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Minority Discounts, Fair Market Value, and the Culture of Estate Taxation

William S. Blatt
University of Miami School of Law, wblatt@law.miami.edu

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WILLIAM S. BLATT*

I. Introduction

In valuing blocks of corporate stock, courts often permit a minority discount—a reduction in value that reflects the difficulty of selling shares lacking corporate control.[1] The allowance of minority discounts encourages transactions designed to reduce transfer taxes.[2] Taxpayers keep property in corporate solution, sometimes in tiered holding companies,[3] and gradually transfer corporate control through multiple gifts of small blocks. Long contested by the government,[4] mi-

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1 This reduction assumes, for example, that unless held as part of a controlling interest, a block of stock equal to 20% of the outstanding stock is worth less than 20% of the value of the corporation. This lower price reflects the exclusion of the block from corporate decisionmaking.

2 Transfer taxes refer to estate, gift, and generation-skipping taxes collectively. The estate tax, a tax on transfers occurring at death, was enacted in 1916. Revenue Act of 1916, ch. 463, § 201, 39 Stat. 756, 777. The current gift tax, a tax on lifetime transfers, was enacted in 1932. Revenue Act of 1932, ch. 209, § 501, 47 Stat. 169, 245-46. Since 1976, these taxes have applied a single progressive rate schedule to an individual's cumulative transfers. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1520, 1846-54. The current tax on generation-skipping transfers was enacted in 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1431, 100 Stat. 2085, 2717-29.

3 Tiered holding companies multiply the applicable discounts. E.g., Whittemore v. Fitzpatrick, 127 F. Supp. 710 (D. Conn. 1954) (allowing successive discounts of 11, 50, and 16%); Dean v. Commissioner, 19 T.C.M. (CCH) 281 (1960) (allowing successive discounts of 21, 14, and 20% to reflect the effect of intervening corporate shells).

4 The total number of cases discussing minority discounts exceeds 90. A WESTLAW search conducted on February 6, 1998 indicated that "minority" occurred within five words of "discount" in 97 cases since 1945 (FTX-CS Database). See also George Cooper, A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance, 77 Colum. L. Rev. 161, 201 n.121 (1977) (counting 63 cases between 1950 and 1975).

nority discounts have cost the Treasury billions in lost taxes.[5] Anecdotal evidence indicates that the size of minority discounts have grown over time[6] and that their use has soared.[7] The most recent innovation is the discount partnership.[8] Rather than give property away outright, a donor first contributes it to a partnership and then transfers an interest in the partnership. In calculating her gift tax, she relies on the existence of a partnership to claim a substantial discount.[9]

Many voice misgivings about the use of minority discounts to reduce transfer taxes.[10] Expert discussion of discounts turns on the

[5] In 1998, the Joint Committee on Taxation estimated that a proposal eliminating nonbusiness valuation discounts would raise an amount ranging from $485 million to $628 million per year in the years 2000 to 2008. Joint Committee on Taxation, Estimated Budget Effects of the President's Budgetary Proposal for Fiscal Year 1999 (visited June 1, 1998) <http://www.house.gov/jct/x-14-98.html> (published Feb. 24, 1998). Revenue estimates of a different proposal by the Joint Committee in 1987 suggest that minority discounts cost roughly $1 billion in lost revenue in 1988 and 1989. Compare H.R. Rep. No. 100-391, at 1638 (1987) (estimating that proposals curtailing both minority discount and estate freeze transactions raised $1.2 billion between October, 1987 and January, 1990), with H.R. Conf. Rep. 100-495, at 1025 (1987), reprinted in 1987-3 C.B. 193, 305 (estimating that estate freeze proposal alone raised only $109 million over that time period). Although differences in data, economic assumptions, and proposals may diminish the estimates' comparability, they illustrate the magnitude of the revenue involved.

A single case cost the Treasury hundreds of millions. Estate of Newhouse v. Commissioner, 94 T.C. 193, 247 (1990) (valuing common stock at $176 million instead of at the underlying property's value of $1.2 billion); Cooper, note 4, at 199 (describing the potential tax savings from another case as in the tens of millions).

[6] Survey Shows Trend Towards Larger Minority Discounts, 10 Est. Plan. 281 (1983) (describing the Service's acceptance of higher discounts).

[7] Professional journals reveal growing interest in minority discounts. A WESTLAW search conducted on February 6, 1998 indicated that "minority" occurred within five words of "discount" in 14 articles published between 1971 and 1985, in 116 articles published between 1985 and 1990, and in 524 articles published after 1989 (TX-TP Database). This is largely because Congress enacted chapter 14 in 1990, which blessed minority discounts while shutting down other estate planning transactions. See, e.g., Wayne L. Warnken & Pamela R. Champine, Securing the Minority Discount for Family Business Transfers, Tr. & Est., Apr. 1993, at 49 (noting that chapter 14 did not alter the use of discounts in valuing minority stock).

[8] Dennis I. Belcher, Drafting Agreements to Take Advantage of Valuation Discounts, 30 Inst. on Est. Plan. ¶ 1000 (1996) (describing how to draft partnership agreements to take advantage of valuation discounts); Michael D. Mulligan & Angela Fick Braly, Family Limited Partnerships Can Create Discounts, 21 Est. Plan. 195 (1994); Susan Scherreik, How to Share the Wealth and Keep Control, Bus. Wk., Jan. 17, 1994, at 94 (describing use of family limited partnerships to obtain valuation discount); Lee A. Sheppard, Can the IRS Challenge Family Limited Partnerships?, 63 Tax Notes 1388 (June 13, 1994).

[9] Jeffrey N. Pennell, Valuation Discord: An Exegesis of Wealth Transfer Tax Valuation Theory and Practice, 30 Inst. on Est. Plan. & 900, at 34 (1996).

[10] 2 Treasury Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth 386-87 (1984) (proposal for taxation of minority discounts); Cooper, note 4, at 195-204, 226-28, 230-32; Joseph M. Dodge, Redoing the Estate and Gift Taxes Along Easy-to-Value Lines, 43 Tax L. Rev. 241, 254-56 (1988); Alan L. Feld, The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares, 122 U. Pa. L. Rev. 934, 934-46 (1974); Mary Louise Fellows & William H. Painter, Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome, 30

meaning of fair market value, the legal standard for tax valuation. The principal question for tax experts is whether the allowance of minority discounts for family-owned companies reflects fair market value. Experts take divergent positions on this issue and have yet to reach agreement.

This Article contends that misgivings about minority discounts cannot be resolved by appeals to the market. Market economics in fact yields no firm conclusions about the appropriateness of discounts. This Article offers an alternative basis for thinking about minority discounts, one that draws from concepts that pervade American culture. These concepts underlie popular intuitions of tax abuse and influence legal attitudes toward closely held entities.

This Article consists of four sections. The first describes the current tax policy debate over minority discounts, which revolves around the meaning of fair market value. Professional appraisers, tax reformers, and judges all invoke this standard to different ends. Appraisers ascertain fair market value by approximating public markets. Pointing to the inflated prices commanded by takeover targets and the depressed prices paid for closed-end mutual funds, they routinely value corporate stock by first determining its pro rata share of corporate value and reducing that amount for lack of control. Reformers counter that such reductions understate the market value of family-owned companies by ignoring likely behavior. They assert that family members govern these companies jointly and sell their interests together for pro rata value, rather than separately at a discount. Most courts reject the reformers' argument and affirm that minority discounts reflect objective value. They claim that other standards mandate a speculative inquiry into the owners' subjective intent. These judicial pronouncements, however, have failed to end the debate.

The second Section argues that experts cannot evaluate the appropriateness of minority discounts by looking to the market. An extensive corporate finance literature suggests that minority discounts cannot be incorporated into market theory. The traditional efficient market hypothesis posits that stock price reflects the value of the underlying assets. It seems clear, however, that managerial behavior and investor preferences often cause stock price to deviate from asset value. Accordingly, some scholars back away from the traditional efficient market hypothesis and assert that stocks and assets are sold in

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Stan. L. Rev. 895 (1978); James R. Repetti, Minority Discounts: The Alchemy in Estate and Gift Taxation, 50 Tax L. Rev. 415, 467-82 (1995); Thomas D. Hall, Comment, Valuing Closely Held Stock: Control Premiums and Minority Discounts, 31 Emory L.J. 139 (1982); Steven E. Monical, Note, The Effect of Corporate Control on Valuation of Closely Held Corporate Stock for Federal Estate and Gift Tax Purposes, 1982 U. Ill. L. Rev. 775.

separate and distinct markets. This assertion explains why stock prices diverge from underlying asset values.

The corporate finance literature undermines the various positions taken in the current tax policy debate. The literature refutes the judicial understanding that minority discounts reflect objective value. In fact, there is no objective value, only a price for stock and a price for assets. This research also contradicts the reformer position that discounts should be disallowed for stock in family-owned companies. The situation is actually not so clear cut. The root causes of minority discounts, managerial behavior and investor preference, diminish but do not disappear with family ownership.

Finally, the literature casts doubt on routine appraisal methods for closely held businesses. By valuing the entire corporation and then adjusting for control, appraisers implicitly assume that managerial behavior and investor preference only depress value. The corporate finance literature shows, however, that these factors also can enhance value. By omitting this potential enhancement, appraisers understate the value of closely held businesses.

The third Section offers an alternative way to think about minority discounts by drawing from two pervasive cultural constructions: concentrations of wealth and family businesses. Each construct suggests a different attitude toward the estate tax. When viewed as a method of attacking the rich, the tax seems well justified; when seen as falling on family businesses, it appears burdensome. These two constructs dominate public debate over transfer taxation and underlie popular intuitions about the abusiveness of fragmenting property. Moreover, despite their fuzziness, these constructs deeply influence legal approaches to closely owned entities.

The fourth Section uses the cultural constructs to assess proposals for addressing minority discounts. Proposals attributing stock ownership among family members or taxing disguised transfers occurring through the exercise or nonexercise of retained rights are likely to be viewed as onerous. More attractive is a proposal to aggregate transfers by the donor or donee. This proposal would prevent a controlling shareholder from obtaining a discount on the transfer of control simply by making successive gifts of minority interests. The most attractive proposal presumes that stock is worth at least its pro rata share of the value of corporate assets if sold in liquidation. This proposal would stop taxpayers from obtaining discounts by transferring passive assets in corporate solution. It thereby would shut down the most outrageous transactions utilizing minority discounts.

II. The Tax Policy Debate Over Minority Discounts in Taxation: The Meaning of Fair Market Value

The current policy debate over the allowance of minority discounts for family-owned companies revolves around the concept of fair market value, "the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[11] This standard requires predicting the behavior of a hypothetical buyer and seller.[12] Actual sales, though relevant, are not necessarily determinative.[13]

The fair market value standard claims support in traditional tax policy norms. In theory, subjective value may be the fairest and most efficient valuation standard. By inquiring into what a particular owner would pay for the property, that standard considers individual well-being and does not affect taxpayer behavior. Since subjective value is the point at which the owner is indifferent between retaining and selling the property, use of that value assures that the taxpayer cannot increase his personal welfare by changing his behavior.[14] A subjective value standard is widely regarded as inadministrable, however, because there is seldom any evidence of subjective value besides self-serving taxpayer testimony. This leaves fair market value as the most administrable alternative. By inquiring into the price to which willing people would agree, that standard assures that no taxpayer will be obviously favored or face discernable incentives to alter behavior.

Despite the broad consensus supporting the fair market value standard, opinions about minority discounts are extremely diverse. Professional appraisers, tax reformers, and judges take different positions, and despite authoritative judicial pronouncements, controversy continues.

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[11] Reg. § 20.2031-1(b).

[12] Judge Jerome Frank described valuation as an inquiry into "what-you-could-have-got-for-it-in-money-if-you-had-sold-it." Andrews v. Commissioner, 135 F.2d 314, 317 (2d Cir. 1943).

[13] For example, fair market value is not determined by a forced sale price. Reg. § 20.2031-1(b). For publicly traded property, past sales are determinative of value. Reg. § 20.2031-2(b) (the value of stock and bonds traded on exchanges is usually the mean between the highest and lowest quoted selling price on the valuation date).

[14] See Joseph Bankman, Thomas D. Griffith & Katherine Pratt, Federal Income Tax: Examples & Explanations 39 (1996) (arguing that taxation of subjective value is fairest and most efficient).

A. *Appraisers: Minority Discounts as Approximating Public Markets*

Appraisers regard minority discounts as necessary to approximate prices found in public markets. They generally value closely held stock in two steps.[15] They first value the entire company and then make adjustments for special factors. They use a similar approach for valuing partnership interests and undivided interests in property.

Appraisers determine total firm value using one of three methods: market, asset, or income.[16] The market method compares the company in question with guideline public companies.[17] Criteria for selecting guideline companies include capital structure, credit status, depth of management, and personnel experience.[18] The asset method sums up the value of corporate assets and subtracts liabilities.[19] The value of assets varies depending on whether they are used in a going concern or sold in an orderly disposition.[20] The income method determines value by dividing the expected economic income by a discount rate derived from public companies.[21] Economic income is taxable income adjusted for items such as noncash charges and capital expenditures, but not for unrealized appreciation.[22] In the absence of comparable guideline companies, appraisers use the asset method for holding companies and the income method for operating companies. Sometimes they consider both in a weighted average.[23]

After determining pro rata value, appraisers make adjustments designed to reflect a half dozen or so features that depress or enhance

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[15] The Service enumerates a host of facts to be considered in valuing closely held businesses. These include the history and nature of the business, the industry and general economic outlook, book value and financial condition, earning capacity, dividend-paying capacity, existence of goodwill or other intangible value, prior sales and the size of the block of the stock, and comparisons to similar publicly traded companies. Rev. Rul. 59-60, 1959-1 C.B. 237.

[16] Gary R. Albrecht, Calculating the Value of a Closely Held Firm, J. Legal Econ., Dec. 1991, at 1 (describing liquidation value and various earnings-based values); James R. Hitchner, Valuation of Closely Held Businesses, 23 Tax Adviser 471, 472-73 (1992) (describing income, market, and cost approaches).

[17] Shannon P. Pratt, Robert F. Reilly & Robert P. Schweihs, Valuing a Business: The Analysis and Appraisal of Closely Held Companies 203-38 (3d ed. 1996) (describing market method).

[18] Id. at 211-12 (listing criteria for selecting comparable companies).

[19] Id. at 256-59 (describing asset method).

[20] Id. at 262 (assets may be valued in continued use, as part of a going concern, in place, as part of a mass assemblage of assets, in exchange, as part of an orderly disposition, or in exchange, as part of a forced liquidation).

[21] Id. at 153-58 (describing income method).

[22] Id. at 156-57 (defining cash flow in terms of taxable income without adjustment for capital appreciation).

