

Effect of Stock Purchases Agreement on Death Tax Valuation

Erwin J. Keup

Follow this and additional works at: <http://scholarship.law.marquette.edu/mulr>



Part of the [Law Commons](#)

Repository Citation

Erwin J. Keup, *Effect of Stock Purchases Agreement on Death Tax Valuation*, 41 Marq. L. Rev. 48 (1957).
Available at: <http://scholarship.law.marquette.edu/mulr/vol41/iss1/4>

This Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Law Review by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrien@marquette.edu.

EFFECT OF STOCK PURCHASE AGREEMENTS ON DEATH TAX VALUATION

I. INTRODUCTION

The question of whether certain types of restrictive agreements concerning corporate stock controls the value of the stock for death tax purposes has received conflicting answers from the courts.¹ There are three common types of agreements normally used by stockholders to restrict the sale of a stipulated amount of their stock upon their death to certain individuals at a given price. These three types are commonly referred to as buy and sell, option, and restrictive sale agreements.²

Mutual buy and sell agreements are those whereby a corporation or individual promises to buy, and the stockholder promises to sell his shares at a specified price upon the happening of a certain contingency, usually the stockholder's death. It is of the essence of such an agreement that prior to the happening of the contingency, the stockholder will not sell the shares and upon the occurrence of such contingency, the buyer is bound to purchase the stocks.

Options to purchase stock at a stated price are similar to buy and sell agreements in that the stockholder agrees not to sell his stock prior to the happening of the contingency, or at least promises to first offer it to the optionee at the stipulated price. Upon the happening of the contingency, the stock must be first offered for sale to the optionee at the stipulated price. Such options differ from a buy and sell agreement in that the optionee is not bound to purchase at the stipulated price at all unless he so desires.

Under the third classification, the restrictive sale agreement, the stockholder agrees that *if* the stock will be sold during his lifetime or after his death it will first be offered to the other contracting party at an agreed price. This type of agreement differs from the other two types because of the possibility that neither the stockholder nor his estate may ever desire to sell the stock, and therefore the stock would pass by testamentary or intestate transfer. The stockholder is not bound to sell to the other party to the agreement at his death. The courts for purposes of federal estate taxes refuse to be bound to the price agreed upon in such agreements in determining valuation, but the courts have considered the depressing effect of such restrictive agreements and weighed them along with other factors in determining valuation.³ The state courts for inheritance tax purposes, are in this matter of restrictive sales agreements, in accord with federal decisions

¹ *In Re Cowles' Estates*, 36 Wash. 2d 710, 219 P. 2d 964 (1950).

² *CCH Inh., Est. & Gift Tax Report* 1820 B (1954).

³ *Worcester County Trust Co. v. Commissioner*, 134 F. 2d 578 (1940).

that such agreements are merely a consideration in determination of stock valuation at death.⁴

The courts have split, however, on whether the first two classifications, the mutual buy and sell agreement and the options to purchase agreements, should establish the value of the stock for death tax purposes when such agreements are for the transfer of stock to take effect after the death of the shareholder at a stipulated price.

The federal estate tax calls for the adoption of the price fixed in the mutual buy and sell agreements and in the options to purchase agreements on the ground that the tax is primarily concerned with the value of the property to the decedent's estate. The tax is measured by the value of the estate to the decedent and is an exercise levied on the transfer of the property from the dead to the living.

Most of the states, on the other hand, levy an inheritance tax on what is received by the heirs, legatees, and distributees. The tax is computed upon the value of the property passing to such individuals and the tax upon such transfers is deducted by the executor before he passes the property on.

It is normally contended that these two different types of death taxes are the underlying reason for the two conflicting solutions arrived at by the courts in their attempt to solve the problem of whether a mutual buy and sell agreement and the option to purchase agreement, when entered into for the purpose of transferring stock to take effect after death, should establish the value of the stock for death tax purposes. The two conflicting solutions have in the past been commonly and conveniently designated the Federal Rule and the Pennsylvania Rule.

