Business Valuation for the Litigation Practitioner

Litigation Lessons from Richmond

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Valuation practitioners can become involved in litigation by way of the Tax Court. A recent Tax Court case[1] (filed February 11, 2014) is instructive in the problems and issues that may be encountered by the valuation practitioner in performing a valuation for estate tax purposes.

Background

At the time of her death, the decedent owned a 23.44 percent interest in a family owned personal holding company (PHC). The assets of PHC consisted primarily of publicly traded stock. The estate tax return reported the fair market value of the decedent's interest PHC as $3,149,767 derived using a capitalization of dividends method to value the estate asset.

At the time of her death, the decedent resided in Pennsylvania. At the time the petition was filed, one executor resided in Pennsylvania where the will was probated. The other executor lived in New Jersey. These locations are important in determining the jurisdiction of the Court of Appeals since appeals courts have ruled differently on the issue of built-in capital gains tax.

The decedent died on December 10, 2005. As of December 2005, PHC had 2,338 shares of common stock outstanding. The shares were held by 25 members whose interests ranged from .17 percent to 23.61 percent. Including the decedent, the three largest shareholders owned a combined total of 59.2 percent.

From inception through the date of death, PHC followed an investment philosophy that maximized dividend income. Since PHC was a personal holding company under IRC section 541, it had a strong incentive to distribute most of the dividend income generated by the securities of the portfolio. Since 1970, the dividends paid by PHC grew at slightly more than 5 percent per year. The turnover of PHC's securities has been averaging approximately 1.4 percent during the 10-year period ending December 31, 2005. At that rate, it would take approximately 70 years for the portfolio to completely turnover.

The owner of appreciating assets becomes liable for a tax on that appreciation only upon an event such as the sale of the assets. A personal holding company that holds such assets may prefer to retain the assets rather than sell the assets in order to defer the tax liability on disposition of the assets. This deferred tax is commonly referred to as "built in capital gains tax" (BICG tax). As of December 2005, 87.5 percent of the value of PHC's portfolio consisted of this appreciation on which the BICG tax had not been paid. Periodically, the financial advisor to PHC advised selling substantial amounts of the portfolio in order to diversify the portfolio.

Transactions in PHC Stock

From 1971 through 1973, there were nine transactions involving the sale or redemption of PHC stock by shareholders. The court indicated that it appears that the value of the stock for those transactions was determined using the dividend model. Additionally, when another shareholder died in 1999, the estate used the dividend model to value its interest in PHC.

1 *Estate of Helen P. Richmond, Deceased , Amanda Zerby, Executrix, Petitioner v. Commissioner of Internal Revenue*, Respondent, T.C. Memo. 2014-26

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Nature of the Interest

The 548 shares of PHC's stock owned by the decedent was a minority interest although the decedent was the second-largest shareholder. As a minority, the decedent could not unilaterally change management or investment philosophy and was unable to unilaterally gain access to the corporate books, change distributions from the company, or cause the company to redeem its stock. The decedent had no right to "put" the stock of the company and the company could not "call" the decedent stock.

Other Events

On February 10, 2004, the decedent executed a codicil to her will that appointed John Lyle and Amanda Zerbey as co-executors of her estate. Mr. Lyle was a CPA and PHC's accountant from 1970 through 2008. Since 1973, Ms. Zerbey was employed as an Internet operations quality control manager and met the decedent in Ms. Zerbey's prior employment as a buyer for a store frequented by the decedent.

Financial Information

On December 10, 2005, PHC held a portfolio with a market value of $52,159,430. Of that amount, $50,690,504 represents common stocks and $976,939 represented government bonds and notes. The common stock investments were in 10 major industries with 42.8 percent of the stock concentrated in four companies. As indicated above, approximately 87.5 percent of the value represented unrealized appreciation with a potential BICG tax obligation of $18,113,083. After subtracting minimal liabilities, the net asset value of PHC was $52,114,041.

The Estate Return

On September 20, 2006, the co-executors filed the estate tax return. Prior to filing the return, they engaged a law firm to prepare the estate tax return and retained their certified public accounting firm to value the decedent's interest in PHC for purposes of the tax return. A CPA in the certified public accounting firm performed the valuation. The valuation analyst graduated with a bachelor of science degree in accounting in 1971 and received a master of science degree in taxation in 1983. He had been employed by the certified public accounting firm since October 1986 and currently chairs the firm's corporate services department and sits on the firm's executive committee. The analyst has experience in public accounting involving audits, management advisory, litigation support and tax planning, and preparation services. He became a CPA in 1975 and a certified financial planner in 1988. He is a member of state and national certified public accounting organizations as well as local tax organizations. The analyst has written 10 to 20 valuation reports and has testified in court, but has no appraisal certifications.

