case by case, with a different rule in each case and in each court. As Judge Frank said in *Commissioner v. Marshall*:⁸ "Value involves a conjecture, a guess, a prediction and a prophecy." Agreeing as I do with this characterization of property valuation methods, I must ask whether it constitutes a sound basis for equitable tax administration. My own opinion is that it does not, although we may conclude that there is no better method. The dilemma of administrators and courts in relation to valuation of closely held business interests has been commented upon by courts in many decisions and considered in a number of articles and comments in the law reviews.⁹ With this background one might expect that the more recent decisions of our judiciary would have evolved some standards for us to consider and possibly follow. Yet, a survey of the cases indicates that the courts have failed in this task.

In most cases involving shares of closely held corporations there are relatively few sales, and the sales which are made so partake of an intra-family nature as to lead many courts to consider them as suspect and unreliable. For example, in *Moffett Estate*¹⁰ the evidence showed sales before and after the date of death of the decedent from her father's estate to the corporation, at prices ranging from \$23.50 to \$25.00 a share, and one sale by decedent's estate at \$24.50. The inheritance tax appraiser set a value of \$50.00 per share upon the stock. Two experts called by the taxpayer, a trust officer and a broker, testified that the \$50.00 valuation was outrageous and stated the basis upon which they had computed what they believed to be the proper value. The trial court, noting that by reason of their occupations these experts were interested in the investment nature of property and that they were therefore primarily concerned with the earning power of the property, gave little consideration to their testimony, stating that elements other than earnings must be taken into consideration. It is interesting to note that although the trial court referred to the basis upon which these experts made their determinations, the opinion contains no reference to the factors considered by the inheritance tax appraiser. This

⁷ *Id.* at 425.

⁸ 125 F.2d 943, 946 (2d Cir. 1942).

⁹ See Polisher, *Federal Estate Taxation of Closely Held Interests—Recent Decisions*, 54 DICK. L. REV. 150 (1950); Johnson, Shapiro & O'Meara, *Valuation of Closely Held Stock for Federal Tax Purposes: Approach to an Objective Method*, 100 U. PA. L. REV. 166 (1951); Note, 37 MARQ. L. REV. 72 (1953).

¹⁰ 369 Pa. 159, 85 A.2d 109 (1952).

attitude of the court emphasizes the heavy burden upon the contesting taxpayer and makes heavier the responsibility of the appraiser for equitable appraisement. In affirming the trial court's determination in the instant case, the Supreme Court of Pennsylvania said that factors other than sales must be considered. In his dissent Justice Bell took the position that where there were bona fide sales they should be regarded as controlling. He stated:¹¹

How, then, is it possible to say that the word "value" in the Inheritance Tax Act does not mean "market value," but means instead "estimated net worth"?

. . . .

Generally speaking, book value is one of the least important factors in determining market value; while [in the absence of sales price standards] . . . earnings ratio and yield are two of the most important factors in determining market value.

This case, considering the trial court, supreme court, and the dissenting opinion, indicates the possible variations in view in *one* jurisdiction in this matter of valuation. If Judge Bell had been the appraiser, an entirely different value would have been put upon the property than was actually done by the inheritance tax appraiser, and that value would, in a majority of the cases, have been upheld by the courts. We thus find, I submit, that the outcome in closely held business interest valuation cases depends on the individuals concerned, whether they be appraisers or judges, rather than on any real standard of market value.

Theoretically, of course, clear market value is that price at which a willing buyer and a willing seller will arrive. Of course, we all know that in a closely held stock situation any such determination is purely fictitious in the absence of a substantial number of bona fide sales. The value for tax purposes cannot be other than that which the appraiser or the court believes in his or its practically uncontrolled judgment is proper. It would seem that the real problem is to devise some method which will determine the relevant factors upon which that judgment is to be exercised. If we have some such set of standards and require them to be used and supported, there will be, in at least one phase of this operation, some trend toward uniformity. Sales may be one factor; the size of the block of shares another; the book value another; management and dividend policies might also be required considerations. As the Minnesota Supreme Court said in *State v. Wagner*:¹²

It should be recognized that in cases where no standardized market is shown to exist for the kind and quantity of property being valued it is pure fiction to regard the value to be determined as a market value in any real sense. In such cases, all that can be done is to determine a fair value for

¹¹ Moffet Estate, 369 Pa. 159, 168-69, 85 A.2d 109, 113 (1952).

¹² CCH INH., EST. & GIFT TAX REP. ¶ 17,381 (Minn. 1951).

the property from all relevant facts in evidence. The federal district court, sitting in Minnesota, has held that where there is no fair market value for property tax assessors must determine the true value of property for taxation purposes from all factors present, although the property cannot be sold at such valuation.