II. THE FEDERAL RULE

The federal rule, according to numerous federal decisions,⁵ holds that the contract price controls where there is an irrevocable agreement to buy and sell in absence of some evidence of an attempt at tax evasion (or in other words some evidence that at arms length transaction has not taken place). Two leading cases, both decided by the United States Court of Appeals for the second circuit, *Wilson v. Bowers*,⁶ and *Lomb. v. Sugden*,⁷ established that the existence at date of

⁴ Worcester County Trust Co. v. Commissioner, 305 Mass. 460, 26 N. E. 2d 305 (1940): Involving the identical "first offer restriction" as the federal estate case, *supra*, note 3.

⁵ The leading case enunciating the federal rule is *Helvering v. Salvage*, 297 U.S. 106, 56 S. Ct. 375, 80 L.Ed 511 (1936), which held that a restriction on a sale to \$100 per share limited the value to that amount.

⁶ 57 F. 2d 682 (2d Cir. 1932). The court here established that an option contract giving shareholders the right to purchase stock at a specific price upon any intended disposal by the owner at his death limited the value of the stock for estate tax purpose to the option price. The court reasoned that since the contract was specifically enforceable, the decedent, during his life could not have sold the stock for more than the low price—at which he was obliged to offer

death of a valid enforceable option, exercise of which would compel the executor to sell the shares at the stipulated price, fixes their value for federal estate tax purposes at the option price.

*The Worcester County Trust Company*⁸ case limited the scope of the federal rule by excluding mere first offer restrictions during life with no restriction at all on testamentary or intestate transfers (restrictive sale agreements), as controlling the valuation, but the case did state that these agreements may serve to reduce the value for estate tax purposes.

The reverse situation, where the stockholder is free to dispose of his shares during his life and the option or mutual buy and sell contract is not to become effective until the shareholder's death, was decided in *Estate of James H. Matthews*⁹ where the court held that such agreements do not limit the valuation of the stock for estate purposes to the contract price.

The *Lomb* case *supra*, was affirmed in 1952 by the second circuit in *May v. McGowan*.¹⁰ This is the case where the court made the classical statement:

"If they [*Lomb* and *Wilson* decisions] leave a loophole for tax evasions in some cases, here the district court found that there was no purpose to evade taxes. Such a loophole, if important, should be closed by legislative action rather than by disregarding the cases we have cited."

Adequacy of the consideration under the federal rule *must* be measured at the time of the transaction if the agreed price is bona fide and reasonable.¹¹

it and that at his death the option price was the most that the executor could receive upon any sale.

⁷ 82 F. 2d 166 (2d Cir. 1936). Here the shareholders's agreement provided that in event of a proposed disposal of stock to an outsider, the stock was first to be offered to other shareholders at a determinable price. If a shareholder died without issue the other shareholders had an option to buy. Each shareholder retained the right to give or bequeath her stock to another shareholder. The decedent bequeathed her stock to her husband who also was a shareholder. The price set by the restrictive agreement at the time of her death was \$69.44, while the fair market value determined by the commissioner was \$100. The court held that the value for estate tax purposes was \$69.44 solely on the grounds that decedents only choice was to give the stock away or sell it at that price.

⁸ *Supra*, note 3.

⁹ 3 T. C. 525; See Rev. Rule 54-77, 1954-1 Cum. Bull., 193-194.

¹⁰ 194 F. 2d 396 (2d Cir. 1950). In return for a son's personal guarantee to a bank on a corporation debt, the son's option price of \$100 for each share of stock that his father owned at death was to be reduced by 1/500th of the then outstanding debt. When the father died the debt was \$90,000 and the son's option price was zero. The court held that the father's interest in the corporation for estate tax purposes was also zero.

