

DETERMINATION OF RELATED PARTIES: A CRITICAL DISCUSSION OF THE VALUE TEST PRESCRIBED IN THE INTERNAL REVENUE CODE

Transactions between closely related taxpayers may result in unintended tax benefits unless such transactions are made subject to special tax treatment.¹ A most important consideration in drafting amendments to disallow these benefits is the test used to determine the "closeness" of given relationships. In the 1934 Revenue Act, Congress introduced a new test designed to measure the extent of the relationship between a corporation and its stockholder—the *percent in value* of the corporation's stock owned by the stockholder.² This "value test" has been carried forward, and is used in several sections of the current Internal Revenue Code.³ Transactions between a stockholder and a corporation which are within the purview of these sections are subject to different tax treatment when the stockholder's interest in the corporation exceeds a prescribed level.

Section 1239, for example, provides that when a stockholder owns more than 80 percent in value of the outstanding stock of the corporation, he will not receive capital gains treatment of the gains derived from selling capital assets to his corporation. Such gains must be treated as ordinary income if section 1239 applies. An illustration of the application of section 1239 was given in a recent court opinion.

Section 1239 prevents capital gain treatment of a "sale or exchange" of depreciable property to a controlled corporation. . . . Without this section a taxpayer who had property which had been depreciated to a low basis could sell that property to a controlled corporation . . . and pay only capital gains rates on the gain. The transferee (*who is virtually identical to the transferor in the proscribed area*) could then redepreciate the property, using the sale price as a new basis. The depreciation, of course, would be deducted from ordinary income. Section 1239 renders such a scheme profitless by taxing the

¹ Reilly, An Approach to the Simplification and Standardization of the Concepts "The Family," "Related Parties," "Control," and "Attribution of Ownership," 15 Tax L. Rev. 253 (1960).

² Act of May 10, 1934, ch. 277, § 24, 48 Stat. 691. Section 267 of the 1954 Code was derived from this act.

³ See Int. Rev. Code of 1954 [hereinafter referred to as the Code], §§ 267(b)(2), (3), (8), 318(a)(2)(C), (3)(C), 1239(a)(2). See also Code § 304(c)(1).

Code § 267 disallows certain losses, expenses and interest resulting from transactions between related parties when the taxpayer owns over 50 percent in value of the corporation's outstanding stock. Section 304, which concerns redemptions through use of related corporations or subsidiaries, alternately defines control as owning at least 50 percent of the total value of all classes of stock. Control is a prerequisite under this section to treatment of certain acquisitions as distributions in redemption of the stock of the issuing corporation. Section 318 sets out rules for attribution of stock ownership between a corporation and a stockholder who owns 50 percent or more in value of the stock of the corporation. These attribution rules are used in eight other sections of the Code, with tax consequences depending upon the extent of the taxpayer's stock ownership including ownership determined by attribution.

gain on the transfer at ordinary rather than capital rates.⁴ (Emphasis added.)

The decision in two recent cases depended on whether section 1239 should be invoked in determining the tax consequences of certain transactions between dominant stockholders and their corporations.⁵ Application of the value test was determinative in both cases, but in spite of remarkably similar facts, the courts' findings were opposite. It is submitted that the outcomes in these apparently contradictory cases illustrate the problems which are inherent in the value test. It is the purpose of this comment to examine the value test prescribed by sections 267, 304, 318, and 1239. Emphasis will be placed on the problems this test presents to the taxpayer in tax planning and to the courts in administering the tax law. An alternative test will be suggested after the value test has been examined in light of these two recent cases.

I. THE PROBLEM: VALUE IS AN ELUSIVE STANDARD

As Justice Brandeis stated, "value is a word of many meanings."⁶ In no area of the law is this more true than in valuation of stock, where at least four different concepts prevail.⁷ While considerable effort has been expended in developing a formula or rule of thumb to resolve valuation problems, none has yet been found. Experts have concluded that every valuation problem is different and that each is affected by its particular time and its particular economic setting. As one commentator has noted, "there is no getting away from a certain amount of laborious investigation, analysis and comparison to which must then be applied the most important factor of all, *good business judgment*."⁸ (Emphasis added.)

Any test which relies heavily on judgment invites dispute. In tax matters, the judgment of the taxpayer and the judgment of the Commissioner will rarely coincide because, as a practical matter, their interests differ. Additional problems arise because the stock which must be valued is generally that of a close corporation, and, therefore, there are less likely to have been sales on an exchange to provide an easy index of valuation.⁹

⁴ United States v. Parker, 376 F.2d 402, 407 (5th Cir. 1967).

⁵ Harry Trotz, P-H Tax Ct. Rep. & Mem. Dec. ¶ 67,139 (1967); United States v. Parker, 376 F.2d 402 (5th Cir. 1967).

⁶ Southwestern Bell Tel. v. Public Serv. Comm'n, 262 U.S. 276, 310 (1923) (dissenting opinion).

⁷ Generally, the four concepts are: (1) "Market value" as the price for which the stock can be sold; (2) "Market value" as the price of equivalent shares; (3) "Intrinsic value" in an investment analysis sense; and (4) Value to the owner. 2 J. Bonbright, Valuation of Property 1020 (1937).

⁸ Ovens, Methods of Valuation for Privately Owned Businesses and Closely Held Companies, 36 Canadian Bar Rev. 57, 59 (1958).

⁹ Rev. Rul. 59-60 § 2.02 states that when a large percentage of a company's stock is held in a few hands (as it is in cases within the purview of these sections) the irregular sales which do occur seldom reflect all the elements in fair market value. Rev. Rul. 60, 1959-1 Cum. Bull. 237. This reasoning should also apply to publicly held corporations within the purview of these sections. Since the taxpayer whose interest is being measured necessarily holds a very large block, the number of shares traded is normally too small in relation to the total number outstanding to accurately reflect the fair market value of the taxpayer's holdings.