In the *Wagner* case the court gave weight to (1) the sale price on the curb, and (2) the testimony of an expert witness based upon the corporate history, market outlook, demand for the product and other factors. The question that concerns me is not the final determination in this case but the indication that even if the evidence was *conclusive* that the stock was not salable at the price placed upon it by the appraiser, the court would still have upheld the appraisers' determination of that price as the clear market value! If this is to be the determination, why should we confuse everyone with the use of the words "market value"? Should not the statutory criterion be value as determined by the appraiser from a consideration of specified factors? Maybe we should provide that the value shall be as determined from these factors with a reservation that if anyone believes other factors to be proper for consideration in the particular case, the burden of showing such factors should be on the party supporting that position, whether it be the state or the taxpayer. If we are to follow what appears to be the policy in Minnesota and elsewhere, that the price for appraisal purposes can exceed the price at which the interest can be sold, we are discriminating between listed stocks and unlisted stocks, or rather between stocks which are actively marketed and those that are not, simply because we have not as yet devised an accurate method for determining market value of the latter type of security.

Some courts seem to have no difficulty in determining that the statutory definition is the criterion and that there are adequate techniques to determine clear market value. Thus, in *Tracy v. Alexander*,¹³ decided this year by the New Jersey Supreme Court, the appraisal of the state agency was accepted although it was 33⅓ per cent higher than the Federal Bureau of Internal Revenue valuation, and 40 per cent higher than the price placed by a witness whom the court termed an expert security analyst. Although in the *Tracy* case the company had only two customers, the court felt that this was not an important item of consideration in the determination of the value of the stock, commenting that the company had recently invested in a new plant and equipment indicating no fear of loss of the customers. Although there was some disagreement as to amount, it is interesting to note that both the state and the appellant's expert discounted the value of the stock on the basis that it was a minority interest. This indicates that they considered the price which could be obtained on the market to be of some importance.

¹³ 17 N.J. 397, 111 A.2d 492 (1955).

Wisconsin has determined that bona fide sales are controlling as to fair market value, but that where the factors present in a particular case are such that fair market value is not obtained in the sale, the sale price is not controlling.¹⁴ In the recent case of *Estate of Gooding*,¹⁵ the Wisconsin Supreme Court reaffirmed this basic rule but stated that sales made in good faith to a corporation by two minority stockholders who were not obliged to sell were not controlling as to price where there was no effort to see what an outsider would pay for the stock. Does this mean that in every case it must be proven that the sales were made at the highest possible price? If so, would this not amount to requiring the equivalent to a "public auction" sale of the interests? Certainly, if we have good faith and a lack of a forced sale, the price obtained should be controlling. The basic stress of the court in this case is its determination of the value of the stock by a comparison with the listed stock of corporations engaged in the same or a similar line of business. The court pointed out, however, that the basic difference between marketability of the closely held corporation stock and listed stock was a factor to be taken into consideration. To this extent I believe the court to be more realistic than the Minnesota court was in the *Wagner* case. It is interesting to see that two qualified experts in the *Gooding* case differed in their valuation by more than \$100.00, one valuing the stock at \$90.00, the other at \$193.00.

Looking to our own state, the recent case of *Kirkwood v. Rowell*¹⁶ involved the valuation of 82 shares of a close corporation as to which there had been no sales. The District Court of Appeal for the Fourth District stated that net worth valuation is not the only way of valuing stock of a close corporation. In determining market value "net worth valuation" may be proper, but only in the absence of other influencing and determining relevant factors. I think this case has added little or nothing as to the standards to be followed in determination of valuation. However, it was helpful in that in its discussion of *Estate of Felton*¹⁷ it stated that net worth is not the sole determining factor in valuation of closely held interests.

Federal cases generally have held with the language of the regulations which require, in the absence of bona fide sales, an examination of relevant factors¹⁸ including yield, net worth, earning power, and comparison with

¹⁴ See Note, 37 MARQ. L. REV. 72 (1953).

¹⁵ 269 Wis. 496, 69 N.W.2d 586 (1955).

¹⁶ 132 A.C.A. 488, 282 P.2d 163 (1955).

¹⁷ 176 Cal. 663, 169 Pac. 392 (1917).

¹⁸ U.S. Treas. Reg. 105, § 81.10 (1944). See also CAL. ADMIN. CODE tit. 18, § 783, which provides, in part:

"(a) The period of time that the issuing corporation has been in existence and its position in the trade.

"(b) The nature of the corporation.