¹¹ *Commissioner v. Bensel*, 36 B.T.A. 246, 253 (1937); *Aff'd*, 100 F. 2d 639 (3rd Cir. 1938). In this case, the majority shareholder of a family corporation, in order to retain the services of his son as an employee, placed his stock in a trust by the terms of which the income was to be paid to the father for life. At the father's death, the son became entitled under the terms of the trust

III. THE PENNSYLVANIA RULE

The most recent Pennsylvania decision to apply the Pennsylvania rule as originally laid down in the 1943 decision of *McClure Appeal*,¹² was *Estate of Carrie E. Fidler*.¹³ In the *Fidler* case, the decedent had entered into an agreement with her son granting him an option to purchase specific shares of stock at her death for a price of \$100 per share, but the court held that the \$200 value set by the state appraisers was the "clear value" taxable at decedent's death. The court concluded:

"Appellant contends that the court, in making its valuation, should have been controlled by the option agreement and refers, in support of the contention, to federal decisions dealing with appraisements of property under the federal estate and gift tax laws. The law requires an appraisal on the behalf of the commonwealth. No agreement by a property owner fixing the value can oust the jurisdiction of or control the commonwealth's appraisers; such agreement does not create a limitation on the value binding the commonwealth but it will be considered with the other evidence."

The court relied on the definition of "clear value" as stated in *Moffet Estate*¹⁴ in which clear value was held to be the consideration of one or more of the following elements at death: 1.) market value; 2) book value; 3) net earnings; 4) dividends, financial policy, etc., of the corporation issuing the inherited stock. The court failed, however, to point out just which of these elements were used by the state's appraisers. In an earlier decision, *In Re Dallone's Estate*,¹⁵ the court held that the court on sufficient evidence could properly accept the book value as the proper value for tax purposes notwithstanding decedent's agreement binding on his heirs not to sell without first offering to the optionee at a price lower than the book value. Pennsylvania has an inheritance tax on what is received by heirs, legatees, and distributees.¹⁶

Thus, in Pennsylvania, a state which has an inheritance tax as distinguished from an estate tax, and where the so-called Pennsylvania rule originated, the courts hold that an option or mutual buy and sell

to purchase the shares at a price which the courts considered reasonable when the agreement was made. In spite of the increased value of the stock at the time of the father's death, the court held the option price controlling. Heavy reliance however, was placed on the obvious hostility between the father and the son by the court in making their decision.

¹² 347 Pa. 481, 32 A.2d 885 (1943). It should be noted that three years before this case laid down the Pennsylvania rule, the Massachusetts court in *Commissioner v. Worcester County Trust Co.*, *supra* note 4, implied that Massachusetts wouldn't apply the federal rule even if a more binding agreement than a restrictive sales agreement came before it. Since then, the Pennsylvania rule was applied in a 1951 tax board decision of *Nichols v. Commissioner*, cited in CCH *Inh., Est. & Gift Tax Reports* 17,469 (1952).

¹³ CCH *Inh., Est. & Gift Tax Reports*, 18,579 (1957).

¹⁴ 369 Pa. 159, 85A. 2d 109 (1953).

¹⁵ 347 Pa. 486, 32A. 2d 888 (1943).

¹⁶ PURDON'S PENNA. STATUTES ANNO., Title 72, 2301 (c) p. 19.

agreement for the transfer of stock to take effect after death does not establish the taxable value of the stock for inheritance tax purposes, but such an option or mutual buy and sell agreement will be considered along with other evidence in the determination of the clear value of the stock at the date of death of the transferor.

IV. OTHER STATES HAVING AN INHERITANCE TAX

The New Jersey Supreme Court followed the Pennsylvania rule in *Schroeder v. Zink*,¹⁷ where the option price was a fixed sum. In that decision, the decedent bound himself to sell and a corporation (of which decedent was the principle stockholder) bound itself to purchase 250 shares of decedent's stock at \$100 per share. At time of death, the shares had a market value of \$420. The Transfer Inheritance Tax Bureau levied an inheritance tax against the beneficiaries of the decedent's will on the \$100 per share received by the estate and also levied against the contracting corporation on the \$320 difference between the market value and the contract price. The court affirmed the *McClure case*, stating that the option was at most, a factor to be taken into consideration in determining fair market value, but not axiomatically fix such value. The court went on to explain the tax imposed on the contracting corporation by stating:

"The transfer thus becomes an effectual substitute for a testamentary disposition in that there was a succession after death without adequate consideration. If the excess value goes untaxed, the corporation will have succeeded to it without the burden ordinarily imposed upon the right to such succession. Certainly the bargain made ten years before could not defeat the statutory policy."

