***James v. Commissioner*, 3 T.C. 1260 (1944)**

A stock restriction agreement, granting other stockholders a right of first refusal, does not automatically limit the stock's value for gift tax purposes to the agreement price, but it is a factor to consider in determining fair market value.

Summary

The petitioner gifted stock to his son. The stock was subject to a restrictive agreement where the stockholder had to offer the stock to other stockholders at an agreed price if he wanted to sell. The Commissioner assessed gift tax based on a value higher than the restrictive agreement price, taking the restriction into account as one factor. The Tax Court held that the restrictive agreement price did not automatically cap the stock's value for gift tax purposes. Because the petitioner failed to provide evidence that the Commissioner's valuation was incorrect considering the restriction, the Commissioner's determination was upheld.

Facts

The petitioner, James, gifted shares of stock in a closely-held corporation to his son. A voluntary agreement among the stockholders dictated that if any stockholder wished to sell their stock, they must first offer it to the other stockholders at a predetermined price. The book value of the stock was approximately $385 per share. The Commissioner determined a gift tax value of $310 per share, considering the restrictive agreement as a depressive factor. The petitioner argued that the stock's value for gift tax purposes should be limited to the price set in the restrictive agreement.

Procedural History

The Commissioner assessed a deficiency based on a valuation of the gifted stock exceeding the price set by the stockholders' agreement. The taxpayer petitioned the Tax Court for review of the Commissioner's determination.

Issue(s)

Whether a voluntary stock restriction agreement, requiring a stockholder to offer the stock to other stockholders at a set price before selling to a third party, automatically limits the stock's value for gift tax purposes to that set price.

Holding

No, because the price set out in the restrictive agreement does not, of itself, determine the value of the stock for gift tax purposes; the restrictive agreement is a factor to consider but not the sole determinant of value. The taxpayer also failed to provide evidence that the respondent did not make sufficient allowance for the depressing effect of the restrictive agreement on the actual value of the stock.

Court’s Reasoning

The Tax Court distinguished the case from situations where a binding, irrevocable option to purchase already existed on the valuation date. In those cases, the stock was already subject to the option, which impacted its value. Here, the stockholder was not obligated to sell. The Court acknowledged that the restrictive agreement is a factor to consider in determining value but not the sole determining factor. The Court noted that other factors like net worth, earning power, and dividend-paying capacity are also relevant. Because the Commissioner considered the restrictive agreement, the Court did not need to determine whether such agreements should be entirely ignored in gift tax valuation. The court noted that the petitioner failed to present any evidence to contradict the respondent’s determination of value. Thus, the court had no basis to conclude that the respondent’s valuation was flawed.

Practical Implications

This case clarifies that stock restriction agreements are a factor in determining fair market value for gift tax purposes, but they do not automatically dictate the value. Attorneys advising clients on estate planning involving closely-held businesses should ensure that valuations consider all relevant factors, including the terms of any restrictive agreements, but should not rely solely on the agreement price. It reinforces the importance of presenting evidence to support a valuation that considers the depressive effect of such agreements. Later cases have cited this ruling to support the position that restriction agreements, while relevant, are not the only factor in determining fair market value, and that the specific terms and enforceability of such agreements are critical to the valuation analysis.

