Case Western Reserve Law Review

Volume 14 | Issue 2

1963

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Recommended Citation

John H. Butala Jr., *Valuation of Securities of Closely-Held Corporations*, 14 W. Res. L. Rev. 193 (1963)
Available at: https://scholarlycommons.law.case.edu/caselrev/vol14/iss2/9

earning power, and its current competitive position in its product field. In most situations, one will find that this valuation factor will range from five times current earnings to fifteen times current earnings. Generally one will find that no possible speculative force exists, as might exist in the stock market, to warrant a capitalization of current earnings at factors of twenty to thirty times current earnings. One will also generally find that, except in the most unusual circumstances, no logical economic explanations exist to justify a capitalization of current earnings at less than five times.

CONCLUSION

The determination of a value of closely-held stock which will be realistic to the taxpayer and convincing to the Treasury Department and the courts will evidence particular elements which must include the following: (1) a sound economic judgment based upon the particular facts of the closely-held corporation being valued, with special emphasis on the current earnings; (2) a value based upon comparison of the costs of similar investments, not necessarily a comparison of the stock market value of securities in a related industry; and (3) a value that evidences sound economic judgment, showing particularly that the valuation is of a business that requires a value determined by opinion and therefore cannot be established by a formula found or developed from the trading price of stock in the New York Stock Exchange, the American Stock Exchange, and the over-the-counter markets for securities. Experience has shown that a value of closely-held stock so determined will be fair, reasonable, and realistic.

IV

VALUATION OF SECURITIES OF CLOSELY-HELD CORPORATIONS

John H. Butala, Jr.

A broad discussion of the various factors involved in the valuation of closely-held stock is contained in the previous article.[1] The present article will focus the discussion on three specific and troublesome aspects of the problem. These are: (1) the valuation approach with respect to stock of a closely-held asset-holding company; (2) the effect of voting

1. Conway, *Valuation of Stock in a Close Corporation for Estate Tax and Gift Tax Purposes*, *supra* at 188.

control in the valuation concept; and (3) the amount of discount, if any, which should be allowed to reflect lack of marketability.

VALUATION OF ASSET-HOLDING COMPANY STOCK

In the context of this discussion, the term "asset-holding company" designates a company whose only function is to hold title to investment type assets. It is to be contrasted with an "operating company" whose primary function is the manufacture or sale of products or services.

In what manner should the stock of an asset-holding company be valued? Should the valuation be determined by the traditional method in which primary emphasis is given to the capitalization of earnings, or is a more accurate valuation obtained by basing the fair market value on the value of the underlying assets of the company? If the value of the underlying assets is considered to be controlling, should any discount be allowed from such net asset value?[2] The courts have not adopted a consistent approach. As might be expected, however, the Internal Revenue Service has. Its attitude is expressed in Revenue Ruling 59-60[3] in an expertly worded statement which lucidly, although argumentatively, sets forth the Service's opinion as to the proper approach, while avoiding a head-on contradiction of statements contained in numerous court decisions. The value of stock of an asset-holding company, one is told, is "closely related to the value of the assets underlying the stock," and "adjusted net worth"[4] should be given greater weight than any other factor. An unmistakable inference is to be drawn, although the language stops just short of saying so, that there is no need to capitalize the earnings of the company because this has already been done in arriving at the fair market value of the underlying assets. The ruling states that one may consider two adjustments to the net asset value: the operating expenses

2. The term "net asset value" represents the fair market value of the underlying assets of the company less its liabilities and preferred stock. The term differs from "book value" in that the latter is computed by taking assets at their cost prices on the company's books rather than at their fair market values.

3. 1959-1 CUM. BULL. 237: "The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity."

4. "Adjusted net worth," as used in the ruling, is the same as net asset value. For a definition of "net asset value," see note 2 *supra*.

of the company[5] and the costs of liquidating the company. There is, however, no indication whatsoever that any percentage discount from net asset value should be allowed to reflect the indirect ownership of the assets.