The New Jersey courts, however, are not in complete accordance with the Pennsylvania rule since they make a distinction between an option with a fixed price and an option where the price is to be fixed by determining the value on the date of death in accordance with a proper formula, mutually agreed upon. The terms of the option formula agreement will control if the formula is reasonable.¹⁸

The Supreme Court of Washington, *In Re Cowles' Estate*,¹⁹ discussed and favored the Pennsylvania rule while pointing up the fact that Washington has an inheritance tax and decisions which were cited as following the federal rule, were all decisions of states levying an estate tax. It should be noted, however, that the court's opinion on the acceptance of the Pennsylvania rule in this case was dicta since the court itself pointed out that even if the State of Washington followed the Federal rule it could not be applied in this decision since the par-

¹⁷ 4 N.J. 1, 77A. 2d 122 (1950).

¹⁸ Grell v. Keyys, 132 N.J.L. 450, 41 A2d 122 (1945).

¹⁹ *Supra*, note 1.

ties to the intra family contract were not dealing at arms length. The court did not fix a price but merely rejected the appellant's contention that restrictive stock agreements were necessarily controlling. The court summarized its opinion as to the effect of stock option agreements by stating:

"It may be that, in some situations the option price fixed in an agreement restricting the sale of stock should establish the market value for tax purposes; the better view would seem to be that the whole matter lies in the realm of fact and is best ascertained upon all the evidence."

Wisconsin, in *Estate of Banta*,²⁰ its first clear cut decision on whether a mutual buy and sell agreement for the transfer of stock to take effect after the death of the transferor is binding upon inheritance tax valuation, adopted a rule very similar to the Pennsylvania rule. In the *Banta* decision, a mother entered into a mutual buy and sell contract with her son in 1928, in which she contracted to transfer 3,101 shares of stock in the family owned corporation along with any shares she might inherit from her husband, and her son contracted to buy said stock within one year from her death at \$15 per share (the 1928 market value). The son in turn, made a similar contract in 1928 with an officer of the firm to sell said officer a sufficient amount of decedent's shares at her death to the extent of bringing the officer's total shares to a stipulated amount.²¹ The price per share in this second contract was also \$15 per share. The fair market value of the stock on the date of the mother's death was \$275 per share.

The Wisconsin Supreme Court held that the stocks were taxable on the \$275 fair market valuation and not on the \$15 contract price although the federal authorities accepted the contract price as the valuation for the federal estate tax. In holding that the transfer was made without adequate and full consideration in money or money's worth, and therefore came within the Wisconsin inheritance tax statute,²² the court made it emphatic that parties to such a contract may not bind the state in their own stipulation of value of property when such transfers are intended to come into possession and enjoyment by the transferee at or after the death of the grantor, vendor, or donor since the Legislature intended that the sufficiency of the consideration of such transfers is to be determined as of the time for the transfer of the property in possession and enjoyment, *i.e.*, the date of death of the

²⁰ 273 Wis. 328, 77 N.W. 2d 730 (1956).

²¹ On June 22, 1928, the decedent's son contracted with an officer who also was a stockholder of the firm to sell said officer enough shares from which the son might receive in the performance of the contract with his mother to bring the officer's holdings up to 2,500 shares at the date of the mother's death. At said date, the officer had 2,188 shares and therefore the son sold him 312 shares of the 3,151 inherited by him on August 23, 1951.

²² WIS. STATS. §72.01 (3) (b) (1955).

transferor. The Court made it clear that Wisconsin does not consider the fact that federal authorities used the contract price of \$15 in the United States inheritance tax proceeding as a guide to interpretation of the Wisconsin inheritance liability because the federal government taxes the estate of the decedent as a whole and therefore, by Mrs. Banta's contract, the stock was worth no more to her estate than \$15 per share. The Court pointed out that Wisconsin was not concerned with the total estate but taxes the property interest which passes to an individual upon the former owner's death. It should be noted that the Court made no mention of the close family relationship present here, as a ground for the refusal of the contract price as binding upon the valuation of the stock for inheritance tax purposes. It can be presumed from the fact that the federal government held that the contract was binding upon valuation for estate tax purposes, that they found the transaction to be bona fide and at arm's length.

