

---

---

# THE HEMPSTEAD LETTER

## Estate and Gift Tax Valuation Edition

---

---

### *Probative Value of Pre-Valuation Date and Post-Valuation Date Transactions Determined* Vol. XXIII. No. 1

In the *Estate of Helen M. Noble v. CIR*, T.C. Memo. 2005-2, the Tax Court determined the fair market value of a minority block of stock in a closely held state bank using post-valuation date evidence. The decedent died on September 2, 1996. She held 116 shares in a closely held state bank. The remaining interest in the bank was held by a family owned bancorporation. She was not related to the owners of the bancorporation. In 1995, the bancorporation acquired 10 shares of the bank for \$1,000 per share. In 1996, the bancorporation acquired 7 shares in the bank for \$1,500 per share. Following the decedent's death, the bancorporation set about acquiring the decedent's 116 shares in an all cash transaction that would result in the bancorporation owning 100 percent of the state bank. The bancorporation obtained an appraisal of the state bank for this purpose, which indicated a fair market value of \$7,569 per share, including a 29 percent discount for minority interest and a 35 percent discount for lack of marketability. The estate rejected an offer based on the appraised value of the stock, but accepted an offer of \$9,483 per share (\$1.1 million) in October 1997.

The parties contested the valuation of the stock for estate tax purposes. At trial the parties made various arguments relating to the use of the pre- and post-valuation date transactions as evidence of the value of the stock on the valuation date.

The estate argued that the pre-valuation date transactions should be used to establish the value of the stock. In making this argument, the estate claimed the requirements that the seller be knowledgeable of all relevant facts as to the property and the seller's shares be comparable to the subject shares were eroded by the Ninth Circuit's decision in *Morrissey v. CIR*, 243 F.3d 1145(9<sup>th</sup> Cir. 2001), which involved

the valuation of the subject block by sales of much smaller blocks. The Tax Court disagreed with the estate's interpretation of *Morrissey*. It found that the *Morrissey* court considered the comparability of the sellers' blocks as well as the knowledge requirement in reaching its decision. The Tax Court then concluded that the seller in the pre-valuation date transaction lacked knowledge of the subject property, which had

---

**... an unforeseeable post-valuation date event may shed light on the value of the stock as of the valuation date ....**

---

the effect of making the transactions not arm's length, because they sold the stock for substantially less than a later valuation of the stock. It further found that the blocks of stock were incomparable as a result of the size differential between the transactions and the subject block. It lastly noted that the price indicated by the transactions did not take into account the special value attributable to the decedent's block occasioned by its position as the last block not owned by the bancorporation, which was looking to acquire 100 percent ownership of the state bank. Thus, it found that the pre-valuation date transaction did not establish the value of the subject block for estate tax purposes.

The Tax Court next considered whether the post-valuation date transaction established the value of the block as argued by the IRS. The estate countered that the post-valuation transaction did not establish the value of the stock on the valuation date because it was not foreseeable and because it involved a strategic buyer. The Tax Court agreed with the IRS. It noted that an unforeseeable post-valuation date event may shed light on the value of the stock as of the valuation date when the valuation date and the post-valuation event are reasonably close in time and where no

---

---

intervening events have drastically affected the value of the property. It found that the time period (14 months) between the two dates was reasonable and that there were not any intervening events that drastically affected the value of the stock. It further noted, “Although petitioners observe correctly that an actual purchase of stock by a strategic buyer may not necessarily represent the price that a hypothetical buyer would pay for similar shares, the third sale was not a sale of similar shares; it was a sale of the exact shares that are now before us for valuation.” The Court further concluded that the price was the subject of negotiation between knowledgeable parties, the transaction price was close to the value determined by the IRS’ expert in this matter (on which the Tax Court did not rely in formulating its valuation conclusion), and an amount below the fair market value testified to by one of the estate’s own experts. Thus, it concluded, “Although the estate may have enjoyed some leverage in obtaining that higher price, as suggested by ... [one of the estate’s experts] by virtue of the fact that the subject shares were the only ... Bank shares not owned by the buyer, this does not mean that the sale was not freely negotiated, that the sale was not at arm’s length, or that either the estate or Bancorporation was compelled to buy or to sell.” Thus, the Tax Court valued the subject stock by reference to the post-valuation date transaction.

