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# “BLOCKAGE” IN VALUATION OF ASSETS FOR FEDERAL TAX PURPOSES

C. W. HUGHES\*

## THE BLOCKAGE THEORY

SOME years ago in *Phipps v. Commissioner* the court stated:

“The ultimate place of the ‘blockage’ theory in the field of valuation has not yet been finally determined. The most that the courts have said is that it is a factor to be considered along with all others in determining value in computing gift taxes under the statute.”<sup>1</sup>

This statement of the court concerning the “blockage” theory is as true today as it was then. Although “blockage” has been an element of valuation in arriving at the fair market value of stocks for gift and estate tax purposes for many years, it is only recently that *Words and Phrases* has included cases defining the term.<sup>2</sup> In *Citizens Fidelity Bank & Trust Co. v. Reeves*,<sup>3</sup> the court held in substance that: “the term ‘blockage’ has a technical meaning in the field of taxation and may be defined as recognition of the fact that in some instances a large block of stock can not be mortgaged and turned into cash as readily as a few shares.” In *Montclair Trust Co. v. Zink*,<sup>4</sup> the court arrived at the same conclusion but referred specifically to determining value of large blocks of corporate stock for gift and estate tax purposes. In this particular case, however, where 53,000 shares of General Motors Corporation stock were involved, it was held that the evidence was insufficient to require application of the “blockage rule”.

While initially use of the blockage rule or theory seems to have been limited to the valuation of corporate stock for gift and estate tax purposes, its use has been broadened in recent years to the extent that it has entered into the determination of the value of corporate stock basis in certain income tax cases. In the recent case of *Babbitt v. Commissioner*<sup>5</sup> the court was concerned with the value of a stock option at the date it was granted, and the value of the stock when purchased. In that case the court said:

“Remembering that petitioner could not assign the option itself, and that if he desired to realize upon it, he would have been required first to invest not less than

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1. 127 F.2d 214, 216 (10th Cir., 1942).
2. 5 *Words & Phrases*, Blockage (Supp. 1956).
3. 259 S.W.2d 432, 433 (Ky. 1953).
4. 141 N.J. Eq. 401, 57 A.2d 372 (Prerog. Ct. 1948).
5. 23 T. C. 850 (1955).

\$30,000 in exercising the option, and then sell under conditions in which the application of blockage principles rendered the yield conjectural at best, we must hold that there is no basis in the record for assigning a fair market value to the option itself, or for that matter, for assigning a fair market value in excess of the option price to the 20,000 shares then covered by it. . . ."<sup>6</sup>

This decision cited two earlier cases, one a stock option case involving the determination of income tax liability<sup>7</sup> and the other, a case involving valuation of a block of restricted stock.<sup>8</sup> This latter case is particularly interesting because it was conceded that the value of the stock without restrictions was \$25 a share, but when sold with restrictions to the taxpayer at \$5 a share, the government's attempt to tax him an additional \$20 a share was denied. This case is one of several cases in which it would appear that the court was attempting to expand its considerations, usually limited to the size of the block, to include the *nature* of the block of stock.

In view of the Commissioner's position with respect to stock valuation, such expansion would not appear unreasonable. The Commissioner does not hesitate to increase the value of "over the counter" stocks from the current trading price where the block of stock being valued carries with it control of the company concerned. It is apparent that in arriving at the higher figure the Commissioner is looking to the nature of the block, as well as to its size. In a midwestern city not too long ago, stock in a large bank was being traded on an "over the counter" basis at \$150.00 a share. At the same time, fifty-one percent of the stock changed hands at \$300.00 a share, or double the "over the counter" price in smaller lots. Strangely enough, the "over the counter" price was in no way affected by the sale of the controlling block and the smaller lots continued to sell at \$150.00 a share. This price appears to have been governed principally by the dividend rate currently being paid.

There are many cases in addition to those previously cited which define or attempt to define the term "blockage" or the term "blockage theory". One case defined what "blockage" is not. In *Safe Deposit & Trust Co.*<sup>9</sup> the court made the following statement:

"Blockage is not a law of economics, a principle of law, or a rule of evidence. If the value of a given number of shares is influenced by the size of the block, this is a matter of evidence and not of doctrinaire assumption."<sup>10</sup>

This case is cited in a Commerce Clearing House editorial<sup>11</sup> where it is

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6. *Id.* at 864.

