Update of

Valuation Case Law

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ANNOTATED
CASE LAW UPDATE

Recent Developments in Valuation

Table of Contents

I.	Valuation in General	3
A.	*Fair market value and the willing seller/willing buyer*	*3*
B.	*Other standards of value*	*6*
II.	Approaches to the Valuation of a Business Enterprise	7
A.	*Understanding the Business Plan*	*7*
B.	*Business Enterprise Valuation Methods.*	*9*
III.	Specific Issues in the Valuation of a Business Enterprise	15
A.	*Built-in Capital Gains of a C Corporation.*	*15*
B.	*Life Insurance Proceeds*	*17*
C.	*Subsequent Events*	*18*
D.	*S Corporations and other Pass-Through Entities*	*18*
E.	*Goodwill*	*23*
F.	*Buy-Sell Agreements*	*24*
IV.	Discounts	25
A.	*In general*	*25*
B.	*Discount for lack of control*	*27*
C.	*Discount for lack of marketability*	*30*
V.	Specific Gift Tax Valuation Issues	32
A.	*Ineffective Transfers of Business Interests*	*32*
B.	*Indirect Gifts Because of Timing of Transactions*	*35*
C.	*Present Interests vs. Future Interest*	*35*
D.	*Transfer Restrictions*	*39*

I. Valuation in General

A. Fair market value and the willing seller/willing buyer

i. *Morrissey v. Commissioner of Internal Revenue*, 243 F.3d 1145 (9th Cir. 2001) (referred to as *Estate of Kaufman* by the Tax Court):

(**Background:** Merrill Lynch had been engaged to value a minority interest in Seminole and had issued an opinion letter as to the value of the stock. Based on this value, two shareholders sold their stock. The Tax Court rejected these sales as not at arm‟s-length and not similar to the estate‟s block of stock because they were smaller blocks. The Tax Court accepted the IRS value, less a 20% discount for lack of marketability.) The Court of Appeals said . . . .

The estate tax is levied not on the property transferred but on the transfer itself. *Young Men's Christian Ass'n v. Davis,* 264 U.S. 47, 50, 44 S.Ct. 291, 68 L.Ed. 558 (1924). "The tax is on the act of the testator not on the receipt of property by the legatees." *Ithaca Trust Co. v. United States,* 279 U.S. 151, 155, 49 S.Ct. 291, 73 L.Ed. 647 (1929). Consequently we look at the value of the property in the decedent's hands at the time of its transfer by death, 26 U.S.C. § 2033, or at the alternative valuation date provided by the statute, 26 U.S.C. § 2032(a). That the tax falls as an excise on the exercise of transfer underlines the point that the value of the transfer is established at that moment; it is not the potential of the property to be realized at a later date.

Fair market value is "the price 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." 26 C.F.R. § 20.2031-1(b). The willing buyer and willing seller are to be postulated, not as a particular named X or Y, but objectively and impersonally. *Estate of McClatchy v. Comm'r,* 147 F.3d 1089, 1094 (9th Cir.1998); *Propstra v. United States,* 680 F.2d 1248, 1251-52 (9th Cir.1982). As the Tax Court itself has held, the Commissioner cannot "tailor 'hypothetical' so that the willing seller and willing buyer were seen as the particular persons who would most likely undertake the transaction." *Estate of Andrews v. Comm'r,* 79 T.C. 938, 956, 1982 WL 11197 (1982). Actual sales between a willing seller and buyer

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are evidence of what the hypothetical buyer and seller would agree on. *See Estate of Hall v. Comm'r,* 92 T.C. 312, 336, 1989 WL 10688 (1989); 26 C.F.R. § 20.2031-2(b).

No good reason existed [for the Tax Court] to reject the sales by Branch and Hoffman as evidence of the fair market value of Seminole stock on April 14, 1994. The sales took place close to the valuation date. The sellers were under no compulsion to sell. There was no reason for them to doubt Weitzenhoffer's report of the Merrill Lynch valuation. That the final report was delivered only in July did not undercut the weight of the formal opinion letter written in March. The sellers had no obligation to hire another investment firm to duplicate Merrill Lynch's work. (243 F.3d at 1147).

. . . The Tax Court also engaged in the speculation that the Estate stock could be sold to a non-family member and that, to avoid the disruption of family harmony, the family members or Seminole itself would buy out this particular purchaser. The law is clear that assuming that a family-owned corporation will redeem stock to keep ownership in the family violates the rule that the willing buyer and willing seller cannot be made particular. *See Estate of Jung v. Comm'r,* 101 T.C. 412, 437-38, 1993 WL 460544 (1993). The value of the Seminole stock in Alice Friedlander Kaufman's hands at the moment she transferred it by death cannot be determined by imagining a special kind of purchaser for her stock, one positioning himself to gain eventual control or force the family to buy him out. (243 F.3d at 1148).

ii. *Estate of Simplot v. Commissioner of Internal Revenue*, 249 F.3d 1191 (9th Cir. 2001):

(**Background**: The corporation had 76.445 total shares of Class A voting and 141,288.584 total shares of Class B nonvoting stock. The decedent owned 18 shares (23.55%) of Class A and 3,942.048 (2.79%) of Class B stock. The Estate obtained a valuation of its stock from Morgan Stanley & Co., and on this basis reported the Class A and Class B shares as worth $2,650 per share. The Commissioner of Internal Revenue valued the Class A stock at $801,994 per share and the Class B stock at $3,585 per share.

