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Simplot Tax Court Ruling Overturned—Estate Planning Attorneys and Business Appraisers Breathe a Sigh of Relief

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Estate planning attorneys (and business appraisers) have not had much to cheer about lately, particularly with the recent tax bill repealing the estate tax over the next 10 years. However, on the case law front, both can breathe a sign of relief now that the popular voting/nonvoting recapitalization strategy is likely less subject to attack and challenge. This relief comes from a recent Ninth Circuit Court of Appeals Decision on appeal from the U.S. Tax Court in *Estate of Richard R. Simplot v. Commissioner*, CA-9, 2001-1 USTC ¶60, 405, rev'g 112 TC 130, CCH Dec. 53, 296.

How Voting/Nonvoting Recapitalizations Work

An estate-planning attorney, working in conjunction with support from a business appraiser, will frequently try to help his or her client by creating a new class of nonvoting stock that will constitute a disproportionate share of the total shares outstanding. By doing this, the owner can put the vast majority of a company value on this class of stock which then is given away. This enables the founder or parent to retain control of the company with a few voting shares that comprise only a small percentage of the total company value. Therefore, at the founder's death, his or her voting shares will only be worth a small dollar amount, thus minimizing estate tax.

For example, assume a parent owns the 100 shares of voting common stock of a Company (its only class of stock). In a recapitalization, the parent decides to exchange all of his 100 shares for 1 voting share and 99 shares of newly issued class of nonvoting common stock. The nonvoting stock is otherwise identical to the voting shares except that the nonvoting stock lacks the power to vote. The parent then begins a program of gifting nonvoting common stock to his children. The parent wants to give away a large share of the value of the Company over time (for estate tax purposes), yet retain control by holding the one voting share. Therefore, at the parent's death, the voting common stock will hopefully only be worth a small dollar amount (in this case 1% or less of the total Company value, since it comprised 1% of total shares outstanding), thus minimizing estate taxes. However, by owning the voting stock, the parent was able to retain control until his death.

How Recapitalizations Were Thrown into Disarray by the Tax Court

The Tax Court's ruling in *Simplot* indicated that the judge did not buy this argument. The Tax Court reasoned that a buyer would pay handsomely for the voting shares held by the Estate, even though the voting stock class as a whole constituted a very small percentage of the total company shares outstanding. The Tax Court in *Simplot* based its result on the IRS's logic that "the investor would likely pay large premiums to induce the [voting stock] shareholders to relinquish control. Once a majority of the [voting stock] is obtained, the investor could force a merger into another company." The judge calculated a 3% "aggregate control premium" (3% of the total value of the corporation), which was then applied to the voting shares only.

The result was a massive total value for the voting shares held by the Estate, even though the shares only amounted to a very small percentage of the total shares outstanding. In fact, when the dust had settled in *Simplot*, the value for the voting shares represented more than a 6,000% premium to the value of the nonvoting shares, many times what a voting shareholder would walk away with if the entire company were sold for its 100% control value. It is certainly arguable that the Court could have reasonably applied a premium to the value of the voting shares in the case. However, it is not reasonable to apply the entire premium for control for the whole company to the one small class of voting shares as the Tax Court ultimately ruled.

Implications of Tax Court Ruling in *Simplot*

The findings of the *Simplot* case at the Tax Court level did not mean that voting/nonvoting recapitalizations should not be done for operating businesses. Routine recapitalizations where the facts are not as stilted as the *Simplot* case certainly make sense, and the problems encountered in *Simplot* might reasonably be avoided or at least their risks reduced. However, the Tax Court's ruling in *Simplot* raised a significant risk in the case of undertaking a very lopsided recapitalization where the number of nonvoting shares dwarfs the amount of voting shares. This risk is also evident in the event that the *Simplot* logic is applied to the 1% General Partner/ 99% Limited Partner situation in many family limited partnerships. The Tax Court's ruling in *Simplot* left many business appraisers wondering if the IRS would challenge their past estate or gift valuations as well.