Further, control and restrictions on alienability are commonly present in close corporations.¹⁰ These factors are important to valuation, but they greatly complicate the valuation process.

Treasury regulations and rulings have been unsuccessful in providing an easy-to-use valuation method. In fact, Revenue Ruling 59-60 specifically states that no formula can be developed.¹¹ The Treasury Regulations only indicate some of the factors to be considered. For example, Regulation 20.2031-2(f)(2) provides for stock valuation based on the company's net worth, prospective earning power, dividend-paying capacity, and other relevant factors, which include good will, the economic outlook of the industry, the company's position in the industry, the company's management, and the degree of control represented by the block. Regulation 20.2031-2(h) adds the factor of restrictions on sale.

These regulations neither explain to the taxpayer how he is to determine the economic outlook of the industry nor how he is to prove it with a sufficient degree of accuracy to arrive at a reasonably precise estimate of value. The same valuation and proof problems are encountered with respect to several of the other factors suggested in the regulation. There is absolutely no guide to the taxpayer as to how much weight each factor is to be accorded in arriving at a final valuation. Regulation 20.2031-2(h) explains that these matters are to be determined upon the facts of each case. It is submitted that such enumerations of factors to be considered offer little help to a taxpayer confronted with a specific valuation problem. They are incomplete and lack rules for appraising the influence of the factors listed.

Neither do court opinions offer the taxpayer much help with his valuation problems, for the courts have not developed a set of basic standards. While there have been hundreds of stock valuations made by the courts, the opinions only point out that there are many factors to be considered, each to be given different weight in different fact situations.¹²

The nonexistence of any easy or sure standard for the valuation of stock holdings is a reflection of the complexity of the determination required. Since tax considerations undoubtedly play an important role in shaping many transactions, the elusiveness of the valuation standard places the taxpayer in a difficult decision-making position because he will rarely be sure that he has complied with the statute. Naturally, the taxpayer can avoid any conflict by keeping his holdings at a level clearly below that allowed by the Code in order to determine the cut-off point for the receipt of tax benefits, or the taxpayer may forego the transaction entirely. But neither of these alternatives should be forced on the taxpayer if they can be avoided by re-drafting the statute.¹³

¹⁰ Since these sections deal only with closely related units, often close corporations, it is to be expected that the dominant stockholder will usually control the corporation and that he will often issue stock to others subject to restrictions which allow him to control any future disposition of the minority interests.

¹¹ Rev. Rul. 60, *supra* note 9, at 243.

¹² Rustigan, Lentz & Olsen, *Problems in Valuing Stock of a Close Corporation*, N.Y.U. 23d Inst. on Fed. Tax. 1261 (1965).

¹³ It should be kept in mind that some tax rate differentials were introduced to encourage certain practices and to provide for deserved deductions. The sections under

II. RECENT CASES

The problems created by the use of the value test were central to the decisions in two recent cases: *Harry Trotz*¹⁴ and *United States v. Parker*.¹⁵ Both cases arose under section 1239, but the valuation issue would have been the same under sections 267, 304 or 318. The taxpayers in both cases were disputing the Commissioner's ordinary-income treatment of the gains they received when they sold capital assets to newly formed corporations. In both cases the valuation issue was important because the taxpayers' holdings were very close to the limit allowed under section 1239—Trotz owned 79 percent of the number of his corporation's stock and Parker owned exactly 80 percent of the number of outstanding shares of his corporation. The other important facts bearing on the valuation issue were also remarkably similar.

In *Parker*, the taxpayer owned a wholesale and retail gasoline and oil company. A corporation was formed to carry on the business. One thousand shares of a single class of common stock were authorized and subscribed, eight hundred shares to the Parkers¹⁶ and two hundred shares to Eaves. The Parkers paid for their stock by transferring property valued at \$93,400 to the corporation. Eaves agreed to pay \$23,350 over five years for his interest.¹⁷ Parker and Eaves entered into a stock-transfer agreement providing that should Eaves resign, die, or be permanently discharged by the corporation, he would sell his stock to Parker for an agreed-upon price determined by the fair market value per share of the corporation's assets excluding intangibles. Notice of the transfer agreement was placed on each stock certificate and the stock could not be transferred except in accordance with it.¹⁸ The stock of both Eaves and Parker was subject to a further restriction which required that an offer be made to the corporation before a sale could be made to an outsider. The latter restriction did not establish the price of the stock. If the corporation did not accept the offer, the stock could be sold at or above the price at which the shares were offered to the corporation.

Parker reported the gain on the property which he transferred to the corporation as a capital gain. The Commissioner invoked section 1239 and taxed the gain as ordinary income. Parker paid the assessment and sued

discussion were passed to disallow these advantages in a limited class of cases. It is a dear price to pay for this result if these sections unnecessarily discourage supposedly favorable transactions or disallow legitimate deductions. In fact, the legislative history of one of these sections demonstrates a congressional intent to minimize the inhibiting effect of that section. That intent was manifested in § 1239 by raising the percentage in value required to invoke the section from over 50 percent to over 80 percent in order not to unduly restrict transactions in capital assets. The relevant history of § 1239 is summarized in *Mitchell v. Commissioner*, 300 F.2d 533, 536 & nn.6-8 (4th Cir. 1962).

¹⁴ P-H Tax Ct. Rep. & Mem. Dec. ¶ 67,139 (1967), deciding on remand from 361 F.2d 927 (10th Cir. 1966), rev'g 43 T.C. 127 (1964).

¹⁵ 376 F.2d 402 (5th Cir. 1967), rev'g 242 F. Supp. 117 (W.D. La. 1965).

¹⁶ Ownership of Parker's wife's shares was attributed to Parker under § 1239.

