TAXATION

CALIFORNIA LAWYERS ASSOCIATION

presents

2023 Estate and Gift Tax Conference

Tax Court Panel-Valuation

Friday, March 10, 2023
1:00 pm - 2:30 pm

Speakers:

John Prokey

Mark Higgins

Judge Halpern

Jenny Casey

Conference Reference Materials

California Lawyers Association
2023 Estate and Gift Tax Conference

Tax Court Panel - Valuation

A Primer on Business Valuation

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Mark was formerly a corporate banker, holding a variety of management positions with Security Pacific Bank, Bank of America, and Wells Fargo. Mark earned an MBA with honors from the University of Southern California, where he earlier received a BS in Finance and Business Economics. Mark is a frequent guest lecturer in undergraduate and graduate business courses and has been a speaker at numerous regional and national conferences on subjects related to valuation, economics, and banking.

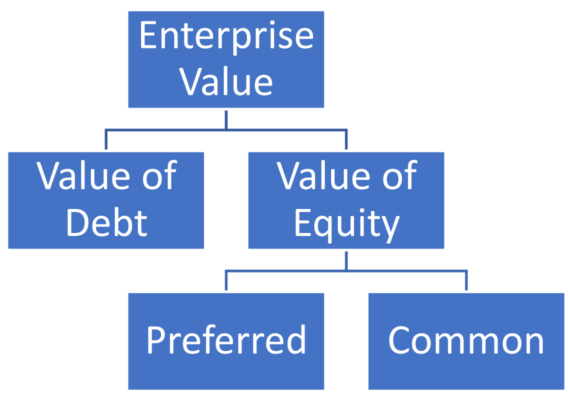
I. OVERVIEW

A. The material below is presented in detailed outline form and arranged by topic. The subjects addressed include:

1. **Components of Business Value**
2. **Drivers of Business Value**
3. **Valuation Contexts and Standards of Value**
4. **Appraiser Qualifications and Report Standards**
5. **How to Find a Qualified Appraiser**
6. **What Should the Appraiser Do?**
7. **Review of Appropriate Methodology**
8. **Update on Valuation Discounts**
9. **Special Issues in Valuing S Corporations**
10. **Defined Value Clauses**

II. COMPONENTS OF BUSINESS VALUE

A. As illustrated in the chart below, the total value of a business is its enterprise value. Enterprise value includes the value to both the holders of debt and equity in the business. In some cases, the equity value is allocated among multiple classes of investors. This capital structure can be quite complex in some businesses, leading to "waterfalls" of returns among investors with an array of prioritized returns. Such capital structures are often seen in complex real estate development entities or development-stage companies that have been funded with multiple rounds of private equity investment.



III. DRIVERS OF BUSINESS VALUE

A. The fundamental drivers of the value of any business (or essentially any financial investment) are as follows:

1. **Earnings (most importantly cash flow)** Investors in businesses are buying a stream of future cash flows. The value of a business rises and falls with the level of these expected future cash flows.

2. **Growth** Value is also positively correlated with expected growth. All else being equal, investors will pay more for future earnings that are expected to grow at a greater rate.

3. **Required Rate of Return (”Discount Rate”)** Investors in our increasingly global economy are presented with a huge array of investment alternatives. The required rate of return for a business is a rate that would compel an investor to invest in a stream of expected future earnings generated by that business. This rate of return is a function of prevailing interest rates at the time of the investment, together with an assessment of the relative risk of a particular business. The value of a business falls as the required rate of return rises, and vice versa.

IV. VALUATION CONTEXTS AND STANDARDS OF VALUE

A. Each business appraisal involves a specific context and accompanying standard of value. Appraisers must understand the appropriate framework and conduct their work accordingly. The business appraisal profession has been evolving into two increasingly distinct practice areas in recent years, commonly referred to as "Fair Value" appraisals and "Fair Market Value" appraisals. Fair Value appraisals are performed primarily for financial reporting purposes. Such appraisals include contexts such as purchase price allocation in business combinations and goodwill impairment studies. In a general sense, Fair Market Value appraisals refer to every other appraisal context, including sub-specialties like estate and gift taxes, income taxes, employee stock ownership plans, eminent domain, and divorce. Each appraisal context is accompanied by a specific standard of value and regulatory requirements that must be followed.

B. In my experience, individual appraisers (and in many cases appraisal firms) are selecting one track or the other. Sub-specialties are also often selected. As with all professions, appraisers are driven to such specialization by an expanding and dynamic body of knowledge and array of regulatory requirements. Professional appraisal organizations are reflecting this trend by increasingly differentiating their continuing education programs along these two tracks.

C. Much of the information in this material is applicable to both appraisal tracks and many of the specific contexts within those tracks. One of the more active and dynamic contexts involves federal transfer (estate and gift) tax matters. Many of the specific subjects discussed in this material relate primarily to that context.

D. The primary valuation contexts and associated standards of value are as follows:

1. **Federal Tax Matters** Under Treasury Regulations Section 20.2031-1(b), the value of property includible in a decedent's estate is determined on the basis of its fair market value. Treasury Regulations Section 25.2512-1 also requires that the value of property transferred by gift be determined on the basis of its fair market value. The Treasury Regulations applicable to income tax matters, including charitable deductions, also require the fair market value standard. Fair market value is defined by the Treasury Regulations as: "The amount at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."

2. **ESOPs** The standard of value in the context of employee stock ownership plans is also fair market value. The definition of fair market value for that context is set forth in the U.S. Department of Labor's *Proposed Regulation Relating to the Definition of Adequate Consideration*, issued May 17, 1988, as follows: "Fair market value is the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset." Additional requirements are included in proposed regulations issued by the U.S. Department of Labor. These factors are set forth by Proposed Regulation 29 CFR § 2510.3-18(b)(2)(i). Among other things, care must be taken to consider the value implications of the "put" provisions associated with employee stock ownership plans.

3. **Divorce** The standard of value in marital dissolution is a function of state statute and case law. It therefore varies from state to state. (In California, for example, the standard of value is "investment value" as set forth in *In re Marriage of Hewitson*, 142 Cal. App. 3d 874, 191 Cal. Rptr. 392 (1983).)

4. **Financial Reporting** The standard of value in financial reporting matters is typically fair value, as defined by accounting standards and securities regulations. U.S. generally accepted accounting

principles (“GAAP”) defines fair value as: “The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

5. **Eminent Domain** The standard of value in eminent domain matters is a function of state statute and case law. In California the standard of value is the familiar fair market value, but is defined in the Code of Civil Procedure as: “The fair market value of the property taken is the highest price of the date of valuation that would be agreed to by a seller, being willing to sell but under no particular or urgent necessity for so doing, nor obliged to sell, and a buyer being ready, willing, and able to buy but under no particular necessity for so doing, each dealing with the other with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available.”

6. **Dissenting Shareholder Rights Actions** The applicable standard is usually fair value as defined by state statue and case law.

7. **Buy-Sell Agreements** The applicable standard is as defined by the parties to the agreement. (And, absent a clear definition, can be a source of confusion and conflict.)

V. APPRAISER QUALIFICATIONS AND REPORT STANDARDS

A. Appraiser Qualifications

1. Neither the “Adequate Disclosure” regulations nor any other statutory source provides a definitive test for what constitutes a qualified appraiser in a transfer tax context. Unlike real estate appraisers, business appraisers are not licensed by the state, so that bright-line distinction is unavailable.

2. The regulations do require that appraisers be independent, that they hold themselves out as appraisers on a regular basis, and that they have the appropriate training, experience, and professional credentials to appraise the subject real or personal property. No reference is made to any specific credentials. However, it seems prudent to use an appraiser who holds a professional credential from a widely recognized appraisal organization.

3. In 2006, the IRS issued Notice 2006-96 which defined “qualified appraisal” and “qualified appraiser” for purposes of substantiating property for which a charitable deduction in excess of $5,000 is claimed.

    a) Section § 170(f)(11)(E)(i) defines “qualified appraisal” as one that is:

(1) Treated as a qualified appraisal under regulations or other guidelines prescribed by the Secretary;

(2) Conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations

b) Section § 170(f)(11)(E)(ii) defines "qualified appraiser" as an individual who:

(1) Has earned an appraisal designation from a recognized professional organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary;

(2) Regularly performs appraisals for which the individual receives compensation;

(3) Demonstrates verifiable education and experience in valuing the type of property subject to the appraisal;

(4) Has not been prohibited from practicing before the Internal Revenue Service at any time during the 3-year period ending on the date of the appraisal.

c) IRS Notice 2006-96 provides further guidance regarding generally accepted appraisal standards and experience requirements.

(1) Generally accepted appraisal standards must be consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice ("USPAP"), as developed by the Appraisal Standards Board of the Appraisal Foundation.

(2) Minimum education and experience is also defined in the Notice.

(a) Real property appraisers must be licensed or certified for the type of property being appraised in the state in which the appraised real property is located.

(b) Non-real property appraisers must have i) successfully completed college or professional-level coursework that is relevant to the property being valued; ii) obtained at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued; and iii) fully described in the appraisal the appraiser's education and experience that qualify the appraiser to value the type of property being valued.

4. There are a number of professional associations that confer professional designations, including:

   a) The American Society of Appraisers, which offers the Accredited Senior Appraiser ("ASA") designation. The American Society of Appraisers was established in 1936. It offers professional training and certifications in a variety of appraisal disciplines, including business valuation, real property, and a variety of personal property.

   b) The National Association of Certified Valuators and Analysts ("NACVA"), which offers the Certified Valuation Analyst ("CVA") and Master Analyst in Financial Forensics ("MAFF") designations. NACVA is also the organization for legacy holders of the Certified Business Appraiser ("CBA"), Master Certified Business Appraiser ("MCBA") and Accredited in Business Appraisal Review ("ABAR") designations, although no new certifications are being offered. NACVA was established in 1990 for the accounting profession. The CVA designation was initially only available to CPAs, but is now available to non-CPAs who meet certain requirements.

   c) The American Institute of CPAs ("AICPA"), which offers the Accredited in Business Valuation ("ABV"), Certified in Entity and Intangible Valuations ("CEIV"), Certified in the Valuation of Financial Instruments ("CVFI"), and Certified in Financial Forensics ("CFF") designations. While targeted at CPAs, the AICPA allows certain non-CPA members of the AICPA to earn these credentials. The AICPA dates back to 1887.

B. **Report Format and Standards**

1. There is limited statutory or regulatory guidance as to what constitutes an acceptable appraisal report. Given that lack of guidance, combined with increased scrutiny of appraisal reports by the IRS, it has become common practice in transfer tax matters to have appraisers prepare reports that conform to the Uniform Standards of Professional Appraisal Practice ("USPAP"). (This is particularly true since the IRS explicitly cited USPAP as an example of acceptable standards in IRS Notice 2006-96.)

2. It is important to note that USPAP contains provisions for an abbreviated form of report called a "Restricted Appraisal Report." This form of report is restricted to the use of knowledgeable insiders only and is not to be relied upon by third parties (like the IRS). This

form of report is tempting because it is generally less costly to the client. However, it is not appropriate to attach to an estate or gift tax return. Ironically, an abbreviated report could satisfy IRS requirements in a given case. But in that case it could not also be represented to conform to USPAP.

VI. HOW TO FIND A QUALIFIED APPRAISER

A. Unlike real estate appraisers, business appraisers are not licensed by the state. No minimum standards are mandated by any government agency.

B. Look for stability and longevity. Your appraiser may have to support his or her work years after the initial assignment is completed.

C. Look for relevant experience, particularly if the business or valuation context is unusual.

D. Look for an appropriate educational background, including undergraduate and/or graduate degrees in areas such as finance, economics, and business administration.

E. Make sure business valuation is the person's primary vocation. (For example, some accountants "dabble" in business valuation.)

F. As with the selection of any professional, referrals from trusted sources increase confidence.

G. Obtain a detailed, specific engagement letter.

H. Appraisers charge either a fixed fee or on the basis of an hourly rate. It is a violation of professional ethics and appraisal standards to charge a fee that is contingent on a specific outcome or tied to the opinion of value.

I. The four professional associations previously referenced have websites that offer the public the ability to search for appraisers according to a variety of criteria, including geographic location and appraisal specialty. The websites for each organization are as follows:

   1. The American Society of Appraisers at www.appraisers.org
   2. The National Association of Certified Valuators and Analysts at www.nacva.com
   3. The American Institute of CPAs at www.aicpa.org

J. An *Appraiser Retention Checklist* is included as Appendix A to this material.

VII. WHAT SHOULD THE APPRAISER DO?

A. The typical steps taken by a professional appraiser are discussed in greater detail below and can be summarized as follows:

1. Clearly Define/Understand the Assignment
2. Prepare an Engagement Letter
3. Gather Information
4. Analyze the Fact Pattern
5. Develop Opinions
6. Present Opinions
7. Organize and Archive Work Papers
8. Support Opinions as Needed

B. **Clearly Define/Understand the Assignment**

1. Many problems can be avoided by first establishing a detailed, clear, mutual understanding of the assignment. A lack of such understanding on the front end of an appraisal project can lead to missed deadlines, fee disputes, or inappropriate value conclusions.
2. The specific elements that must be defined include:
   a) The purpose of the appraisal and the applicable standard of value.
   b) The formal name of the business entity.
   c) The valuation date. (This is critical because the value of a business will change over time, sometimes dramatically in a short period.)
   d) The specific business or investment interest being valued.
   e) When the opinion is needed.
   f) The form of the final work product.
   g) The fee structure.

C. **Prepare an Engagement Letter**

1. The above-referenced elements of the assignment should be captured in an engagement letter. (A checklist of suggested engagement letter elements is included in Appendix A.)
2. Engagement letters should be prepared with the understanding that they are commonly requested by the IRS as a part of the audit process.

D. **Gather Information**

1. A solid, supportable opinion of value relies upon a complete factual foundation.
2. Once an appraisal assignment has been defined and is underway, a variety of information must be gathered from the client. The appraiser should provide a clear, comprehensive checklist to the client. Such a checklist should be tailored to the specific facts and circumstances of the engagement, not conveyed in some "boiler plate" form.
3. The appraiser also gathers relevant industry and economic data. In some cases the appraiser also gathers data about comparable public or private companies.
4. After this information is gathered and analyzed, a management interview is scheduled to gain insight into the general operation of the business, its strategies and plans for the future, competitive and industry trends, etc. Site visits are also warranted for most operating companies (as opposed to an asset holding company).
5. A useful guide for appraisers is to focus on what you would want to know before personally investing in the business.

E. **Analyze the Fact Pattern**

1. Once relevant information is gathered, the resulting data needs to be carefully analyzed.
2. Revenue Ruling 59-60 establishes a framework for the factors to consider in valuing a closely held business for tax purposes. In spite of its age, these factors remain reasonable today, albeit a bit general. While relevant in substance, it is also important as a matter of form for the appraiser to cite Revenue Ruling 59-60 in tax-related valuation matters. The specific factors include:
    a) The nature of the business and the history of the enterprise from its inception.
    b) The economic outlook in general and the condition and outlook of the specific industry in particular.
    c) The book value of the company and the financial condition of the business.
    d) The earning capacity of the company.
    e) The dividend-paying capacity of the company.
    f) The enterprise's goodwill or other intangible value.
    g) Sales of stock and the size of the block of stock to be valued.
    h) The market prices of securities of corporations engaged in the same or a similar line of business and actively traded in

a free and open market, either on an exchange or over-the-counter basis.