[23] 5 Boris I. Bittker & Lawrence Lokkin, Federal Taxation of Income, Estates and Gifts, & 135.4.3, at 135-66 to 135-67 (2d ed. 1993).

stock value.[24] The most important adjustments are for rights conveyed by corporate control: the ability to determine management, distributions, and corporate structure.[25] Because these rights permit controlling shareholders to enrich themselves, either by entering into favorable corporate contracts for goods and services or by tailoring corporate investments to personal risk, income, and time horizons, stock conveying control generally commands a premium. Conversely, in recognition of the potential exploitation of minority shareholders, stock lacking control generally[26] receives a minority discount.[27] Ap-

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[24] Id. at 135-28 (listing modifications for lack of marketability: abnormally large parcels, tracts or holdings (blockage), premiums for control and discounts for minority status in closely held enterprises, loss of a key executive, lack of diversification, especially in the case of family companies, governmental restrictions and taxes on transfers or other transactions involving the property, private restrictions and encumbrances, including buy-sell agreements covering interests in closely held businesses); Cooper, note 4, at 196 (listing discounts for blockage, unmarketability, minority interest, costs of flotation and sale, restrictions on disposition, and capital gains and other tax liabilities); Hitchner, note 16, at 476-78 (listing discounts for minority interest, lack of marketability, key man or thin management, investment company, information access and reliability, comparability, market absorption and blockage, and liquidation and/or capital gains).

[25] Ian R. Campbell, The Principles and Practice of Business Valuation 114 (1975) (describing five valuable rights of corporate control: (1) the right to elect the board of directors, which translates into control of the economic direction of the investment, (2) the right to liquidate the company, which allows the shareholder to recoup asset value in the event the company fails as a going concern, (3) the right to sell the company, which is the ability to dictate the liquidity of the investment, (4) the right to appoint officers of the company, which, if the compensation is excessive, results in drawing out profits that otherwise would accrue to minority shareholders, and (5) the right to determine the amount and timing of dividends, which is the benefit of determining the cash flow from the investment); Pratt et al., note 17, at 301 (listing of powers and prerogatives of control: appointing management, determining management compensation and prerequisites, setting policy, acquiring or liquidating assets, selecting supplies and awarding contracts, making acquisitions, liquidating, dissolving, selling out or recapitalizing the company, selling or acquiring treasury shares, registering the company's stock for a public offering, declaring and paying dividends, and changing the articles of incorporation and bylaws); James R. Hitchner & Kevin J. Rudd, The Use of Discounts in Estate and Gift Tax Valuations, Tr. & Est., Aug. 1992, at 49, 53 (controlling shareholder rights of electing directors, selecting management, determining dividend policy, establishing compensation and benefits, acquiring and liquidating assets, selling the company, liquidating and dissolving the company, recapitalizing the company, acquiring or merging, revising the articles of incorporation and bylaws, establishing buy-sell agreements, and going public).

[26] State law often disallows minority discounts in valuing stock in appraisal proceedings. 2 Principles of Corporate Governance: Analysis and Recommendations § 7.22(a) (1994) (appraisal value determined without any discount for minority status). This disallowance is based upon the purpose of the appraisal right rather than assumptions about market behavior. E.g., Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1145 (Del. 1989) ("to fail to accord to a minority interest the full proportionate value of his shares imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder, a clearly undesirable result").

[27] Control often is regarded as involving a zero sum game. 5 Bittker & Lokken, note 23, at 135-33 ("Control premiums and minority discounts can be regarded as mirror images, on the theory that they reflect a division among the shareholders of a fixed amount (the value

praisers usually increase the discount if management has broad latitude,[28] stock ownership is concentrated,[29] or corporate value is small.[30] Closely related to adjustments for control are those for marketability. Appraisers discount shares lacking a public market.[31]

The type of adjustment depends upon the method used to value the entire business.[32] Thus, the market method already reflects the effect of minority ownership.[33] Asset value often takes into account lack of marketability.[34] Depending on how the discount rate is derived, the income approach may reflect one or both discounts.[35]

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of the entire corporation) and that every dollar of extra value ascribed to the controlling shares must therefore be offset by a minority discount."); Fellows & Painter, note 10, at 909-10 ("A minority discount . . . is a corollary of a majority premium and depends on the latter for its validity. A discount for lack of control is only appropriate if the amount discounted already includes a majority premium.").

In fact, control sometimes is a zero sum game and sometimes not. See generally 5 Bittker & Lokken, note 23, at 135-34 to 135-35 (noting that control premiums are attributable both to the hope of operating the company more efficiently and the possibility of self dealing); William Andrews, The Stockholder's Right to Equal Opportunity in the Sale of Shares, 78 Harv. L. Rev. 505, 522-37 (1965) (discussing reasons for acquiring corporate control); Henry G. Manne, Some Theoretical Aspects of Share Voting, 64 Colum. L. Rev. 1427, 1430 (1964) (identifying four reasons for seeking corporate control: monopoly power, use of economies of scale, salaries and other perquisites, and improved management).

For recent attempts to model the effect of lack of control upon the value of minority shares, see Jerome S. Osteryoung, Donald A. Nast & William H. Wells, Pricing Minority Discounts in Closely-Held Corporations, in Advances in Small Business Finance 19 (Rassoul Yazdipour, ed., 1991) [hereinafter Small Business Finance] (proposing option pricing model for valuing agency costs incurred by minority shareholders); Zenichi Shishido, The Fair Value of Minority Stock in Closely Held Corporations, 62 Fordham L. Rev. 65, 85-87 (1993) (determining minority discount and control premium by adjusting discounted cash flow for risk of squeeze out, entrepreneurial rewards, and effect of dissatisfied minority owners).

[28] See Pratt et al., note 17, at 66.

[29] Concentrated ownership increases the chance that controlling shareholders will exploit the minority. Hitchner & Rudd, note 25, at 53.

[30] Small size means that the prerequisites claimed by controlling shareholders deplete a larger percentage of corporate value. H. Calvin Coolidge, Fixing Value of Minority Interest in a Business; Actual Sales Suggest Discount as High as 70%, 2 Est. Plan. 138, 141 (1975); Hitchner & Rudd, note 25, at 54-55 (describing evidence for an additional discount for small companies).

[31] See Bittker & Lokken, note 23, at 135-28 to 135-32.

[32] See John A. Bogdanski, Federal Tax Valuation 4-117 to 4-118 (1996).

[33] See Hitchner & Rudd, note 25, at 22 (if appraisal uses publicly traded stock data its results are on a minority, marketable basis). But see Bittker & Lokken, note 23, at 135-42 (recognizing the possibility that minority interest in privately owned companies may be "more disadvantageous than a minority position in the comparable public companies").

[34] See Bittker & Lokken, note 23, at 135-29 (describing lack of marketability discount as "an adjustment for the fact that the property being valued would be harder to sell than the otherwise comparable property").

[35] See id. at 135-30 ("When property is valued by capitalizing its anticipated net earnings, no marketability discount is needed if the capitalization factor reflects not only the earnings in isolation, but usually also the fact that the investor may find it difficult to liquidate the investment."); id. at 135-42 (capitalization rate drawn from public companies re-

Public markets supply the most important empirical evidence for discounts. Appraisers find empirical evidence of control premiums and minority discounts in two public market phenomena.[36] One is the premium paid to take over a public company.[37] Purchasers inevitably pay more than the stock exchange price. The other source is the price paid for shares in a closed-end mutual fund, an investment company whose shares are not redeemable upon demand.[38] The price of these shares is usually less than the pro rata value of the underlying portfolio.[39] Appraisers support lack of marketability discounts by pointing to the positive effect of an initial public offering on stock price and the depressed price of nonregistered stock.[40]

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flects minority discount because transactions in public companies usually involve minority shares).

[36] One might try to substantiate discounts by pointing to Tobin's *q*, the ratio of the market value of a company's debt and equity to the current replacement costs of its assets. See James Tobin, A General Equilibrium Approach to Monetary Theory, 1 J. Money, Credit & Banking 15, 21 (1969). Although many firms have a *q* of less than one, there are other explanations for a low *q*. See Reinier Kraakman, Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive, 88 Colum L. Rev. 891, 907-08 (1988).

[37] See Lance S. Hall & Timothy C. Polacek, Strategies for Obtaining the Largest Valuation Discounts, Est. Plan., Jan.-Feb. 1994, at 38, 42 (describing acquisitions of controlling interests in the public marketplace as the primary source of data for discounts); J. Michael Maher, An Objective Measure for a Discount for a Minority Interest and a Premium for a Controlling Interest, 57 Taxes 449 (1979) (deriving an objective measure for a minority discount from the cash premium offered in excess of the publicly traded market price of minority interests in the same corporation); Shannon R. Pratt, Valuing a Minority Interest in a Closely Held Company, Prac. Acct., June 1986, at 60, 66-67.

[38] See Whittemore v. Fitzpatrick, 127 F. Supp. 710, 720 (D. Conn. 1954) (relying on experience of closed end investment trusts); Cooper, note 4, at 200 (describing deep discounts in publicly traded closed-end investment companies as the justification for minority discounts); Hall & Polacek, note 37, at 42 (real estate investment trusts compute their discount by comparing the appraised value of their real estate holdings to the publicly traded price of their shares) (citing Estate of Berg v. Commissioner, 61 T.C.M. (CCH) 279, aff'd in part and rev'd in part, 92-2 USTC & 60,117 (8th Cir. 1992)); Hitchner & Rudd, note 25, at 55 (describing evidence of investment company discounts in real estate holding companies).

[39] There is also some data on the prices garnered on private sales. See Coolidge, note 30, at 138-41 (survey of difference between book value and price at private sales of closely held companies).

[40] See Milton Gelman, An Economist-Financial Analyst's Approach to Valuing Stock of a Closely-Held Company, 36 J. Tax'n 353, 354 (1972) (determining lack of marketability discount by reference to price differences between restricted and nonrestricted stock); Hitchner & Rudd, note 25, at 50 (finding evidence of marketability discounts in price differences between registered and unregistered stocks of the same company, in the comparison of closely held stocks with subsequent initial public offerings, in costs of flotation for a public offering, and in court cases).

B. *Tax Reformers: Minority Discounts as Inconsistent With Likely Family Behavior*

Reformers criticize the allowance of minority discounts for transfer tax purposes.[41] They argue that discounts "erode" the estate tax base[42] by imposing less tax on a lifetime gift than on a testamentary bequest. A controlling shareholder who makes multiple gifts of small blocks receives a minority discount, but one who makes testamentary bequests to multiple beneficiaries does not.[43]

This discrepancy alone does not necessarily undermine the allowance of minority discounts. Different values may be appropriate for gift and estate tax purposes if the discount reflects true diminution in value. Thus, reformers usually supplement their base erosion argument with the claim that discounts do not reflect real diminution in value because family members do not deal with each another at arm's length.[44] A family member is less likely to be hurt by, and may well benefit from, corporate contracts and decisions regarding management, distributions, and corporate structure. This means that the value of a minority interest to a family member exceeds the price to which a willing buyer and willing seller would agree. The retention value of the minority interest exceeds its sale price.[45]

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[41] See, e.g., Stanley D. Neeleman, Kasner Disregards Sound Tax Policy, Says Professor, 61 Tax Notes 867 (Nov. 15 1993) ("The tax avoidance possibilities that derive from the continued availability of discounts for transfers of fractional interests among family members undermine the integrity of the transfer tax system and make a mockery of the principles of tax equity.").

[42] See Cooper, note 4, at 197 (claiming that "valuation discounts have opened the door to wholesale erosion of the estate tax base"); Dodge, note 10, at 254 (noting that current valuation methods reduce tax base); Feld, note 10, at 946 (observing that minority discounts "result in permanent avoidance of estate and gift tax"); Fellows & Painter, note 10, at 899 (describing how controlling shareholders reduce estate and gift tax liability through gratuitous transfers of minority blocks of controlling shares); Repetti, note 10, at 431-34 (describing use of valuation methods to reduce gift and estate taxes).

[43] See Estate of Curry v. United States, 706 F.2d 1424, 1427 (7th Cir. 1983); Ahmanson Foundation v. United States, 674 F.2d 761, 769 (9th Cir. 1981); David E. Watts, The Fair Market Value of Actively Traded Securities, 30 Tax Law. 51, 71 (1976) (stating no argument for fragmentation even in the case of multiple specific bequests of the stock).

[44] Cooper, note 4, at 197 (criticizing courts that allow valuation discounts for ignoring the special family circumstances in which the valuation is being made); Dodge, note 10, at 255 n.54 ("Of course, in many . . . cases, the economic loss attributable to the creation of minority interests is probably illusory, or else the transaction would not have been undertaken in the first place."); Feld, note 10, at 943 (arguing against allowing minority discounts for family businesses); Fellows & Painter, note 10, at 927-28 (noting that valuation does not include de facto control by a group with sufficiently similar interests, even though such control adds value).

[45] Retention value usually equals sale price. Buyers pay the present value of benefits accruing if the stock is retained. See text accompanying note 21. Sometimes, however, stock price deviates from retention value. See Elliott Manning, Corporate Buy-Sell Agreements 94 (1995) ("The price specified in a buy-sell agreement that permits gifts to family members does not fix the gift tax value of shares transferred subject to the restrictive provi-

Reformers approximate this retention value by assuming that the family acts as a single unit. Family members are likely to manage the company for mutual benefit and, when the time comes, to sell their stock jointly for full value rather than separately for a discounted amount. Accordingly, reformers argue that discrete transfers of stock should be valued as part of the family-owned block.[46] In Revenue Ruling 81-253, the Service denied minority discounts for family-owned companies by adopting such a "family attribution" rule.[47]

C. *Courts: Minority Discounts as Objective Value*

Notwithstanding the reformer critique, many claim that discounts represent fair market value.[48] This position has triumphed in the courts, Congress, and the Service. In *Estate of Bright*,[49] the Fifth Circuit affirmed that minority discounts were part of fair market value. The Government argued that a discount for stock passing from wife to husband was inappropriate because together they owned a majority of the outstanding shares. The court rejected this argument, relying on precedent, the willing-buyer, willing-seller standard, and the need for stability and predictability.[50] Citing the "hypothetical seller" language in the regulations, it said that the fact that husband and wife together owned a majority was irrelevant: "[V]aluation is based on a sale by a *hypothetical seller* . . . who is related to no one."[51]

Bright has been widely followed. The Ninth Circuit defended *Bright*'s objective standard as avoiding "the uncertainties that would otherwise be inherent if the valuation methods attempted to account for the likelihood that estates, legatees, or heirs would sell their inter-

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sions of the agreement. The theory apparently is that the shares have a retention value as well as a sale value."); Daniel S. Goldberg, Fair Market Value in the Tax Law: Replacement Value or Liquidation Value, 60 Tex. L. Rev. 833, 846-52 (1982) (discussing the choice between replacement value and liquidation value).

