TAX COURT CASE UPDATE

Citation:

Estate of Rankin M. Smith, Jr. v. U.S., 109 AFTR 2012-987, February 13, 2012.

Overview:

Mr. Smith and his family owned the Atlanta Falcon NFL franchise when he died in 1997. The decedent's shares lost preferential voting rights at his death. The issue at trial was whether the value of the Class A voting shares which were worth $30 million with the preferential voting rights were includable in his estate or whether the value of the shares without the voting rights was includable.

The Facts:

The decedent originally owned common stock and voting preferred stock in a C corporation. When the corporation converted to an S corporation in 1986, the shares were converted to Class A and Class B shares which reflected the earlier voting rights of the common voting preferred shares. After the conversion, the decedent owned 81.75 percent of the vote of all outstanding shares (he owned all Class A shares). A separate shareholders' agreement for each class of stock was executed which provided that the Class A shares would lose their preferential voting rights if they were sold or redeemed, but that the decedent could gift or bequeath the Class A shares with the voting rights intact.

In 1991, some of the family members sold their Class B shares, and as a result. a new shareholders' agreement was executed that encompassed both classes of stock. The new agreement provided that the Class A shares would be converted into Class B shares upon the sale of the Class A shares or upon the decedent's death.

Subsequent to the sales, on March 27, 1991, the Articles of Incorporation were amended to state:

> Shares of Class A Common Stock shall automatically be converted into shares of Class B Common Stock on a one-for-one basis upon the sale or transfer for consideration of any such shares of Class A Common Stock by the original holder thereof. All outstanding shares of Class A Common Stock shall automatically be converted into shares of Class B Common Stock on a one-for-one basis upon the death of Rankin M. Smith, Sr.

The decedent died in 1997 and his Class A shares converted to Class B shares. As a result, rather than having 81.75 percent of the vote, the shares had 32.65 percent of the vote. The IRS audited and assessed estate tax claiming that Code Section 2704(a) applied to cause the value lost upon the lapse of the voting rights to be included in the estate. The estate paid the tax and sued for a refund. The parties stipulated to the values of the shares prior to the hearing ($30 million with the enhanced voting rights and $22.5 million without).

Discussion:

The issue at trial was whether Code Section 2704(a) applied to the automatic conversion of the Class A Shares to Class B Shares upon the decedent's death. Also to be decided was whether the creation of the restrictions on the voting rights of the Class A shares occurred prior to the October 8, 1990 effective date of Code Section 2704.

Code Section 2704 applies to restrictions or limitations on rights created after October 8, 1990. According to Regulation Section 25.2704-1, "if a corporation is controlled by a family, then the lapse of a voting right is deemed to be a transfer by the holder of the voting right to the holder's family. If the transfer of the voting rights occur during the holder's lifetime (which is the plaintiff's contention), the lapse of the voting right is a transfer by gift. If the transfer of the voting right occurs at the holder's death (which is the defendant's contention), the lapse is a transfer included in the holder's estate."

The legal arguments in the case revolved around the legal construct and interpretation of Code Section 2704. The first prong had to do with the issue of family control of the company. The estate argued that although the family had voting control of the corporation, since the family did not have the power to restore the voting lapse, Section 2704 did not apply. However, the Court disagreed with this argument as it could find nothing in the legislative history that discussed that the successors needed the power to reinstate the lapsed power.

As an alternative to the prior argument, the estate attempted to re-characterize the transaction as a gift of the lapsed enhanced voting rights instead of as a testamentary transfer. However, the Court determined that the lapse of the voting rights occurred at the decedent's death, not back in 1991 when the Articles of Incorporation were changed and the new shareholders' agreement was signed.

Another argument made by the estate was that the lapse of the restrictions on the shares took place in 1986, prior to the enactment of Code Section 2704, and therefore, this code section was not applicable. However, the Court disagreed because the 1986 agreement did not provide for the voting rights to lapse at death; they only lapsed on sale.

The next argument concerned the valuation of the shares. The estate argued that a hypothetical purchaser would be aware that the transferred shares would not have the enhanced voting rights, and therefore, would not pay for them. However, the Court disagreed with this argument stating:

> Plaintiffs' theory is at odds with the explicit valuation provisions of 26 U.S.C. §2704(a)(2)(A), which states that the value of the stock immediately before the lapse should be 'determined as if the voting rights… were nonlapsing,' which would lead to the higher valuation of the shares to be included in Mr. Smith's Estate.

The final argument had to do with the application of Code Section 2703. The estate argued that the transaction that took place in 1991 was an arm's length business transaction, and it was this transaction that created the lapsing voting rights. They further argued that although Code Section 2703(a) states that property will be valued with regard to any restriction on the right to sell or use such property, the exception to this is if the restriction arises when there is a bona fide business transaction as a result of an arm's length transaction. However, the IRS argued that Code Section 2703 did not apply to this case and the Court agreed stating, "… voting rights associated with stock ownership are not property and cannot be sold separately from the underlying stock. Therefore, there could not be a sale of the enhanced voting rights, only a sale of the stock to which those rights related."

Conclusion:

The Court concluded that Code Section 2704 applied to the transfer of shares from Mr. Smith to his estate as of the data of death, and that the value of the shares includable in the estate was $30 million.