Snyder v. Commissioner, 93 T. C. 529 (1989)

The Black-Scholes method is inappropriate for valuing common stock, and failure to convert preferred stock to a cumulative dividend class can result in a gift to common shareholders if the underlying assets appreciate.

Summary

Elizabeth Snyder transferred Gore stock to Libbyfam, Inc. , in exchange for common and Class A preferred stock, then gifted the common stock to a trust. The court rejected using the Black-Scholes method to value the common stock, affirming its value at $1,000 as reported by Snyder. Additionally, the court held that Snyder's failure to convert her Class A to Class B preferred stock (which would have accumulated dividends) resulted in a gift to the common shareholders when the underlying Gore stock appreciated sufficiently to cover the increased redemption price. This case clarifies the valuation of closely held stock and the tax implications of unexercised shareholder rights.

Facts

Elizabeth Snyder transferred 300 shares of Gore stock to Libbyfam, Inc. , a personal holding company she created, in exchange for 1,000 shares of voting common stock and 2,591 shares of Class A preferred stock. The Class A preferred stock was nonvoting with a 7% noncumulative dividend and convertible into Class B preferred stock, which had a 7% cumulative dividend. Snyder then gifted the common stock to an irrevocable trust for her great-grandchildren. The Commissioner challenged the valuation of the common stock and alleged that Snyder made additional gifts by not converting her Class A to Class B preferred stock, which would have accumulated dividends.

Procedural History

The Commissioner issued deficiency notices for the gift tax returns filed by Snyder and her husband, asserting that the common stock was undervalued and that additional gifts were made by not exercising the conversion rights. The case was heard by the United States Tax Court, which ruled on the valuation of the common stock and the tax implications of the unexercised conversion rights.

Issue(s)

1. Whether the Black-Scholes method is appropriate for valuing the Libbyfam common stock?
2. Whether the value of the Libbyfam common stock transferred to the trust was correctly reported at $1,000?
3. Whether Snyder made a gift to the common shareholders by failing to convert her Class A preferred stock to Class B preferred stock?
4. Whether Snyder made a gift to the common shareholders by not exercising her

put option to redeem her preferred stock?

Holding

1. No, because the Black-Scholes method is designed for valuing options, not common stock, and does not account for the perpetual nature of stock ownership.
2. Yes, because the common stock's value was correctly reported at $1,000, reflecting the stock's subordination to the preferred stock's redemption rights.
3. Yes, because by not converting to Class B preferred, Snyder transferred value to the common shareholders to the extent the Gore stock appreciated enough to cover the increased redemption price.
4. No, because failing to exercise the put option did not transfer value to the common shareholders as the interest on any redemption note would be offset by the dividends that should have accumulated.

Court's Reasoning

The court rejected the use of the Black-Scholes method for valuing the common stock, as it is designed for valuing options with a finite term, not perpetual stock ownership. The court affirmed the $1,000 valuation of the common stock, finding it accurately reflected the stock's value after accounting for the preferred stock's redemption rights. Regarding the conversion of preferred stock, the court found that by not converting to Class B preferred, Snyder effectively gifted the value of the unaccumulated dividends to the common shareholders when the Gore stock's value increased enough to cover the redemption price. The court distinguished this situation from *Dickman v. Commissioner*, clarifying that the case dealt with debt, not equity, and thus did not apply. The court also rejected the notion that failing to exercise the put option resulted in a gift, as the value of any foregone interest would be offset by the dividends that should have accumulated.

Practical Implications

This decision instructs that the Black-Scholes method is inappropriate for valuing common stock, emphasizing the need for valuation methods that account for the perpetual nature of stock ownership. It also highlights the tax implications of unexercised shareholder rights, particularly in closely held corporations where failure to convert to a more favorable class of stock can result in taxable gifts if the underlying assets appreciate. Practitioners should carefully consider the potential tax consequences of holding different classes of stock and the impact of corporate structure on stock valuation. Subsequent cases may reference Snyder when dealing with similar issues of stock valuation and the tax treatment of unexercised shareholder rights.