[46] See Cooper, note 4, at 227, 231-32 (proposing that courts consider the relationship of the donor to other shareholders); Fellows & Painter, note 10, at 928 (describing proposal to attribute ownership of voting shares by related family members and entities for valuation purposes).

[47] The ruling states:

> [W]here a controlling interest in stock is owned by a family, the value per share of the stock owned by one family member is the same as stock owned by any other family member and is the same value that would exist if all the stock were held by one person.

Rev. Rul. 81-253, 1981-2 C.B. 187, 188.

[48] See, e.g., Thomas W. Dant, Jr., Courts Increasing Amount of Discount for a Minority Interest in a Business, 43 J. Tax'n 104, 105 (1975); Robert E. Moroney, Most Courts Overvalue Closely Held Stocks, 51 Taxes 144, 156 (1973).

[49] Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981).

[50] Id. at 1005-06.

[51] Id. at 1007.

ests together with others who hold undivided interests in the property" and the "delicate inquiries into the feelings, attitudes, and anticipated behavior of those holding undivided interests in the property in question."[52] The Tax Court also adopted the *Bright* standard. Refusing to "tailor 'hypothetical' so that the willing seller and willing buyer were seen as the particular persons who would most likely undertake the transaction," that court required "a truly hypothetical willing seller and willing buyer."[53]

In the wake of these decisions, both Congress and the Service ceased challenging minority discounts. In 1987, Congress rejected a proposal mandating family attribution within a single class of stock,[54] while enacting one addressing estate freeze transactions, codified at § 2036(c).[55] The estate freeze proposal applied only to capital structures conferring preferred rights to income or control.[56] In 1988, the Service blessed certain minority discounts by exempting transfers of nonvoting common stock from § 2036(c).[57] In replacing that subsection with special valuation rules in 1990, Congress disclaimed any effect on discounts.[58] Finally, in 1993, the Service revoked Revenue Ruling 81-253[59] and ruled that it would not disallow a minority discount solely because the family owns a controlling interest.[60]

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[52] Propstra v. United States, 680 F.2d 1248, 1252 (9th Cir. 1982).

[53] Estate of Andrews v. Commissioner, 79 T.C. 938, 956 (1982); see Ward v. Commissioner, 87 T.C. 78, 106-08 (1986) (allowing minority discounts for gift tax purposes); Note, *Estate of Bright* and *Propstra:* Rejection of Family Attribution in Estate Valuation, 2 Va. Tax Rev. 357, 362-64 (1983).

[54] The House bill would have provided that corporate stock was worth its pro rata value within a single class and that stock held by a family would be voted together. These provisions were not included in the conference bill. See H.R. Conf. Rep. No. 100-495, at 995 (1987), reprinted in 1987-3 C.B. 193, 275.

[55] Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10402, 101 Stat. 1330, 431-32.

[56] Chapter 14 likewise was limited. See IRC § 2701(a)(2)(B) (exempting situations in which the transferor retains stock of the same class as the transferred stock).

[57] Section 2036(c) included certain gifted stock in the transferor's estate. The Service interpreted the provision as not applying if the donor gave away nonvoting common stock while retaining voting common stock. See Notice 89-99, 1989-2 C.B. 422, at 428-29 (exempting stock that differed only with respect to voting or managerial powers). Chapter 14 also exempted this transaction. IRC § 2701(a)(2)(C) (exempting situations in which the transferor retains stock that is proportionally the same as the transferred stock, except for either nonlapsing differences in voting power or, in a partnership, nonlapsing differences with respect to management and limitations on liability).

[58] Senate Finance Comm., 136 Cong. Rec. S15,681 (Oct. 18, 1990), reprinted in 1990-3 C.B. (vol. 3) S15681-4; see H.R. Rep. No. 101-964, at 1137 (1990).

[59] Rev. Rul. 93-12, 1993-1 C.B. 202.

[60] Id. at 203.

D. *Continuing Controversy*

Notwithstanding these authoritative pronouncements, minority discounts still spark controversy. Well after *Bright*,[61] judges still questioned their use. Judge Richard Posner offered an extended analysis of the economics of discounts and criticized *Bright* for its simplistic disregard of likely behavior.[62] Judge John Colvin of the Tax Court went further and denied an estate a minority discount for a 49.65% block of stock created by the transfer of an 88% interest 18 days earlier.[63]

Moreover, despite its declared intentions, Congress disallowed some discounts. Over the course of the estate freeze legislation, Congress gradually adopted assumptions about family behavior similar to those underlying minority discount reform.[64] The final product, Chapter 14, §§ 2701 through 2704 of the Code, undermines certain minority discounts. Section 2701 cast doubt on discounts resulting from the retention of voting preferred stock;[65] §§ 2703 and 2704(b) jeopardized discounts for entities for which liquidation value exceeds going concern value;[66] and § 2704(a) expressly taxes the value of cor-

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[61] Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981).

[62] Citizens Bank & Trust Co. v. Commissioner, 839 F.2d 1249, 1253 (7th Cir. 1988) (describing *Bright* as "driven by an overmastering desire for simplicity, achieved by always valuing a transfer as if the parties were strangers rather than members of the same family or otherwise entangled in a web of relationships that might change the actual value of the gift in either direction").

[63] Estate of Murphy v. Commissioner, 60 T.C.M. (CCH) 672, 672 (1990); see Note, Minority Discounts in the Valuation of Closely Held Stock: *Estate of Murphy v. Commissioner*, 45 Tax Law. 609 (1992).

[64] The minority discount provision was based on doubts as to whether related parties could have competing interests. H.R. Rep. No. 100-391, at 1042 (1987) ("The assignment of a discount to minority ownership of an enterprise assumes that the owners of that enterprise have adverse interests. The committee believes that such an assumption is less defensible . . . when the owners are related."). The estate freeze provision, however, was premised upon the analogy between an estate freeze and a retained life estate. Id. at 1042-43. In explaining the retention of § 2036(c) in 1988, the committee report expressed concern that the donor would not exercise retained rights in an arm's length manner. H.R. Rep. No. 100-795, at 422-23 (1988). In replacing § 2036(c) in 1990, the Senate Explanation accompanying the bill asserted that family members do not exercise rights "in an arm's length manner." Senate Finance Committee, note 58, at S15681-1.

[65] Section 2701 values a residual interest by subtracting the value of preferred stock from the value of the entire company and by giving the preferred stock value only to the extent of fixed rights to income. Reg. § 25.2701-3(b) (valuing gift by reducing the value of the entire business by the retained interest). This procedure could eliminate the discount attributable to the retention of voting preferred stock. Although the regulations accord value to voting rights associated with stock with equal rights to distributions, see Reg. § 25.2701-3(b)(4)(ii) (allowing adjustment for interests of the same class), they make no express adjustment for voting rights retained in conjunction with preferred rights to distributions. See Howard M. Zaritsky & Ronald D. Aucutt, Structuring Estate Freezes Under Chapter 14, at 2-32 to 2-34 (1993).

[66] Sections 2703 and 2704(b) disregard restrictions depressing value in valuing estates. IRC § 2703(a)(2) (disregarding restrictions on the right to sell or use property); IRC

porate control passing through the lapse of voting or liquidation rights.[67]

Finally, despite withdrawing Revenue Ruling 81-253, the Service still challenges minority discounts in unusual situations. In one technical advice memorandum, it valued three gifts of 30% interests to different children by considering "the swing vote potential," namely, the possibility of joining with another block.[68] In another, it limited the discount for an undivided interest in real property to the estimated cost of partition.[69] In recent partnership regulations, it disallowed a minority discount for a gift of an interest in a partnership that owned a vacation home and was not engaged in "bona fide joint business activities."[70]

III. Minority Discounts and the Market

Missing from the debate over minority discounts in taxation is a coherent theory of corporate investment.[71] Appraisers do not elabo-

§ 2704(b) (disregarding restrictions on liquidation of a family controlled entity). This permits the government to challenge minority discounts for entities in which liquidation value exceeds going concern value by arguing that the corporate or partnership structure itself is such a restriction. See T.A.M. 9723009 (Feb. 24, 1997); Note, Minority Interest Discounts and the Effect of the Section 2704 Regulations, 45 Tax Law. 877 (1992).

[67] This section creates a transfer equal to the decline in the donor's wealth. IRC § 2704(a); Reg. § 25.2704-1(d) (defining transfer amount as the excess of the value of all interests owned by the holder immediately before the transfer over the value of such interests immediately after the lapse). This rule creates a gift equal to the difference between the control premium enjoyed before the transfer and the minority discount enjoyed after. Section 2704(a) is limited, however, to voting rights that are restricted or eliminated. Reg. § 25.2704-1(b), (c) (creating a lapse only when the voting or liquidation right is restricted or eliminated). A controlling shareholder who transfers voting rights intact may still claim a minority discount. The transfer of an interest that results in a lapse of a liquidation right does not create a lapse under § 2704 if the rights with respect to the transferred interest are not restricted or eliminated. Reg. § 25.2704-1(c). This rule exempts transfers of stock when a family owns only a single class. Reg. § 25.2704-1(f)(Ex. 4). This treats a controlling shareholder whose voting rights lapse as making a gift of corporate control.

[68] T.A.M. 9436005 (May 26, 1994); see Steven A. Horowitz & Alfred A. Scope, IRS on Minority Interest Discounts: It Don't Mean a Thing If It Still Got That Swing, 73 Taxes 76, 79 (1995).

[69] See T.A.M. 9336002 (May 28, 1993); see Jerry A. Kasner, The IRS Still Doesn't Understand Valuation Principles, 61 Tax Notes 591, 592 (Nov. 1, 1993) (criticizing T.A.M. 9336002).

[70] Reg. § 1.701-2(d) (Exs. 5, 6) (1995), T.D. 8588, 1995-1 C.B. 109, 115-16. These examples were later withdrawn. T.D. 8592, 1995-1 C.B. 119, 120. In the 1998 Budget, Treasury proposed eliminating valuation discounts except as they apply to active businesses. Interests in entities would be valued at a proportional share of net asset value to the extent that the entity owns readily marketable assets. The reasonable working capital needs of an active business would be treated as part of the business. Treasury Dep't, General Explanation of the Administration's Revenue Proposals 129 (1998).

[71] Bittker & Lokken, note 23, at 135-33 ("Although solidly embedded in practice, control premiums and minority discounts rest on vague and often contradictory theories of

rate upon how their procedure mimics the market. Reformers emphasize the special circumstances of family-owned companies but do not delineate how those circumstances affect price. Courts rely on objective value, but fail to explain why discounts are objective. Fortunately, the corporate finance literature contains extensive theoretical discussion of discounts. That discussion undermines the positions taken in the tax debate.

A. *A Survey of the Corporate Finance Literature*

Corporate finance discussions of minority discounts revolve around the effort to fit empirical observations into a theory of the market. The starting point for this effort is the efficient market hypothesis,[72] which states that prices at any time fully reflect all available information.[73] Economists describe three levels of market efficiency: weak efficiency, in which prices reflect all the information in the record of past prices, semi-strong efficiency, in which prices reflect all other published information, and strong efficiency, in which prices reflect all information that could be acquired about the company and economy.[74]

In its strong form, the efficient market hypothesis implies that stock price approximates both asset value[75] and expected cash flow.[76] This implication is a premise of the irrelevance theorem, which shows that

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corporate investment."); see also Bogdanski, note 32, at 4-36 to 4-47 (surveying rationales for discounts).

[72] Michael C. Jensen, Some Anomalous Evidence Regarding Market Efficiency, 6 J. Fin. Econ. 95, 95 (1978).

[73] See Eugene F. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383, 383 (1970); Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 554 (1984).

[74] See Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 295-96 (4th ed. 1991); Harry V. Roberts, Statistical Versus Clinical Prediction of the Stock Market (unpublished paper presented to the Seminar on the Analysis of Security Prices, University of Chicago, May 1967) (described in Brealey & Myers, supra, at 295 n.1).

[75] Chang-Soo Kim, Investor Tax-Trading Opportunities and Discounts on Closed-End Mutual Funds, 17 J. Fin. Res. 65 (1994) ("If capital markets are perfect, the market value of assets should be equal to the value of the claims upon those assets."); Donald C. Langevoort, Theories, Assumptions and Securities Regulation: Market Efficiency Revisited, 140 U. Pa. L. Rev. 851, 851 n.1 (1992) ("In essence, the [efficient market] hypothesis posits that there will be an identity of interest between two equilibria: securities prices and asset values."); Kraakman, note 36, at 891 (describing the "common presumption in the finance literature that informed securities prices credibly estimate the underlying value of corporate assets").

[76] Kraakman, note 36 at 898 ("Financial economics conventionally assumes that share prices are best estimates, given available information, of the present value of expected corporate cash flows available for distribution to shareholders."); William K.S. Wang, Some Arguments That the Stock Market Is Not Efficient, 19 U.C. Davis L. Rev. 341, 344 (1986) ("In a rational stock market, common stock prices should reflect the discounted present value of future dividends and other payouts (using an appropriate discount rate.").

managerial decisions to make distributions or issue stock do not affect value.[77] The strong form also implies that investors have homogeneous expectations, and that the demand for stocks is perfectly elastic, that is, that investors will buy as much stock as is available at market price.[78]

It is difficult to reconcile the strong form of the efficient market hypothesis with takeover premia[79] and discounts on closed-end funds.[80] Premia suggest a disparity between asset and stock prices, whereas discounts demand it. Economists offer two explanations for premia and discounts.[81] The first is management. One variant of this explanation focuses on agency costs. This variant attributes takeover premia to improved management,[82] and closed-end fund discounts to inflated salaries and perquisites.[83] A more controversial variant

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Economists relate return and risk in the capital asset pricing and arbitrage pricing models. See Brealey & Myers, note 74, at 161-65.

77 Merton H. Miller & Franco Modigliani, Dividend Policy, Growth and the Valuation of Shares, 35 J. Bus. 243 (1962) (stating dividend policy does not affect stock value in a perfect capital market); Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 Am. Econ. Rev. 261, 288-93 (1958) (affirming that the value of the firm is unaffected by choice of capital structure).

78 See Lynn A. Stout, Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law, 99 Yale L. J. 1235, 1239-244 (1990) [hereinafter Premiums] (relating assumption of perfect elasticity to efficient market hypothesis and the capital asset pricing model); Lynn A. Stout, Are Stock Markets Costly Casinos? Disagreement, Market Failure and Securities Regulation, 81 Va. L. Rev. 611, 651 (1995) [hereinafter Casinos].

79 See, e.g., Bernard S. Black, Bidder Overpayment in Takeovers, 41 Stan. L. Rev. 597, 598 (1989) (describing takeover premia as "a continuing puzzle").