Curiously, in two recent court cases, both decided after publication of Revenue Ruling 59-60,[6] the Service produced expert witnesses who testified that a percentage discount was appropriate. In *Paulina DuPont Dean*[7] the Service's expert witness testified that a discount of twenty-five per cent should be allowed, and the Service conceded the propriety of a discount. In *Drybrough v. United States*[8] the parties appear to have agreed to a valuation approach consisting of the determination of underlying net asset value and the subtraction of a discount from such value. The Service's witness testified that a twenty per cent discount was proper. Despite the Commissioner's argument on brief that no discount should be allowed (which surely must have been half-hearted), the court determined that a thirty-five per cent discount should be allowed. It is perhaps more of a hope than a logical inference to conclude that these two cases signal a softening of the Service's attitude in the future.

What may the litigant expect if he decides to press the valuation issue beyond the administrative level? Despite the fortunate experiences encountered by the taxpayer in the *Dean*[9] and *Drybrough*[10] cases, the litigant may expect the Service to maintain its insistence that net asset value without discount controls fair market value, although it will profess to have considered all factors. However, the courts will probably not adopt this approach. On the following pages[11] is a tabulation of all of the asset-holding company valuation cases which the author could find. In each case, the fair market value ultimately found by the court has been expressed in terms of a discount from underlying net asset value. The tabulation should not be taken as suggesting that all of the cases proceeded in this manner, *i.e.*, to determine net asset value and then to allow a discount from that value. On the contrary, a variety of approaches was involved, and, as a matter of fact, the aggregation of cases may be cited for the proposition that in most instances net asset value will not be considered controlling. The most consistent approach has been a general one, *i.e.*, a generalized discussion of earnings, dividends, and net worth, much the same as though the valuation of stock of an operating company were involved. This approach appears to have been molded by a desire

5. It is clear from the context of the statement that such operating expenses do not include the corporate income tax.
6. 1959-1 CUM. BULL. 237.
7. 29 P-H Tax Ct. Mem. 314 (1960).
8. 208 F. Supp. 279 (W.D. Ky. 1962).
9. 29 P.H. Tax Ct. Mem. 314 (1960).
10. 208 F. Supp. 279 (W.D. Ky. 1962).
11. At 196-99 *infra*.

DISCOUNTS ALLOWED FROM NET ASSET VALUE OF CORPORATE ASSETS IN DETERMINING THE FAIR MARKET VALUE OF CLOSELY-HELD SECURITIES

	Company and Nature of Assets	*Shares Owned*	*Total Shares*	*Net Asset Value Per Share*	*Value Per Court Per Share*	*% Discount*
Cases in Which Net Asset Value Controlled						
Estate of Joseph E. Goar 19 P-H Tax Ct. Mem. 795 (1950).	*Goar Corp.* (securities, including closely-held stock)	100	250	$ 2,547.35	$ 2,547.35	-0-
Estate of Frank A. Cruikshank 9 T.C. 162 (1947).	*Cruikshank Investment Co.* (securities and real estate)	547	2,079	224.51	224.51	-0-
Richard v. Commissioner 151 F.2d 102 (2d Cir. 1945).	*Piedmont Financial Co.* (marketable securities)	5,100	100,000	95.509	95.509	-0-
Bank of Cal. v. Commissioner 133 F.2d 428 (9th Cir. 1943).	*Oakburn Company* (securities and real estate)	1,295	7,700	179.46	179.46	-0-
Cases in Which a Discount From Net Asset Value Was Allowed						
Mary A. B. du Pont Laird 38 B.T.A. 926 (1938).	*Christiana Securities Co.* (shrs. of Dupont and Atlas Powder)	1,000	150,000	1,760.60	1,000.00	43.2
	Delaware Co. (shrs. of Dupont, Atlas Powder, & Hercules Powder)	250	8,000	15,066.51	8,500.00	43.59
First Trust Co. v. Landy 38-2 U.S. Tax Cas. ¶ 9442 (D. Minn. 1938)	*William Lindeke Land Co.* (commercial real estate)	774	2,000 (Gov't) (Estate)	123.58 83.83	80.00	35.3 4.6
Estate of Harold H. Brittingham 11 P-H B.T.A.-Tax Ct. Mem. 155 (1942).	*Lumber Industries, Inc.* (closely-held lumber companies and marketable securities)	668 2/3	3,500	665.23	625.00	6.1

