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## ESTATE PLANNING†

### ESTATE VALUATION — THE INTERNAL REVENUE SERVICE STANDPOINT

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Any discussion of valuation must start with the definitions to be used. In the case of Internal Revenue Service valuation, the estate and gift tax statute furnishes no definition, simply using the word "value." The regulations, however, supply the missing elements—section 20.2031-1(b)<sup>1</sup> provides that the value to be used is "fair market value," which is defined as "the price at which the property will 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."

Fair market value does not mean the value in a "fair market" but instead the fair value of the particular property in the then existing market. At times it has been argued that where the market for a particular property was distorted by external conditions, the resulting value was an improper measure. This position has been generally rejected, however.

The term "willing buyer and willing seller" is of course unambiguous, but the re-creation of these two fictional characters is very difficult. Typically, the taxpayer assumes the role of the willing seller, while the government agent is much more impressed by the probable willingness of the buyer.

Similarly, the lack of compulsion upon the parties is unambiguous, and ordinarily it poses little difficulty in interpretation. It of course bars forced sales as any criterion of the value of the property sold, and in appropriate cases would rule out other sales made under forced

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<sup>1</sup> Treas. Reg. § 20.2031-(b) (1958).

conditions, whether affecting either the buyer or the seller. An apparent exception to the rule is where liquidation of property has been commenced prior to the critical date. In such a case the realized value would appear to be fair market value of the particular property regardless of obvious compulsion to complete the liquidation.

The final element in the definition relates to knowledge of the facts in the case. Note that this is limited to a "reasonable" knowledge of "relevant" facts. In effect this is a restatement of the rule as to fair value in the existing market, since not infrequently there may be unknown facts having substantial effect upon ultimate value. In the *Wright Estate* case<sup>2</sup> certain damaging facts about a stock were unknown at the date of death and became known thereafter. The executor urged that the market value should be reduced by the impact of the subsequent knowledge. The court disagreed upon the ground that such knowledge could not reasonably be imputed to anyone and that the market as it then existed measured the value as of the date of death.

Once the matter of definitions is settled, the question arises as to what evidence of value will be acceptable. The evidence carrying the greatest weight is the sale of identical or comparable property in an arms-length transaction at a time reasonably close to the valuation date. But what are comparable properties? What makes a transaction one at arms-length? What length of time is unreasonable? All of these are matters of judgment, and here, as in the "willing buyer and willing seller" area, the Internal Revenue Service is likely to be much more critical than the taxpayer. By that I mean that it will set much higher standards of comparison, and will question closely the relationship of the parties, whether personal, financial or social. It will doubt whether too long a period did not elapse to permit a valid comparison. On the other hand, the taxpayer will take the same dim view of a sale of comparable property which seems to him to have been unreasonably high, and in the recent era of rising prices, such instances have not been uncommon.

Despite this understandable difference in attitude, however, the existence of reasonably comparable sales is usually a quite persuasive factor in valuation.

Lacking such sales, it is obvious that opinion evidence must be called upon, and here the question becomes one of the credibility both of the witness and of his basis for opinion. The expert knowledge of the witness is of particularly great importance in the valuation of real estate and tangible personal property, although the background for

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<sup>2</sup> 43 B.T.A. 551 (1941).

the opinion may also be thoroughly explored in the case of large items or when some doubt as to credibility exists in the mind of the examining agent or his superior.

In the valuation of intangibles, by contrast, the background of the opinion is ordinarily much more important than the knowledge of the witness himself. Whoever he is, he must be prepared to defend his position by the use of all the weapons of a financial analyst. If he looks at sales of similar property (as contrasted with comparable property) the degree of similarity must be established solidly. If he uses income as a basis for his opinion, he needs to justify his capitalization rates and any estimate of future income as differing from the past.

Ordinarily, real estate values and the values of tangible personal property can be worked out with relative ease. With respect to both of these, the government is usually at an initial disadvantage in that the agent auditing the return seldom has the services of an expert to call upon. This is not true in very large cases where the Engineering Division of the Service may be called upon to provide such advice. This is a most unusual situation, however, and in the ordinary case a revenue agent must pick up his information as best he can.

With rare exception, an examining agent makes a serious attempt to establish fair valuations for these types of property. In most cases he acquires a stable of more or less expert real estate appraisers who are good natured enough to give him free valuation advice. He tries to average out the result of two or three such opinions, realizing that these people never have an opportunity to make a detailed examination of the property and often make their appraisal from simple memory of a neighborhood. Surprisingly enough, however, a good many will actually go to look at property at their own expense.