80 Kim, note 75, at 65 ("The discount phenomenon on closed-end mutual funds is a puzzle to financial economists, since arbitrage activities should drive discounts to zero in a perfect capital market."); Charles M.C. Lee, Andrei Shliefer & Richard H. Thaler, Investor Sentiment and the Closed-End Fund Puzzle, 46 J. Fin. 75, 75 (1991) ("Few problems in finance are as perplexing as the closed-end fund puzzle."); Burton G. Malkiel, The Valuation of Closed-End Investment-Company Shares, 32 J. Fin. 847, 858 (1977) ("It would appear then that the pricing of closed-end investment-company shares does provide an example of a market imperfection in the valuation of capital assets.").

81 See Kraakman, note 36, at 897-901 (describing misinvestment and market explanations for discounts).

82 Frank H. Easterbrook & Daniel R. Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 705 (1982) ("Corporate control transactions can reduce agency costs if better managers obtain control of the firm's assets or if they alter the incentive structure facing existing managers."). But see Black, note 79, at 633 (attributing premia to overpayment by acquiring managers).

83 Michael J. Barclay, Clifford G. Holderness & Jeffrey Pontiff, Private Benefits From Block Ownership and Discounts on Closed-End Funds, 33 J. Fin. Econ. 263, 275-81 (1993) (finding discounts correlated with managerial stock ownership and attributing this correlation to private benefits received by management); Greggory A. Brauer, "Open-Ending" Closed-End Funds, 13 J. Fin. Econ. 491, 496-99 (1984) (finding that managerial resistance to open ending funds to be correlated with the fund's expense ratio); Stuart Rosenstein & David F. Rush, The Stock Return Performance of Corporations That Are Partially Owned by Other Corporations, 13 J. Fin. Res. 39, 50 (1990) (finding that partial ownership reduces

points to the conflict between managers and shareholders over distributions: Managers retain free cash flow within the corporation rather than distributing it to shareholders.[84] By positing that distributions affect share value, this variant contradicts the assumptions underlying the irrelevance theorem.[85]

The empirical evidence indicates that firm management alone cannot account for takeover premia or discounts on closed-end funds. The size of the premia and discounts exceeds the benefits siphoned off by managers. Shareholders lose far more than managers gain.[86] Thus, economists offer a second explanation, based upon clientele preferences, by which I mean, investor specific costs and benefits in the demand for stocks. This explanation posits that investors evaluate stocks differently[87] and that discrepancies between stock and asset prices reflect the preferences of differing clientele.[88] The clientele preference explanation emphasizes the role of synergy[89] and tax savings in acquisitions,[90] factors that make the target more valuable to the purchaser than to other investors. The clientele preference explanation of closed-end fund discounts relies on divergent attitudes to-

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risk adjusted return and attributing low return to intercorporate transactions favorable to the partial owner); Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 4 J. Fin. Econ. 305, 305-60 (1976) (discussing financial compensation and perquisites); Ronald C. Lease, John J. McConnell & Wayne H. Mikkelson, The Market Value of Control in Publicly-Traded Corporations, 11 J. Fin. Econ. 439, 468 (1983) (finding that stock with superior voting rights trades at premium; attributing this premium to the potential for receiving incremental benefits).

84 Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 Am. Econ. Rev. Papers & Proc. 323, 324-25 (1986) (explaining corporate takeovers by excess cash flow available to corporate managers).

85 Richard A. Booth, Discounts and Other Mysteries of Corporate Finance, 79 Cal. L. Rev. 1055, 1070-77 (1991) [hereinafter Discounts]; Kraakman, note 36, at 914-20.

86 Kraakman, note 36, at 905 ("agency cost theories have difficulty explaining why the past performance [of closed end funds] is only a modest predictor of discounts"); Malkiel, note 80, at 855-56 (finding little correlation between size of discount on closed-end funds and management fees and turnover).

87 See Stout, Premiums, note 78, at 1244-52 (arguing that investors have heterogeneous beliefs); Stout, Casinos, note 78, at 625-35 (describing heterogeneous investor expectations regarding performance); id. at 657-59 (describing different investor preferences for risk, liquidity, and taxes).

88 See Booth, Discounts, note 85, at 1076 (linking discounts to heterogeneous investor preferences).

89 Michael Bradley, Anand Desai & E. Han Kim, The Rationale Behind Interfirm Tender Offers: Information or Synergy?, 11 J. Fin. Econ. 183, 204-06 (1983) (concluding that takeover bids are attempts to exploit potential synergies).

90 See Alan J. Auerbach & David Reishus, Taxes and the Merger Decision, in Knights, Raiders and Targets: The Impact of the Hostile Takeover 301 (John C. Coffee, Jr., Louis Lowenstein & Susan Rose-Ackerman eds., 1988).

wards taxes[91] and distributions,[92] as well as a lack of marketing.[93] By positing heterogeneous preferences and elastic demand,[94] the clientele preference explanation clashes with the traditional efficient market hypothesis.

The management and clientele explanations are complementary.[95] Discounts reflect behavior both inside and outside a firm; managers and investors alike tolerate deviation between asset value and stock price. In the most ambitious account of closed-end funds to date, Charles Lee, Andrei Shleifer, and Richard Thaler discuss both managerial behavior and clientele preference. They describe how self-interested promoters and managers sell funds to naive investors, who purchase fund shares only to see their price rapidly plummet.[96] They also describe how continuing discounts reflect prices offered by two separate and distinct clienteles: the unsophisticated individuals who buy shares in the funds and institutions who dominate the market for the stocks in the funds' portfolios.[97]

Responding to takeover premia, discounts on closed-end funds and other market anomalies, some scholars revise the efficient market hypothesis.[98] Some claim only speculative (or informational) efficiency—that security prices reflect financial returns on the securities, and not allocative (or fundamental) efficiency—that stock prices mir-

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91 Kim, note 75, at 74-75 (attributing part of discount to the loss of tax trading opportunities).

92 Rex Thompson, The Information Content of Discounts and Premiums on Closed-End Fund Shares, 6 J. Fin. Econ. 151, 181 (1978) (attributing discounts to overlapping clienteles and "heterogeneous investor demands for attributes such as the timing, magnitude, and tax status of shareholder distributions").

93 See Malkiel, note 80, at 857-58 (describing lack of broker enthusiasm for closed-end funds); Eugene J. Pratt, Myths Associated With Closed-End Investment Company Discounts, Fin. Anal. J., July-Aug 1966, at 79, 82 (attributing discount to a "lack of sales effort and public understanding"). The variation in discounts over time also suggests the importance of "market psychology" in discounts. See Malkiel, note 80, at 857.

94 See Richard A. Booth, The Efficient Market, Portfolio Theory, and the Downward Sloping Demand Hypothesis, 68 N.Y.U. L. Rev. 1187, 1194-202 (1993) [hereinafter: Demand Hypothesis]; Andrei Shleifer, Do Demand Curves for Stocks Slope Down?, 41 J. Fin. 579, 580-88 (1986).

95 Booth, Discounts, note 85, at 1058 (arguing that both market and misinvestment explanations are correct and are "nothing more than alternative formulations of the same basic truth").

96 Lee et al., note 80, at 84, ("[T]here is no 'efficiency' reason for the existence of closed-end funds. Like casinos and snake oil, closed-end funds are a device by which smart entrepreneurs take advantage of a less sophisticated public.").

97 See id. at 82. But see Abraham Abraham, Don Elam & Alan J. Marcus, Abstract, Does Sentiment Explain Closed-end Fund Discounts? Evidence From Bond Funds, 28 Fin. Rev. 607, 607 (1993) (arguing that investor sentiment does not completely explain discounts).

98 See Langevoort, note 75, at 864-72; Booth, Demand Hypothesis, note 94, at 1190 n.6 (collecting authorities).

ror economic returns on real assets.[99] This revision salvages part of the efficient market hypothesis by allowing stock prices to reflect available information but not fundamental value. An investor still cannot beat the stock market.

Another revision, known as noise theory, posits two distinct types of traders. One type, consisting largely of individuals, is not fully rational, that is, its demand for stock is based on factors other than fundamentals. The other type, consisting mostly of institutions, is guided by fundamentals but cannot assume the risk of long-term arbitrage necessary to fully rationalize stock prices. The presence of these two types of traders causes stock prices to deviate from asset value.[100]

Revisions in the efficient market hypothesis explain market anomalies but dispense with a single unified market. Limiting the claim to speculative efficiency severs financial markets from asset markets. Noise theory, too, severs these markets by positing that irrational traders skew the demand for stocks but not for assets.

The idea of multiple, segmented markets also emerges in explanations of takeover premia and closed-end fund discounts. Louis Lowenstein attributes takeover premia to separate markets for assets and stocks.[101] Likewise, accounts of closed-end funds discounts emphasize the market segmentation created by barriers to entry. Rainier Kraakman, for example, roots the persistence of discounts in resistance by corporate managers, potential competition from rival bidders, and expectations of target shareholders.[102] Professors Lee, Shleifer, and Thaler attribute the existence of discounted closed-end funds to arbitragers' short-term investment horizons, managerial resistance, and regulatory restrictions.[103]

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[99] See Ian Ayres, Back to Basics: Regulating How Corporations Speak to the Market, 77 Va L. Rev. 945, 965-83 (1991); Jeffrey N. Gordon & Lewis A. Kornhauser, Efficient Markets, Costly Information and Securities Research, 60 N.Y.U. L Rev. 761 786-96 (1985); Wang, note 76, at 344-49. Some criticize the utility of this distinction. See Jonathan R. Macey & Geoffrey P. Miller, The Fraud-On-The-Market Theory Revisited, 77 Va L. Rev. 1001, 1012-15 (1991).

[100] For overviews of noise theory, see, e.g., Langevoort, note 75, at 866-72; Andrei Shleifer & Lawrence H. Summers, The Noise Trader Approach to Finance, 4 J. Econ. Persp., Spring 1990, at 19.

[101] Louis Lowenstein, Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 Colum. L. Rev. 249, 304 (1983) (arguing that institutional investors' focus on short-term values is quite different from that of a potential acquiror; describing more generally the phenomena of different values for different markets and describing use of different markets to value closely-held stocks); see also Louis Lowenstein, Management Buy Outs, 85 Colum. L. Rev. 730, 751-54 (1985) (describing asset and stock markets as consisting of different sets of buyers).

[102] Kraakman, note 36, at 920-25.

[103] Lee et al., note 80, at 83 (describing why arbitragers cannot eliminate closed-end fund discounts); see also Morris Mendelson, Closed-End Fund Discounts Revisited, Fin. Rev., Spring, 1978, at 48, 67 (arguing that free riding discourages tender offers); Kim, note

B. *The Implications of the Corporate Finance Literature for the Debate over Minority Discounts in Transfer Taxation*

The corporate finance literature undermines the positions taken by courts, reformers, and appraisers alike in the tax debate. First, that literature refutes the judicial contention that an "objective" standard of valuation requires the allowance of minority discounts. Both the traditional efficient market hypothesis and its recent revisions contradict this assertion. The efficient market hypothesis supports the existence of an "objective" standard, but denies the existence of discounts. Rational investors pay pro rata value, and departures from that value reflect subjective preferences. Adherents of efficient markets view discounts as involving precisely the subjective inquiry into the "feelings, attitudes and anticipated behavior"[104] disavowed by courts.[105]

Recent revisions of the efficient market hypothesis also deny minority discounts a role in valuation. Economists who claim only speculative efficiency or adopt noise theory admit that discounts exist. They do not, however, view discounts as objective. The stock and asset markets reflect different assumptions. A discount simply reflects one of two prices, established on different markets. The revised models describe only the existence of discounted and undiscounted prices, not the priority of one price over the other. Corporate stock is discounted when bought on a stock exchange, but not when purchased in an acquisition. Investment portfolios and real estate are discounted if owned through a closed-end fund, but not if held directly.

Thus, even revisions in the efficient market hypothesis leave room for disallowing discounts under the willing-buyer, willing-seller standard. Those revisions recognize all buyers and sellers as hypothetical; the only question is what to hypothesize in a particular situation. A hypothetical buyer and seller might arrive at a price that anticipates sale to a third party who will pay for the benefit of control.[106] The hypothetical buyer and seller might assume that a company will be acquired and operated as a division, or liquidated and drained of its assets.

75, at 75 (attributing continued existence of funds to market frictions such as free-rider problems, short-sale restrictions, and the like).

[104] See text accompanying note 53.

[105] See Stout, note 78 (efficient markets hypothesis assumes homogeneous expectations).

[106] Citizens Bank & Trust Co. v. Commissioner, 839 F.2d 1249, 1255 (7th Cir. 1988) (asserting that minority discounts might be disallowed "not because the court should have tried to estimate the probability of the heirs' getting together and reassembling their father's control bloc but because the . . . shares should have been valued as if sold to a hypothetical buyer, who would pay a premium for control"). Courts valuing stock for appraisal purposes often dispense with minority discounts. Robert B. Heglar Note, Rejoicing the Minority Discount, 1989 Duke L.J. 258, 260-61 (1989) (describing split in courts).

At the same time, the literature offers little solace to reformers. Shared familial interests may diminish agency costs and conflicts over cash flow, but they do not eliminate them. Family members can still differ over investment philosophy, risk, and distributions. Indeed, family members usually have differing interests: The older generation prefers a secure stream of current income, whereas the younger generation favors riskier capital accumulation.[107]

Moreover, even if family ownership decreases transaction costs, it does not necessarily result in a commensurate reduction in the size of discounts. Investor preferences may still support large reductions from pro rata value. Even slight transaction costs can give rise to substantial discounts. Accordingly, the clientele explanation for discounts suggests that one cannot, as the Service attempted to do in its technical advice memorandum,[108] limit the discount for an undivided interest in real property to the costs of partition.

Finally, the corporate finance literature casts doubt on standard appraisal methodology. Appraisers consider managerial behavior and clientele preference in adjusting stock prices for control, but not in determining total firm value. The result is a one-sided account in which managerial behavior and clientele preference only diminish value.

For example, the methods used to determine total firm value ignore how managerial behavior, together with close holding and small size, can enhance value. The selection of guideline public companies under the market method fails to recognize how close holding reduces transaction costs[109] and improves profitability.[110] The asset method sums up the value of corporate assets and liabilities but ignores how the existence of a firm reduces the cost of contracting.[111] By omitting unrealized appreciation, the income method neglects the close alignment

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[107] Cf. Wilber G. Lewellen, Kenneth L. Stanley, Ronald C. Lease & Gary G. Schlarbaum, Some Direct Evidence on the Dividend Clientele Phenomena, 33 J. Fin. 1385, 1395-96 (1978) (describing how differing preferences for dividends affect stock price).

[108] T.A.M. 9336002 (May 28, 1993).