¹⁷ Stock was issued to Parker and Eaves in proportion to the amount of paid-in capital each contributed. Of total paid-in capital of \$116,750, Parker contributed 80 percent and Eaves contributed 20 percent.

¹⁸ The operative provisions of the agreement are set out by the court of appeals. 376 F.2d at 404 n.1.

for a refund in the district court. The district court held that the per-share value of Parker's shares was equal to the per-share value of Eaves' shares, and therefore, since Parker owned only 80 percent of the number of shares outstanding, section 1239 was improperly applied. It made no difference that all of Eaves' shares were not issued and could not be voted¹⁹ or that the transferability of Eaves' stock was limited by a stock-transfer agreement which did not apply to Parker's stock. The market value of the stock was established by the amount of paid-in capital. Since both Eaves and Parker contributed equal amounts per share, and too little time had passed for the stock to change in value, Parker did not own more than 80 percent in value of the outstanding stock.

The court of appeals reversed, holding that the words "in value" referred to fair market value of the stock, and that Parker's stock had a greater per-share value than Eaves' stock. The court found that the restrictions placed on Eaves' stock made it less easily transferable than Parker's stock and, therefore, less valuable. In addition, the court held that corporate control increased the value of Parker's shares in relation to Eaves', for by virtue of his overwhelming control, Parker could protect his investment by conducting the affairs of the corporation according to his own judgment and without regard to Eaves' opinions. The court noted that it was not necessary to determine the extent to which restrictions and control increased the value of Parker's shares. Since he owned 80 percent of the number of outstanding shares, *any* increase in the relative value of Parker's shares or decrease in the relative value of Eaves' shares would mean that Parker owned over 80 percent in value of the stock. Therefore, the court held that section 1239 was properly invoked by the Commissioner.

Although the court of appeals in *Parker* never reached a dollar valuation, its approach to the valuation issue is similar to the approach traditionally used by courts in stock valuation for other tax purposes. In the *Trotz* case, however, the Tax Court used a quite different approach even though it was dealing with a similar fact pattern. Harry Trotz, the owner of a small construction firm, decided to reorganize his business in a corporate form. The charter of Trotz Construction, Inc. (hereinafter referred to as Construction) provided for four hundred shares of authorized common stock, par value \$100 per share. Three hundred-sixteen shares (79%) were distributed to Trotz and his wife, and eighty-four (21%) were distributed to Ben F. Kelly who became an officer in Construction. This percentage distribution was chosen specifically to avoid the consequences of section 1239.²⁰ Trotz purportedly loaned Kelly the \$8,400 required for Kelly's stock purchase, and to secure payment, Kelly pledged his shares and any dividends he might receive to Trotz. As part of the same transaction, Kelly executed an option contract which permitted Trotz to purchase Kelly's stock at a price prorated

¹⁹ The district court found that under Louisiana law, while shares subscribed are considered outstanding, they cannot be issued until the subscription price is fully paid, and that only issued shares could vote. *Parker v. United States*, 242 F. Supp. 117, 120-21 (W.D. La. 1965). Eaves' original payment of \$7,500 entitled him to 64,239 issued shares. It is noted that Parker's subscription of 800 shares was fully paid and issued, and had full voting rights.

²⁰ Brief for Petitioner on Remand at 5, P-H Tax Ct. Rep. & Mem. Dec. ¶ 67,139.

to tangible book value. The option was operative at any time Kelly ceased to be an officer or director of the corporation.²¹ Since the by-laws of Construction allowed any officer or director to be removed by majority vote of the stock, in effect the option could be exercised as Trotz desired.

In deciding the case, the Tax Court first attributed the ownership of Kelly's shares to Trotz because of the option agreement and the fact that Trotz could make it operative at any time. The court of appeals reversed on this issue stating that the ownership attribution provisions of section 1239 did not provide for attribution on the basis of an option to purchase. The Government, however, made the argument that even if Kelly's shares could not be attributed to Trotz, he nevertheless owned over 80 percent in value of the outstanding shares. This question had been left open in the Tax Court. The court of appeals rejected Trotz' response that the value test was to be applied only where a corporation had more than one class of stock, pointing out that no such distinction is called for in the statute. It similarly rejected Trotz' contention that the value test was too difficult to apply. The court held that since the statute uses the words "in value," they must have meaning, and that a numerical count of the number of shares owned was not determinative. The case was remanded to the Tax Court to make a factual determination as to whether Trotz' holdings were over 80 percent in value of the outstanding stock. The opinion of the court of appeals in *Trotz* is consistent with the opinion of the court of appeals in *Parker* since the court clearly implied that it would be proper for the Tax Court to find Trotz' shares more valuable than Kelly's.

In the Tax Court on remand,²² the Government argued that Trotz' holdings were worth more per share than Kelly's because the true book value of the stock was \$42,000, and that Trotz' 79 percent stock interest had a value of \$38,000 or 90 percent because Trotz had control of an option to purchase Kelly's stock.²²

The court rejected these arguments and held in favor of the taxpayer. It did not do so, however, by a simple count of the shares held by Trotz and Kelly. Its decision was based upon the nature of a small construction business which worked for the State on a low bid basis. It reasoned that since such a corporation had no going-concern value, no goodwill could be attributed to it. The court then concluded that the existence of control was irrelevant since a purchaser of such a business would not be acquiring a going business, but rather the underlying assets.

The restrictions were also held to have no effect upon the value of the

²¹ The operative provisions of the agreement are set out by the Tax Court. *Harry Trotz*, 43 T.C. 127, 129-30 (1964).