"(c) The operating history of the corporation and, particularly, its earnings over a reasonable period of time.

listed stock of similar corporations. In *Estate of McDermott*¹⁹ the court, in deciding against the Commissioner, took cognizance of facts which made the stock unsalable except at a figure below book value. Among these were that the banks had refused to accept the stock as collateral and that the principal customer, the Milwaukee Railroad, could cancel its contract at any time. In *Estate of Montgomery*²⁰ the tax court held that among the factors to be taken into consideration were: (1) book value of the stock; (2) earnings; (3) history; (4) dividend record; (5) other sales; (6) management; and (7) the opinion of expert witnesses. In the court's opinion, book value was not determinative.

It is my belief that until we find a more adequate method for the valuation of closely held business interests, we should take the position that bona fide sales close enough to the date of the decedent's death to be pertinent should be controlling as to the value of the interest. If there are no sales close to the date of death, an effort should be made to ascertain the facts necessary for an adjustment of the sale price on the basis of the developments since the date of the last sale; and if there is a reasonable basis for such adjustment, the value so adjusted should be controlling. If there is a total absence of sales, it is my recommendation that the factors shown in section 783 of title 18, California Administrative Code, should be required to be considered. In that regard it is my position that the appraiser should be required to show that he had considered *all* of the factors, and not just some of them, in his determination. It will be true that in some instances some of the factors will not be present or information relative to them will be unavailable. But in such instances the appraiser should be required to show the basis for his failure to consider such factors. This, I believe, would give a better set of standards than the somewhat haphazard consideration which now seems to be in vogue. In addition, it would allow the parties interested in contesting any appraisal to prepare their case more adequately. Actually, I believe that if the detailed examination which I

"(d) The balance sheet of the corporation.

"(e) The standard of earnings maintained by concerns engaged in similar lines of endeavor.

"(f) The strength and danger of competition, both existing and potential.

"(g) The management and personnel.

"(h) The effect of possible governmental regulation.

"(i) The present and future requirements of the corporation in the matter of new land, buildings and equipment.

"(j) Current business policy.

"(k) Dividend payment history.

"(l) The prices paid on private sales of the shares to persons who were in a position to know their value.

"(m) The prospects for future earnings."

¹⁹ 12 T.C.M. 481 (1953).

²⁰ 12 T.C.M. 1380 (1953). But see *Estate of Gwinn*, 25 T.C. No. 7 (Oct. 18, 1955).

consider proper is made and evidenced, much litigation would be avoided, because it would be apparent that all necessary items had been considered. Further, I believe that if the appraiser, the state inheritance tax officer, or the decedent's counsel believes that additional factors other than those covered under the regulations are pertinent for consideration, the burden of showing such fact should be on the person contending for the inclusion of the additional factors. One of the factors which I consider pertinent is that presented when the stock is marketable only at a lower price than that found to be its value by the consideration of the appraisal factors. Proof of such marketability should be considered if offered, but the burden of persuasion of relevancy should be on the person making such offer, and close regard should be paid to the nature of the interest and the factor of stock ownership in a close corporation.

II

INTERESTS SUBJECT TO RESTRICTIONS

Another of the hotly disputed aspects of the valuation of closely held business interests concerns interests which are subject to restrictions on their disposal. Restrictions on such interests have been the subject of some interesting recent income tax cases. Some cases appear to hold that such restrictions render the stock subject to them valueless for income tax purposes.²¹ In the estate and inheritance tax area the basic question has been whether the value is affected by the restrictions, and if the restrictions are as to price, whether the appraiser is bound to value at the agreed price. As you know, the administrative and judicial determinations have developed two contrary rules: the Federal Rule and the Pennsylvania Rule. The leading case enunciating the federal rule is *Helvering v. Salvage*²² which, although it did not involve an estate tax, holds that a restriction on sale to \$100.00 per share limited the value to that amount. In *May v. McGowan*²³ a father and son each owned one-half of the outstanding shares of the stock of a corporation. Each agreed that he would not sell without offering to the other at \$100.00 per share, reducible in the case of the son by 1/500ths for each \$100 of an indebtedness to a bank, which indebtedness the son had guaranteed. At the time of the father's death, the indebtedness exceeded \$90,000 and, thus, the son could acquire the stock without any payment to the estate. The court of appeal, citing *Wilson v. Bowers*²⁴ and *Lomb v. Sugden*,²⁵ held the value to be zero and stated that the expressed fear that

²¹ Phil Kalech, 23 T.C. 672 (1955); Harold and Jenny Kuchman, 18 T.C. 154 (1952); Robert Lchman, 17 T.C. 652 (1951).

²² 297 U.S. 106 (1935).

²³ 194 F.2d 396 (2d Cir. 1952).

²⁴ 57 F.2d 682 (2d Cir. 1932).