[109] Easterbrook & Fischel, note 82, at 706 (describing how going private eliminates or substantially reduces agency costs and costs attributable to public ownership including substantial legal and auditing fees, stockholder relations costs and compliance with disclosure obligations mandated by the SEC and organized stock exchanges); John C. Easterwood & Ronald F. Singer, Are the Motivations for Leveraged Buyouts the Same for Large and Small Firms, in Small Business Finance, note 27, at 79 (describing effect of buyouts on transaction costs).

[110] Louis De Alessi, Private Property and Dispersion of Ownership in Large Corporations, 28 J. Fin. 839 (1973); Easterbrook & Fischel, note 82, at 706 n.22; Miron Stano, Executive Ownership Interests and Corporate Performance, 42 S. Econ. J. 272 (1975).

[111] R. H. Coase, The Nature of the Firm, 4 Economica 386 (1937), reprinted in Ronald H. Coase, The Firm, The Market and the Law 33 (1988) (describing the firm as a means of lowering transaction costs); see generally Oliver E. Williamson & Sidney G. Winter, The Nature of the Firm: Origins, Evolution, & Development (1991).

of management and ownership in many small firms.[112] Unlike owners of large firms, owners of small firms often have access to unrealized appreciation and other value. Even though state law sometimes protects such access,[113] appraisers seldom consider it.

Similarly, appraisers omit how financing and capital structure enhance total firm value[114] by tapping into different clientele.[115] The interpolation of a corporate shell, for example, can increase price by attracting investors who prefer owning stock. Some investors attach independent value to attributes such as limited liability, ongoing contracts, and "packaging."[116] Such investors account for the successful public offering of closed-end mutual funds.[117]

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[112] Ronald J. Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes, 73 Va. L. Rev. 807, 828 (1987) (arguing that small, growing companies experience little conflict of interest between managers and shareholders); Easterwood & Singer, note 109, at 88 (concluding that small firm buyouts are more likely to be motivated by a desire to reduce shareholder servicing costs and diminish owner-manager conflicts than buyouts by larger firms).

[113] Pedro v. Pedro, 489 N.W.2d 798 (Minn. App. 1992) (holding fiduciary duty owed minority shareholders includes continued employment); Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657(Mass. 1976) (same).

[114] See, e.g., Brealey & Myers, note 74, at 412 (financing can affect firm value appealing to unsatisfied clientele); Sudipto Bhattacharya, Corporate Finance and the Legacy of Miller and Modigliani, J. Econ. Persp., Fall 1988, at 155 (arguing that an optimal debt-equity mix exists).

[115] Perhaps the best illustration of the clientele effect is the asset-backed securities market. See Division of Investment Management, U.S. Securities & Exchange Comm'n, Protecting Investors: A Half Century of Investment Company Regulation 2 (1992) (estimating that $292.8 billion of asset-backed securities were issued in 1991, representing 50% of all public security issuances). This market flourishes because corporations can reduce financing costs by issuing securities backed by mortgages and consumer debt. James A. Rosenthal & Juan M. Ocampo, Analyzing the Economic Benefits of Securitized Credit, J. Applied Corp. Fin., Fall 1988, at 32, 41 (concluding that General Motors Acceptance Corporation saved up to 1.3% annually by securitizing its loan receivables). Although the cash flow from that debt remains unchanged, the securitization allocates risk and return in ways that better match clientele preferences. Steven L. Schwarcz, The Alchemy of Asset Securitization, 1 Stan J.L. Bus. & Fin. 133, 151 (1994) (arguing that securitization of debt into senior and subordinated securities reduces net financing costs by limiting the monitoring costs to those most competent to perform such monitoring).

[116] Some investor preferences are difficult to fathom. For example, investors apparently sometimes prefer stock lacking voting rights. Several studies show that the price of nonvoting stock occasionally exceeds that of otherwise identical voting stock. Lease et al., note 83, at 466, 469 (observing that from 1940-1978, voting common stock sometimes traded at a discount from nonvoting common stock in the same firm); Ronald C. Lease, John J. McConnell & Wayne H. Mikkelson, The Market Value of Differential Voting Rights in Closely Held Corporations, 57 J. Bus. 433, 451-56, 466 (1984) (finding that for one publicly traded company the class of stock with superior voting rights traded at a discount relative to the class with inferior rights); Haim Levy, Economic Evaluation of the Voting Power of Common Stock, 38 J. Fin. 79 (1983) (finding that for three of twenty-five stocks listed on Israeli stock exchange, voting common stock sometimes traded at a slight discount from nonvoting common stock).

[117] Melvin Aron Eisenberg, The Structure of Corporation Law, 89 Colum. L. Rev. 1461, 1518 & n.255 (1989) (citing empirical study indicating that initial marketings of closed-end

Appraisers probably omit the effect of managerial behavior and clientele preference on total firm value because it is difficult to quantify. This omission, however, understates value in obvious ways. For example, under standard methodology, three investors can make equal capital contributions in a routine incorporation and each show a loss equal to the minority discount.[118] This "loss" results, however, solely from excluding the effects of managerial behavior and clientele preference from the first step of the appraisal while considering them in the second.

In the real world, incorporations occur only if they increase overall value. Managerial behavior or clientele preference might explain such increase. The cost savings of contracting within a firm may exceed the agency costs of separating ownership from management. Alternatively, investors may value shared control over pooled resources more than exclusive dominion over some limited portion. The value added by combining tracts of land, for instance, can exceed the agency cost incurred by reason of joint ownership. In valuing closely held companies, however, appraisers do not consider these possibilities.

To take another example, standard appraisal methodology assumes that privately traded companies are invariably worth less than public comparables. Appraisers begin from public guideline companies and adjust downward.[119] The first step uses data from public companies to establish total firm value; it does not acknowledge the potential positive effect of private holding. Private holding becomes relevant only in the second step, at which point it can only reduce value.

In the real world, however, at least some companies are more valuable when traded privately.[120] This is suggested by the failure to take most companies public and the affirmative removal of some companies from public markets in going-private transactions.[121] Again, managerial behavior and clientele preferences might explain added value. The costs of public trading may exceed the benefits, or inves-

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funds reach a large pool of uninformed investors); see, e.g., John W. Peavy III, Returns on Initial Public Offerings of Closed-End Funds, 3 Rev. Fin. Stud. 695, 695-707 (1990) (describing average 10% premia on initial public offering of closed end funds).

118 Manning, note 45, at 64 (claiming that this result demonstrates a flaw in standard valuation techniques).

119 The market and income methods both begin with data from public companies. See text accompanying notes 16-23.

120 Harry DeAngelo, Linda DeAngelo & Edward M. Rice, Going Private: Minority Freezeouts and Stockholder Wealth, 27 J.L. & Econ. 367 (1984) (concluding that going-private transactions increased shareholder wealth); Easterbrook & Fischel, note 82, at 706 (noting that changes in a business or financial structure may make it worthwhile for a firm to go private).

121 This is particularly likely for small companies with low agency costs. Booth, Discounts, note 85, at 1208 (noting tendency of large corporation to acquire small, growing companies and to operate them as captive subsidiaries).

tors may value a company with concentrated holdings more than one with widely disbursed stock. Appraisers, however, acknowledge neither possibility.

C. *The Irrelevance of Current Valuation Standards*

The economic literature renders current valuation standards largely irrelevant to the issue of minority discounts. That literature establishes that minority discounts cannot be understood in terms of fair market value.[122] There is no single market, only a choice among multiple markets. In allowing a discount, an appraiser decides that the interest being valued is comparable either to stock in a corporation that is not a takeover target or to shares in a closed-end investment fund. In disallowing discounts, she decides that such interest is more like stock in a takeover target or shares in an investment portfolio.

There is no established legal standard for choosing among markets. The little authority that addresses this question[123] is divided between conflicting approaches. One alternative looks to the most visible market. This approach underlies rules looking to the market on which the item is "commonly sold to the public"[124] and using market quotations without reduction for commissions.[125] This approach eases administration by using the most readily ascertained price but at the expense of obvious unfairness and inefficiency. It favors taxpayers with access

[122] The economic literature casts a shadow beyond the minority discount issue. Some scholars use revisions of the traditional efficient market hypothesis to argue against reliance on fair market value in all circumstances. Stout, Premiums, note 78, at 1288 ("No single shareholder's estimate can, on its face, be said to be more valid than any other's. Market price is nothing more than the equilibrium intersection of a fixed supply function with a downward sloping demand function at a point where the least optimistic of the firm's current shareholders values her stock."); Booth, Discounts, note 85, at 1107 (criticizing the assumption of an objectively fair price for a share of stock).

[123] Courts often deny that alternative markets exist. In United States v. Cartwright, 411 U.S. 546 (1972), for example, a majority of the Supreme Court valued shares in an open-end mutual fund at their redemption price, that is, after sales charges, because that was the only market. Id. at 552-53 ("[T]he only price that a shareholder may realize and that the fund—the only buyer—will pay is the redemption price."). The majority ignored entirely the market on which shareholders purchase their shares. Id. at 561 (Stewart, J., dissenting) ("[A] perfectly normal market of willing buyers and sellers does exist with respect to such shares prior to their issuance.").

[124] Reg. § 20.2031-1(b) ("Nor is the fair market value of an item of property to be determined by the sale of the item in a market other than that in which such item is commonly sold to the public, taking into account the location of the item whenever appropriate."); Lio v. Commissioner, 85 T.C. 56 (1985), aff'd sub nom., Orth v. Commissioner, 813 F.2d 837 (7th Cir. 1987).

[125] Scott v. Hendricksen, 41-2 USTC (CCH) & 10,098 (W.D. Wash. 1941). This approach also may underlie the decision in *Cartwright*, 411 U.S. at 546, to value open-ended funds based on redemption price. Although this price reflects commissions, it is used in newspapers to report fund value.

to less visible markets and creates incentives to own assets with such access.

The alternative looks to the market in which the actual owner would sell the property.[126] Thus, for example, although most goods are valued on the retail market,[127] those owned by a manufacturer are valued by reference to the wholesale market.[128] This approach cures problems with fairness and efficiency but entails a costly inquiry into probable behavior.

Not only is the authority on choosing among markets divided, it also fails to address squarely the allowance of minority discounts. For minority stock interests, it is simply unclear which market is more visible or likely to be used by the actual owner. For some companies, particularly those whose stock is publicly traded, stock value is better known; for others, such as investment companies, asset price is more readily ascertained. Likewise, although most minority shareholders participate only in the stock market, those belonging to a control group also have access to the asset market.

IV. Cultural Constructs and Minority Discounts

A. *Concentrations of Wealth, Family Businesses, and Popular Understandings*

Thus, current law and policy do not provide a coherent framework for understanding minority discounts. There is, however, a prospective that does. It draws from two concepts embedded in the larger culture: concentrations of wealth and family businesses.[129] Culturally constructed, these concepts are like poles on a spectrum, distinct but blurring as they converge. Concentrations of wealth are large, impersonal, inactive, and selfish, whereas family businesses are small, per-

[126] Reg. § 1.170A-1(c)(2)("[F]air market value is the price which the taxpayer would have received if he had sold the contributed property in the usual market in which he customarily sells."); Anselmo v. Commissioner, 80 T.C. 872, 882 (1983), aff'd, 757 F.2d 1208 (11th Cir. 1985) (valuing unset gems by reference to the jewelers' market); Transamerica Corp. v. United States, 88-2 USTC (CCH) & 9501, at 85,404 (Cl. Ct. 1988) (valuing motion picture prints in the market created by dealers, libraries, and archives); Jennings v. Commissioner, 56 T.C.M. (CCH) 595, 600 (1988) (valuing artwork by reference to auction market rather than primary or broad markets); Perdue v. Commissioner, 62 T.C.M. (CCH) 845, 857 (1991) (valuing artifacts recovered from sunken galleon in auction and museum shop markets rather than the numismatic market).

[127] Reg. § 20.2031-1(b). For example, a used car is valued at the price at which a member of the general public could purchase such car rather than the price at which dealers would purchase it. Id; Skirpack v. Commissioner, 84 T.C. 285, 322 (1985) (valuing large quantities of academic books in the retail market composed of university libraries).

[128] Reg. § 1.170A-1(c)(2).

[129] This Section summarizes a description contained in an earlier article. William Blatt, The American Dream in Legislation: The Role of Popular Symbols in Wealth Tax Policy, 51 Tax L. Rev. 287, 315-17 (1996).

sonal, active, and altruistic. Concentrations of wealth pose obstacles to the middle class hope of achieving the American dream; family businesses embody that dream. These concepts surface in popular classics such as Frank Capra's *It's a Wonderful Life.*[130] In that film, Mr. Potter, the town banker, is a classic symbol of the concentration of wealth: a solitary, selfish old man. By contrast, the Bailey Savings and Loan is a family business, born of the hard work of its founder and committed to helping ordinary people.[131]

These cultural constructs extend beyond mass entertainment. They also dominate public debate over transfer taxes. Seeking popular support, politicians and lobbyists use them to depict the object of taxation. Proponents of the estate tax point to concentrations of wealth. Presidents Theodore and Franklin Roosevelt railed against "fortunes swollen beyond all healthy limits,"[132] "great accumulations of wealth," and the transmissions of "vast fortunes."[133] President Hoover decried "frozen and inactive capital"[134] and Andrew Carnegie criticized "the millionaire's unworthy life."[135] Critics of the tax counter by evoking the family business. They argue that the family business manifests the family,[136] represents its founder's

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130 It's a Wonderful Life (Liberty Films, Inc. 1946).

131 A family business may become a concentration of wealth in succeeding generations.

132 18 The Works of Theodore Roosevelt 578 (1925). Later, he wrote that very large fortunes "are needless and useless, for they make no one really happy and increase no one's usefulness, and furthermore they do infinite harm and they contain the threat of far greater harm." Letter from Theodore Roosevelt to Jacob August Riis (Apr. 18, 1906), in 5 The Letters of Theodore Roosevelt 212 (Elting E. Morison ed., 1952).

133 H.R. Rep. No. 74-1681, at 2 (1935), reprinted in 1939-1 C.B. (vol. 4) 642, 643 (quoting letter from Franklin Roosevelt, President of the United States, to the Congress of the United States (June 19, 1935)). See Hearings on Internal Revenue Revision Before the House Comm. on Ways & Means, 67th Cong. 224, 225 (1921) (statement of C. William Ramseyer) (quoting Andrew Carnegie).

134 Herbert Hoover, The Memoirs of Herbert Hoover 29 (1952).

135 Andrew Carnegie, The Gospel of Wealth and Other Timely Essays 22 (Edward C. Kirkland ed., 1962).

136 Discussion Draft Relating to Estate Valuation Freezes: Hearing Before the House Comm. on Ways and Means, 101st Cong. 241-43 (1990) [hereinafter Discussion Draft Hearing] (statement of Gerald O. Haviland, family business consultant) ("These businesses are not just enterprises. They are also manifestations of family values and family beliefs. . . . The business represents the values, the hopes and heritage of a family system. Husbands, wives, sons, daughters, brothers and sisters all working together for a common dream.").

hard work,[137] and performs altruistic service to the community.[138]

The cultural constructions underlie public intuitions about the abusiveness of transactions fragmenting property. Reformers link fragmentation to the transfer of concentrations of wealth.[139] Claims that transactions fragmenting property constitute "tax avoidance" and suspect "estate planning,"[140] connote the transfer of preexisting wealth between generations. Defenders of discounts counter by linking fragmentation to family businesses.[141] They assume that divided ownership is part of joint business activity undertaken to produce wealth.

