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Blockage Valuation in Federal Tax Law

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BLOCKAGE VALUATION IN FEDERAL TAX LAW

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Rebecca died at the age of eighty-five. In life she conceived only four children. In death, she gave birth to many more problem children. For, Rebecca was possessed of 58,557 shares of Bridal Nightgown Company common stock, and her flesh and blood progeny owned the other 41,443 shares.

To the Federal Tax Collector, problems of valuation were not new. In fact, his training antedated the stock market crash of 1929, and from personal experience he recalled that sales of a few shares did not guarantee the sale of a large block of shares at the same price. He knew that value is an association of an item of property in terms of money and is a question of fact to be determined from all the circumstances, and that in order to have such value the stock must possess potential, easy and prompt realization. But, alas, he turned to his books, seeking a definition from whence to begin.

GENERAL VALUATION

There he found that the statutes, the tax regulations, and the courts assumed that the phrase "fair market value" possessed a meaning. Yet apparently, attempts to define "value" had been in vain,—or rather successful in establishing that value may mean one thing for one purpose, and quite a different thing for another. For value is a word of many meanings,[1] and if it be taken from its environment, it becomes as a fish out of water—lifeless. Its connotation will differ according to the use, whether it be applied in bankruptcy, condemnation, rate-fixing, accounting or taxation.

"Valuation . . . means the procedure and technique of estimating the value of specific property at a stated time and place." [2] Here our environment is taxation, and for purposes of the Internal Revenue Code, the regulations have attempted to define,[3] albeit obtusely, what is meant by "fair market value."

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1. Mr. Justice Brandeis, in Southwestern Bell Telephone Company v. P. S. C., 262 U. S. 276, 310 (1923).

2. 1 BONBRIGHT, VALUATION OF PROPERTY (1st ed. 1937) 10.

3. Regulations 105, Relating to the Estate Tax, Section 81.10 (1941):

Valuation of Property.

(a) General—The value of every item of property includible in the gross estate is the fair market value thereof at the time of decedent's death; . . . The fair market value is the price at which the property would change hands between

This the regulations do via the hypothetical willing-but-not-obliged-to-buy-purchaser premise.[4] We are further directed to seek the market price or the mean between the highest and the lowest quoted selling prices on the valuation date and to take into consideration all relevant facts and elements of value.

Blockage Valuation

Rebecca died possessed of a block of over 58,000 shares, nearly 60% of the outstanding stock. May the size of the holdings be considered as a relevant fact or element of value? Economically speaking, the laws of supply and demand do realistically affect price. As was proved in 1929, a supply greater than an existing demand will depress the market. Can this principle of elementary economics be applied to the valuation of securities under existing law?

After having twice been declared invalid,[5] the 1934 Regulations expressly prohibiting a discount for blockage were revised,[6] and those

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a willing buyer and a willing seller, neither being under any compulsion to buy or to sell. The fair market value of a particular kind of property includible in the gross estate is not to be determined by a forced sale price. Such value is to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of the property. For example, in the case of shares of stock or bonds, such unit of property is a share or a bond. All relevant facts and elements of value as of the applicable valuation date should be considered in every case.

(b) Real Estate. . . .

(c) Stocks and Bonds.—The value of stocks and bonds, within the meaning of the Internal Revenue Code, is the fair market value per share or bond on the applicable valuation date.

In the case of stocks and bonds listed on a stock exchange, the mean between the highest and lowest quoted selling prices on the valuation date shall be considered as the fair market value per share or bond. . . .

If actual sales or bona fide bid and asked prices are not available, then . . . in the case of shares of stock, upon the basis of the company's net worth, earning power, dividend-paying capacity, and all other relevant factors having a bearing upon the value of the stock. Complete financial and other data upon which the valuation is based should be submitted with the return.

In cases in which it is established that the value per bond or share of any security determined on the basis of selling or bid and asked prices as herein provided does not reflect the fair market value thereof, then some reasonable modification of such basis or other relevant facts and elements of value shall be considered in determining fair market value.

4. This is very nearly the definition of "fair market value" found in Metropolitan Street Railway Co. v. Walsh, 197 Mo. 392, 398, 94 S. W. 860, 861 (1906): "the price which property will bring when it is offered for sale by one who is willing, but who is not obliged, to sell it, and is bought by one who is willing or desires to purchase, but is not compelled to do so." See also Helvering v. Wallbridge, 70 F. (2d) 683 (C. C. A. 2d, 1934), *cert. denied*, 293 U. S. 594 (1934); Tracy v. Comm'r., 53 F. (2d) 575 (C. C. A. 6th, 1931); Doric Apartment Co. v. Comm'r., 94 F. (2d) 895 (C. C. A. 6th. 1938).

