Philosophy 101 —
What is Reasonable Knowledge?

By Elie J. Foy

A good decision is based on knowledge and not on numbers. - Plato

On Sept. 27, 2019, the IRS Office of Chief Counsel turned the long-standing law regarding valuation of publicly-traded stock on its head. In the ruling, the Service held that the proper valuation for publicly-held stock was not the mean of the high and low trade prices on the date of the transfer, but rather outside factors had to be considered. Now practitioners are tasked with determining what “reasonable knowledge” a hypothetical buyer would have and how it would affect the price a buyer is willing to pay.

General Valuation Rules

Section 2512 of the Internal Revenue Code provides that when a gift of property is made, the value of the property on the date of the transfer is the amount of the gift. The Regulations under I.R.C. Section 2512 expand upon this and tell us that “the value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.” Treas. Regs. § 25.2512-1 (emphasis added). In the case of stocks or bonds, if there is a market for such property, either on a public exchange, over-the-counter market, or otherwise, “the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or per bond.” Treas. Regs. § 25.2512-2(b).

Do Facts That May Not Be Public Knowledge Affect the Valuation of Publicly-Traded Stock?

Horwith v. Comm'r, 71 T.C. 932 (1979). In the past, taxpayers have argued that the mean of the high and low trading prices on the date of transfer is not an accurate reflection of value because of external factors known to the taxpayers. In other words, the taxpayers sought an exception to the general valuation rule under I.R.C. Section 2512 and argued that their knowledge of the relevant facts led to a different valuation.

In Horwith v. Comm'r, the taxpayers and the IRS disagreed on the value of stock received from Mr. Horwith's employer under an alternate stock plan. During 1971 and 1972, Mr. Horwith was vice president and secretary-treasurer of Mattel, Inc. Id. at 933-934. As part of his compensation package, Mr. Horwith was granted certain stock options. In 1971, Mattel introduced an alternate stock plan whereby employees could exchange their options for Mattel shares without paying any cash. Id. at 934.

Mr. Horwith decided to take advantage of the alternate stock plan and in February and March of 1972 Mattel issued 838 and 1822 shares of Mattel stock to Horwith. Id. On the taxpayer's 1972 W-2, Mattel valued the stock at $75,954. The company arrived at that figure by valuing the stock at the closing price for the dates of issue. Id. at 935. However, on his income tax return, Mr. Horwith valued the Mattel stock at $43,367.50. Id.

As late as Feb. 5, 1973, Mattel stated that it would report satisfactory earnings; however, less than three weeks later, Mattel reported a loss of approximately $32 million. Id. As a result, Mattel became the subject of several class action lawsuits that alleged the company had violated antifraud provisions of federal securities laws. The following year, Mattel reported that it had information which raised substantial questions about the accuracy of the company's financial statements for the 1971 and 1972 fiscal years. Id. at 936. Ultimately, a judgment was filed against Mattel in 1974, which included the following language from the special counsel's report:

“The investigation revealed that Mattel's annual and interim financial reports, together with related releases of financial information to the public and filed with the SEC, were, for various periods and in various respects, deliberately false and misleading. The financial misstatements were apparently motivated by a desire to maintain the appearance of continued corporate growth.” Id.

In 1977, Mattel settled the consolidated class action cases for $34 million and in 1978 a Federal grand jury indicted five officers, directors, and employees of Mattel with securities law violations. Id. at 937. Apparently, Mr. Horwith was not one of those indicted.

Mr. Horwith argued under the facts outlined above, that the stock exchange price was not an accurate reflection of the value of the Mattel shares he received in 1972. The Tax Court disagreed, noting that in a previous case the court dismissed a similar argument because it would have required the court to hold that “a universally accepted market price, the result of numerous transactions in which the general public freely participate, should be disregarded because more than two years later concealed facts were disclosed, which had they been known, might have created a different market from that which the facts show actually existed.” Id. at 939 (quoting Wright v. Comm'r, 45 BTA 551 (1941)). Therefore the Tax Court held that the trading prices of the Mattel stock on the dates of issue establish the fair market of the stock received by the taxpayer.

In a similar case involving a Mattel employee, the court held that the publicly-traded share price was the best evidence of the value of Mattel shares. Johnson v. Comm'r, 673 F.2d 262 (1982).