²² The Commissioner arrived at this figure by adding his estimate of goodwill (\$2,000) to the corporation's book value of assets (\$40,000). The Commissioner also maintained that Trotz' 79 percent stock interest had a value of \$38,000, or 90 percent of the corporation's value. This was an increase in value of \$7,600 from his original contribution of \$31,600. The Commissioner justified his valuation on the grounds that the factor of control was present in Trotz' holdings and because Eaves' shares were subject to Trotz' option. The taxpayer commented on the Government's financial manipulations by stating, "It is a study in the creation of 'instant wealth' . . ." Brief for Petitioner on Remand at 8, P-H Tax Ct. Rep. & Mem. Dec. ¶ 67,139.

stock due to the lack of going-concern value. Kelly was guaranteed a price equal to his pro rata share of underlying assets, and this was the highest price that could be obtained on the market.

Although both cases involved similar fact situations, they were decided differently. That the court of appeals in *Parker* and the Tax Court in *Trotz* used different criteria to value the stock before them is not surprising since the problems involved in stock valuation are numerous and there is no generally accepted agreement on the proper way these problems should be met.

III. TWO FACTORS INFLUENCING VALUE

The factors of corporate control and restrictions on alienability were important to the stock valuations in both *Parker* and *Trotz*. Even with regard to factors which occur as frequently as do restrictions and control, it is difficult to find accord among the courts on the treatment of such factors.

A. Restrictions on Alienability

Before attempting an appraisal of the effect of a restriction on the value of the restricted stock it is necessary to establish the exact nature of the restriction. In *Helvering v. Tex-Penn Oil Co.*,²³ a restriction which prohibited sale of the stock as long as the current operating syndicate functioned was held to deprive the restricted stock of all value. One reason for the decision was that the restrictions on sale of the stock and the speculative nature of the business²⁴ prevented the stock from having a reasonably ascertainable market value.²⁵ Because of the nature of the business and the indefinite duration of the stock restriction,²⁶ *Tex-Penn* presents an extreme fact situation, but other cases with less extreme facts have followed *Tex-Penn* in finding stock subject to similar restrictions valueless. In *Propper v. Commissioner*,²⁷ the stock of a textile company was subject to a five-year agreement prohibiting sales except with the consent of the bankers who were aiding in the financing of that corporation. The value of stock not subject to the restriction was established by sales at \$33.00 per share. The Commissioner valued the restricted stock at \$21.00 per share, but his valuation was not upheld. The court of appeals followed *Tex-Penn* and found the stock to be without ascertainable value.

Other restrictions on the alienability of stock have been held by several courts to be determinative of the value of the restricted stock without depriving it of all value. An option which can be exercised at the call of

²³ 300 U.S. 481 (1937).

²⁴ The restriction is set out by the Board of Tax Appeals. *Tex-Penn Oil Co.*, 28 B.T.A. 917, 939-40 (1933). *Tex-Penn* was engaged in developing oil leases. The Supreme Court did not indicate to what extent its holding was based on the speculative nature of the business, it only stated that it was one factor considered. This element has often been used to distinguish the case. See p. 179 *infra*.

²⁵ The Court seemed concerned that any value found would be based largely on guesswork. But other courts have been less troubled by this problem. See, e.g., *Edith G. Goldwasser*, 47 B.T.A. 445 (1942).

²⁶ For another approach to determine the effect of a restriction with an indefinite duration, see *William C. Newman*, 10 B.T.A. 158 (1928), *aff'd*, 40 F.2d 225, rehearing denied, 41 F.2d 743 (10th Cir.), cert. denied, 282 U.S. 858 (1930).

²⁷ 89 F.2d 617 (2d Cir. 1937).

the option holder, has been held to limit the value of the restricted stock to the price at which the option is available. A leading case in this area is *Helvering v. Salvage*,²⁸ where the stock was available at the option price of \$100.00. Each share of unencumbered stock in this case was found to be worth \$1,164.70 based on the book value of the corporation's assets; the taxpayer had purchased the stock for \$166.66. The Supreme Court held the maximum value for the stock was \$100, the price at which the option was available. Similarly, in *Wilson v. Bowers*,²⁹ stock was available at an established price on the option holder's demand but the Commissioner taxed them at a substantially higher value. As in *Salvage*, the court held that the option price set an upper limit on the stock value.

Judge Learned Hand, expanding on the rule of the *Salvage* and *Wilson* cases in *Commissioner v. McCann*,³⁰ stated that it applied when the option was immediately available, since it is assumed that the option will be exercised if the market value exceeds the option price. But, when the option is exercisable only on the happening of a future event, the court reasoned that the option price was not determinative but was only one factor to be considered in valuation. He held the latter rule to apply in *McCann* even though on the happening of the event which made the option operable (the death of the stockholder or the termination of his employment with the corporation) the corporation was *obligated* to purchase the stock for its book value.

Salvage, *Tex-Penn* and *Propper* should not be relied upon as authority without question, even for cases with similar fact situations. Each valuation problem presents a unique fact situation and some courts have tended to emphasize the differences in the case before them rather than the similarities with these leading cases. Because valuation is a mixed question of law and fact, sufficient latitude is available to courts to make such distinctions. For example, the court in *Heiner v. Gwinner*³¹ valued stock subject to a one year prohibition against sale. The court distinguished *Tex-Penn* because of the lack of speculative element in the business,³² and it distinguished *Propper* because the restriction in that case was for five years. The court also purported to rely on other factual distinctions but it did not elaborate on them.

The stock before the court in *Charles T. Kline*³³ contained two restrictions. The first, similar to that in *Salvage*, required that an offer be made to the directors at a set price should the stockholder leave the employment of the corporation. Varying prices were set depending on the circumstances surrounding the termination of the stockholder's employment. The other restriction was similar to that in *Tex-Penn*, that is, it prohibited sale of the

²⁸ 297 U.S. 106 (1936).

²⁹ 57 F.2d 682 (2d Cir. 1932). This is an estate tax case. By its terms, the option was operable on the stockholder's death. Therefore, at the time of valuation, the option was subject to immediate exercise. Although in *Salvage* the option was exercisable at any time, the practical effect of the option in *Wilson* at the time of valuation was the same.