5. Helvering v. Safe Deposit & Trust Co., 95 F. (2d) 806 (C. C. A. 4th, 1938), and Comm'r. v. Shattuck, 97 F. (2d) 790 (C. C. A. 7th, 1938).

6. Regulations 80 (1934), Art. 13 (3), read in part:

"In exceptional cases in which it is established by clear and convincing evidence that the value per bond or share of any security determined upon the basis of selling or bid and asked prices as herein provided does not reflect the fair mar-

presently in force now directly permit some reasonable modification of the basis of "mean between bid and asked prices" where it can be shown that market quotations do not show actual fair market value. The rule that the value of a block of stock is conclusively established merely by multiplying the value of one share at the market on the valuation date by the number of shares has been rejected by recent decisions.[7] Further, the courts recognize that a market in which sales of small lots can be accomplished at a specified price may lack the body and breadth necessary to support sales of large blocks of securities at the same unit price.[8] Although no clear rule can be stated it is doubted whether the commission has ever applied the blockage rule to a stockholding representing less than 10% of the stock outstanding. An interesting side-issue is whether several blocks transferred to several persons at substantially the same time can be considered as one block.[9]

In the recent case of *Groff v. Munford,*[10] where a deduction for blockage was allowed, the Circuit Court said, "Estimates of value such as we have discussed are difficult to justify in detail for they involve factors the weight of which is uncertain, but they are more reliable than appraisals made in disregard of the *amount* of stock to be valued."

As was said in *Helvering v. Maytag,*[11] "As well as any controverted question of administrative law may be settled without declara-

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ket value thereof, other relevant facts and elements of value will be considered in determining the fair market value. The size of holdings of any security to be included in the gross estate is not a relevant factor, and will not be considered in such determination."

The latest revision was by T. D. 5351, March 27, 1944.

7. Havemeyer v. U. S., 59 F. Supp. 537 (Ct. of Cl., 1945), where petitioner valued 160,000 shares at $25.00 against market of $28.125 and 20,000 other shares at $22.00 against market of $24.50, and won on both valuations. At page 549, the Court observed, "The Board was right in basing its conclusions upon the realities as it found them rather than upon considerations of abstract logic. It could not ignore the pregnant fact . . . that a large block of stock cannot be marketed and turned into money as readily as a few shares." Comm'r. v. Stewart's Estate, 153 F. (2d) 17 (C. C. A. 3rd, 1946); Colonial Trust Co. v. Kraemer, 63 F. Supp. 866 (D. C. Conn., 1945).

Note: The Commissioner is quick to refuse to follow a "market price" fixed by a few sales when he feels that "intrinsic value" is greater, Walter v. Duffy, 287 F. 41 (C. C. A. 3rd, 1923); S. M. 2522, C. B. Dec. 1924, p. 23; Florence Guggenheim, 39 B. T. A. 251, 117 F. (2d) 469 (C. C. A. 2d, 1941); Safe Deposit and Trust Co. of Baltimore, 35 B. T. A. 259, 95 F. (2d) 806 (C. C. A. 4th, 1938).

8. Richardson v. Comm'r., 151 F. (2d) 102 (C. C. A. 2d, 1945); Rice v. Eisner, 16 F. (2d) 358, 361 (C. C. A. 2d, 1926), *cert. denied,* 273 U. S. 764 (1927). "Any attempt to market so large a quantity would have probably sent down the value far below the prices which prevailed." Phipps v. Comm'r., 127 F. (2d) 214 (C. C. A. 10th, 1942), *cert. denied,* 317 U. S. 645 (1942). Here the petitioner gave away 10,000 shares to thirteen donees on the same day. The court treated this as thirteen separate blocks. *Contra,* Helvering v. Kimberley, 97 F. (2d) 433, 435 (C. C. A. 4th, 1938), where the court said, "It is difficult to believe that the sale of three blocks of 10,000 shares each would have had a different effect from a sale of one block of 30,000 shares. . . ." But *cf.* Sewell L. Avery, 3 T. C. 963 (1944).

9. See note 8 *supra.*

10. 150 F. (2d) 825, 828 (C. C. A. 2d, 1945). The Commissioner had valued 14,000 shares of Electrolux stock at the Montreal exchange rate on the date of the gift, but the Tax Court reduced the valuation by $1.875 per share to $21.50.

11. 125 F. (2d) 55, 63 (C. C. A. 8th, 1942), *cert. denied,* 316 U. S. 689 (1942).

tion by the Supreme Court, it is established that the size of a block of listed stock may be a factor to be considered in its valuation for gift or estate tax purposes."