Prentice v. Comm'r, T.C. Memo 1956-3. The Prentice case involved the valuation of stock owned by a decedent. Mr. Prentice died on June 12, 1948 owning 3,857 shares of stock in Fulton Trust Company (about 19% of the total outstanding shares). Id. at 14. (Due to an optional valuation election, the valuation date for the Fulton Trust shares was June 12, 1949.) On Mr. Prentice's estate tax return, his
Executors reported the stock at $147 per share. In June 1949, the bid prices and ask prices on the over-the-counter market for shares of Fulton Trust were $142 to $146 and $147 to $151, respectively. The actual sales prices nearest decedent’s date of death were between $143 and $148.50 per share. However, the IRS determined the value to be $250 per share.

In late 1948 through June 15, 1949, Fulton Trust had entered merger negotiations with New York Trust Company; however, these first negotiations did not result in an agreement. Id. at 18. On June 21, 1949, negotiations began again and on July 18, 1949, the parties agreed to a merger and on a price of $250 per share to be paid by New York Trust Company to Fulton Trust. Id.

The IRS argued that reliance on the market price and contemporaneous sales was not reliable because sellers and buyers did not know of the merger negotiations, and therefore did not have all relevant facts. Id. at 20. The Court disagreed and held that the “requirement of reasonable knowledge of the facts in the definition of fair market value is not a requirement that the public have knowledge of all facts concerning the corporation.” Id. The Court further held that the fact that there was no public knowledge of the merger negotiations as of the valuation date did not detract from the evidentiary value of contemporaneous sales.

CCA 201939002

With this background in mind, let’s turn to CCA 201939002. In this Chief Counsel Advice memorandum, the Service examined whether a hypothetical willing buyer and hypothetical willing seller would consider a pending merger when valuing stock for gift tax purposes. The donor was the Chairman of the Board of a publicly-traded corporation. The donor transferred shares to a grantor retained annuity trust. At a later date, the corporation announced a merger with a second corporation. The merger negotiations had been taking place over a period of time with several corporations and even before the date of the gift to the GRAT. Predictably, the value of the shares dramatically increased after the merger, although less than the agreed-upon merger price.

The Service reviewed what all practitioners know to be black-letter law in the area of valuation of publicly-traded stock. The Regulations provide that when a gift is made, the value of the gift for transfer tax purposes is the value on the date of the transfer. The value is what a willing buyer would pay a willing seller, neither being under any compulsion to buy or sell and both being reasonably informed of all relevant facts.

The Regulations go on to provide a rule for the valuation of publicly-traded stock – it is generally the mean of the high and low trading prices for the date of the transfer. However, if the value established on the trading market “does not represent the fair market value, . . . then some reasonable modification of the value determined on that basis or other relevant facts and elements of value shall be considered in determining fair market value.”

The Service noted that in evaluating the hypothetical of a willing buyer and a willing seller, the parties are presumed to work for the maximum economic advantage. When the parties to the transaction are presumed to have reasonable knowledge of all relevant facts, that reasonable knowledge includes those facts that a party would uncover during the course of negotiations. Ultimately, the Service held that a hypothetical buyer would have done the legwork necessary to discover the merger negotiations.

In its holding, the Service relied heavily on Ferguson v. Commissioner, 174 F.3d 997 (4th Cir. 1999) (affirming 108 T.C. 244 (1997)). However, the facts in Ferguson are very different from those presented to the Service in the CCA.

In Ferguson, American Health Companies, Inc. (“AHC”) acquired Diet Center, Inc. (“DC”) which was wholly owned and managed by Roger and Sybil Ferguson and their five children. Id at 998. As a result of the merger, the Fergusons collectively owned approximately 18% of the outstanding AHC shares. In July 1988, AHC entered into a merger agreement with CDI Holding, Inc. (“CDI”) and CDI’s wholly owned and newly formed subsidiary, DC Acquisition Corp (“DC Acquisition”). The merger agreement provided: (i) DC Acquisition would purchase the majority of the AHC stock through a tender offer at $22.50 per share; (ii) DC Acquisition would merge into AHC, leaving AHC as a wholly owned subsidiary of CDI; and (iii) as permitted under Delaware corporate law, concurrently with the merger, each outstanding share of AHC stock would be converted into a fixed right to receive $22.50 in cash. Id. at 999.