In the event that the agent runs into a great deal of opposition with respect to the valuation of a particular property, he will usually go back to his appraisers and query whether they have taken into account circumstances and defects pointed out by the taxpayer's representatives. As a result, litigation of the values of this type of property is relatively unusual.

Not so, however, with the valuation of intangibles. As a matter of fact, the valuation of business interests, especially close corporation stocks, is the area of greatest uncertainty in estate and gift tax, in the absence of an effective buy-sell arrangement. It is here that valuation is most an art and least a science. Here, too, the Internal Revenue Service takes heart from the statement of the court in *Wishon v. Anglim*<sup>3</sup> that the Commissioner has the first guess at value and will ordinarily prevail. It is significant that while the regulations themselves are still

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<sup>3</sup> 42 F. Supp. 359, 42-1 U.S.T.C. ¶ 10,123 (N.D. Calif. 1941).

most sketchy in the treatment of the valuation of business interests, the Service has issued two comprehensive revenue rulings on the subject, the last and by far the most sophisticated being Revenue Ruling 59-60.<sup>4</sup> This ruling will be discussed in detail later.

Traditionally, the Service has followed general principles of evaluation of intangible property. One of the most interesting of the early decisions was that of *James Couzens*.<sup>5</sup> In the opinion in this case, Judge VanFossan determined the value of Ford Motor Company stock, and did a masterly job of outlining the various considerations underlying such evaluation. I recommend the opinion both for its technical quality and the interesting factual situation involved.

Generally speaking, there are three principal approaches to the valuation of a business. These are asset value, earnings value and dividend value. These in turn are subdivided into various groupings of fact and speculation, and usually a combination of these are considered together by the appraiser in arriving at a final valuation.

The published position of the Service throughout its history has been that all relevant factors must be considered in valuation of this sort of property. For many years this was practically the only statement in the regulations, except in connection with listed or over-the-counter securities. And in the revenue rulings referred to, this flexibility was in essence retained, especially in Revenue Ruling 59-60.

In practice, the Service in earlier days tended to use fairly stereotyped formulae in approaching the valuation of business interests. Despite the breadth and clarity of the *Couzens* decision,<sup>6</sup> many estate tax agents remained blissfully unaware of its principles since it involved income tax and was thus foreign to their experience.

This practice, of course, was a matter of wide variation. In the more sophisticated financial centers of the east, revenue agents were correspondingly better equipped to deal with valuation problems. They had the further advantage of often dealing with cases of sufficient size to warrant calling upon business experts to evaluate the properties involved. By and large, however, the representatives of the Service tended to adopt formulae which were applied indiscriminately to valuation of businesses and resulted in an unjustifiable rigidity of evaluation unduly favorable to some taxpayers, unduly harsh as to others.

There was over-all progress, however. For many years during the initial period of estate tax administration, for example, book value or asset value was considered as of primary importance, despite the fact that even if it were accurate, ordinarily it was unavailable to the

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<sup>4</sup> Rev. Rul. 59-60, 1959-1 Cum. Bull. 237.

<sup>5</sup> 11 B.T.A. 1040 (1928).

<sup>6</sup> *Supra* note 5.

owner of a share in a business. Gradually, it was recognized that this was a factor which affected only the rate of capitalization properly attributable to earnings capacity, except in those unusual cases in which liquidating control rested in the interest to be evaluated. At about the same time a combination earnings-book value formula, devised for use in income tax cases, was adapted to and widely applied in estate and gift tax cases. This is the familiar "A.R.M. 34."<sup>7</sup>

While in many situations the formula had substantial merit, the capitalization rates originally suggested were often inflexibly applied and the results were far from happy. It did, however, point up the importance of intangible value, or earnings value, as compared with asset value, and focus attention upon what has come to be called "good will."

As used by the Internal Revenue Service, good will is not merely the traditional legal term identifying the chance that the public will continue to patronize a particular business. Instead it is a blanket term which covers all kinds of intangible values. Thus any special competitive advantage, such as patents or secret processes, will contribute to good will. Franchises or chain names, methods of operation and so on, efficient management, exceptional technical knowledge—all of these are a part of what the Internal Revenue Service regards as the "good will" of a particular enterprise.