(The Tax Court found the Class A shares on a per share basis to be "far more valuable than the Class B shares because of the former's inherent potential for influence and control." The Tax Court added

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that "a hypothetical buyer" of the shares "would gain access to the 'inner circle' of J.R. Simplot Co., and by having a seat at the Class A shareholder's table, over time, the hypothetical buyer potentially could position itself to play a role in the Company. In this regard, we are mindful that 'a journey of a 1,000 miles begins with a single step.' "

(The Tax Court went on to "consider the characteristics of the hypothetical buyer" and supposed the buyer could be a Simplot, a competitor, a customer, a supplier, or an investor. The buyer "would probably be well- financed, with a long-term investment horizon and no expectations of near-term benefits. The hypothetical buyer might be primarily interested in only one of J.R. Simplot Co.'s two distinct business activities--its food and chemicals divisions--and be a part of a joint venture (that is, one venture being interested in acquiring the food division and the other being interested in acquiring the chemical division)." The Tax Court entertained the possibility that Simplot could be made more profitable by being better managed at the behest of an outsider who bought the 18 shares. The Tax Court went on to envisage the day when the hypothetical buyer of the 18 shares would hold the largest block because the three other Simplot children had died and their shares had been divided among their descendants; the Tax Court noted that, even earlier, if combined with Don and Gay's shares together, or with Scott's shares alone, the 18 shares would give control.

(In the light of "all of these factors," the Tax Court assigned a premium to the Class A stock over the Class B stock equal to 3% of the equity value of the company, or $24.9 million. Dividing this premium by the number of Class A shares gave each Class A share an individual premium of $325,724.38, for a total value of $331,595.70, subject to a 35% discount for lack of marketability with a resultant value of $215,539. The Class B stock was valued at $3,417 per share.) The Court of Appeals said . . . .

The Tax Court in its opinion accurately stated the law: "The standard is objective, using a purely hypothetical willing buyer and willing seller.... The hypothetical persons are not specific individuals or entities." The Commissioner himself in his brief concedes that it is improper to assume that the buyer would be an outsider. The Tax Court, however, departed from this standard apparently because it believed that "the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that

affect value." Obviously the facts that determine value must be considered.

The facts supplied by the Tax Court were imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with Simplot children or grandchildren and what improvements in management of a highly successful company an outsider purchaser might suggest. "All of these factors," i.e., all of these imagined facts, are what the Tax Court based its 3% premium upon. In violation of the law the Tax Court constructed particular possible purchasers. (249 F3d 1195).

iii. Also see

a. *Estate of Litchfield v. Comm'r.*, T.C. Memo 2009-21 (T.C. 2009), for a recent discussion of fair market value, the willing seller/ willing buyer, and valuations for estate tax purposes.

b. *Estate of Blount v. Commissioner of Internal Revenue*, 428 F.3d 1338 (11th Cir. 2005).

c. *Estate of True v. Commissioner of Internal Revenue*, T.C. Memo 2001-167, 82 T.C.M. (CCH) 27, affirmed by *Estate of True v. Commissioner of Internal Revenue*, 390 F.3d 1210 (10th Cir. 2004), for a detailed discussion of valuations for gift and estate tax purposes.

B. Other standards of value

i. "Fair market value" is standard of value used in many valuation cases. "Fair value" is a standard of value applicable in many dissenting stockholder actions. It is similar to fair market value but differs in the applicability of discounts for lack of control and lack of marketability. See, e.g., *HMO-W Incorporated v. SSM Health Care System*, 234 Wis.2d 707, 611 N.W.2d 250 (2000), and *Swope v. Siegel-Robert, Inc.*, 243 F.3d 486 (8th Cir. 2001).

ii. Unlike fair market value, which determines value to a hypothetical buyer and seller, "investment value" determines value to a specific or particular investor.

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II. Approaches to the Valuation of a Business Enterprise

A. Understanding the Business Plan

i. *Delaware Open MRI Radiology Associates, P.A., v. Kessler*, 898 A.2d 290 (Del. Ch. 2006) – understanding the business plan:

(**Background**: This case involved a dissenting stockholder action, in which the value of the dissenting, minority stockholders" pro rata interest in an expanding magnetic resonance imaging business was at issue. One expert considered only the two open MRI centers; the other expert considered these two centers plus three more that were in the planning stages as of the date of valuation.)

Delaware law is clear that "elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered." (footnote omitted). Obviously, when a business has opened a couple of facilities and has plans to replicate those facilities as of the merger date, the value of its expansion plans must be considered in the determining fair value. To hold otherwise would be to subject our appraisal jurisprudence to just ridicule. The dangers for the minority arguably are most present when the controller knows that the firm is on the verge of break-through growth, having gotten the hang of running the first few facilities, and now being well-positioned to replicate its success at additional locations – think McDonald's or Starbucks. Here, the business plan of Delaware Radiology involved the strategy of opening additional MRI Centers in Delaware with . . . . This strategy was part of what the Supreme Court would call the "operative reality" of Delaware Radiology on the merger date and must be considered in determining fair value.

ii. *Polack v. Commissioner of Internal Revenue*, T.C. Memo 2002-145 (footnote 8), affirmed by *Polack v. CIR*, 366 F.3d 608 (8th Cir. 2004) – understanding the business"s operations:

Petitioner contends we should accept his expert's testimony because his expert is significantly more experienced than respondent's expert. As our discussion indicates, our conclusion turns on factual disputes and reflects our finding that petitioner's conclusions regarding disputed factual issues are not grounded on credible evidence. An expert, no matter how skilled, can only work

with the factual record he is given by his client or obtains through his own efforts. In this case, petitioner's expert relied primarily on petitioner's unsupported opinion regarding the disputed factual matters.

