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VALUATION IN ESTATE PLANNING*

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Introduction

The valuation of assets and business interests is a difficult task. The primary difficulty perhaps stems from the sheer elusiveness of value as a concept. There have been put forth many definitions of value, but one that seems particularly appropriate to this discussion is that the value of an object is "its estimated capacity to satisfy a want."[1] This definition implies several things. Before value exists there must be an unsatisfied want. Thus, a business interest has value because of the anticipation of income from that business. This anticipation is the measure of the value of that enterprise.

This definition also implies that value is unique, because individuals are unique. Wants are the products of individuals and not only are individuals different, but the same individual has different estimates of his unsatisfied wants at different times. Therefore, the value of a given asset may be different for two different individuals and may not be the same for the same individual at any two instants of time. Thus, value is unique as to persons and as to time.

We might say that value is gauged by the belief a person has as to the capacity of a given item to satisfy his wants. A person bases his action on this belief. Even though predicated on the best evidence available, the belief may be inconsistent with the truth. One's willingness to forego other objects in order to obtain a given object is based on his estimates of its want-satisfying capacities. Thus, belief determines value. If one wants a business enterprise because of the income to be derived from it, the value of the business stems from his belief as to what the income will be. His estimate may prove to be erroneous, but he proceeds on the assumption

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1. Long, *Value Theory and Buy-and-Sell Agreements*, THE JOURNAL OF THE AMERICAN SOCIETY OF CHARTERED LIFE UNDERWRITERS, Spring, 1955, pp. 172-175.

that it is correct and bases his willingness to act on the assumption that it is a correct estimate.

We can conclude from this that the reality of value is in the mind; it cannot exist separate from the mind that concerns it. Therefore, there is no meaning to value unless it is related to time and person.

These thoughts should be kept in mind as we discuss the problems concerned with the value of specific assets since they contribute to an understanding of why the determination of value is a very complex subject — the complexity being magnified by substantially more than the increase in the number of parties who are involved in arriving at the value of the asset in question.

Definition of the Gross Estate

Section 2031 of the Internal Revenue Code states that the value of the gross estate of the decedent "shall be determined by including . . . the value at the time of his death of all property, real and personal, tangible and intangible, wherever situated outside the United States."[2]

The value at the time of the decedent's death is taken to be the "fair market value" which has been defined as "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell."

What is a willing buyer? What is a willing seller? Their values are dependent upon their individual estimates of the capacity of the asset to satisfy a want! Is it any wonder that the fair market values selected by the executor of an estate, by the Commissioner of Internal Revenue, and the value decided upon by a court of law, all might be different, and conceivably all might be *right* based upon their own estimate of the capacity of the asset to satisfy the want of an unknown purchaser?

With this background, let's consider the value for federal estate tax purposes of specified types of assets. The four types to be considered are real estate, stocks and bonds, partnership interests, and life insurance proceeds.[3]

2. INT. REV. CODE OF 1954, § 2031.
3. For additional information concerning the valuation of these assets see FUNDAMENTALS OF FEDERAL INCOME, ESTATE AND GIFT TAXES, pt. III, c. 3 (White ed. 1956).

Valuation of Real Estate

Several general rules are applicable to the valuation of real estate. These rules might be stated as follows:

1. Real estate should be included in the gross estate at fair market value, not at its assessed value for property tax purposes.
2. Fair market value should include a consideration of the amount of rental received, the size of the lot, the location of the lot, and the prices at which adjoining lots were sold.
3. Expert opinion is advisable to substantiate the values reported, but courts of law have to be satisfied that the appraiser is an expert and that his method of valuation is reasonable.

   (Comment: In the case of Estate of Henry E. Huntington, 36 B.T.A. 693 (1937), the experts started with a gross selling price from which discounts ranging from 5% to 45% were deducted to arrive at fair market value. These discounts were based primarily on the period of time estimated to elapse before disposition and covered such things as future taxes, selling expenses, interest on investment until sold, and carrying charges. The court held that the discounts were predicated on speculative and indeterminable future developments, and any values based on such discounts would be a mere guess. Instead, the court arrived at a value based on comparable prices, expert opinions, and clearly established facts of record.)
4. The qualifications of the real estate appraiser and his basis of valuation should be known.