	Company and Nature of Assets		Shares Owned	Total Shares	Net Asset Value Per Share	Value Per Court Per Share	% Discount
Wishon v. Anglim 42 F. Supp. 359 (N.D. Cal. 1941).	*Wishon-Watson Co.* (securities and farm real estate)	(1) (2)	250 250	1,000 1,000	838.36 1,023.95	548.23 678.55	30.31 33.7
Forbes v. Hassett 124 F.2d 925 (1st Cir. 1942).	*North Vancouver Land & Impr. Co.* (Canadian real estate)		2,250	10,705	7.46	6.34	15.
Blackard v. Jones 62 F. Supp. 234 (W.D. Okla. 1944).	*Chestnut Securities Co.* (marketable securities)		4,584	19,500	122.51	91.89	25.
Colonial Trust Co. v. Kraemer 63 F. Supp. 866 (D. Conn. 1945).	*J. H. Whittemore & Co.* (securities, real estate)	(1) (2)	720 20	1,580 1,580	* 1,636.82 * 1,485.15 * Book Value	1,000.00 1,000.00	38.9 32.7
Emma Clarke Baldwin 14 P-H Tax Ct. Mem. 67 (1945).	*C. W. Clarke Co.* (ranch properties)		340	1,000	3,077.60	1,400.00	54.5
Estate of Belle A. H. Nathan 15 P-H Tax Ct. Mem. 576 (1946).	*Hamburger Realty Co.* (stocks, cash, and large commercial building)		104.167	1,000	3,927.15	3,900.00	.7
	A. Hamburger & Sons, Inc. (stocks, bonds, stock of Hamburger Realty Co., and loans to shareholders)		452.817	3,774.183	1,028.51	1,000.00	2.77
Fred Pabst, Sr. 16 P-H Tax Ct. Mem 1016 (1947).	*Comet Co.* (41,265 pfd. shrs. and 223,215 com. shrs. of Pabst Brewing)		650	28,727	286.20	212.00	25.9

	Company and Nature of Assets	Shares Owned	Total Shares	Net Asset Value Per Share	Value Per Court Per Share	% Discount
Estate of Amy H. DuPuy 9 T.C. 276 (1947).	*Morewood Realty Corp.* (commercial real estate)	859	4,998	2,056.00	1,300.00	36.77
Estate of Lillian May Schroeder 13 T.C. 259 (1949).	*Heberlein Patent Corp.* (textile patents and marketable securities)	750	10,000	41.84	25.00	40.3
Estate of Lloyd R. Smith 19 P-H Tax Ct. Mem. 50 (1950).	*Smith Investment Co.* (263,265 shrs. of A. O. Smith Corp.)	408	1,860	7,317.28	5,700.00	22.1
Estate of Irene de Guebriant 14 T.C. 611 (1950).	*Phelps Estate, Inc.* (real estate and reinvested proceeds from sale)	511 1/2	3,860	42.69	32.02	25.0
Bishop Trust Co. v. United States 50-1 U.S. Tax Cas. ¶ 10764 (D. Hawaii 1950).	*Henry P. Baldwin, Ltd.* (stocks listed on Honolulu exchange)	1,861	15,000	480.65	323.00	32.8
Goss v. Fitzpatrick 97 F. Supp. 765 (D. Conn 1951).	*Alden M. Young Co.* (marketable securities and real estate)	1,900	13,518	107.00	60.00	43.9
Estate of Jessie Ring Garrett 22 P-H Tax Ct. Mem. 1026 (1953).	*Ring Co.* (timberlands and other real estate)	1,251 1/3	10,000	82.88	55.94	32.5
Whittemore v. Fitzpatrick 127 F. Supp. 710 (D. Conn. 1954).	*J. H. Whittemore Co.* (securities, real estate, farm, and art objects)	600	820	3,118.00	1,057.00	66.1
Bartram v. Graham 157 F. Supp. 757 (D. Conn. 1957).	*Bartram Brothers Co.* (diversified marketable securities)	2,740	148,235	163.04	130.00	20.3