Even in cases where no reduction in value for blockage is allowed, the courts generally pay dicta tribute to the rule.[12] Those cases that do not allow a reduction for blackage will be found to involve some special element such as rising markets,[13] closely-held stock that shows unusually high earnings,[14] actual trading of shares in quantities greater than the block,[15] or a block that carries with it control of a corporation.[16]

A very serious doubt can be raised as to the soundness of these four positions. They all proceed on the assumption that within a reasonable time after the critical date for valuation the owner is going to be able to receive an amount equal to or greater than the value fixed. But what kind of a valuation is this which uses totally unrelated hindsight to fix a valuation.[17] Compare two owners on January 1, 1946, both facing a rising market. Mr. *A* values his stock at the market $50 for he has only 10 shares. The estate of Mr. *B* attempts to value its stock at $45 because it holds 100,000 shares which the market will not absorb *on the day of death* at $50. In six months there has been a 20% increase. Mr. *A* received a profit of $10 per share. If Mr. *B*'s estate is compelled to accept a valuation of $50 on January 1st and yet cannot sell the stock within the six months for more than $55 ($5 off market) its profit will be limited to $5 rather than $10.

These exceptions and the blockage rule properly raise the question of the possible, and the most sound methods for valuing blocks of securities:

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12. Phipps v. Comm'r., 127 F. (2d) 214 (C. C. A. 10th, 1942), *cert. denied*, 317 U. S. 645 (1942); Robert L. Clause v. Comm'r., 5 T. C. 647 (1945), *aff'd* (C. C. A. 4th, Apr. 18, 1946).

13. Gamble v. Comm'r., 101 F. (2d) 565 (C. C. A. 6th, 1939), *cert. denied*, 306 U. S. 664 (1939). Within four months, the stock had advanced from market of $280. to $350.

14. Allen, 3 T. C. 1224 (1944). The mean between high and low on the date of gift of 10,000 shares was accepted as fair market value.

15. Mott v. Comm'r., 139 F. (2d) 317 (C. C. A. 6th, 1943), involving 100,000 shares of General Motors Corporation stock. In the two following months, 375,000 shares were traded with no depreciation in the market.

16. If the stock to be valued carries with it the control of the corporation, the value at market may be at a premium. Helvering v. Safe Deposit and Trust Co., 95 F. (2d) 806, 812 (1938). A very similar situation arises in the valuation of undivided interests in land, resulting in a depressed value for a minority interest, and an enhanced value for a controlling interest. Estate of Campanari, Tax Court Docket No. 4384, July 23, 1945; Estate of Henry, Tax Court Docket No. 109972, Dec. 7, 1944.

17. The correct use of hindsight is more properly reflected in the Portage Silica Co., 11 B. T. A. 700 (1928), *aff'd.*, 49 F. (2d) 985 (C. C. A. 6th, 1931), *cert. denied*, 284 U. S. 667 (1931), where it was used to demonstrate the unsoundness of theoretical computations of an antecedent date. See also Sinclair Refining Co. v. Jenkins Petroleum Process Co., 289 U. S. 689, 698 (1933), "But a different situation is presented

1. They might be valued at market without modification (if a market exists).[18]
2. At market modified by relevant considerations.[19]
3. At the discount which a recognized brokerage firm would demand to market the securities in view of the breadth and depth of the market.
4. At the present value of the sums which could be realized by sale of the securities over the length of time required for sale in order not to depress the market.[19a]
5. By dividing the assets by the number of shares outstanding [20]
   (a) modified by the income or market record
   (b) unmodified.
6. By capitalization of the earnings of the corporation as is done under A R M 34 to determine 1913 value or the value of good-will.[21]
7. Through "expert" testimony.[22]
8. By prorating the "profit" on a later sale over the period from date of purchase to date of sale, thus arriving at a "value" on the basic date.[23]

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if years have gone by before the evidence is offered. *Experience is then available to correct uncertain prophecy.* Here is a book of wisdom that courts may not neglect. We find no rule of law that sets a clasp upon its pages, and forbids us to look within."

18. It must be recognized that a market "may exist independent of . . . sales," Crowell v. Comm'r., 62 F. (2d) 51, 53 (C. C. A. 6th, 1932).

19. It has been suggested that the use of the word "fair" in the statute bars "exceptional and extraordinary conditions giving an abnormal value for the moment to stock." Strong v. Rogers, 72 F. (2d) 455 (C. C. A. 3rd, 1934), *cert. denied,* 293 U. S. 621 (1934). See also Regulations, *supra* note 3.

19a. Great Northern Ry. Co. v. Weeks, 297 U. S. 135, 140 (1936); Safe Deposit & Trust Co. of Baltimore, 35 B. T. A. 259, 95 F. (2d) 806 (C. C. A. 4th, 1938).