   (Comment: In the case of T. I. Hare Powell, 10 B.T.A. 166 (1928), the executor introduced a deposition of a man engaged in the real estate business for 27 years. He owned land in Nebraska and Iowa in the amount of 8,000-10,000 acres and handled 40,000 acres as an agent. He was acquainted with the land in question and had been an agent in renting these lands, paying taxes, and collecting rents for 21 years. The value placed on the land by the executors was based on his knowledge and experience with these properties and similar properties in the same community. The court

ruled that the estate's valuation should stand since the appraiser hired by the Commissioner did not present his experience and qualifications and since no basis was presented to show his method of valuation.)

Some of the factors which have been considered by the courts in arriving at fair market value of real estate are as follows:

1. The amount of rentals received from the property.
2. Market activity and price at which comparable property in the same area sold for near the applicable valuation date.
3. Value accepted by the state probate court for state death tax purposes when based on appraisals by qualified real estate experts.
4. Other factors include offered price, age of property, location of property, and value of improvements.

It should be noted at this point that sound values are important for two reasons: to arrive at the gross estate value for federal estate tax purposes *and* to determine the basis for gain or loss on resale for federal income tax purposes. This two-fold character of the valuation figure increases the complexity of the problem for the executor in that he is faced with the dilemma, in some instances, of keeping the value low in order to reduce the federal estate tax and making the value high in order to save federal income taxes. Which value takes precedence depends to a great extent upon where his responsibilities lie.

This discussion of the factors to consider in valuing real estate suggests the following recommendations that might be made to an executor who has responsibilities in this area:

1. Although an appraisal by experts is not required where the executor can arrive at a reasonable value through personal knowledge or by consulting bankers and business associates, it is advisable to obtain experts where important real estate holdings are concerned. The courts have given serious weight to the opinions of qualified experts who have explained their method of valuation.
2. The estate is not required to return an inflated value, but should present a conservative estimate that will stand the test of an investigation.

Valuation of Securities

Listed Securities

General rules applicable to the valuation of listed securities might be stated as follows:

1. Where stocks and bonds have a wide market and are dealt in on recognized exchanges, the prices quoted in a standard financial magazine such as the Commercial and Financial Chronicle can be used in preparing the inventory for federal estate tax purposes.
2. For securities listed on the exchange the value is the mean between the highest and lowest selling prices on the valuation date.
3. If there are no sales on the valuation date, the value is the mean between the selling prices on the nearest dates before and after the valuation date if the dates of sale were within a reasonable period. In this case it is necessary to make an apportionment between the dates of sale and the valuation date, *i.e.* if the mean selling price on February 10 was $15 and on February 15 was $20, the valuation on February 12 would be $17.

A special problem arises where the stock constitutes a large block. It is usually contended that, because of a depressed market which results from the sale of a large block at one time, a lower valuation per share is merited than if only a few shares were involved. This is called the *blockage rule*. The courts have recognized the general economic theory of the blockage rule, but the executor would be in error if he relied on it solely. The decisions on this subject indicate that there is no necessary presumption that a large block will have a lesser value per share than a smaller block. It is necessary to consider whether the market is such that a large block could be absorbed without a sacrifice in price. It is necessary to consider also the reputation of the stock and the ability to feed the stock into the market in small units over a reasonable period of time. Thus, mere reliance on the general theory that wholesale sales will result in lower unit prices will not suffice, but in the absence of off-setting evidence, the blockage rule will prevail.

Unlisted Securities

The framework for the valuation of securities not listed on

an organized exchange is set forth in section 2031(b) of the Internal Revenue Code, which states "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 reference 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 lines of business which are listed on the exchange."[4]

It seems clear from this statement that there is no established controlling method of arriving at the value of unlisted securities. The problem of determination of fair market value must be solved by the exercise of sound judgment through the application of a method which is fair and proper under the facts and circumstances as they appear in each particular case.

Some of the factors that should be considered, in addition to the value of similar listed securities, are as follows:

1. The nature of the business and the history of the enterprise — its stability, growth characteristics, and amount of diversification.
2. The economic outlook in general and the condition and outlook of the specific industry in particular — success relative to competitors, prospective competition, and public appraisal.
3. The book value of the stock and the financial condition of the business — liquid position, working capital, capital structure, indebtedness, and non-essential assets.
4. The earning capacity of the company — recurring vs. non-recurring income, potential future income, and operating success of various parts of the business.
5. Dividend paying capacity.
6. The effect of the death of a key-man on stock prices — existence of trained replacement personnel and the use of life insurance.

