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VALUATION OF SECURITIES UNDER THE FEDERAL ESTATE TAX OF THE REVENUE ACT OF 1932

THE search for a new basis of taxation has been never-ending. It was early discovered that the transfer of property resulting from the death of the owner was an available source of revenue. Death taxes, as these have generally been termed, were known in Rome as far back as 6 A. D.[1] when the Emperor Augustus established a 5% tax on inheritances and bequests, limited in its application to Roman citizens. It is said that Augustus borrowed the idea from the Egyptians, who appear to have exacted some tax as a part of the system of the transfer of property as early as the seventh century B. C.

In this country such taxes have variously been termed inheritance taxes,[2] estate taxes,[3] succession [4] or transfer taxes,[5] but in each case death is the generating source of the tax. The Death Tax has been part of the fiscal scheme of the federal government since the adoption of the Revenue Act of 1916, taking the form of a levy on the estate as a whole rather than on the individual shares passing to the separate beneficiaries. Hence the tax has been known as an estate tax. The subsequent Revenue Acts [6] have all retained this basis of

[1] Seligman's *Essays in Taxation*, INHERITANCE TAX (10th ed. 1928) p. 126.

[2] GENERAL INHERITANCE AND ESTATE TAX, FLORIDA LAWS OF 1931, c. 14, p. 739.

[3] REV. ACT OF 1932, §161, Supplement E.

[4] Chapter 77, CONN. REV. STAT. 1930.

[5] *Ibid.*

[6] REV. ACT OF 1916, §201; REV. ACT OF 1917, §300; REV. ACT OF 1918, §§403, 401; REV. ACT OF 1924, §301; REV. ACT OF 1926, §303; REV. ACT OF 1928, art. 4, §301.

raising revenue, increasing or decreasing the rates as the fiscal exigencies of the government warranted, and also eliminating or adding features making for a fairer and more efficient administration of the law. The Revenue Act of 1918 included, as part of the taxable estate dower,[7] courtesy, insurance in excess of $40,000.00 payable directly to beneficiaries other than the estate,[8] and property passing under a general power of appointment.[9] This Act also provided for the deduction from the taxable estate of such property as had been previously taxed as part of some other estate.[10]

The Revenue Act of 1924 established the precedent of allowing as a credit against the estate tax, 25% of state inheritance taxes paid.[11] The Revenue Act of 1926 increased this credit to 80%.[12] The latter feature in the scheme of taxation suggests the possibility of employing a similar device in connection with the income tax, which is exacted both by the states and the federal government to an evermore burdensome degree. The Revenue Act of 1932 imposes an additional estate tax, a sort of super estate tax,[13] and includes also the gift tax [14] aimed to prevent to some extent the avoidance of the estate tax.

In this country taxpayers have attempted to resist the employment of new fiscal devices by questioning the power to levy such taxes under the Constitution of the United States. A number of constitutional questions have thus been raised under the Estate Tax laws. The right of the federal government to levy a death tax was questioned in *Knowlton* v. *Moore*,[15] the contention raised being that such a tax was within the exclusive jurisdiction of the several states. The Court rejected this contention. Except for power to regulate interstate commerce, which is exclusively within the jurisdiction of the federal government, it would appear that there is overlapping jurisdiction to employ the same tax

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[7] REV. ACT OF 1918, §402 (b).
[8] *Ibid.*
[9] REV. ACT OF 1918, §402 (e).
[10] REV. ACT OF 1918, §403 (2).
[11] REV. ACT OF 1924, §301 (b).
[12] *Ibid.*
[13] REV. ACT OF 1932, tit. II, §401.
[14] REV. ACT OF 1932, tit. III, §501.
[15] 178 U. S. 41, 20 Sup. Ct. 747 (1900).

bases both by the federal and state sovereignties. The tax was declared to be an excise and not a direct tax in *New York Trust Co.* v. *Eisner.*[16]

An attempt has been made to distinguish between a tax on the power to transmit property at death and a tax on the privilege of succession to property, the Court holding that both may be made the basis of classification in a single statute.[17] Other questions of constitutionality have been concerned with the problems of jurisdiction and retroactivity, the latter having been provocative of several excellent opinions, especially the dissenting ones, on questions of transfers to take effect at death, where such transfers were made before the tax laws became operative.[18]

In the administration of the estate tax law the government is faced with the practical problem of what to tax, a problem of valuation. The various taxable interests of the decedent, as enumerated in Section 302,[19] (a) to (l) inclusive, that go to make up the gross estate, are required to be set up at their value on the date of death of the decedent. Generally this means the fair market value. The Treasury Department Regulations[20] covering the Estate Tax Law define fair market value as "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell."

