Valuation of Stock in a Close Corporation for Estate Tax and Gift Purposes

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not agreed upon a common approach. The one block theory, however, represents the sounder view. From a legal viewpoint, the determination is of the gift tax liability of the donor, and his position and not that of the donees should control. From a practical viewpoint, a disposition as of a given date of several blocks of the same stock would appear to create the same effect upon the market as a disposition of one block involving an identical number of shares. In either event, special marketing arrangements would be required if the market could not absorb by the normal method of sale the number of shares involved.

III

VALUATION OF STOCK IN A CLOSE CORPORATION FOR ESTATE TAX AND GIFT TAX PURPOSES

John J. Conway

INTRODUCTION

For purposes of the federal estate tax it is necessary to determine the value of various types of assets owned by the decedent at the time of his death. It is also necessary in the case of a gift to determine the value of various kinds of assets as of the date of the gift. As in the case of death, so in the case of inter vivos transfers, the federal government imposes an excise tax upon the value of the property transferred. It is evident that the determination of the amount of the federal estate tax or federal gift tax resulting from the transfer of property inter vivos or at death requires a determination of value before application of the tax rates.

In many cases the value placed on property transferred is more determinative of the amount of the federal gift or estate tax than the rates of tax imposed upon the transfer. Equality of tax for all taxpayers is generally not the result, for valuation truly is a matter of opinion and represents a dollar value which cannot be reduced to a formula by the Internal Revenue Code nor the courts. The most striking example of dif-

40. See Phipps v. Commissioner, 127 F.2d 214 (10th Cir. 1942); Commissioner v. Shatruck, 97 F.2d 790 (7th Cir. 1938); Helvering v. Kimberly, 97 F.2d 433 (4th Cir. 1938); Phillips v. Tomlinson, 62-2 U.S. Tax. Cas. 912093 (S.D. Fla. 1962); Havemeyer v. United States, 103 Ct. Cl. 564, 59 F. Supp. 537, 548 (1945); Thomas A. Standish, 8 T.C. 1204 (1947).
41. For estate tax purposes, a block of stock bequeathed to a number of legatees certainly would not be valued as though it consisted of several independent blocks, and the analogy lends support to the one block theory in the gift tax situation.
ferences in dollar value of property is found in the valuation of closely-held stock.

The valuation of stock in a closely-held corporation generally presents a complex problem both to the taxpayer and to the Treasury Department. In the typical case the stock of the corporation from the date of its inception has been owned by a family group. No sales have been made of the stock, nor are any such sales contemplated within the foreseeable future.

To determine the value of shares of stock in any closely-held corporation, some acceptable procedure must be developed. The procedure must evidence particular facts and logical economic conclusions in order to support a value which by definition will not be tested by the willing buyer and the willing seller. In other words, in a given valuation of closely-held stock neither the Treasury nor the taxpayer will be in the position to verify value by pointing to a sale of like property between disinterested persons at a date near or contemporaneous with the valuation date of the subject property. It therefore follows that the proof of value will be solely dependent upon the soundness and logic of the economic procedure of valuation.

This article is limited to a discussion of the procedural method of valuing closely-held stock in a corporation whose income results from the production or sale of inventory property. The author has dispensed with a discussion of the valuation of stock in that kind of closely-held company which he chooses to call an asset-holding company, that is, a corporate entity whose major or sole function is the holding of investment property consisting of stocks, bonds, or real estate. The reason for this is that the valuation approach to the corporation deriving income from the manufacture or sale of inventory products is decidedly different from the valuation of an asset-holding corporation.

In section 2031 of the Internal Revenue Code of 1954, Congress legislated on the valuation of closely-held stock. Subsection (b) of section 2031 provides:

Valuation of Unlisted Stock and Securities. In the case of stock and securities of a corporation the value of which, by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with references to sales prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or similar line of business which are listed on an exchange.4

1. INT. REV. CODE OF 1954, § 2031 [hereinafter cited as CODE §].
2. CODE § 2503.
4. CODE § 2031(b).
The Internal Revenue Service has expanded and elaborated on the considerations necessary for purposes of valuing stock in closely-held corporations. District courts, tax courts, courts of appeal, and the Supreme Court have decided numerous valuation cases involving the value of closely-held stock, and the reporting of these decisions would involve at least a two-volume edition. Study of these materials would reveal that the factors considered for the proper determination of the value of closely-held stock are many and varied.

As a former tax attorney for the Treasury Department and as a representative of the taxpayer, the author's experience in regard to the valuation of closely-held stock has strongly indicated that there are certain prime valuation factors which must be considered in all valuations of closely-held stock. It is also his experience that these prime valuation factors will be the primary determinants of the resultant value of any closely-held stock. These primary valuation factors are book value, current earnings per share, five previous years of earnings per share, and current dividend-paying capacity. Further, if any one factor is the most determinative of the value of closely-held stock, it is current earnings per share.