20. Compare the Estate Tax Sections of the Int. Rev. Code and Regulation 105, sec. 81.10, cited *supra* note 3, with Int. Rev. Code § 113 (a) (14) (1939), "In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date." There is a general tendency to reject this as a controlling valuation method. Frank C. Rand, 40 B. T. A. 223 (1939), *aff'd,* 116 F. (2d) 718 (C. C. A. 1st, 1934).

21. See also A. R. R. 252, 3 CUM. BULL. 46 1920); Boyd v. Heiner, 5 A. F. T. R. 6069 (W. D. Pa.); Rheinstrom v. Willcuts, 26 F. Supp. 306 (D. Minn. 1938); and the various Ford stock valuations—12 B. T. A. 755, 12 B. T. A. 916, 12 B. T. A. 956, 12 B. T. A. 935, 12 B. T. A. 1085, 12 B. T. A. 1111, 13 B. T. A. 201, 13 B. T. A. 223 (all decided in 1928).

22. The Commissioner is not bound to accept opinion evidence, Tracy v. Comm'r., 53 F. (2d) 575 (C. C. A. 6th, 1931), but it is admissible and often valuable, Heiner v. Crosby, 24 F. (2d) 191 (C. C. A. 3rd, 1928), and may not be completely rejected, Dempsey Mill Mfg. Co. v. Burnet, 46 F. (2d) 604 (App. D. C. 1931). An exhaustive review of the issue of the weight to be given such opinion evidence will be in Gloyd v. Comm'r., 63 F. (2d) 649 (C. C. A. 8th, 1933), *cert. denied,* 290 U. S. 633 (1938). Note its extensive use in Colonial Trust Co. v. Kraemer, 63 F. Supp. 866 (D. C. Conn., 1945).

23. T. D. 2740, June 24, 1918; T. B. M. 73, 1 C. B. 35 (1919); Hays v. Gauley Mountain Coal Co., 247 U. S. 189 (1918).

CLOSED CORPORATION VALUATION

One of the necessary elements in a fair market is the existence of a willing buyer. Where the stock of a corporation is closely held by a few share-owners, the buyers are usually restricted in number to those few.[24] Hence, the fair market value of a few shares will often bear little resemblance to its book or intrinsic value. It may well be that if the other stockowners are not particularly anxious to increase their holdings, that it will have to be offered at a substantial discount, or be held for sale for such a long period of time awaiting the appearance of a willing buyer, that the owner can no longer be regarded as a "willing" seller. Few people care to buy into a family affair.[25] If "fair market value" is to be the criterion we shall find a difference whether a minority interest or a majority interest [26] is being offered.

In *Richardson v. Commissioner*,[27] thirty-three members of a family owned all 100,000 shares of an investment company. The securities and other assets on the critical day had a fair market value of $9,809,000 but the shares of the family corporation were not listed on any exchange. In determining value, the Tax Court deducted accrued taxes and other expenses, and divided by the number of shares to reach a value of $95.509 per share. Except for a study of corporate earnings and balance sheets, the Tax Court failed to specify which other factors had actually been applied as having had weight and relevance in its determination.

Petitioner argued that no outsider could be found to buy a minority interest (5100 shares) in a family corporation except at a substantial discount from the price based upon the asset value. Other testimony showed that in respect of a group of comparable corporations whose stocks were listed, there was a substantial differential between market value and asset value.[28] On appeal, Judge Hincks, who wrote

24. Cartier v. Comm'r., 37 F. (2d) 894, 895 (C. C. A. 6th, 1930). "Stock in a close corporation is notoriously hard to sell. There is no market except that afforded by the few other stockholders."

25. A. B. C. Dohrmann, 19 B. T. A. 507, 515 (1930).

26. See note 16 *supra*.

27. 151 F. (2d) 102, 103 (C. C. A. 2d, 1945). The second half of the decision involved the unlisted stock. The first half involved 12,487 shares of Vick Chemical Company stock. Sales averaged 4,000 per month, and under 400 per day in the gift year. For the six months preceding the critical date, the price trend was moderately upward. No blockage deduction was allowed, because "the tribunal charged with the task of valuation will not lightly deviate from evidence based on actual sales; only when it is convinced by persuasive evidence that at the critical time the market was such that it could not absorb sales in the larger volume at the price level obtaining for small lots will it conclude that such prices must be discounted in arriving at the fair market value of large blocks."

