Opinion No. 63-46

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BY: OPINION of EARL E. HARTLEY, Attorney General

TO: Mr. Charles C. Brunacini Commissioner of Revenue State Capitol Santa Fe, New Mexico

QUESTION

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If a husband and wife enter into a contract whereby, upon the death of one of them, the survivor has the option to purchase the separate property of the deceased, does the purchase price specified in the contract represent the value of the property for succession tax purposes?

CONCLUSION

Yes, in certain circumstances, but see analysis.

OPINION

*{*95}* **ANALYSIS**

The question posed is one of first impression in New Mexico. It must be answered in light of our appraisal statute, Section 31-3-5, N.M.S.A., 1953 Compilation, which requires an estate to be appraised "at its full value" at the time of death. The question really is whether the existence of the option fixes full value. At first glance, anyone is likely to answer with an emphatic "no", since it is generally conceded that private persons *{*96}* may not, by contract, restrict the state in making valuations for estate tax purposes. A review of a large number of cases on the question, however, leads to a different conclusion under certain circumstances.

The facts out of which this particular question arises are as follows: A man and woman, each the owner of separate property, enter into a joint business venture to which they devote their separate property. Through the years, they acquire vast holdings, principally in oil and gas. Part of these holdings are located in New Mexico. After going into business, the men and women marry. Subsequent to their marriages, they enter into an agreement whereby either of them who desires to withdraw from the business must offer to sell his or her share to the other at one and one-half times the then book value of the property, which is determined on the basis of cost of acquisition and equipping the property, less depletion and depreciation, and losses on abandonment. The offer must be accepted within 90 days. The agreement further provides that, upon the death of one of the parties, the survivor shall have the option to purchase properties

owned by the decedent at one and one-half times the book value on the date of death. The agreement requires the option to be exercised within six months of the date of death.

The wife died, and was survived by her husband and three children whom she had adopted during a previous marriage. Her death occurred some seventeen months after the date of the option agreement. She left a will devising her New Mexico properties to her husband, and among other things, designating the adopted children as residuary legatees. Her husband filed a timely exercise of the option to purchase, but took the property under the will and did not pay the option price. The option price, at one and one-half times book value, comes to $ 531,789.24. Estimates of the full value of the New Mexico properties, in the absence of agreements affecting their value, run substantially higher.

The problem is annotated at length at 5 A.L.R. 2d 1122, et seq., from which we quote at page 1123:

"While it is not disputed that it is not competent for individuals, by means of a private agreement, arbitrarily to restrict the right of the government to impose taxes upon the actual value of the property, many cases are to the effect that a contract or bylaw fixing the price at which specific property may or must be sold, purchased, or offered for sale should be given consideration, although it is not necessarily controlling, in the valuation of such property for the purpose of the assessment of an estate, succession or gift tax. It is recognized that the effect of such a restrictive agreement or provision must be determined in the light of its peculiar factual situation."

In order to give controlling effect to an agreement such as we have here, the decided cases have established several tests that the agreement must meet.

Did the option exist prior to death? This question must be answered "yes", because either of the parties, upon withdrawal from the business, was required to offer his or her interest to the other at a price fixed by the formula.

Was there an adequate consideration? The answer in this case *{*97}* would seem to be "yes", in view of the formula agreed upon, the speculative nature of oil and gas properties, etc. A figure of one and one-half times book value would not appear to be an inadequate consideration.

Was the agreement entered into in good faith for a business purpose? Again, the answer is "yes", in view of the fact that the business involved was commenced prior to marriage, and also considering the natural desire of the owners to provide for continuity of ownership, to avoid fragmenting the ownership upon the death of either, and to impress upon persons with whom the husband and wife did business that one or the other of them would continue to own and manage the business despite the death of either.

Was the agreement mutual?

Yes, it was binding on both parties.

Was the holder of the option the natural object of the bounty of the deceased? This element is important in those cases where the holder of the option could rightfully expect to inherit or be devised the interests that are subject to the option. A low option price in such circumstances suggests an attempt to evade our succession tax. However, in the instant case, the surviving husband did not necessarily have any expectation of being devised his deceased wife's property. Her three adopted children were likely the primary object of the wife's bounty, and, had she died intestate, would have inherited the bulk of her separate estate. Hence, the agreement under consideration does not appear to have been an attempt to evade our succession tax laws.

Was the agreement simply an attempted testamentary disposition? No. This agreement existed during the lifetime of each of the parties to the agreement, and was entered into some seventeen months before the death of the wife. It was a vested right during life.

Did the agreement operate to restrict the owner's disposition of the property during life? Yes. The agreement was mutual and binding on the parties during their respective lives.

Was the agreement revocable, or was it specifically enforceable? This agreement concerned oil and gas properties, which are considered interests in real property in New Mexico. Hence, the agreement was specifically enforceable, and could not have been revoked by either party.

From the foregoing analysis, it appears that the agreement in question meets every test established by the decided cases to give it controlling effect in setting the value of the property for estate tax valuation purposes.

One issue remains to be examined. As noted above, the surviving husband, holder of the option, actually took his interest in the property under the will, and did not pay the option price for the properties, although he filed written notice of election to exercise the option. This, at first glance, would lead to the conclusion that the option was not in fact exercised, that it therefore lapsed and no longer exists to effect the value of the property. However, in valuing property for estate tax purposes, we must remember that the value in question is value at the time of death. At the time of death in this case, the option was outstanding, and it is not permissible *{*98}* to speculate on whether or not it would be exercised. This was the holding of the court in **Wilson v. Bowers,** 57 F.2d 682, and **Lomb v. Sugden,** 82 F.2d 166.

In conclusion, it is our opinion that where a man and wife are business partners and enter into an agreement requiring either to offer to sell to the other his or her interest in the business property in case either desires to withdraw from the business, and granting to the survivor of them an option to purchase the interest of the first of them to die, and

where the option existed prior to death, was based on an adequate consideration, was entered into in good faith for a business purpose, was mutual rather than unilateral, was not an attempted testamentary disposition, was not revocable at the instance of either party, but was enforceable, and where the option was not granted to the natural object of the bounty of the deceased, then the purchase or option price as stated in the agreement, or computed from a formula contained in the agreement, should be accepted by the New Mexico taxing authorities as the value of the property for estate tax valuation purposes. Each case will have to be reviewed in light of its particular facts to determine whether all the tests prescribed by law have been met.

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