iii. *Gray v. Cytokine Pharmasciences, Inc.*, unpublished opinion of Court of Chancery of Delaware (2002 Del. Ch. LEXIS 48) – understanding the business‟s operations:

(**Background:** dissenting stockholder action; "As is all too often the case, the parties' experts examined PSI's operations and assets at the time of Merger, analyzed the corporation's financial performance, both historical and projected, and came up with enormously disparate conclusions as to its value. Penny, for the Respondent, concluded that PSI's going concern value was only $26.5 million and, thus, Gray was entitled to approximately $271,136 for his shares. Davis, for the Petitioner, arrived at a value of $192.5 million for the Company and approximately $1,971,360 for Gray's shares. Obviously, the underlying assumptions that drive these valuations must be tested to ensure that all relevant facts are properly and reasonably considered."

(Merrill Lynch had also done a valuation at the time of the merger, but it was not relied on by the company, who tried to undermine it. The judge used Merrill Lynch report. In addition, the dissenting stockholder‟s expert had previously been retained by the stockholder as a consultant and received warrants for stock in a related company. He reached a value conclusion nearly twice the Merrill Lynch value.)

I also find that Penny's DCF is so heavily dependent on the determination of PSI's terminal value that the entire exercise amounts to little more than a special case of the comparable companies approach to value and, thus, has little or no independent validity. (footnote omitted) This is easily seen from the fact that Penny's discounted terminal value calculations equal or exceed 75% of the total discounted cash flow value of the enterprise in the lowest case and 85% or more in the other three cases presented. . . . Aside from disregarding management's revenue projections, Penny also ignored management's projections in several other respects. Specifically, Penny increased management's projected General and Administrative expenses from 5% to 10%; increased management's projected Cost of Goods Sold and Royalties from 37.6% of sales to

50% of sales; and increased the tax rate to 40% from management's projected 35%. Penny did not provide valid reasons to warrant all of these adjustments. In sum, I cannot accept that Penny, with his limited experience with the Company, was better equipped to make future financial projections than PSI's management. Consequently, I find Penny's litigation-driven projections to be unreliable and, thus, disregard his DCF analysis. Any other result would condone allowing a company's management or board of directors to disavow their own data in order to justify a lower valuation in an appraisal proceeding."

B. Business Enterprise Valuation Methods.

i. *Dunn v. Commissioner of Internal Revenue*, 301 F.3d 339 (5th Cir. 2002) – an asset-based approach is based on the sale of a business‟s assets and the ability to sell those assets:

The Tax Court made a more significant mistake in the way it factored the „likelihood of liquidation‟ into its methodology, a quintessential mixing of apples and oranges: considering the *likelihood* of a liquidation sale of assets when calculating the *asset*-based value of the Corporation. Under the factual totality of this case, the hypothetical assumption that the assets will be sold is a foregone conclusion--a given--for purposes of the asset-based test (footnote omitted). The process of determining the value of the assets for this facet of the asset-based valuation methodology must start with the basic assumption that all assets will be sold, either by Dunn Equipment to the willing buyer or by the willing buyer of the Decedent's block of stock after he acquires her stock. By definition, the asset-based value of a corporation is grounded in the fair *market* value of its assets (a figure found by the Tax Court and not contested by the estate), which in turn is determined by applying the venerable willing buyer-willing seller test. By its very definition, this contemplates the consummation of the purchase and sale of the property, i.e., the asset being valued. Otherwise the hypothetical willing parties would be called something other than "buyer" and "seller."

In other words, when one facet of the valuation process requires a sub-determination based on the value of the company's assets, that value must be tested in the same willing buyer/willing seller crucible as is the stock itself, which presupposes that the property being valued is in fact bought and sold. It is axiomatic that an

asset-based valuation starts with the gross market (sales) value of the underlying assets themselves, and, as observed, the Tax Court's finding in that regard is unchallenged on appeal: When the starting point is the assumption of sale, the "likelihood" is 100%!

This truism is confirmed by its obverse in today's dual, polar-opposite approaches (cash flow; assets). The fundamental assumption in the income or cash-flow approach is that the assets are *retained* by the Corporation, i.e., *not* globally disposed of in liquidation or otherwise. So, just as the starting point for the asset-based approach in this case is the assumption that the assets are sold, the starting point for the earnings-based approach is that the Corporation's assets are retained--are *not* sold, (other than as trade-ins for new replacement assets in the ordinary course of business)--and will be used as an integral part of its ongoing business operations. This duly accounts for the value of assets--unsold--in the active operations of the Corporation as one inextricably intertwined element of the production of income. (301 F.3d at 353).

ii. *Estate of Heck v. Commissioner of Internal* Revenue, T.C. Memo 2002-34 – guideline public companies and discounted cash flow method (see full case for application of discounted cash flow method and discussion of different assumptions by the experts):

Even if we were to accept that Dr. Spiro relied on both Canandaigua and Mondavi as guideline companies, as respondent argues, we would still reject Dr. Spiro's use of the market approach in this case. Respondent points out that we have approved the use of the market approach based upon as few as two guideline companies. See *Estate of Desmond v. Commissioner,* T.C. Memo.1999-76. But in that case, all three companies were in the *same,* and not just a *similar,* line of business (manufacture and sale of paint and coatings). Here, Mondavi and Canandaigua were, at best, involved in similar lines of business. Under section 2031(b) and section 20.2031-2(f), Estate Tax Regs., publicly held companies involved in similar lines of business may constitute guideline companies, and we have so held. See, e.g., *Estate of Gallo v. Commissioner,* T.C. Memo.1985-363, where, in valuing the stock of the largest producer of wine in the United States, we approved the use by taxpayer's experts of comparables consisting of companies in the brewing, distilling, soft drink, and even food processing industries. But, in that case, the experts used at least 10 companies as guideline companies. See also *Estate of Hall v.*