Appraisers may accord primary consideration to earnings in valuing stocks of companies which sell products and serv-

4. INT. REV. CODE OF 1954, § 2031(b).

ices, and may accord primary consideration to assets underlying the security to be valued in the case of an investment type company.

At this point some statement should be made about the usefulness of considering the value of securities of corporations engaged in the same or similar lines of business which are listed on the exchange. On the surface this might seem to be a simple task. However, care must be taken to select companies which are truly comparable. The tests are similarity not only as to the type of business, but also similarity as to trend of earnings, capital structure, volume of sales, and size. Assuming comparability, the estate will normally report a value equivalent to that of companies engaged in similar activities having listed securities yielding the same return.

It is generally recognized that sales of *listed* securities are usually made at a much lower figure than the fair market value would be if computed by application of the common formulae usually employed in the case of closely held stock. This hardship is a primary reason why the Internal Revenue Code provision states that consideration should be given to the value of securities of corporations engaged in similar lines of business whose securities are listed.

One conclusion that can be drawn from these observations concerning the valuation of unlisted stock is that the federal government's experience with this problem in its relation to the administration of the estate tax has dictated the advisability of departing from any theoretical standard. The merit of this lack of a standard is that it contemplates the working out of an equitable valuation result. This is consistent with the introductory comments because it recognizes that the value of the unlisted stock will vary over time and among persons. The defect is that it furnishes a changing and uncertain standard under which frequently the final valuation cannot be determined until after investigation and an appeal. The effect of this approach is that it necessitates an intelligent analysis by the executor in the first instance.

There is, however, an effective way of avoiding the hardship and attendant uncertainties concerning the valuation of unlisted securities. This is through the medium of a restrictive agreement commonly called a "buy and sell" agreement.[5]

5. For additional information concerning restrictive agreements, see White, BUSINESS INSURANCE, at pp. 411-413 (1956).

There are two major types of these agreements. One is an outright agreement by the estate to sell and the other party (usually the surviving stockholder(s)) to buy, at an agreed price, the shares owned by the deceased. The other type consists of an option agreement in which a first offer must be made to the named party at an agreed price before selling to others.

There are at least two advantages to such restrictive agreements. First, they establish the value of the property for federal estate tax purposes if certain standards are met. Secondly, they save the trouble and expense of ascertaining the value of the closely-held corporation stock in the light of the company's net worth, earning power, dividend paying capacity, and other relevant factors.

The standards that must be met in order for the restrictive agreement to establish the value for estate tax purposes are as follows (with comment):

1. The agreement must be the result of bona fide bargaining at arm's length, resulting in an agreed price which constitutes adequate pecuniary consideration intended to reflect the fair value of the business interest at death.

   (Comment: The price must be fair and adequate at the time the agreement is made and would be binding even if the price was not adequate when death occurred.[6] If the relationship of the contracting parties is such that the prospective buyer would be the natural object of the prospective seller's bounty, the agreed purchase price will not hold for estate tax purposes unless the parties "dealing at arm's length" set a fair figure. Presumably this could be done if the parties called in an accredited accountant to appraise and report in writing the value of the stock, and such value was incorporated into the agreement.)

2. The agreement must require the sale of the business interest upon death at an agreed price.

   (Comment: A *first offer* contract has a depressive effect on value, but does not necessarily establish the value for estate tax purposes. It fixes a limitation on the price obtainable by the shareholder for his

6. Edith M. Bensel Executors, 36 B.T.A. 246 (1937); *aff'd.* Comm. v. Bensel, 100 F. 2d 639 (3d Cir. 1938).

shares only if he wishes to sell and the prospective purchaser wishes to buy. To accomplish a clearly established federal estate tax value, the first offer contract would have to be accompanied by an enforceable agreement to purchase at the critical date, at the owner's death. If there is no agreement requiring sale at a specified price at death, then the executor is free to sell at the going rate. Thus, an option during lifetime may have a depressive effect on the value of the stock, but it, by itself, does not conclusively establish value. It must be combined with an agreement at death to sell.[7])

3. The agreement must preclude the decedent from transferring the business interest during his lifetime without first offering it to the prospective purchaser at the agreed price.

