

New Tax Case Tackles Key Aspects of Private Company Value

Estate of Gallagher v. Commissioner, T.C. Memo. 2011-148, 2011 WL 2559847 (U.S. Tax Court)(June 28, 2011)

The decedent owned 15% in a private Subchapter S corporation that held various newspaper assets. When she died in July 2004, her estate valued her 15% share at \$35 million based on an appraisal by its CEO, but the IRS said it was worth closer to \$50 million. At trial before the Tax Court, both sides enlisted new appraisers and closed the gap slightly: \$28 million for the taxpayer versus \$41 million for IRS. In particular, they disputed four broad aspects of the valuation:

1. *Date of financial information.* The IRS's expert relied on second quarter 2004 financial information, even though it was published after the July 2004 valuation date. In contrast, the taxpayer's expert relied on the most recently published financial data (March 2004), claiming that a willing buyer and seller would be unaware of any subsequent information. The court found the second quarter data more accurately depicted market conditions as of the valuation date, and that a hypothetical buyer was likely to elicit the non-public information in its due diligence.

2. *Adjusted financial statements.* The court disregarded any adjustments to financial statements for non-recurring expenses which the taxpayer's expert failed to adequately explain or support.

3. *Market approach.* Both experts used the guideline public company method (GPCM), but the taxpayer's expert ultimately rejected it, due to the lack of sufficient comparables, while the IRS accorded it equal weight. The GPCM is "generally accepted" for valuing a private company, the court found. But in this case, only one of the comparables was arguably similar enough, and a "single company is insufficient on which to base the valuation method," the court ruled.

4. *Adjustments to the DCF.* Overall, the court agreed with the taxpayer's expert that the discounted cash flow (DCF) analysis was the more appropriate for valuing the closely held company. But it rejected his growth rates because they were based on industry

data, preferring the IRS's expert's rate (4.5%) based on company-specific revenues.

Not surprisingly, the IRS's expert declined to tax-affect the S corporation's earnings, but the taxpayer's expert applied a 39% rate. He failed to adequately explain his reasons, however, and, based on prior case law, the court declined to impose "an unjustified fictitious corporate tax rate burden on [the company's] future earnings." For the same reasons, it rejected the taxpayer's expert's cost of equity that used a 40% corporate tax rate and his DCF adjustments based on "S shareholder tax savings."

As for the company's weighted average cost of capital (WACC), the court once again criticized the taxpayer's expert for failing to explain his calculations, particularly his determinations of a firm-specific risk premium. The court also observed that WACC might be an improper rate to assign to a company that was planning to pay down its debt, but nevertheless adopted the debt/equity ratio (75/25) used by the IRS's expert to conclude an overall WACC of 10%.

Discounts need supporting data. The IRS's expert derived a 17% minority discount based on the inverse of control premium data for the newspaper publishing industry. Interestingly, the taxpayer's expert declined to apply one, because his DCF already resulted in a

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minority interest value, he said. The court rejected this approach and adopted a 23% discount, based on its findings that, this time, the IRS's expert failed to adequately support his selection from industry data.

The experts were only 1% apart on their discounts for lack of marketability, and the court adopted the 31% used by the taxpayer's expert, given his slightly better review of the data and the holding periods at issue. Based on all its findings, the court held that the decedent's 15% share in the company was worth \$32.6 million as of the valuation date—notably, not too far off from the CEO's original appraisal.

Is a Buy-Sell at Book Value Unconscionable, When FMV is 60x Greater?

Estate of Cohen v. Booth Computers, 2011 WL 2694288 (N.J. Super)(July 13, 2011)

A father created an income-producing partnership on behalf of his three grown children, funded in part with Palm Beach property originally purchased for \$750,000. In keeping with its closely held nature, the partnership agreement provided that, on a partner's divorce or death, the remaining partners "shall" repurchase the divorced/deceased partner's shares at the "true value" of the partnership, defined as "net book value" based on the most recent financial statement, plus \$50,000.

In 1997, one of the partners died, and the partnership paid the estate \$97,650 for the decedent's interest, based on the buyout provision. By the time one of the two remaining partners died in 2007, the oceanfront property had appreciated to \$45 million. An appraiser for the deceased partner's estate estimated the "full" or fair market value of the partnership at just over \$23 million, based on the net asset approach, which, when added to the appraised value of all of the partnership's properties, exceeded \$68 million.