Commissioner, supra at 325, where we adopted an expert report utilizing a market approach based upon a comparison with six somewhat similar companies. As similarity to the company to be valued decreases, the number of required comparables increases in order to minimize the risk that the results will be distorted by attributes unique to each of the guideline companies. In this case, we find that Mondavi and Canandaigua were not sufficiently similar to Korbel to permit the use of a market approach based upon those two companies alone (footnote omitted) . . . .

This Court considers the discounted cashflow (DCF) method employed by both experts to be an appropriate method for use in valuing corporate stock. See, e.g., *N. Trust Co. v. Commissioner,* 87 T.C. 349, 379, 1986 WL 22171 (1986). Moreover, where we have rejected use of the market approach as unreliable, we have based the value of a closely held corporation on the DCF approach alone. See *Estate of Jung v. Commissioner,* 101 T.C. 412, 433, 1993 WL 460544 (1993).

iii. *In re Young Broad., Inc*., 430 B.R. 99, 109 (Bankr. S.D.N.Y. 2010), ruling that a leveraged DCF approach was not acceptable:

A DCF analysis arrives at a value for a company by performing the following steps: (1) determining the projected distributable cash flow of a company within a forecast period of time; (2) determining the company's terminal value by the end of a forecast period, by applying a selected metric of value, which is usually a company's EBITDA, to an appropriate multiple; (3) determining the present value of both free cash flow and the terminal value of the company by applying an appropriate discount rate; and (4) calculating the sum of the present value of cash flow and present value of terminal value, which represents the total enterprise value of the company.

The expert for the Debtors (Kuhn), on the other hand, performed the following steps in his analysis: (1) determined zero projected distributable cash flow because the Committee assumed all cash will be accumulated to pay off the Debt upon maturity in November 2012; (2) determined the approximate value of equity in 2012 and assumed a sale of the Company at that value; (3) subtracted net debt and preferred stock outstanding from the projected sale value and labeled it "terminal value"; and (4) applied

a discount rate, that accounts for only the cost of equity, to determine the present value of the common equity.

The Court found that, although the expert used DCF terminologies, there were practically no substantive similarities between the generally accepted DCF method and the levered DCF method. Kuhn had made multiple novel assumptions that do not exist in the DCF analysis and altered the way a company's terminal value should be calculated.

Additionally, the Levered DCF fails to meet any of the *Daubert* factors: it is not a method that has been tested or relied upon by other experts; it had never been subjected to peer review or discussed in any publication; the potential rate of error is unknown; and there is no evidence that this method was ever employed, discussed, and certainly not generally accepted in any academic or professional community.

Kuhn's explanation on the issue does not give him free rein to employ a brand new valuation method that he conceded has never been used by any valuation expert in court. In light of the significant missteps and speculative assumptions in Kuhn's novel valuation approach, the Court found that he did not conduct an appropriate DCF analysis.

iv. *In re Sunbelt Bev. Corp. S'holder Litig*., 2010 Del. Ch. LEXIS 1 (Del. Ch. Jan. 5, 2010), discussing the determination of small-firm and company specific risk premia:

An independent basis should be used for determining the risk premium because an issue of circularity exists: knowing the value of the company is necessary to obtain the risk premium; however, knowing the risk premium is necessary to calculate the value of the company. The Court ultimately selected the small-firm risk premium (3.47%), a weighted balance between the ninth and tenth decile premiums, to account for the possibility that the company is on either side of the line.

The Court ruled that a company-specific risk premium was unwarranted because the reasons given by the defendant to use it were either a) applicable to the industry as a whole or b) based on

Sunbelt‟s management projections, which were not deemed by the Court to be excessively optimistic. Additionally, defendants provided no specific, quantitative explanation for why 3% was the appropriate level for a company-specific risk premium.

v. *Dunn v. Commissioner of Internal Revenue*, 301 F.3d 339 (5th Cir. 2002) – weighting results from different valuation approaches or methods:

(**Background:** "Having painted this clear and detailed valuation-date portrait of Dunn Equipment, the Tax Court proceeded to confect its valuation methodology. The court selected two different approaches to value, one being an income-based approach driven by net cash flow and the other being an asset-based approach driven by the net fair market value of the Corporation's assets. The court calculated the Corporation's "earnings-based value" at $1,321,740 and its net "asset-based value" at $7,922,892, as of the valuation date. The latter value was calculated using a 5% factor for built-in gains tax liability, not the actual rate of 34% that the Corporation would have incurred on sale to a willing buyer.) The Court of Appeals continued:

Given the stipulated or agreed facts, the additional facts found by the Tax Court, and the correct determination by that court that the likelihood of liquidation was minimal, our expectation would be that if the court elected to assign unequal weight to the two approaches, it would accord a minority (or even a nominal) weight to the asset-based value of the Corporation, and a majority (or even a super-majority) weight to the net cash flow or earnings- based value. Without explanation, however, the Tax Court baldly--and, to us, astonishingly--did just the opposite, assigning a substantial majority of the weight to the *asset*-based value. The court allocated almost two-thirds of the weight (65%) to the results of the asset-based approach and only slightly more than one-third (35%) to the results of the earnings-based approach. We view this as a legal, logical, and economic non sequitur, inconsistent with all findings and expressions of the court leading up to its announcement of this step in its methodology. We also note that the Tax Court's ratio roughly splits the difference between the 50:50 ratio advanced by the Estate and the 100:0 ratio advocated by the Commissioner.