	Company and Nature of Assets	Shares Owned	Total Shares	Net Asset Value Per Share	Value Per Court Per Share	% Discount
Paulina DuPont Dean 29 P-H Tax Ct. Mem. 314 (1960).	*Nemours Corp.* (securities — large block of shares of another holding company)	4,000	36,172	924.57	640.00	30.8
Estate of Lida R. Tompkins 30 P-H Tax Ct. Mem. 1927 (1960).	*H. Street Building Corp.* (commercial buildings and undeveloped land)	186	650	* 7,076.04	5,500.00	22.3
		*Net asset value computed by taking into account investments in subsidiary companies at book value.				
William Hamm, Jr. 30 P-H Tax Ct. Mem. 1983 (1961).	*United Properties, Inc.* (commercial real estate and 10 closely-held subsidiaries)	263 1/3	1,000	11,684.96	8,506.40	27.2
Drybrough v. United States 208 F. Supp. 279 (W.D. Ky. 1962).	*620 Fifth Street, Inc.*		*	** 35,929.00	23,348.00	35.0
	655 South Fifth Street, Inc.		*	72,000.00	46,800.00	35.0
	800 South Fourth Street, Inc.		*	46,400.00	30,160.00	35.0
	725 South Fourth Street, Inc.		*	40,000.00	26,000.00	35.0
	720 South Fifth Street, Inc.		*	58,400.00	37,960.00	35.0

*40% of the total shares outstanding.

**Net asset values and values per court are stated in total amounts rather than per share figures.

to minimize risk of reversal upon appeal. From this viewpoint, the safest course is to be general rather than specific, to discuss all factors as though touching all bases, and, above all, not to even suggest that any one factor may be controlling. The results of the cases clearly indicate, however, that a taxpayer may reasonably anticipate a valuation substantially below net asset value.[12]

Four cases did not allow any discount from underlying net asset value.[13] But these cases can hardly be regarded as reliable precedent for the Service's approach. In *Estate of Joseph E. Goar*[14] the taxpayer did not claim any discount. His entire argument concerned the proper determination of net asset value.[15] In *Estate of Frank A. Cruikshank*[16] the net asset value approach was adopted by both parties and that value was stipulated. The taxpayer argued that a discount should be allowed to reflect commissions and capital gains taxes which would be incurred by the company upon a sale of all of its assets and a distribution to the shareholders. Faced with this specific argument, the court properly rejected it. No liquidation was contemplated. Further, even if liquidation were assumed, distribution could be made in kind, and both commissions and corporate capital gains thereby eliminated.[17]

In *Richardson v. Commissioner*[18] the language of the lower court's opinion[19] clearly indicated sympathy with the Service's position. It upheld the Service's determination of value which coincided with net asset value carried out to three decimal places. However, the lower court prudently expressed the magic words that its decision had been based upon a consideration of all factors and was not based upon net asset value alone. The appellate court, notwithstanding a forceful dissent, affirmed, stating that a valuation based solely on net asset value was subject to reversal but declining to reverse in the face of the statement that all factors had been considered.[20] Since the final value was identical to net asset value ex-

12. It is recognized, of course, that a taxpayer may desire to obtain a high value rather than a low one, as, for example, where fair market value on a given date may establish the income tax cost basis of a security. In the great majority of cases, however, usually for estate and gift tax purposes, a low value is the objective.

13. Richardson v. Commissioner, 151 F.2d 102 (2d Cir. 1945); Bank of Cal. v. Commissioner, 133 F.2d 428 (9th Cir. 1943); Estate of Joseph E. Goar, 19 P-H Tax Ct. Mem. 794 (1950); Estate of Frank A. Cruikshank, 9 T.C. 162 (1947).

14. 19 P-H Tax Ct. Mem. 794 (1950).

15. The most valuable asset held by the company was the stock of another closely-held company. *Ibid.*

16. 9 T.C. 162 (1947).