The criterion set up by the Department in the Regulations would appear to be a fair basis of valuation and for all practical purposes it is a workable basis. And yet it is beset with difficulties that work considerable hardship in numerous cases, particularly where property remains in an estate unreduced to cash and is depreciating in value. Such a situation is familiar to executors and attorneys who have been interested in estates of decedents dying just before the market crash of October, 1929, which estates were and still are in the process of liquidation in a period of decline in the economic life of the country. In some instances the applica-

[16] 256 U. S. 345, 41 Sup. Ct. 506 (1920); also Schwab v. Doyle, 258 U. S. 529, 42 Sup. Ct. 391 (1921).

[17] Stebbins v. Riley, 268 U. S. 137.

[18] Nichols v. Coolidge, 274 U. S. 531, 47 Sup. Ct. 710 (1926); Coolidge v. Long, 282 U. S. 582, 51 Sup. Ct. 306 (1931).

[19] ACT OF 1926 and made part of the ACT OF 1932 under tit. III.

[20] Reg. 70, Art. 13 (1).

tion of what appears to be a reasonable regulation has been so severe as to become almost confiscatory. It would appear that some remedial measures should be taken in the interest of administering the tax law more equitably in the matter of valuations. It is not reasonable to assume that Congress ever intended to effect some of the ludicrous situations arising from the taxation of estates on the basis of market values on the date of decedent's death, where such values have been disastrously shattered by economic forces during a period immediately following decedent's death. And yet in considering a new revenue law this year, the Senate rejected a proposal [21] of the House to soften the harsh effects of the present law, and the Conference Committee of the Senate and the House similarly rejected any remedial measures. This amendment would have permitted the executor, in the cases of estates of decedents who died between September 1, 1928 and January 1, 1932, to revalue the estate as of a date eighteen months after the decedent's death, and "the tax to be paid under this title shall bear the same ratio to a tax computed without reference to this section as the subsequent value of the net estate bears to the value of the net estate computed as of the date of decedent's death." It becomes necessary, therefore, to examine once again the law as it stands today, to determine what measures can be taken under the present law to ease the burden on estates, and perhaps to indicate some equitable steps that the Department could take in the interest of a fairer administration of the law.

The Regulations [22] make the problem of easing the burden on estates more difficult by a statement corollary to its definition of market value, namely, "neither depreciation nor appreciation in value subsequent to the date of decedent's death will be considered." In applying the principles of valuation to the various types of property, it is proposed to deal primarily with the valuation of stocks and bonds, because of the special and peculiar situation surrounding this type of property, particularly where such securities appear to have a ready market in that they are listed upon a stock exchange.

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[21] Proposed amendment to tit. III of the REV. ACT OF 1926, §811, "Revaluation of Depreciated Assets."
[22] *Supra* note 6.

The Regulations [23] assume that the fair market value of stocks and bonds so listed upon a stock exchange is the "mean between the highest and lowest quoted selling prices upon the date of death, *except where such selling prices do not reflect the fair market value.*" (Italics mine.) Considerable evidence has been accumulated during the past two years to indicate the unreliability of stock exchange prices as a criterion of value. The ease with which prices of securities can be manipulated up or down through pools and other artificial combinations makes the stock exchange a legal gambling device, and when the bubble bursts, causes untold suffering not only to the host of speculators involved, but also to the legitimate investors. It is submitted that stock exchange prices cannot reflect fair market values in a period of economic decline, even if the Treasury Department's definition of market value be accepted as a reliable guide. The essence of market value is a willing buyer and a willing seller, neither being under a *compulsion* to buy or sell. In the face of all the distress selling and enforced liquidation made necessary by the havoc of the economic tidal wave of the past two years, can it be said that the selling prices on the exchange represented willing sellers disposing of their wares freely and without compulsion?