7. John C. Wahl, 19 T. C. 651, 658 (1953).

8. Harold Kuchman, 18 T. C. 154, 164 (1952).

9. 35 B.T.A. 259 (1937), *aff'd*, 95 F.2d 806 (4th Cir. 1938).

10. *Id.* at 263.

11. 3 CCH 1956 Stand. Fed. Tax Rep. ¶ 4430.257.

shown that while the quoted price ordinarily represents the fair market value, in the case of securities traded on the open market or in a recognized exchange, this is not necessarily conclusive. The editorial also pointed out that the Treasury Department's estate tax rulings do not accord specific recognition of the "blockage theory" to large blocks of stock, but that the Department does recognize that the use of market quotations may not always be appropriate. Note was also taken of the fact that the Tax Court recognized that the "blockage theory" is not necessarily applicable under all circumstances.

A recent Prentice-Hall release<sup>12</sup> stated:

"Quoted prices on the exchanges are sometimes inaccurate as criteria because the stock to be valued is such a large block that, if it were put on the market at once, the price would be depressed. A downward adjustment to the quoted price may then be justified under the so-called 'blockage rule'."

This was the only statement discovered by the author in which it was specifically said that the "blockage" rule refers only to "downward adjustments". On the other hand, in no case did the taxpayer attempt to invoke this rule for any purpose other than a downward adjustment, nor did the Government attempt to use this rule, under the designation "blockage", to justify an increased value. However there would appear to be circumstances in which the size of the block might justify an upward adjustment, for example, where the block was of sufficient size to carry control. Perhaps this is not a proper use of "blockage" and should be considered as a case in which consideration is given to "other elements and factors of value". In view of the tendency in a few later cases to consider, at least collaterally, the nature of the block, it is possible that the idea that "blockage" only justifies a "downward adjustment" may become obsolete. In this event the size and nature of the block, and its effect upon the market, would be considered in arriving at fair market value—whether fair market value was more or less than the mean of the day's market.

The same discussion in Prentice-Hall, citing regulations,<sup>13</sup> noted that:

"The Commissioner takes the position that the quoted price will govern regardless of the size of the block to be valued."<sup>14</sup>

It stressed the fact that the courts do not hesitate to disagree with this regulation where the facts warrant, but that the courts will not assume that the market would be depressed by placing a large block of stock on sale.

The article suggested that, where it is desired to have the valuation of

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12. P-H 1956 Tax Ideas Rep. ¶ 8011.4.

13. U.S. Treas. Reg. 118 §§ 39.113(a)(14)-1 (b)(1956).

14. See note 12 *supra*.

a block of stock valued downward under the "blockage rule", it should be established that:

1. The market was so thin on the day in question that prices would be depressed if a large block were placed on the market, or
2. A buyer could not be found for so large a block unless a lesser price were accepted, or
3. The cost of selling such a block in a way that the price would remain stable would be exorbitant.

Finally it warned that "if one is relying upon the 'blockage rule' that litigation should be expected."<sup>15</sup>

#### PROBLEMS OF PROOF

There are a number of decisions which set out in detail the evidence and the proof essential to establish the necessity of applying the "blockage rule" to arrive at fair market value. In one such decision the taxpayer was successful in an action to recover overpayment of a gift tax.<sup>16</sup> A gift had been made of 160,000 shares of sugar stock in one company, and 20,000 shares in another. The taxpayer contended that the fair market value of the 160,000 shares was \$25.00 per share, and that of the 20,000 shares was \$22.00 per share on the date of gift, although the mean of prices realized for small lots of shares sold on the stock exchange on the same date was greater. The evidence that the taxpayer introduced included daily sales of stock for the month of the gift, weekly sales for three months (starting one month before and ending one month after the month of gift), and the monthly sales for two years. These sales established that a total of 160,000 shares did not change hands in any month, and there was not a total of that many sales in several six-month periods. The taxpayer further introduced expert testimony to show that the best method of marketing a large block of stock would have been through syndicate or investment bankers. A dissent<sup>17</sup> by Judge Madden pointed out that while the market would decline if an order to sell 160,000 shares was filed, that an order to buy such a block would send the price up. He reasoned that the mean of the market would be a fair market value in this case.