And as the extent of the definition broadened, so too did the flexibility of the Service in dealing with these elements. The traditional fifteen per cent capitalization for intangibles under "A.R.M. 34" was stretched out as high as twenty-five per cent, the yield on tangibles went from eight to ten per cent. In fact, in one unusual case, where the agent was called upon to value a gambling operation he used a fifty per cent capitalization rate of the intangible earnings. The reason—the owner was the estate of the brother of the mayor of the city; the mayor had a further period of two years in office; the probabilities were that he would not be re-elected.

Along with this increased attention to intangible elements of value came an additional awareness of discount factors as well. The incapacity of management, the lack of any successor to the deceased executive, a probability of a continuing decline in market or the threat of new competition, all of these were in appropriate cases urged upon and recognized by internal revenue agents. The entire valuation process in the Service thus continued in a state of progress.

All of this change involved a growing recognition of the importance of earnings. In essence, the value of any piece of property at a given moment is the prospect of advantage which it offers to its

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<sup>7</sup> 2 Cum. Bull. 31 (1920).

owner in the future. Such prospects of advantage depend primarily upon the existence of earnings which can be distributed by the business to the proprietor. A purely historical approach is based upon the belief that past history will repeat itself in the future, but this belief must always be modified by the recognition of trends which exist at any particular time. Earnings are not a static thing except in the area of monopolies, but rather depend upon the conditions in the particular industry or business, upon conditions in the economy as a whole, upon changing geographical considerations and many other factors. With increasing emphasis upon earnings, all of these factors were accorded more and more consideration. And all of these are reflected in Revenue Ruling 59-60 as factors which must be considered by the internal revenue personnel evaluating this type of property.

One thing which has been overlooked, or at least minimized throughout the Service's developing valuation policy, has been the final fact that earnings must be available to the business owner and that unless the interest which is being valued has control sufficient to appropriate the earnings, dividends or yield is the most important single factor to be considered.

The classic example of this is, of course, the minority holding of stock in a close corporation. There is absolutely no control over dividend policy in such a case, and unless some unreasonable circumstances exist, such as a large accumulation of surplus without any business purpose, or some evidence of mismanagement, the holder of this stock is at the mercy of the controlling shareholders as to any realized or realizable yield. Obviously this limits the market value of such a holding drastically, yet the Service has never published any recognition of this fact, and revenue agents are very chary of giving much weight to it as a result. It apparently has not been urged in litigation by taxpayers, the only case in which the importance of the minority nature of the holding is stressed being *Mathilde B. Hooper*,<sup>8</sup> although some other cases do mention it as a factor to be considered.

Interests in publicly-held corporations have likewise benefited from a change in valuation concepts over the years. The Service's original position was that the published market price as of the date of death or gift governed value, and it bitterly fought all attempts to inject a discount factor based upon the size of the block held. It received no support from the courts, however, who recognized that a thin market and a substantial block of stock in many cases meant that the market price was wholly unrealizable as a fact.

Taxpayer's counsel attempted in several cases to generalize this

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<sup>8</sup> 41 B.T.A. 114 (1940).

"blockage" principle as a rule of law applicable to all large blocks. The courts, however, declined to follow this argument and have consistently held that blockage is a question of fact and not of law, and that the estate or donor has the burden of demonstrating the effect of blockage upon the fair market value of the particular block of stock to be valued.

The rule has evolved that fair market value in such a case is the amount which a skilled broker, selling the block of stock on the best terms possible and within a reasonable time, could secure from such a sale. Excellent discussions of the rule may be found in *Bull v. Smith*,<sup>9</sup> and in *Helvering v. Maytag*.<sup>10</sup> The Service has since reluctantly accepted blockage as a material question of fact.

Probably the most fertile area for valuation disputes involves the stock of closely-held corporations. In Revenue Ruling 59-60, previously referred to, a very detailed statement of Service principles and aims is made. This represents a flexible and reasonably sophisticated approach to this valuation problem, and may well be taken as a statement of general principles which will be applied to the valuation of all business interests other than those having an established market. Its only defect lies in the continued refusal to accept the controlling importance of dividend yield in the case of minority interests, which presumably remains a "Pandora's box" in the eyes of the Service.

The ruling recognizes and approves the use of comparative values, another instance of reluctant concession by the Service. Taxpayers have urged for thirty years that the best yardstick for close corporation stocks was the price-earnings and other ratios of stocks of comparable companies quoted in the market. It took amendment of the taxing statute to get the Service to recognize any applicability of this criterion, however, and even then it was emphasized and underscored that such a comparison was only *one* of the factors to be considered in appropriate cases.