Court of Appeals Finds for the Estate

Fortunately, the Court of Appeals reversed the Tax Court's finding and remanded it. Central to the Court's reversal were several key issues. The Tax Court reasoned that the few voting shares held by the Estate would later become more valuable in the hands of other family members to whom it and other interests were likely to be transferred to in the future. In effect, the Court of Appeals said that making these future assumptions about the shares and assuming their value in the hands of a specific buyer violates the standard of fair market value, which is based on a hypothetical willing buyer, willing seller, not a specific buyer. The Court of Appeals stated as follows:

> The Tax Court, however, departed from this standard apparently because it believed that 'the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect value.' Obviously the facts that determine value must be considered.
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> The facts supplied by the Tax Court were imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with Simplot children or grandchildren and what improvements in management of a highly successful company an outsider purchaser might suggest. 'All of these factors,' i.e., all of these imagined facts, are what the Tax Court based its 3% premium upon. In violation of the law the Tax Court constructed particular possible purchasers.

Similarly, the Court of Appeals found no supporting justification that a willing buyer would pay the high control type of price as determined by the Tax Court for what amounted to a small number of voting shares that had no control and no assurance of having influence on key decisions. The Court of Appeals clearly sets forth these problems as follows:

> The Tax Court erred further by finding what premium all the Class A shares as a block would command and then dividing this premium per each Class A share. Doing so, the Tax Court valued an asset not before it—all the Class A stock representing complete control. There was no basis for supposing that whatever value attached to complete control a proportionate share of that value attached to each fraction of the whole. Under the applicable regulations, the fair market value of 'each unit of property' is to be ascertained; in the case of shares of stock, 'such unit of property is generally a share of stock.' 26 C.F.R. §20.2031-1(b).
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> The Tax Court committed a third error of law. Even a controlling block of stock is not to be valued at a premium for estate tax purposes, unless the Commissioner can show that a purchaser would be able to use the control 'in such a way to assure an increased economic advantage worth paying a premium for.' *Ahmanson Foundation v. United States,* 674 F.2d 761, 770 (9th Cir. 1981). Here, on liquidation, all Class B shareholders would fare better than Class A shareholders; any premium paid for the 18 Class A shares be lost. Class A and B had the right to the same dividends. What economic benefits attended 18 shares of Class A stock? No 'seat at the table' was assured by this minority interest; it could not elect a director. The Commissioner points out that Class A shareholders had formed businesses that did business with Simplot. If these businesses enjoyed special advantages, the Class A shareholders would have been liable for breach of their fiduciary duty to the Class B shareholders.

Additionally, the Court of Appeals indicated that the IRS value for the Estate's shares is based on many future speculative events and alliances occurring that would enable the Estate's shares to have substantial influence that they do not presently possess. The Court of Appeals suggests a buyer would not pay a price today that reflects these speculative future events and also indicates that this violates the fair market value standard. Regarding the speculative future assumptions made by the Tax Court, the Court of Appeals had the following to say:

> Much of the Commissioner's argument is devoted to speculation as to what might happen after the valuation date—the Simplots might fall out with each other, the purchaser might find ways of making Simplot more profitable and persuade the company to adopt

his strategy, the purchaser might be willing to wait fifteen years to get any return. The speculation is as easily made that the company would go downhill when its founder, J.R. Simplot, 84 at the valuation date, retired; or that McDonald's, Simplot's largest customer for its potatoes, would change its supplier; or that Micron would prove to be an unwise investment. Speculation is easy but not a proper way to value the transfer at the time of the decedent's death. *Olson v. United States*, 292 U.S. 246, 259, 78 L. Ed. 1236, 54 S. Ct. 704 (1934). In Richard Simplot's hands at the time of transfer his stock was worth what a willing buyer would have paid for the economic benefits presently attached to the stock. By this standard, a minority holding Class A share was worth no more than a Class B share.

Conclusion

Fortunately the Court of Appeals focused on fair market value in the *Simplot* matter and accurately discerned the logical flaws in the Tax Court's findings, which made no economic sense whatsoever. This is certainly good news for clients who have undertaken such recapitalizations in the past (and the business appraisers who valued them); however, we remind our readers that this case is precedent only in the Ninth Circuit. Business appraisers still need to have a healthy degree of skepticism about the highly lopsided recapitalization. ◆