The Valuation Process

The co-executors provided the analyst with information about the stock transactions occurring in the 1990s as well as some valuation reports for prior estates that included PHC stock. Since the CPA firm was the accountant for PHC, the analyst already had records such as audit reports, corporate tax returns, and investment reports of PHC as well as the knowledge of the history of the company and the pattern for its shareholders to hold their stock long-term. The analyst prepared a draft report and valued the decedent's interest in PHC at $3,149,767 using a capitalization of dividends method. The analyst provided the unsigned draft of the valuation report to the executors and to the return preparer and was never asked to finalize the report. Without further consultation with the analyst, the estate reported value of the decedent's interest in PHC as $3,149,767 on the federal estate tax return.

The Notice

On June 12, 2009, the IRS issued a statutory notice of deficiency to the estate, determining an upward valuation of the estates interest in PHC to $9,223,658. Consequently, the estate tax liability was increased by $2,854,729. The notice of deficiency determined accuracy-related penalty of $1,141,892 pursuant to IRC section 6662. The estate filed a timely petition with the Tax Court seeking a redetermination of the deficiency and penalty determination.

The IRS Expert

The IRS expert using the cost approach calculated the decedent's 23.44 percent interest in PHC to be $12,214,525. He then applied a discount of 6 percent to adjust for the fact that the decedent held a minority interest in PHC and a discount of 36 percent to adjust for both lack of marketability of non-publicly traded shares and for the BICG tax. The resultant value of the decedent's 23.44 percent interest in PHC was $7,330,000.

The Estate's Expert

For trial purposes, the estate engaged Robert Schweihs and requested that the court accept Mr. Schweih's valuation and his testimony as an expert witness. Mr. Schweihs valued the decedent's interest at $5,048,724 using a dividend growth model.[2] Mr. Schweihs also

2 Neither the statutory notice of deficiency nor the court opinion indicates how the estates analyst arrived at his value for estate tax reporting purposes.

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calculated a value of decedent's interest using the net asset valuation method. Mr. Schweihs started with the net asset value of PHC and subtracted 100 percent of the applicable BICG tax, $18,113,083, then applied an 8 percent discount for lack of control as well as a 35.6 percent discount for lack of marketability and multiplied the result by 23.44 percent to arrive at an estate value of $4,721,962. At trial, the estate offered the estate's analyst as a fact witness to testify as to how he determined the value for the estate tax return.

The court then was faced with the IRS value of $7,330,000 and the estate's value of $5,048,724 or $4,721,962. The IRS did not dispute that the capitalization of dividends method can be used to value stock, but did dispute the appropriateness of using it in this instance.

Findings

The court found that PHC's net asset value of $52,114,041 should be discounted by $7,817,106, the IRS's concession of 15 percent of PHC's asset value for BICG tax, to yield a $44,296,935 value prior to any discounts. Further, the court found that the decedent's 23.44 percent interest to be further discounted by 7.75 percent for lack of control and by 32.1 percent for lack of marketability, yielding a fair market value of $6,503,804 at the date of death.

Reasoning–Methodology

The court cited *Estate of Smith v. Commissioner,* T.C. Memo. 1999-368 that stated "[I]n general, an asset-based method of valuation applies in the case of corporations that are essentially holding corporations, while an earnings-based method applies for corporations that are going concerns." The court also noted the parties disagreed about what is generally correct and how it applied in this case.

The court stated,

> The theory behind the income capitalization valuation method is that if an asset produces a predictable income stream, the market value of the asset can be ascertained by calculating the present value of that future income stream. PHC did have a history of reliably paying out dividends, and over the preceding 35 years its distributions had increased by about 5% per year. Predictable annual dividend payments were PHC's stated goal (and would presumably be the subjective primary investment goal of someone purchasing a minority interest in PHC), so the estate used this method.

The court indicated that dividend capitalization is one method for valuing a business and may be entirely appropriate where a company's assets are difficult to value. The method relies on estimates about the future and, therefore, they ignore the most concrete and reliable data of value that are available—i.e., the actual market prices of the publicly traded securities. The net asset value method does come with its own difficulties and uncertainties (e.g., discounts), but does begin by standing on firm ground; stock values that one can simply look up. The dividend capitalization method assumes that the only thing a potential investor would consider when contemplating whether to buy PHC's stock is the present value of the dividend stream that can be expected to be received. However, in December 2005, a potential investor would certainly have known that the PHC portfolio consisted primarily of marketable securities with a value of approximately $52 million, while the dividend capitalization method would essentially overlook that fact, which is certainly relevant and helpful to a potential investor.