   (Comment: The related court cases point up the fact that an agreement calling for purchase and sale at death, standing alone, is not sufficient to establish estate tax value; the agreement must have restrictions imposed on the parties during their lifetime if their option agreement or their agreement to purchase at a stipulated price at death is to establish estate tax value.

   Thus, if a binding buy and sell agreement exists, if it is coupled with a first offer agreement during lifetime, and the price is representative of value, this price will establish the value for federal estate tax purposes.[8])

Parenthetically it might be stated that if the buy and sell agreement exists and it is coupled with an *insured* stock purchase plan, the courts have held that there can be no double taxation by taxing both the value of the stock and the amount of the insurance.[9]

Valuation of Partnership Interests

In valuing a partnership interest for estate tax purposes, consideration must be given to both tangible and intangible

7. Worcester County Trust Co. v. Comm., 134 F. 2d 578 (1st Cir. 1943).
8. Wilson v. Bowers, 57 F. 2d 682 (2d Cir. 1932); Lomb v. Sugden, 82 F. 2d 166 (2d Cir. 1936); C. G. Hoffman, 2 T. C. 1160 (1943); Est. of J. H. Matthews, 3 T. C. 525 (1944).
9. Estate of John T. H. Mitchell, 37 B.T.A. 1 (1938).

assets, and to earning capacity. The tangible assets that are likely to give difficulty are real estate and securities and they are subject to the rules considered heretofore.

The major intangible asset is good will and it gives the most trouble. In the case of *business* partnerships the Treasury Regulations state that "special attention should be given to fixing an adequate figure for the value of the goodwill of the business in all cases in which the decedent has not agreed, for an adequate and full consideration in money or money's worth, that his interest therein shall pass at his death to his surviving partner or partners."[10]

It is generally assumed that good will is attributable to business prestige, ownership of patents, successful operation over a long period in a particular locality, and so on. The portion of the good will that is important for estate tax purposes is that portion attaching to the business which exists regardless of ownership and not that portion which is attributable to the decedent's personal activities.[11]

The value of the partnership interest should be based solely on net tangible assets where no good will exists. Good will was held not to exist where the business was not unique, did not have a peculiarly advantageous location, possessed no patents, trademarks, or exclusive agency contracts, and its earnings were attributable to the efforts of the partners.

The U. S. Treasury method of valuation consists of three steps: (1) calculate the average income for five years, (2) subtract from the average income a fair return to the partners for their personal services (8% - 10% of average net assets for five years). The balance equals excess average earnings. (3) Capitalize the excess average earnings at 15% - 20% to get the amount of good will.

This method has not always been successful in the courts for several reasons:

1. No good will *attaching to the business* actually existed.
2. The Commissioner's determination based on this formula was declared to be excessive.
3. Adjustments had to be made because of the extraordinary circumstances of the business which made its continuance doubtful.

10. Reg. 105, § 81.10(d); Proposed Reg. 20.2031-3.
11. Estate of Leopold Kaffie v. Comm., 44 B.T.A. 843 (1941).

4. The period of years used to determine the average earnings did not contain a representative number of good and bad years.

In the case of professional and personal service partnerships, good will usually ceases with the decedent so that the value of a partnership interest is based on net assets. In cases where good will does attach to the business, such as through the continuance of the firm name, the computation of the value of such good will is subject to the same problems as in the case of a business partnership. As indicated previously, the Treasury method of computing the value of the good will might be a good starting point, but the result must be carefully scrutinized and due allowances must be made for situations where the assumptions underlying the formula do not coincide with the facts of the case at hand.

Valuation of Life Insurance

Proceeds of life insurance must be included in the gross estate when (1) the estate is designated beneficiary of a policy on the decedent's life *and* (2) when other beneficiaries are in receipt of the proceeds on a policy on the life of the decedent with respect to which the decedent possessed any incidents of ownership exercisable alone or in conjunction with another person.