B. *Cultural Constructions in Transfer Tax Law*

Recognizing the tremendous power cultural constructions exert in the public mind, most tax experts nonetheless exclude them from serious discussion of the tax base. They find the concentration of wealth and family business constructs too fuzzy to use at that level of detail. Tax experts prefer greater precision. Concepts like fair market value provide the determinacy implicit in the rule of law. By distinguishing the tax base from tax rates, experts can design taxes without discussing wealth redistribution.

As the minority discount question demonstrates, however, some issues fall outside expert vocabulary. For such issues, cultural construc-

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137 See, e.g., Revenue Revision, 1925: Hearings Before the House Comm. on Ways and Means, 69th Cong. 328 (1925) (statement of State Sen. W.S. Baird) ("We want to help the individual who is willing to advance his money and take his chances in the enterprises of the country. . . , we want him to have the result of his enterprise himself. We do not want somebody else after he is dead to come in and take it away through any subterfuge whatever."); Proposed Taxation of Individual and Corporate Incomes, Inheritances and Gifts: Hearing Before the House Comm. on Ways and Means, 74th Cong. 275, 279 (1935) (statement of Roy C. Osgood, U.S. Chamber of Commerce) ("To the extent that the desire to assure continuance in a family of the possession and development of a going business is a strong inducement to the hard application of energy and prudent administration of affairs, the knowledge that estate and inheritance taxes will defeat such a purpose would mean inevitably a lessening of incentive on the part of men of ability.").

138 See Discussion Draft Hearing, note 136, at 285-86 (statement of James H. Woody, Union Tel. Co.) ("We also employ nearly 30 others from the local community. . . . [W]e have made a commitment to our customers and community.").

139 George Cooper, for example, highlights how wealthy families such as the du Ponts used minority discounts to avoid the transfer tax over generations. Cooper, note 4, at 199.

140 Cooper, note 4, at 197 (describing valuation discounts as "an estate planner's dream"); Dodge, note 10, at 254 (alluding to "widespread use of carving minority interests out of [property] in order to claim minority interest discounts for gift and estate tax purposes").

141 Cf. Kasner, note 69, at 592 (arguing that IRS efforts to tax minority discounts "are substantive changes that seriously affect closely held and family businesses"); Baker & Botts Opposes Changes to Estate Tax Valuation Rules Taxing the Minority Discount of a Close Corporation, 37 Tax Notes 285 (Nov. 9, 1987) (arguing that the 1987 house bill "would have a profound adverse affect on family-owned businesses and family farms").

tions unconsciously come into play. Although fuzzy, the constructs constitute a common cognitive lens through which people see the world. They inevitably influence assumptions about plausible behavior and moral intuitions about legal rules. Concentrations of wealth connote a monolithic, single actor, whereas family businesses suggest multiple, independent agents. Taxation of concentrations of wealth is praiseworthy; taxation of family businesses is troubling.

These assumptions permeate the estate taxation of closely owned entities. They are obvious in special estate tax relief provisions[142] limited to small,[143] active businesses[144] that involve family members personally.[145] They are also evident in the rules including property in the gross estate, which apply to property subject to a retained income interest but not to undivided interests in property or corporate stock.[146] Because the retained income interest involves sequential ownership of passive assets, it evokes concentrations of wealth. The inclusion rule reflects the assumption that life estates and remainders are a single property owned by one person[147] and a willingness to impose higher taxes on arrangements resembling concentrations of wealth.[148]

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142 The transfer tax contains three relief provisions for family businesses. Section 2032A provides special use valuation for certain real property. Section 2033A creates an exclusion for family-owned business. Section 6166 grants an extension in time of payment for interests in closely held businesses.

143 The special valuation benefit is limited to $750,000 plus an inflation adjustment for estates after 1998, IRC § 2032A(a), the exclusion for family-owned businesses is limited to $1.3 million, IRC § 2033A(a)(2), and a special 2% interest rate on the deferral benefit is limited to the tax on $1 million, IRC §§ 6166, 6601(j)(2).

144 IRC § 2032A(b)(2) (requiring land to be used in a business); § 2033A(e)(2)(D) (denying exclusion to portion of business attributable to passive assets); § 6166(b)(9) (denying deferral to companies holding "passive assets").

145 IRC § 2032A(c)(1)(B), (c)(6)(B)(ii) (requiring heirs to materially participate in management of the farm or business); § 2033A(f)(1)(A) (imposing similar requirements).

146 See Estate of Boykin v. Commissioner, 53 T.C.M. (CCH) 345 (1987) (holding that preferred stock and common stock are separate properties for purposes of § 2036(a)).

147 A similar line is drawn in the income tax, in which a life tenant and remainderman are often treated as one person. A life tenant is taxed on all income from gifted property and the remainderman is taxed on none. The life tenant receives no deduction for amortization, IRC § 273, and her basis jumps to the remainderman, Reg. § 1.1001-1(e). IRC § 167(e) disallows an amortization deduction for certain term interests in property. See generally Kenneth F. Joyce & Louis A. Del Cotto, The AB (ABC) and BA Transactions: An Economic and Tax Analysis of Reserved and Carved Out Income Interests, 31 Tax L. Rev. 121 (1976); Jeffrey L. Kwall, The Income Tax Consequences of Sales of Present Interests and Future Interests: Distinguishing Time From Space, 49 Ohio St. L.J. 1 (1988). Interestingly, this principle does not apply to a corporate bond. IRC § 1286 (treating each stripped coupon as a separate original issue discount bond).

148 Unlike most other transfers, gifts of remainder interests are taxed twice. Once, when the gift is made, and again when the entire property is included in the gross estate. Furthermore, the present value of the transfer tax is higher than it would be if the entire property had been transferred by bequest because the gift tax is paid prior to death and no adjustment is made for the government's use of the money prior to death.

The cultural constructs also affect the valuation of fragmented property. Assets in corporate solution, for example, are valued more favorably than those outside a corporation. Transfers of corporate stock routinely receive a discount and are valued without regard to stockholders' other holdings.[149] By contrast, transfers of passive real property receive fewer and smaller discounts[150] and are more likely to be valued in conjunction with other property.[151] By assigning less value to incorporated assets, appraisers assume that managerial behavior only reduces value. As demonstrated above, however, incorporation need not have that effect.[152] The effect of incorporation upon value depends upon the governing market. The solicitude accorded incorporated enterprises makes sense, however, as a sympathetic reaction to the family business.[153] Corporations evoke business activities and direct ownership connotes passive wealth accumulation.[154]

The influence of cultural constructs upon transfer tax valuation is also evident in rules governing the valuation of entitlements that vary over time. Split temporal interests in property, for example, are disfavored. The Code and regulations have long disallowed discounts in valuing life estates and remainders.[155] In contrast, undivided interests

149 5 Bittker & Lokken, note 23, at 135-12 (courts apply minority discount "without any consideration of [the value of corporate stock] to shareholders seeking dominance or absolute control.").

150 See Anna C. Fowler, Valuation of Undivided Interests in Realty: When Do the Parts Sum to Less Than the Whole?, 13 J. Real Estate Tax'n 123, 130 (1986) (noting that 11 of 29 cases denied discounts for transfers of undivided interests in property). The size of the discount is also smaller. Id. at 150 (describing 15% discount as the median; 25% discount as high).

151 Some courts consider the possibility of assembling real property into a larger tract. See, e.g., Estate of Freiders v. Commissioner, 40 T.C.M. (CCH) 403, 408 (1980), aff'd, 687 F.2d 224, 227 (7th Cir. 1982), cert. denied, 460 U.S. 1011 (1983). In addition, the valuation of real property by reference to its "highest and best use" allows inquiry into the effect of neighboring property upon value. See Lewis v. United States, 71-1 USTC & 12,739 (D. Wyo. 1970) (valuing land used as farm as residential property for estate tax purposes); Frazee v. Commissioner, 98 T.C. 554 (1992) (same).

152 See text accompanying note 114-17.

153 There is also a tendency to value corporations with operating businesses more favorably than those with passive holdings. Compare Citizens Bank & Trust Co. v. Commissioner, 839 F.2d 1249, 1252 (7th Cir. 1988) (expressing concern for "facile avoidance of gift or estate tax"), and Estate of Murphy v. Commissioner, 60 T.C.M. (CCH) 645, 659-66 (1990) (disallowing discount for tax motivated transactions), with Estate of Newhouse, 94 T.C. 193, 247-52 (allowing a huge discount to corporation actively managed by family). See also Reg. § 1.701-2(d) (Exs. 5, 6)(1995), T.D. 8588, 1995-1 C.B. 109, 115-16 (disallowing minority discounts for those not engaged in a bona fide joint venture). These examples were later withdrawn. T.D. 8592, 1995-1 C.B. 119, 120.

154 For other situations in which the tax law rewards activity, see, e.g., IRC § 469 (denying deductions for passive activities); §§ 541-547 (imposing additional tax on personal holding companies).

155 A life estate is valued under actuarial tables issued by the Service, and a remainder is valued by subtracting the value of the life estate from the value of the whole property.

in real property owned by tenants in common often receive a discount.[156] Thus, the law values life estates and remainders by reference to a different market than that used for other property. It presumes that life tenants and remaindermen, unlike tenants in common, sell their interests together. This presumption runs contrary to likely fair market value.[157] Less liquid than cotenancies, life estates and remainders would likely carry a greater discount on real markets. Use of a different rule for them is based on their resemblance to concentrations of wealth. Retention of lifetime enjoyment evokes estate planning between generations rather than an ongoing joint entrepreneurship among them.

Similarly, throughout the estate freeze legislation of the 1980's, capital structures granting preferential rights to income fared worse than those creating pro rata rights. Congress rejected family attribution for minority discounts and excluded corporations with a single class of stock from § 2036(c) and chapter 14.[158] Again, concentrations of wealth and family businesses explain this treatment. The resemblance of the preferred stock freeze to a retained life estate and the term "estate freeze" itself conjure up concentrations of wealth. In contrast, proposals that disallow minority discounts evoke family businesses.[159]

Neither interest is reduced for minority ownership or lack of marketability. IRC § 7520; Reg. §§ 20.2031-7, 25.2512-5.

[156] See note 150. Joint tenants with rights of survivorship do not receive a discount. See Bogdanski, note 32, at 5-17 to 5-20.

[157] Commentators argue that this approach is inconsistent with the willing-buyer, willing-seller standard. See 5 Bittker & Lokken, note 23, ¶ 135.4.10, at 135-82 ("The willing-seller, willing-buyer standard has never been applied directly to private annuities, life estates, terms of years, remainders, reversions, and similar split interests in property, probably because such interests are rarely sold at arm's length."). At least, it represents a different understanding of that standard than that applied to corporate stock. See O'Reilly v. Commissioner, 973 F.2d 1403, 1407-09 (8th Cir. 1992) (arguing tables approximate the result that would be reached under the willing-buyer, willing-seller standard, though the tables will not be used when they produce unreasonable results); Palfrey v. United States, 36 F. Supp. 153, 156 (D. Mass. 1940) (upholding reliance on tables, notwithstanding the lack of actual sales of similar property); Raimondi v. Commissioner, 29 T.C.M. (CCH) 70, 72 (1970) (rejecting argument that remainder interests are valueless under the willing-buyer, willing-seller standard because they are rarely sold; "if a willing buyer and willing seller could be found, they would value decedent's interests in very much the same fashion as provided" in the regulations.").

[158] See text accompanying notes 53-55.

[159] See Richard L. Dees, Section 2036(c): The Monster That Ate Estate Planning and Installment Sales, Buy-Sells, Options, Employment Contracts and Leases, 66 Taxes 876, 876 (1988) (describing the 1987 conference decision "as a fair compromise, as the discount provision was perceived as affecting many more family businesses than the preferred stock limitation.").

V. Concentrations of Wealth, Family Businesses, and Proposals Addressing Minority Discounts

To sum up, legal doctrine formally determines value by reference to fair market value. There is, however, no single market by which to measure a minority discount. Minority discounts only appear if there is more than one market, and if they do, it is uncertain which market governs for tax purposes. At this juncture, cultural constructs color the legal answer. These constructs make discounts seem more appropriate for entities resembling family businesses than for arrangements evoking concentrations of wealth.

This reliance upon cultural constructions has been largely unconscious. At least where fair market value proves indeterminant, however, tax experts should raise the unconscious to the conscious by relying on cultural constructs in formulating tax proposals.[160] The critical role played by cultural constructions in the political debate demonstrates that they resonate with majoritarian preferences. Expert vocabulary expresses those preferences as well,[161] but when gaps appear in that vocabulary, theorists can use cultural constructs as best evidence of majority will.

This does not mean that cultural constructs can supplant legal doctrine or traditional tax policy analysis. Standing alone, the constructs do not generate blueprints for a tax system. Most would not tolerate a system that simply taxed "concentrations of wealth" but not "family businesses" without further elaboration. The rule of law requires the development of an administrable standard, such as fair market value, that distinguishes between these constructs. The underlying cultural constructions however, can still inform application of that standard. Thus, they can guide the development of appropriate rules for determining fair market value.

The constructs provide a fresh perspective on the reform of minority discounts. So far, reformers have focused on attributing stock

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160 See Michael Livingston, Risky Business: Economics, Culture and the Taxation of High-Risk Activities, 48 Tax L. Rev. 163, 231 (1993) ("Academics . . . should be prepared to debate culture as well as economics, applying the same rigor and skepticism in one area that they would apply in the other."); Edward J. McCaffery, Cognitive Theory and Tax, 41 UCLA L. Rev. 1861, 1947 (1994) (describing the possibility of "a general, comprehensive theory of tax, that can unite the diverse insights of law, psychology, economics, philosophy, and other disciplines in a manner that can help us analyze and understand existent tax systems and prescribe new ones.").

161 Expert vocabulary does not, however, capture all popular preferences. I have argued elsewhere that tax theorists should use cultural constructs as a source of policy norms and as a means of evaluating existing norms. See Blatt, note 129, at 330. Such use might lead to tax rules deliberately designed to reward hard work and encourage community. Id. at 332-36. One need not subscribe to that project to use cultural constructs in the more modest way described here.

ownership among family members or taxing disguised transfers occurring through the exercise or nonexercise of retained rights.[162] The concentration of wealth and family business constructions suggest that reform efforts are better directed elsewhere. The cultural constructs indicate less resistance to aggregating multiple transfers, and positive support for presuming that a minority interest is worth at least its pro rata share of the value of corporate assets if sold in liquidation.

A. *Attributing Stock Ownership Among Family Members*

The cultural constructs suggest stiff resistance to the proposal that has dominated the reform agenda to date: the attribution of stock ownership among family members.[163] This proposal assumes that family members act as a single unit. A natural response to rejection of prior versions of this proposal[164] is to narrow the definition of "family" to those most likely to cooperate,[165] perhaps by excluding siblings.[166] Stories dating back to the biblical account of Cain and Abel attest to the pervasive enmity that exists among siblings.[167]

In the abstract, family attribution seems appealing. Many Code provisions attribute ownership among family members.[168] The cul-

[162] See Section IV. A & B.

[163] Rev. Rul. 81-253, 1981-2 C.B. 187, 188; H.R. Rep. No. 100-391, note 64, at 1043; Cooper, note 4, at 227, 231-32; Fellows & Painter, note 10, at 928.

[164] Revenue Ruling 81-253, 1981-2 C.B. 187, did not limit or define the term and the 1987 House Bill encompassed collateral relatives. See H.R. Rep. No. 100-391, note 64, at 1043 (defining family as "an individual's spouse, any lineal descendent of such individual or of such individual's spouse, any parent or grandparent of such individual, and any spouse of any of the foregoing").

[165] See Comments on Estate and Gift Tax Revenue Increases, attached to Letter of Charles W. Hall to David H. Brockway (Nov. 19, 1987) ("[T]o attribute the stock owned by a sibling of an individual is too broad. . . . One of the most common sources of conflict in closely held businesses is rivalry between the children of the founder of the business."), reprinted in ABA Members Criticize Proposed Estate and Gift Tax Changes as Shortsighted and Burdensome, 87 TNT 230-59, Nov. 30, 1987, available in LEXIS, Fedtax Library, TNT File.

[166] See, e.g., IRC § 318 (attribution rule based on lineal descendants). For an even narrower attribution rule, see Treasury I, note 10, at 386-87 (proposal to value gift as equal to pro rata value of total interests owned by the transferor and transferee). Chapter 14 uses a mix of rules. Compare IRC § 2701(a), (e) (attributing ownership to lineal descendants), with § 2704 (attributing ownership to siblings), and § 2702(a), (e) (applying to transfers to siblings but attributing only stock owned by lineal descendants).

[167] For a self conscious account of the cultural dimensions of family attribution, see Metzger Trust v. Commissioner, 693 F.2d 459, 460 (5th Cir. 1982) ("We decide today a story driven by tensions as old as Genesis but told in the modern lexicon of the tax law. It is the story of David who built a business and left it in the charge of his eldest son Jacob to be shared with Jacob's two sisters Catherine and Cecelia, of the alienation and resulting quarrel with the tax collectors.").

[168] See generally Glenn E. Coven, The Affinity Provisions of the Internal Revenue Code: A Case Study in Nonsimplification, 45 Tenn. L. Rev. 557 (1978).

tural constructions, however, suggest that family attribution in the transfer tax is controversial. The family business is part of the American Dream. Family attribution burdens family businesses by increasing the cost of their transfer. In addition, family attribution "penalizes" gifts to family members by taxing those transfers more heavily than transfers to unrelated persons.

Current law confirms that family attribution for transfer taxation is problematic. Historically, family attribution was confined to the income tax, which excludes gratuitous transfers.[169] When used, attribution was reserved largely for "nonproductive" transactions such as loss sales between related taxpayers,[170] and corporate redemptions,[171] which shrink the business. Much of the controversy surrounding the estate freeze legislation derived from its reliance on attribution.[172] As finally revised, that legislation used family attribution only for split temporal interests and other arrangements evocative of concentrations of wealth.[173]

Thus, any family attribution rule that flatly eliminates minority discounts will likely encounter stiff resistance. Case law suggests that even narrowed attribution has little appeal. In *Estate of Bright*, the Fifth Circuit refused to attribute stock even between husband and wife.[174] Ironically, narrowed attribution may be even less palatable, because it would target the closest relationships, most central to the family business. It would tax a gift to a son more heavily than one to an uncle or cousin.

B. *Taxing Disguised Transfers Occurring Through the Exercise or Nonexercise of Retained Rights*

The cultural constructs also reveal strong resistance to approaches that tax transfers occurring when related persons do not deal with each other at arm's length.[175] These approaches would tax the excess of the retention value of the stock over its arm's length price. They would do so by taxing disguised transfers occurring through the con-

[169] IRC § 102(a).

[170] See IRC § 267.

[171] See IRC §§ 302(b), 318.

[172] See text accompanying notes 54-61.

[173] Two provisions in chapter 14 applied to split temporal arrangements. IRC §§ 2701, 2702 (valuation rules for corporations and trusts). The other two were limited to narrow tax abuse situations. IRC § 2703 (disregarding restrictions not comparable to those entered into in arm's length transactions); § 2704 (rules governing lapsing rights and certain restrictions on liquidation).

[174] Estate of Bright v. United States, 658 F.2d 999, 1003 (5th Cir. 1981).

[175] See text accompanying notes 53-69 (describing alternatives enacted for estate freezes).

trolling shareholder's exercise or nonexercise of retained rights. By failing to oppress the minority as assumed in the willing-buyer, willing-seller standard, the controlling shareholder diverts value to the minority.

Theoretically, the exercise or nonexercise of a retained right may result in an immediate taxable gift. For example, after years of litigation,[176] it is now clear that the failure to charge interest on a loan results in a taxable gift of forgone interest, determined by reference to the treasury bill rate.[177] The failure to exercise other rights, however, can be far more difficult to detect and to value.[178] To catch these hard-to-detect transfers, one can shift the event giving rise to a taxable transfer.[179] The alternatives are a hard-to-complete rule and an easy-to-complete rule,[180] variations of which were enacted for estate freezes.

The hard-to-complete rule postpones taxation until the last event, which is often death. This approach offers more accurate valuation because it waits until all information is available.[181] Section 2036(c) approximated this result for estate freeze transactions by including the

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[176] See, e.g., Dean v. Commissioner, 35 T.C. 1083, 1090 (1961) (holding that failure to charge interest did not result in taxable gift).

[177] IRC § 7872; Dickman v. Commissioner, 465 U.S. 330 (1984) (holding that interest-free demand loan resulted in transfer for federal gift tax purposes).

[178] See William F. Nelson & Peter J. Genz, New Uncertainties in the Equity Freeze: The Impact of *Dickman* on Capital Call Rights and Other Issues, 63 Taxes 999, 1015 (1985) (arguing that failure to exercise rights to put or call corporate capital does not give rise to a taxable gift).

[179] Altering gift completion does not dramatically change the present value taxed. See Alvin Warren, The Timing of Taxes, 39 Nat'l Tax J. 499, 499 (1987) ("The present value to a taxpayer of a consistently defined tax will be the same whether the tax is deferred or accelerated, as long as the tax rate remains constant and the base of a deferred tax increases over time by the rate of return generally applicable to investment of proceeds available after payment of an accelerated tax."); Harry L. Gutman, A Comment on the ABA Tax Section Task Force Report on Transfer Tax Restructuring, 41 Tax Law. 653, 655 (1988) (Warren's "principle tells us that if a transfer is to be taxed at the same rate now or later, and other conditions remain constant, we can be indifferent as to when the transfer is treated as complete.").

Because estate and gift taxes are defined inconsistently, deferral or acceleration affects present value, tax exclusivity, and the like. Other features favoring lifetime gifts are the time value of the rate brackets and unified credit, see Gutman, supra, at 665, and the $10,000 per donee annual gift tax exclusion. IRC § 2503(b).

[180] For further description of the choice between hard-to-complete and easy-to-complete rules, see ALI, Federal Estate and Gift Tax Project 42-48 (1968).

[181] See Dodge, note 10, at 244 (advocating using hindsight to assure accurate valuation); Joseph M. Dodge, Rethinking Section 2036(c), 49 Tax Notes 199, 201 (Oct. 8, 1990) ("The compelling policy reason to tax the property when the transferor ceases to own the retained interest is that taxing it at such time is the only way that is capable of accurately valuing the amount actually transferred from the transferor to the transferee(s)."); Gutman, note 179, at 655 ("Consequently, if postponing the taxable event results in more accurate measurement of the amount transferred, there is no tax reason to reject deferring the taxable event.").

residual interest in the transferor's gross estate.[182] A broader hard-to-complete rule taxes retention value by postponing the taxable transfer until the transferor terminates ownership in the business.

In contrast, an easy-to-complete rule taxes the earliest event, typically the first gift. By tying the taxable transfer to a volitional act and separating the tax from obligations of the estate, this rule makes it more probable that funds will be available to pay the tax. Transferors are more likely to anticipate and provide for a gift tax. An example of an easy-to-complete rule is § 2701, which essentially presumes that certain preferred rights will be exercised to transfer wealth to residual shareholders.[183] A broader version taxes retention value by creating a taxable transfer of the business upon the first transfer of stock.[184]

Although altered gift completion rules draw upon the cultural assumption that parents provide for their children, widespread sympathy for the object of taxation suggests that such rules for minority discounts are too harsh.[185] If aimed at a broad array of managerial rights, both hard-to-complete and easy-to-complete rules strike at the activity that lies at the heart of the family business. The estate freeze legislation shows that such rules are likely to be viewed as burdensome.[186] So does the longstanding policy controversy over the taxation of transfers of services and business opportunities.[187] Although such taxation raises administrative concerns about liquidity and valuation, the core objection is that it infringes upon quintessential family business activity.[188] Concerns about familial activity make one reluc-

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182 Section 2036(c) had elaborate rules to assure taxation of distributions and dispositions made prior to the donor's death. See IRC § 2036(c)(4) (1988).

183 For the mechanics of § 2701, see note 65.

184 This version has different forms. It could treat the transfer of a minority interest as a gift of the entire company, or it could treat the transfer of a minority interest as the transfer of control, that is, as if the gifted interest held all voting rights.

185 See Dodge, note 10, at 255 (dismissing hard-to-complete rule for minority discount transactions as impractical).

186 A hard-to-complete rule is particularly onerous because it bunches the transfer tax, increasing the likelihood that the family business will be sold in order to pay taxes. The specter of such sale was critical in repealing § 2036(c) and replacing it with chapter 14. See Blatt, note 129, at 323.

187 Compare Gutman, note 179, at 672-73 (defending taxation of wealth attributable to services or control exercised by decedent), with Ronald D. Aucutt, Further Observations on Transfer Tax Restructuring: A Practitioner's Perspective, 42 Tax Law. 343, 348-50 (1988) (arguing that nonproperty transfers lie outside the transfer tax system). Compare Randall J. Gingiss, The Gift of Opportunity, 41 DePaul L. Rev. 395, 395-98 (1992) (describing transfers of services and opportunities as "loopholes"), with Case Hoogendoorn, Transfers of Opportunities—An Opportunity to Avoid Transfer Tax?, 71 Taxes 892, 901 (1993) (defending distinction between opportunity and wealth). See generally Paul L. Caron, Taxing Opportunity, 14 Va. Tax Rev. 347, 402-23 (1994) (discussing gifts of opportunity).

188 See Aucutt, note 187, at 349-50 (arguing that taxation of opportunities is "simply too intrusive into intrafamily relationships. Everyone knows that family members advise one

tant to tax these transfers even in the absence of administrative concerns.[189]

C. *Aggregating Transfers*

The cultural constructs suggest less resistance to proposals that aggregate stock transfers.[190] These proposals would reverse *Estate of Bright*,[191] which ignored not only stock owned by other family members but also stock owned by the donor and donee. Under *Bright*, a parent who owns all the stock of a corporation can make three successive one-third transfers to a child and claim a minority discount on each. Even the second transfer is valued by reference to a hypothetical person who owns no stock rather than the actual participants in the transfer who do.[192]

Reformers often criticize this aspect of *Bright*. It is incongruous to treat the second transfer as part of a minority interest when, in fact, it is continuously held as part of a control block. The snag comes in choosing whether to value that transfer by reference to the donor or the donee. The donor rule usually has broader reach. It treats a second one-third transfer as participating in control regardless of the donee's holdings. By contrast, the donee rule treats such transfer as participating in control only if the donee receives other stock.[193]

Current law provides no overall guidance to the choice between donor and donee. The general estate tax rule looks to the value owned

another, affirm one another, and assist one another in innumerable ways. Such is the stuff of family."); Gingiss, note 187, at 426-29 (proposing exempting closely held business from the transfer tax in order to encourage the development and growth of family business); Hoogendoorn, note 187, at 900-01 (exemption of transfers of opportunities necessary to encourage "family-based economic activity").

189 For example, waiver of executor or trustee fees does not result in a taxable gift even if the amount is fixed by statute. See Rev. Rul. 70-237, 1970-1 C.B. 13; Rev. Rul. 66-167, 1966-1 C.B. 20.

190 See Cooper, note 4, at 227, 231 (proposing to value gifts by loss in value to the donor); Feld, note 10, at 945 (suggesting presumption that transfers of stock in a closely held corporation by controlling shareholders are made to transferees who will be part of the control group); Fellows & Painter, note 10, at 923 (proposing that gratuitous transfer of shares from donor who originally owned controlling interest be valued as if they were part of the controlling block). But see Monical, note 10, at 791-97 (proposing to value gift by reference to value received by the recipient). One can also combine these rules. Professor Dodge has proposed valuing at the higher of the value to the donor or the donee, on the theory that any other rule distorts dispositions. See Dodge, note 10, at 254-56.

191 Estate of Bright v. United States, 658 F.2d 999 (5th Cir., 1981).

192 Cf. Estate of Lee v. Commissioner, 69 T.C. 860 (1978) (valuing stock in decedent's estate without reference to other stock owned by person to whom stock is bequeathed); Ltr. Rul. 9432001 (Mar. 28, 1994) (same). See also Repetti, note 10, at 432-33.

193 The donee rule has broader reach only in the rare case in which the donor never held a controlling interest.

by the transferor at the time of death,[194] yet longstanding specific rules tax the value inherited by the heir.[195] Furthermore, the gift tax looks to the transferee more often than the estate tax does. Its tax exclusive base[196] and annual exclusion[197] both adopt the donee's perspective.

On the narrow question of discounts, current law provides more direction. Under the estate tax, minority discounts are determined by reference to the decedent.[198] Thus, the choice between donor and donee rules raises the question of the desirability of a discrepancy between estate and gift taxes.[199] Most reformers would eliminate this discrepancy by valuing the gift by reference to the donor,[200] which is also the rule adopted for lapsing voting rights.[201] They argue that this rule promotes fairness among similarly situated persons by treating donors and decedents alike and levels the playing field among property dispositions by reducing the tax incentive for lifetime gifts.[202]

The argument for a donor rule diminishes, however, if the gift truly destroys value, that is, if fragmentation makes the property less saleable. In that case, a donor making lifetime gifts is not truly comparable to a decedent bequeathing property to different heirs. By exempting economic waste and personal lifetime consumption, the transfer tax necessarily treats donors and decedents differently. Failure to tax real diminution in value does not produce unfairness or create incentives to transfer property.[203]

The cultural constructs indicate that a rule aggregating stock transfers is more palatable than proposals that attribute ownership among

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[194] IRC § 2033. This provision often is read as referring to the moment prior to death. See Dodge, note 10, at 253.

[195] IRC §§ 2039, 2042 (including death benefits and life insurance in gross estate); see Dodge, note 10, at 253-54.

[196] The gift tax is assessed on the amount received by the transferee whereas the estate tax is imposed on the amount surrendered (including the tax paid) by the transferor. Thus, assuming a 50% rate, a $100 gift results in $50 tax, while a $150 estate would pay a $75 tax.

[197] IRC § 2503 (excluding the first $10,000 given each donee).

[198] See note 43.

[199] See Estate of Murphy, 60 T.C.M. (CCH) 645, 659-66 (1990) (disallowing minority discount, in part because Congress intended to eliminate disparate impact of estate and gift taxes).

[200] See note 190.

[201] IRC § 2704(a).

[202] See generally Repetti, note 10, at 470-72, 474-81 (applying efficiency and fairness analysis to issue of minority discounts).

[203] Even if lifetime fragmentation of property does not destroy value, discrepancies between estate and gift taxes may be appropriate. The behavioral impact of a tax is not necessarily minimized by maintaining a constant present value. Depending upon the relative elasticities of gifts, bequests, and consumption, a lower effective gift tax may be less distortionary. Alternatively, any incentive for lifetime gifts created by a donee rule might further a purpose of transfer taxation by encouraging the dispersion of wealth.

family members or tax disguised transfers occurring through the exercise or nonexercise of retained rights. Aggregation applies only if the donor or donee personally owns a controlling interest, regardless of whether their family owns such interest. Thus, an aggregation proposal is narrower than stock attribution proposals.[204] Nor would aggregation "penalize" gifts to family members. It only presumes that the donor or donee will maximize the price of a minority block by selling it with other stock.

The cultural constructs also help choose between donor and donee rules. As the broader approach, a transferor rule is most plausible when the taxpayer is closely associated with concentration of wealth. This association is longstanding under the estate tax. Its enactment in 1916[205] and increases in the 1930's[206] responded directly to popular fears of concentrations of wealth.[207] Accordingly, it makes sense that the estate tax determines value by reference to the decedent.

Conversely, a transferee rule becomes more attractive when the taxpayer is less closely associated with concentration of wealth. That rule eliminates discounts only when multiple transfers are made to a single person. A donee rule may be appropriate under the gift tax because of the weak association of that tax with concentrated wealth. The gift tax was a controversial and belated addition to the transfer tax system. It was enacted in 1924,[208] repealed in 1926,[209] and reenacted in its current form in 1932,[210] 16 years after enactment of the estate tax.[211] Furthermore, a donee rule may coincide better with contemporary attitudes. In the transfer tax legislation of the last 50 years, concerns for family businesses have supplanted fears of concentrations of wealth.[212] In this environment, a donor rule may not command support beyond egregious tax avoidance.

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204 See Bogdanski, note 32, at 4-63 (distinguishing proposals that aggregate transfers from those that attribute stock ownership).

205 See Revenue Act of 1916, Pub. L. No. 271, §§ 200-212, 39 Stat. 756, 777-80.

206 See Revenue Act of 1934, Pub. L. No. 216, § 405, 48 Stat. 680-754-55; Revenue Act of 1935, Pub. L. No. 407, § 201, 49 Stat. 1014, 1021.

207 See Blatt, note 129, at 344-45.

208 See Revenue Act of 1924, Pub. L. No. 24-176, §§ 319-24, 43 Stat. 253, 313-16.

209 See Revenue Act of 1926, Pub. L. No. 26-20, § 1200(a), 44 Stat. 9, 125-26.

210 See Revenue Act of 1932, Pub. L. No. 32-154, §§ 501-32, 47 Stat. 169, 245-59.

211 See generally C. Lowell Harriss, Legislative History of Federal Gift Taxation, 18 Taxes 531 (1940).

212 See Blatt, note 129, at 315-17.

D. *Presuming That Minority Interest Is Worth at Least its Pro Rata Share of the Value of Corporate Assets if Sold in Liquidation*

The cultural constructs suggest positive support for a final proposal, one that provides that a minority interest in a family-owned corporation is worth at least its pro rata share of the value of corporate assets if sold in liquidation.[213] This proposal does not affect discounts allowed from other baselines. If, for example, the business is worth $3 million if liquidated and $4.5 million if maintained, the proposal gives a one-third interest a minimum value of $1 million. It thus applies family attribution for a single valuation method. In determining share value under the asset method, the proposal assumes that family members act in concert.

This proposal would have a similar effect to current provisions disregarding restrictions that depress the value of property.[214] Like those provisions, it would eliminate discounts when liquidation value exceeded going concern value. The proposal, however, would extend current law in two ways. First, it would eliminate exceptions for arrangements comparable to those entered into in arm's length agreements[215] or no more restrictive than those generally applicable under law.[216] Second, the proposal would mandate the use of liquidation value. Current law admits the possibility that the business would not be liquidated even in the absence of legal restrictions.[217] Controlling shareholders might benefit from maintaining a corporation as a going

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213 Cf. Reg. § 1.453-1(d)(2)(ii) (minimum value of an installment obligation is the fair market value of the property sold). See also Bankruptcy Code, 11 U.S.C. § 1129(a)(7)(B) (1997) (holder of bankruptcy claim receives an amount not less than value of holder's interest). Under this proposal, the value of undivided real property would equal the sum of the values of the divided parcels, less the costs of partition.

214 See IRC §§ 2703, 2704(b).

215 Section 2703 applies only to agreements not comparable to those entered into in an arm's length agreement. See IRC § 2703(b)(3).

216 Section 2704(b) does not apply to agreements subject to § 2703. Reg. § 25.2704-2(b) (excluding from § 2704(b) "an option, right to use property, or agreement that is subject to section 2703"). Nor does it apply to restrictions more onerous than those generally applicable under state law. IRC § 2704(b)(3) (exempting restrictions imposed or required to be imposed by state or federal law); Reg. § 25.2704-2(b) (restricting § 2704(b) to limitations on liquidation (in whole or in part) that are more restrictive than those that "would apply under the State law generally applicable to the entity in the absence of the restriction").

217 See Preamble to Notice of Proposed Rulemaking, 56 Fed. Reg. 46,245, 46,247 (Sept. 11, 1991) ("[D]isregarding an applicable restriction does not arbitrarily require that an interest be valued at its liquidation value."); E. James Gamble, Will Chapter 14 Freeze Buy-Sell Agreements and Make Lapsing Rights Disappear?, 26 Inst. on Est. Plan. § 1305.1 (1992) ("Nothing in section 2704(b) or the regulations provides that liquidation value rather than going concern value is to be used if an applicable restriction is ignored."). Delaware courts, for example, do not use liquidation value as a minimum for appraisal proceedings, reasoning that dissenting shareholders cannot force liquidation. See Rapid-American Corp. v. Harris, 603 A.2d 796, 802-03 (Del. 1992) (rejecting use of break up

concern; the value they could extract from minority shareholders might exceed the amount they would receive upon liquidation. In contrast, the proposal would require using pro rata value even if controlling shareholders benefit from maintaining the business as a going concern.

The proposal would narrow family attribution to a situation in which joint action is especially likely. If owners are rational, a business should be worth at least the value of its assets. Notwithstanding arm's length bargaining and state law, the owners would liquidate immediately a business whose assets were worth more than the going concern and put the proceeds to better use.[218] The continuation of such a business can only mean that the amount that the controlling shareholder extracts from the corporation exceeds the amount she could receive from liquidating it and investing the proceeds. Such extraction occurs at the expense of the other shareholders, whose funds are underinvested.[219]

The cultural constructs provide powerful support for adopting pro rata asset value as a minimum. First, they suggest that it is exceedingly unlikely that a controlling shareholder will deliberately waste total family wealth. More importantly, they suggest popular support for applying family attribution under the asset method. The proposal would increase taxes on family members, but it would do so in a way that targets concentrations of wealth. It would fall heavily on passive holding companies, for whom liquidation value exceeds going concern value. It would deny only discounts predicated upon adverse temporal interests—where some shareholders benefit from continued operation while others benefit from immediate termination.

By contrast, the proposal would exclude most family businesses. It would fall lightly on operating companies, which are ordinarily worth more than their underlying assets. The proposal would exempt most value attributable to activity. It would not tax future services and, as a practical matter, would have difficulty reaching intangible assets like

value); Bell v. Kirby Lumber Corp. 395 A.2d 730, 735 (Del. Ch. 1978) (rejecting liquidating value of stock as the sole measure of value).

[218] See Estate of Curry v. United States, 706 F.2d 1424, 1431 (7th Cir. 1983) ("In short, the sole relevant consideration in determining whether the company here should be valued as liquidated or as a going concern is which alternative could be expected to yield the profit-maximizing result."); Elmer J. Schaefer, The Fallacy of Weighting Asset Value and Earnings Value in the Appraisal of Corporate Stock, 55 S. Cal. L. Rev. 1031 (1982) (arguing that market value is the greater of asset or earnings value).

[219] If locked into an underperforming investment, a minority shareholder might be forgoing superior returns even if going concern value exceeds liquidation value. Identifying this situation, however, requires knowledge of available returns. A minority share in a high growth company may be more valuable than control of a poorly performing company. When liquidation value exceeds going concern value, however, there is no doubt that the minority shareholder can achieve better returns.

goodwill, the value of which depends upon continuing services. Furthermore, the proposal would have little impact on companies whose continued operation benefits all shareholders.

The cultural power of this proposal is evident in the fact that it catches the most commonly cited abuse: the use of entities to avoid transfer taxes. The proposal would prevent taxpayers from reducing value simply by passing property in corporate or partnership solution. It thus frustrates the scheme underlying discount partnerships and addressed by the recent partnership regulations.[220] It captures the suspicion that such schemes lack economic reality, that is, that unrelated persons would not create or maintain the entity.

On the other hand, the proposal potentially would increase taxes on the family farm, the earliest, and prototypical, family business.[221] As much a way of life as a profit making enterprise, the family farm often occupies valuable real estate. Congress is reluctant to "penalize" the family that decides to farm its land rather than to develop it as suburban housing. Recent history suggests, however, that the family farm has lost its premier position in the family business pantheon. Over the last 30 years, such farms have disappeared from the economic[222] and political[223] landscape. Recent defenses of the family business pay more attention to its importance in productivity and job creation,[224] and less to its function as a way of life. This shift in attention suggests

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220 See note 8 (describing discount partnerships) and note 70 (describing partnership regulations).

221 Unlike the European peasant, the American farmer owned his own land, a commodity in its own right, see James Oliver Robertson, America's Business 25-30 (1985) (describing how Americans viewed land as a commodity), and produced for market, id. at 23-25 (describing how Americans viewed agriculture as a business). Over time, the ideal of the family farm extended to small businesses more generally. See John H. Bunzel, The American Small Businessman 19 (1979).

222 This change reflected increasing concentration in American agriculture. See Richard S. Kirkendell, A History of the Family Farm, in Is There a Moral Obligation to Save the Family Farm? 79, 96 (Gary Comstock ed., 1987) (concluding that the family farm has become "nearly extinct"); Ingolf Vogeler, The Myth of the Family Farm: Agribusiness Dominance of U.S. Agriculture 3 (1981) (describing significant decline in farm residences from 1920 to 1977).

223 Compare Stanley S. Surrey, Reflections on the Tax Reform Act of 1976, 25 Clev. St. L. Rev. 303, 319-22 (1976) (describing role of farm lobbying in the Tax Reform Act of 1976), with Blatt, note 129, at 311 n.145 (minimal farm lobbying in transfer tax legislation of the late 1980s).

224 See Mansel G. Blackford, A History of Small Business in America at xi (1991)(describing increasing interest in small businesses on the part of historians, social scientists, and faculty members at business schools); The State of Small Business: A Report of the President xvii (1992) (finding small business accounting for 68% of net new job growth from 1977 to 1987).

that any residual concerns for the family farm may be addressed adequately through existing[225] or additional special provisions.[226]

VI. Conclusion

Thus far, reformers have cast minority discounts as a classic tale of tax avoidance. It is a tale of popular will subverted by a powerful elite, of just laws undermined by arcane schemes, of high tax rates eroded by crafty planning. In this tale, the reformer plays the hero. He challenges the elite and uncovers the schemes. He reveals minority discounts as mere subterfuge.

This tale gets attention, but at a cost. The reformer gets bogged down in technical arguments over how the market would price property, to which he can respond by either qualifying or oversimplifying his position. He can admit that he doesn't know the appropriate level of discount or maintain that none ought be available. At the same time, he has difficulty garnering political support. Popular outrage at the elite runs remarkably shallow. Despite his protests, his allies are easily swayed by sympathetic stories. Too often, the reform effort grinds to a halt.

This Article presents a less dramatic but hopefully more realistic tale. Economic analysis suggests that one cannot confidently determine what discount, if any, would be produced on the market. Moreover, the tale is not simply one of the battle between elites and the people. Much of the conflict plays out in cultural ideas to which all subscribe. Prosaic as it may be, this tale provides a means of sustaining a commitment to taxing the wealthy.

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[225] See IRC § 2032A (valuing farm property as a farm rather than at its highest and best use). Family farms also benefit from provisions granting relief to small businesses generally. See, e.g., IRC § 2033A ($1.3 million exclusion for family-owned businesses); IRC § 6166 (deferred payment for closely held business interests).

[226] In the 1998 Budget, Treasury proposed eliminating valuation discounts, except as they apply to active businesses. See note 70. Going beyond the proposal described in the text, the Treasury proposal incorporates the cultural distinction between family businesses and concentrations of wealth. Thus, for example, it would allow a full discount to a family farm that is worth more as suburban housing.

The drawbacks to the Treasury proposal are those associated with overt reliance on cultural constructions. The proposal appears more arbitrary because it deviates more from fair market value. It would disallow not just the discount attributable to the existence of a business entity, but also that attributable to joint ownership. Similarly, the proposal would deny a minority discount even when the whole family owns a minority interest. It thus would disallow discounts for small holdings in a closed-end mutual fund.

Furthermore, by explicitly incorporating the active business concept, the Treasury proposal is less easily administered. It mandates a new and potentially controversial set of allocations distinguishing between readily marketable assets and reasonable working capital.