Assuming even that stock market prices reflected honest values, the range of prices possible in one day's trading is so wide that a more scientific method of valuation is necessary instead of the rule-of-thumb method outlined in the Regulations. Is it too much to expect administrative officials of such an important tax law as the Estate Tax to make computations involving weighted averages which take into consideration the number of shares traded in at different prices? It would appear that the Regulations [24] permit the Treasury Department to make more flexible its determination of values on the basis of the further proposition that "all relevant facts and elements of value should be considered in every case." Can it be said that the economic background of the past three years is not such a relevant fact as to demand adequate consideration in determining values? And yet,

[23] Art. 13 (3).

[24] *Supra* note 6.

except for the situation where the decedent has left a large block of stock in his estate, the Department has been adamant in ruling that values shall be measured according to the letter of the law.

What of securities dealt in actively through brokers although not listed upon an exchange? The value in such a case is determined "by taking the sale price as of the date of death, or where there was no sale on that date, of the nearest date thereto upon which a sale was made, if within a reasonable period." [25]

In the case of inactive securities, the value is the sales price nearest the date of death, "provided such sale was made in the normal course of business between a willing buyer and a willing seller." Where sales made in the open market are disproportionate to the holdings of the decedent, and the securities are bona fidely sold by the executor within a reasonable time, the amount so realized will be accepted as the value. Some little relief is thus afforded estates in the latter situation.

Article 13 (3) of the Regulations permits the Commissioner to disregard the usual rules for determining fair market value, "where as to any particular security conditions of sale or ownership are such that the fair market value, determined as already indicated, would not afford a proper basis for valuation, the Commissioner, on final audit, will establish the value by considering all relevant factors. In any case where the estate contends that the value, if established by the general rules already given, is not the fair market value as of the date of death the evidence upon which it bases its contention should be filed with the return." The Commissioner has seen fit to employ this discretionary power only in cases where the estate holds large blocks of stock. Presumably the value as of the date of death for large blocks is unfair since the disposition of such large amounts cannot be made at market values.

In the case of stock in a close corporation, the Department permits a more scientific basis of valuation. All factors having a bearing upon the value of the stock are considered, including the net worth of the company, earning ca-

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[25] Reg. 70, Art. 13 (3).

pacity, and dividend-paying capacity. These must be based upon complete financial data. Broadly speaking such securities are best valued by determining accurately the earning capacity of the business, taking into consideration the element of risk, and then capitalizing the income at a fair rate. It is not the purpose of this analysis to go too deeply into this phase of the subject. Professor Badger [26] has made such a study and some of his conclusions will be indicated. In valuing bonds of close corporations, Professor Badger distinguishes between investment bonds and speculative bonds. The former are valued by determining the yield of the bond and adjusting the price of the bond on the basis of this yield to what bonds of a similar character are selling for on the open market. In the case of speculative bonds, the earnings available for bonds averaged over a period of five years are capitalized at rates varying from 11% to 14%.

The values of preferred and common stocks are similarly determined by capitalizing the income available for the preferred or common stocks respectively. The process of determining the income requires an analysis of the balance sheets and profit and loss statements of the company for a period of years. The rates to be applied for capitalizing the income will, of course, depend upon the element of risk in the investment. Professor Badger classifies industrial companies and the suggested ratios for capitalization as follows:

CLASS I	LOW RISK....................	12% to 15%
CLASS II	MEDIUM RISK............	15% to 20%
CLASS III	HIGH RISK..................	20% to 25%
CLASS IV	VERY HIGH RISK......	Over 25%

The valuation of securities of a close corporation are ordinarily taxed on a higher basis than securities listed on stock exchanges, since prices on the exchange are customarily lower than those determined by applying methods of valuation to the financial picture of the close corporation. A further reason for this is the fact that the Regulations tax the good will of a business. The usual method of evaluating good will is to take average earnings for a period of from