3. Other factors commonly considered include:

   a) The stated or expected term of the entity.

   b) The terms of governing documents (such as articles of incorporation, bylaws, shareholder agreements, operating agreements, and partnership agreements) and the related benefits and restrictions attendant to the subject interest.

   c) The nature and value of underlying assets.

   d) The allocation of returns among various classes of investors.

   e) Relevant state law.

F. **Develop Opinions**

1. Valuation of the entire business

   a) Once the relevant facts have been analyzed, the appraiser then develops his or her opinions. In doing so, a variety of valuation methods must be considered. These include:

      (1) Market Approaches

      (2) Asset Approaches

      (3) Income Approaches

   b) The application of all approaches is neither necessary nor appropriate in every case. The choice of methods must be carefully tailored to the specific facts of the appraisal assignment. The appraiser must also be able to articulate the specific rationale for the methods used and not used.

   c) A more detailed discussion of these three approaches is presented later in this outline.

2. Allocation of business value

   a) Depending upon the valuation method applied and the capital structure of the business, it may be necessary to allocate the value of the entire business among various stakeholder groups, including:

      (1) Debt

      (2) Preferred stock

      (3) Various classes of common stock

      (4) Stock options or other dilutive rights

3. Calculation of pro rata value of the subject interest

a) Once value is allocated among the various stakeholders described above, the pro rata value of the subject interest is determined. This is commonly as simple as dividing the total value of a particular class of interest (such as common stock) by the total number of shares of that class of stock outstanding. In the case of partnerships or LLCs it is often a function of multiplying the fair market value of total partners' or members' equity by the specific percentage interest being appraised.

4. Application of valuation adjustments

a) The application of valuation adjustments is an important consideration in every appraisal, particularly those involving minority interests. These adjustments are typically applied to the pro rata value that is derived from the application of the methods described above. The most common of these adjustments are applied to reflect the lack of marketability and lack of control attendant to fractional interests in closely held companies.

(1) *Lack of Marketability*. Lack of marketability issues arise in the appraisal of most closely held businesses. This discount reflects the fact that there is no market for partial interests in closely-held entities.

(2) *Lack of Control or Control Premium.* Lack of control discounts are appropriate when valuing a minority interest in a closely held business. The value of an entire business is usually based on the assumption that it is owned and controlled by a single party. The lack of control discount reflects the fact that a minority owner lacks this control. Valuation data derived from transactions in public companies usually incorporate any discounts investors might require for lack of control. If you use this data to value a controlling interest in a private company, you must typically apply a control premium.

b) Other, less common, adjustments include key-person discounts and blockage adjustments.

(1) *Key-Person Discount.* This discount is applicable if one or more individuals are key to attaining the projected financial performance of a business. It is intended to recognize the risk associated with the business losing such an individual. (Such key-person risk can also be captured in the appraisal of a 100% equity interest in the business, often through the

application of a relatively higher discount rate in an income approach.)

(2) *Blockage.* This discount recognizes the fact that a large block of stock might trade at a discount to smaller blocks. This phenomenon usually applies to large blocks of the stock of thinly traded public securities.

c) When applying these discounts, one must develop a framework for comparing the subject fact pattern to the empirical data. A clear, compelling nexus is critical.

5. The Mechanics

a) Lack of marketability and lack of control discounts are applied sequentially. They are not additive. For example, a 20% lack of control adjustment and a 25% lack of marketability adjustment yield a total adjustment of 40%.

6. In any appraisal assignment, a balance is needed between quantitative analysis and a practical, "real world" perspective. A more detailed discussion of valuation discounts is presented later in this material.

G. **Present Opinions**

1. Preliminary or summary opinions are often provided in advance of a full narrative report. This allows business or estate planning decisions/ transactions to be finalized.

2. Narrative report

a) A detailed narrative report is the normal work product of an appraisal. The key elements of an appropriate appraisal report are as follows:

(1) It should be detailed and explicit, but must remain clear to the reader. This is particularly important because many readers of these reports are not intimately familiar with the business, nor are they trained in matters of financial analysis or appraisal.

(2) In most cases, the report should conform to the Uniform Standards of Professional Appraisal Practice ("USPAP"). These standards are promulgated by The Appraisal Foundation, which has been authorized by Congress as the source of appraisal standards and appraiser qualifications.

(3) In gift tax matters, it must conform to the "Adequate Disclosure" regulations.

(4) It should have an independent, unbiased tone.

b) Some circumstances allow an abbreviated "restricted" appraisal report. This is typically allowed only if the report is to be used only by knowledgeable insiders, not third parties.

c) An *Appraisal Report Checklist* is included in Appendix B.

3. In some cases, an appraiser is presenting his or her opinions in an audit, appeals, deposition, or courtroom setting. The formality and level of preparation required vary significantly with the venue.

H. **Organize and Archive Work Papers**

1. There are a variety of reasons why an appraiser's work papers may need to be accessed months or years after the work is completed. The appraiser should prepare a complete, well-organized file of the documents relied upon in performing the appraisal. This file then needs to be stored in a secure location in a manner that allows timely retrieval.

2. The appraiser should retain all work papers for a minimum of five years from the date the work is completed.

a) The appraiser should follow the standards associated with their particular professional association.

b) It is also good practice for the appraiser to consult with the client's attorney and/or CPA in individual engagements to identify any particular record retention needs.

3. Know your appraisers' record retention practices!

I. **Support Opinions as Needed**

1. After presenting his or her report, an appraiser must be prepared to support his or her conclusions, often years later. The circumstances requiring this support include:

a) Explaining opinions to clients and their advisors.

b) Participating in the audit and/or appeals processes.

c) Testifying in depositions, mediation, arbitration, or at trial.

d) Responding to inquiries (or formal discovery) from outside auditors, the Department of Labor, the SEC, or other government agencies.

2. In many circumstances, an opposing party will retain an appraiser to validate or refute your appraiser's findings.

VIII. REVIEW OF APPROPRIATE METHODOLOGY

A. There are three basic approaches to valuing a closely held entity:

1. *Market approaches* include the application of value multiples derived from comparable public companies to a private company. For example, say a comparable public company had a price/earnings multiple of 10 and the private company being valued had $100,000 in current earnings. The resulting value indication would be $1 million ($100,000 x 10). Most private companies are not large enough to allow the reasonable application of public company data. Another market approach involves an analysis of the prices paid for comparable privately held businesses in acquisitions. The quality of private company transaction databases has improved significantly over the past few years, allowing more frequent and precise application of this method[1].

    a) As a practical matter, it is important to know that market multiples are strongly and consistently correlated with business size. For example, an analysis of the DealStats database of 2022 transactions indicates the following array of EBITDA multiples:

Revenue Range	**Median EBITDA Multiple**
Less than $1 million	2.4
$1 to $5 million	3.5
$5 to $25 million	4.9
Greater than $25 million	13.6

    b) While the median multiples change each year, particularly during major events such as recessions (or global pandemics!), the positive correlation between business size and EBITDA multiples remains consistent.

2. *Asset approaches* are based upon the value of underlying assets. In a typical situation, the assets and liabilities of a business would be adjusted to reflect their market values. The resulting "adjusted net worth" would provide an indication of the total equity value of the business. This method is most appropriately applied to asset holding companies or asset-intensive operating companies. Care must be taken to consider the value of any intangible assets (such as business goodwill) when applying this method.

3. *Income approaches* involve discounting the value of expected future earnings or cash flow to a present value. This involves either an explicit forecast of future cash flow or the capitalization of current earnings. Income approaches are very sensitive to assumptions

[1] Examples of commonly used transaction databases include DealStats and BIZCOMPS, both available on a paid subscription basis.

about future earnings growth and the discount rate applied to those projected earnings.

B. The application of all approaches is neither necessary nor appropriate in every case. The choice of methods must be carefully tailored to the specific facts of the appraisal assignment. The appraisal report should acknowledge each method and include an explanation of why each method was either selected or rejected in the appraisal.

C. Appraisers can go astray in a variety of ways. Some common mistakes to look for include the following:

1. Getting "lost in the weeds". Focusing too much on the mechanics of a valuation method without first establishing a practical understanding of the subject business.

2. Overestimating or underestimating long-term future earnings growth. The risk of this error is amplified during times of significant economic growth or contraction.

3. Failing to make appropriate adjustments to reported earnings. Such adjustments often include market compensation, market rent for properties rented from related parties, unusual and non-recurring income or expenses, and non-operating assets.

4. Not capturing the value implications of excess or deficient liquidity.

5. Improper application of value multiples. For example, a multiple of EBITDA[2] results in the total enterprise value of the business. The value of debt must be subtracted from the enterprise value to arrive at the value of equity.

6. Failing to develop an adequate nexus between empirical evidence regarding valuation discounts and the specific fact pattern of the subject business.

IX. UPDATE ON VALUATION DISCOUNTS

A. The IRS continues to challenge valuation discounts from both a legal-issues perspective and from an appraisal perspective. This discussion focuses on recent developments in the appraisal aspect of this topic. Barring any legal challenge to their application, such as the various "2036" arguments, it is broadly accepted that valuation discounts are appropriately applied to fractional interests in privately held entities to reflect the lack of marketability and lack of control attendant to such interests. The primary debate, which is as hot as ever, concerns the following:

1. What empirical evidence should be used to support the discounts?

2. How should that evidence be utilized?

[2] Earnings Before Interest Taxes Depreciation and Amortization

3. How large should the resulting discounts be?

B. **Lack of Control Discounts**

1. The issues associated with lack of control are relatively more settled than those dealing with lack of marketability. When valuing a minority interest in a corporation, a broadly accepted empirical benchmark comes in the form of transaction data concerning the purchase of public companies. The stock of a typical public company is held by a large universe of investors, each holding a minority, non-controlling interest. When such a public company is acquired, the buyer gains control. These transactions almost always occur at a premium to the public trading price preceding the acquisition. Implied lack of control discounts may be calculated by taking the inverse of the premiums paid. The almost universally accepted source of this data is a publication called *Mergerstat Review*. The data are presented each year at an individual transaction level, subtotaled by industry, and on an aggregated basis across all industries.

2. Many appraisers use the aggregated data for a relevant period as the basis for the discount. Others argue for applying the data for the particular industry in which the subject company operates. While the latter approach has the appeal of greater rigor, great care must be taken when looking at smaller subsets of the data. The premiums paid in individual transactions can vary significantly from one to another. These differences typically are driven by factors other than control. For example, a buyer may have a particular strategic interest in a target company, causing the buyer to pay a larger premium. Using data from a smaller sample can cause an appraiser to substantially understate or overstate the lack of control discount.

3. Application to Partnerships and LLCs

    a) While there is general consensus on the data appropriate for interests in corporations, there is greater debate as it relates to partnerships and LLCs. Some appraisers continue to use the *Mergerstat* data as the sole basis for the discounts for these entities. However, there is greater use of data from other sources such as syndicated real estate limited partnerships ("RELPs"), real estate investment trusts ("REITS"), and closed-end mutual funds.

    b) If the subject of the appraisal is a real estate partnership or LLC, there is growing consensus that the data concerning RELPs is appropriately applied. A challenge with this data is that there has been a trend of liquidations of RELPs in recent years, resulting in fewer entities and transactions from which to draw empirical data. Given the substantial differences between REITs and private partnerships, there is less agreement on the application of REIT data. In notable cases[3] the Tax Court has not indicated a definitive opinion about which source of data is more reasonable, but it has indicated that one should rely more heavily on the source that better matches the character of the subject entity being appraised.

c) In the case of partnerships or LLCs that hold marketable securities, there is a frequent application of data derived from closed-end mutual funds. While this has the benefit of a closer comparison of underlying assets, a closed-end mutual fund is substantially different from a private partnership in many other respects.

d) In the case of a partnership or LLC holding a mix of assets, some appraisers advocate the bifurcation of the discounts by asset type. In other words, using the closed-end fund data to develop the discount applicable to the partnership's securities portfolio while using RELP or REIT data to develop the discount applied to the real estate portfolio. This results in a blended discount that varies with an entity's asset allocation. This approach has been embraced in a number of Tax Court cases.[4]

4. The question of "minority basis" cash flows

a) Some appraisers assert the position that, if no control-based adjustments are made to reported earnings, then no lack of control discount is warranted. Others argue that discount rates derived from the public equity markets are inherently minority discount rates, thereby also voiding the application of a lack of control discount to a value derived from those discount rates.

b) This issue was one of many valuation issues addressed in the *Gallagher*[5] case. (Judge Halpern's opinion in *Gallagher* includes a 23% lack of control discount.)

C. **Lack of Marketability Discounts**

1. If discounts for lack of control are applied in relatively settled territory, then lack of marketability discounts remain the Wild West. The array of alternative methods that have emerged over the years can be arrayed in three broad categories.

a) Analysis of market data

[3] See for example Astleford v. Commissioner (T.C. Memo 2008-128)
[4] See for example Peracchio v. Commissioner (T.C. Memo 2003-280); Lappo v. Commissioner (T.C. Memo 2003-258); and McCord v. Commissioner (120 T.C. 13)
[5] Gallagher v. Commissioner (T.C. Memo 2011-148)

b) Discounted cash flow models

c) Option models

2. Analysis of market data

a) Lack of marketability discounts have traditionally been derived from the following sources:

(1) IPO studies, which contrast the trading prices of stock in companies before and after their initial public offerings.

(2) Restricted stock studies, which analyze the differences in the prices paid for restricted stock compared to the prices of the freely traded stock of the same public companies.

(a) The data above is analyzed in varying ways and degrees of detail to derive the discount applicable to a particular fact pattern.

(b) Regression analysis can be used to measure how discounts are correlated to specific variables, such as earnings volatility, company size, and holding period.

3. Discounted cash flow

a) Z. Christopher Mercer, ASA, CFA, has developed a model he refers to as the *Quantitative Marketability Discount Model* ("QMDM"). The QMDM model is essentially a discounted cash flow model that estimates the cash flows, including cash flow from the ultimate sale of a business interest, during an estimated holding period. The discount rate applied is higher than would be applied in the appraisal of a 100% equity interest in the business, which results in the implied discount for lack of marketability.

b) There are other variations of the QMDM approach in use. QMDM and similar models are subject to criticism based upon the fact that they are very sensitive to the underlying assumptions used in the models, which can lead to highly variable results.

4. Option Models

a) More recently a number of appraisers have developed approaches that are variants of an option pricing model. These models analyze lack of marketability by examining the opportunity cost of not having the right to immediately sell the interest, as measured by the value of a put option. The key inputs in a typical option pricing model are the price of a security at a given date, the term of the option, and the expected price volatility of the security. All else being equal, the value of an option rises and falls with volatility and with its term to expiration. Consider put options on two stocks:

(1) Stock A is worth $10 today. It has high price volatility and the put option on the stock expires in 2 years.

(2) Stock B is also worth $10 today. But it has low price volatility and the put option on the stock expires in 1 year.

b) The put option on stock A is worth more than the put option on stock B in the above example. The logic behind applying such models to the development of lack of marketability discounts can be summarized as follows:

(1) By holding an illiquid asset you are giving up the right to sell it for a period of time.

