Redstone v. Commissioner[1]—Service Examines Gift Made 41 Years Earlier

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A transfer was made in 1972 and a federal gift tax deficiency notice was issued in 2013. How did that happen? What are the valuation issues? The issues addressed in this discussion include (1) the remoteness of prior transactions in a subject company's stock used as indications of fair market value, (2) how the fact pattern surrounding a transaction can support whether it meets the fair market value standard, (3) the timeliness of deficiency determination notices, (4) what makes a gift a gift, and (5) an unnecessary examination by the Internal Revenue Service (the "Service").

Background

National Amusements, Inc. (NAI) was incorporated in 1959 as a means to consolidate various interests in certain Redstone family entities operating in the drive-in movie theater business. Mickey Redstone and his two sons, Edward and Sumner, contributed their stock in the pre-existing family drive-in movie companies to NAI.

Mickey, Edward, and Sumner contributed $30,328 in stock and $3,000 in cash, $17,845 in stock, and $18,445 in stock, respectively. In return, they each received 100 shares of the common stock of NAI. This inconsistency between the value of the contributions and the number of shares issued, proved to be problematic several years later.

In 1968, Mickey gifted 50 shares of his NAI stock to a trust he created for his grandchildren and exchanged his remaining 50 shares for 86,780 shares of NAI preferred stock. As a result, Mickey became the NAI sole preferred stockholder, and the NAI common stockholders were Edward, Sumner, and the trust for Mickey's grandchildren.

In 1971, Edward decided to leave NAI and wanted possession of his stock certificates in order to sell them or have NAI redeem them at an appropriate price.

Mickey refused to deliver the stock certificates to Edward saying that although all of the certificates were in Edward's name, Edward was actually not entitled to all of the certificates. This was because Mickey had made a larger initial contribution to NAI than Edward.

Mickey contended that the extra shares were subject to an "oral trust" for the benefit of Edward's children.

Edward and Mickey negotiated for six months and could not come to an agreement on terms, so Edward filed lawsuits against Mickey, Sumner, and the Redstone family companies.

After an additional six months of negotiation, on June 30, 1972, it was settled that Edward was the free and clear owner of 66⅔ shares of the NAI stock, and the remaining 33⅓ shares had always been held by Edward for the benefit of his children in trust.

The settlement agreement provided for NAI to redeem Edward's 66⅔ shares based on terms provided in the redemption agreement. The redemption agreement provided for a purchase price of $5 million in the form of a promissory note.

The promissory note bore interest at the floating prime rate and was to be paid in 44 quarterly installments (of principal and interest) of $125,000.

The settlement agreement also provided for mutual releases regarding certain claims surrounding Edward's ownership in NAI, Edward's employment at NAI, and other family businesses, as well as Edward's involvement as trustee of all family trusts.

On July 21, 1972 (three weeks after the settlement agreement was executed), Sumner executed irrevocable declarations of trust for his two children (the "Children's Trusts").

Sumner reissued 16⅔ of his shares to each of the Children's Trusts, while the remaining 66⅔ shares were reissued to Sumner.

In 1984, NAI redeemed 83⅓ shares from several trusts for $257,143 per share or $21,428,571 in aggregate. All remaining voting common shares were owned directly by Sumner (66⅔ shares) or by the trusts for his children (33⅓ shares).

In 2006, Michael Redstone (Edward's son) and trustees of certain family trusts filed suit[2] against Sumner, Edward, and NAI for causing NAI to redeem shares from certain family trusts at less than fair market value. The plaintiffs also alleged that more shares of stock should have been transferred to the Children's Trusts due to the existence of the oral trust.

During the litigation, the trial court concluded that the plaintiffs had failed to prove that the oral trust had ever been created and that the argument that shares were redeemed at less than fair market value was time barred.

Further, at trial, Sumner testified that he had not been compelled to transfer a third of his NAI stock to trusts for his kids through legal means, but had done so voluntarily, consistent with what he wanted to do for his kids and due to his desire to please his father. Sumner also testified that he did not file a gift tax return for the 1972 transfers to the Children's Trusts based on the determination by his accountants and lawyers that no tax was due.