[26] VALUATION OF INDUSTRIAL SECURITIES (1925).

three to five years, deduct therefrom interest on the invested capital at 6%, and then multiplying the remainder by a number varying from one to ten. This is known as capitalizing the value of excess earnings over a fair rate of return.[27]

The question of the valuation of securities has to some extent received the attention of the courts. In the case of *Bingham's Administrator et al.* v. *Commonwealth*,[28] among other things, the question was raised as to whether large blocks of stocks and securities customarily traded in and quoted daily in the open markets should be appraised by the same rule as small blocks of such stocks. The Court could see no reason for setting up a different basis of valuation. In the course of the opinion, the Court did suggest a method of valuation based upon the average of prices actually established on the market through a reasonable period of time, rather than on the taxing date merely, if on that date the price was extraordinarily high or low. The latter suggestion could well be adopted by the Treasury Department. In the more recent case of *Clabby's Estate*,[29] a Pennsylvania court reiterated reliance upon Stock Exchange values as the basis for taxation of large blocks of stock. The Court held that the sale price of corporate stock on a recognized stock exchange furnishes a proper basis for appraisement of the stock. The fact that the block of stock is so large that its sale would depress the market value is a consideration to be taken into account, but is not controlling in the determination of its value, unless it is manifestly unfair and unconscionable to do so. In the instant case the estate held a block of 17,370 shares of common stock of the Texas and Pacific Railway Company, about 4% of the outstanding stock, selling on the New York Stock Exchange at $29.00 per share on July 21, 1922, the date of decedent's death. The executor had testified that it would have been absolutely impossible to sell so large a block without breaking the market price. Stockbrokers had testified that if the stock had been sold gradually over a period of two months after decedent's death about $24.00 a share would have been realized. The appraisal

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[27] A. R. M. 34 C. B., June, 1920, p. 31.
[28] 196 Ky. 318, 244 S. W. 781 (1922).
[29] 15 D. & C. Rep. 681, Pa. (1931).

was made in 1925 and after the adjudication the stock had actually appreciated in value to about $50.00 per share. This fact may have influenced the Court in its decision.

In the case of close corporations the Board of Tax Appeals [30] has rejected the method of comparing assets, stock sales and earnings of a competitor corporation as a criterion of value. Nor did it accept the determination of value on the basis only of dividends declared over a period of ten years.[31] The value of securities must be established by affirmative and convincing evidence.[32] In the latter case the attempt was made to establish the value of securities through an outside appraisal of the assets of the corporation. There being no adequate support of the appraisal, it was rejected. In one case the Board did accept a value based upon a sale of securities six weeks after death.[33] In this case the entire outstanding issue of 3,000 shares had been sold, together with some of the assets that had been retained. The net amount received for both was made the basis of the value of the stock.

In a case involving the depreciation to nothing, within two years after the date of death, of assets worth about $50,000 on the date of death, the Court [34] rejected the contention of the executor that the stock had no value on the date of death because two and a half years later the stock became worthless by reason of the failure of the bank corporation.

In the *Estate of Louise N. Schulz* [35] the decedent owned stock in a corporation. The by-laws of the corporation contained a provision that the Board of Directors shall fix the value of the shares. The Board held that the shares held by the executor could not be affected by this by-law. The decision was affirmed by the courts.

In the *Matter of Dupignac* [36] the Court defines fair market value as synonymous with "clear market value" or "cash

[30] Appeal of Fish, 1 B. T. A. 882 (1925).
[31] Appeal of Stearns, 1 B. T. A. 1252 (1925).
[32] Appeals of Sturgess, 2 B. T. A. 69 (1925).
[33] Estate of Jonas Fisher, 9 B. T. A. 1314 (1928).
[34] John L. Minnaugh, Jr., Executor v. U. S., 66 Ct. Cl. 411 (1928).
[35] 14 B. T. A. 419, *aff'd* (C. C. A., 1st Circuit, 1930).
[36] 123 Misc. 211, 204 N. Y. Supp. 273 (1924), *aff'd*, 211 App. Div. 862, 207 N. Y. Supp. 833.

value." The fair market value of closely held stock is the value that a buyer would set on the corporate assets. This process determines the book value of the stock, its intrinsic worth, and this becomes the nearest approximation to the fair market value. There is no inflexible rule, the Court says, for ascertaining good will. "The value may be fairly arrived at by multiplying the average net profits for a number of years by a number of years' purchases, such number being suitable and proper, having regard to the nature and character of the business."