28. The 1944 amendment to section 81.10 (v) specifically authorizes consideration as a relevant factor the value of securities of corporations engaged in the same or a similar line of business whose securities are listed on an exchange. *Cf.* note 3 *supra* and Int. Rev. Code § 811 (k) (1944 Amend.).

the opinion, expressed the belief that the Tax Judge had applied some personal notion of intrinsic value [29] instead of fair market value, as required by Treasury Department regulations. Feeling that there was substantial doubt as to the proper standards applied in the Tax Court for this valuation, he favored a remand, but was overruled by his brethren on the court.

In *Blackard v. Commissioner*,[30] the same issue was decided, but with the opposite result. The District Court reversed the Tax Court and allowed a 25% deduction in valuing 4,584 shares in a family corporation for estate tax purposes. The opinion rejected a determination of value arrived at by dividing the total value of the gross assets by the number of outstanding shares as being arbitrary, and fixing an excessive value upon the shares. "The method followed was in conflict with the then prevailing regulations of the Bureau of Internal Revenue as promulgated by the Secretary of Treasure." [31]

The use of the words "fair market value" when applied to closely held stock is meaningless. Because there is no market to guide, such stock must be appraised in some other way. Other factors such as trend of business, earnings, book value, blockage, minority or controlling interest, and intrinsic worth are material. However, care must be exercised in closely held stock to distinguish intrinsic value from clear market value, as the two are easily confused.[32] Interfamily transactions merit little if any weight in determining fair value.[33] Value determined by capitalizing the average earnings over a five year period has been considered merely evidentiary, and if this formula is used to the exclusion of any other evidence, the valuation may be held erroneous as a matter of law.[34]

Restrictive Covenants

Restrictive covenants are of many varieties and have widely varying effects on stock valuation. They may make a sale impossible [35] and render the value practically *nil* or show that the stock has no "fair

29. The Tax Court judge deplored the use of family holding companies to deal in securities for the owners as a device to avoid taxes. He felt that the only real or practical way to value such an investment company was "by primarily considering the value of the securities owned by the corporation. Any other approach would . . . be futile." 151 F. (2d) 102, 105.

30. 62 F. Supp. 234 (W. D. Okla., 1944).

31. *Ibid.* at page 237. See also Colonial Trust Co. v. Kraemer, 63 F. Supp. 866 (D. C. Conn., 1945).

32. A. B. C. Dohrmann, 19 B. T. A. 507 (1930).

33. True v. U. S., 51 F. Supp. 720, 726 (1943).

34. A. R. M. 34 was the formula used to determine the value of a business on March 1, 1913, and it is still used to determine the value of intangibles such as good will, special skill, or business "know how." Worcester County Trust Co. v. Comm'r., R., 134 F. (2d) 578 (C. C. A. 1st, 1943).

35. Helvering v. Tex-Penn Oil Co., 300 U. S. 481 (1937).

market value." [36] Few covenants will affect value in the same way. One may operate to the advantage of both the seller and purchaser, to maintain the market or enhance the market value.[37] Another may merely give a certain person a first opportunity to purchase without any substantial effect on value,[38] or the restriction may be as to the length of time within which no sale may be made, where the courts have attempted a rather arbitrary distinction between limitations of more or less than a year.[39] But it is not with this type of restrictive covenant that we are concerned—we shall instead examine the covenants which mention or attempt to set a price. What affect on valuation do these have?

These covenants may be either ineffective, partially effective, or fully effective to establish a value for the stock. In determining into which of the three above categories a covenant falls, the courts attempt to discover the actual interest that is being transferred. The test does not appear to be "specific enforceability of the restriction," as some courts have decided.[40]

The test seems to be the converse of the rule which tests the taxability of a pre-death trust in the decedent's estate. Thereunder there is included in the gross estate of a decedent the value of any trust which he established during life over which at the date of death he possessed a power to alter, amend, revoke or terminate. If the decedent had some beneficial interest, his estate paid a tax. The test for the restrictive covenant which is fully effective in establishing its stipulated value as the value of the stock is: Does someone have a vested adverse interest in the stock, effective during decedent's lifetime, so that the value of the property is not affected by death? Did the owner sur-

36. Propper v. Comm'r., 89 F. (2d) 617 (C. C. A. 2d, 1937); U. S. v. State Street Trust Co., 124 F. (2d) 948 (C. C. A. 1st, 1942).

37. G. & K. Mfg. Co. v. Comm'r., 76 F. (2d) 454 (C. C. A. 4th, 1935). If a covenant provides that the stock can only be paid for out of dividends, its value is actually far greater than that stated on its face, or that listed as book value, even though a second covenant requires that the stock be resold to the corporation at book value if employment in the concern ceases. Behles v. Comm'r., 87 F. (2d) 228 (C. C. A. 7th, 1937).