(2) The longer you are restricted from selling and the greater the volatility of the illiquid asset you are holding, the greater the implied cost of this illiquidity.

(3) The cost can be estimated by valuing a put option on the equity interest you are valuing.

(4) The value of the put option divided by the undiscounted value of the security can be expressed in percentage terms as a lack of marketability discount.

5. All of the methods above are making a positive contribution to the ongoing development of methods to tackle of lack of marketability question. However, each is imperfect and subject to misuse.

6. How did we get here?

a) The root cause of this debate is the fact that there is no available data from which to directly measure the discounts associated with the purchase and sale of interests in privately held entities. When valuing real estate, in contrast, one can look at sales of directly comparable properties. When valuing a fractional interest in a privately held business, no such comparable data exists. An appraiser is forced to look at other transaction data as a proxy, which by definition yields imperfect results.

b) In spite of the limitations on the available data, and perhaps because of it, there is a growing call from the Courts, the IRS, and within the appraisal community to apply more rigorous and explicit methods for developing discounts. It is in this climate that the relatively new "option models" have been developed. While this effort is important and understandable, we should keep the following in mind: **Detailed and precise does not always equal reasonable and appropriate.** The goal of pursuing a "better" method for developing discounts has led to the risk of false precision.

7. What to do now?

   a) Make sure your appraisers are aware of the various alternative approaches and that they can:

      (1) Discuss the pros and cons of each primary alternative

      (2) Clearly articulate why they are applying their chosen method

   b) While the "right" method has yet to be determined, there are some key guidelines to keep in mind when developing supportable discounts:

      (1) Use data that is as reasonably comparable to the subject business interest as possible.

      (2) Develop an explicit, compelling nexus between the data, the subject fact pattern, and the specific discount applied. Do not simply apply the same broadly derived average discounts to every situation.

      (3) Supplement empirical data with direct, practical research when possible. For example, a recent engagement involved the appraisal of limited partnership interests in a number of private hedge funds and private equity funds. As a part of that work, the appraisers conducted interviews with a number of investment advisors who routinely place clients in these investments. This allowed the appraisers to bolster admittedly imperfect empirical evidence with "real world" input from industry experts.

   c) Be prepared for the growing threat of *Daubert*[6] challenges to your expert in valuation cases.

8. Enter the IRS "Job Aid"

   a) The IRS has published the "Discount for Lack of Marketability Job Aid for IRS Valuation Professionals" dated September 25, 2009. While dated 2009, the document was not made public until 2011. It may now be found on the

[6] Daubert v. Merrell Dow Pharmaceuticals, Inc., 43 F.3d 1311 (9th Cir. 1995)

IRS website at www.irs.gov/pub/irs-utl/dlom.pdf. This document, which is over 100 pages in length, provides an overview and evaluation of what the IRS identifies as the universe of alternative approaches to determining lack of marketability discounts. It has generated substantial debate and disagreement that remains unresolved. In the meantime, it provides a very useful aid to appraisers and advisors in understanding the IRS perspective on this topic.

X. SPECIAL ISSUES IN VALUING S CORPORATIONS

A. The ongoing debate over appropriate valuation discounts often involves differences of opinion in a relatively narrow range, say 5 to 15 percentage points. And these differences are often resolved by "splitting the baby". The value implications of this debate pale by comparison to the issue involving the valuation of S corporations. This issue alone can drive differences in value of 65% or more!

B. Should you tax-affect the earnings of an S Corporation?

1. Alternative positions

a) Tax-affect and do nothing else (treat as C corporation)

b) Tax-affect but make adjustment to reflect benefits of "S" status

c) Apply no taxes

2. What do the current IRS posture and some recent Tax Court cases imply?

a) When a taxpayer's appraisal includes a tax-affected appraisal method for an S corporation, a common response is to remove the taxes and leave all other variables unchanged. As illustrated in the table below, this approach results in an increase in value that can easily reach 67%. As I prepare this outline there is continued discussion about increasing both corporate and personal tax rates. As such, the illustration below uses a pre-2017 combined tax rate of 40%.

Implications of Not Tax-Affecting

		Tax Affected		Not Tax Affected	% Difference
Pre-Tax Earnings		$1,000,000		$1,000,000	
Taxes	40%	-$400,000	0%	$0	
Net Income		$600,000		$1,000,000	67%
Cap Rate		0.15		0.15	
Indicated Value		$4,000,000		$6,666,667	67%

3. What is the actual difference in cash flow at the shareholder level?

   a) There is no evidence-based, economic foundation for an assertion that an S corporation is worth anywhere near 67% more than an otherwise comparable C corporation. As illustrated in the table below, net after tax cash flow to shareholders, under the assumption of a 100% dividend/distribution payout, would be more in the range of 20% higher for an S corporation before the new tax rates/ structure enacted with The Tax Cuts and Jobs Act of 2017 (the "TCJA").

   b) All else being equal, the TCJA reduced the benefits of pass-through tax status. The benefit of pass-through tax status is also more complicated to determine and is eliminated altogether for businesses that cannot take the 20% QBID. Furthermore, the corporate tax rate is "permanent", while the QBID and other rates sunset in 2025. This further reduces the relative benefits of pass-through tax status.

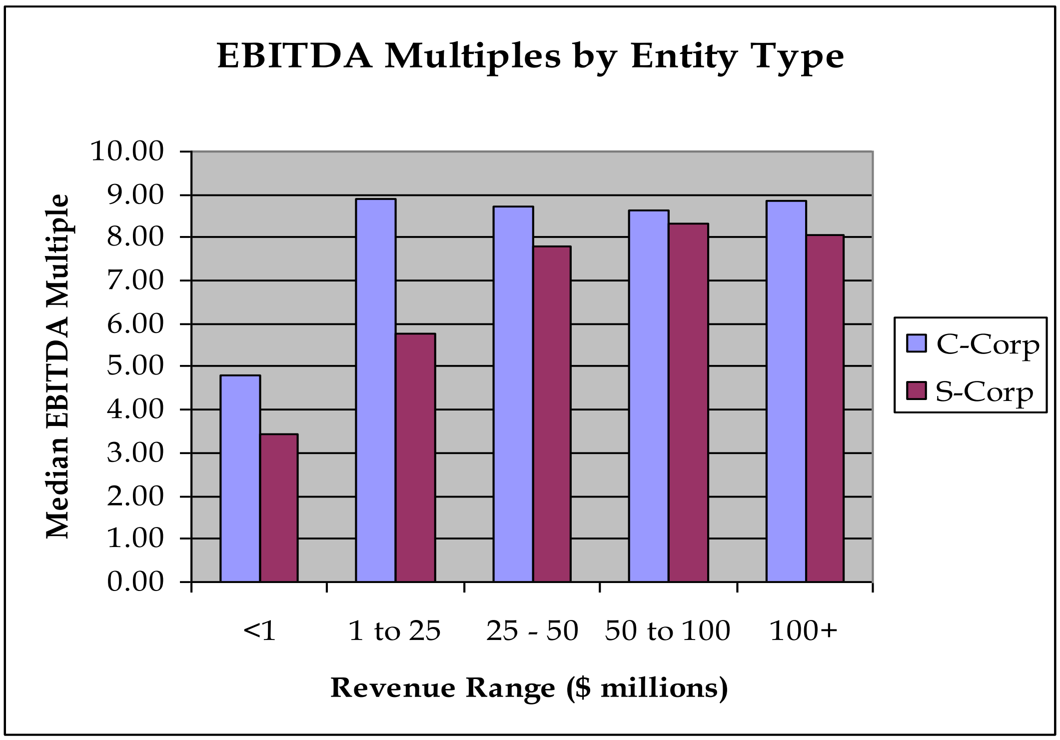
Net Shareholder-Level Cash Flows

		C Corp		S Corp	% Difference
Pre-Tax Earnings		$1,000,000		$1,000,000	
Corporate Taxes	40%	-$400,000	1.5%	-$15,000	
Net Income		$600,000		$985,000	
Dividend/Distribution	100%	$600,000		$985,000	
Personal Taxes[7]	34%	-$204,000	51%	-$502,350	
After Tax Cash Flow		$396,000		$482,650	22%

C. What's happening in the real world?

[7] Based on highest marginal California and Federal rates, including Unearned Income Medicare Contribution Tax before The Tax Cuts and Jobs Act of 2017.

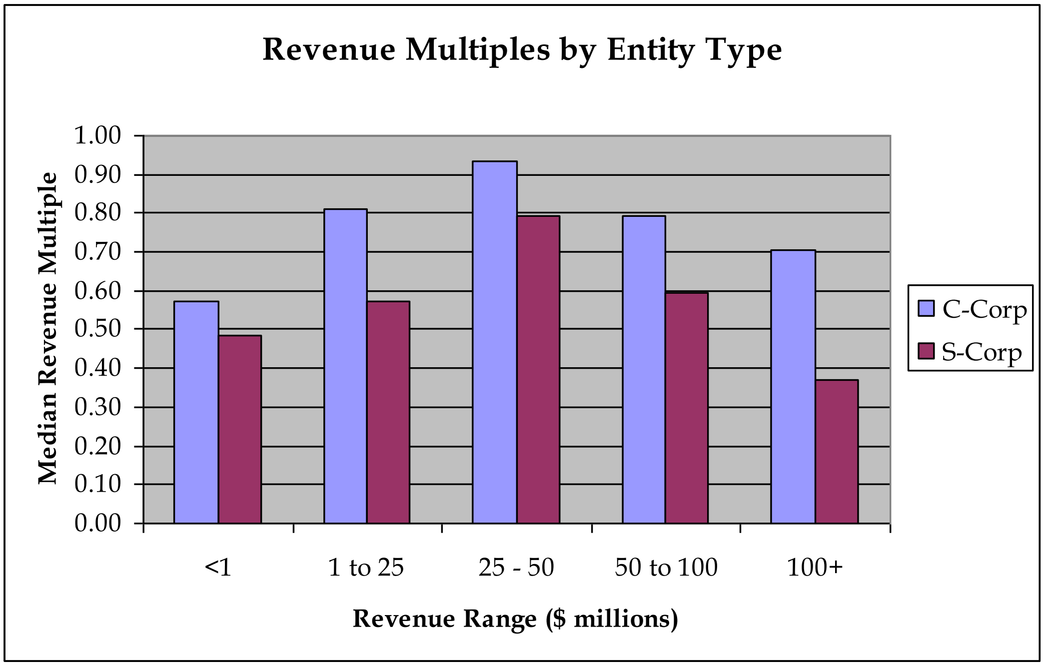
1. While the tax-affecting debate rages, we are left with the practical question of whether or not buyers actually pay more for S corporations compared to otherwise comparable C corporations. We recently conducted an analysis of transaction data in the DealStats database. The query covered the years 1992 to the present and was not limited by industry or geography. Of this universe of transactions, there were 7,884 that included a calculated multiple of EBITDA[8]. 3,051 (39%) of these transactions involved C corporations. The remaining 4,833 (61%) involved S corporations. S corporations tend to be smaller, so the data was arrayed by sales size to eliminate potential size bias in the multiples. The results are presented in the graph below. As indicated, buyers paid substantially higher multiples for C corporations compared to S corporations for businesses with revenues less than $25 million. When companies get larger, the gap narrows. There is no revenue range in which buyers paid more for S corporations compared to comparably sized C corporations.



2. We also analyzed prices paid in terms of revenue multiples. Of the starting universe of DealStats transactions, there were 12,224 that included a calculated multiple of revenue. 5,449 (45%) of these transactions involved C corporations. The remaining 6,775 (55%)

[8] The analysis was focused on EBITDA multiples, since they are derived from pre-tax earnings.

involved S corporations. The results are presented in the graph below. As with the EBITDA multiple, buyers paid substantially higher revenue multiples for C corporations compared to S corporations. This holds true across all revenue ranges. It is this sort of practical data that need to be presented to the Tax Court.



D. Enter another IRS "Job Aid"

1. A former IRS valuation engineer obtained a copy of an internal IRS "Job Aid" related to the valuation of S corporations. The document is dated October 29, 2014 and was obtained using the Freedom of Information Act process. (A Job Aid with the same date, related to reasonable compensation, was obtained at the same time.)

2. The S-corporation Job Aid was broadly distributed to the valuation community (not by the IRS) during the last week of April 2015. It is now available on the IRS website at https://www.irs.gov/pub/irs-utl/S%20Corporation%20Valuation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf. Unlike the Job Aid related to lack of marketability discounts, the S-corporation Job Aid does not identify the array of alternative approaches. It does identify a number of relevant Tax Court cases. It also clearly takes the position that methods involving the tax-affecting of S corporations are rarely appropriate.

E. Tax Court Cases

1. The handling of tax-affecting has had mixed results in U.S. Tax Court, as further discussed in the material submitted by my co-panelist. The appraisal community is seeing a positive trend and is optimistic that a more consistent, reasonable approach will emerge from additional cases in which the proper evidence and methodology are presented.

XI. DEFINED VALUE CLAUSES

A. We have seen a substantial increase in the use of defined value clauses, initially in connection with 2012 gifts. Does the use of such techniques have an impact on appraisers or valuation methodology?

1. Generally, no. The selection and application of valuation methodology is not changed by the use of defined value clauses. Similarly the value conclusion should not be impacted.

2. However, there may be a material difference in the presentation of the opinions in the appraiser's report.

a) For example, if an appraiser is asked to appraise 2,500 shares in a corporation, the required presentation of that opinion is obvious. The assignment can be clearly described as the appraisal of 2,500 shares, and the valuation of that 2,500-share block is then presented.

b) On the other hand, use of a defined value clause may result in an assignment such as: "Determine the number of shares with a fair market value equal to $11.7 million." For the sake of comparison, let's assume the appraiser concludes that 2,500 shares are equal to $11.7 million. How should the appraiser describe the assignment and present his or her opinions? One option is to simply present the 2,500 share value (which happens to equal $11.7 million) without reference to the fact that the number of shares was solved for based upon the defined value of the gift. The other option is to explicitly describe the assignment as determining the number of shares equal to $11.7 million, and then showing how the 2,500-share block was derived. In my experience this second approach is the best practice. It is important to discuss this important detail with your appraisers before they prepare their reports.