In *Phipps v. Commissioner*,<sup>18</sup> the court ruled against the taxpayer, but raised the interesting point of a gift of a large block of stock not to one individual but to several. The case in point involved a gift of 10,000 shares to thirteen persons. The taxpayer in this case treated the block of

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15. *Ibid.*

16. *Havemeyer v. United States*, 103 Ct. Cl. 564, 59 F. Supp. 537 (1945).

17. *Id.* at 594, 59 F. Supp. at 552.

18. See note 1 *supra*.

stock as a single gift, while the Board of Tax Appeals held that the transaction constituted thirteen separate gifts. The taxpayer offered no testimony as to the value of the thirteen blocks (if they were to be treated as such), but did attempt to establish that the "blockage theory" applied to this gift. The court held against the taxpayer as to the application of "blockage," but did not decide whether there were thirteen gifts or one for purposes of imposing the rule, though it did mention that there appeared to be no case upon this particular point. The court further stated that it did not rule on this point, as the result would have been the same in either case under the particular facts.<sup>19</sup> In this case there was a dissent by Judge Phillips, who felt that the petitioner proved his case for the use of the "blockage theory," and that if the gift totalled 10,000 shares, the block was 10,000 shares and not 10,000 divided by the number of donees.<sup>20</sup>

In any event, it would appear that the treatment of the total of the gifts should be influenced to some extent by whether the gifts were made on the same day, or spread over the year. If all of the stock was given to various donees on the same date or approximately the same date, there would appear to be strong justification for Judge Phillips' position, whereas if the gifts were scattered throughout the year it seems that they should be treated separately, and probably would be under the foregoing decision and other similar cases.

#### THE COMMISSIONER'S VIEWPOINT

The Commissioner of Internal Revenue in his regulations does not encourage the application of the "blockage" rule in the valuation of stocks or bonds. The current regulations<sup>21</sup> dealing with valuation of assets for federal estate tax purposes state:

"Such value is to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of the property. For example, in the case of shares of stock or bonds, such unit of property is a share or a bond. All relevant facts and elements of value as of the applicable valuation date should be considered in every case."

It would appear that after shutting the door on the "blockage theory" in the first sentence the Commissioner opened it again in the last.

Maurice H. Greenberger, in the footnotes to his lecture entitled *Valuation Problems in Dispositions of Property*,<sup>22</sup> listed estate and gift tax cases in which the "blockage" rule has been considered. Some of the cases he cited have been discussed herein, and in addition, comment has been

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19. *Id.* at 217.

20. *Id.* at 219-20.

21. U.S. Treas. Reg. 105 § 81.10(a) (1954), 1 CCH Fed. Est. & Gift Tax Rep. ¶ 1200 (1955).

22. N.Y.U. 14th Inst. on Fed. Tax. 409, 417-18 (1956).

made on the fact that the "blockage" rule appears to have been extended to cover stocks in stock option cases where income tax is involved. Mr. Greenberger declared:

"Reference to the fairly numerous blockage decisions shows that while quoted market prices will not furnish an automatic criterion, nevertheless blockage itself is subject to the same scrutiny as the mean trading price, namely, it must be supported by the relevant facts. This, in turn, requires a full and persuasive record, above and beyond the opinion testimony of qualified financial experts."<sup>23</sup>

Before considering some of the practical aspects in using "blockage" as an element of valuation, it is advisable to stress again the fact that it has long been established that a court will not assume that the market will be depressed by placing a large block of stock on sale. Nor is it sufficient, particularly in the case of a listed corporation with many shares outstanding, to show a great disparity between the size of the block being valued and a single day's sales on the exchange.<sup>24</sup> In *Mott v. Commissioner*<sup>25</sup> a gift of 100,000 shares of General Motors common stock, made on December 5, 1939, was involved. The value set by the Commissioner was the mean of the day's market on December 5, 1939, although only some 7,900 shares changed hands on that date. In discussing the element of "blockage" in this case the court remarked that "blockage" is not an inevitable factor.

