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# Bosland: Estate Tax Valuation in the Sale of Merger of Small Firms


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ESTATE TAX VALUATION IN THE SALE OF MERGER OF SMALL FIRMS. By *Chelcie C. Bosland*. New York: Simmons-Boardman. 1963. Pp. viii, 289. $10.00.

This is a study, financed by the Small Business Administration, to determine the extent to which estate tax valuation problems of close corporation stock cause small business concerns to sell out or to merge. The owner of stock in a family corporation is faced perennially with two kinds of problems arising under the federal estate tax: (1) the problem of liquidity—providing the cash to meet heavy estate tax liabilities, and (2) the problem of valuation—the uncertain determination of the fair market value of family corporation stock not traded on a market. The second is often crucial because it constitutes the large part of the tax base and therefore determines the amount of liquidity required. After extensive interviews with business executives involved in merger plans, the 1951 study by Butters, Lintner and Cary[1] concluded, however, that while a variety of tax problems constitute a substantial motivation for merger,

> ". . . valuation problems do not appear to have been a major reason for the sale of closely held enterprises. They seem more frequently than not to be of secondary importance in relation to other tax motivations for sale, especially liquidity considerations, and to non-tax motivations."[2]

Since that study, Congress has alleviated the liquidity problem somewhat (a) by immunizing from dividend treatment corporate distributions of cash in redemption of a sufficient amount of such stock to pay death taxes and costs, and (b) by authorizing an extension of time up to ten years for paying the estate tax attributable to the close corporation stock. But neither Congress nor the Internal Revenue Service has done anything of substance about the problem of uncertainty concerning the valuation of family corporation stock; it remains subject to a very wide range of administrative and judicial discretion. The present study is an updated effort to ascertain whether the uncertainty of estate tax valuation is in fact a substantial motivation for selling a family business to a large, national concern whose stock is actively traded and thus valued daily in the market place.

Using information supplied by the Federal Trade Commission, the author sent a letter and questionnaire to the executives of some 3,000 of the 4,502 concerns that merged or sold out in the five years 1955-59 inclusive. Public-owned companies with quoted stock were excluded. In all, a total of 401 usable replies were received. According to the information so provided, of the 401 merged concerns, estate and gift taxes, generally, and uncertainty about valuation problems were "very important" in 165 decisions to merge,

1 BUTTERS, LINTNER & CARY, EFFECT OF TAXATION ON CORPORATE MERGERS (1951).
2 *Id.* at 11.

"moderately important" in 87, and "not important" in 149 decisions to merge. Other reasons for merger included the desire for capital gains treatment rather than dividend treatment, need for investment diversification, the desire to retire, and need for more funds for expansion, improvement, or working capital purposes. The desire to exchange non-marketable, close corporation stock for marketable stock is strongly related to both the liquidity and the valuation problems arising under the estate tax. With respect to the specific problems of estate tax valuation as a motive for merger, fifty-one percent of the replies listed uncertainties about valuation as a factor in the decision to merge, thirty-two percent listed fear that the stock might sell for less than the tax value, and forty-four percent listed the desire to avoid the valuation problem by obtaining readily marketable stock through a merger. From the replies received, the author feels that the "safest conclusion is that both [valuation and liquidity problems] are highly important aspects . . . in merger motivations, which to a greater or lesser degree affected three-fifths of the decisions to merge or sell out."[3]

Having found as a fact that valuation of closely held stocks is an important factor in merger motivation, and that this arises from a belief or fear that the Internal Revenue Service will find an excessive value for such stock, the book raises the question whether the Service does tend to impose excessive valuations on closely held stocks, and whether relief from this practice is impracticable or impossible to obtain. In successive chapters, the author, who has served as an expert witness for the taxpayer in several litigated cases on the valuation of closely held stock, shows that where there are no actual market transactions in a stock, we have no objective test or commonly accepted formula for determining value. Neither the Congress, nor the Treasury, nor the Internal Revenue Service have supplied anything very helpful in the determination of fair market value of corporate stock which is not traded, and some observers have seen nothing more scientific or objective than "horse-trading," each party starting from an indefensible position. Revenue Ruling 59-60 and other administrative rulings are said to present an array of factors to be considered, but to provide little guidance on how they shall be used, and Mr. Bosland asserts that agents continue to make "educated guesses" rather than careful studies which give proper considerations to all the factors listed.