In 1975, a Service agent examined Sumner's transfers made to political committees between 1970 and 1972 for potential gift tax liability. After reviewing the documentation and schedules of the transfers, the Service agent concluded that no gift tax return was required for 1972.

In 2011, a Service revenue agent examined Sumner's 1972 transfers to the Children's Trusts to evaluate the potential for gift tax liability, unaware of the previous examination that occurred in 1975.

The Service issued a notice of deficiency in January 2013, and Sumner petitioned the Tax Court in April 2013 for redetermination of gift tax deficiency and additions to tax for fraud and negligence.

The disputed issues included the following:

1. Whether the determination of deficiency was timely since it was delivered 41 years after the transfers
2. Whether the taxpayer was unnecessarily subjected to a second examination, thus invalidating the determination of tax deficiency
3. Whether the transfer should be classified as a gift
4. The value of the 33⅓ shares of NAI that were transferred by Sumner on July 21, 1972
5. The justifiability of the additions to tax imposed for fraud and negligence

The Valuation Experts

The Service Valuation Expert

The Service valuation expert applied the direct capitalization, guideline publicly traded company, and guideline merged and acquired company methods in order to estimate the value of the 33⅓ shares of NAI stock transferred by Sumner on July 21, 1972.

The guideline merged and acquired company method was primarily based on the $5 million price at which NAI redeemed Edward's 66⅔ shares on June 30, 1972. The Service valuation expert concluded that the redemption price was:

1. negotiated at arm's length as evidenced by the six-month negotiation and
2. contemporaneous with the transfer of shares by Sumner.

The Service valuation expert concluded that the $75,000 per-share value established by the redemption transaction represented a private noncontrolling interest transaction that was indicative of the rights and restrictions of a noncontrolling, nonmarketable interest holder. The concluded value from the guideline merged and acquired company method was $2.5 million.

The Service valuation expert concluded that a discount for marketability of 34 percent was appropriate for the indications of value estimated using the guideline publicly traded company and direct capitalization methods. The resulting indications of value were approximately $2.4 million and $2.9 million, respectively.

The Petitioner Valuation Expert

The petitioner valuation expert applied the engrafting method to estimate the value of the shares transferred by Sumner in 1972.

The engrafting method involved using the $257,143 per-share price paid to redeem NAI shares from certain trusts in 1984 as the starting point for the analysis.

The petitioner valuation expert calculated ratios of the 1984 redemption price to (1) the NAI average 1981 to 1983 net income and (2) the book value of the NAI common shareholder's equity in 1984. The ratios were then applied to the net income and book value common shareholder's equity on or about July 21, 1972.

The petitioner valuation expert concluded that the value of the 33⅓ shares transferred by Sumner on July 21, 1972, was $735,981.

The Judicial Decision

Timeliness of Deficiency Notice

Regarding the statute of limitations and other threshold issues, the burden of proof is on the petitioner. The petitioner argued that the Service was barred from determining in 2013 that there was a tax deficiency for the third quarter of 1972.

The Tax Court determined that because Sumner did not file a gift tax return reporting the 1972 transfers, the notice of deficiency was timely even though it was issued 41 years after the transfer.

Multiple Examinations

The petitioner further argued that the Service violated the second examination rule by examining books and records surrounding transfers Sumner made in 1972 to 1975 and again in 2011 to 2013, and that the gift tax deficiency should be disregarded.

Section 7605(b) addresses restrictions on examinations of the taxpayer and states that taxpayers are protected from:

> unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

The Tax Court declined to set aside the deficiency, citing that it has been established that the failure of the commissioner to comply with Section 7605(b) does not invalidate a deficiency.

The Tax Court also noted that a taxpayer may object to what he or she deems to be a second examination by refusing to permit the examination and opposing any enforcement actions.

The Tax Court determined that Sumner and his attorneys complied with all requests associated with both examinations and did not complain or oppose the examinations until a year after the notice of deficiency was issued. The Tax Court concluded that the petitioner consented to the 2011 to 2013 examination and, thus, waived its rights under Section 7605(b).

Sumner's July 21, 1972, Transfers as Gifts

The petitioner contended that the 1972 transfers were exempt from federal gift tax because they were made in the ordinary course of business and thereby made at full and adequate consideration.