³⁰ 146 F.2d 385 (2d Cir. 1944).

³¹ 114 F.2d 723 (3d Cir.), cert. denied, 311 U.S. 714 (1940).

³² See note 24 *supra*.

³³ 44 B.T.A. 1052, 1056 (1941), aff'd, 130 F.2d 742 (3d Cir.), cert. denied, 317 U.S. 697 (1943).

stock without consent of the directors of the corporation. In *Kline*, the taxpayer argued that the restricted stock had no value, and alternatively that its maximum value was the lowest price set by the option, that available on his discharge.³⁴ The Commissioner valued the stock at \$43.00 per share; both the Tax Court and the court of appeals indicated that the intrinsic value of the stock was above that figure. The court of appeals distinguished *Tex-Penn* and *Propper* on the grounds of lack of a speculative element. It distinguished *Salvage* because the court felt it was unlikely the option would be exercised by the directors. The court upheld the Commissioner's valuation, noting that although the restriction may have lessened the value of the stock, the Commissioner had made ample allowance for any reduction in value by his appraisal of \$43.00.

The *Kline* case is illustrative of the second general effect restrictions have been found to have on value, that is, to lower the value of the restricted stock. This was the position taken by the court in *Parker where Worcester County Trust Co. v. Commissioner*³⁵ was cited with approval. The restriction in *Worcester County Trust* required that before any sale of the stock could be made to an outsider, an offer must first be made to the corporation which could then purchase the stock for book value plus dividends. This restriction was included in the by-laws of the corporation, and any subsequent purchaser of the stock took subject to it. The court held that the price in the agreement at which the corporation could purchase was not determinative of the stock's value since, if the corporation did not exercise its option, the stock could be sold for any price. It stated, however, that the restriction did have a depressing effect on value because a commodity capable of being freely sold is obviously worth more than the same commodity with restrictions on alienability. The crucial fact was that subsequent purchasers took subject to the restriction.

In *James Couzens*,³⁶ the court dealt with a similar right of first refusal, except in *Couzens* subsequent purchasers did not take subject to the restriction. The court found the restriction to have no depressing effect on value,³⁷ because the determination of fair market value requires the assumption of a willing buyer and seller. Therefore, the court reasoned, although the stock was more difficult to buy and sell,³⁸ that fact should not have a depressing effect on value. However, the assumption of a willing buyer and seller, which was made in *Couzens*, should not change the reluctance of a future purchaser to pay full value for stock which will remain subject to a restriction in his hands as was the case in *Parker*. A buyer would be unwilling to pay the full value since he is not receiving full value, that is, he is not receiving freely alienable stock.

In *Trotz*, a buyer of the restricted stock would take subject to restric-

³⁴ In *Kline*, the stock was being valued for gift tax purposes, therefore, the taxpayer was arguing for the lowest possible value.

³⁵ 134 F.2d 578 (1st Cir. 1943).

³⁶ 11 B.T.A. 1040 (1928).

³⁷ Accord, *La Motte T. Cohu*, 8 T.C. 796 (1947).

³⁸ An example of the difficulties such a restriction would impose on the sale of the restricted stock would be presented by a situation where the potential buyer would be unwilling to wait until the option's time limit had expired.

tions on future sales, but the Tax Court did not allow a discount for the restricted shares. The court provides a satisfactory explanation for the seeming contradiction with *Parker* and *Worcester County Trust*, in that its decision was based on the nature of Construction—the fact that it had no going-concern value. Because of this, the court found the maximum value for *all* stock of the corporation to be its pro rata share of tangible assets. If the option on Eaves' shares were exercised, the price guaranteed would be equal to the pro rata share of these assets, therefore, no loss to the stockholder would occur. The court's reasoning appears sound. Stock has value because it represents ownership of a corporation's assets and because it allows the stockholder to share in future earnings of the corporation.³⁹ Because the latter element is not present in Construction, the court seems correct in excluding it from its consideration while establishing the value of that corporation's stock.

It is fortunate for the courts in both *Trotz* and *Parker* that they were not required to appraise the *extent* of the influence of the restrictions. Although it is difficult to assess whether a restriction affects stock value, it is much more difficult to determine the extent of any effect found to exist. The latter issue involves such a maze of factual determinations that any resolution of the problem is bound to be an approximation. Several of the cases already discussed suggest some of the elements which must be considered when assessing the extent of the effect of a restriction on alienability on the value of the restricted stock. The court in *Kline* speculated on the probability that the option holder would press an economic advantage and exercise the option.⁴⁰ The court in *McCann* suggested to the lower court that it consider the stockholder's power to alter the by-laws and remove the restriction.⁴¹ Many more examples of the factors relevant to the effect of restrictions on stock value could be listed, but these few illustrations show that not only is there no general agreement which factors should be included, but that many of the factors by their very nature defy a precise quantitative measurement.

Whenever the taxpayer decides to structure the transaction to approach the statutory cut-off point, he runs the risk that the Commissioner may review the transaction and make an independent valuation. Although the Commissioner may use the same standard, there can be no assurance that he will reach the same dollar valuation reached by the taxpayer, especially if factors such as restrictions on alienability are present. Not only is the Commissioner's viewpoint different, there is no true standard upon which either party can form or justify its appraisal of the precise effect of the factors involved. In any judicial determination of this conflict the Commissioner's valuation is *prima facie* correct, and the burden of proof rests on the taxpayer to prove affirmatively a higher or lower valuation.⁴² Because

³⁹ See Rev. Rul. 60, *supra* note 9, at 238-42; 14 W. Fletcher, *Private Corporations* § 7005 (perm. ed. 1965).

⁴⁰ 44 B.T.A. at 1056.

⁴¹ 146 F.2d at 386.