The court then considered the assumed 10.25 percent expected rate of return (k) derived from the Ibbotson study period,1926 through 2004, used by Mr. Schweihs and the dividend growth rate (g) of 5 percent derived from the data in the 1970 to 2004 time period. The court calculated its own expected rate of return (discount rate) using the 1972 2004 time period and arrived at a discount rate of 9.414 percent.

The court stated,

> When we correct the estate's calculation by using an expected rate of return of 9.414% and keeping the annual dividend growth rate constant at 5%, the present value of future dividends is about $1 million higher— i.e., $6,005,000 (rounded) —than as calculated by the estate. This confirms the sensitivity inherent in using the capitalization-of-dividends valuation method, which in our opinion makes it less reliable.
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> For such reasons, courts are overwhelmingly inclined to use the NAV method for holding companies whose assets are marketable securities.

The court then distinguished the instant case from *Kohler v. Commissioner*, T.C. Memo. 2006-152; *Barnes v. Commissioner*, T.C. Memo. 1998-413; and *Estate of Campbell v. Commissioner*, T.C. Memo. 1991-615. In these cases, the company to be valued held stock in an operating company rather than publicly traded stock.

Reasoning–BICG Tax

The parties agreed that, assuming a 39.74 percent combined federal estate tax rate, the BICG tax would be $18,113,083. The parties also agreed that the value of the stock of PHC should be discounted to some extent for the BICG tax attributable to the unrealized appreciation. The court stated that no investor interested in owning such a company would be indifferent to the potential obligation.

The court reasons,

> …the estate contends that PHC's value should be discounted by 100% of the $18,113,083 BICG liability. To support this contention the estate relies on opinions by the Courts of Appeals for the Fifth and Eleventh Circuits[3] that have held that in a net asset valuation the value should be reduced dollar for dollar by the amount of a BICG tax liability…
>
> However, other Courts of Appeals and this Court have not followed this 100% discount approach, and we consider it plainly wrong in a case like the present one. The relevant inquiry is, of course, what price a willing buyer and seller would agree to; and it is clear that they would not agree to a 100% discount.

While the court did not endorse the approach to calculating the BICG tax, they viewed the resulting discount to be a concession on behalf of the Commissioner.

The court extensively discussed the calculation of the BICG tax obligation. It considered the estate's estimate that it would take 70 years to liquidate the investments of the PHC holdings and based on that time frame discounted the $18.1 million to a present value at a 7 percent discount rate to arrive at a present value of the BICG tax obligation of $3,664,119. The court observed that the 70-year assumption would mistakenly allow PHC's unique, subjective investment goals to dictate the value of the company resulting in a value to a particular buyer as

3 See *Estate of Jelke v. Commissioner,* 507 F.3d 1317; *Estate of Dunn v. Commissioner*, 301 F.3d at 353; *Estate of Jameson v. Commissioner*, 267 F.3d 366 (5th Cir. 2001) (finding that the Tax Court improperly determined only a partial discount for capital gains tax liability inherent in a bequest of stock because the Tax Court failed to use a truly hypothetical willing buyer), vacating and remanding T.C. Memo. 1999-43.

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opposed to fair market value—the price at which PHC would change hands between a hypothetical willing buyer and a hypothetical willing seller. The court did indicate that the investment policy of PHC may impact the magnitude of the discount on account of lack of control.

The court made its own BICG tax calculation with discount rates ranging from 7 percent to 10.27 percent and terms of 20 and 30 years (as opposed to 70 years). The result ranged from $5.5 million to $9.6 million and the court accepted the $7,817,106 BICG tax calculation by the IRS expert as "reasonable."

Reasoning–Discount for Lack of Control (DLOC)

Both experts agreed that a discount for lack of control was appropriate and both used the same database; the net asset values and trading prices of 59 closed-end funds for the week of December 9, 2005. The IRS expert analyzed the percentage difference between the net asset value and the trading price. He found the mean of the premiums and discounts of all 59 data points to be 6.7 percent. He observed that the decedent and one other owner each owned 23 percent of PHC and the next largest holding was about 12 percent. He observed that the decedent's block was influential so that the lack of control was somewhat mitigated. He reduced the discount to 6 percent and the court noted that there was no justification presented for the amount of the reduction, 0.7 percent.

