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Agreements to Fix Stock Value

-by Neil E. Harl*

The rapid run-up in farm and ranch land values[1] in recent years with real estate values reaching record levels in many states, has focused attention on the valuation of corporate stock as well as the valuation of other types of ownership interests where the entity owns farm or ranch land.[2] In almost every instance, it is unlikely that all of the descendants of the group initially forming the entity will want to continue to own interests in the entity indefinitely. That means that a fair valuation of the ownership interests is needed to avoid conflicts between on-farm and off-farm heirs.[3]

Problem unique to small firms

The problems related to valuing ownership interests is a significant problem for farm and ranch operations (and other small businesses). Larger firms, with ownership listed on stock exchanges or traded over-the-counter, can rely on market-oriented transactions but that is not the case with most small businesses. In the bigger picture, virtually all farm and ranch firms are small businesses.

Solutions for farms and small businesses

With no ready access to markets which can establish fair market values on almost a daily basis, small firms are left with several choices in establishing values as needed if not on a regular basis – (1) ignore the problem until the need to value ownership interests arises; (2) use book value (which is essentially the income tax basis for the underlying assets); (3) employ an appraiser to establish values for the assets and, indirectly, fix stock and other ownership values for the entity; or (4) rely upon a periodically negotiated fixed price.[4]

Ignoring the problem until valuation is needed. While all too frequently relied upon, ignoring the problem until a death occurs, a gift is to be made or disagreements have emerged that threaten the operation, assures that conflict (between or among the owners or between the entity and the Internal Revenue Service) is likely to have arisen, thus complicating the valuation process.

Using book value. While relatively easy to derive from income tax records, book value is often unacceptable because of the typical understatement of value relative to fair market value. In one recent Iowa case, a farm corporation after several years of existence with no provision for stock valuation, adopted a bylaw amendment in 1984 establishing book value as the valuation method and set the book value at $686 per share.[5] No subsequent adjustment was made in the book value so that a value set nearly 30 years earlier (which then probably reflected a small percentage of fair market value) was insisted upon by the

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majority shareholder in response to a request from a minority shareholder to cash out of the operation even though farmland values had increased roughly seven fold in the interim. It is hardly surprising that the Iowa Supreme Court held that the majority owner had acted "oppressively" and ordered appropriate relief.

Periodically renegotiated fixed price. Perhaps the most workable method of valuation is what has been termed the "periodically renegotiated fixed price."[6] With this approach, the bylaws, backed by a provision in the articles of incorporation (for a corporation) specifies that within a specified period after the close of the taxable year (typically 45 days), the board of directors (or shareholders) are directed to meet and agree upon the value for the stock for the coming 12-month period by setting a value on every asset held by the entity. Usually, commodity prices are readily obtainable from the local elevator or cooperative, farm equipment dealers are a convenient source for used farm machinery values, livestock are valued based on available market values and the land value is adjusted using surveys from dependable sources (often the state university).

But are such agreements to fix value upheld? The answer is in the affirmative. Some may recall that agreements of this nature before 1990 were used widely if four conditions were met – (1) the price was fixed or determinable by formula; (2) the estate, in the case of time of death valuations, was under an obligation to sell under a buy-sell agreement or upon exercise of an option;[7] (3) the obligation to sell was binding during life;[8] and (4) the arrangement was entered into for *bona fide* business reasons and not as a substitute for a testamentary disposition.[9] In 1990, a new section was added to the Internal Revenue Code, Section 2703,[10] which, at first glance, appeared to curb such agreements by specifying that, as a general rule, property was to be valued without regard to any option, agreement, restriction or "other right" which set price at less than the fair market value of the property.[11] However, the same section of the Internal Revenue Code specified that the general rule did not apply if the option, arrangement, restriction or "other right" met each of three requirements – (1) the arrangement was a *bona fide* business arrangement; (2) it was not a "device" to transfer value to family members for less than full consideration; and (3) the terms are comparable to "similar" arrangements entered into in an arm's length transaction.[12] A 2006 Tax Court decision[13] confirmed that the general rule did not apply where the three exceptions were satisfied. The *Amlie* case involved the stock valuation of a bank in Humboldt, Iowa.[14]

The experience has been, for those who have used the "periodically renegotiated fixed price" for several decades, that the required annual determination of value results in valuations which are respected by the owners (at the scheduled time for valuation, no one knows for sure who is going to die that year or even who may be wanting to sell or gift ownership interests that year) and the result is less conflict over valuations later when the occasion requires a determination of value because of death of an owner, gifting of ownership interests or sale of ownership interests.

ENDNOTES

[1] E.g., Duffy, "Iowa Land Value Survey," Iowa Agriculture and Home Economics Experiment Station, Iowa State University, Dec. 2013.

[2] See generally 2 Harl, *Farm Income Tax Manual* § 7.07 (2013 ed.).

[3] See Baur v. Baur Farms, Inc., 832 N.W.2d 663 (Iowa 2013).

[4] See 6 Harl, Agricultural Law § 52.02[5] (2013).

[5] Baur v. Baur Farms, Inc., 832 N.W.2d 663 (Iowa 2013).

[6] See 7 Harl, *Agricultural Law* § 52.02[5][c][vi] (2013).

[7] See, e.g., Estate of Littick v. Comm'r, 31 T.C. 181 (1958), *acq*., 1959-2 C.B. 5.

[8] See, e.g., Estate of Gannon v. Comm'r, 21 T.C. 1073 (1954).

[9] Estate of Gloeckner v. Comm'r, T.C. Memo. 1996-148, *rev'd,* 152 F.3d 208 (2d Cir. 1998) (restrictive agreement controlled valuation; testamentary purpose not behind agreement).

[10] Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602(a), 104 Stat. 1388 (1990).

[11] I.R.C. § 2703(a).

[12] I.R.C. § 2703(b).

[13] Estate of Amlie v. Comm'r, T.C. Memo. 2006-76.

[14] *Id*.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ADVERSE POSSESSION

EASEMENT. The plaintiff's predecessor in interest purchased 800 acres from the defendant. The deed granted an easement over the defendant's property for access to the property. Before the plaintiff purchased the property the defendant had constructed a fence on the boundary line in order to manage deer on the defendant's property and the fence enclosed the easement area. After the plaintiff purchased the property, the plaintiff attempted to use the easement but was prevented by the defendant. The defendant argued that the easement failed because the easement could not be located with reasonable certainty. The plaintiff provided aerial photographs over several years that agreed with the somewhat vague description in the deed. In particular, the photographs showed a gate in a location consistent with the description. The defendant claimed to have acquired the