The Court noted that when using a post-valuation date transaction to establish the value of the stock

---

**Thus, the Tax Court valued the subject stock by reference to the post-valuation date transaction.**

---

for estate tax purposes, some adjustment for intervening occurrences may be required. Those occurrences may include “(1) Inflation, (2) changes in the relevant industry and the expectations for that industry, (3) changes in business component results, (4) changes in technology, macroeconomics, or tax law, and (5) the occurrence or nonoccurrence of any event which a hypothetical reasonable buyer or a hypotheti-

cal reasonable seller would conclude would affect the selling price of the property subject to valuation (e.g., the death of a key employee).” The Court concluded that only an adjustment should be made for inflation. It used the statistics from the Bureau of Labor and Industry to determine that inflation was 3 percent for 1996 and 1997. It then reduced the transaction price to account for inflation and concluded that the stock had a fair market value of \$1.067 million on the valuation date. ■

### ***Restrictive Non-Price Terms in Buy-Sell Agreement Adequately Accounted for in General Marketability Discount***

In the *Estate of H.A. True, Jr. v. CIR*, No. 02-9010 (10<sup>th</sup> Cir. December 2, 2004), the U.S. Court of Appeals for the Tenth Circuit considered several issues involving buy-sell agreements and the federal estate tax. The decedent died unexpectedly on June 4, 1994. At that time, he owned interests in several oil and gas and cattle ranching operations, which were operated as partnerships or S corporations. Each business interest was subject to a buy-sell agreement. The buy-sell agreements contained significant non-price terms that included the active participation in the business of the interest holder. Moreover, the agreements created a mandatory redemption obligation in the event that the business owner dies, became disabled or offered his/her interest for sale. The agreements included a formula price based on the tax book value of the business interests. When the decedent died, the business interests were redeemed pursuant to the buy-sell agreements. The decedent’s estate reported the fair market value of the interests at the redemption price.

The IRS successfully argued before the U.S. Tax Court that the price listed in the buy-sell agreements did not reflect the fair market value of the business interests. In reaching its determination, the Tax

---

---

Court concluded that the buy-sell agreements failed the fourth prong of the price control test (also known as the *Lauder* test), which requires that the agreements have a bona fide business purpose and not be a testamentary device. It concluded that the agreements were testamentary devices and they provided for a price below what a willing buyer and willing seller would agree to in an arm's length negotiation. Thus, it ruled that the price terms of the buy-sell agreements did not establish the fair market value of the stock. It further held, "the 'restrictive provisions of the buy-sell agreements (including but not limited to the formula price) are to be disregarded' for estate and gift tax valuation purposes." Nonetheless, the Tax Court applied a discount for lack of marketability when it valued the business interests.

The estate appealed to the Tenth Circuit where it argued that the Tax Court erred when it concluded that the buy-sell agreements did not establish the value of the stock for estate tax purposes. It further argued that even if the price terms were not determinative of the fair market value of the business interests, the Tax Court erred when it disregarded the non-price terms contained in the buy-sell agreements when it valued the interests.

The Tenth Circuit first considered whether the price terms in the buy-sell agreements should have been determinative of the fair market value of the interests for estate tax purposes. The court noted that in order for the price terms to control, the price control test must be met. The prongs of the price control test are (1) the price is fixed and determinable under the agreement, (2) the agreement is binding in life and death, (3) the agreement is legally binding and enforceable, and (4) the agreement has a bona fide purpose and is not a testamentary device. The Tenth Circuit noted that the evidence showed that the agreements were testamentary devices. Even so, it noted, the price terms may be determinative if they are similar to terms entered into by a willing seller and a willing buyer in arm's length negotiations. The estate contended that the adequate consideration prong was contrary to law and

violated the precedent set forth in *Brodrick v. Gore*, 224 F.2d 892 (10<sup>th</sup> Cir. 1995). *Brodrick* held that in order for a buy-sell agreement to be determinative it must be legally enforceable and binding in life and death. The Tenth Circuit rejected this argument. It found that *Brodrick* dealt with the estate of a man dying in 1951 and thus was subject to the Tax Code as written