Throughout its comprehensive and logical background analysis, the Tax Court recognized that Dunn Equipment is an *operating*

company, a going business concern, the Decedent's shares in which would almost certainly be purchased by a willing buyer for continued operation and not for liquidation or other asset disposition. For purposes of valuation, Dunn Equipment is easily distinguishable from true asset-holding investment companies, which own properties for their own intrinsic, passive yield and appreciation--securities, timberland, mineral royalties, collectibles, and the like. For the Tax Court here to employ a valuation method that, in its penultimate step of crafting a weighting ratio assigns only one-third weight to this operating company's income-based value, defies reason and makes no economic sense (footnote omitted). Our conclusion is all the more unavoidable when viewed in the light of the Tax Court's disregard of the ubiquitous factor of dividend paying capacity--in this case, zero--which, if applied under customarily employed weighting methods, would further dilute the weight of the asset-value factor and reduce the overall value of the Corporation as well. The same can be said for the effect on cash flow of the underpayment of officers' compensation.

Bottom Line: The likelihood of liquidation has no place in either of the two disparate approaches to valuing this particular operating company. We hasten to add, however, that the *likelihood of liquidation* does play a key role in appraising the Decedent's block of stock, and that role is in the determination of the relative *weights* to be given to those two approaches: The lesser the *likelihood* of liquidation (or sale of essentially all assets), the greater the *weight* (percentage) that must be assigned to the earnings(cash flow)-based approach and, perforce, the lesser the weight to be assigned to the asset-based approach. . . . .

We hold that the correct methodology for determining the value of Dunn Equipment as of the valuation date requires application of an 85:15 ratio, assigning a weight of 85% to the value of the Corporation that the Tax Court determined to be $1,321,740 when using its "earnings-based approach" and a weight of 15% to the value that the court determines on remand using its "asset-based approach" but only after recomputing the Corporation's value under this latter approach by reducing the market value of the assets by 34% of their built-in taxable gain--not by the 5% as previously applied by that court--of the built-in gain (excess of net sales value before taxes over book value) of the assets, to account for the inherent gains tax liability of the assets.)

vi. Also see

a. *Okerlund v. U.S.*, 53 Fed.Cl. 341, *aff'd.,* 365 F.3d 1044 (Fed.Cir. 2004) – weighting of results from different methods – income approach weighted 70% and market approach weighted 30%.

b. Also see footnote 36 in *Dunn v. Commissioner of Internal Revenue*, 301 F.3d 339 (5th Cir. 2002):

Fomented in significant part by myriad valuation challenges instituted by the IRS over the past decades, a full-fledged profession of business appraisers, such as the American Society of Appraisers, has emerged, generating its own methodology and lexicon in the process; which in turn have contributed to the profession's respect and mystique. Because--absent an actual purchase and sale--valuing businesses, particularly closely held corporations, is not a pure science replete with precise formulae and susceptible of mechanical calculation but depends instead largely on subjective opinions, the writings and public pronouncements (including expert testimony) of these learned practitioners necessarily contain some vagaries, ambiguities, inexactitudes, caveats, and qualifications. It is not surprising therefore that from time to time disagreements of diametric proportion arise among these practitioners. As the methodology we employ today may well be viewed by some of these professionals as unsophisticated, dogmatic, overly simplistic, or just plain wrong, we consciously assume the risk of incurring such criticism from the business appraisal community. In particular, we anticipate that some may find fault with (1) our insistence (like that of the Estate's expert) that, in the asset-based approach, the valuing of the Corporation's assets proceed on the assumption that the assets are sold; and (2) our determination that, in this case, the *likelihood* of liquidation or sale of essentially all assets be factored into the weighting of the results of the two valuation approaches and not be considered as an integral factor in valuing the Corporation under either of those approaches. In this regard, we observe that on the end of the methodology spectrum opposite *oversimplification* lies *over-engineering.*

III. Specific Issues in the Valuation of a Business Enterprise

A. Built-in Capital Gains of a C Corporation.

i. *Dunn v. Commissioner of Internal Revenue*, 301 F.3d 339 (5th Cir. 2002), discusses when taxes arising from built-in capital gains on assets should be considered in establishing the value of a business interest:

> The Tax Court's fundamental error in this regard is reflected in its statement that--for purposes of an asset-based analysis of corporate value--a fully-informed willing buyer of *corporate shares* (as distinguished from the Corporation's assemblage of assets) constituting an operational-control majority would *not* seek a substantial price reduction for built-in tax liability, absent that buyer's intention to liquidate. This is simply wrong: It is inconceivable that, since the abolition of the *General Utilities* doctrine and the attendant repeal of relevant I.R.C. sections, such as §§ 333 and 337, any reasonably informed, fully taxable buyer (1) of an operational-control majority block of stock in a corporation (2) *for the purpose of acquiring its assets,* has not insisted that all (or essentially all) of the latent tax liability of assets held in corporate solution be reflected in the purchase price of such stock.
>
> We are satisfied that the hypothetical willing buyer of the Decedent's block of Dunn Equipment stock would demand a reduction in price for the built-in gains tax liability of the Corporation's assets at essentially 100 cents on the dollar, regardless of his subjective desires or intentions regarding use or disposition of the assets. Here, that reduction would be 34%. This is true "in spades" when, for purposes of computing the *asset*-based value of the Corporation, we assume (as we must) that the willing buyer is purchasing the stock to get the assets (footnote omitted), whether in or out of corporate solution. We hold as a matter of law that the built-in gains tax liability of this particular business's assets must be considered as a dollar-for-dollar reduction when calculating the *asset*-based value of the Corporation, just as, conversely, built-in gains tax liability would have no place in the calculation of the Corporation's *earnings*-based value (footnote omitted). (301 F.3d at 352)