#### PRACTICAL APPLICATIONS OF "BLOCKAGE"

From the author's many years experience, first as an agent with the Internal Revenue Service, and then as a practicing attorney, it seems that the element of "blockage" is often ignored in valuing stocks, when a properly prepared showing of the size and nature of the block would result in substantial savings to the taxpayers concerned. While "Tax Ideas" was earlier quoted as warning that "if one is relying upon the 'blockage rule' that litigation should be expected,"<sup>26</sup> there is no desire on the part of the Commissioner to undertake needless litigation. One exception to this is, perhaps, a case similar to one in which the Commissioner has non-acquiesced. It is also true that in cases involving many disputed points, the element of blockage may strengthen the taxpayer's trading position in conference, if well documented, and may aid in securing a settlement from which no further appeal may be necessary.

There are many thousands of small corporations whose stock is listed on no exchange, and in which there is no real "over the counter" market.

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23. Id. at 418.

24. Leonard B. McKitterick, 42 B.T.A. 130 (1940).

25. 139 F.2d 317 (6th Cir. 1943), affirming Charles Stewart Mott, 1 CCH Tax Ct. Mem. 356 (1943).

26. See note 12 supra.

Some of these corporations are closely held companies, others may have a large number of stockholders, all located in one comparatively small area. The element of "blockage" may rather frequently enter into the valuing of stocks of such corporations, both as to the size and as to the nature of the block. If such element is present it is seldom identified by the term "blockage," but the size of the holding to be valued as compared with the available market is a pertinent factor in arriving at the stock's value. The Internal Revenue Service will not overlook the nature of the block—particularly if it carries control of the company.

Concerning the valuation of unlisted stock and securities for the purpose of ascertaining the gross estate for estate tax purposes, the 1954 Internal Revenue Code says:

"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."<sup>27</sup>

Note the words ". . . in addition to all other factors. . . ." The Internal Revenue Agent's Manual of a few years ago used the following language: "After considering all factors and elements of value. . . ." The size of the block of securities being considered is surely one of the "other factors," and can be a powerful one if properly and forcefully presented. A careful presentation as to what market exists for the securities in question helps. Often the only market for the stock, when control is held in a single family, consists of friends of that family, customers of the company, or employees. Under such circumstances a sizeable "minority block" should be valued downward. Technically this appears to be a recognition of the element of "blockage" or an imposition of the "blockage rule," yet the term will probably never be used, unless it is necessary to appeal the value finally determined by the Internal Revenue Service. There appears to be a strong prejudice on the part of the Service against recognizing "blockage" as such, but in conference, or before the Appellate Staff, the size of the block and its effect on the market will be considered.

As previously stated, the nature of the block as distinguished from the size is not, to date, a proper subject of "blockage," though some of the cases<sup>28</sup> do indicate that in certain instances the court has extended its considerations beyond size in deciding to invoke or deny the "blockage rule." Certainly, the Internal Revenue Service and courts do consider the nature of a block of stock as one of the "other factors" of value. The

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27. Int. Rev. Code of 1954, § 2031(b).

28. See p. 703 and notes 7 and 8 *supra*.



Service always considers whether the block carries control, and whether the stock is restricted or unrestricted. Restrictions considered may run from restriction on sale or transfer to restrictions imposed under a pooling agreement. Whether the stock is voting or non-voting, fully paid, etc., all enter into valuation, whether under the scope of "blockage" or not.

As shown earlier,<sup>29</sup> where the "blockage rule" is imposed, it results in an exception to the general rule that a listed stock will be valued at the mean of the day's market on the valuation date. Another exception to this general rule was seen in the recent case, *Estate of Oei Tjong Swan v. Commissioner*.<sup>30</sup> In this case a discount was allowed on taxable listed stocks located in Holland and subject to wartime restrictions on exchange.

If the taxpayer desires to invoke the "blockage rule" the time to begin is with the initial appraisal of the property. In the case of appraisal by the probate or similar court in connection with the administration of an estate, the appraisers should be cautiously selected, and in addition care should be taken to see that they have expert assistance available in considering the effect of the size of the block upon the market at the date upon which it is to be valued. When the field agent of the Internal Revenue Service makes his examination of the return as filed, all of the data afforded the probate court appraisers should be submitted to the agent, and the issue of "blockage" should then be clearly presented to him. As a practical suggestion—if the stock is unlisted it may be well to stay away from the term "blockage" or "blockage rule," but to present the factors of size and limited market as such, and to establish the quality of the appraisers, the completeness of data available to them, and the abundance of evidence to support the taxpayer's position. By early establishment of a strong position, litigation may be avoided.