On the final day of the tender offer, September 9, the Fergusons exchanged a significant amount of their AHC stock for CDI common and preferred stock, and they tendered the remainder of their AHC stock pursuant the tender offer. Id. at 1000. On September 12, DC Acquisition announced its acceptance of all tendered shares and purchased all shares in accordance with the tender offer terms. On October 14, the merger was effectuated.

While the aforementioned events were occurring, the Fergusons transferred some of their AHC stock to three charities. On September 8, the Ferguson’s broker made an in-house journal entry that transferred the stock from the Fergusons’ accounts to the accounts of the charities. On September 9, the Fergusons executed final letters of authorization. Id. at 1001.

The issue before the court was whether the Fergusons completed their transfers of the AHC stock before it had “ripened from an interest in a viable corporation into a fixed right to receive cash.” Id. at 1002. The Fergusons argued the date of delivery to the charities was the date the broker made the in-house journal entry, September 8. Id. However, the Court found that the contributions were not complete until September 9, 1988, the date petitioners executed their final letters of authorization. Id. at 1003.

The Court then had to consider whether the right to the income from the tender of the AHC stock had “ripened.” The Ninth Circuit agreed with the Tax Court that as of August 31, 1998, “it was practically certain that the tender offer and the merger would be completed successfully.” Id. at 1004.

The Service also cited Kollsman v. Commissioner, T.C. Memo 2017-40, which was an estate valuation case involving two paintings held by the decedent at her death. Ms. Kollsman’s estate held two seventeenth-century “Old Master” paintings. Around the time of Ms. Kollsman’s death, she had spoken to Sotheby’s about auctioning the paintings. Id. at 1. A few weeks later, Sotheby’s sent a letter to the decedent’s attorney stating that “based on firsthand inspection of the property” the paintings were worth $500,000 and $100,000. Id. at 2. This letter was attached to the estate’s tax return. Sotheby’s also sent an exclusion consignment rights agreement which gave Sotheby’s the right to auction the paintings for five years.

Pursuant to the consignment right agreement, Sotheby’s sold one of the paintings approximately three and a half years after the valuation date for $2,434,000. Id. at 4. Not surprisingly, the IRS issued a notice of deficiency and argued the total value of the two
The court noted the oft-quoted definition of fair value as the price a willing buyer would pay a willing seller. However, the Court believed that because of the condition of the paintings, a buyer would make a reasonable investigation about having them cleaned. Id. at 9. The Court also held that a “hypothetical willing buyer is presumed to be ‘reasonably informed’ and ‘prudent’ and to have asked the hypothetical willing seller for information that is not publicly available.” Id. Ultimately, the Court held that a buyer would have gathered the relevant information regarding the cleaning of the paintings and would discover that it was a low-risk endeavor that could dramatically increase the value.

Observations

CCA 201939002 appears to ignore the holdings in Horwith and Pretice and takes too simplistic an approach to the valuation question at issue. Further, the Service’s reliance on Kollsman is misplaced. In Kollsman, it was not only plausible but possible that a buyer would have been able to obtain the relevant information. However, in the CCA, in concluding that a reasonable buyer would have done the investigation necessary to determine that the subject corporation was involved in merger negotiations, the Service assumed that such information would be available. Certainly, the CEO of a publicly-traded company involved in merger negotiations would be prohibited from publicly discussing such negotiations due to Federal securities laws. The Chief Counsel Memorandum does not address this fact.

Further, the Ferguson case is hardly dispositive of the issue. It appears the Service determined the outcome and then looked for any case it could fashion to support it. Ferguson examined the assignment of income doctrine and in that case, the shares were transferred the same day they were tendered and accepted in exchange for cash. It is not a leap to conclude that the value of stock transferred on date X, the same date the shares are tendered for cash, is the amount of the cash received. However, those are not the facts of the CCA – there was no price for the shares set in stone at the time the donor made the transfer to the trust. In fact, the Service even points out in the memorandum the share price after the merger was less than the agreed upon merger price.

The Service has previously held that outside facts should not be considered when valuing publicly-traded stock, even when that information reveals that the company at issue lied about its earnings and misled investors. Query whether the Service would have come to the same conclusion in CCA 201939002 if the merger negotiations resulted in a lower valuation. Would the Service take that consideration into account and determine that the market share price did not accurately reflect the value of the transferred stock in that instance?

Practitioners should take note of CCA 201939002, but this author believes that taxpayers can continue to rely on the average of the high and low trading prices for publicly-traded stock. This may be the one time when a good decision can, indeed, be based on numbers.

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