ii. *Estate of Jelke v. Commissioner of Internal Revenue*, 507 F.3d 1317 (11th Cir. 2007), *cert. denied*, 129 S. Ct. 168, 172 L. Ed. 2d 43, 77 U.S.L.W. 3197 (U.S. 2008) builds on *Dunn* and accepts the dollar-for-dollar deduction for the amount of the built-in gain tax.

The subject company in *Jelke* was essentially a portfolio of publicly traded stocks, and the estate‟s interest was a minority block of stock that could not unilaterally force the sale of any of the underlying securities. The court concluded that the approach in "*Dunn* eliminates the crystal ball and the coin flip and provides certainty and finality to valuation as best it can, already a vague and shadowy undertaking" (1332).

iii. *Estate of Jensen v. Commissioner*, 2010 WL 3199784 (U.S. Tax Ct.)(Aug.10, 2010), also adopted the dollar-for-dollar discount for embedded capital gains tax liability:

Tax Court adopted the taxpayer‟s dollar-for-dollar discount for embedded capital gains tax liability based on 2nd Circuit precedent and its own present-value analysis, but specifically declined to adopt the per se rule of the 5th and 11th Circuits.

The estate‟s expert concluded that a dollar-for-dollar discount for the built-in LTCG tax was appropriate because the adjusted book value method was based on the inherent assumption that the assets will be liquidated, which automatically gives rise to a tax liability predicated upon the built-in capital gains that result from appreciation in the assets.

The court accepted the estate‟s value for the built-in LTCG tax discount (a 100% discount) because it is within the range of values that may be derived from the evidence.

iv. Also see: *Estate of Litchfield v. Comm'r.*, T.C. Memo 2009-21, which determined the discount associated with the tax on the built-in capital gains but used a method approved in cases before *Estate of Jelke v. Commissioner of Internal Revenue*, 507 F.3d 1317 (11th Cir. 2007). Footnote 10 in *Litchfield* acknowledges the 2007 *Jelke* decision and notes that its decision in *Litchfield* might have been different if a dollar-for-dollar discount had been argued.

B. Life Insurance Proceeds

i. *Estate of Blount v. Commissioner of Internal Revenue*, 428 F.3d 1338 (11th Cir. 2005), also provides a recent discussion on the treatment of life insurance proceeds in the valuation of a business

when the proceeds are committed to the purchase of a decedent"s stock pursuant to a buy-sell agreement.

C. Subsequent Events

i. Valuations are typically done as of a specific date. In some instances, subsequent events may be considered to establish value as of an earlier date. In *Estate of Noble v. Commissioner of Internal Revenue*, T.C. Memo 2005-2, the price at which the Estate"s stock was sold nearly fourteen months after the valuation date was used to establish the fair market value as of the date of death. The court stated,

> Generally speaking, a valuation of property for Federal tax purposes is made as of the valuation date without regard to any event happening after that date. See *Ithaca Trust Co. v. United States*, 279 U.S. 151, 49 S.Ct. 291, 73 L.Ed. 647 (1929). An event occurring after a valuation date, however, is not necessarily irrelevant to the determination of fair market value as of that earlier date. An event occurring after a valuation date may affect the fair market value of property as of the valuation date if the event was reasonably foreseeable as of that earlier date. [citations omitted] An event occurring after a valuation date, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller for the subject property as of the valuation date. [citations omitted] Unforeseeable subsequent events which fall within this latter category include evidence, such as we have here, "of actual sales prices received for property after the date [in question], so long as the sale occurred within a reasonable time . . . and no intervening events drastically changed the value of the property." [citations omitted].

ii. Also see *Okerlund v. U.S.*, 53 Fed.Cl. 341, 2002 WL 1969642 (Fed.Cl.), 90 A.F.T.R.2d 2002-6124, *aff'd.*, 365 F.3d 1044, 93 A.F.T.R.2d 2004-1715 (Fed.Cir. 2004), for assessing future risks when subsequent events prove their accuracy.

D. S Corporations and other Pass-Through Entities

i. *Wall v. Commissioner of Internal Revenue*, T.C. Memo 2001-75 (footnote 19, questioning imputing a tax on an S corporation).

ii. *Gross v. Commissioner of Internal Revenue*, 272 F.3d 333 (6th Cir. 2001)(petition for certiorari denied).

[Note: Clay, J., announced the judgment of the court and delivered an opinion, in which Daughtrey, J., and Cohn, D.J., concurred except as to Part II.B.1. Cohn, D.J. (pp. 351-56), delivered a separate opinion, in which Daughtrey, J. concurred, which constitutes the opinion of the court on the issue addressed in Part II.B.1.]

