2 T.C. 702 (1943)

When stock is subject to a binding agreement requiring sale back to the corporation at a defined book value, the value of the stock for gift tax purposes is limited to that book value, regardless of other valuation factors.

Summary

The case concerns the valuation for gift tax purposes of shares of stock in McCann-Erickson, Inc., gifted from one employee to another. The stock was subject to restrictions outlined in the company's bylaws, limiting ownership to employees and requiring that the stock be sold back to the corporation at a defined book value upon termination of employment. The Tax Court held that the value of the stock for gift tax purposes was limited to the book value due to the restrictions, reversing the Commissioner's higher valuation based on other factors such as net worth and earning power.

Facts

Harrison K. McCann gifted 2,500 shares of Class B stock of McCann-Erickson, Inc. to his wife on November 27, 1939. Both McCann and his wife were employees of the corporation. The Class B shares were incentive shares issued only to employees. The company's bylaws restricted ownership of the shares to employees only. Upon termination of employment, the employee was required to sell the shares back to the corporation, and the corporation was obligated to purchase them, at a price equal to the book value at the end of the following month. The certificate of incorporation prevented an employee-shareholder from assigning shares to another employee except by special permission of the board of directors, which was granted in this case.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in McCann's gift tax for 1939, increasing the valuation of the stock from $89,887.50 to $219,400. McCann challenged the Commissioner's determination in the United States Tax Court. The Tax Court reversed the Commissioner's determination.

Issue(s)

Whether the value of the McCann-Erickson, Inc. Class B stock, subject to restrictions requiring its sale back to the corporation at a defined book value, should be valued at that book value for gift tax purposes, or at a higher value based on the corporation's net worth, earning power, and dividend-paying capacity.

Holding

No, because the restrictions on the stock effectively fixed its value at the defined

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book value, as the shareholder had no market in which to sell the shares at a higher price.

Court’s Reasoning

The court reasoned that the value of the Class B shares was controlled by the bylaw restrictions. The employee-shareholder could not sell the shares at their own price because there were no available buyers other than the corporation. The corporation was required to buy the shares at book value, and the shareholder was prevented from asking for more. The court distinguished this situation from cases involving options where the corporation had the right, but not the duty, to purchase the shares. The court stated, “The employee-shareholder had no market in which he could sell at his own price, for there were no available buyers, no matter how willing…There was but one market, comprised of one buyer, the corporation, and the bylaw fixed the price in that market at the prescribed book value and prevented the seller from asking or agreeing upon any more and required the buyer to pay that price.” Therefore, the court held that the customary methods of stock valuation were not applicable, and the value was fixed at the book value.

Practical Implications

This case establishes that for gift tax purposes, stock subject to a binding agreement requiring its sale back to the corporation at a defined book value is valued at that book value, regardless of other valuation factors such as the corporation’s net worth or earning potential. This ruling has significant implications for closely held corporations that utilize such stock restrictions as part of their employee incentive programs. Attorneys should advise clients that if such restrictions are in place, the stock’s value for gift or estate tax purposes will likely be limited to the book value defined in the agreement. Subsequent cases have cited McCann to support the principle that restrictions on the transferability of stock can significantly impact its value for tax purposes. It emphasizes the importance of carefully considering and documenting stock restrictions when planning for gifts or estate taxes involving closely held businesses.

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