Some of the cases where the "blockage rule" was denied give the impression that the case was lost to the taxpayer because of his evidence being "too little and too late." It appears in other instances that after a tax determination was made, the taxpayer had, as an afterthought, attempted to offset an unexpected increase in his taxes by asserting the "blockage rule" to reduce his own appraisers' figures. Under certain circumstances it may be possible to accomplish this, but it obviously makes a far from simple task more difficult. There is a natural tendency on the part of a field agent to feel that a value submitted to the Government for tax purposes is not going to be overstated, unless by infrequent error. The preponderance of tax deficiencies over over-assessments supports the accuracy of this inclination. When the taxpayer has failed to consider the effect of "blockage" in his initial appraisal or in his tax return, and then

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29. See p. 704 supra.

30. 24 T.C. 829 (1955).

at a later date attempts to invoke the rule, his problem is doubly burdensome, though not necessarily impossible. The courts, too, may be inclined to discount what appears to be a taxpayer's afterthought.

If after submitting a return, a field agent, upon examination, disregards the evidence of the appraisal and other data and denies the element of "blockage," the issue should be pressed both in informal conference, if one is had, and before the Appellate Staff, unless it is decided to pay the tax and sue on a claim for refund. Such claim when filed will usually be disallowed as a matter of form if it is clear that the purpose of the claim is to put the issue before a district court. In presenting the case for imposition of the "blockage rule" one should not overlook the point that "blockage" is merely one of many factors which must be considered in establishing value.

#### "BLOCKAGE" AND REAL ESTATE VALUES

The "blockage rule," as defined and applied in all decisions to date, has been limited to cases involving valuation of stocks, bonds, or similar securities. "Blockage" is not recognized with respect to real estate, nor with respect to other assets than those aforementioned. This is true, although in many parts of the country the size of a block of real estate is perhaps as influential upon selling price as any one other factor. One of the reasons for its importance, particularly in recent years, has been the increase in the price of real estate generally, making it more difficult to locate persons desiring property within a given area, who have either the cash or credit with which to purchase.

In Western Kansas, as of two or three years ago, it was not uncommon for first class dry quarters (approximately 160 acres of unirrigated land) to sell at \$20,000 a quarter. Because of a fear of drought and other weather factors, the maximum loan available on such land from commercial sources, such as insurance companies, was \$4,000. The Federal Land Bank loans would not exceed commercial loan levels in ordinary cases. Under such circumstances, a purchaser had to put up at least \$16,000 a quarter in cash, or have available other substantial security to buy.

As a practical matter the Internal Revenue Service has long recognized that a subdivision of 1000 lots is not worth a million dollars because a few lots have been sold out at \$1,000 per lot. It is recognized that years may often be required to sell all of the subdivision. However, the Service recently did attempt to value over eighty quarters of top grade land at the average selling price of three or four quarters. The land in question was all in one county, and was being valued for estate tax purposes. In conference it was shown that in three years only nine comparable quarter sections had been sold, and that to purchase the eighty plus quarters would have required more money than had been expended in that county

for land of all types during the past several years, even though the years in question had been the best in the county's history. The conferee refused to recognize the size of the block involved, but the case was satisfactorily settled by other adjustments. The graphs and tabulations submitted in support of the taxpayer's position as to the land values may or may not have entered into the settlement finally effected. Of course the size of the block in such a case actually causes difficulty in selling the property at the prevailing price—in some cases, at any price, if buyers with sufficient funds are not available.