The lead opinion appears to emphasize the apparent unfairness to Taxpayers if G & J's stock is not tax affected and accuses the IRS and the Tax Court of being "hypocritical" and "arbitrary" in their valuations. Unfairness, however, is not the issue and even if it was, the Taxpayers were not unfairly treated by not tax affecting G & J's stock. First, the lead opinion disagrees with the Tax Court's finding that the IRS policy manuals do not establish that tax affecting is a necessary part of valuing an S Corporation. I do not believe that this finding is clearly erroneous and in fact is well supported in the record. Not only do the statements in the IRS manuals fail to affirmatively advocate tax affecting for all S Corporation valuation, both the guide and handbook provide that are not to be relied upon as binding authority, thus even if Taxpayers relied on these materials, their reliance was not justified.

Moreover, focusing solely on the perceived unfairness to the Taxpayers is improper because the willing buyer willing seller rule does not permit a determination of fair market value based solely on the price-lowering desires of the willing buyer. *See Mandelbaum v. Comm'r of Internal Rev.,* 69 T.C.M. (CCH) 2852, 2866, 1995 WL 350881 (1995), *aff'd without published opinion,* 91 F.3d 124 (3d Cir. 1996)("[i]gnoring the views of a willing seller is contrary to the willing buyer/willing seller test"). Thus, determining fair market value also requires consideration of the standpoint of the willing seller.

Secondly, the lead opinion discusses the possibility of G & J losing its Subchapter S status, concluding that "a willing buyer

and seller anticipating the corporation's future earnings would have to note the fact that G & J's S corporation status was not guaranteed." To the extent that the lead opinion finds that G & J's Subchapter S status "was not guaranteed," this conclusion appears to contradict the Tax Court's factual finding that "[w]e do not however, think it is reasonable to tax affect an S corporation's projected earnings with an undiscounted corporate tax rate without facts or circumstances sufficient to establish the likelihood that the election would be lost." (JA at 192). The lead opinion's conclusion that willing buyers and willing sellers might consider that G & J would lose its Subchapter S status is contrary to the evidence of record at the time the gift was made and reflects its own independent opinion of what willing buyers and sellers would consider when valuing G & J's stock.

The lead opinion also criticizes the Tax Court's decision regarding tax affecting because prior decisions permitted tax affecting, and because the IRS accepted prior returns of the Taxpayers which contained valuations that were tax affected. The lead opinion relies on *E.W. Bliss Co. v. United States,* 224 F.Supp. 374 (N.D.Ohio 1963), *aff'd* 351 F.2d 449 (6th Cir.1965) to support its conclusion that the IRS acted arbitrarily in refusing to accept the returns at issue. *Bliss,* however, is inapposite. In *Bliss,* the district court held that the "Commissioner is without authority to act retroactively in a particular case where his own regulations are broad enough to allow the taxpayer's method as one in accordance with generally accepted accounting principles or best accounting practices and one which was consistently followed." 224 F.Supp. at 384. First of all, as noted above, there was disagreement among the experts as to whether tax affecting was generally accepted. Second, *Bliss* involved an appeal from a decision of the Commissioner to the district court, not an appeal from a decision of the Tax Court. Thus, the district court presumably had more latitude in reviewing the Commissioner's decision to make the determination that the Commissioner acted arbitrarily in that case.

Most significantly, however, as the Commissioner points out, the Commissioner is not precluded from correcting an error. *See Sirbo Holdings, Inc. v. Commissioner,* 509 F.2d 1220, 1222 (2d Cir.1975); *Wagner v. United States*, 181 Ct.Cl. 807, 387 F.2d 966, 968 (1967); *Kehaya v. United States,* 174 Ct.Cl. 74, 355 F.2d 639, 641 (1966), *Ward v. Comm'r Internal Rev.,* 240 F.2d 184 (6th Cir.1957). Thus, the fact that tax affecting may have been approved in other cases, and was even approved in prior returns

filed by the Taxpayers, does not, and should not, preclude a different result in another case, particularly where there is disagreement over whether to tax affect in determining the value of stock in the first place.

III. Conclusion

Reviewing the conflicting experts' opinions, it appears that Dr. Bajaj's valuation was from an academic perspective, and he clearly took a scholarly approach to the valuation issue. McCoy's valuation, on the other hand, was from the perspective of a business professional, who has performed numerous valuations in his professional career. This distinction is observed not to diminish McCoy's expertise or elevate Dr. Bajaj's, but simply to point out the different ways the experts approached the valuation question to the facts at hand. Ultimately, the Tax Court found that Dr. Bajaj's method was the better reasoned one under the facts and circumstances of the case. I cannot say this was clear error.
The Taxpayers spend a good deal of time arguing that willing buyers would not know Dr. Bajaj's valuation techniques, and that Dr. Bajaj used data available after the date of the gift, and therefore the Tax Court erred in applying the willing buyer--willing seller rule. This argument is poorly conceived. First, the Tax Court is not prohibited from considering post-valuation data if relevant to shed light on facts existing on the date of the valuation. *See Estate of Gilford v. Comm'r of Internal Rev.,* 88 T.C. 38, 52-53, 1987 WL 49260 (1987). Second, the purpose of valuation is to determine what a willing buyer would pay, and what a willing seller would accept, for the stock on the date of the valuation; it is not to determine what methodology the willing buyer would apply. The willing buyer-willing seller rule presupposes that the price will be the fair market value. Valuation, through the use of expert methodology, is the means, not the end, to application of the willing buyer willing seller rule.