38. Jay v. Darling, 4 B. T. A. 499 (1926).

39. T. W. Henritze, 28 B. T. A. 1173 (1933); Heiner v. Gwinner, 114 F. (2d) 723 (C. C. A. 2d, 1940). See Goldwasser v. Comm'r., 47 B. T. A. 445 (1942), *aff'd.*, 142 F. (2d) 556 (C. C. A. 2d, 1944), where taxpayer could make *no* offering but must hold it as investment.

40. Wilson v. Bowers, 57 F. (2d) 682 (C. C. A. 2d, 1932), and Lomb v. Sugden, 82 F. (2d) 166 (C. C. A. 2d, 1936). Stockholders agreed that transfer of shares was forbidden without first offering it to other stockholders at a price about 30% less than market at the date of decedent's death. It was held that the taxable value of the stock was limited by this contract since it was specifically enforceable. The value of the stock to the estate could be no greater than that with which the deceased parted.

But the courts have been extremely reluctant of late to follow these two cases, and generally find some ground for distinguishing. See Krauss v. U. S., 140 F. (2d) 510 (C. C. A. 5th, 1944).

render a part of his legal rights or present interest in the stock? [41] If he did, the restrictive covenant will be fully effective in establishing a value for the stock.[42] Because few owners care to restrict their ownership to this extent, such covenants appear quite rarely.

The mass of litigation concerns the other two types—the partially effective, and the ineffective covenants. These two types are worded quite similarly, but whether or not the covenant determines value seems to depend upon whether the transferor is a donor or a testator. If he is a donor, and his stock is subject to an option at a fixed or determinable price, the Commissioner generally allows a reasonable discount in value for the effect of the restriction,[43] but he is not bound by it.[44] It the estate tax is involved, however, the general rule is that the stock must be included at its full value in the tax return; the difference in price between the option and market is a legacy to the optionee.[45]

Although covenants do not often establish a value so far as the estate is concerned, they do fix a value upon the stock for the optionee. In *Mack v. Commissioner* [46] the taxpayer acquired stock under an option in the will of his father at a price equal to one-half of its actual

41. Estate of Matthews, 3 T. C. 525, 528 (1944).

42. Comm'r. v. Bensel, 100 F. (2d) 639 (C. C. A. 3d, 1938), where decedent agreed with his son that his estate would sell stock at son's option if the son would continue in his executive position in the father's corporation during the latter's lifetime.

See also: Helvering v. Tex-Penn Oil Co., 300 U. S. 481 (1937), where the covenant operated to prevent a sale: Helvering v. Salvage, 297 U. S. 106 (1936), holding that the value to the optionee at the time of acquisition is the option price, not the fair market value.

43. James v. Comm'r., 148 F. (2d) 236 (C. C. A. 2d, 1945). Petitioner gave his son 100 shares in a closely held corporation which were subject to the stockholder's agreement that they could not be transferred unless they were first offered to the stockholders at $200 per share. The book value at the time of the gift was $385.05 per share. The Commissioner made an allowance for the covenant by valuing it at $310.00.

Raymond J. Moore, 3 T. C. 1205 (1944). Donee could not dispose of stock without first offering it to the directors of the corporation in their individual capacity, then to the stockholders at the adjusted book value. All gave consent to the trust. In view of the high earnings of the corporation, the court felt that the Commissioner had allowed a sufficient deduction for the restrictive effect of the agreement.

Estate of James Smith, 46 B. T. A. 337 (1942).

44. Kline v. Comm'r., 130 F. (2d) 742 (C. C. A. 3d, 1942). Two covenants were involved. The first prevented sale without the consent of the company. The second subjected the stock to a one year option to purchase at 33⅓% to 75% of book value if the owner left the employ of the company. The gift was approved, and petitioner valued at 33⅓%. The Commissioner chose 75% of book plus surplus earnings available on the stock. The Commissioner's determination was upheld.

45. The Cem Securities Corp. v. U. S., 102 Ct. Cl. 86 (1944). An option to purchase 1000 shares at $10 when market was $22.75 per share amounts to a combination promise to sell and a promise to make a gift of $12,750.

Estate of Matthews, 3 T. C. 525 (1944). Decedent and a business associate agreed that the survivor should have an option to purchase all the stock of the deceased at $90.00 per share if purchased within three months of death. Both parties were free to dispose of stock during life. Fair market value for estate tax purposes was held to be $120.00 and not the option price.

Claire G. Hoffman, 2 T. C. 1160 (1943). The difference between the option price and market is a legacy.