In some cases the courts have refused to consider difficulty or probable difficulty in selling real estate. One such case was *Estate of H. E. Huntington*.<sup>31</sup> It is possible that the refusal in this case may have resulted from a conflict in experts' testimony as to the amount of discount to be taken for such probable difficulty. A much more recent case recognizes the difficulty of securing a purchaser as constituting an element of value.<sup>32</sup>

While the courts do not recognize the "blockage" rule, as such, with respect to real estate, they recognize many other factors involving the nature of the interest or block. One which is frequently recognized is the effect of a fractional interest on price. Because of difficulty in selling a fractional interest, a New York court allowed a discount of twelve and one-half percent on such an interest in property located in New York City.<sup>33</sup> In a still later case, the court allowed a discount of fifteen percent on an undivided minority interest in jointly owned improved real estate, but refused to increase the discount because of the control of the Alien Property Custodian over the interest of one of the other joint owners.<sup>34</sup>

It is difficult to understand, after considering all of the cases ordinarily cited in real estate valuation matters, and after considering the security cases where the "blockage" rule has been either invoked or denied, why the same rule should not be recognized in real estate cases and perhaps in cases involving other assets. There is no question that the size of a holding may make it difficult to sell. An examination of the results of public sales of land clearly establishes that once a saturation point is reached, prices decline sharply. Failure to recognize the size of the block ordinarily results in overvaluation whether in the case of stocks, bonds, securities, land or other assets. One of the largest estates to be probated in Kansas in recent years held a public auction of a part of its very large land holdings. One item sold was a large ranch. It sold several dollars an acre under its tax appraised value as finally determined by a representa-

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31. 36 B.T.A. 698 (1937).

32. *Estate of James D. McDermott*, 12 CCH Tax Ct. Mem. 481 (1953).

33. *Estate of Nina M. Campanari*, 5 T.C. 488 (1945).

34. *Estate of Clarence S. Herter*, 13 CCH Tax Ct. Mem. 298 (1954).

tive of the Internal Revenue Service. The value fixed by the Service was apparently based on the sale of other grass land in the vicinity in substantially smaller tracts. It appears that the size of the ranch substantially depressed its sale price per acre.

In many years of dealing with the valuation of real estate for gift, income, and estate tax purposes, the author has found that many elements are given consideration and weight by the Revenue Service in addition to sales of similar property. This is particularly true where sales are few, and where there is a question as to whether certain of the sales were open market sales. Some of the factors that are considered include whether a section of land is "square" or "contiguous." It is rather uniformly held that a square section of ground consisting of four quarters of approximately 160 acres each, is worth more than a section consisting of four adjacent quarters making up parts of three different sections. The holding of the Internal Revenue Service seems to conform on this point with actual sales. The Internal Revenue Service will give consideration to acres lost out in wet seasons on account of "lagoons" on flat sections.

Where a farm "spread" is well located with respect to the farm home and buildings, and is large enough to constitute a sound economic unit, the value placed on such a farm will be on a unit basis and somewhat higher than, for example, that placed on a well improved quarter section. The reason is that it is general knowledge, in this area at least, that a quarter section will not support a farm enterprise by itself.

It has been found, in evaluating oil and gas leases held for future development, that a "solid block" will be valued higher than a "checkerboard block," and that each type of block will be valued at more than isolated scattered leases which would ordinarily be valued at a nominal dollar an acre in an area where there is little or no oil or gas production at the present time.

It is anomalous that when the Internal Revenue Service purports to consider "all factors and elements of value" in valuing all assets and goes to such lengths to do so, it has consistently refused to recognize the effect of the size of a block or of the holdings of an individual and the effect they would have upon the market at valuation date in the event that they were sold. The only circumstances under which size or extent of holdings enters into Internal Revenue Service consideration seems to be where there is difficulty in selling the holdings.

#### CONCLUSION

As stated earlier,<sup>35</sup> it is difficult to understand why the "blockage rule" as defined and used in tax decisions to date is always limited to downward

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35. See p. 704 and note 12 *supra*.

adjustments. It would appear, after giving consideration to the decisions, that the rule could well be applied for the purpose of increasing value under certain circumstances. The Internal Revenue Service's holding that a block of stock which carries control should receive a higher valuation for tax purposes than one that does not is an example of how "blockage" could be applied to raise value.

It would also appear that the "blockage" rule could be extended to cover any class of assets, whether they be stocks, bonds or other corporate securities presently governed by the rule, or whether they be real estate or other holdings. The ends of justice would appear to be well served by such an extension. It is further suggested that application of the rule might well take into account the nature of the block of assets as well as its size.