Using the same data, the estate's expert selected the median of the data set, 8 percent. An examination of the data set by the court indicated that there were three outliers that skewed the mean. By removing the three outliers, the court calculated the minority discount at 7.75 percent, which was comfortably close to the estate's expert's median of 8 percent.

Reasoning–Discount for Lack of Marketability (DLOM)

Again, both experts agreed a discount for lack of marketability was appropriate and used the same data; restricted stock studies and IPO studies. Both experts calculated a range of the discount for lack of marketability at 26.4 percent to 35.6 percent, with an average of 32.1 percent. The IRS expert started with 26.4 percent, the bottom end of the range, and further reduced the rate to arrive at a discount of 21 percent. The IRS expert stated a reduction from the bottom was necessary because the companies making up the restricted stock studies and IPO studies were more risky than PHC; PHC had a history of dividend payments, had little debt, and was managed by professional investors. The court indicated that these characteristics would be considered, but the IRS expert provided no basis for the reduction from the starting point of 26.4 percent.

Conversely, Mr. Schweihs chose the high end of the range, 35.6 percent, indicating that the securities in the studies would be freely marketable within a relatively short period of time. The court resolved the issue by simply averaging low end, 26.4 percent, and the high end, 35.6 percent, yielding a discount for lack of marketability of 32.1 percent.

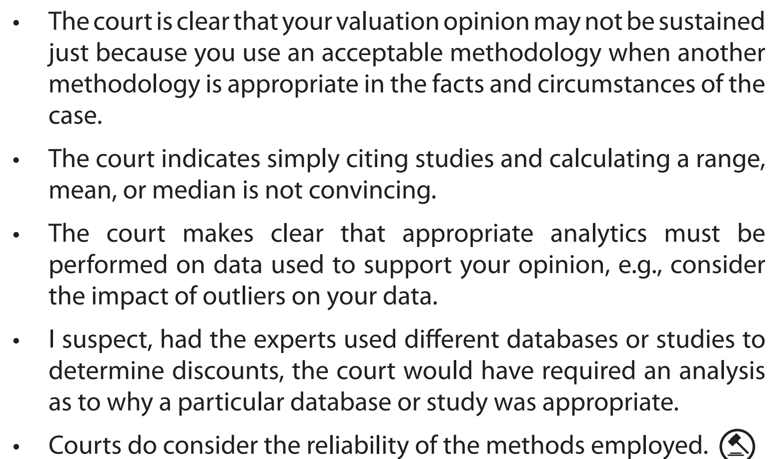
Accuracy-related penalty

The court concluded there was a substantial understatement (IRC 6662(g)) since the return as filed reported a value of $3,149,777, and the court determined a value of $6,503,804 (the amount reported on the estate tax return was less than 65 percent of the proper value). The court considered the IRC 6662 (a) penalty and attempted to determine if the estate acted in good faith with respect to the underpayment. Citing other cases, the court indicated that to establish good faith, taxpayers cannot rely blindly on advice from advisors or on appraisal. The court concluded,

> On the record before us, we cannot say that the estate acted with reasonable cause and in good faith in using an unsigned draft report prepared by its accountant as its basis reporting the value of the decedent's interest in PHC on the estate tax return. [The estate's appraiser] is not a certified appraiser. The estate never demonstrated or discussed how [the estate's appraiser] arrived at the value reported on the estate return except to say that two prior estate transactions involving PHC stock used the capitalization-of-dividends method for valuation. Furthermore, the estate did not explain—much less excuse—whatever defects in [the estate's appraiser's] valuation resulted in that initial $3.1 million value being abandoned in favor of the higher $5 million value for which the estate contended at trial. Consequently, the value reported on the estate tax return is essentially unexplained.

The estate argued that the range on the four different valuations ($3.1 million to $9.2 million) indicated the difficulty of valuing the PHC interest. The court indicated that it agreed with the estate's analysis, and it indicated that circumstance supports the need to hire a qualified appraiser. The court concluded that the 20 percent penalty is appropriate.

Lessons for Valuation Professionals in Litigation



- The court is clear that your valuation opinion may not be sustained just because you use an acceptable methodology when another methodology is appropriate in the facts and circumstances of the case.
- The court indicates simply citing studies and calculating a range, mean, or median is not convincing.
- The court makes clear that appropriate analytics must be performed on data used to support your opinion, e.g., consider the impact of outliers on your data.
- I suspect, had the experts used different databases or studies to determine discounts, the court would have required an analysis as to why a particular database or study was appropriate.
- Courts do consider the reliability of the methods employed.

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