Nevertheless, the partnership paid the deceased partner's estate just over \$177,800, based on the buyout provision and the financial information as of the date of death. The estate sued the partnership, requesting specific performance of the buyout provision at its "true value" of \$68 million. Given the gross disparity between fair market value and net book value, any other interpretation was unconscionable and voided the buy-sell provision, the plaintiffs said.

At trial, the partnership presented a CPA expert, who concluded that the purchase price of \$177,800

accurately reflected the partnership's book value. Moreover, the partnership's books shouldn't have reflected the fair market value of the Palm Beach property, the CPA expert explained, because the tax code and generally accepted accounting principles require investment property to be recorded at cost.

The trial court agreed, finding that the partnership had always booked its assets at cost rather than market value. This historic treatment comported with the "plain language" of the partnership agreement, which clearly pegged the buy-out price to book value (as it did when one partner died in 1997). Under these facts, there was nothing "inherently offensive" in the buyout formula, the trial court held, and the estate appealed.

"We recognize the disparity between net book value and fair market value," the appellate court observed, yet the disparity, alone, was not sufficient to "shock the judicial conscious." The controlling factor is the language of the partnership agreement, which in this case was clear and comported with standard definitions of book value, the court held, and affirmed the buyout at net book value.

Valuing Contingency Claims: How to Factor Subsequent Events

IRC Sec. 2053 and related Treasury regulations provide that an estate may deduct a claim in effect at the date of death, even "though its exact amount is not then known, provided it is ascertainable with reasonable certainty, and will be paid." Currently, there is a split among the federal circuits regarding the use of "post-death" events when determining the value of contingent claims. Two new Tax Court cases—decided on the same day, by the same judge (Cohen)—successfully sidestepped this conflict by focusing on whether the large disparity between a taxpayer's and the IRS's appraisals provides sufficient evidence that the contingent claims are not "ascertainable with reasonable certainty."

1. *Estate of Saunders v. Commissioner*, 136 T.C. No. 18 (April 28, 2011). In this case, the estate claimed a \$30 million deduction related to litigation pending at the decedent's 2004 death. The estate eventually settled the case in 2007 for approximately \$250,000, and the IRS subsequently disallowed the deduction, permitting only a nominal amount (\$1.00) and asserting a \$14.4 million deficiency.

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At trial, the estate submitted the original appraisal plus a supplement prepared by the attorney in charge of the litigation, which reasserted the \$30 million valuation. The estate also presented an independent expert, who valued the claims at \$25 million under a “decision tree” analysis. Lastly, a plaintiff’s attorney concluded the claims had a “risk-adjusted” value of \$22.5 million.

The IRS submitted two appraisals. The first, prepared by an attorney, said that the claims had “at most a 3% chance of recovery.” The second report, by an IRS appraiser, used a “probability-adjusted, net present value” analysis to value the claims at \$3.2 million.

The Tax Court confirmed the validity of the valuation methods, but also recognized the different extent to which federal jurisdictions consider post-death events when valuing contingent liabilities. To avoid this “minefield,” the court found that the “stark” differences among the six appraisal reports reinforced the uncertainties inherent in valuing the claims. “Stating and supporting a value is not the same as ascertaining it to the required degree of certainty,” it said. Section 2053 expressly contemplates that some claims will be simply too uncertain at the time of death to be taken as a deduction. Since none of the estate’s experts could reasonably opine that the estate would pay the \$30 million liability (or any specific lesser amount), the court denied its deduction.

2. Estate of Foster v. Commissioner, 2011 WL 1598633 (U.S. Tax Ct.)(April 28, 2011). This case concerned ERISA claims asserted against the estate, for which it claimed a \$14.7 million deduction, and possible litigation on behalf of the estate, for which it reported no value. After the ERISA claims were dismissed and the estate received nearly \$18 million to settle the litigation, the IRS assessed a deficiency of nearly \$15 million.

At trial, the parties asserted widely disparate positions on the likely resolution of the various contingency claims and their respective values at the date of death. Once again, the Tax Court avoided the potential “minefield” of subsequent events by citing its rationale in *Saunders*. There, “we declined to attempt to reconcile these cases and did not consider the effect of a post-death settlement of a claim against the taxpayer-estate,” the court said, “because we instead found that the value of the claim was not ascertainable with reasonable certainty on the valuation date.”