Appendix A
Appraiser Retention Checklist

- ☐ Do they have the requisite professional credentials and are they current?
- ☐ What is their educational background?
- ☐ How long have they been practicing?
- ☐ Have they been disciplined or disqualified by a professional organization, a court, the IRS?
- ☐ Is valuation their primary vocation?
- ☐ Who is actually going to do the bulk of the work on a given assignment?
- ☐ What is their experience supporting their opinions at audit, appeals, and trial?
- ☐ Have they valued the subject type of business before?
- ☐ Do they have professional liability insurance and in what amount?
- ☐ What is their record retention practice and policy?
- ☐ Do they plan to interview the client and/or conduct a site visit of the subject business?
- ☐ Have they dealt before with the legal issues presented?
- ☐ Have you seen a sample of their reports?
- ☐ Does the engagement letter clearly identify:
    - The client
    - The entity to be appraised
    - The specific interest to the be appraised
    - The purpose of the appraisal
    - The appropriate standard of value, including the appropriate statutory reference
    - The form of report to be produced and if it will be USPAP compliant
    - The timing of report delivery and acknowledgement of specific deadlines (such as a Form 706 filing date)
    - In an estate tax matter, whether appraisals will be done as of both the date of death and alternate valuation date
    - The proposed fee structure (fixed or hourly)
    - A checklist of information required to conduct the appraisal

Appendix B
Appraisal Report Checklist

- ☐ Addressed to the right party
- ☐ Clear statement of assignment
- ☐ Intended user and use identified correctly
- ☐ Entity and specific interest appraised identified
- ☐ Valuation date(s)
- ☐ Appropriate standard of value identified
- ☐ Appraiser certification and signature(s)
- ☐ Identification of any assumptions or limiting conditions
- ☐ USPAP compliance statement
- ☐ Should be opinion of appraiser signing report - not someone else
- ☐ Report not drafted by attorney or other advisor
- ☐ Discussion of legal assumptions
- ☐ Contains all elements needed for its purpose
  - Substantiation of charitable deductions
  - Adequate disclosure
  - Other
- ☐ Description of business and all relevant facts
  - History
  - Type of entity
  - Nature of business
  - Capitalization and ownership
  - Management and directors
  - Products and services
  - Customers and markets served
  - Facilities
  - Competition
- ☐ Historical financial analysis

- Income statement history
- Balance sheet history
- Ratio analysis
- Comparison to industry averages

☐ Adjustments to reported earnings (as needed and appropriate)

☐ Relevant economic and industry analysis

☐ Overview of appraisal process employed

☐ Description of methods considered but not used and why

☐ Description of methods used and why

☐ Application of reasonable valuation methodology

☐ Detailed exhibits

☐ Explicit presentation of all calculations leading to stated opinions

☐ Presentation of basis for all underlying assumptions and valuation variables

☐ Application of valuation discounts
  - Description of methodology
  - Empirical evidence
  - Nexus to specific fact pattern

☐ Sources of information used

☐ Studies or other data cited

☐ Summary of appraiser qualifications

☐ General

  - Does it have a clear, unbiased tone?
  - Does it disclose and deal with "bad facts" as well as "good facts"
  - Is it free of grammatical, mathematical, and typographical errors?
  - Should be clear and understandable
  (These can compromise the "authority" of an otherwise sound opinion)

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Curriculum Vitae

John Prokey is a partner of Ramsbacher Prokey Leonard LLP. Mr. Prokey's law practice focuses on providing advice in wealth planning, estate and trust administration, and tax. His clients include individuals, private fiduciaries, institutions, and other business and non-profit entities. The wealth planning portion of Mr. Prokey's law practice emphasizes advising individuals and fiduciaries in estate planning, wealth preservation, tax, and business matters. Mr. Prokey also advises fiduciaries and beneficiaries in trust and probate administration matters, with emphasis in complex administrations. Mr. Prokey's law practice includes representing taxpayers in all levels of federal tax controversy, including IRS examination and Appeals, and before the U.S. Tax Court. Clients, their families, and other practitioners rely on Mr. Prokey for dispute resolution in these arenas, including serving as a mediator.

Mr. Prokey is a Fellow of The American College of Trust and Estate Counsel. He is also a member of the California Lawyers Association. He served on the Trusts and Estates Section Executive Committee and the Taxation Section Executive Committee of the California State Bar; and also served as Chair (2004-2005) of the Taxation Section's Estate and Gift Tax Sub-Committee. John is a member of the Silicon Valley, Santa Clara County, and American Bar Associations.

Mr. Prokey is a frequent lecturer and guest speaker at numerous seminars and conferences throughout California and elsewhere, and is an author on various tax and estate planning topics. Speaking engagements include the Heckerling Institute on Estate Planning, Jerry A. Kasner Estate Planning Symposium, AICPA Advanced Estate Planning Conference, CalCPA Advanced Estate Planning Institute, Annual Estate Planning Symposium, Tax and Update Planning Conference, the San Diego Tax and Estate Planning Forum, the Hawaii Tax Institute, CEB/UCLA Estate Planning Conference, Continuing Education of the Bar Estate Planning and Administration, San Francisco, San Mateo County, and Silicon Valley Bar Associations, East Bay, Orange County, Sacramento, Santa Clara County, Santa Cruz County, and Stanislaus County Estate Planning Councils, CPE Forum of the Central Coast, East Bay Trust & Estates Lawyers Seminar, and Paralegal Association of Santa Clara County.

Mr. Prokey received his Baccalaureate of Science degree from Santa Clara University in 1994 and his Juris Doctor degree from Santa Clara University School of Law in 1999, graduating *cum laude* in both undergraduate and law school studies.

Table of Contents

I. APPEAL OF TAX COURT CASES AND THE *GOLSEN* DOCTRINE.

The Tax Court is a court from which the venue for appeal is not limited to one United States Circuit Court of Appeals. *See* I.R.C. §7482(b). The venue for appeal by a non-corporate petitioner from a Tax Court deficiency case is to the circuit in which is located the residence of the petitioner when the petition was filed. *See* § 7482(b)(1). If the residence of the petitioner is not within any of the circuits (e.g., overseas), then venue is the United States Court of Appeals for the District of Columbia Circuit. §7482(b)(2); *see Est. of Israel v. Commissioner of I.R.S.*, 159 F.3d 593, 595 (D.C. Cir. 1998), *rev'g* 108 T.C. 208 (1998). Moreover, by mutual agreement of the parties, the appeal may be to any of the circuit courts. § 7482(b)(2).

Because the Tax Court considers itself a court of national jurisdiction that should decide cases uniformly across the United States, it has held that it is not bound by circuit authority with which it disagrees. *See Lawrence v. Commissioner*, 27 T.C. 713, 718 (1957), *rev'd*, 258F.2d 562 (9th Cir. 1958). As a matter of "judicial administration," however, the Tax Court follows "a Court of Appeals decision which is squarely in point where appeal from [its] decision lies to that Court of Appeals and to that court alone." *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir.1971) (the *Golsen* doctrine). But deciding that there is only one court of appeals to which appeal would lie has proven difficult because, as said, appeal may by mutual agreement lie to any of the appellate courts. *See* §7482(b)(2). Moreover, more than one petitioner in a case may have the right to appeal, and each may have the right to appeal to a different court of appeals. *See, Estate of Israel v. Commissioner v. I.R.S.*, 159 F.3d 593, 596 (D.C.Cir. 1998), *rev'g and remanding sub nom. Estate of Israel v. Commissioner*, 108 T.C. 208 (1997). The Tax Court has said that it is not bound by the *Golsen* doctrine where I.R.C. section 7482(b)(1) allows for multiple possible venues. *See, e.g., Estate of Israel v. Commissioner*, 108 T.C. at 226 (where co- executors resided in different circuits). In that case, the Court will follow its own precedent.

II. VALUING THE CORRECT ASSETS

A. Overview. The general two-step principle of federal taxation is that state law determines the nature and scope of property rights, and federal law determines the appropriate tax treatment of those rights. *United States v. National Bank of Commerce*, 472 U.S. 713, 722 (1985); *United States v. Rodgers*, 461 U.S. 677, 683 (1983); *Aquilino v. United States*, 363 U.S. 509, 513 (1960); *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940). In many cases, the property rights that transfer can be overlooked, hard to determine due to shifting legal relationships, or require legal conclusions.

B. Special Tax Issues.

1. Gift Tax Considerations – No Family Attribution. Revenue Ruling 93-12 and *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981). In Revenue Ruling 93-12, 100% of a closely-held corporation's stock was gifted simultaneously to children (20% to each of 5 children). The Service ruled each gift was to be valued separately, i.e. no aggregation.

2. Estate Tax Considerations – Aggregation of Interest that Pass At Death.

a. General Rule: The value of a decedent's estate is the value of all property to the extent of the decedent's interest as of the time of his or her death. “There is nothing in the statutes or in the case law that suggests that valuation of the gross estate should take into account that the assets will come to rest in several hands rather than one.” *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). Therefore, all interests in a single entity (e.g., voting, and non-voting stock) are to be aggregated for estate valuation purposes. Ahmanson Foundation, infra.

b. QTIP Trust Exception: However, interests in a decedent’s estate and those in a QTIP Trust includible in the decedent’s gross estate are not aggregated for valuation purposes. See *Bright*, supra, *Mellinger*, 112 TC 26 (1999), A.O.D. 1999-006; *Nowell*, T.C. Memo. 1999-15; and *Lopes*, T.C. Memo. 1999-225. Also see *Fontana*, 118 TC 318 (2002), wherein the Tax Court held that for valuation purposes interests in an estate are to be aggregated with interests in a general power of appointment marital trust (i.e. a Section 2056(b)(5) trust), thus distinguishing IRC Sections 2041 (general power of appointment) and 2044 (QTIP).

3. Chapter 14 Considerations. Even after clearly identifying gift versus estate legal issues and confirming the property rights subject to valuation, the special valuation rules of Chapter 14 (IRC sections 2701 – 2704, inclusive) must be considered. In particular, Chapter 14 must be considered when valuing: (i) preferred or subordinate entity interests; (ii) assets subject to options, agreements, other rights to acquire or use the property at a price less than the fair market value of the property, or restrictions on the right to sell or use such property; and (iii) interests in partnerships or corporations with lapsing voting or liquidation rights or restrictions on liquidation.

4. Is the Account, or the Account Assets the Proper Subject of Valuation?

a. *Estate of Kahn v. C.I.R*, 125 T.C. 227 (2005). Decedent’s estate filed a Form 706, and the IRS issued a notice of deficiency that inter alia asserted increases to the gross estate by disallowing a reduction in value of Decedent’s individual retirement accounts (“IRAs”), by the expected Federal income tax liability resulting from the distribution of the IRAs' assets to the beneficiaries under IRC Section 408(d)(1). The Estate argued that the application of the willing buyer-willing seller test mandates a reduction in the fair market value of the IRAs to reflect the tax liability associated with their distribution. The logic of the Estate's argument is that the IRAs themselves are not transferable and therefore are unmarketable. According to the estate, the only way that the owner of the IRAs could create an asset that a willing seller could sell and a willing buyer could buy, is to distribute the underlying assets in the IRAs and to pay the income tax liability resulting from the distribution. Upon distribution, the beneficiary must pay income tax. Therefore, according to the Estate, the income tax liability the beneficiary must pay on distribution of the assets in the IRAs is a “cost” necessary to “render the assets marketable,” and this cost must be taken into account in the valuation of the IRAs.

The Court held, in computing the gross estate value, the value of the assets held in the IRAs is not reduced by the anticipated income tax liability following the distribution of the IRAs. A hypothetical sale between a willing buyer and a willing seller would not trigger the tax liability of distributing the assets in the IRAs, because the subject matter of a hypothetical sale would be the underlying assets of the IRAs (marketable securities), not the IRAs themselves (as they are not transferrable).

Further, IRC Section 691(c), addresses the potential double tax issue. Accordingly, the valuation of the IRAs should depend on their respective net aggregate asset values. A hypothetical buyer would not take into account the tax consequences of distributing the assets in the IRAs because the buyer would be purchasing the securities, not the IRAs themselves. The tax liability associated with the distribution of the IRAs would not be passed on to the buyer. In addition, IRC Section 691(c) provides relief from the double taxation that would be imposed on the beneficiaries of the IRAs in this case. Accordingly, a discount for lack of marketability is not warranted because the assets in the IRAs are publicly traded securities. Payment of the tax upon the distribution of the assets in the IRAs is not a prerequisite to making the assets in the IRAs marketable. Thus, there is no basis for a discount.

b. *Estate of Foster v. Commissioner*, (T.C. Apr. 28, 2011), affrm'd 113 AFTR 2d 2014-1519 (9^{th} Cir. 2014). The Tax Court also rejected any discounts against the Estate's liquid assets due to a bank choosing to freeze the assets. It reasoned that while the Estate's interest in the assets were frozen, the assets themselves were not. Furthermore, the Court found that the litigation claim was not viewed as an impairment of the assets. In a one-page opinion, the Ninth Circuit upheld the Tax Court's decision. It found that the Tax Court did not err in declining to apply discounts for hazards of litigation, lack of control, or lack of marketability because a hypothetical buyer of the trust assets would not become a defendant in the first suit. Similarly, it found that the Tax Court properly declined to apply discounts for lack of control and lack of marketability because the freeze in the first suit applied to the Decedent, not the underlying trust assets.

c. *Estate of Kessel v. Commissioner*, (T.C. May 21, 2014). In this case, Decedent held a personal pension plan that invested with Bernard L. Madoff Investment Securities, LLC. The account ostensibly held assets worth $4,800,000 at Decedent's July 16, 2006 death. Decedent's estate timely filed an estate tax return and reported the account as a $4,800,000 asset. Following Decedent's death, his fiancé and son withdrew $2,800,00 from the account. In 2008, Bernie Madoff's Ponzi scheme was uncovered, and the Estate subsequently filed a supplemental return stating that the value of the Decedent's Madoff account was $0. The IRS issued a notice of deficiency for $339,143 and denied the Estate's $1,937,391 refund claim. The IRS moved for summary judgment on two issues. The issue relevant to this discussion (the other is discussed under III. B. below) argued that the asset being valued was the Madoff account and not its purported holdings. The court agreed with the IRS that the Madoff account existed at the Decedent's death. However, the question regarding whether the account (which may have had been a property right in itself) or the assets allegedly held by the account, were the "asset" in Decedent's estate was a disputed issue based on New York state law. Therefore, summary judgment was denied. Contrast this case to *Kahn v. Commissioner*, 125 T.C. 227 (2005) (where the Tax Court held that the hypothetical willing buyer, willing seller test required valuation of the IRA assets, not the IRA itself, since the buyer would receive the assets without regard to the IRA).

d. *Estate of Beyer v. Commissioner*, (T.C. Sep. 29, 2016). Decedent was a long-term employee of Abbott Laboratories and owned a significant portion of Abbott stock. Decedent created a family limited partnership, or an "FLP" (a management trust was the 1%

general partner and Decedent's living trust was the 99% limited partner). Six months later, Decedent transferred nearly all of his assets to the FLP. Approximately a year later, Decedent created an irrevocable grantor trust and later that same year, Decedent (from his living trust) sold his entire 99% limited partner interest to the grantor trust for a secured promissory note. The FLP entered into a restricted management agreement as to 75% of its assets with an investment advisor, restricting any withdrawals from the account for four years. After Decedent's death, the FLP made various distributions directly for the Decedent's benefit, including gift taxes and Decedent's estate taxes (even though neither the Decedent nor his living trust owned the 99% limited partnership interest in the FLP at those times).

The court determined that all of the FLP assets were included in the Decedent's estate under IRC Section 2036(a)(1), as the bona fide sale for full consideration exception to IRC Section 2036 did not apply (there were no purported nontax reasons for the FLP). Decedent had an implied agreement of retained enjoyment, based primarily on the actual distributions made to Decedent during his life and for the Decedent's estate after his death. The negative facts include: (i) the marketable securities FLP; (ii) that Decedent continued to receive assets from the FLP (even after he ceased to be a partner); (iii) a failure to properly maintain capital accounts; and (iv) that the FLP was clearly designed to merely create discounts and reduce estate taxes.