17. However, if the shareholders are numerous or the assets are non-liquid in nature, sale of the underlying assets may be a practical necessity in order to effect distribution. The present § 337 of the Internal Revenue Code of 1954 eliminates the corporate capital gain tax if a plan of liquidation is adopted and liquidation is completed within one year thereafter.

18. 151 F.2d 102 (2d Cir. 1945).

19. H. Smith Richardson, 12 P-H Tax Ct. Mem. 1577 (1943).

20. Richardson v. Commissioner, 151 F.2d 102, 105 (2d Cir. 1945).

pressed through three decimal places, the decision should probably be regarded as an example of compulsive politeness or enormous gullibility. It may also be cited for the proposition that words sometimes speak louder than action. *Bank of Cal. v. Commissioner*[21] is similar. The "consideration" was of all factors but the result was a net asset value determination.

On occasion a court has approached the problem upon a liquidating value basis.[22] Where liquidation is in process or contemplated, this approach assumes considerable importance, for a deduction will be allowed for costs of liquidation.[23] Where liquidation is not contemplated, the courts will generally not consider this factor as influential. This is particularly true where a minority interest is involved and liquidation cannot be forced.[24]

Another line of cases has approached the problem by comparing the closely-held stock of an asset-holding company to the shares of closed-end investment trusts.[25] A closed-end investment trust is essentially a publicly-held and listed asset-holding company. This approach appears to be as sensible as it is simple. The statute requires that there be taken into consideration a comparison with companies engaged in the same or a similar line of business.[26] A closed-end trust, unless it deals in special situations or provides extensive management services, appears to be engaged in a "similar line of business," *i.e.,* the holding of investment type assets. A publicly-held trust is, of course, usually much larger than the typical closely-held asset-holding company.[27] If the investment trust is diversified in nature and meets certain other requirements, it is free of

21. 133 F.2d 428 (9th Cir. 1943). The decision illustrates another variation of method in arriving at a net asset value result. The court considered earnings and dividends but rejected them as being abnormal and thus not indicative of the future. It therefore fell back upon net asset value as the sole reliable criterion in evidence. The approach is not sound. Valuation cannot be predicated upon one stable factor out of three as though the stock is thereby rendered stable. Although earnings and dividends may be erratic, abnormal, or non-existent, the investing public never ignores these factors but places a speculative value upon the stock. If a security normally sells for less than its book value or net asset value, a succession of deficit years surely will not cause the security to rise in price to book value or asset value.

22. Liquidating value would appear to be nothing more than net asset value less the costs of liquidation.

23. See Forbes v. Hassett, 124 F.2d 925 (1st Cir. 1942); Weber v. Rasquin, 101 F.2d 62 (2d Cir. 1939).

24. See Bartram v. Graham, 157 F. Supp. 757 (D. Conn. 1957); Bishop Trust Co. v. United States, 50-1 U.S. Tax Cas. ¶ 10764 (D. Hawaii 1950); Colonial Trust Co. v. Kraemer, 63 F. Supp. 866 (D. Conn. 1945); Estate of Charles W. Heppenstall, Sr., 18 P-H Tax Ct. Mem. 115 (1949).

25. Goss v. Fitzpatrick, 97 F. Supp. 765 (D. Conn. 1951); Blackard v. Jones, 62 F. Supp. 234 (W.D. Okla. 1944); Fred Pabst, Sr., 16 P-H Tax Ct. Mem. 1016 (1947); Estate of Harold H. Brittingham, 11 P-H Tax Ct. Mem. 155 (1942).

26. INT. REV. CODE OF 1954, § 2031(b) [hereinafter cited as CODE §].

27. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, has eliminated the requirement contained in prior Rev. Rul. 54-77, 1954-1 CUM. BULL. 187, that comparability must include similarity in size. The effect of the former requirement was to render the statutory requirement inapplicable in virtually every case.

capital gains tax.[28] Because of this advantage on the side of the publicly-held comparative companies, a comparison with such trusts should suggest the upper limits in the valuation of the stock of a closely-held asset-holding company.