Similarly, in this case the “sharp discrepancy” in the experts’ figures evidenced “a lack of reasonable

certainty in the values they suggested” and an inability to “reasonably opine” that the estate would have to pay any of the suggested amounts, the court said, and denied the estate’s deduction for the ERISA claims. As for the claims held by the estate, the parties’ experts were equally “overzealous,” the court said. The estate’s appraiser concluded that only one claim had any value (\$33,000) at the time of death, while two IRS appraisers said the claims were worth \$5.1 million. As a result, the court had little confidence that either side’s appraisers were “objective and reliable.” Based on its own findings regarding the probabilities of success, the court valued the litigation as of the date of death at \$930,000.

Statutory Fair Value: Courts Tackle DLOM, BIG Discounts, and Burden of Proof

From New York to Nevada, courts are still struggling to interpret the standard of value in statutory fair value determinations, including whether to include discounts for lack of marketability (DLOM) as well as discounts for built-in capital gains (BIG), and which party bears the ultimate burden of proof. Expert appraisal evidence (or its absence) can prove critical to the courts’ ultimate conclusions of fair value.

In *Gaiimo v. Vitale*, 2011 WL 1549064 (N.Y. Sup.) (April 25, 2011), a special referee determined the statutory fair value of a 50% interest in a family business that owned and operated 19 Manhattan apartment buildings. Although he declined to apply a marketability discount to the net asset value (NAV), he did accept a present value discount for built-in capital gains (BIG) tax liability, based on expert evidence. After the trial court adopted the special referee’s findings, both parties appealed the application of discounts to statutory fair value, which is unsettled in New York.

In particular, New York has not adopted the amendments to the Model Business Corporation Act (MBCA), which prohibit marketability and minority discounts in statutory fair value appraisals. Instead, New York courts determine fair value based on a going concern standard, which precludes a minority discount but should account for the shares’ illiquidity, the appellate court held. An expert can capture this risk through a marketability discount or the selection

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of a cap rate or even in the assessment of goodwill value. Thus, the court rejected the referee's rationale for omitting a marketability discount but approved his ultimate conclusion of value, based on the inherent discretion in the standard and the "ample" evidence that due to the lack of similar properties in the market, a prospective buyer would have to purchase through the parties' corporation.

Based on this same evidence, the court found a "sound legal and factual basis for the referee's decision to reduce the BIG to present value" and rejected the argument that no BIG deduction should apply or, alternatively, that the court should make a dollar-for-dollar deduction. Although other jurisdictions might preclude a BIG discount unless there is evidence of an imminent sale, "New York follows the contrary view that it is irrelevant whether the corporation will actually liquidate its assets," the court held.

Similarly, in *Dawkins v. Hickman Family Corp.*, 2011 WL 2436537 (N.D. Miss.)(June 13, 2011), several dissenting shareholders requested a judicial dissolution and buyout of their nearly 40% combined interest in a family business that held primarily farmland. Although they declined to submit an appraisal, the corporation presented an expert who determined that the NAV of the partnership was worth \$225,000, after application of a BIG discount. The federal district court accepted this value and the plaintiffs moved it to reconsider the discount.

The court denied the request. Although state law precluded the application of minority and marketability discounts, "a tax adjustment must be taken into account" to determine "actual fair value of the shares," the court held. The current tax basis of the farmland was less than \$20,000, creating a substantial liability on sale. "From even just a fairness standpoint, it only makes sense to include the built-in capital gains tax liability when valuing the corporation *based on its assets*," the court emphasized, in confirming its

original findings of fair value.

In *American Ethanol, Inc. v. Cordillera Fund, LP*, 2011 WL 1706823 (Nev.)(May 5, 2011), the Nevada Supreme Court faced an issue of first impression: which party bears the burden of proving fair value under the applicable statute in a dissenting shareholder case. Like New York's, Nevada's dissenting shareholder statute is patterned after the original MBCA, without the subsequent amendments that bar discounts. "Like other [MBCA] states, we conclude that, in determining fair value, the trial court may rely on proof of value by any technique that is generally accepted in the relevant financial community, but the value must be fair and equitable to all parties," the court held, citing cases from Minnesota, Colorado, and New Jersey.

The court also noted that various jurisdictions place the burden of proving fair value on the corporation, the stockholder, or neither. Delaware's corporate laws, like Nevada's, leave the ultimate determination to the trial court. Rather than imposing the "no burden" approach (as in New York, for example), Delaware courts require both sides to support their respective valuation positions "by a preponderance of the evidence," the Nevada court explained, leaving the trial court to make independent determination. Since the Delaware approach accords with concepts of judicial fairness as well as economy, the Nevada court adopted its "flexible" standard, finding in this particular case that the trial court did not err when it determined fair value according to the dissenting shareholders proof of a recent merger price plus SEC documentation of the same.



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