No discount was permitted for the restricted management account because the account manager was not prohibited from selling assets inside of the account. The IRS relied on two cases that had refused to apply a discount for estate tax purposes of assets in accounts, even though in one case Decedent was not allowed to sell interest in the account (*Estate of Kahn v. Commissioner*, 125 T.C. 227 (2005)), or to withdraw assets from the account in the other case (*Estate of Foster v. Commissioner*, T.C. Memo 2011-95, aff'd, 565 F. App'x 654 (9th Cir. 2014)). In both cases, and here, the manager was not prohibited from selling the assets in the management agreement account. Further, the restricted management account was clearly designed to merely create discounts and reduce estate taxes. Thus, even though the restricted management account prohibited the distribution of assets from the account to the FLP (for investment purposes), the court concluded that no discount was allowed because the manager was allowed to sell assets within the account during that fixed term.

As an additional point, the Court seems to have overlooked the fact that the manager could sell and reinvest assets during the fixed four-year term. The rationale for a discount is that the owner has limited rights to the assets for the four-year term. However, the Court did not focus on that restriction, and instead focused only on the fact that the manager could sell the assets within the account.

5. Valuing Choses in Action. In *Estate of Foster v. Commissioner*, TC Memo 2011-95, affrm'd 113 AFTR 2d 2014-1519 (9^{th} Cir. 2014), most estate assets were easily valued. The exceptions were choses in action related to litigation. On the one hand, the Estate was sued for unpaid legal fees. On the other hand, the Estate had claims against the attorney who sued the Estate and a corporate trustee. Three years after the date of death, the IRS audited the Estate's Form 706. Four years after the date of death, the attorney settled by paying $1,000,000 to the Estate. Then, the IRS issued a Notice of Deficiency. Thereafter, the corporate trustee settled by paying $17,000,000 to the Estate.

In the Tax Court proceedings, the Estate conceded it improperly failed to report the claims as assets of the Estate. The Court agreed and found that these claims are not covered under Section

2053(a). Rather, they are assets of the estate and their date of death fair market value must be included in the taxable estate. To value these claims, the Tax Court adopted the Estate's expert's methodology, with some adjustments. The claims were valued based upon a decision-tree matrix that applied probabilities at the various critical decision nodes and potential outcomes. The resulting values were then present-valued to determine the value of the asset in the Estate. The Tax Court determined that the uncertainty of the litigation claims resulted in a FMV of $1,000,000 (versus the subsequent $18,000,000 settlement value; $1,000,000 from the attorneys, and $17,000,000 from the bank). The Ninth Circuit affirmed a $1,000,000 date-of-death value for the claims, despite the Estate ultimately receiving $18,000,000.

6. Valuing Shifting Legal Rights. In *Estate of Koons v. Commissioner*, (T.C. Apr. 8, 2013), affrm'd 119 AFTR 2d 2017-1609 (11th Cir. 2017), the Decedent and his four children owned an LLC. Before his death, Decedent offered to redeem his children from the LLC and all four of his children agreed to be redeemed. The redemptions had not, however, been completed before Decedent's death. Before the redemptions, Decedent held 47% of the vote. After the redemptions, Decedent would hold over 70% of the vote and gain the ability to liquidate the LLC. Thus, the driving issue of the case was "what interest in the LLC did Decedent own at death?" The Tax Court found that the redemptions were agreed to before Decedent died and were probable to occur. Thus, the interest includible in the estate must be valued with the voting control and power to liquidate. The Tax Court allowed only a 7.5% discount to net asset value on the LLC interest includible in Decedent's estate (the Estate argued for a 31.7% discount based on only 47% of the vote). The Eleventh Circuit affirmed the Tax Court's findings and holding. This case confirms that all contractual rights, and the impact of those rights on assets, must be considered when determining what property rights are the subject of the valuation.

7. Valuing Assemblage or Separate Parcels. In *Estate of Pulling v. Commissioner*, (T.C. July 23, 2015), Decedent held three parcels of land (parcels 3, 4, and 5) and a minority interest in a land trust (which owned two additional parcels of land (parcels 1 and 2)). The five parcels were contiguous, all of which were zoned agricultural. The three parcels owned by the Decedent had historically been used as tree and plant nurseries. The two parcels owned by the land trust had historically been used for cultivation of citrus fruits. Lack of direct access to a public road and utilities meant it was not economically feasible to develop any of the parcels owned by the estate unless they were first combined with the land trust parcels. An appraisal prior to the Decedent's death treated parcels 1 through 5 as if they were a single large tract of land. Upon Decedent's death, the Estate filed its Form 706, including a copy of the prior appraisal. The IRS determined a deficiency attributable to undervaluation of the fair market value of parcels 3, 4, and 5. The Estate later hired a different appraiser to appraise parcels 3 through 5 held in the estate during the estate tax examination. The new appraisal valued parcels 3 through 5 significantly less than the prior appraisal.

During trial, each party's expert agreed that if the Estate's parcels could be assembled with the land trust's parcels, then residential development of the whole would be the highest and best use. Each party also agreed that if assemblage were not possible, residential development of the Estate's property would not be economically feasible. The parties disagreed over whether it would be appropriate to consider a use that required combining the property to be valued with another property not under common ownership. The Court agreed with the IRS and found that federal law, specifically, *United States ex rel. Tenn. Valley Auth. v. Powelson*, 319 U.S. 266 (1943), governs whether assumed assemblage is allowable in the valuation of the parcels. Powelson holds that a property's fair market value may reflect "not only the use to which the property is presently devoted, but also that use to which it may be readily converted." However, "there must be a reasonable probability of the land in question being combined with other tracts for that purpose in the reasonably near future."

The Tax Court held that assembly of the Estate's parcels with the land trust's parcels was not reasonably likely, and therefore assembly for purposes of residential development was not the highest and best use of the Estate's property. The Tax Court upheld the lower appraised value of the parcels. The IRS argued that the court should assume assemblage because of: (i) the economic benefits of assemblage; and (ii) the ties between Decedent and the various stakeholders in the land trust. However, the Court found that there was no evidence in the record suggesting that assemblage was reasonably likely, as there was no evidence regarding the intent of the other land trust stakeholders or details as to their relationship with Decedent. The mere fact that the other stakeholders were members of Decedent's family was not enough to support the proposition that they would be reasonably likely to agree to combine properties.

8. Partner Versus Assignee. In *Estate of Streightoff*, (T.C. Oct. 24, 2018), the issue was whether the transfer of an 88.99% interest in a limited partnership was a transfer of a limited partnership interest or a transfer of an assignee interest. After reviewing cases such as *Kerr v. Commissioner*, 113 T.C. 449 (1999), aff'd, 292 F.3d 490 (5th Cir. 2002), and *Astelford v. Commissioner*, (T.C. May 5, 2008), the Court concluded that as a matter of form and substance, the interest was a limited partnership interest. Why did this distinction matter? In a word, valuation. If the interest were a limited partnership interest, then no discount for lack of control would apply. The court did find, however, that a discount for lack of marketability should still apply, and applied an 18% lack of marketability discount to the 88.99% limited partnership interest.

Note that the Judge Halpern estate tax case of *Tanenblatt v. Commissioner*, T.C. Memo 2013-263, also considered this issue. Judge Halpern ultimately held that the subject interest should be valued as an LLC member interest, not an assignee interest.

III. VALUATION EXPERTS IN TAX COURT

A. Generally. The Tax Court has very specific, and unique, rules for admitting appraisal reports into evidence. First, the appraiser is an expert. As such, the appraiser must "prepare a written report for submission to the Court and to the opposing party…" Tax Court Rule 143(g). The report must contain: "(A) a complete statement of all opinions the witness expresses and the basis and reasons for them; (B) the facts or data considered by the witness in forming them; (C) any exhibits used to summarize or support them; (D) the witness's qualifications, including a list of all publications authored in the previous 10 years; (E) a list of all other cases in which, during the previous 4 years, the witness testified as an expert at trial or by deposition; and (F) a statement of the compensation to be paid for the study and testimony in the case. The appraisal report will be admitted into evidence and be the direct testimony of the appraiser "unless the Court determines that the witness is not qualified as an expert." Tax Court Rule 143(g). Subject to limited exceptions, an appraiser's testimony will be excluded altogether for failure to comply with Rule 143(g).

An appraiser and his or her report (which is his or her direct testimony) must also meet the standards of Federal Rule of Evidence 702. That rule provides as follows:

> "A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:
>
> (a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;
>
> (b) the testimony is based on sufficient facts or data;
>
> (c) the testimony is the product of reliable principles and methods; and
>
> (d) the expert has reliably applied the principles and methods to the facts of the case."

See also *Daubert V. Merrell Dow Pharm., Inc*., 509 U.S. 579 (1993), whereby the United States Supreme Court made trial judges responsible to act as gatekeepers for excluding unreliable expert testimony. *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999) confirmed that the gatekeeper function applies to all expert testimony.

The Tax Court's practice is to have the appraiser appear at trial and be admitted as an expert by the presiding judge. Typically, the party advancing the appraiser as an expert will ask questions of the appraiser to establish, he or she is an expert, then ask the presiding judge to admit the appraiser's report into evidence as expert testimony. The presiding judge must consider the qualifications of the appraiser, the methodology used by the appraiser, and the opinions expressed.

B. Make Sure Expert Shows at Trial. The expert's report must follow the procedures to be admitted into evidence. In the Judge Halpern estate tax case of *Tanenblatt v. Commissioner*, T.C. Memo 2013-263, Petitioner attached a copy of its expert witness appraisal to its petition. The parties stipulated to copies of the petition and the answer, but in doing so stated that the pleadings are not admitted into evidence. Petitioner asked the Tax Court to allow the appraisal into evidence and consider it expert testimony. Why this unorthodox approach? Well, apparently Petitioner's expert would not appear at trial due to a fee dispute. In denying Petitioner's request, the Tax Court looked to Tax Court Rule 143. The expert witness appraisal must be identified and adopted by the witness, the witness must be qualified as an expert, and the report must be admitted into evidence. Further, a copy of the report must be submitted to the Tax Court and served on the other party at least 30 days before the call of the trial calendar. Note the <u>*Tanenblatt*</u> case also addresses the issue of whether the estate's interest in an LLC was a membership interest or assignee interest. The Tax Court found it was a membership interest and not an assignee interest.

IV. SUMMARY OF TAX AFFECTING CASES

A. Tax Cases where the Court allowed tax affecting:

1. *Estate of Jones v. Commissioner,* T.C. Memo. 2019-101.

a. Tax-affecting applied in valuation of a partnership and an S Corporation

b. Court found that taxpayer's expert provided evidence of tax affecting whereas Respondent's experts did not provide evidence against the inclusion of tax affecting.

2. *James F. Kress, et ux v. US,* (2019) E.D. Wisconsin, 2019-1 U.S.T.C. (March 26, 2019).

3. Both experts tax affected the earnings of an S Corporation valued by reference to public equivalents. Ultimately, the Court preferred the taxpayer's expert's report over Respondent's and that determined the outcome.

4. The Court relied on the taxpayer's appraiser who did work in the ordinary course of business for the S Corporation and its shareholders (not the appraisers hired for trial).

B. Tax Cases where the Court disallowed tax affecting:

1. *Gross v. Commissioner*, T.C. Memo. 1999-254, aff'd 272 F.3d 333 (6th Cir. 2001).
   a. Court found that:
      i. There was disagreement among professional appraisers as to the propriety of employing tax affecting; and
      ii. There was no evidence that the corporation would lose its Subchapter S status.
   b. Court found that it is appropriate to use a zero corporate tax rate to estimate net cashflow when valuing S corporation
2. *Heck v. Commissioner*, T.C. Memo. 2002-34.
   a. Respondent's expert applied a 10% discount for additional risks associated with an S corporation, including possible loss of Subchapter S status.
   b. Court did not allow the discount and settled on a combined 35% for DLOM and DLOC
3. *Adams v. Commissioner*, T.C. Memo. 2002-80.
   a. When Petitioner's expert applied a capitalization rate to the S-corporation's earnings, Petitioner's expert converted the capitalization rate from a post-tax capitalization rate (20.53%) to a pre-tax capitalization rate (31.88%)
   b. Court rejected this approach stating that the S-corporation's earnings are post-tax, albeit a 0% tax rate. Thus, Petitioner's expert should have just used the post-tax capitalization rate (not the pre-tax capitalization rate)
4. *Dallas v. Commissioner*, T.C. Memo. 2006-212.
   a. Court found there were insufficient facts to conclude that:
      i. The corporation would lose its favorable tax treatment as an S Corp.; and
      ii. A hypothetical willing buyer would tax-affect earnings in valuing the stock.
5. *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, supp'd by T.C. Memo. 2011-244.

a. Court rejected tax-affecting because the taxpayer's expert did not justify it but again acknowledged that the benefit of a reduction in the total tax burden borne by S Corporation owners should be considered when valuing an S Corporation.

6. *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141, rev'd and remanded, 14 AFTR 2d 2014-xxxx (9th Cir. Dec. 5, 2014). T.C. Memo, 2016-114.
   a. Court found that that the taxpayer's expert's method was faulty – he used a pretax discount rate to present value post tax cashflow.
7. *Wall v. Commissioner*, 81 T.C. M. 1425, 1432–33 n.19 (2001).
   a. The Court noted that taxpayer's expert acknowledged that appraisers disagree on whether it is appropriate to tax-affect the income of an S Corporation.
      i. Both experts tax-affected here
      ii. Taxpayer's expert undervalued the S Corporation (did not use correct projections, undervalued shares)
      iii. Respondent's expert overvalued the S Corporation (did not apply a minority discount, used very few performance measures/comparable companies)
   b. The Court noted that, because S Corporation stockholders are generally not subject to a second level of tax when income is distributed to them, this could make an S Corporation more valuable than an equivalent C Corporation.
   c. The Court was critical of an approach that decreased the value of the S Corporation for taxes, but failed to add a premium from not having a second layer of tax.
8. *Estate Of Jackson v. Commissioner*, T.C. Memo 2021-48
   a. Petitioner's experts applied tax affecting – but different appraisers used different rates. Respondent objected to tax affecting.
   b. After citing some aspects of tax affecting, the Court rejected tax affecting in this case, stating: "This all leads us to find that tax affecting is inappropriate on the specific facts of the case."

C. IRS Job Aid Position Tax Affecting. "A Job Aid For IRS Valuation Analysts," dated October 29, 2014. "This Job Aid is not Official IRS position and was prepared for reference purposes only; it may not be used or cited as authority for setting any legal position." Here is a quote from that Job Aid:

> "With respect to the question of pass-through taxation, no entity level tax should be applied in the valuation analysis of a non-controlling interest in an electing S Corporation, absent a compelling demonstration that independent third parties dealing at arms-length would do so as part of a purchase price negotiation. In a similar manner, the personal income taxes of a potential interest buyer or interest seller are not relevant in determining the fair market value of an interest in an electing S Corporation. The application of investor level characteristics such as personal tax rates results in an investment value to an assumed candidate buyer

rather than a fair market value based on the informed, competing interests of the hypothetical willing and financially able parties contemplated by the fair market value standard."