For a moment it might appear that we have discarded many other valuation factors considered by the Internal Revenue Service and by the courts. These valuation factors would include such considerations as: (1) the nature of the business and the history of the enterprise from its inception; (2) the economic outlook, in general, and the condition and outlook of the specific industry, in particular; (3) the presence or absence of good will or other intangible value of the enterprise; and (4) the market price of stocks of corporations engaged in the same or a similar line of business, which stocks are actively traded in a free and open market, either on an exchange or over-the-counter. To the contrary, these valuation factors will be essential for purposes of determining the value of the closely-held stock.

**Current Earnings — The Prime Valuation Factor**

A proper valuation requires that one segregate his valuation tools and apply them in accordance with logical economic valuation procedure. Basically, the prime valuation factor is current earnings. However, these current earnings must be translated into value of stock. To translate earnings into value, they must be capitalized. The capitalization of earnings may range from twenty per cent to four per cent, *i.e.*, the closely-held stock may have a value ranging from five times current earnings to

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twenty-five times current earnings. In the selection of the capitalization rate to be placed on current earnings, all of the previously mentioned valuation factors are utilized. For purposes of determining the proper capitalization factor of current earnings, detailed consideration must be given to all economic factors which affect the closely-held corporation. These factors must be considered on a current as well as a historical basis. Prior earnings are a guide to projected future earnings.

The value of closely-held stock is generally presumed to be never less than its book value. Any valuation, which must necessarily be founded on current earnings, must demonstrate unusual economic circumstances to reflect a closely-held value at less than current book value. In any given valuation of closely-held stock, it will generally be necessary to determine a value in excess of book value. At some point during the course of the valuation, the critical decision must be made as to how much in excess of book value the closely-held stock is worth. This decision will be made primarily on the basis of the capitalization of current earnings. The capitalization factor selected will result from logical economic study. The determination of whether the current earnings should be capitalized at twenty per cent or four per cent or be multiplied by five or twenty-five will be made on the basis of a consideration of all factors, including the corporation's financial history, the product history of the corporation, the comparisons of similar companies, and the comparisons of possible competitive investments.

Valuation by Comparison with Value of Stocks Listed on an Exchange

A comparative corporation, whether it is listed on an exchange or traded in the over-the-counter market, will be examined to determine at what rate the public capitalizes current earnings in the purchase of similar stocks. Necessarily, valuation judgment must be applied to the capitalization factor obtained from comparative companies, mindful that the comparative company has an established market place for its stock. In other words, a listed comparative company has a value built into its security because it does have a market place. It also may have a value built into its security by the speculator.

It is necessary in the valuation of closely-held stocks to consider, but not necessarily adopt, the capitalization rate of earnings of comparable listed and over-the-counter securities. In the use of the capitalization rate of such securities, one must remove from that rate the value of the mar-

ket place and the value placed on all listed securities at given times by
the speculator. This effect of the speculator’s values in the market place
was recognized in Strong v. Rogers.\textsuperscript{11} The court, in reducing the value
of stock listed and traded on the New York Stock Exchange from the
traded price of approximately one-hundred eight dollars a share to a de-
termined value of sixty-five dollars a share, stated:

It appears that at the time the market was greatly affected by the
presence of thousands of unskilled and unreasoning buyers and sellers
who entered the market in ignorance of the true facts, underlying values
and purely for the purpose of speculation. It is true that the stock
market undoubtedly has at all times been affected to some extent by
the presence of such reckless buyers and sellers; but in normal times
their presence is not in sufficient numbers to produce such wild and
unreasonable prices as obtained in the years 1927, 28 and 29. During
this entire period the prices generally as well as the prices of the stocks
in question did not show sufficient earnings behind them to warrant the
marked quotations.\textsuperscript{12}

In the past year the new issue market in over-the-counter securities
revealed strong speculative forces at work. It is evident that many of
these new issues have sold at prices unsupported by the assets behind the
stock and unsupported by their earning power. It would therefore appear
that the valuation of closely-held stock by reference to the securities of
comparable businesses selling in the over-the-counter or listed market re-
quires economic study and economic logic not afforded by simple com-
parative methods. In given speculative periods, a proper valuation of a
closely-held stock might truly require that comparable listed securities be
ignored because of the speculative forces present in the market place.
In any event, it does require that any comparable figures be adjusted to
remove the known speculative factor existing in the market at any given
time, which speculative factor has no relationship to the assets or the
earning power of the corporation.

OTHER VALUATION FACTORS

In most situations, valuation of the closely-held corporation must be
accomplished by selection of a capitalization rate which is generally re-
lated to the economic facts of business generally, not necessarily the eco-
nomic facts which exist in a stock market at a given inflationary and
speculative time.

The question presented is simply what would a willing buyer pay for
stock in a specific closely-held corporation with full knowledge of its
product, its financial history, its current earning power, its probable future

\textsuperscript{11} Strong v. Rogers, 14 Am. Fed. Tax R. 1207 (D. N.J. 1933), \textit{aff’d}, 72 F.2d 455 (3d
Cir.), \textit{cert. denied}, 293 U.S. 621 (1934).
\textsuperscript{12} \textit{Id.} at 1224.