⁴² *Fesler v. Commissioner*, 38 F.2d 155, 157 (7th Cir.), cert. denied, 281 U.S. 755 (1930); *Rice v. Eisner*, 16 F.2d 358 (2d Cir. 1926); *J. Bonbright*, *supra* note 7, at 1026. Cf. *Worcester County Trust Co. v. Commissioner*, 134 F.2d 578 (1st Cir. 1943), where

of the lack of a sound standard, the taxpayer's opportunity to disprove the Commissioner's valuation is slight. To be upheld, the Commissioner probably only needs to show that he considered the various factors.⁴³

But such lack of predictability is not peculiar to the effects of restrictions on alienability; similar problems plague all factors in valuation. Another of these factors, important to both the *Parker* and *Trotz* cases, is the effect of corporate control on the value of the taxpayer's stock.

B. Corporate Control

The case law concerning the effect of control on stock valuation meets with the same general questions as that dealing with the effect of restrictions on value, that is, whether control is a factor to be considered in valuation cases, and if it is, how much weight should it be given in a particular situation. There is a line of authority which holds that control should not be considered as a factor. In *Lewis v. Racine*,⁴⁴ the court held that the "market value of stock is to be determined from the value of that stock generally and not from the special value which accrued to plaintiffs [sellers] by reason of their majority control."⁴⁵ The court held all shares were of equal value even though it recognized that as a practical matter controlling shares could generally command a premium on sale.⁴⁶ Similarly, the court in *Rice v. Eisner*⁴⁷ found that any increase in stock value caused by control is wholly speculative. Furthermore, since any attempt to market a controlling block would probably depress the market price of the stock, the court held that if the size of the taxpayers' holdings mattered at all it tended to lower the value of the stock.⁴⁸

But the weight of authority holds that control increases value.⁴⁹ This line of authority recognizes that controlling shares can be sold at a premium, a consideration that was noted, but disregarded in *Rice*. There are several reasons why control increases the value of stock. First, control permits the stockholder to develop special relations with the corporation and provides opportunities for profit which are not available to minority stockholders.⁵⁰ Second, it costs less and it is often more convenient to deal in large blocks of stock than in smaller blocks. Third, and perhaps most important with regard to the effect of control on value is the power that control gives to the

the Commissioner's valuation was struck down without the taxpayer showing a suitable alternative value. In this case, the Commissioner's valuation was found to be arbitrary.

⁴³ Compare *Worcester County Trust Co. v. Commissioner*, 134 F.2d 578 (1st Cir. 1943) with *Charles T. Kline*, 44 B.T.A. 1052 (1941), aff'd, 130 F.2d 742 (3d Cir.), cert. denied, 317 U.S. 697 (1943).

⁴⁴ 179 Wis. 210, 190 N.W. 476 (1923).

⁴⁵ Id. at 220, 190 N.W. at 480.

⁴⁶ See *Estate of Nieman*, 230 Wis. 23, 283 N.W. 452 (1939).

⁴⁷ 16 F.2d 358 (2d Cir. 1926).

⁴⁸ The court felt a lower sales price would result from an attempt to market such large quantities of the stock. Id. at 361.

⁴⁹ *Levy v. American Beverage Corp.*, 265 App. Div. 208, 38 N.Y.S.2d 517 (1942); *Tyron v. Smith*, 191 Ore. 172, 229 P.2d 251 (1951); *Hill, The Sale of Controlling Shares*, 70 Harv. L. Rev. 986 & n.1 and authorities cited therein (1957).

⁵⁰ See, e.g., *Moore-McCormack Lines, Inc.*, 44 T.C. 745 (1965), where the purchaser of a large block of stock was able to secure employment for former associates.

shareholder to direct the affairs of the corporation, and thereby protect his investment.⁵¹ It is only reasonable to expect that since such practical considerations as the opportunities to develop special relations, the economies of dealing with large blocks, and the power to direct the corporation's affairs are reflected in the market price of the stock that they should also be reflected in the law of valuation.

As with restrictions on alienability, corporate control generally exerts an undeniable but indeterminate influence on value. Well-reasoned authority on the subject of control recognizes this influence and attempts to minimize the uncertainties inherent in the appraisal of its extent by considering most of the relevant factors in the particular case under consideration. As with restrictions, there are no established rules to aid the taxpayer in determining the dollars and cents value of controlling shares. Determination of the influence of the relevant factors is a matter of "good business judgment."⁵² Even if the taxpayer makes an allowance for the factors of control in his valuation, he is likely to encounter a revaluation by the Commissioner and thereafter, proof problems similar to those encountered when dealing with restrictions. While the appraisal of the effect of control is difficult because of the many factors which the various court opinions suggest should be considered, there may be other factors, not yet mentioned by the courts, which should be considered in a truly complete analysis. Although there is general agreement that a premium can be obtained for controlling stock, some courts have held that the seller does not have an absolute right to retain this premium. Even when courts talk of an "inalienable right" to sell the controlling stock upon any terms that can be obtained, the right to keep the premium is contingent on the seller not breaching a duty owed to the corporation.⁵³ There have been long-established limits on the right of a selling stockholder to retain the premium gained in the sale of controlling stock.⁵⁴ Berle and Means introduced a theory which would further limit this right, namely, that control is a corporate asset.⁵⁵ The corporate asset theory led to the conclusion that if a controlling interest was sold, any premium for control could not be retained by the selling stockholder, but must be returned to the corporation. Since that time, several other theories have been developed to reach the same result. Although these theories have been criticized,⁵⁶ some writers think they form the basis for the decision in *Perlman v. Feldmann*,⁵⁷ a case which may have implications in the stock valuation area.

⁵¹ For a discussion of all these factors see Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 Harv. L. Rev. 505 (1965).

⁵² See p. 172 & note 8 *supra*.

⁵³ E.g., *Stanton v. Schenck*, 140 Misc. 621, 251 N.Y.S. 211 (Sup. Ct. 1931).