D. Select Non-Tax Cases Addressing Tax Affecting

1. *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006). Shareholder Dispute.
   a. There are favorable tax benefits of a profitable S corporation that should be considered in valuing stock in the corporation.
   b. Not tax affecting earnings S corporation earnings at all results in an artificial inflation of the value of the corporation.
   c. Applied tax-affecting because the Court found that it is necessary to use a method that considers the difference between the value as a C corporation and the value as an S corporation.
   d. Other factors in this case: Small entity, no indication there would be a loss of Subchapter S status, distributes cash in excess of the shareholder level taxes shareholders must pay, and S corporation tax status is a highly valuable attribute to the shareholders.
   e. Court discussed differences between *Adams*, *Heck*, and *Gross* – this Delaware shareholder dispute case is a "fairness" value. Court wanted to consider benefits and detriments on cash received by shareholders.
2. *Bernier v. Bernier*, 449 Mass. 774 (2007). Family Court Divorce and Separation.
   a. Applying C corporation tax rates to an S corporation severely understates fair market value by ignoring existence inherent tax benefits of an S corporation, and thus fails to compensate the seller accordingly
   b. However, failure to tax affect S corporation earnings entirely will artificially inflate its value by overstating the rate of return that the retaining shareholder could hope to achieve
   c. "[T]he metric employed by the *Kessler* court provides a fairer mechanism for accounting for the tax consequences of the transfer of ownership of the [S corporations] from one spouse to the other in the circumstances of record." Thus, the case was remanded to the trial judge to employ the tax affecting approach adopted in *Kessler*.

V. VALUING FRACTIONAL INTERESTS

A. *Ludwick v. Commissioner*, T.C. Memo. 2010-104

This Judge Halpern case attracted a lot of attention when it was published in 2010. The importance of a cost of partition analysis in deriving the quantum of fractional interest discount and that the tenants in common agreement was not mentioned in the opinion led to a lot of speculation.

In this gift tax case, husband, and wife each created a QPRT. Husband transferred an undivided 50% interest in a Hawaiian vacation home to his QPRT and wife transferred an undivided 50%

interest in the same property to her QPRT. The question before the Court was the quantum of discount applicable to each 50% undivided interest.

The taxpayers claimed a 30% fractional interest discount on their gift tax returns. In the 90-Day Letter, IRS allowed only a 15% fractional interest discount. On brief, IRS argued for a discount of not more than 11%.

The Court made the following findings before proceeding to compute the quantum of fractional interest discount applicable in this case:

1. A contested partition would take 2 years to resolve (including 1 year to sell the property) and that the costs made necessary by the litigation would be 1 percent of the value of the property (that is, $72,500).

2. A buyer would expect partition to be necessary 10 percent of the time.

3. The cost of selling the property (which the sellers would bear in any case) would be 6 percent of the value of the property (that is, $435,000).

4. The annual operating cost of the property was approximately $350,000. We assume that a buyer of a one-half undivided interest in the property would expect to bear only half the costs described above; the buyer would expect the remaining petitioner to bear the other half.

The Court then proceeded to apply two value scenarios and weigh them: (i) if partition is <u>not</u> necessary – weighted 90% and sale within 1 year; and (ii) if partition is necessary – weighted 10% and sale within 2 years. From this approach the Court concluded that a 17.2% fractional interest discount was applicable to each undivided 50% interest in the property.

One point to discuss before leaving the *Ludwick* case. There was a tenancy common agreement in place on the property. That agreement removed the right of partition. It also provided each owner the right to put his or her interest to the other owner for a value equal to a pro rata share of the whole. It also gave each owner the right to cause sale of the property in its entirety.

B. *Elkins v. Commissioner*, 767 F.3d 443 (5th Cir 2014)

Petitioners sought to eliminate an estate tax deficiency resulting from the Service's disallowance of a "fractional-ownership discount" applied by the Estate in determining the taxable values of Decedent's pro rata shares of the jointly stipulated fair market values of 64 works of art, in which the Decedent owned only fractional interests at his death. Rejecting both the Service's zero-discount position and the Estate's various fractional-ownership discounts, the Tax Court applied a "nominal" 10 % fractional-ownership discount across the board.

At issue on appeal: given the parties' stipulation of the FMVs, is the Estate taxable on Decedent's undiscounted pro rata share of those FMVs (Service's position), a pro rata share discounted by 10% (Tax Court's holding), or the various percentages espoused by the Estate?

The Fifth Circuit begins by stating that because the determination of "fair market value" is a mixed question of fact and law, *de novo* is the appropriate standard of review. The court then holds that it will not grant any special deference to the Tax Court's prior findings because (1) the Tax Court did not express nor imply any witness credibility concerns; and (2) the willing buyer/willing seller test of fair market value is not peculiar to federal tax issues but rather is "universally employed in myriad legal contexts."

The Fifth Circuit then hold that the Tax Court misinterpreted the IRC's burden of proof standard under 26 U.S.C. § 7491, but that its error would ultimately have no effect. Under 26 U.S.C. § 7491, when the petitioning taxpayer provides sufficient evidence to establish the material facts, the Service has the burden of refuting such facts and proving different ones. As such, when the Estate produced credible and highly probative evidence in support of both the applicability of such discounts and their precise respective percentages, the burden shifted to the Service. When the Service chose not to produce any evidence whatsoever, the case should have ended at that point in favor of the Estate.

It should be noted that prior courts have contributed several wrinkles to the burden of proof issue. In *Schutt v. Commissioner*, T.C. Memo 2005-126, the Tax Court noted that while the burden of proof primarily rests with the Petitioner on issues raised in the statutory notice of deficiency, the Service bears the burden of proof on those issues raised later. Furthermore, in *Tanenblatt v. Commissioner*, T.C. Memo 2013-263, the Tax Court held that a Petitioner argument in the face of Respondent expert testimony requires the Petitioner to introduce its own expert testimony suggesting a conclusion different than Respondent's.

Returning to *Elkins*, the Fifth Circuit then stated that even under the "preponderance of the evidence" standard used by the Tax Court, the Tax Court nevertheless should have used the Estate's evidence. That is, when the only evidence on an issue is presented by one party, and "by the one party that did not have the burden of proof," there is no "preponderance" per Black's Law Dictionary as it "takes two to tango." Again, however, the Fifth Circuit noted that this error in application of the "preponderance" standard ultimately makes no difference, for two reasons: (1) because the Service "put all of [its] eggs in the one, no-discount basket at trial," the Service is precluded from questioning the Estate's evidence on appeal; and (2) given the total absence of evidence provided by the Service regarding the discounts, the Tax Court should have accepted and applied the Estate's discounts, which were provided with "much more than substantial evidence."

The Fifth Circuit then found that the Tax Court should have known to reject its own nominal 10 percent discount given several factors. First, this trial transcript of this appeal diametrically opposes the decisions in *Estate of Scull*, 67 T.C. Memo 2953 (1994) and *Stone v. United States*, 2007 WL 2318974 (2007), both of which awarded nominal discounts only "because of a lack of proof [by the taxpayer] that any greater discount was warranted." Unlike those cases, the Estate here presented "all," and "a surfeit" to boot, of the discount evidence. Second, after review of the entire transcript of testimony of the Estate's experts and their written reports, the court is "satisfied beyond cavil" that the experts had considered and correctly weighed all pertinent factors in forming their opinions. Further, not only had they provided accurate evidence, this evidence is also uncontradicted because it was the only such evidence presented. As such, the Tax Court's arbitrary holding of a 10% nominal discount constitutes reversible error under "any standard of review."

The Fifth Circuit also found that the Tax Court "inexplicably veer[ed] off course" when it turned its focus to the role of "the Elkins children" as owners of the remaining fractional interests in the works of art. In doing so, the Tax Court gave "short shrift to the time and expense that a successful willing buyer would face in litigating the restraints on alienation and possession and otherwise outwaiting those particular co-owners." The Fifth Circuit also noted that the Elkins heirs are neither "*hypothetical* willing buyers nor *hypothetical* willing sellers" any more than the Estate is "the hypothetical willing seller." That being said, the Fifth Circuit acknowledged that a hypothetical willing buyer would take into account all aspects of the remaining fractional interests in art owned by the Elkins heirs, and not just the likelihood that the Elkins heirs would want to acquire the Decedent's fractional interests from a successful buyer. However, the Estate's experts' written reports and their testimony at trial "demonstrates beyond question" that the Elkins heirs' wealth, avowed disinterest in selling their interests, and their willingness to legally frustrate a willing buyer minimize the effects of these "other" aspects. Furthermore, if the heirs were to purchase such interests, they would first consult experts as to the price, and these experts would likely be the same experts the Estate used at trial (who substantially discounted below FMV). Finally, any potential willing buyer would "undoubtedly insist" on a further discount due to the Elkins heirs formidably resisting any "quick resale" after a purchase.

In sum, the 5th Circuit in Elkins (1) affirmed the Tax Court's rejection of no fractional-ownership discount; (2) affirmed the Tax Court's holding that a discount is warranted; (3) reversed the Tax Court's holding that the discount is a nominal 10 percent across the board; (4) applied the discounts proffered by the Estate's experts (or 44.75% uniformly to the Decedent's interest in each work of art); and (5) refunded the taxpayer $14,359,508.21.

VI. SUBSEQUENT EVENTS (AND PRE-VALUATION DATE EVENTS)

A. Actual Sales. If there is no public market or the asset is not sold at retail, then the best evidence of value will be actual arm-length sales at or near the valuation date. *Andrews v. Commissioner*, 79 T.C. 938 (1982). Thus, a critical question when valuing assets where there is no public market is, "Whether there are any actual sales at or near the valuation date."

1. *Estate of Scanlan v. Commissioner*, (T.C. July 24, 1996). This gift and estate tax case involved valuation of shares of stock in Eatelcorp, Inc., a privately-owned corporation ("Eatel"). Decedent and his wife gifted 10,667 shares of Eatelcorp on April 12, 1991, and Decedent owned a 50% community property interest in 50,000 shares at his death (July 16, 1991). The shares at issue constituted a minority interest in Eatelcorp, which had 964,666 shares of outstanding stock as of the valuation dates. Decedent's family owned approximately 37% of the outstanding Eatelcorp stock. Based on appraisals, the 1991 gift tax return reported a $34.84 per share value for the April 1991 gifts, and the estate tax return reported a $35.20 per share value for the stock as of Decedent's July 16, 1991 death.

In September 1992 (17 months after the gifts and 14 months after Decedent's date of death), Eatelcorp solicited offers for the purchase of all stock in the company. Various offers came in for the purchase of the stock, and the highest offer was made for $72,500,000 (or $75.1555 per share) from an unrelated third party (Brighton). In **January 1994** **(approximately two and half years after the valuation dates)**, subject to their right of first refusal, the Decedent's family bought out the rest of the Eatelcorp stockholders for a per share price of $75.1555. Based on the 1994 redemption price, the IRS determined that the per share price on the 1991 valuation dates was $72.15 per share (less a 4% minority interest discount). There were no sales or redemptions of Eatel stock between 1989 and 1994.

In challenging the increase in value, the Decedent's estate attempted to exclude evidence of the 1993 offers and the 1994 sales, claiming that they were not relevant to value because: (i) they occurred too long after the valuation dates; (ii) there was a dramatic increase in profitability between the valuation dates and the sales dates; and (iii) there was no plan or agreements to sell the stock as of the valuation date.

The Tax Court found the 1993 offers and the 1994 sales to be relevant because the "best indicator of the value of unlisted stock often is arm's-length sales of that stock at or around the time of valuation." The court found the redemption price probative even though it was "more than 1 year [removed] from the Valuation Dates" (actually more than 2 years). In its analysis, the court found the passage of time and the company's financial data between the valuation dates and the redemption date must be used to discount the redemption date value to the present value as of the valuation dates.

The Court rejected both the IRS and the Estate's value determinations and applied its own valuation analysis. The Court started with the $75.1555 redemption value as of August 1993, adjusted this figure to account for passage of time via an income analysis, and applied a 30% minority interest discount. The Court concluded that a value of $50.50885 per share was the fair market value of the Eatelcorp stock on both valuation dates. Coincidentally, this was close to splitting the difference between the Estate's value and the IRS' value, even though the court claimed it completely rejected those values.

2. *Estate of Freeman v. Commissioner*, (T.C. Aug. 13, 1996). Decedent was a founder of Xilinx and a member of its board of directors. From inception through June 1990, the company sold preferred stock at prices from $1 to $4. In August 1989, the corporation was authorized to sell common stock to outside sales representatives for $1.25 per share. In July 1989, stock options were granted to certain employees at $1.25 per share. In August 1989, the board of directors discussed an IPO, but had not yet filed a registrations statement. Decedent died on October 22, 1989. In December 1989, the corporation was authorized to sell common stock to outside sales representatives for $2.25 per share. Also, in December 1989, stock options were granted to certain employees at $2.25 per share. In June 1990, the company had an IPO at $10 per share. Here were the positions and the Court's conclusion on a per share basis: **Estate: $1.02; IRS: $4.20; Court: $4.20.** The Court rejected the Estate's appraisal because the Estate's appraiser did not inquire whether the company had any IPO plans as of the date of death and did not consider the possibility of an IPO.

3. *Estate of Busch v. Commissioner*, T.C. Memo 2000-3. This estate tax case involved valuation of a 50% interest in 90.74 aces of real property held by Decedent as of his February 26, 1993, date of death. The Alameda County property was zoned for agricultural use as of the Decedent's date of death. However, under the Pleasanton General Use Plan in effect at the

Decedent's date of death, the property was designated for medium and high density residential zoning that had yet to be approved. About a year after the Decedent's death, various developers made offers to purchase the property based upon the assumption that the property would be able to be developed. In June 1994 (16 months after a valuation date), a contract was entered into for the sale of the land for $150,000 per acre with a 9% increase annually through the date of the first closure of a lot, or June 30, 2000, and depending on the number of lots approved for development.

Since the property had not been zoned for development yet, the Estate's expert used a comparable sales method to value the property and concluded that the property's value was $100,000 per acre but should be discounted 60-80% for a lack of development approval. The IRS' expert used the $150,000 per acre price in the sales contract plus $50,000 for each unit expected to be approved in excess of 250 units. The Court rejected the Estate's analysis and rejected the portion of the IRS' analysis involving the $50,000 per unit upward adjustment. The Court used the post-death contract price of $150,000 per acre and applied a 9% discount rate. This value prevailed, even though development was not approved by the city and the sale fell through. Therefore, the Court's reliance on post-valuation date sales resulted in an unfair result for the taxpayer because the sale never occurred, however, it still served as the valuation basis.

4. *Estate of Noble v. Commissioner*, (T.C. Jan. 6, 2005). This estate tax case involved valuation of 116 shares (or an 11.6% interest) in Glenwood State Bank ("Glenwood"), a closely-held corporation, owned by the Decedent at her <u>September 2, 1996</u> death. The Estate reported a value of $903,988 for these shares (or $7,793 per share). On <u>October 24, 1997</u> (almost 14 months after the valuation date), the Estate sold the shares to Bancorporation, which owned all of the other shares, for $1,100,000 (or $9,483 per share). The IRS issued a notice of deficiency claiming that the value of the stock on September 2, 1996 was $1,100,000 based on the post-valuation date sales price.