Thus, Wisconsin seems to have a strict rule in regard to mutual buy and sell agreements for the transfer of stock to take effect at or after death, in that unlike the Pennsylvania rule, the Wisconsin Court did not mention that the agreement would even be considered along with other evidence in the determination of the inheritance tax valuation of stock; the Court on the other hand, was rather unhesitant in declaring that the fair market value at the time of the transferor's death would govern in fixing the state inheritance tax upon the shares. The strictness of the Wisconsin rule seems to be emphasized by the Court's ruling in this decision that the son's contract to immediately resell a quantity of the inherited stock to a third person was not material to affect the value of these particular shares in regard to the son's interest in the estate. It would seem that such a contract would limit the value of the stock to the contract price since that would be the actual value of the stocks in the hands of the transferee. But if the courts were to recognize such transferee—third party contracts, it would open a big loophole, in that while the original transferor—transferee contract would not bind the state, the transferee, by entering into a second transfer contract with a third person could effectively limit the estate's valuation. The Court's reasoning seems to be that an inheritance tax is not based on the actual value of the stocks in the hands of the transferee but rather on the fair market value of the interest to which the transferee succeeds at the date of the transferor's death, and if the transferee was imprudent enough to contract such value away for less before such date, it is of no concern of the state.

From the strong and unambiguous language of the court in the *Banta* decision that the Legislature intended sufficiency of consideration is to be determined at the death of the transferor, and that such sufficiency of consideration is the fair market value, coupled with the

particular wording of the WISCONSIN STATUTE, Sec. 72.01 (3) (b) that the consideration must be in "money or money's worth,"²³ it seems very improbable that Wisconsin would have accepted the mutual buy and sell agreement in the *Banta* decision as binding even if the agreement price had been reasonably close to the fair market value at the date of transferor's death or if the agreement had contained a formula determining value, at the transferor's death, of the transferred stocks.

Although no case on point has arisen, the Attorney General of North Carolina in 1940 indicated that the state inheritance tax rule need not be concerned with such stock options and restrictions.²⁴

V. STATES HAVING AN ESTATE TAX

The New York court in *Matter of Miller*,²⁵ in holding a binding stock option agreement should be controlling as to tax value stated:

The Federal Estate tax law in this respect is similar to the estate law of this state, and the above federal decisions [*Wilson* and *Lomb*] are accepted as good authority in this case."

A more recent New York decision²⁶ carries the federal rule even further than the Federal Government's interpretations²⁷ when the New York court, in interpreting its estate tax, held that an option to buy all of the stock owned by a party first dying, at date of death, although the grantor of the option could alienate the shares during his lifetime with no restrictions, was binding upon the estate valuation. The court also held that although the option price under the contract was considerably less than the actual value of the shares at the date of death:

" . . . inadequacy of the consideration does not destroy the obligation of the contract."

The New York Courts assume that states having an estate tax as distinguished from an inheritance tax will automatically apply the Federal rule. It is well worth noting however, that the New York Court in *Matter of Fieux*²⁸ in 1925 applied the Federal rule before the

²³ 28 AM. JUR., INHERITANCE, ESTATE & GIFT TAXES §184. "Some statutes require that in order to avoid the tax (inheritance), the consideration shall be equal in money or Money's worth, to the full value of the property transferred."

²⁴ North Carolina Attorney General's Opinion, Feb. 19, 1940, CCH Inh., Est. & Gift Tax Reports (1940) 8563.

²⁵ 191 Misc. 784, 79 N.Y.S. 2d 372. A contract between three holders of all the corporate stock provided for the sale of the holder first dying to the remaining holders for a designated sum. *Held*: The contract was not to defraud the state or the federal government in respect to estate taxes but to establish a market value for the mutual protection to the stockholders and therefore the estate tax should be determined on the basis of value of the stock as provided in the contract.