⁵⁴ See, e.g., *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941), which concerned the sale of a controlling interest to persons who should have been suspected of having an intent to loot the corporation. See generally Annot., 50 A.L.R.2d 1146 (1956).

⁵⁵ A. Berle & G. Means, *The Modern Corporation and Private Property* 244 (1932).

⁵⁶ *Honigman v. Green Giant Co.*, 309 F.2d 667 (8th Cir. 1962), cert. denied, 372 U.S. 941 (1963); *Hill, The Sale of Controlling Shares*, 70 Harv. L. Rev. 986 (1957).

⁵⁷ 219 F.2d 173 (2d Cir. 1955), rev'g 129 F. Supp. 162 (D. Conn. 1952). For views that the corporate asset theory is expressed in *Perlman*, see Andrews, *supra* note 51, at 512-13; Jennings, *Trading in Corporate Control*, 44 Calif. L. Rev. 1, 10-11 (1956). But see *Honigman v. Green Giant Co.*, 309 F.2d at 670.

In *Pelzman*, a controlling interest in a steel producing corporation was sold to a syndicate of ultimate steel users. The court in *Pelzman* held that the premium obtained for control when the majority stockholder sold his interest should be returned to the corporation. The court required the seller to return the premium since it was compensation for the sale of a corporate asset. The asset the court referred to was the power to control allocation of the corporate product in a time of short supply, therefore, the case is not direct support for the Berle and Means theory which viewed control as the corporate asset. But *Pelzman* is obviously based on a closely related principle.

The limits of the *Pelzman* doctrine have not yet been defined, but if carried to the logical extremes, there are many situations in which corporate control could be removed as a factor in stock valuation since the premium could not be retained. Even without carrying *Pelzman* to its logical extremes, several factors are suggested which should be included in an appraisal of the effect of control on value. For example, perhaps it should be queried whether the duties which accrue by virtue of holding a majority interest will discount any increase in value which control implies. And perhaps there should be an examination of the field of potentially willing buyers to determine if there can be any who are not only willing to pay a premium but from whom the premium received could be retained. No court has yet considered such factors, but they would seem to be necessary to a complete analysis in some cases.

In *Parker*, such an analysis was not necessary because the court found sufficient added value to invoke section 1239 by simply considering the increase due to the investment value of controlling shares. In *Trotz*, however, the court did not discuss even the more generally accepted implications of control on value. *Parker* in this respect is in accord with the authorities previously discussed, while *Trotz* is apparently incorrect in light of the traditional approach. Even granting the lack of going-concern value of Construction, control still allowed *Trotz* to protect his investment. This investment value would be reflected in the market price as surely in *Trotz* as it was in *Parker*.

The court in *Trotz* also apparently overlooked another influence control might have on value. It held the value of all stock equal to its pro rata share of the underlying corporate assets. It reasoned that a purchaser would only be interested in purchasing the stock to gain possession of these assets. But the court overlooked that purchasing *Trotz*' controlling stock would give the buyer effective use of *all* the assets of the corporation, not just the percentage of the assets determined by the ratio of *Trotz*'s shares to all outstanding shares. This is the essence of corporate control. It is submitted that to gain use of all the assets, a buyer would be willing to pay a premium for controlling stock and that this premium indicates a greater value in the controlling shares than in the minority shares. If viewed in this light, sufficient justification could have been found to hold that control increased the value of *Trotz*' shares over their pro rata share of the underlying assets.

But even if the court in *Trotz* had used this approach there is no assurance it would have held for the Commissioner. It would still have been necessary for the court to determine if the increase in value was large enough

to give Trotz ownership of more than 80 percent in value of the outstanding stock. Because Trotz' numerical holdings were so close to 80 percent, it is reasonable to expect that the court would have held for the Commissioner. But what if Trotz had held only 70 percent of the number of the outstanding shares? Control would still be present in his holdings, but it cannot be said with assurance that this fact would cause a 10 percent increase in the value of his shares in relation to Kelly's. The difficulty in making such determinations is the heart of the problem facing a taxpayer considering a transaction within the purview of section 1239 and the other sections which use the value test. This is not an impossible problem, but it is fraught with enough complexity to make it extremely difficult for the taxpayer to be sure of his answer. It is submitted that conflict is inevitable when such a complex concept as stock valuation is made central to tax determinations. By requiring stock valuation to be made, Congress has, in effect, made conflict inevitable. The wisdom of this decision is open to question.

IV. THE STATUTORY VALUE TEST

The legislative history of the value test in section 1239 and related sections of the Code reveals that this test was chosen to deal with a specific evil. The value test first appeared in the Code when section 24(a)(6)(B)⁵⁸ was added by the Revenue Act of 1934. The House Bill which added this section provided for a test based on the *number* of voting shares owned by the taxpayer in order to measure the relationship between an individual and his corporation.⁵⁹ The Senate substituted a test which measured this relationship by the percentage *in value* of the outstanding stock of the corporation.⁶⁰ It is the value test drafted by the Senate which prevailed in section 24. Later sections, such as section 1239, apparently adopted the test without question, changing only the percentage requirement to meet the specific objectives of the section.⁶¹

The House test, based on a count of the voting stock, had one distinct advantage: it was easy to apply. It set forth a standard for tax planning under which virtually no confusion could arise. A simple count of the number of voting shares was all that the House version required. Neither taxpayers nor the courts were required to consider the multitude of factors which enter into stock valuation.

One shortcoming, however, caused its replacement by the value test. The Senate foresaw that in corporations where there was more than one class of stock, situations would arise where an individual holding stock of considerable value in relation to all outstanding stock, and yet not holding a large proportion of the voting stock, could receive the benefits which section 24 was intended to disallow. The Senate proposed the value test to close this loophole, and the House acquiesced.

⁵⁸ Act of May 10, 1934, ch. 277, § 24, 48 Stat. 691. Section 267 of the 1954 Code was derived from this act.