Reasons for Discount from Net Asset Value

Why should the stock of an asset-holding company sell at a discount from underlying net asset value? Various reasons may be advanced:

(1) As the Internal Revenue Service concedes,[29] additional expenses are incurred by the owner of such stock, such as the expense of operating the corporation and the costs of liquidating the corporation, should that course be elected.

(2) A corporate income tax, ranging in rates from fifty-two to fifteen per cent,[30] is incurred. The earnings are thus reduced by corporate taxes before transmission to the shareholders. This fact in itself appears to be a refutation of the Service's argument that there is no need to capitalize the corporate earnings since this has been done in the process of valuing the underlying assets. The earnings of the underlying assets and the earnings of the corporation are not the same because of the corporate income tax.

(3) There is at least a risk that a corporate capital gains tax may be incurred if liquidation is not properly handled.

(4) When a hypothetical buyer may buy the identical or similar property directly, he will not buy into a closely-held family holding company except at a substantial discount.

(5) A minority shareholder cannot force a liquidation. He is at the mercy of the controlling shareholders, who may manage the properties to suit their objectives rather than his.

(6) Closed-end publicly-held investment trusts usually sell at a discount from underlying asset value. For the same reasons, whatever they may be in the minds of the investing public, the stock of a closely-held asset-holding company should sell at a similar discount.

In the author's opinion, the stock of an asset-holding company should be valued at an appreciable discount from net asset value. Any one or more of the factors enumerated may be present in any given situation, sometimes as an open matter of contention but more frequently latent. All are reflections of the disadvantages of indirect ownership. These disadvantages are properly expressed by an appropriate discount from the value such assets would have if held directly.[31]

28. CODE § 852.

29. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237.

30. CODE §§ 11, 243 (relating to the usual tax on a corporation's dividend and other income). There are also penalty taxes imposed in special situations.

31. A problem similar to that of valuing stock of an asset-holding company arises in the case

EFFECT OF VOTING CONTROL IN THE VALUATION CONCEPT

Inasmuch as the courts have usually adopted a broad and generalized (and non-appealable) approach to the valuation of closely-held stock, it is not surprising that the proper emphasis to be given to voting control has not been delineated by the courts. Voting control has been frequently mentioned but almost never discussed.

Control perhaps may be usefully segregated into three types: (1) majority control — control of more than fifty per cent of the outstanding stock; (2) liquidating control — the power to effect a dissolution of the corporation irrespective of the desires of minority shareholders;[32] and (3) effective control — a concept mentioned in Revenue Ruling 59-60[33] which, it is assumed, is the ownership of sufficient stock, although less than fifty per cent, to permit control of the policies of the corporation because other shareholders are numerous, scattered, or passive in their attitudes.

These refinements of definition are surplusage in any discussion of the judicial attitude. Totally aside from the numerous cases which merely contain a fleeting mention of the control factor, the actual cases which have involved control situations are of little help in assessing the importance of control. With one exception,[34] the cases have not taken a different approach because of the presence of voting control.[35] Again, the approach has been general. All factors are considered and rarely is one factor singled out for emphasis. *Whittemore v. Fitzpatrick*[36] is illustrative. In that case, 600 shares out of a total of 820 shares outstanding of an asset-holding company were involved in the valuation issue. Yet the court's determination of fair market value represented a discount from net asset value in excess of fifty per cent.

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of valuing stock of an operating company which holds a large portfolio of securities in excess of its business needs. It has been suggested that the proper valuation approach here is to determine the value of the going business and then add to it the value of the securities.

In Worthen v. United States, 192 F. Supp. 727 (D. Mass. 1961), the court refused to adopt this approach where a minority shareholder was involved. Among the reasons cited was the fact that such a shareholder could not have caused the securities to be distributed to him and hence would not pay full value for them. See also Estate of Charles H. M. Atkins, 20 P-H Tax Ct. Mem. 917 (1951).

32. In Ohio, liquidating control is governed by OHIO REV. CODE § 1701.86. Liquidation requires the affirmative vote of two-thirds of the total shares, unless the articles of incorporation have established a different requirement.

33. 1959-1 CUM. BULL. 237.