No matter what method is employed in the valuation of securities, due regard should be given to the factor of economic conditions and their effect upon values, particularly their effect upon stock exchange values. An inflexible rule is unscientific and must work an unnecessary hardship in a great number of cases.

In an attempt to mitigate the harshness of the regulations governing the valuation of securities, the writer submitted to the Department a basis for valuing securities, feeling that the Commissioner had sufficient power to exercise some discretion where circumstances warranted. The basis was not accepted by the Commissioner, although the State Tax Commission of the State of New York found the basis acceptable.

A range of daily market prices was selected covering a period of twelve months, six months prior to the date of death and six months subsequent to the date of death. The daily market values were weighted and a geometric mean taken. Professor Frederich Cecil Mills in his book on *Statistical Methods* [37] considers the geometric mean a scientific method of computing averages, particularly well adapted to the averaging of price changes. Furthermore, this method gives less weight to extreme deviations. Applying this method of determining the value of the common stock of Goldman Sachs Trading Corporation on September 5, 1929, the following facts were disclosed. The total number of shares traded in over a period of twelve months from March 5, 1929 to March 5, 1930 amounted to four million, five hundred and fifteen thousand, four hundred (4,515,400), the minimum

[37] Chapter 4, pp. 135-141 and p. 145.

number sold on one day being one hundred shares and the maximum number being 187,500 shares. The average daily price was taken for each day and multiplied by the number of shares traded in for that day to obtain the weighted average. To minimize the arithmetical computations involved, logarithmic computations were made. During the twelve-months period average daily prices ranged from 33½ on November 14, 1929 to 118⅞ on March 16, 1929. The total of the daily weighted averages divided by the total number of shares traded in for the entire period resulted in an average geometric mean of 82.75924 as the value of the common stock of Goldman Sachs Trading Corporation. The average price on the date of death was 109¾ as determined by the Treasury Regulations. On that day 14,500 shares were traded in. The estate held a block of 1,600 shares and the Department contended that this amount could have been absorbed by the market during the month of September, since on September 16th more than 60,000 shares were traded in and on September 17th, 50,000 shares were traded in. The relief asked for, a reduction in the value of the stock from 109¾ to 82.76, is quite modest considering that the present value of the stock is about 2¾ and that the estate is still in possession of the stock.

A similar analysis was made of the preferred stock of Tri-Continental Corporation. The total number of shares traded in for a period of twelve months was 163,400. The average geometric mean value was calculated as 84.7966, whereas the value as of the date of death was 111½.

Both securities were of the holding company type and the contention might well have been raised that the value might be determined by considering the value of the underlying holdings themselves.

In the administration of state inheritance tax laws, tax commissions and state courts appear to be adopting a more realistic attitude toward the situation presented. In the state of Washingon the basis of the tax was considered as the amount actually received by the estate where the property was sold by order of the Court for less than the appraised value on the date of death.[38] In the case of *Estate of Charles*

[38] *In re* Ferguson's Estate, 113 Wash. 598, 194 Pac. 771 (1919).

W. Spitly,[39] the Court held that stock exchange values of corporate shares as of the date of death were not conclusive and that evidence could be introduced to show that such values did not represent true values because of operations of a pool which created false and untrue values stimulated by artificial transactions on the stock exchange. The judicial recognition of the artificial nature of stock exchange values is a hopeful sign that possibly courts will grant relief where administrative officials refuse to exercise a discretion that the law clearly permits them to employ in meritorious cases. To insist upon a rigid interpretation of the Treasury Regulations means that help must be sought either in the courts on the ground that the results are unfair and unconscionable, or else that taxpayers must resort to Congress for remedial legislation.

BENJAMIN HARROW.

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[39] 70 Calif. App. 191, 13 Pac. (2d) 385 (1932).