46. 148 F. (2d) 62 (C. C. A. 3d, 1945).

market value. When the optionee decided to sell the stock, he could not include the value of his option in his base to determine his capital gain, although the estate may have paid a tax upon its value as a legacy. The basis of the stock was held to be the amount which he actually paid. Hence, as the law now stands, such an option is subject to double taxation, once under the estate tax as a legacy, and a second time under the income tax as a capital gain.[47]

Tax Practice

When an appeal is made from the valuation set by the Commissioner, the courts are wont to notice the subsequent history of the stock. The Electrolux shares in the *Groff v. Munford*[48] case had dropped to $22.00 per share at the end of the third month following the gift. The Tax Court is not obliged to close its mind to subsequent facts which demonstrate the correctness of the Commissioner's determination.[49] It can be argued, of course, that events subsequent to the critical date should have no effect upon taxable value. Actually, this "hindsight" is not used to *establish* a value, but is used merely as *evidence to prove that a valuation chosen on a certain date was correct.* To this practice there can be no real objection, not only because it proves that no real mistake was made, but also because it may often inure to the taxpayer's benefit. If the stock drops in price, he can introduce into evidence the lower rates of subsequent months to prove that the Commissioner valued too high.

This was done in the *Avery* case[50] to obtain a lower valuation than the market on the day of a gift of Montgomery Ward Company stock. The Tax Court studied the quotations on this stock not only for the entire month of the gift, but for the two succeeding months as well, to conclude that a fair valuation was $36.50 per share instead of $37.50 as claimed by the Commissioner.

The tax lawyer should marshal his strongest case for the Tax Court, for here is his best chance to overrule the Commissioner. Generally speaking, the Government is no more anxious to litigate than is the taxpayer. But if the case does go to the Tax Court, the likeli-

47. Despite § 113 (a) (5) of 26 U. S. C. A.

48. 150 F. (2d) 825 (C. C. A. 2d, 1945), cited *supra* note 10.

49. Mott v. Comm'r., 139 F. (2d) 317 (C. C. A. 6th, 1943).

50. Sewell L. Avery, 3 T. C. 963 (1944). Four gifts of 6,500 shares of M. W. and 4,000 shares of U. S. Gypsum were made on Dec. 31. For January and February following, the M. W. Co. stock varied between 35¼ and 39½, while the U. S. Gypsum varied between 60 and 69½. The Tax Court determined that 36½ and 64½ were respectively the fair market values. The court took note of a disposal of 4,700 shares of U. S. Gypsum two years later, which was effected without depressing the market. Similarly, a secondary distribution of Ward stock a year after the gift brought $37.50 per share to the vendors, when market was $39.00.

hood that its decision will be accepted is great. Unless the Commissioner feels that the Tax Court is clearly in error, he will not appeal further, for appeals from the Tax Court have not been fruitful. The Circuit Courts constantly emphasize that the determination of the Tax Court is not subject to review if supported by some substantial evidence.[51] In fact, the statute provides that the Tax Court may be reversed only on the law.[52]

The question of value is a question of fact. But the decision may involve one of law.[53] While the Circuit Court may not challenge facts found by the Tax Court if supported by some substantial evidence, the determination of the rule or standard of valuation to be applied, raises a question of law which is reviewable by the higher court.[54] But ordinarily, weighing the evidence, determining its probative value, and drawing inferences therefrom is peculiarly and exclusively the function of the Tax Court. [55]

The general rule is that the burden of showing that there is an overassessment is on the taxpayer.[56] Hence he must make out a case to show that the Commissioner's determination is invalid, but he is not required to establish by evidence the correct amount.[57] However, the same evidence that indicates that the Commissioner had overvalued will generally affirmatively show the correct value.

In the rare case where the Commissioner values stock above market rate, is this rule as to burden of proof changed? It can be argued that since the regulations require market rate where available, the burden of proof should fall upon the party who wishes to modify

51. Helvering v. Maytag, 125 F. (2d) 55 (C. C. A. 8th, 1942). Here trading was "continuous" and the amounts of stock changing hands "substantial," but there were no trades involving 133,000 or 400,000 shares. The Court affirmed the determinations of the Board of Tax Appeals at $3.10 and $3.80 per share against the Commissioner and market of $4.75 and $4.56 per share. The Circuit Court made no attempt to answer the skilled arguments on behalf of the government, contenting itself to cite sixteen cases in the various circuits in support of its decision.

52. Int. Rev. Code § 1141 (c) (1) (1939); John Kelly v. Comm'r., 66 S. Ct. 299 (1946); Dobson v. Comm'r., 320 U. S. 489 (1943).