²⁵ 82 F.2d 166 (2d Cir. 1936).

such valuation would encourage tax evasion was a matter for legislative rather than judicial action. This view has recently been affirmed in *Estate of Weil*²⁶ and in *Broderick v. Gore*.²⁷ The Federal Rule that the option price controls where there is an irrevocable agreement to buy or sell, in the absence of some evidence of an attempt at tax evasion (or, in other words, some evidence of a lack of bona fides) has been followed in some of the states. The contrary Pennsylvania Rule has been followed in others. The Pennsylvania Rule has been stated by the Pennsylvania court as follows:²⁸

No agreement by a property owner . . . can oust the jurisdiction of or control the Commonwealth's appraisers; such agreement does not create a limitation on the value binding the Commonwealth but it will be considered with the other evidence.

In a recent Pennsylvania case the court considered: (1) expert testimony; (2) the earning record; (3) corporate assets; and (4) the report of the company for capital stock tax purposes. The result was an upholding of a value of \$15.00 despite admittedly expert testimony that the value would not exceed \$8.00 in view of the restrictions.²⁹ In *In re Cowles' Estate*,³⁰ the Washington Supreme Court recently followed the Pennsylvania approach and affirmed the rule that the option price is only one factor to be considered in determining market value, and stated that the question of value as one of fact must be based upon all relevant factors. Perhaps this case may not be approving the Pennsylvania Rule because the opinion indicates that an arms length transaction was not involved. In Maryland the attorney general in recent years has ruled that an option price of a partner's survivorship agreement was controlling for inheritance tax purposes.³¹

The Pennsylvania Rule was followed in Massachusetts recently in the Tax Board decision in *Nichols v. Commissioner*.³² In a recent Wisconsin Supreme Court case³³ the court ducked the issue where the option agreement set a price but the surviving partner was the beneficiary under the decedent's will. The court held that he received under the will and not by virtue of the agreement. It is obvious from this brief résumé that we cannot find any evidence of uniformity among the taxing jurisdictions on this problem.

²⁶ 22 T.C. 1267 (1954).

²⁷ 224 F.2d 892 (10th Cir. 1955).

²⁸ *Estate of Mohn*, CCH INH., EST. & GIFT TAX REP. ¶ 17,303 (Orph. Ct. Pa. Nov. 10, 1950).

²⁹ *McClure Appeal*, 347 Pa. 481, 32 A.2d 885 (1943).

³⁰ 36 Wash.2d 710, 219 P.2d 964 (1950).

³¹ OPS. ATT'Y. GEN. MD. cited in CCH INH., EST. & GIFT TAX REP. ¶ 17,186 (1950).

³² *Nichols v. Comm.*, CCH INH., EST. & GIFT TAX REP. ¶ 17,469 (Mass. Appel. Tax. Bd. Aug. 13, 1951).

³³ *Estate of Michel*, 262 Wis. 432, 55 N.W.2d 388 (1955).

California has not, as far as I know, any judicial determination dealing with this question specifically. Under our law, the market value of the property transferred is the basis of the inheritance tax appraisal. If Jones leaves his entire estate to his wife and part of his estate is stock or a partnership interest subject to a restrictive price agreement entered into in good faith or for consideration, what can be said to be transferred at the time of death? If the agreement is valid and binding the ultimate distribution to the wife cannot exceed the option price. She will either get the stock or the partnership interest subject to the restriction, or she will get the price paid for that stock or partnership interest. It hardly seems appropriate or equitable to adopt the Pennsylvania Rule and hold the wife subject to tax computed upon values which she can never realize. The transfer to the wife in this hypothetical case is only of property upon which she can realize a specified price. Certainly, where there is a bona fide irrevocable agreement prior to death for the sale of real property, the price under that agreement would be considered as the amount transferred to the beneficiary. This would be true even though at the time of death there had been developments resulting in a material increase in the value of the property. There would seem to be no logical reason for any different view in the instance of closely held business interests as far as the wife is concerned. If we are seeking certainty of valuation, it would seem that this is one place where we need not introduce the very uncertain factors which appear to be required in the valuation of closely held interests. Generally, I would believe that it would be appropriate and necessary to require substantial evidence of the bona fides of the transaction, especially where the optionee is a member of the family of the optionor. In most of the situations in this field that I have considered there appears to be evidence of the good faith of the parties and of adequate consideration for the agreement. If those factors are present, I personally can see no basis for the adoption of the Pennsylvania Rule. It could, of course, be argued that what the decedent has done is transfer property of the value of the option price to the beneficiary and transfer property valued as the difference between that option price and the fair market value, to the optionee. Such a determination would transform a clear bargain and sale arrangement into a gift or testate transfer contrary to the undisputed facts. I suggest that at least in this area we achieve some uniformity by adopting the Federal Rule unequivocally.