---

**"We agree that the existence of such a restrictive agreement ... should be acknowledged when determining the fair market value of an interest."**

---

in 1939. It noted that the Tax Code was substantially changed in 1954 and has evolved since that time. Moreover, it noted that I.R.C. sec. 2703 codified the adequate consideration analysis for estates of individuals dying after 1990, such as the case here. Thus, it concluded, "In light of the foregoing analysis, *Brodrick* is overruled to the extent that it holds the terms in a buy-sell agreement are wholly controlling for estate tax purposes when the agreement's restrictive terms bind all parties equally at life and death. For us to constrain our analysis on this question to the approach employed in *Brodrick* would run counter to the last fifty years of development in this area of the law."

The Tenth Circuit next addressed the estate's second argument, which claimed that the Tax Court erred when it failed to consider the non-price terms contained in the buy-sell agreements. The Tenth Circuit agreed to an extent. It stated, "We agree that the existence of such a restrictive agreement, and the bona fide business reasons supporting it, should be acknowledged when determining the fair market value of an interest. A willing buyer and a willing seller with knowledge of all the relevant facts surrounding the exchange would certainly take this approach. Despite the tax court's seemingly ardent language to the contrary, however, we are not convinced the court ignored the restrictive nature of the True company buy-sell agreements in the course of valuing the interests at issue here." On analyzing the Tax Court's ruling, the Tenth Circuit concluded that the Tax Court considered the

---

---

## Buy-Sell Agreement *Cont. from page 3*

taxpayers' desire to maintain family ownership of the company as well as the state laws impacting their choice of business form in making its decision to apply a discount for lack of marketability. However, it found that the Tax Court did not specifically allocate any part of the discount to the non-price terms of the buy-sell agreements. It concluded, "Where a court's task is to determine the value of interests on which a willing buyer and willing seller would agree, its analysis would be distorted by giving explicit weight and recognition to buy-sell restrictions whose testamentary purpose has been established. ... However, a willing buyer and a willing seller would certainly take into account the limited market existing for the True companies by virtue of the family's intent to keep the entities under their control, as well as the impact state partnership law would have on the value of the interests. The tax court's application of a general marketability discount adequately took such limitations into account." Thus, it affirmed the Tax Court's valuation conclusions in this matter. ■

---

The material presented in The Hempstead Letter should not be construed as definitive legal, accounting, financial, or business advice nor should it be acted upon without consultation with legal or other professional counsel. Copyright © 2005

*Hempstead & Co. is a financial consulting firm providing services in the following areas:*

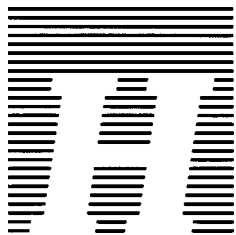
- *Valuations of Businesses and Corporate Securities*
- *Valuations of Intangible Assets*
- *Loss of Business Damage Analysis*
- *Mergers & Acquisitions*

*The members of our professional staff have backgrounds in valuation finance, accounting, economics, engineering, and investment banking. Professional designations include Accredited Senior Appraiser, American Society of Appraisers (ASA), and Chartered Financial Analyst (CFA). We welcome the opportunity to serve you. Please call Mark Penny at (800)541-3323 or contact him via e-mail at [jmpenny@hempsteadco.com](mailto:jmpenny@hempsteadco.com).*

---

**We'd like to hear from you!** Please contact us regarding information found in *The Hempstead Letter*, or with any mailing address updates.

---



***Hempstead & Co., Inc.***

807 Haddon Ave.

Haddonfield, NJ 08033

**Address Service Requested**

***In This Issue:***

- ***Post-Valuation Date Events: Do They Affect Value? (Estate of Noble).***
- ***Marketability Discount is Sufficient to Cover Buy-Sell Restrictions. (Estate of True).***