53. Powers v. Comm'r., 312 U. S. 259 (1941).

54. Comm'r. v. McCann, 146 F. (2d) 385, 386 (C. C. A. 2d, 1944). "We say nothing as to how the shares shall be appraised; that is, the Tax Court's duty, from any interference in which we must rigidly abstain. It may come to the same conclusions after weighing all the relevant factors." As a matter of law here, the evidence did not support the findings, because the lower court failed to weigh these relevant factors: (a) The average dividend of 12% for the nine preceding years; (b) The taxpayer owned two-thirds of the stock, and could therefore change the by-laws containing the restrictive covenant at will; (c) The prospective earnings of the corporation; (d) The life expectancy of the donor, since the gift was to his wife.

55. Zanuck v. Comm'r., 149 F. (2d) 714 (C. C. A. 9th, 1945). Petitioner urged that the Tax Court had failed to give sufficient weight to the evidence showing the war's effect upon the corporation's extensive foreign holdings, or to the effect of its current labor troubles. Here there was a gift of 30,000 shares of Twentieth Century-Fox Film Corp. stock in trust to three children. No argument was made for applying the blockage rule. Market rate prevailed.

56. Helvering v. Taylor, 293 U. S. 507, 514 (1935).

57. Worcester County Trust Co. v. Comm'r., 134 F. (2d) 578 (C. C. A. 1st, 1943).

the market rate. In *Estate of Spencer v. Commissioner,*[58] the court refused to expressly deny the presumption of correctness of the Commissioner's valuation, but it did say that if the Commissioner was to choose any value other than market rate, that he should show the other relevant facts and elements that affected value. This he had not done, so the Tax Court in effect sustained petitioner's contention by valuing at market.

Conclusion

The Internal Revenue Code, the Regulations and the Courts seek to apply a primarily objective test of value. They seek facts, but facts can never be completely divorced from opinion. Obviously, no test can be completely objective, because buyers and sellers in any market make subjective tests of value before trading. The most objective test of all, namely, actual market rate, is nothing less than a series of individual subjective estimates by those who do trade.

The normal way of showing value is by evidence of actual sales upon a free and open market. It is also well settled that value may be shown by the opinion of any competent person having knowledge of the facts, whether an expert or an ordinary witness,[59] though the tendency is to treat this as secondary evidence because subjective. If expert, they should testify in blockage cases to the result of a skillful liquidation of the block over a reasonable time, and not to the result to be expected from a liquidation to be accomplished in ten days.[60] Too, the courts seem to prefer opinion evidence based upon good business sense to the use of formulas, although the use of a formula capitalizing earnings is permissible as a factor to be considered along with other evidence in arriving at a value.[61]

In the blockage field, the rationale of economics is permitted to temper a determination of value, because otherwise, the application of a purely objective test becomes arbitrary, and, for closely held stock, objective evidence is difficult to obtain. Tax Commissioners are unwilling to accept par or book value, especially where the corporate earnings record belies such figures. They then attempt to capitalize earnings and to apply some test such as A. R. M. 34. Finally, in the field of restrictive covenants, although the stock itself may be valued objectively by market in some instances, the restriction must be analyzed, and a subjective estimate of its effect upon the value of the stock must be made.

58. Tax Court Docket No. 2254, Oct. 12, 1945.
59. Montana Railway Company v. Warren, 137 U. S. 348, 353 (1890).
60. Richardson v. Comm'r., 151 F. (2d) 102 (C. C. A. 2d, 1945).
61. White & Wells Co. v. Comm'r., 50 F. (2d) 120 (C. C. A. 2d, 1931); Robertson v. Routzahn, 75 F. (2d) 537 (C. C. A. 6th, 1935); Estate of James Smith, 46 B. T. A. 337 (1942). Average return for five years is capitalized usually at 10%, but often at 15%, and sometimes at 20%, if the business is speculative.

Although there may be some *logic* in such positions as that valuing large blocks at a lesser price per unit than small holdings will benefit the rich [62] and that if the market rises no reduction for blockage should be allowed, these would seem to have no justification under our tax plan. The statute already taxes large estates at higher rates than lesser estates. Any further adjustment necessary should be made through these rates—not by torturing concepts of valuation. It must be remembered that valuation comes into the picture solely to determine how large the estate is *on the date of death* or the gift at the date of gift.

Ultimately, the best criterion for measuring value probably lies in an analysis such as a prudent investor would require of an experienced broker. This might call for a revision of existing regulations to permit a freer exercise of discretion by the tax assessor. Evidentially this should require consideration of all the factors already outlined, with emphasis on the methods by which the stock could in fact be disposed of.

62. Bingham's Adm. v. Commonwealth, 196 Ky. 318, 244 S. W. 781 (1922), *aff'd.*, 199 Ky. 402, 251 S. W. 986 (1923); Helvering v. Maytag, 125 F. (2d) 55 (C. C. A. 8th, 1942).