Funsten v. Commissioner, 44 B.T.A. 1052 (1941)

The fair market value of stock for gift tax purposes is not necessarily limited to the price determined by a restrictive buy-sell agreement, particularly when the stock is held in trust for income generation and the agreement is between related parties.

Summary

Funsten created a trust for his wife, funding it with stock subject to a restrictive agreement limiting its sale price. The IRS argued the gift tax should be based on the stock's fair market value, which was higher than the restricted price. The Board of Tax Appeals held that while the restriction is a factor, it's not the sole determinant of value, especially when the stock generates substantial income for the beneficiary. The court upheld the IRS's valuation, finding the taxpayer failed to prove a lower value.

Facts

Petitioner, secretary-treasurer, and a director of B. E. Funsten Co., owned 51 shares of its stock. He created a trust for his wife, transferring 23 shares. A stockholders' agreement restricted stock sales, requiring shares to be offered first to directors and then to other stockholders at book value plus 6% interest, less dividends. The adjusted book value per share on June 6, 1940, was $1,763.04. The IRS determined a fair market value of $3,636.34 per share. The company's net worth and strong dividend history supported the higher valuation. The trustee was required to make payments to the wife out of trust assets as she demanded with the consent of adult beneficiaries. The trustee was authorized to encroach upon the principal for the benefit of beneficiaries, except to provide support for which the grantor was liable.

Procedural History

The IRS assessed income tax deficiencies, arguing the trust income was taxable to the grantor under Section 166 of the Internal Revenue Code due to a perceived power to reacquire the stock's excess value. The IRS also assessed a gift tax deficiency, claiming the stock's fair market value exceeded the value reported on the gift tax return. The Board of Tax Appeals consolidated the proceedings.

Issue(s)

1. Whether the grantor is taxable on the trust income under Section 166 of the Internal Revenue Code, arguing that the restrictive stock agreement allows him to reacquire the stock's value.

2. Whether the fair market value of the stock for gift tax purposes is limited to the price determined by the restrictive stockholders' agreement.

Holding

1. No, because the power to reacquire the stock is not definite or directly exercisable by the grantor without the consent of other directors and stockholders. The assessment requires a more solid footing.

2. No, because the restrictive agreement is only one factor in determining fair market value, and the stock's income-generating potential supports a higher valuation.

Court's Reasoning

Regarding the income tax issue, the court rejected the IRS's argument that the grantor could repurchase the stock and strip the trust of its value. The court emphasized that Section 166 requires a present, definite, and exercisable power to repossess the corpus, which was not present here. The court deemed the IRS argument too tenuous to stand.

Regarding the gift tax issue, the court acknowledged that restrictive agreements are a factor in valuation. However, it distinguished cases where the agreement was between unrelated parties dealing at arm's length. Quoting Guggenheim v. Rasquin and Powers v. Commissioner, the court stated, "[T]he value to the trust and to the beneficiary was not necessarily the amount which could be realized from the sale of the shares. Those shares are being retained by the trustee for the income to be derived therefrom for the benefit of the beneficiary." The court emphasized the stock's high dividend yield, concluding that the taxpayer failed to prove the stock's value was less than the IRS's determination.

Practical Implications

This case clarifies that restrictive agreements are not always the sole determinant of fair market value for tax purposes, particularly in gift tax scenarios. Attorneys should advise clients that: (1) Agreements between related parties are subject to greater scrutiny. (2) The income-generating potential of the asset must be considered. (3) Taxpayers bear the burden of proving a lower valuation. Later cases may distinguish Funsten based on the specific terms of the restrictive agreement, the relationship between the parties, and the asset's unique characteristics. Careful valuation is essential when transferring assets subject to restrictions, and expert appraisal advice is often necessary.