Overall, the entire valuation process is a fiction--the purpose of which is to determine the price that the stock would change hands from a willing buyer and a willing seller. However, a court is not required to presume hypothetical, unlikely, or unreasonable facts in determining fair market value. *See Estate of Watts,* 823 F.2d 483, 487 n. 2 (11th Cir.1987). Valuation is a fact specific task exercise; tax affecting is but one tool in accomplishing that task. The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction. The Tax Court did that and determined that tax

affecting was not appropriate in this case. I do not find its conclusions clearly erroneous. (272 F.3d at 354).

iii. *Heck v. Commissioner of Internal Revenue*, T.C. Memo 2002-34 – The underlying company, F. Korbel & Bros., Inc., had elected S corporation income tax status. Neither expert imputed a corporate income tax in his valuation. (Note: Dr. Bajaj, the expert for the taxpayer, was the expert for the government in *Gross*.)

iv. *Estate of Adams v. Commissioner of Internal Revenue*, T.C. Memo 2002-80 – The underlying company had elected S corporation income tax status, and the expert did not tax effect the projected income and cash flows. The court concluded that because the company had elected S corporation income tax status, the projected income and cash flows were after a zero-percent corporate income tax rate.

v. *Delaware Open MRI Radiology Associates, P.A., v. Kessler*, 898 A.2d 290 (Del. Ch. 2006):

(Background: The minority stockholders in a corporation owning magnetic resonance imaging (MRI) facilities brought combined entire fairness and statutory appraisal actions against the majority stockholders, who served as directors of a new entity established as an acquisition entity, and against the surviving S corporation in a squeeze-out merger, alleging breach of fiduciary duty by effecting the merger in a procedurally and substantively unfair manner.)

. . . In undertaking this analysis, I embrace the reasoning of prior decisional law that has recognized that an S corporation structure can produce a material increase in economic value for a stockholder and should be given weight in a proper valuation of the stockholder's interest. (footnote omitted). That reasoning undergirds not only holdings of the *Adams, Heck*, and *Gross* cases in the U.S. Tax Court, but an appraisal decision of this court, which coincidentally also involved a radiology business. (citation omitted). The opinion in *In re Radiology Associates* noted that "under an earnings valuation analysis, what is important to an investor is what the investor ultimately can keep in his pocket.

The amount that should be the basis for an appraisal or entire fairness award is the amount that estimates the company's value to [plaintiffs] as S corporation stockholders paying individual income taxes at the highest rates-an amount that is materially more in this

case than if Delaware Radiology was a C corporation. In coming to a determination of how [plaintiff's] interest in Delaware Radiology would be valued in a free market comprised of willing buyers and sellers of S corporations, acting without compulsion, it is essential to quantify the actual benefits of the S corporation status. That is also essential in order to determine the value of what was actually taken from the Kessler Group as continuing stockholders. . . . Assessing corporate taxes to the shareholder at a personal level does not affect the primary tax benefit associated with an S Corporation, which is the avoidance of a dividend tax in addition to a tax on corporate earnings. (footnote omitted). This benefit can be captured fully while employing an economically rational approach to valuing an S corporation that is net of personal taxes. (footnote omitted). To ignore personal taxes would overestimate the value of an S corporation and would lead to a value that no rational investor would be willing to pay to acquire control (footnote omitted). This is a simple premise – no one should be willing to pay for more than the value of what will actually end up in her pocket . . . .

vi. *In re Sunbelt Bev. Corp. S'holder Litig*., 2010 Del. Ch. LEXIS 1 (Del. Ch. Jan. 5, 2010), concluding that there was no basis for an upwards adjustment of the per-share value of Sunbelt on the basis of Sunbelt‟s post-merger conversion to an S corporation. While Delaware Open MRI was an S corporation at the time of its merger, Sunbelt, in contrast, converted to an S corporation post-merger. Delaware law clearly excludes from the valuation of the shares any enhanced value stemming from Sunbelt‟s post-merger conversion to S-corporation status.

vii. *Dallas v. Commissioner of Internal Revenue*, TC Memo 2006-212, elaborates further on the valuation of S corporations. This gift tax case highlights the importance of evidence that characterizes the hypothetical willing buyer and seller and that supports the conclusion that the buyer would, or would not, continue the S-corporation election. *Dallas* follows the earlier cases – *Gross, Heck,* and *Delaware Open MRI Radiology Associates* – that did not impute an income tax at the corporate level when valuing an S corporation.

E. Goodwill

i. *McReath v. McReath***,** 2010 WL 2943198 (Wis. App.)(July 29, 2010):

Goodwill is defined as that element of value "which inheres in the fixed and favorable consideration of customers arising from an established and well-conducted business." "Professional goodwill" (or "personal goodwill") varies from "corporate goodwill" (or "business goodwill," "going concern value," "commercial goodwill," and "enterprise goodwill.").

One of the primary mechanisms through which professional goodwill is sold is a non-compete agreement. The Court held that no reasonable buyer would purchase Tim‟s practice without an agreement preventing Tim from competing in the two communities where Tim‟s offices were located. There was no dispute that the hypothetical willing buyers would demand a non-compete agreement. Additionally, there was no serious dispute that, if a sale occurred, the non-compete aspect of the sale would be a mechanism for the transfer of some portion of Tim‟s professional goodwill to the buyer.

There was no dispute that the professional goodwill at issue here was salable. *Holbrook, 103 Wis. 2d 327, 309 N.W.2d 343*, supports the proposition that non-salable professional goodwill is not a divisible asset. However, *Holbrook* declined to adopt a blanket rule excluding salable professional goodwill from divisible property.

The court rejected Tim‟s proposed blanket exclusion of salable professional goodwill from divisible property because unfairness would plainly be the result in some circumstances. Additionally, Tim did not present expert testimony explaining why it would be necessary to exclude the entire value of salable professional goodwill in order to avoid "double counting." