

12-1-1979

## Federal Estate Tax—Valuation of a Deceased Spouse's Interest in Community Owned Stock—Estate of Lee v. Commissioner, 69 T.C. 860 (1978)

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### Recommended Citation

Lisa S. Frye, Recent Developments, *Federal Estate Tax—Valuation of a Deceased Spouse's Interest in Community Owned Stock—Estate of Lee v. Commissioner*, 69 T.C. 860 (1978), 55 Wash. L. & Rev. 271 (1979).

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FEDERAL ESTATE TAX—VALUATION OF A DECEASED  
SPOUSE'S INTEREST IN COMMUNITY OWNED  
STOCK—*Estate of Lee v. Commissioner*, 69 T.C. 860 (1978).

In *Estate of Lee v. Commissioner*,<sup>1</sup> the United States Tax Court held that a deceased spouse's one-half interest in a community owned block of shares should be valued after the block is divided in half for inclusion in the gross estate for federal estate tax purposes. The court concluded that the shares being valued constituted a minority interest subject to discount.<sup>2</sup> Because the *Lee* valuation approach offers obvious advantages to residents of community property states, it will undoubtedly be adopted by other courts in community property states.<sup>3</sup>

Elizabeth and Rhoady Lee, Washington residents, transferred substantial property to their controlled corporation, F. W. Palin Trucking, Inc., intending to use the reorganized company as an estate planning vehicle.<sup>4</sup> In the process of reorganization, shares representing one-third of the Palin stock were purchased from a nonfamily holder. Recapitalization created two classes of stock, common and preferred. The Lees owned 80% of the common stock and 100% of the preferred as community property.<sup>5</sup> Their son held the remaining 20% of the common shares. The resulting closely held corporation was a holding company which engaged in minimal busi-

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1. *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978), *appeal dismissed per stipulation*, No. 79-7223 (9th Cir. Sept. 18, 1979).

2. The court never mentioned minority discounts in its opinion, but recognized that the method it adopted would result in lower value. *Id.* at 873 n.6.

3. See Greene, *Valuation Inclusion of Community Property in the Gross Estate: A New Approach*, 15 Hous. L. Rev. 93 (1977) for a general discussion of the possible advantages of this valuation method. Greene notes that the method gives residents of community property states a significantly lower valuation than residents of common law states. A federal district court in Texas recently decided a case very similar to *Lee*. That court ruled before trial without explanation that as a matter of law no element of control could be attributed to the deceased spouse in determining the value of her interest in the corporation. *Estate of Bright v. United States*, No. CA-3-76-1264-F (N.D. Tex., filed Apr. 13, 1978) *appeal docketed*, No. 78-2221 (5th Cir., June 7, 1978).

4. Mrs. Lee's codicil to her first will expressed the Lees' intent in recapitalizing the corporation:

My husband and I and our children are financially interested in substantial and diverse businesses and properties and have been working toward a reorganization of our business interests to the end of having a centralized management, coordination and control of said businesses; and as a part of the comprehensive plan of reorganization, it is the intent and purpose of my husband to transfer the majority of our property to one business entity; namely, F. W. Palin Trucking Company.

*Estate of Lee v. Commissioner*, 69 T.C. 860, 864 (1978).

5. Each share of common stock was entitled to one vote in the management of the corporation. The preferred shares entitled the owner to vote on amendment of the articles of incorporation and merger or dissolution, but not on election of the board of directors or on general policy or management of the corporation. *Id.* at 862.

ness operations and was owned exclusively by the Lee family.<sup>6</sup> Upon her death Mrs. Lee bequeathed her community one-half interest in the common stock to her husband and her community one-half interest in the preferred stock to charity.<sup>7</sup>

The question presented to the Tax Court was the proper method of valuing Mrs. Lee's interest in the shares of stock held by her husband and her as community property for the purpose of federal estate taxation.<sup>8</sup> The *Lee* court chose between two possible methods of valuing a spouse's one-half interest in community held shares.<sup>9</sup> One method would have first valued the entire block of shares held by the community, then divided that value in half to determine the value of the decedent's interest.<sup>10</sup> Since the block held by the community was a majority block, this method would have produced a higher valuation because a control premium would have been assessed.<sup>11</sup> The method chosen by the *Lee* court was to divide the community held block in half first, then to value the half-size block sepa-

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6. Most of Palin's assets were undeveloped realty and only five percent of the stipulated net asset value of the corporation was accounted for by the trucking operation which lent its name to the holding company. *Id.* at 870.

7. The court's discussion of the valuation of the preferred stock bequeathed to charities, *id.* at 876, is beyond the scope of this note.

8. The valuation procedure determines the value of the decedent's interest in property includible in her gross estate for federal tax purposes. The Internal Revenue Code provides: "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death." I.R.C. § 2033. State law determines the nature and extent of the interest to which federal tax provisions apply. *See, e.g.,* *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940). *Morgan* held that the federal court initially must determine whether an interest or right created by local law was the object intended to be taxed before federal law can be applied to tax the interest. *See also* *Poe v. Seaborn*, 282 U.S. 101, 109-10 (1930). Valuation of the gross estate is covered by I.R.C. § 2031.

9. 69 T.C. at 873-74.

10. *Id.* at 871.

11. If a shareholder died owning a controlling interest, a control premium would be added to the value of the shares taxed to his estate, whether he transferred the entire block to one beneficiary who acquired control or to several beneficiaries, none of whom acquired control. *See* *Watts, The Fair Market Value of Actively Traded Securities*, 30 *Tax Law.* 51, 71 (1976). The *Lee* court apparently disregarded the fact that this method would have produced a value higher than half the net asset value represented by the Lees' block. The valuation method it chose discounted from a proportion of the corporation's net asset value and did not include a control premium. Strictly speaking, halving the value represented by the community owned block would not have assumed control value.

The terms "premium" and "discount" are difficult to apply to interests in closely held corporations because they assume a set price (as they do in the conventional context of listed securities) upon which to add or subtract value. In a closely held corporation there generally is no set price. As one commentator has noted, a minority discount is not appropriate unless a majority premium has been assumed: "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." *Fellows & Painter, Valuing Corporations for Federal Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 *STAN. L. REV.* 895, 909-10 (1976).

rately.<sup>12</sup> This latter method results in a lower valuation of the spouse's interest. Since the block produced by dividing the community property is a minority interest, a discount for lack of control is allowed.<sup>13</sup>

This note questions the propriety of allowing discounts to reflect lack of control where spouses enjoyed joint control over undivided interests in a majority block of shares. The issue is examined in light of existing case law and by reference to Washington community property law and federal estate taxation policies. The note concludes that, although *Lee* is not contrary to any explicit provision in the Internal Revenue Code, discounting a deceased spouse's share of a community owned majority block neither accurately reflects the degree of control its owners enjoyed nor effectively taxes wealth transfers at death.

### I. BACKGROUND

#### A. Valuation of Stock in Closely Held Corporations

The effect of community property ownership on valuation had not been considered prior to *Lee*. Valuation of stock in closely held corporations, however, generally has been a matter of some dispute, particularly with regard to minority interest discounts.<sup>14</sup> Part of the difficulty inheres in the nature of closely held corporations. Because there is no active stock trading, value cannot be based on quoted prices. Furthermore, in family corporations there rarely are arms-length transactions which might indicate value.<sup>15</sup>

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12. 69 T.C. at 872-74.

13. A minority interest denotes ownership of a block of shares which represents 50% or less of the outstanding shares in a corporation. Generally a minority interest does not give its owner managing control of a corporation because it does not give voting control. But lack of effective control is not always a concomitant. The term 'arithmetic minority' as used in this note refers merely to the size of a block of shares. It does not imply any degree of control incident to its ownership. See note 21 and accompanying text *infra* (discussion of advantages of owning a controlling interest).

14. Cohan, *Valuation of Interests in Closely Held Businesses*, 44 TAXES 504 (1966); Feld, *The Implications of Minority Interest and Stock Restrictions in Valuing Closely Held Shares*, 4 U. PA. L. REV. 934 (1974); Fellows & Painter, note 11 *supra*. Feld advocates a presumption that a donor who makes minority transfers to those who will be part of a control group should be required to come forward with evidence to show that a recipient who is claimed to be a minority shareholder actually suffers the disability of an outsider. Feld, *supra*, at 945. Some courts have used this approach. See, e.g., *Blanchard v. United States*, 291 F. Supp. 348 (S.D. Iowa 1968) (potential discount for minority shares disallowed because control was an element of value transferred to donee or legatee). *But see Maytag v. Commissioner*, 187 F.2d 962 (10th Cir. 1951); *Phipps v. Commissioner*, 137 F.2d 141 (2d Cir. 1943).

15. See Rev. Rul. 59-60, 1959-1 C.B. 237, which outlines the methods to be used and factors to be considered in valuing shares of stock in closely held corporations for federal estate and gift tax purposes. The Ruling defines closely held corporations:

Closely held corporations are those corporations the shares of which are owned by a relatively

The Code and Treasury Regulations provide that the fair market value of unlisted stocks and securities is to be included in a decedent's gross estate for federal estate tax purposes.<sup>16</sup> Fair market valuation involves a heavily fact-oriented inquiry which depends on a number of factors,<sup>17</sup> including the size of the block to be valued and the degree of control it represents.<sup>18</sup> But neither the Revenue Rulings nor the case law provide a method of applying the relevant factors, and neither elucidate the relationship between value and control.<sup>19</sup>

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limited number of stockholders. Often the entire stock issue is held by one family. The result of this situation is that little, if any, trading in the shares takes place. There is, therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the term "fair market value."

Rev. Rul. 59-60, 1959-1 C.B. 237, § 2.03.

16. I.R.C. § 2031(b); Treas. Reg. § 20.2031-2, T.D. 7432, 1976-2 C.B. 264; § 25.2512-2, T.D. 7238, 1973-1 C.B. 544. The Code states:

In the case of stock and securities of a corporation the value of which, by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined by taking into consideration, *in addition to all other factors*, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange.

I.R.C. § 2031(b) (emphasis added).

The Treasury Regulations define fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b), T.D. 7432, 1976-2 C.B. 264. *See also* Treas. Reg. § 25.2512-1, T.D. 7238, 1973-1 C.B. 544.

17. Revenue Ruling 59-60 lists the factors to consider in determining the fair market value of closely held stocks:

- (a) The nature of the business and the history of the enterprise from its inception.
- (b) The economic outlook in general and the condition and outlook of the specific industry in particular.
- (c) The book value of the stock and the financial condition of the business.
- (d) The earning capacity of the company.
- (e) The dividend-paying capacity.
- (f) Whether or not the enterprise has goodwill or other intangible value.
- (g) Sales of the stock and the size of the block to be valued.
- (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Rev. Rul. 59-60, 1959-1 C.B. 237, § 4.01. The Code provides that valuation of unlisted stocks and securities should take into consideration "all other factors." I.R.C. § 2031(b).

18. Treasury Regulations declare that the degree of control associated with a block of shares is relevant to valuation. Treas. Reg. § 20.2031-2(f), T.D. 7432, 1976-2 C.B. 264; § 25.2512-2(f), T.D. 7238, 1973-1 C.B. 544. Revenue Ruling 59-60 notes that the size of a block and the degree of control associated with it should be considered in valuation and emphasizes the factual nature of fair market valuation. Rev. Rul. 59-60, 1959-1 C.B. 237, §§ 3.01, 4.02(g).

19. While Rev. Rul. 59-60 clearly states that the size of a block does not determine whether it connotes a controlling interest, the Ruling does not mention what circumstances may indicate a higher valuation for an arithmetic minority. Rev. Rul. 59-60, 1959-1 C.B. 237, § 4.02(g).

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### B. Control as an Element of Value

Minority interest discounts reflect the lower value of a minority block of shares due to the owner's inability to exercise control over corporate decisionmaking.<sup>20</sup> Corporate control includes, for example, the power to declare dividends, effect liquidation, and create salaried management positions.<sup>21</sup> The Internal Revenue Service has provided no clear standards concerning when a discount is available for lack of control, and the decisions are in conflict.<sup>22</sup> The Service has indicated that control is a question of fact<sup>23</sup> and is not determined solely by the size of a block.<sup>24</sup> Some courts, however, have allowed discounts based only on a finding that a block constitutes an arithmetic minority (fifty percent or less of the corporation's outstanding shares).<sup>25</sup>

Other courts have recognized that mechanical applications of discounts

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20. The propriety of minority discounts was first discussed in *Ray Consol. Copper Co. v. United States*, 268 U.S. 373 (1925). The Court noted that the value of capital stock in a company bears no necessary relation to the value of the company's net assets. Furthermore, because control of a corporation may justify a higher price for a particular block of stock, small amounts of stock are not necessarily worth their proportionate share of the whole. *Id.* at 377. *Stewart v. Commissioner*, 31 B.T.A. 201 (1934), *nonacq.*, 14 C.B. 38 (1934) was the first case to define percentage discounts for minority interests. The trend has been toward greater discounts: 42% was the average discount in the period 1970-75. Dant, *Courts Increasing Amount of Discount for a Minority Interest in a Business*, 43 J. Tax. 104, 109 (Aug. 1975). See also Moroney, *Most Courts Overvalue Closely Held Stocks*, 51 TAXES 144 (1973). See generally Cohan, note 14 *supra*; Feld, note 14 *supra*.

The control factor in valuation should be distinguished from lack of marketability, a factor which reflects that there is generally no ready market in which to trade closely held stocks such as there is for shares in a publicly held corporation. *Fellows & Painter*, *supra* note 11, at 918 n.82. Lack of marketability has been confused with minority discount by some courts, which have referred to minority interest discounts as compensation for lack of marketability. See, e.g., *Estate of Bright v. United States*, No. CA-3-76-1264-F (N.D. Tex., filed Apr. 13, 1978), *appeal docketed*, No. 78-2221 (5th Cir., June 7, 1978); *Worthen v. United States*, 192 F. Supp. 727, 729, 732 (D. Mass. 1961); *Goss v. Fitzpatrick*, 97 F. Supp. 765, 767 (D. Conn. 1951); *Estate of Cotchett v. Commissioner*, 33 T.C.M. (CCH) 138, 142 (1974). Lack of marketability and degree of control are independent factors in valuation. For example, a small block of shares in a public corporation may have a reduced value because of lack of control and yet be readily traded. And a majority block in a closely held corporation is a controlling interest but there may be no ready market for its sale.

21. See *Andrews, The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505, 526 (1965); Feld, *supra* note 14, at 936.

22. See notes 25 & 26 and accompanying text *infra*.

23. Rev. Rul. 59-60, 1959-1 C.B. 237, § 3.01.

24. Rev. Rul. 59-60 states:

The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, *either actual or in effect*, representing as it does an added element of value, may justify a higher value for a specific block of stock.

Rev. Rul. 59-60, 1959-1 C.B. 237, § 4.02(g) (emphasis added).

25. See, e.g., *Sundquist v. United States*, 74-2 U.S. Tax Cas. ¶ 13,035 (E.D. Wash. 1974).

for minority interests may be inappropriate where de facto control is held by members of a family through an aggregate majority interest.<sup>26</sup> The rationale for disallowing discounts under such circumstances is that related minority shareholders suffer no disability in corporate decisionmaking. Thus a family group enjoys actual control even though individual members hold minority interests.<sup>27</sup> Furthermore, transfers by related shareholders who constitute a control group are often intrafamily so that family control is retained.<sup>28</sup>

### C. *Minority Discounts in the Marital Context*

The argument that de facto control should be recognized in valuing minority interests held by members of a controlling group is even stronger in the marital context. This conclusion follows not only from a recognition that spouses cooperate in managing their business interests, but also from pragmatic considerations. There are obviously greater economic benefits to be gained from joint management and sales of majority blocks than from minority transactions. It would presumably take a great deal of hostility between spouses to override these considerations. If in fact spouses enjoy control over decisionmaking in a closely held corporation, and if

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26. In an early valuation case the Tax Court emphasized that finding a minority interest in a family corporation should not, without more, trigger a minority discount. *Richardson v. Commissioner*, 2 T.C.M. (CCH) 1039 (1943), *aff'd*, 151 F.2d 102 (2d Cir. 1945), *cert. denied*, 326 U.S. 796 (1946). The *Richardson* view has not been generally accepted. Discounts have been disallowed, however, where donors made gifts of minority interests to family members. *See, e.g.*, *Driver v. United States*, 76-2 U.S. Tax Cas. ¶ 13,155, at 85,699 (W.D. Wis. 1976) (no minority discount allowed where donor who owned controlling interest made inter vivos gifts of minority interests); *Blanchard v. United States*, 291 F. Supp. 348 (S.D. Iowa 1968) (no minority discount allowed where donor, whose family owned the controlling interest in a bank, made gifts of minority interests to six relatives). *But see* *Clark v. United States*, 75-1 U.S. Tax Cas. ¶ 13,076, at 87,489 (E.D.N.C. 1975); *Drybrough v. United States*, 208 F. Supp. 279 (W.D. Ky. 1962); *Hermelin v. Commissioner*, 36 T.C.M. (CCH) 426 (1977); *Messing v. Commissioner*, 48 T.C. 502 (1967), *acq.* 1968-1 C.B. 2.

Many courts have not allowed minority discounts in valuing a decedent's minority interest where controlling stock is owned by family members. *See, e.g.*, *Forbes v. Hassett*, 124 F.2d 925, 929 (1st Cir. 1942); *Rothgery v. United States*, 475 F.2d 591, 594 (Ct. Cl. 1973); *Estate of Jenner v. Commissioner*, 36 T.C.M. (CCH) 241, 246-48 (1977); *Estate of Hayes v. Commissioner*, 32 T.C.M. (CCH) 1102 (1973); *Estate of Cruikshank v. Commissioner*, 9 T.C. 162, 165 (1947). *But see* *Sundquist v. United States*, 74-2 U.S. Tax Cas. ¶ 13,035, at 85,870 (E.D. Wash. 1974); *Obermer v. United States*, 238 F. Supp. 29, 34-36 (D. Hawaii 1964); *Goss v. Fitzpatrick*, 97 F. Supp. 765, 766-67 (D. Conn. 1951); *Righter v. United States*, 439 F.2d 1204, 1218-19 (Ct. Cl. 1971); *Estate of Katz v. Commissioner*, 27 T.C.M. (CCH) 825, 834 (1968).

27. *See, e.g.*, *Richardson v. Commissioner*, 151 F.2d 102 (2d Cir. 1945), *aff'd* 2 T.C.M. (CCH) 1039 (1943), *cert. denied*, 326 U.S. 796 (1946); *Blanchard v. United States*, 291 F. Supp. 348, 352 (S.D. Iowa 1968).

28. *See, e.g.*, Price, *Transmission of Wealth at Death in a Community Property Jurisdiction*, 50 WASH. L. REV. 277, 311 (1975) ("in all jurisdictions studied, an overwhelming majority of the married testators have given all of their property to their surviving spouses").

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those spouses do not devalue interests in majority blocks by dispositions which would destroy control, the value of the transferred interests should not be subject to the same discounts for lack of control which are proper for minority interest transfers by outsiders.

The Internal Revenue Service has urged rejection of minority discounts in cases where a husband and wife's shares together constituted a controlling interest in a family corporation. Courts considering the issue, however, have decided that a spouse's minority interest was subject to discounting.<sup>29</sup>

In *Obermer v. United States*,<sup>30</sup> the court held that the decedent spouse's one-half interest in a corporation owned entirely by the spouses was subject to a discount. The court found that the decedent's ability to transfer only his half interest justified this result because a hypothetical buyer would be unable to gain control by acquiring the interest. In *Sundquist v. United States*,<sup>31</sup> a Washington case, the spouses together owned a controlling interest in the family fruit and cold storage business. The court found the presumption in favor of community property overcome by a separate property agreement between the spouses respecting the business.<sup>32</sup> Since either spouse could transfer only a block comprising less than half of the corporation's total shares,<sup>33</sup> the court found that a minority discount was proper. In neither case did the legal interests of the spouses in the shares of stock extend over the entire block owned by the husband and wife together. Neither the *Obermer* nor the *Sundquist* courts considered whether the deceased spouses had effective control. Further, even though in both instances the surviving spouse became the sole owner of the corporation by the decedent's bequest, because a hypothetical buyer would be unable to gain control by acquiring the decedent's interest the courts determined that discounting was proper.<sup>34</sup>

## II. LEE COURT'S REASONING

The *Lee* court determined that the most pertinent factors in valuing the stock were "its net asset value, the specific rights under the preferred and

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29. *Sundquist v. United States*, 74-2 U.S. Tax Cas. ¶ 13,035, at 85,868 & 85,870 (E.D. Wash. 1974); *Obermer v. United States*, 238 F. Supp. 29 (D. Hawaii 1964).

30. 238 F. Supp. 29 (D. Hawaii 1964).

31. 74-2 U.S. Tax Cas. ¶ 13,035 (E.D. Wash. 1974).

32. *Id.* at 85,868.

33. Of the total of 2,000 shares, the couple owned 1,100, or 55%. The Internal Revenue Service considered this to be community property. *Id.* At the time of her death, the wife held 550 shares in her own name. The separate character of this property was established by a prior family partnership agreement and by mutual observation of this agreement. *Id.* at 85,870.

34. *Obermer*, 238 F. Supp. at 34; *Sundquist*, 74-2 U.S. Tax Cas. ¶ 13,035, at 85,870.



common stock, and the degree of control of the business represented by the blocks of stock to be valued."<sup>35</sup> In its consideration of the degree of control represented by Elizabeth Lee's interest, the court found her ability to bequeath only an undivided one-half interest in the community owned stock determinative.<sup>36</sup> The court assumed that shares of stock are fungible and found that the entire 4,000 shares of common and 50,000 shares of preferred stock owned by the community constituted one item in which the Lees each had an undivided one-half interest.<sup>37</sup> The court reasoned that, since under Washington law the surviving spouse had an undivided one-half interest in the entire block of the community owned shares,<sup>38</sup> his interest could not be satisfied by other property equal to the value of one-half the shares.<sup>39</sup> The court, therefore, determined that the value of the decedent's interest could not be half the value of the total number of shares.

However, by assuming that the shares of stock were fungible,<sup>40</sup> the court found that each spouse's undivided one-half interest "was *equivalent* to each having a separate interest in a block of 2,000 shares of common and 25,000 shares of preferred."<sup>41</sup> Thus the court concluded that Mrs. Lee's interest should be valued after the total number of shares was divided in half.<sup>42</sup> Since the division produced two blocks, each of which represented forty percent of the outstanding common shares and fifty percent of the outstanding preferred shares, Mrs. Lee's interest in the corporation was found to be a minority interest.<sup>43</sup> Since the court did not consider whether in fact Mrs. Lee's interest represented any significant degree of managerial control, its conclusion that the value of this interest should be reduced by a minority discount was apparently based on an assumption that the holder of a minority interest is unable to exercise control over corporate affairs.

### III. CRITICISM AND ANALYSIS

The *Lee* court's conclusion that a spouse's interest in community property should be valued after dividing the property in half rested on two

35. Estate of Lee v. Commissioner, 69 T.C. 860, 869-70 (1978).

36. *Id.* at 874.

37. *Id.*

38. *Id.* at 873 (citing *In re Estate of Patton*, 6 Wn. App. 464, 494 P.2d 238, *review denied*, 80 Wn. 2d 1009 (1972)).

39. Estate of Lee v. Commissioner, 69 T.C. 860, 873 (1978).

40. *Id.* at 874 n.7. The court's assumption that shares of stock are fungible is mistaken. With regard to value, one share of a majority block is worth more than one share of a minority block.

41. *Id.* at 874 (emphasis added).

42. *Id.* at 875.

43. *Id.*

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premises. First, the court reasoned that, because a spouse can bequeath only an undivided one-half interest in an item of community property at death, that spouse's interest in the corporation is equivalent to a separate interest in half the total number of shares owned by the community.<sup>44</sup> Second, it assumed that a separate interest amounting to fifty percent or less of the outstanding shares was automatically entitled to a minority interest discount.<sup>45</sup> Both these premises are incorrect because they ignore the basis for allowing minority discounts: actual lack of control over corporate decisionmaking.<sup>46</sup>

The *Lee* valuation method assumes that, because the legal characterization of a spouse's interest in community property changes at death to separate property,<sup>47</sup> the nature of the property interest prior to death is irrelevant to its valuation for estate tax purposes. But federal estate tax, which taxes the decedent's estate, attaches to the value of property in the decedent's hands.<sup>48</sup> This is to be distinguished from gift taxes, for example, which tax the value of the property interest created.<sup>49</sup> The *Lee* court failed to examine facts which may have indicated that Mrs. Lee enjoyed control over the corporation through her interest in the majority block owned by the community. Community property law was considered significant only insofar as it limited a spouse's testamentary power of disposition.<sup>50</sup>

Disregarding the community property nature of the shares amounted to treating Mrs. Lee's interest in the corporation as if it were a separate interest. Given that the degree of control associated with a block of shares is a question of fact, the community property character of Mrs. Lee's interest was clearly relevant to determining whether the value of that interest should be reduced to reflect lack of control.

Under Washington law, each spouse has an undivided one-half interest in community property.<sup>51</sup> Either spouse may, under most circumstances,

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44. *Id.* at 874.

45. *Id.* at 876.

46. See notes 21, 23 & 24 and accompanying text *supra*.

47. WASH. REV. CODE § 26.16.030(1) (1976); *In re Estate of Patton*, 6 Wn. App. 464, 494 P.2d 238, *review denied*, 80 Wn. 2d 1009 (1972).

48. See I.R.C. § 2031(a). See also note 11 *supra*.

49. See *Mayer v. Reinecke*, 130 F.2d 350 (7th Cir.), *cert. denied*, 317 U.S. 684 (1942) (estate tax is excise upon transfer of estate at death of owner; it attaches to the interest caused by reason of death rather than the interest to which some person succeeds on death). See also Committee on Death Taxation of Estates and Trusts, Probate and Trust Division, *Property Owned With Spouse: Joint Tenancy, Tenancy by the Entireties and Community Property*, 11 REAL PROP., PROB. & TR. J. 405, 414 (1972).

50. *Estate of Lee v. Commissioner*, 69 T.C. 860, 874 (1978). See WASH. REV. CODE § 26.16.-030(1) (1976).

51. *In re Estate of Towey*, 22 Wn. 2d 212, 155 P.2d 273 (1945); *In re Estate of Patton*, 6 Wn. App. 464, 494 P.2d 238, *review denied*, 80 Wn. 2d 1009 (1972).

transfer any or all of the community interest.<sup>52</sup> In contrast, neither spouse may make an inter vivos transfer of only that spouse's interest in the community property under any circumstances.<sup>53</sup> Washington community property law gives either spouse total power to dispose, manage, and control community personal assets to the same extent as separate assets.<sup>54</sup> Either spouse can vote the entire block of stock owned by the community and can assign proxy rights to it.<sup>55</sup>

A spouse's interest in community owned stock allows nearly unfettered control over the entire block, not just half of it. Where the community owns a majority block, either spouse can exercise majority control.<sup>56</sup> Thus, the degree of control incident to an undivided one-half interest in a community owned majority block is not equivalent to the degree of control incident to a separate minority block, since each spouse is able to partake in the benefits of a controlling interest. But neither is the degree of control equivalent to separate ownership of a majority block, which would give its owner sole individual control over the corporation. Community property law allows the spouses joint control, which amounts to

52. WASH. REV. CODE § 26.16.030 (1976). The statute also explicitly states the exceptions to a spouse's power to dispose of community property.

53. WASH. REV. CODE § 26.16.030(2) (1976). Nor is the interest of only one of the spouses in the community capable of being severed on levy and execution upon either a separate or community obligation. See *Sagmeister v. Foss*, 4 Wash. 320, 30 P. 80 (1892); *Littel & Smythe Mfg. Co. v. Miller*, 3 Wash. 480, 28 P. 1035 (1892); *Brotton v. Langert*, 1 Wash. 73, 23 P. 688 (1890).

54. WASH. REV. CODE § 26.16.030 (1976). In *Hanley v. Most*, 9 Wn. 2d 429, 115 P.2d 933 (1941), the court held that this statute provides for complete and unrestrained management power and that the husband has the power to deal with such property. As long as the spouse acts for the community and the community interest, the court will not interfere with management decisions. The 1972 amendments to R.C.W. § 26.16.030 allow each spouse, not just the husband, to manage community personal property to the same extent that a spouse may control and manage separate property. Ch. 108, § 3, 1972 Wash. Laws, 2d Ex. Sess. 246 (amending WASH. REV. CODE § 26.16.030 (1963)). Professor Cross notes that analyses defining the extent of management and transfer powers held exclusively by the husband prior to 1972 now apply to both spouses. Thus, pre-1972 cases on the subject are still authoritative. Cross, *Equality for Spouses in Washington Community Property Law—1972 Statutory Changes*, 48 WASH. L. REV. 527, 541 (1973).

55. R.C.W. § 23A.08.310 provides that for community owned stock only the signature of the spouse named as the shareholder is required for making a valid stock transaction:

Certificates of stock and the shares represented thereby standing in the name of a married person may be transferred by such person, such person's agent or attorney, without the signature of such person's spouse. All dividends payable upon any shares of a corporation standing in the name of a married person, shall be paid to such married person, such person's agent or attorney, in the same manner as if such person were unmarried, and it shall not be necessary for the other spouse to join in a receipt therefore; and any proxy or power given by a married person, touching any shares of any corporation standing in such person's name, shall be valid and binding without the signature of the other spouse.

WASH. REV. CODE § 23A.08.310 (1976).

56. The major limitation on control is a practical one. Since each spouse has coextensive powers under the 1972 amendment, see note 54 *supra*, a spouse is unable to exercise control where he or she disagrees with the other spouse and the latter exercises the power first.

## Valuation of Community Owned Stock

something greater than a separate minority interest, but something less than a separate majority interest. Thus the fact that a majority block is held as community property clearly affects the value of each spouse's interest. The *Lee* method does not recognize the additional value of control that community property ownership confers. By dividing the community owned majority block prior to valuation, this method values a deceased spouse's interest as if it were a minority interest completely unrelated to the original controlling block.<sup>57</sup>

### IV. PROPOSAL

By dividing the community property prior to valuation, the *Lee* court found, in effect, that as a matter of law no degree of control is attributable to a deceased spouse's interest in a community owned majority block of shares. The court's refusal to value the community's majority block prior to determining the value of the decedent's one-half interest apparently was based on a perception that to do so would equate the decedent's one-half interest with a separate interest in the entire majority block. This rejected alternative method is not, however, equivalent to valuing the decedent's interest as a separate majority interest. If the decedent's one-half interest were valued as a separate majority interest, her estate would be assessed the entire control premium associated with that majority block. But assessing a control premium for the entire community block, then halving that value, includes in the decedent's estate only one-half the control premium. Thus the alternative method essentially splits the value of control between the decedent's estate and the surviving spouse's one-half interest.

This method appears to comport with the degree of control that each spouse actually has over a community held majority block. A spouse's undivided one-half interest in a community held majority block is something greater than a separate minority interest and something less than a separate majority interest. The proposed method of including half the value of a control premium assessed against the entire community estate reflects the degree of control associated with an undivided one-half inter-

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57. The *Lee* method treats spouses with a community property interest in stock as outsiders. An outsider is a minority shareholder who owns shares having asset value and income value, but who is unable to participate in determining the operating policies of a corporation. Feld, *supra* note 14, at 936. As one commentator stated: " 'Minority stockholders' means only noncontrolling stockholders, even if the controlling stockholder is not a majority stockholder." Andrews, *supra* note 21, at 506 n.5. This usage of the term "minority stockholder" is supported by a leading case on corporate control. *Perlman v. Feldmann*, 219 F.2d 173, 175 (2d. Cir.), *cert. denied*, 349 U.S. 952 (1955).

est in a majority block more accurately than the method employed by the *Lee* court.

## V. CONCLUSION

The valuation method used in *Lee* disregards the control that spouses have over a community held majority block of shares in a closely held corporation. The *Lee* method precludes an inquiry in individual cases to determine whether in fact the transferor of a minority interest suffers from a lack of control such that a lower valuation is appropriate. The Code, Treasury Regulations, and Revenue Rulings presently support and arguably mandate a more refined inquiry into the degree of control associated with a given block of stock than a determination of its size. Particularly in closely held corporations where control is retained within the family and where there is no intention to offer shares for sale to the public, allowing discounts merely on the finding that an interest is an arithmetic minority produces a windfall for the taxpayer.

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