34. Slimp v. United States, 54-2 U.S. Tax Cas. ¶ 10949 (D. Tex. 1954).

35. See Whittemore v. Fitzpatrick, 127 F. Supp. 710 (D. Conn. 1945); Estate of James D. McDermott, 22 P-H Tax Ct. Mem. 450 (1953); Estate of Bozo Banac, 17 T.C. 748 (1951); Estate of Frank L. Gray, 20 P-H Tax Ct. Mem. 752 (1951); Estate of Ambrose Fry, 9 T.C. 503 (1947); Estate of Charles E. Kimball, 15 P-H Tax Ct. Mem. 913 (1946); P. C. Pendleton, 20 B.T.A. 618 (1930); Estate of T. C. Thompson, 3 B.T.A. 902 (1925).

36. 127 F. Supp. 710 (D. Conn. 1945).

The exception mentioned is *Slimp v. United States.*[37] The case qualifies as a curiosity as well as an exception. The decedent owned fifty per cent of the stock of a company. His son owned the other fifty per cent. On the same date the decedent made gifts of his shares, in part to his son and the balance to other children and grandchildren. The court determined, without discussion, that the fair market value of the shares given to the son was $175 per share while the fair market value of the shares given to the other family members was $150 per share. The absence of discussion may be a blessing, for the result seems patently incorrect. If control in the hands of the recipient is the determinative factor, then only one of the shares given to the son should have been valued at a premium.

Revenue Ruling 59-60[38] mentions the control concept in two instances. In discussing the weight to be given to dividend paying capacity, it points out that, where actual or effective control is involved, the dividend factor is not a material element in the valuation approach since the controlling group will presumably manipulate the dividend payment to suit the shareholders' tax objectives and may distort the net income of the company (which controls dividend paying capacity) by substituting salary and bonuses for dividends.[39] It also indicates that sales of small amounts of stock cannot be taken as a measure of value where controlling interests are involved, inasmuch as control represents "an added element of value."[40]

Internal Revenue Service personnel sometimes adopt what may be termed an informal "family attribution" approach in determining control. This is illustrated in *Estate of Charles W. Heppenstall, Sr.*[41] This approach groups the entire family holdings to determine whether control exists. Presumably this proceeds from the premise that all family members will act in concert, that the company will be liquidated upon the taxpayer's request, if that be desired, or that his stock will be accommodatingly redeemed at his wish. No court appears to have given any recognition to such an approach. Nor is the argument persuasive from a practical approach. Again, the disadvantages of indirect ownership present obstacles to concerted action. Even a related or friendly shareholder is not likely to agree to a liquidation if he is burdened (or blessed) with a low income tax cost basis in contrast to an estate's newly acquired high basis. Redemption may not be possible because of the financial

37. 54-2 U.S. Tax Cas. ¶ 10949 (D. Tex. 1954).
38. 1959-1 CUM. BULL. 237.
39. *Ibid.*
40. *Ibid.*
41. 18 P-H Tax Ct. Mem. 115 (1949).

condition of the corporation. Where finances are not an obstacle, the income tax family attribution rules[42] may make the tax cost prohibitive.

Clearly, where majority control is involved, the stock has an added element of value which should be recognized in the valuation approach. Such control carries with it the right to direct the corporation's policies, many of which, such as the payment of salaries and the determination of dividend payments, can result in direct and increased monetary return. Effective control should similarly command a premium in the valuation of the stock, although there are hazards in determining its existence and in assessing its permanence. In the usual case, the premium to be accorded to a control block of stock should produce a valuation somewhat above that indicated by a capitalization of earnings, but not extending to the valuation which might be determined if liquidating control were involved. Where liquidating control exists, estimated liquidating value should reasonably establish a minimum value or "floor" in the determination of fair market value. One may credibly assume that closely-held stock will not be sold for something less than would be realized by liquidating the company.

