Estate of Helen M. Noble v. Commissioner, TCM 2005-2, January 6, 2005

The Facts: Ms. Noble died on September 2, 1996. She owned 116 shares of Glenwood State Bank, which represented an 11.6% equity interest. The remaining 88.4% equity interest was owned by Glenwood Bancorporation. The expert for the estate valued the 116 shares of Glenwood State Bank at its 1996 book value ($14,169 per share) less a 45% minority interest discount (equaling a value of $903,988). The IRS argued that the fair market value was $1.1 million.

Glenwood Bancorporation had purchased two blocks of Glenwood State Bank stock in the 15 month period prior to Ms. Noble's death. The first purchase was in June 1995- 10 shares at $1,000 per share. The second purchase was in July of 1996- 7 shares at $1,500 per share.

The primary shareholder of Bankcorporation's stock attempted to buy the 116 shares held by the estate based on a written appraisal of the fair market value of those shares as of December 31, 1996 as determined by Dennis Hein of the accounting firm Seim, Johnson, Sestak & Quist, LLP. Mr. Hein concluded that the fair market value of the shares held by the estate was $878,004 as of December 31, 1996 (including a 29% discount for minority interest and 35% discount for lack of marketability). The estate refused to sell the stock at this appraised price. The estate later sold the 116 shares to Bancorporation for $1.1 million on October 24, 1997 (13+ months after the date of death).

Several different appraisals were prepared throughout this case. However, the Tax Court basically ignored these appraisals in determining fair market value.

The Findings: The Tax Court did not find that the sales of 10 shares and 7 shares prior to the valuation date were indicative of the value of the 116 shares because they did not believe that the transactions represented sales made by a knowledgeable seller who was not compelled to sell (because they sold for much less than amounts determined in later appraisals).

While the Tax Court agreed that a valuation is generally performed without any regard to subsequent events, it added that a subsequent event is not necessarily irrelevant if it was reasonably foreseeable as of the valuation date. The Tax Court also went on to say that events occurring after the valuation date, even if unforeseeable as of the valuation date, also may be relevant to establishing the fair market value as of the valuation date. The Tax Court ultimately decided that the sale of the shares 13+ months after the date of death should be used to determine the fair market value.

The taxpayers argued that the subsequent sale was strategic value and not fair market value, while the IRS argued that it was an arm's length sale. The taxpayer indicated that Bancorporation would want to pay a premium since they were acquiring the only other block of stock outstanding. The Court determined the transaction to be fair market value since it was between unrelated parties.

The Tax Court also noted that the record did not reveal any evidence that there was any material change in market conditions that occurred between the valuation date and the subsequent sale. Accordingly, the Court only inflation adjusted the $1.1 million sales price back 3% for inflation in arriving at a fair market value.

The Decision: The Court arrived at a fair market value of $1,067,000 ($1.1 million less 3% for inflation).

Parting Thoughts:

This was an interesting case…a sale over one year after the date of death was used to determine value even though it could easily be argued that this was not reasonably foreseeable as of the valuation date. Interesting, huh?

Also, why would the Court use inflation to adjust the price back to fair market value as of the date of death? Appraisers typically use rates of return commensurate with the risk of an investment (and the risk of the closely-held bank is clearly greater than inflation). Furthermore, the DJIA increased over 40% during the same time period. It is important to note that the value reported on the estate tax return ($903,988) is only approximately 18% less than the $1,100,000 sales price. Thus, it may have been fair to say that the entire increase in value to $1.1 million between the date of death and subsequent sale was attributable to market conditions.