Proceeds are considered to be payable to the estate even though payable to a beneficiary other than the estate if such beneficiary is legally bound to use the proceeds for the benefit of the estate. An unexercised power possessed by the trustee as beneficiary to use the proceeds to pay debts and death taxes of the insured's estate will not bring the proceeds within the estate value if the proceeds were not used for that purpose. Whereas, if the trustee is legally obligated to use the proceeds for the benefit of the estate, they are includible in the gross estate.[12]

The estate tax has a checkered history with respect to the taxation of proceeds receivable by beneficiaries other than the insured's estate. A brief review of that history will serve to explain the current status of the law. From 1919-1942 proceeds of insurance policies "taken out" by the insured on his own life payable to a named beneficiary were includible in the gross estate beyond a specified exemption of $40,000.

12. Estate of C. H. Wade, 47 B.T.A. 21 (1942).

What constituted "taken out" varied from time to time. First, an insured was considered to have taken out a policy if he paid the premiums. Then, in 1929, the Supreme Court interpreted "taken out" to refer to situations where the insured possessed legal incidents of ownership in the policy. During the period 1934-1941 only the incidents of ownership test applied. During 1941-1942 the premium paying test only was applied.

For the period 1942-1954 the $40,000 exemption was eliminated and both the premium paying test and the incidents of ownership test were part of the law.

The 1954 law eliminated the premium paying test for those dying after August 16, 1954. On this point section 2042 (2) of the Code states: "the gross estate includes the value of life insurance to the extent receivable by beneficiaries other than the estate with respect to which the decedent possessed at his death any of the incidents of ownership exercisable either alone or in conjunction with any other person".[13]

This latest treatment concerning the extent to which proceeds payable to beneficiaries other than the estate are includible in the gross estate raises two important questions (with answers following):

1. What proceeds are deemed payable to beneficiaries other than the estate?
   a. A policy payable to a trustee is considered payable to another beneficiary unless the trustee is legally bound to use the proceeds for estate purposes or if he has the power to use the proceeds for estate purposes and actually so uses them.
   b. A policy payable to the estate is considered payable to another beneficiary if the state law requires that the proceeds enure to the benefit of the family.
2. What rights are considered to be incidents of ownership?
   a. The right to change or designate the beneficiary.
   b. The right to surrender, borrow, or assign the policy.
   c. The right to select or revoke a settlement option.
   d. A reversionary interest if the value of the interest exceeds 5% of the value of the policy before the insured's death.[14]

13. INT. REV. CODE OF 1954, § 2042(2).
14. Spiegel's Estate v. Comm., 335 U. S. 701 (1949).

Rights which are not considered to be incidents of ownership are rights to receive dividends on the policy and rights to disability income from the policy if it does not reduce the death proceeds.

If the insurance policy provides that the beneficiary could not exercise ownership rights without the written consent of the insured during his lifetime, then the insured has retained incidents of ownership which are exercisable in conjunction with another and the insurance must be included in the gross estate. If a trust owns the policy and any modification of the trust requires the insured's consent, he has in the policy an incident of ownership exercisable in conjunction with another. However, if the policy on a partner's life belongs to a partnership, and the partner as an individual has no rights in it, he possesses no incidents of ownership exercisable in conjunction with another and the proceeds are not includible in his estate.

As this discussion of the valuation of life insurance indicates, the main problem is whether or not the proceeds should be includible in the gross estate. After it has been determined that the proceeds are includible, the valuation problem is solved in that the dollar amount of proceeds constitutes the includible amount in arriving at the gross estate value.

Conclusion

There are few "cut and dried" principles applicable to the determination of the value of a given asset that should be included in the gross estate. Assets should be included at their fair market value, but the determination of what constitutes fair market value is no simple task in many cases. All of the facts surrounding the status of a given asset must be considered in selecting a fair value. Even then, because value varies over time and among the persons determining the value, the same facts can be used by two different appraisers to arrive at radically different values. Disparities in value calculated by the executor of the estate and the Commissioner of Internal Revenue frequently must be resolved by a court of law. The history of the court-determined value suggests that in many cases the courts have resolved disputes over value by arriving at a value which was approximately half-way between the two values suggested by the Commissioner and the executor of the estate. In the light of the difficulties in-

volved in arriving at fair market value, if the asset holdings are large, the executor probably should call in an expert appraiser to determine the value and should be prepared to satisfy a court that the appraiser is an expert and that the methods used in arriving at the value are clearly indicated. In the absence of a need for an expert appraiser, the executor should arrive at a conservative estimate that will stand the test of an investigation.