Sumner argued that he facilitated the settlement of Edward's litigation by creating and transferring shares to trusts at a time when he would not have otherwise done so. Therefore, the transfers were indicative of actions taken in the ordinary course of business and for adequate and full consideration.

The Tax Court determined that there was no dispute regarding Sumner's ownership of the shares and no resulting arm's-length negotiation regarding the value of the shares. The Tax Court further determined that evidence showed that Mickey and Sumner conspired to push Edward out of the business and used the oral trust argument and litigation to achieve that goal.

The Tax Court found no convincing evidence that Sumner's actions facilitated the settlement of Edward's litigation because the settlement agreement:

1. was signed three weeks before Sumner's transfer,
2. did not make Sumner's transfers a condition of the settlement, and
3. did not obligate Sumner to anything other than mutual releases.

The Tax Court, therefore, concluded that the transfers were indicative of donative intent, not done in the ordinary course of business within the meaning of Section 25.2512-8, and should be subject to federal gift tax.

The Valuation

When the valuation of property transferred for gifting purposes is disputed, the Tax Court has the ability to consider the opinions of experts and accept an expert's opinion in its entirety or make its determination based on its selection of the most persuasive arguments presented by various valuation experts. The Tax Court's conclusions about the respective valuation expert reports are summarized below.

The Petitioner Valuation Expert

As mentioned previously, the petitioner's valuation expert applied the engrafting method using the price of NAI shares redeemed in 1984 as the basis for the value of the shares transferred by Sumner in 1972.

Generally, events and information known or knowable on or about the valuation date are acceptable for use in estimating fair market value. However, subsequent events, including sales of subject company stock, may be considered as evidence supporting the fair market value of the subject company stock as of a specific valuation date.

In order for subsequent sales of the subject company stock to be a reliable indication of fair market value, the subsequent sales used to estimate value should have occurred reasonably close to the valuation date.

In this case, the subsequent transaction used in the engrafting method occurred 12 years after the date of the 1972 transactions that were the subject of the deficiency notice.

In order to make a supportable or persuasive case for using an indication of value that remote from the specified valuation date, adjustments should be made for changes in such factors as (1) economic conditions; (2) inflation; (3) company operations, financial performance, and risk profile; and (4) industry dynamics.

However, the petitioner's valuation expert did not make any adjustments for changes in factors that could influence the valuation and did not provide support for the lack of adjustments.

Consequently, the Tax Court found the petitioner's valuation expert's report to be unreliable, and it did not address whether the 1984 transfer price was too remote for the valuation of the shares transferred in 1972 or whether the engrafting method was an acceptable valuation method.

The Service Valuation Expert

The Service valuation expert relied primarily on the price at which Edward's NAI shares were redeemed on June 30, 1972, to value the shares transferred on July 21, 1972.

The Service valuation expert concluded that the price paid for Edward's stock was the result of an arm's-length negotiation and was contemporaneous with Sumner's transfer.

The Tax Court agreed with the Service valuation expert and found that the redemption of Edward's shares was not too remote relative to Sumner's transfer to use as an indication of the NAI stock on July 21, 1972. The Tax Court found that the NAI operations and risk profile as well as the prevailing market and economic conditions were comparable on the dates of the two transfers.

The fact that the redemption price of Edward's stock was deemed to be the result of an arm's-length negotiation also supported the Tax Court's decision. This conclusion was supported by the fact that each of Mickey, Edward, and Sumner had intimate knowledge of the NAI history, current operations, outlook, and risks associated with that outlook.

The fact that there was a dispute that lead to litigation is indicative of the two sides: Edward on one side and Mickey and Sumner on the other, pursuing their own self-interest which was in opposition of the other side.

The negotiations lasted for over a year and resulted in a redemption price of $75,000 or $2.5 million for the 33⅓ shares transferred to the Children's Trusts by Sumner in 1972.

Petitioner's Arguments against the 1972 Redemption Price as Fair Market Value

Fair market value for federal gift tax purposes is defined as the price at which 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 the relevant facts.