At trial, the Estate attempted to argue that the $1,100,000 was an inflated price because Bancorporation was a strategic buyer who would pay more to own 100% of the bank after acquiring the Estate's 116 shares. Therefore, the price paid by a strategic buyer is not the price that a hypothetical willing buyer would purchase the property for. The Tax Court found that there was a lack of evidence to prove that Bancorporation was a strategic buyer. Therefore, the Tax Court used the $1,100,000 sales price as a basis for valuing the stock, but discounted it by 3% to account for the passage of time. Therefore, the Court, relying on the post-valuation date sales, determined the fair market value of the stock to be $1,067,000.

5. *Levy v. United States*, 402 Fed. Appx. 979 (5^{th} Cir. 2010). This estate tax case involved valuation of agricultural land in Plano, Texas. At the time of Decedent's death, the property was zoned for agricultural use only, despite Decedent's prior attempts to obtain approval to develop the land into residential property.

The lower Court decision was the result of a jury trial, so there is no written opinion from the lower Court and there are very few facts set forth in the Third Circuit's opinion. However, the Third Circuit found that post-valuation date offers for the purchase of the property were admissible. Likewise, the final sales price for the property two years after the valuation date was admissible. The sales price was a valid basis for the value determination since the real estate market in Plano was "relatively flat" from the valuation date to the sales date. The Court also found that it was foreseeable that the property would be zoned for development at the date of death even though prior attempts to zone for development had been rejected. Therefore, the Third Circuit applied the $25,000,000 sales price based on post-date of death events.

6. *Estate of Giovacchini v. Commissioner*, (T.C. Jan. 24, 2013). This gift and estate tax case involved valuation of a 2,356-acre parcel of land outside of Lake Tahoe, CA, subject to a conservation easement. In 2000, Decedent sold a 50% interest in the land to an LLC controlled by Decedent's family members for $2,500,000 (no appraisal was conducted). In October 2001, Decedent's trust and the LLC entered into a contract to sell a portion of the land (1,790 acres) to American Land Conservancy ("ALC") for 95% of its fair market value. Decedent died on October 8, 2001, prior to the ALC sale, so she still owned an undivided 50% interest in the land. The ALC purchase agreement was finalized on January 14, 2003, for $29,500,000 in exchange for the 1,790 acres. After the sale, Decedent's estate kept its share of the $29,500,000 purchase price and an undivided 50% interest in the remaining 566 acres.

The 2000 sale of the 50% interest in the land to the LLC was not reported on a gift tax return because the Estate was informed that this was a sale for fair market value. The Estate reported a value of $3,235,117 (approximately $2,800,00 for land and $453,000 for timber) as the value of the 50% interest in the land at Decedent's death. The IRS issued a notice of deficiency for the 2000 gift tax return and the estate tax return for, respectively, $3,784,333, and $9,818,040 plus penalties.

The Tax Court noted that the IRS' expert relied almost exclusively on the January 2003 sale of the land to determine the 2000 and 2001 values, while the Estate's expert disregarded the January 2003 sale completely. The Court sided with the IRS and refused to disregard the partial sale of the land in January 2003, stating that such sale is "undoubtedly some evidence of High Meadows' values for estate and gift tax purposes." The Court found that even though there were some changes to the property between the valuation dates and the sale date, they were not sufficient to eliminate the sale's relevance to valuation. The Court also found that the January 2003 sale was the "only truly comparable sale worthy of consideration." The Court then adjusted the 2003 sale price for inflation, the time value of money, and increases in the market. Thus, it discounted the $29,500,000 sales price by 9% for estate tax purposes and 17% for gift tax purposes. The Court, in essence, ended up splitting the difference between the Estate's and the IRS' values, but the Court also refused to apply penalties under the Neonatology Associates, P.A. test. The Court noted that penalties should not apply because the Estate used good faith in relying on competent advisors to determine the fair market value of the land for gift and estate tax purposes.

7. *JP Morgan Chase Bank, N.A. v. Comm'r (In re Estate of Newberger)*, (T.C. Dec. 22, 2015). Decedent died on July 28, 2009. Her estate timely filed a Form 706 United States Estate Tax Return, reporting three paintings: (i) a Picasso; (ii) a Motherwell; and (iii) a Dubuffet. The Estate reported date of death values of $5,000,000, $450,000, and $500,000, respectively, based on appraisals from Christie's and Sotheby's. On August 14, 2013, the IRS issued a notice of deficiency, and determined that the Picasso, the Motherwell, and the Dubuffet had date of death values of $13,000,000, $1,500,000, and $750,000, respectively.

The Picasso: On February 2, 2010, the Picasso sold at Christie's London auction for $12,927,874. The Estate argued that the sale price of the Picasso should not be taken into account as evidence of its fair market value because "it was a fluke" and could not have reasonably been anticipated on the date of death. Based on a December 2009 appraisal from Christie's, which accounted for a decline in the market for fine artwork from 2008 to 2010, the Estate reported on its Form 706 that the Picasso had a $5,000,000 date of death value. The Court held that no evidence was more probative of fair market value than the direct sale price, and therefore the Estate's failure to consider the sale of the Picasso rendered its valuation unreliable. The Court agreed with the IRS' expert, and after adjusting the sale price downward to reflect July 28, 2009, market conditions, valued the Picasso at $10,000,000.

The Motherwell: On November 11, 2010, a similar work by Motherwell sold for $1,426,500. The Estate and the IRS agreed that the November 2010 sale was the best comparable sale relating to the Estate's Motherwell. The Estate argued that the sale price should be adjusted downward to $800,000 to reflect July 28, 2009, market conditions. The IRS offered no explanation for its higher $1,500,000 valuation. The Court held that the IRS should have made the same downward market adjustment to the Motherwell as it made to the Picasso. The Court agreed with the Estate's expert and valued the Motherwell at $800,000.

The Dubuffet: On November 14, 2007, a similar work by Dubuffet sold for $825,000. The Estate and the IRS agreed that the November 2007 sale was the best comparable. The Estate relied on an appraisal by Sotheby's to assert a $500,000 date of death value. The IRS offered no explanation for its higher $900,000 valuation. The Court found that the IRS' contention that the Dubuffet's value was higher during the market downturn than before the market downturn was nonsensical. The Court agreed with the Estate that the Sotheby's appraisal of $500,000, which included a downward market adjustment, properly reflected the Dubuffet's date of death value.

B. Unaccepted Offers At or Near the Valuation Date. If there are no actual sales, but there has been an unaccepted offer to purchase the subject property, is that evidence of value? In a word, maybe. Cases are split regarding how much weight should be given to the value of unaccepted offers near the valuation date. Some cases support the proposition that unaccepted offers – if the offeror is knowledgeable or acted on the advice of experts – should be accorded substantial weight. Other cases decline to use unaccepted offers as an indication of value, instead relying on a market approach (using comparable sales) or income approach to determine value.

In each of the cases discussed below, pre-, and post-valuation offers are at least discussed, if not afforded weight in the valuation process. Therefore, knowledge of all offers (both before and after the valuation date) is critical, and analysis of market trends between the offer date and the valuation date is also important. The determination of whether or not offers should be afforded weight in valuation revolves around the amount of other valuation evidence close to the valuation date (e.g., recent sales of the subject property, quality of comparable sales, and other evidence of value). Below is an analysis of the cases discussing offers and their effect on value. The discussion that follows begins with cases where unaccepted offers were found relevant in the valuation. Thereafter, the discussion turns to cases where unaccepted offers were **not** found relevant in the valuation.

1. *Estate of Wilson v. Commissioner*, 5 BTA 615 (1926). This estate tax case involved an estate tax deficiency of $46.15, and the issue was the value of real property held by the Decedent at death. In determining the value, the Court considered rejected offers both before (for $12,000) and after ($16,000) the Decedent's death. With very little analysis, the Court applied a value directly in between the two offers ($14,000).

2. *Estate of Brown v. Commissioner*, T.C. Memo 1956-240. This estate tax case involved valuation of a tract of land known as “Godlington Manor.” Decedent died on May 4, 1950. In 1940, the manor was listed for sale at $315,000 (this offer was advertised through June 1950, which was after death). Shortly before the Decedent’s death, a real estate agent offered to buy the property for $75,000, but the offer was rejected as being too low. Between the Decedent’s date of death and October 24, 1950, an offer for $120,000 was received but was rejected because the Estate didn’t think the financing was feasible. A second $120,000 offer was made on October 24, 1950, but was subsequently withdrawn due to concerns about the impact the Korean War would have on the economy.

The estate tax return valued the manor at $80,000, and the IRS applied a value of $120,000 (based on the offers received after the valuation date). The IRS expert stated that the offer was indicative of value because it was a bona fide offer made by a willing and able purchaser. The Tax Court found that a “bona fide offer, made by a willing and able purchaser, which is rejected by the seller, is some evidence of what the owner considered the lower limits of such value to be . . . but does not conclusively establish the fair market value of the property.” The Court’s finding seems somewhat contradictory because the Court stated that the offers are not determinative of value because they were rejected and therefore are too low, but then the Court (without much analysis) applied a value of $100,000 to the property (which was lower than the rejected $120,000 offer).

3. *Estate of Paul Mitchell v. Commissioner,* (T.C. Apr. 9, 2002). This case involved valuation of a 49.04% interest in John Paul Mitchell Systems (“JPMS”) – a hair care corporation. Paul Mitchell died on April 21, 1989. In the years leading up to Mr. Mitchell’s death, a series of offers for the purchase of a 100% interest in JPMS were made: (i) in the fall of 1987, Minnetonka made a $100,000,000 offer, which was rejected due to being too low (JPMS wanted $125,000,000); (ii) in the fall of 1988, Minnetonka made a $125,000,000 offer, but this offer was rejected because it was “just a little short”; (iii) in the fall of 1988, Gillette allegedly made an offer for $150,000,000 plus a royalty of 2% of sales for the sellers’ lifetimes. These last offers were approximately six months before Mr. Mitchell’s death.

On the estate tax return, the Estate claimed the value of the JPMS interests was $28,500,000, and the IRS claimed its value was $105,000,000. All of the Estate’s and the IRS’ experts used earnings models, comparable companies, and discounted cashflow models to determine their values. The experts obviously used very different discount rates in their income approaches to determine their final values. The experts also used different discounts for lack of marketability to reflect that the Decedent only held a 49.04% interest in JPMS; the Estate applied a 45% discount and the IRS applied a 30% discount.

The Court determined that the comparable company and discounted cashflow methods were too “theoretical” to value interests in JPMS, which was a unique company that did not have sufficient similarities to the “comparable” companies in the studies. Instead, the Court stated that the “real-world acquisition offers by Minnetonka and Gillette” served as a better indication of value of JPMS, even though neither of these offers were accepted. The Court placed a $150,000,000 value on JPMS at the moment prior to Mr. Mitchell’s death; the Court also applied a 35% discount for lack of marketability to the Decedent’s 49.04% interest in JPMS. In determining this value, the Court “considered all the evidence but gave the greatest consideration to Minnetonka’s real-world $125,000,000 offer in the fall of 1988 (which the seller found “a little short”) and the Gillette offer of $150,000,000. Therefore, the Court found rejected offers close in time to the valuation date to be a better starting point for the determination of value than the values derived from the comparable sales and discounted cashflow methods.

4. *Georgia Ketteman Trust v. Commissioner*, 86 T.C. 91 (1986). This gift tax case involved the valuation of farmland in Kansas that Georgia Ketteman sold on May 3, 1967, to a corporation of which she, certain family members, certain friends, and her attorney were shareholders. In January 1967 (four months before the sale), an offer of $460,000 was made for the purchase of the property; this offer was rejected. The May 3, 1967, sales price was $480,000; no gift tax return was filed because Mrs. Ketteman thought the sales price was equal to the fair market value of the land. In December 1967 (seven months after the sale and when the property was acquired by the corporation), a prospective purchaser made an offer of $1,579,620 to buy the property; the corporation rejected this offer due to the payment terms. Also, in December 1967, the corporation offered to sell the property to another buyer for $1,579,620; the purchaser did not accept this offer. Finally, in July 1968 (14 months after the sale) the corporation sold the property for $2,500,360. In 1977, in lieu of foreclosure, the seller deeded a portion of the property back to the corporation. From 1967 to 1968, an airport was constructed near the property and it was anticipated that the farmland could be developed into commercial property; therefore, this explains the dramatic increase in value.

At trial, both the Taxpayer's expert and the IRS' expert used the market data approach to determine the value of the property; the Taxpayer's expert determined a value of $550,000, and the IRS' expert determined a value of $1,265,000 (the value difference is attributable to differing adjustments). The Tax Court agreed that the market data approach was the proper method for valuing the farmland, even though there were a number of unaccepted offers within months of the valuation date and the property actually sold just more than a year after the valuation date. The Tax Court determined that the market was in such a state of flux (i.e., dramatically increasing in value due to the airport construction) that the rejected offers were "not conclusive evidence of value of the land" and were not even entered into evidence for valuation purposes. In the end, the court determined a fair market value of $726,122 for the land, which resulted in a $246,122 taxable gift.

5. *Estate of Dunia v. Commissioner*, (T.C. May 20, 2004). This estate tax case involved the valuation of a tract of real property held for sale as a commercial site. Decedent died on June 22, 1996, owning a 92.91-acre parcel of undeveloped land outside of Los Angeles (the "Victorville Property"). The value of the Victorville Property "bottomed out in 1996." In October 1996 (four months after the valuation date), Lanfolio submitted an offer to purchase the Victorville Property for $5,320,000; this offer was countered by the seller's listing agent and the counter was not accepted. In February 1997 (8 months after the valuation date), Landfolio submitted an offer to purchase the property for $6,000,000 (there is a dispute as to whether this offer was actually presented). In March 1997 (9 months after the valuation date), GVD actually entered into a purchase agreement to buy the Victorville Property for $8,400,000, but this purchase fell through due to GVD's withdrawal. In May 1998 (almost two years after the valuation date), the trustees of the Decedent's trust entered into a joint venture agreement regarding the Victorville Property and 15.87 acres (17% of the property) were sold on July 1, 1999 (about three years after the valuation date) for $4,100,000.

The estate tax return (which was filed in March 1997, so before the 1999 sale) claimed the value of the property was $4,050,000. The IRS valued the property at $16,300,000. The taxpayer's expert relied on the comparable sales approach and determined that a value of $1.14 per square foot was the proper valuation metric (resulting in a value of $4,050,000). The IRS' expert relied on comparable sales as well as the unaccepted offers and partial sale to conclude a value of $2.10 per square foot or $8,500,000 for the total property.

The Tax Court found the IRS' expert's reliance of the partial sale and unaccepted offers to be improper methodology. The Court found the actual sale should only be given limited weight because it was a partial sale too far removed from the valuation date (3 years). Also, there was too much speculation regarding the offer terms and presentation of offers for those offer values to be relied upon. Ultimately, using a comparable sales approach, the Tax Court determined the fair market value of the property to be $5,463,666 (or $1.35 per square foot).

C. Other Pre and Post Date Events. Other events that may occur prior to or after the valuation date can affect the fair market value of the subject property. The key to these events rests on whether they are reasonably foreseeable. Also relevant is whether the taxpayer can establish the basis for his or her claim.