⁵⁹ H.R. 7835, 73d Cong., 2d Sess. (1934).

⁶⁰ Senate Committee on Finance, 73d Cong., 2d Sess., Report on the 1934 Revenue Bill, 1 CCH Stand. Fed. Tax Serv. ¶ 341.04 (1935).

⁶¹ See note 13 *supra*.

The value test is not without merit. It provides the flexibility required in a test which measures the relationship between an individual and his corporation. Flexibility is necessary because an inflexible test such as that proposed by the House can be avoided by use of a complex capitalization arrangement. Use of the value test enables the Commissioner and the courts to examine the capitalization of the corporation to determine the extent of the stockholder's ownership, even where different classes of stocks with different rights are used. While different classes of stock cannot be compared by a standard such as voting power since some classes of stock cannot vote, all stocks can be compared by use of a value test. The stockholder's interest can then be computed simply by multiplying the number of shares he owns by the value determined for each share. But the determination of the stockholder's interest by stock valuation is not as easy in practice as it is in theory. Although the value test's flexibility provides its advantages, this flexibility is also responsible for the complexity which the test entails.

A further shortcoming is that the value test is not precise. The test involves such a multitude of factors, each with a different weight in different situations that it invites error. In view of the reasons for the valuation, however, it is not practical to make a truly exact valuation. Because value has many different meanings, it is necessary before making a valuation to consider the purposes for which the valuation is required.⁶² Both *Parker* and *Trotz* discuss valuation as though they were valuing stock for estate or gift tax purposes since this is the area in which stock valuation law developed.⁶³ Perhaps in the estate and gift tax areas the problems inherent in stock valuation must be suffered since there is no alternative; property must be appraised at a dollar value before it can be taxed. But under section 1239 and related provisions, valuation of stock is not important as an end in itself. Once the value is determined, no tax rate is applied to it in order to determine a tax liability. On the contrary, value in the context of the sections under consideration is useful only so far as it provides an index to measure the nature and extent of the relationship between the taxpayer and the corporation. As in *Parker* and *Trotz*, when courts consider valuation problems, they will discuss the importance of restrictions on alienability and corporate control to the value of the taxpayer's shares. Although such a focus is in accord with traditional valuation law, this focus can tend to lose sight of the real issue under section 1239—the extent of the relationship between the taxpayer and his corporation. The restrictions on alienability of *Eaves'* and *Kelly's* shares, and the corporate control attached to *Parker's* and *Trotz's* shares, is very revealing of the nature and extent of this relationship. That these factors are also indicative of the value of the taxpayer's shares is only of incidental importance except that section 1239 requires the value test to be used.

V. AN ALTERNATIVE TEST

While the value test is useful in measuring the relation between a stockholder and a corporation in which a complex capitalization arrangement

⁶² 1 J. Bonbright, *The Valuation of Property* 10 (1937).

⁶³ See, e.g., *Wilson v. Bowers*, 57 F.2d 682 (2d Cir. 1932) (Estate tax); Charles T. Kline, 44 B.T.A. 1052 (1941) (Gift tax).

is used, the Code makes no allowance for an alternative test to be applied when such complexities are not present. It is important in this regard to note that a large number of corporations do not use more than a single class of stock.⁶⁴ Therefore, as a practical matter, the complex value test is required more often than can be justified. It is submitted that in corporations with but a single class of stock an alternative to the value test should be used. The proposed alternative test would measure the relationship by the *number of shares* of the corporation owned by the taxpayer in relation to the total number of outstanding shares.

The suggested simplification need not be limited to corporations with a single class of stock. If, for example, a corporation issues one class of common stock, and a single class of preferred stock which can be converted into common stock at the will of the directors or the stockholder, these preferred shares could, for the purposes of the statute, be considered equal to the number of shares of common stock that such conversion would bring. The use of the value test is justified only when it provides a means of judging the relative importance of stockholder's holdings when those holdings are nonfungible. When a more easily applied standard is available, the use of the value test injects unnecessary complexity into the determination. Congress should amend the present statute accordingly.

While it could be argued that the influence of control is so important to the stockholder-corporation relationship that the proposed alternative is defective because it does not reflect control, a reduction of the percentage required to invoke the statute could solve the problem. Since control occurs so commonly, an estimate of the average reduction of the statutory percentage which would compensate for influence of control could be made. A similar solution could be used, when redrafting the statute, to negate the influence of other commonly occurring factors such as restrictions on alienability, if it is felt that these factors should be reflected in the measurement.

It could also be argued that even with the adjustments suggested above the alternate test is not ideally suited to measuring the relationship between the stockholder and the corporation because it fails to account accurately for many facets of the stockholder-corporation relationship. But it must be remembered that the value test which it would replace is not ideally suited to measuring this relationship either. In fact, the relationship is so complex that any practical measurement must necessarily be only an approximation. Like the present value test, the alternative measures the relationship by its most important characteristic, the extent of the individual's ownership of stock of the corporation. But unlike the value test, the alternative test can

⁶⁴ No statistics have been compiled to support this statement, but due to the nature of the corporations with which § 1239 and related provisions are concerned, substantially one-man businesses, the statement appears reasonable. Corporations of this type do use more than one class of stock in special situations, for example, to obtain outside financing or in employee incentive programs. But many corporations do not require outside financing, and by using stock alienability restrictions, as did Parker and Trotz, the dominant stockholder can allow employees to hold stock without risking loss of control. For these reasons, it seems that *Trotz* and *Parker* present capitalization arrangements typical of many corporations within the purview of § 1239 and related sections.

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be easily administered and it offers a standard for tax planning. The ease with which the alternate test can be applied appears to outweigh its slight relative inaccuracy. While limited use of the value test may be necessary, its present wide use can not be justified in light of the available alternative.

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