The book provides an interesting and rather detailed analysis of more than a hundred valuation cases in the Tax Court over a period of some sixteen years, and concludes with a valuable summary and appraisal of Tax Court findings in these cases. The author states that there is convincing evidence in these Tax Court cases that the Service has tended to use the method of valuation which will result in the highest value and the maximum tax liability—book value, asset value, earnings, or dividends. However, the Service is not helped much by the taxpayer, and the whole process of valuation would be improved if both Service and taxpayer would

3 P. 75.

make a genuine attempt to discover fair market value by reference to market conditions, rather than by taking extreme positions and hoping for a favorable compromise. While the Tax Court has afforded some excellent examples of good analysis, it has never assigned any order of importance among valuation factors, and on the whole has been too tolerant of shifts from one base to another, perhaps reflecting the decision-making processes of sixteen different judges. Moreover, the Tax Court judges are somewhat inclined to reach compromise decisions "with a regularity that belies its accidental quality."[4] The background of the judges is said to be legalistic, whereas valuation is economic or financial. The financial community is constantly finding market values for previously unmarketable securities because those determining value have knowledge, outlook, and "feel" for the market. This "feel," however, cannot be introduced into every trial.

What suggestions for improvement does this study propose? In chapter 15 the author surveys the suggestions previously made to improve the estate tax valuation problem of close corporation stock, and in chapter 16 he presents his own suggestions. The basic premise of all such suggestions is that the Government should take the initiative, set the good example, and develop techniques to insure that unrealistic valuations will not occur. The prior suggestions of others include (1) advance rulings by Internal Revenue Service as to the *method* of valuation to be used for a particular company; (2) having the Small Business Administration buy stock of the corporation at the value fixed for estate tax purposes, thus providing liquidity as well as responsible valuation, the stock to be sold back to the corporation or family within a number of years; (3) the development of current valuation formulas for different groups of stocks by the Securities and Exchange Commission; and (4) the attainment of a degree of definiteness by deciding to use asset value per share in the valuation of close corporation stock, modified to take account of extraordinarily large earnings.

The author suggests that since our best economic minds struggle with problems of value determination, it is entirely too much to expect that a revenue agent, faced with all kinds of tax problems and probably far removed from actual market experience, is either equipped or has the time for the work involved in thorough stock evaluation. Nevertheless, it is important to improve the technique at the grass-roots level because that is where the trouble starts. He suggests that the Internal Revenue Service itself has great power to improve the situation by deciding upon a priority of factors—earnings, dividends, asset value, book value, etc.—for the determination of fair market value of close corporation stock; he is also critical of its present practice of shifting from one base to another in order to get the highest possible valuation. But Mr. Bosland's principal contribution seems to be the suggestion that a "good case can be made for providing a completely independent non-judicial body of experts, who know securities and market values, to aid the courts and take the valuation burden from their

4 Pp. 178, 248.

shoulders."[5] Such a "Valuation Commission" would be completely divorced from the Internal Revenue Service. It would not be bound by court rules of procedure and evidence, but its decisions would be appealable to the Tax Court, with the presumption of correctness being with the Commission. He suggests that such a commission specializing in economic and market variations could well establish standards of objectivity and fairness in value determinations that would earn the respect of all, and relieve the courts of a problem not to their liking. The author asserts that this is not a radical proposal, but one which promises to restore the confidence of owners of family-owned businesses that valuation problems will be treated as objectively as if their stocks were marketable.

Lawyers interested in valuation problems concerning close corporation stock will find this non-legal treatment of the problem interesting reading. The relationship of estate tax valuation problems concerning family-owned corporate businesses to the substantial increase in corporate mergers and the comparison to our antitrust policies and encouragement of small business are in themselves challenging and broadening. This reminds one of a recent statement in a somewhat different context by an elder statesman of American tax lawyers that "the Government discloses a kind of split personality; its great dependence on the income tax leads it, in general, to encourage these businesses, yet on the occasion of death it is found intentionally making their operation more difficult—at a time when discouragement is most damaging."[6] Perhaps of most help to the lawyer is the economic analysis of several Tax Court valuation cases and a separate analysis of "Four Tax Court Cases in Depth." Lastly, it is believed that the author's suggestions have considerable merit. Lawyers with experience in tax valuation problems know that present practice includes a substantial element of "horse-trading," which puts a premium on the assumption of an irresponsible position at the outset. The Internal Revenue Service would do well to take the initiative in the improvement of valuation techniques in order to reduce the "adversary nature" of solving this problem.

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5 P. 267.

6 Miller, *Needed: Selective Reductions of the Federal Estate Tax Rates,* 49 A.B.A.J. 1060, 1062 (1963).