T.C. Memo. 1999-409

In valuing stock of a closely held company for estate tax purposes, a voting rights premium can be applied to shares with voting rights, even minority shares, especially when the capital structure has a disparate ratio of voting to non-voting shares.

Summary

In 1993, Richard R. Simplot died owning voting Class A and nonvoting Class B stock in J.R. Simplot Co., a closely held, family-controlled company. The IRS assessed a deficiency in estate tax, disputing the estate's valuation of the stock, particularly the Class A voting stock. The Tax Court addressed the fair market value of both classes of stock and whether a voting premium should be applied to the Class A shares. The court held that a voting premium was warranted due to the unique capital structure and the potential influence of even a minority voting stake. The court determined the fair market value of both classes of stock, applying marketability discounts and a voting rights premium, and found no penalties were warranted due to the estate's reasonable reliance on professional advice.

Facts

Richard R. Simplot (decedent) died in 1993, owning Class A voting and Class B nonvoting stock in J.R. Simplot Co. J.R. Simplot Co. is a large, privately held agribusiness and frozen food company founded by J.R. Simplot. The company had two classes of stock: Class A voting and Class B nonvoting. Class A stock had voting rights, while Class B stock did not. Decedent owned 18 shares of Class A voting stock (23.55% of voting stock) and 3,942.048 shares of Class B nonvoting stock (2.79% of nonvoting stock). The remaining Class A stock was owned by decedent's siblings. Class B stock was largely owned by descendants of J.R. Simplot and an ESOP. J.R. Simplot Co. had never declared a dividend. The articles of incorporation placed restrictions on the transfer of Class A voting stock, including a right of first refusal. The company was operationally divided into five groups: Food Products, Agriculture, Diversified Products, Minerals and Chemical, and Development and Corporate. J.R. Simplot Co. also held a significant investment in Micron Technology stock.

Procedural History

The Estate of Richard R. Simplot filed a Form 706, valuing both Class A and Class B shares at $2,650 per share. The IRS issued a notice of deficiency, significantly increasing the valuation of the Class A voting stock and Class B nonvoting stock, and assessed penalties. The Estate petitioned the Tax Court to contest the deficiency and penalties. The Tax Court was tasked with determining the fair market value of the stock and whether penalties were warranted.

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Issue(s)

1. Whether the fair market value of the 18 shares of Class A voting common stock of J.R. Simplot Co. owned by Richard R. Simplot on June 24, 1993, should include a premium for voting rights.
2. Whether the fair market value of the 3,942.048 shares of Class B nonvoting common stock of J.R. Simplot Co. owned by Richard R. Simplot on June 24, 1993, was correctly determined.
3. Whether the amount of the section 2056 marital deduction to be allowed to the estate of Richard R. Simplot was correctly calculated.
4. Whether the petitioner is liable for section 6662 penalties as determined by the respondent.

Holding

1. Yes, because the Class A voting stock possesses voting rights that warrant a premium, especially given the company's capital structure and the disproportionate ratio of voting to nonvoting shares.
2. The fair market value of the Class B nonvoting stock was determined by the court, considering marketability discounts.
3. The amount of the marital deduction must be recalculated based on the court's valuation of the Class A voting stock and Class B nonvoting stock.
4. No, because the petitioner acted reasonably and in good faith by relying on the advice of tax professionals and appraisers in valuing the stock.

Court's Reasoning

The court determined fair market value based on the hypothetical willing buyer and willing seller standard, considering all relevant facts and circumstances on the valuation date. The court found the respondent's experts' valuation methodology, which accorded a premium to the voting privileges of Class A stock, more persuasive than the petitioner's experts' methodology, which found negligible difference between voting and nonvoting shares. The court emphasized the unique capital structure of J.R. Simplot Co., with a very small number of voting shares relative to nonvoting shares (1 to 1,848). The court stated, "The disparate ratio of nonvoting to voting stock in this case is particularly important because it dramatically increases, on a per share basis, the value of the Class A shares… Simplot's extreme ratio of nonvoting to voting shares — 1,848.24 to one, with only approximately 76 voting shares — magnifies the per share premium by a thousand times or more compared to any company with a typical single digit ratio." The court adopted a 3% voting rights premium based on the equity value of the company, ultimately valuing the Class A voting stock at $215,539.01 per share after applying a 35% marketability discount and the Class B nonvoting stock at $3,417.05 per share after a 40% marketability discount. Regarding penalties, the court found the estate acted reasonably and in good faith by relying on professional appraisals from Morgan Stanley, thus negating penalties under section 6662.

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Practical Implications

Simplot v. Commissioner provides crucial guidance on valuing voting stock in closely held companies, particularly those with dual-class capital structures. It highlights that even minority voting blocks can command a premium, especially when voting shares are scarce relative to nonvoting shares. Attorneys and appraisers should carefully analyze the capital structure of closely held companies and consider voting rights premiums when valuing stock for estate tax and gift tax purposes. The case demonstrates that traditional valuation methods may need to be adjusted in situations with unusual capital structures. It underscores the importance of expert testimony in valuation cases and the Tax Court's willingness to adopt methodologies that account for the specific characteristics of the company and its stock. Furthermore, it reinforces the reasonable cause defense against penalties when taxpayers rely on qualified professionals for complex valuations.

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