For example, in *Okerlund v. United States*, 53 Fed. Cl. 341 (2002), affrm'd 365 F3d 1044 (Fed. Cir. (2004), the issue was the value of closely held stock transferred by sibling donors to trusts for the benefit of their respective children. The Court found a 70/30 combination of market and income approaches was appropriate. Discounts for lack of control and lack of marketability aggregating 45% were also applied. Significant gifts were made in 1992, and in 1993 the company's founder and top executive officer died. In addition, a salmonella outbreak occurred after the 1992 gifts. These events led to declines in the company's sales and income in 1993 and 1994. To what extent should the 1993 and 1994 results be considered in valuing the 1992 gifts? The Tax Court found that "plaintiffs did not demonstrate that the risk of food contamination faced by SSE in 1992 was greater or any different than that faced by the guideline companies…Furthermore, although Marvin Schwan was undoubtedly a key management figure, neither his death the following year nor his retirement was expected as of the 1992 valuation date." The Appeals Court found that these findings of the Tax Court were not reversible error, stating, "The death of the company's founder and a salmonella outbreak, although identifiable risks, were unexpected occurrences that led to declines in the company's sales and income in 1993 and 1994. The valuations proffered by the parties' experts incorporated the risks of both the reliance on a key executive and the possibility of contamination. The earnings data for 1993 and 1994 were not relevant in valuing the stock because of the significance of these "exogenous" events occurring after the valuation date."

For a case illustrating the importance of considering reasonably foreseeable events, see *Bergquist v. Commissioner*, 131 T.C. No. 2. While an income tax case, the same standard of value is used, and therefore, the case has merit in estate and gift tax valuations.

Estate of Kessel v. Commissioner, (T.C. May 21, 2014), was discussed above. However, the IRS also moved for summary judgment on the issue of whether a hypothetical buyer and seller of the Madoff account would reasonably know or foresee that Mr. Madoff was operating a Ponzi scheme at the date of Decedent's death. The Court noted that under the hypothetical willing seller and buyer standard, “later occurring events affecting the value of the property transferred are relevant to the determination of fair market value only if they were reasonably foreseeable at the time of the transfer.” Furthermore, “later occurring events not affecting value may be relevant to the determination of fair market value regardless of their foreseeability at the time of transfer.” The IRS argued that due to Mr. Madoff’s skill and the fact that the Ponzi scheme was not discovered for two years after Decedent’s death, the Ponzi scheme was not reasonably foreseeable. The Court disagreed and said that there was speculation for years that the Madoff accounts were “too good to be true.” Therefore, summary judgment was denied because the issue of what knowledge a hypothetical buyer and sell would have regarding the Madoff account is a triable issue of fact.

The gift and estate tax case of *Giovacchini v. Commissioner*, (T.C. Jan. 24, 2013), involved valuation of a 2,356 parcel of land outside of Lake Tahoe, CA, subject to a conservation easement. In the year 2000, the Decedent sold a 50% interest in the land to an LLC controlled by the Decedent’s family members for $2,500,000 (no appraisal was conducted). On October 4, 2011, (four days before the decedent's death), the Decedent’s trust and the LLC entered into a contract to sell a portion of the land (1,790 acres) to American Land Conservancy (“ALC”) for 95% of its fair market value, with the understanding that it was ALC's intention to secure acquisition of the property by a public agency. Decedent died on October 8, 2001, prior to the ALC sale, so she still owned an undivided 50% interest in the land. Negotiations between the trust, the LLC, and ALC went on for over a year. In March 2002, ALC informed the U.S. Fire Service ("USFS") that it had an option contract to buy the property, and USFS engaged an appraiser to value the land (using the Uniform Appraisal Standards for Federal Land Acquisitions ("UASFLA"), which resulted in a $29,500,000 value. On January 14, 2003, ALC assigned its rights under the purchase agreement to the U.S. Department of Agriculture (at the behest of USFS). The sale closed for $29,500,000 on January 31, 2003. The Tax Court somewhat criticized USFS' appraisal report for using UASFLA appraisal standards instead of USPAP standards and acknowledged that the appraisal was missing property characteristics that should have been considered.

After the sale, the Decedent’s estate kept its share of the $29,500,000 purchase price and an undivided 50% interest in the remaining 566 acres. The year 2000 sale of a 50% interest in the land to the LLC was not reported on a gift tax return because the Estate was informed that this was a sale for fair market value. The Estate reported a value of $3,235,117 (approximately $2,800,000 for land and $453,000 for timber) as the value of the 50% interest in the land at the Decedent’s death. The IRS issued notice of deficiency for the 2000 gift tax return and the estate tax return for, respectively, $3,784,333, and $9,818,040 plus penalties. The Tax Court noted that the IRS’ expert relied almost exclusively on the January 2003 sale of the land to determine the 2000 and 2001 value, while the Estate’s expert disregarded the January 2003 sale completely. The Court sided with the IRS and refused to disregard the partial sale of the land in January 2003, stating that such sale is “undoubtedly some evidence of High Meadows’ values for estate and gift tax purposes.” The Court found that even though there were some changes to the property between the valuation dates and the sale date, they were not sufficient to eliminate the sale’s relevance to valuation. The Court also found that the January 2003 sale was the “only truly comparable sale worthy of consideration.” The court then adjusted the 2003 sales price for inflation, the time value of money, and increases in the market. Thus, it discounted the $29,500,000 sales price by 9% for estate tax purposes and 17% for gift tax purposes. The Court, in essence, ended up splitting the difference between the Estate's and the IRS' values, but also refused to apply penalties under the Neonatology Associates, P.A. test. The Court said penalties should not apply because the Estate used good faith in relying on competent advisors to determine the fair market value of the land for gift and estate tax purposes. Read the case and decide for yourself whether the Tax Court should be tasked with pre-approving purchases made by the U.S. Forest Service (in addition to being the gatekeeper for admission of expert testimony into evidence)!

VII. HOW TO ADDRESS NON-OPERATING ASSETS

A. *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101.

This gift tax case involves valuation of interests in a partnership holding timber lands (SJTC) and an affiliated S corporation producing lumber (SSC). IRS asserted a gift tax deficiency of nearly $45 million. On May 28, 2009, Mr. Jones gifted 10,267.67 limited partner units to each of his three daughters. Each gift represented approximately 18.5% of SJTC. Also on May 28, 2009, Mr. Jones gifted shares in SSC as follows: (i) 1,300 shares of Class A voting stock to a voting trust (about 2.5% of SSC); (ii) 4,800 shares of Class B non-voting to each of three trusts, one such trust for each daughter and her descendants (each about 9.4% of SSC); and (iii) 5,456 shares of Class B non-voting to each of three trusts, one such trust for daughter (each about 10.7% of SSC). The questions for the Court were focused on valuation and included the following: (i) whether an asset based approach or an approach that uses the income and market based approaches should be used to value the 100% going concern value of SJTC; (ii) whether the 2009 revised financial projections for SJTC should be used; (iii) whether tax-affecting or a zero tax rate approach should be used in valuing SJTC and SSC; (iv) when valuing SSC, whether loans to SJTC and a 10% general partner interest in SJTC should be considered operating assets; and (v) what is the proper discount for lack of marketability.

The Court began by determining what valuation approaches should be applied to SJTC, a partnership holding timberlands. Both parties used market based approached – guideline public company method. Where they differed is on the second approach. Petitioner's expert used an income approach while Respondent's expert used an asset approach. After the Court concluded that SJTC had aspects of both an operating company (income approach) and an investment or holding company (asset based approach), the Court then went on to analyze which approach (or weighting of approaches) should be used under these circumstances.

The Court looked to the likelihood that that timberlands would be sold. Respondent argued that circumstances could arise resulting in SJTC selling its timberlands. Petitioner argued that SJTC should be considered as part of SSC, and that the subject block of limited partner units could not force a sale of the timberland. Further, SSC would never exercise its authority as general partner of SJTC to sell the timberland. The Court ultimately found that an income approach (DCF) was more appropriate for SJTC than an asset based approach (NAV approach).

In reviewing Petitioner's income (DCF) approach for SJTC, the court addressed two issues: (i) whether to use revised financial projections; and (ii) whether to tax-affect SJTC's earnings in the DCF model. SJTC issued annual reports that included yearly projections for SJTC. Two months after issuing its annual report, SJTC issued revised projections. Petitioner's expert relied on the revised projections and Respondent argued that the revised projections were unreliable. The Court found that the revised projections (made in April 2009) were the most current as of the valuation date and thus appropriately used.

The Court then turned to tax-affecting SJTC's earnings. The discussion, while under the DCF heading, also included a discussion of the market approach used by Petitioner's expert. "Tax-affecting" is adjusting earnings to account for taxes. When valuing a pass-through entity, such as a partnership or an S corporation, the earnings of the entity do not reflect any tax being paid. Yet, a DCF model is designed to capture the cash received from the entity's operations. Market approaches are designed to compare the subject company to public companies that are subject to C corporation taxes. Here, Petitioner's expert used a 38% combined federal and state income tax rate as a taxable C corporation (although he used individual rates, not corporate rates). After adjusting earnings for taxes, Petitioner's expert applied the discount rate the tax-affected earnings. Similarly, Petitioner's expert also used the tax-affected earnings when applying multiples derived from the guideline public company approach. After weighting the DCF approach and the guideline public company approach, Petitioner's expert applied a 22% premium to the weighted enterprise value of SJTC to reflect the benefit of SJTC's tax structure.

In a typical situation, the value of an enterprise run as a pass-through entity is lower if the earnings are tax-affected. This is true even after application of a premium to address the tax benefits of the pass-through entity. Respondent's position is that there should be no tax-affecting of earnings. Respondent argued that there is no evidence it is used in arms-length transactions, and the proper way to reflect the benefits of a pass-through entity structure is to not tax-affect earnings. In several tax cases discussed above, courts rejected tax-affecting earnings. Here, petitioner's expert presented evidence of tax-affecting. Respondent's experts were according to the Court, Respondent's experts "are noticeable silent." This led to the Court's observation, "Thus, we do not have a fight between valuation experts but a fight between lawyers."

The Court distinguished *Jones* from prior cases that rejected tax affecting earnings. With respect to *Gross*, the Court stated, "on the record of that case, a zero-percent corporate tax rate properly reflect those tax savings rejecting the expert's offered justifications." In a footnote, the Court further clarified that the expert in *Gross* tax-affected earnings using a 40% tax rate, but did not apply a premium to reflect the tax benefits. With respect to *Gallagher*, the Court stated, "we again rejected tax-affecting because the taxpayer's expert did not justify it but again acknowledged that the benefit of a reduction in the total tax burden borne by S corporation owners should be considered when valuing an S corporation." With respect to *Giustina*, the Court stated, "we rejected tax-affecting in the valuation of a partnership because we found taxpayer's expert's method to be faulty: He used a pretax discount rate to present value posttax cashflow."

In valuing SSC, the Court addressed intercompany debt ($32.7 million debt owed by SJTC to SSC), SSC's general partner interest in SJTC, and tax-affecting SSC's earnings. On the intercompany debt ($32.7 million), the Court found that Petitioner's expert properly treated the debt as part of SSC's operations that produced operating income (instead of adding the debt to the value of SSC). The Court also found that Petitioner's expert properly used expected distributions to represent the value of the 10% general partner interest (instead of simply adding the value of a 10% general partner interest to the enterprise value of SSC). On tax-affecting SSC's earnings, the Court accepted the tax-affecting applied by Petitioner's expert for the same reasons it accepted tax-affecting for SJTC. This was the case because the expert used the same methodology as with SJTC (and even though used the same methodology yielded a different rate for the dividend tax avoided for the implied benefit of pass thought tax treatment).

In terms of incorporating other non-operating assets, SSC's 10% general partner interest in SJTC was included based on its expected distributions to SSC (not as an addition to value based on its value as an asset).

B. ***Kress v. United States,*** 372 F. Supp. 3d 731 (E.D. Wis. 2019)

In *Kress v. United States*, the Kress family members were shareholders of a closely-held S-corporation, Green Bay Packing. The bylaws contained a Family Transfer restriction that allowed the Kress family to gift or sell their stock to their children and grandchildren. In 2006, 2007, and 2008, the Kresses' gifted minority shared to their children and grandchildren and reported it on their gift tax returns.

In 2014, the IRS sent notices of deficiency, challenging the valuation of the gifted shared. The taxpayer's expert represented an in-depth understanding of the company and a wide range of comparable companies in his analysis. The IRS's expert valued the company using the guideline public company as a C corporation and applied an S corporation premium. Accordingly, the U.S. District Court of Eastern District of Wisconsin concluded:

1) The taxpayer's expert appropriately valued the S-Corporation's stock.
2) The IRS's expert analysis of the market approach and income approach resulted in a higher estimate of the stock's fair market value because it did not consider the minority interest in evaluating the non-operating assets and stock as a whole.

IRC Section 2703(a) provides the valuation of any stock shall be determined without considering restrictions to sell the stock unless: (1) the transaction is a "bona fide business arrangement;" (2) the transaction is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration; and (3) the transaction's terms are comparable to similar arrangement entered into by persons in an arms' length transaction shall be considered when valuing such property.

Taxpayer's expert considered transfer restrictions in the Bylaws when valuing the company. The government argued that the restrictions on the transfer of stock in the company should have been disregarded under Section 2703 and thereby omitted during the valuation. The court analyzed the three-prong exception to I.R.C. Section 2703(a):

1) The first prong was satisfied because it was a bona fide business arrangement consistent with the goals of maintaining a family business, providing for the family members to make a living, and ensuring the interest of employees and the community.

2) The second prong was satisfied because the gifts were lifetime, not on death transfers. Surprisingly, the court held that this prong can only be failed if the valuation is in an estate tax context, it is automatically satisfied in lifetime transfers.
3) The third prong was not satisfied because the taxpayers did not prove that the transfer restrictions were comparable to similar arrangements.

Because third prong was failed, the court determined that the company specific transfer should not affect the marketability discount.

However, this did not alter the persuasiveness of the taxpayers' expert valuation since the court adjusted the marketability discount by merely three percent. The taxpayers' expert analysis of the fair market value approach was more accurate. This is because it considered the company's financial position, the 2008 recession, non-operating assets to the extent the assets contributed to the overall earnings, payment of dividends, the company's management, possibility of any future public offerings, and its status as an S-corporation.

It is important to note that Green Bay Packing held the following non-operating assets:

1. Hanging Valley Investments LLC – a wholly-owned subsidiary of Green Bay Packing manage long-term investments in mezzanine financing obligations, private equity funds, real estate investment funds, gas, oil, and other commodities. The assets of this LLC ranged from $65million to $77 million across the valuation dates.

2. Group Life Insurance Policies – these policies were on key employees and shareholders and had substantial cash values as of the valuation dates. The cash surrender value of these policies, less certain obligations against them, ranged from $86 million to $111 million across the valuation dates.

3. Two Private Aircraft – on average, the planes were used half of the time for business purposes and the other half for the Kress family's personal purposes.

When considering how to account for these non-operating assets in the valuation approach, the Court rejected what many see as a common approach. That is, the Court rejected an approach that would separate these non-operating assets out of the corporations operating financials, value them independently, and then add the values back to the business' operating value. Instead, the Court held that when valuing a minority position in the corporation, non-operating assets should be considered to the extent that those assets contributed to Green Bay Packing's overall earnings. This is because a minority owner could not access their value.