VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

Valuation & Litigation Consulting, LLC
600 E. Granger Road, Second Floor
Cleveland, Ohio 44131

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RESTRICTIVE AGREEMENTS AND VALUE
GIFT TAX V. ESTATE TAX
THE COURT'S VIEW

It is well settled that restrictive agreements generally do not control value for Federal gift tax purposes, pursuant to a long line of case-law. At most, a restrictive agreement may be a factor to consider in determining gift tax value. Over the years, many reasons have been advanced by the courts for the disparate treatment accorded restrictive agreements for gift tax versus estate tax purposes.

In estate tax cases, the purchasing individuals or entities have immediately exercisable, valid, and irrevocable rights to purchase the decedent's interest from the estate as of the valuation date. The critical event (death) that subjects the stock to the purchase right has occurred, and it is clear that the seller/estate can receive no more than the formula price in the agreement. However, in gift tax cases, the transferring stockholder or partner is under no immediate obligation to sell. Instead, he merely agrees to offer his interest to the other owners on stated terms if and when he decides to sell or transfer his interest. Thus, the obligation to sell has not matured in the gift tax cases, and therefore cannot set a ceiling on transfer tax value.

Similar doctrines emerge in cases involving the estate valuation of entity interests subject to so-called buy-sell agreements. Where the estate of a deceased shareholder was *obligated to offer* the partner's interest to the surviving partners and where the surviving partners were *obligated to buy* that interest at a predetermined price based solely on book value, the predetermined price was held to be the proper one for estate valuation purposes. **But**, where the surviving partners were not obligated to purchase the decedent's interest, a similar restrictive agreement was held to be only a factor in ascertaining the fair market value of the decedent's interest.

Resale value is not the only factor to consider in determining fair market value for gift tax purposes. Until the transferor actually disposes of his interest, he is entitled to all the rights and privileges of ownership (e.g., rights to receive dividends and to decide when to dispose of his interest). Thus, courts have found that gift tax fair market value should include this "retention value", which the restrictive agreement price does not adequately capture. The transferor has retained the right to choose when and if a disposition would occur. In the meantime, the transferor is entitled to receive dividends or partnership distributions, and to enjoy the other benefits associated with his or her investment. The estate executor has no such discretion at the stockholder's death.

One court's rationale for rejecting the formula price as the absolute determinative of fair market value is that such a figure does not represent the value of all of the rights inherent in the ownership of a stock certificate. The right to surrender (dispose of) was only one of the "substantial legal incidents of ownership". The shareholder also had the "right to retain it for its investment virtues". He retained the right to receive dividends. In the case of liquidation, the shareholders are presumably entitled to recapture the equitable value underlying the shares. And finally, any possible long-term appreciation would inure to the benefit of the shareholders. Consequently, the so-called "retention value" of shares whose transferability has been restricted has been recognized as constituting an important criterion in determining the fair market value of such securities for gift and estate valuation purposes, but it is certainly not absolute.

If you would like additional information, or have a question, please do not hesitate to call.

Terri A. Lastovka, CPA, JD, ASA
Ph: 216-661-6626
Fax: 888-236-4907
lastovka@valueohio.com

Member of:

American Society of Appraisers
ASA
The International Society of Professional Valuers

Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.