The ruling states the current position of the Service, that the taxpayer must establish valid comparisons, and when that is done, very great weight will be given to the ratios demonstrated. When this is taken into account together with the discount factor that courts have recognized on account of lack of marketability, a broad and relatively sound basis for valuation is made available to the estate planner and administrator.

The ruling also covers valuation based upon assets of the corporation, either as shown on the balance sheet or as modified to reflect cur-

<sup>9</sup> 119 F.2d 490, 27 Am. Fed. Tax R. 151, 41-1 U.S.T.C. ¶ 10,049 (2d Cir. 1941).

<sup>10</sup> 125 F.2d 55; 42-1 S.T.C. ¶ 10,129 (8th Cir.), *cert. denied*, 316 U.S. 689 (1942).

rent market values. This approach is discussed solely as a contributing factor, and not as one of controlling importance. The value of stock based upon its dividend yield is likewise mentioned, but again only as a contributing factor. And except in the case of a minority holding, this approach is clearly correct.

The principal discussion centers about the determination of value based upon earnings, or "dividend-paying capacity." Here a most helpful list of elements which should be considered in arriving at value is given by the Service, and it should be studied in detail by anyone having the question of valuation of business interests.

The ruling also covers a number of special cases, the most important being the existence of a buy-sell agreement. Over the past fifteen years the importance of such agreements has grown immensely, in spite of a number of attacks by the Service upon income tax aspects of the matter. These attacks are not ended, the most serious ones presently confronting the taxpayer being the possibility of unreasonable accumulation of surplus so far as corporate income taxes are concerned, and the possible attribution of stock in family-held corporations as to personal income tax effects. Despite these factors, thousands of buy-sell agreements are in existence today and if they comply with the judicial rules of being actual and not sham, and of binding the parties from the date of execution of the agreement rather than merely upon death, the value they fix will be binding upon the taxing authorities for estate tax purposes.

Holding company values are likewise discussed in the ruling, and these have provided a number of valuation cases in the past. The question ordinarily involved is that of discounting the value of the underlying assets to reflect lack of liquidating control, taxable capital gains upon disposition by the holding company and so on. In general, such a discount factor has been recognized in the absence of liquidating control; for examples, see *Laird v. Comm'r*,<sup>11</sup> *Smith Estate*,<sup>12</sup> and *Garrett Estate*.<sup>13</sup>

It may be noted that some relief may be found in this situation by the use of comparatives. There are a number of closed-end investment trusts which are sold over the counter at very substantial discounts from underlying asset value. On the other hand, other trusts of this type sell either at asset value or even a slight premium. The selection of true comparatives in this field is unusually difficult.

As I said a moment ago, the general principles of Revenue Ruling 59-60 are applicable to most business interests. There are, of course,

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<sup>11</sup> 85 F.2d 598, 18 Am. Fed Tax R. 470, 36-2 U.S.T.C. ¶ 9455 (3d Cir., 1936).

<sup>12</sup> 9 CCH Tax Ct. Mem. 907, 19 P.H Tax Ct. Mem. 819 (1950).

<sup>13</sup> 12 CCH Tax Ct. Mem. 1142, 22 P-H Tax Ct. Mem. 1026 (1953).

special factors in the case of non-corporate holdings. Thus, in partnership valuations, there must be considered the effect of the state law as to disposition of assets in the absence of special agreement. Also there is always a question of the effect of the partnership agreement, which often is in substance a buy-sell arrangement between the partners.

The question of good-will values in partnerships has likewise caused substantial litigation, an early case having held that there was no such thing.<sup>14</sup> Later cases have generally applied the ordinary rules for valuation of intangible yield, however.

One question peculiar to non-corporate businesses is the matter of taxes. In valuing corporation stock on the basis of earnings, corporate taxes are subtracted from net earnings in order to arrive at the number of dollars available to the owners. In partnerships these earnings are taxed only in the hands of the owners themselves. There has been a great deal of dispute as to what allowances should be made for this tax burden in evaluating the worth of a partnership interest or a sole proprietorship.

While there is no announced Service policy in connection with this valuation problem, a taxpayer might well treat partnership income as equivalent to corporation income and apply corporate tax rates to determine the after-tax dollars available. Validity of this approach may be questioned, but a good many revenue agents will give it weight as bringing the valuation procedure in such a case into line with the accepted rules on corporation stock values.

This has necessarily been an incomplete and sketchy presentation of an important problem confronting estate planners and administrators alike. I hope it has been of some assistance in pulling together the elementary considerations presently valid in the field.

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<sup>14</sup> Kaffie Estate, 44 B.T.A. 843 (1941).