²⁶ In Re Galewitz, Estate, 206 Misc. 218, 132 N.Y.S. 2d 297 (1954).

²⁷ *Supra*, note 3.

²⁸ 241 N.Y. 277, 149 N.E. 857 (1925). Case involved a stockholder's agreement not to dispose of any of stockholder's stock, but to hold it intact for the benefit of other stockholders and to sell it at par to them at their election on

national courts did and when New York had an inheritance tax instead of its present estate tax. This decision has been very often cited unsuccessfully by proponents of the Federal rule in inheritance tax jurisdictions.

Mississippi follows the federal rule in its leading case of *Strange et al v. State Tax Commissioner*,²⁹ but like New York, the state has an estate tax which in substance is the same as the federal tax.³⁰

There has not been much litigation as to whether stock options or mutual buy and sell agreements are binding upon estate evaluations in the states which have an estate tax. This lack of litigation stems from the fact that such states follow the federal decisions as law. A typical example of this is in Maryland, where in 1950, although no case on point had arisen, the attorney general of that state voiced his opinion that an option price of a partner's survivorship agreement was controlling for death tax purposes.³¹ Maryland now has an amendment which expressly applies the regulations promulgated by the federal estate tax to the estate tax situations arising in Maryland.³²

VI. CONCLUSION

A thorough study of existing decisions tends to show that the conflicting solutions arrived at by the courts in their attempt to solve the problem of whether an option or a mutual buy and sell agreement for the transfer of stock to take effect after death should establish the value of the stock for death tax purposes, are due to the type of tax being levied. If an estate tax on the value of the property to decedent's estate is levied, an option or a mutual buy and sell agreement, if reasonable and entered into as part of an arms length transaction, will control the valuation of the stock for estate tax purposes. If the tax is an inheritance tax levied on the value of the stock *passing* to the optionee, the option or mutual buy and sell agreement price will not bind the estate.

There is a slight conflict among the states which employ an inheritance tax as to whether a stock option agreement or a mutual buy and sell agreement should be completely ignored or whether it should be a consideration, in determining the value of the stock for inheritance tax purposes. It is the author's opinion that the wording of the

his death or leaving of the corporation. *Held*: Not a taxable transfer since the agreement was irrevocably binding upon the stockholder.

²⁹ 192 Miss. 765, 7 So. 2d 542. Surviving brother exercised option to take certain stock by paying \$10,000 to deceased brother's estate as authorized by a contract which the brothers had executed. *Held*: Value of the stock to decedent's estate for death tax purposes was the sales price in the contract, and not the greater book value of the stock at the time the option was exercised.

³⁰ MISS CODE (1942 Anno.), Vol. 7, §9266d, p. 127.

³¹ Opinion Attorney General of Maryland, cited in CCH *Inh., Est. & Gift Tax Reports* 17,186 (1950).

³² LAWS OF MARYLAND, Chap. 102, 159, p. 274 (1956).

statute itself will determine the answer. If the statute is the same as the Wisconsin statute³³ and requires "adequate and full consideration in money or money's worth," then fair market value at the time of the transferor's death will govern the fixing the value of the stock for inheritance tax purposes. If the state has a statute similar to the Pennsylvania statute³⁴ requiring an adequate valuable consideration, then a stock option agreement or a contract to purchase stock at or after death of the transferor would be a consideration in the evaluation of the stock for inheritance tax purposes.

The strict view which Wisconsin takes eliminates the stock option or mutual buy and sell agreement as having any effect on the valuation of the stock for tax purposes. The Pennsylvania rule leaves the optionee uncertain at the time of contracting as to what the final evaluation will be upon the death of the optioner, but it does present the possibility that the appraiser will consider the option or mutual buy and sell agreement and that such consideration will result in an evaluation that is lower than the fair market value.

The federal rule, on the other hand, allows an individual who proves good faith and an arms length transaction to limit the value of the stock for estate tax purposes to a certain designated sum, which might be considerably less than the fair market value at the time of the transferor's death and resulting in a tax saving to the optionee.

ERWIN J. KEUP

³³ *Supra*, note 22.

³⁴ *Supra*, note 16.