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Preferred Stock and Special Use Valuation

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The special use valuation statute clearly contemplates that land held by an entity should be eligible for special use valuation. However, regulations have not been issued providing guidance on the procedure for valuing land held by a corporation, partnership or trust even though the issuance of regulations was mandated in the statute, enacted in 1976.

Other than for a Tax Court case holding that a corporation could not utilize special use valuation and at the same time claim a minority discount, until the issuance of a 1992 private letter ruling, estates have been forced to rely on the general guidance in the statute itself in making special use valuation elections involving stock, particularly with respect to preferred stock.

In general, a net asset value approach to stock valuation, with discounts for minority interests and non marketability has seemed to be appropriate. While a willing buyer-willing seller approach to stock valuation has appeal in many situations, as a practical matter in most farm and ranch situations a willing buyer-willing seller value often would be derived from a net asset value with adjustments. Therefore, net asset value is used as a starting point in this discussion.

1992 letter ruling

The Internal Revenue Service, in Ltr. Rul. 9220006, addressed the issue of the eligibility of land owned by a corporation with preferred stock as well as common stock for special use valuation. In the facts of that ruling, the decedent in 1978 had undertaken a freeze of asset values involved with a ranch. The decedent at that time incorporated the ranch operation and received both common and preferred stock. The $100 par preferred shares were nine percent, non-cumulative preferred with a fixed liquidation value and were redeemable at any time.

The decedent transferred all of the 2,000 shares of common stock and 1,922 of the 9,000 shares of preferred stock to her children and a grandchild. At her death, the decedent owned 7,078 shares of preferred stock.

Although the ruling is not clear on the point, the corporation at the time of the decedent’s death owned, at fair market value, $1,000,000 of land and $100,000 of other assets for a total corporate net worth of $1,100,000. The land was valued at $200,000 under the special use valuation rules.

The Internal Revenue Service first concluded that land represented by preferred stock could be eligible for special use valuation. The ruling states that the preferred stock was an equity interest in the ranching operation for purposes of special use valuation. The Service noted that the ranch was an active business and that the decedent had made management decisions until death, thus meeting the material participation test. It should be noted that an earlier private letter ruling had indicated that it was not necessary for a decedent as a corporate shareholder to be personally involved in management for the material participation test to be met by the decedent or a member of the decedent’s family.

The estate had valued the land by first determining that land was valued at $200,000 under the special use valuation. The ruling states that the preferred stock was represented by preferred stock could be eligible for special use valuation elections involving stock, particularly with respect to preferred stock.

The Internal Revenue Service then proceeded to reject the estate’s valuation approach. The ruling notes that it is not legitimate to treat the common stock and the preferred stock as equivalents. The ruling points out that such an approach does not properly reflect the important attributes of the preferred stock (redeemable at par and having a liquidation preference). The ruling does not, however, explain how those differences are to be taken into account.

A generalized approach

While Ltr. Rul. 9220006 involved only common and preferred stock, a corporation could involve debt securities as well as common and preferred stock. It has been suggested elsewhere that asset values should be allocated to the various classes of securities on the basis of their face or par values with the residual imputed to the common stock.

Applying that approach to the facts of Ltr. Rul. 9220006 would produce the following results —

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6 Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
The court held that the property was transferred to the debtors executed and attempted to disclaim the deed post-petition. sugarcane was limited to transportation distances of about 25 miles. The debtor was found guilty of several willful violations of the Migrant and Seasonal Agricultural Worker Protection Act and the plaintiffs in that suit sought collateral estoppel effect of that judgment such that the economic feasibility of growing and selling sugarcane was limited to transportation distances of about 25 miles. The ruling by contrast, reaches the startling conclusion that the common stock has no value. Obviously, the common stock does have value, arguably the residual above the preferred's par value or $200,000 in amount.

FOOTNOTES
2. See I.R.C. § 2032A(g).
5. See generally 6 Harl, supra n. 1, § 46.02[2] (gift tax); 8 Harl, supra n. 1, § 58.05[2][c] (estate tax).
6. The helpful comments by Prof. J. A. Kasner, University of Santa Clara School of Law, are acknowledged. See Kasner, "Special Use Valuation Permitted for Preferred Stock in Ranch Corporation" ("But there Is a Catch"), 56 Tax Notes 98 (1992).
9. See 5 Harl, supra n. 1, § 43.03[2][e].

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

ANTI-TRUST
LEASES. The plaintiffs were sugarcane farmers who subleased land from the defendants who leased the land from the owners. The defendants also owned sugarcane mills and required the plaintiffs to sign leases which required the tenants to deliver all sugarcane grown on the land to the mills owned by the sublessors. The court ruled that such "tying arrangements" were a violation of the Sherman Anti-Trust Act in that the arrangements eliminated competition in the geographical area around each mill. The court applied the law to the limited geographical area around the mills because it found that the economic feasibility of growing and selling sugarcane was limited to transportation distances of about 25 miles. Breaux Bros. Farms, Inc. v. Teche Sugar Co., Inc., 792 F. Supp. 1436 (W.D. La. 1992).

BANKRUPTCY
GENERAL

DISCHARGE. The debtor was found guilty of several willful violations of the Migrant and Seasonal Agricultural Worker Protection Act and the plaintiffs in that suit sought collateral estoppel effect of that judgment such that the judgment amount was nondischargeable in the debtor's bankruptcy case. The court held that the judgment amount was nondischargeable except as to the judgments entered because of the default of the debtor. In re Kallmeyer, 143 B.R. 271 (Bankr. D. Kan. 1992).

ESTATE PROPERTY. On the day prior to the filing for bankruptcy, the debtors' parents executed a deed for 60 acres of farmland to the debtors. The deed was recorded an hour after the filing of the petition. The debtors had thought that the bankruptcy petition was filed before the deed was executed and attempted to disclaim the deed post-petition. The court held that the property was transferred to the debtors before the bankruptcy filing and was estate property, making the disclaimer an unauthorized transfer of estate property. In re Strotheide, 142 B.R. 850 (Bankr. S.D. Ill. 1992).

The debtors' Chapter 11 plan was confirmed and substantially consummated when the debtors defaulted on payments to a secured creditor. The debtors claimed that they transferred all of their post-petition farm property to their son in exchange for lifetime support and filed a motion to convert the case to Chapter 7. The bankruptcy court had dismissed a motion by the trustee to adjudicate the parties' rights to the property because after confirmation of the plan, all property reverted back to the debtors such that no bankruptcy estate remained subject to bankruptcy court jurisdiction. The litigation moved to state court where it was held that the property transfer was ineffective. The court in this case held that because it had no jurisdiction to affect the state court ruling and the property was no longer bankruptcy estate property, the issue of the rightful owner of the property was moot and beyond the jurisdiction of the federal courts. In re Helms, 142 B.R. 964 (D. Kan. 1992).

EXEMPTIONS

AVOIDABLE LIENS. The debtors were not allowed to avoid a judgment lien against their homestead where the debtors had no equity in the homestead eligible for an exemption. Matter of Arevalo, 142 B.R. 111 (Bankr. D. N.J. 1992).

The debtors had claimed a tractor as exempt and had received a discharge in 1988. The tractor was subject to a nonpossessory, nonpurchase money security interest which was not avoided in the case. The creditor sought to reopen the case to obtain an order for recovery of the tractor under the lien. The debtor argued that Owen v. Owen, 111 S.Ct.