The petitioner argued that the redemption price for Edward's shares did not meet the definition of fair market value for the following reasons:

1. Edward and NAI were compelled to buy or sell the NAI shares.
2. The redemption proceeds were received via a note payable and not in cash.
3. The note was actually worth less than $5 million because the interest rate was a below-market rate.
4. The redemption price compensated Edward for his 66⅔ shares of NAI stock as well as for the execution of the releases of claims he held against Mickey, Sumner, and NAI.
5. The redemption price reflected the impact of a control premium.

Edward and NAI Were Compelled to Buy and Sell Shares

The Tax Court found no evidence of any compulsion to buy or sell the 33⅓ shares of stock by Edward or Sumner/NAI/Mickey. The petitioner argued that these compulsions manifested in Mickey's and the NAI's desire to buy the stock so an outsider wouldn't own it and Edward wished to sell it to alleviate financial strain.

The Tax Court found that the fact that the two sides engaged counsel and participated in a year-long negotiations process was indicative of neither side feeling compelled to act. The fact that both sides had reasonable knowledge of the facts and certain leverage over one another was viewed as an incentive to hold out rather than let the other side win by giving in.

The Redemption Note Had a Below-Market Interest Rate

The Tax Court found no evidence that the $5 million note receivable was actually worth less than face value due to a below-market interest rate. The note payable bore interest at the floating prime rate; the same rate at which NAI borrowed funds from its institutional lender.

Therefore, assuming that the interest rate on NAI borrowings was a negotiated rate that took into account market conditions and risks associated with NAI's ability to pay debt obligations as they came due, it was concluded that the prime rate was an arm's-length market-based interest rate that fully compensated Edward for the risk of nonpayment.

Redemption Price Was Compensation for Shares and Releases

The petitioner contended that the $5 million redemption price was compensation for the 66⅔ shares of NAI stock and Edward's execution of certain releases of claims held against NAI, Mickey, and Sumner. The assumption being that the releases had value that, once subtracted from the $5 million redemption price, would result in an NAI share value below $5 million.

The settlement agreement and redemption agreement provided that consideration of $5 million be paid to Edward exclusively and specifically as compensation for his stock.

The releases were provided for separately in the settlement agreement whereby each of Mickey, Edward, NAI, and Sumner were to provide mutual releases of claims. There was no mention of monetary consideration in exchange for any of the releases.

Therefore, the Tax Court concluded that there was no reason to believe that any releases given by any particular party were more beneficial or valuable than the releases received by any particular party, and that the $5 million redemption price was consideration for the shares only.

Redemption Price Included a Price Premium for Control

The petitioner contended that the redemption price included a price premium for control. This was because, once redeemed, Sumner would have control of NAI.

This argument assumes that Sumner was willing to breach his fiduciary duty to the shareholders of NAI and to the trusts of which he was trustee by redeeming Edward's shares for a price in excess of fair market value in order to gain control of NAI. The Tax Court found it improbable that Sumner would take such action.

The Tax Court rejected this argument, noting that the redemption price was negotiated for over a year. The Tax Court noted that this negotiation was indicative of buyer's and seller's engaging in arm's-length transaction activities.

The Tax Court accepted the Service valuation expert's conclusion that NAI would not have redeemed the shares for more than the price Edward could have negotiated with an unrelated, third-party buyer; noting that an unrelated third party would negotiate a price that reflects the lack of control and the lack of marketability characteristics of the block of shares purchased.

Conclusion

This case raises certain considerations that should be taken into account when performing a valuation analysis. Several legal issues, such as the timeliness of the deficiency notice and the second examination rule, among others, may not be issues on which valuation analysts opine.

However, analysts should be aware of these issues and should discuss these issues with counsel in order to understand the valuation engagement and to determine how to best perform the analysis.

Issues such as the remoteness of previous transactions in a company's stock and how the other characteristics of the transaction conform to the definition of fair market value can materially affect the reliability of the valuation analysis.

The valuation analyst should carefully consider these issues and how an analysis may be challenged in order to produce a reliable and defensible valuation analysis.

Note:

1. Redstone v. Commissioner, T.C. Memo 2015-237 (December 9, 2015).
2. O'Conner v. Redstone, 896 N.E.2d 595 (Mass. 2008).

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