Discount for Lack of Marketability

Still another factor in the valuation concept has proved to be troublesome to assess and has been historically handled by the courts in the vaguest of terms. This is the discount, from the value otherwise determined, to reflect the lack of marketability of closely-held stock. The basis for the discount is the common sense belief that a purchaser will pay less for an asset which may prove difficult to resell than he will for an asset which is easily traded. The courts have agreed that such a discount is a proper factor to be considered,[43] but they have seldom stated the extent of the discount. The usual practice has been simply to state that such a factor has been considered in arriving at the final determination of fair market value. A few cases have expressed the discount in percentage terms.[44]

In two recent cases,[45] however, a more specific approach has been

42. CODE §§ 302, 318. These rules may convert the redemption into a dividend, and capital gain or loss into ordinary income.

43. See Bank of Cal. v. Commissioner, 133 F.2d 428 (9th Cir. 1943); Baltimore Nat'l Bank v. United States, 136 F. Supp. 642 (D. Md. 1955); Schnorbach v. Kavanagh, 102 F. Supp. 828 (W.D. Mich. 1951); Fred Pabst, Sr., 16 P-H Tax Ct. Mem. 1016 (1947).

44. Snyder v. United States, 182 F. Supp. 71 (W.D. N.C. 1960), *rev'd on other grounds,* 285 F.2d 857 (4th Cir. 1961) (ten per cent, which included factors other than lack of marketability) Bader v. United States, 172 F. Supp. 833 (S.D. Ill. 1959) (fifteen per cent); First Trust Co. v. United States, 59-1 U.S. Tax Cas. ¶ 11843 (W.D. Mo. 1958) (fifteen per cent); Central Trust Co. v. United States, 305 F.2d 393 (Ct. Cl. 1962), (12.17 per cent).

45. First Trust Co. v. United States, 59-1 U.S. Tax Cas. ¶ 11843 (W.D. Mo. 1958); Central Trust Co. v. United States, 305 F.2d 393 (Ct. Cl. 1962).

adopted. This approach may be stated as follows: If a discount is to be allowed to reflect the lack of a market, then the measure of that discount should be the cost of making such a market. The cost of making a market is the cost of a public offering or "flotation cost." In *First Trust Co. v. United States*[46] the court, adopting this approach, permitted a fifteen per cent discount for lack of marketability. This case was cited with approval by *Central Trust Co. v. United States*,[47] which, also using flotation costs as the measure, considered a 12.17 per cent discount for lack of marketability in arriving at its ultimate determination of fair market value. The Securities and Exchange Commission periodically publishes data with respect to flotation costs of public offerings, and this data is generally introduced in evidence as the basis for such a discount. The flotation costs are expressed as percentages of the offering prices and range from 19.6 per cent for small offerings ($2.5 million) to 4.88 per cent for large offerings ($10 million or more).[48]

Previously in *Campbell's Estate v. Kavanagh*[49] this approach had been specifically rejected. In that case the parties stipulated that closely-held stock could have been publicly offered at $175 per share but that $26 per share of flotation costs would have been incurred. The taxpayer argued that the fair market value was therefore $149 per share. In a scatter-shot opinion, somewhat hysterical in tone, the court rejected the discount, characterizing it as "ridiculous," and appeared ready to override the stipulations as well. Presented in the manner in which it was, the claimed discount appeared to be equivalent to an estimated broker's commission upon the sale of a listed stock, and this fact perhaps influenced, or more likely, confused the court.

A more serious objection to the use of flotation costs as the measure for the discount is the fact that such costs may not be a realistic measure for small holdings of stock. Obviously, a very small company could never market its stock; the cost of attempting to do so would be prohibitive. As a compromise, this situation somewhat logically leads to the application of the percentage discount, approximately twenty per cent, incurred with respect to small public offerings to the great majority of valuations for tax purposes.

Despite the possible objections mentioned, the approach has much to commend it. It is a logical attempt at measurement and has welcome substance in an area where vagueness and lip-service recognition long prevailed. One may hope that the approach will gather further judicial support.

46. 59-1 U.S. Tax Cas. ¶ 11843 (W.D. Mo. 1958).
47. 305 F.2d 393 (Ct. Cl. 1962).
48. SEC, Cost of Flotation of Corporate Securities 1951-1955 at 40, June 1957.
49. 114 F. Supp. 780 (E.D. Mich. 1953).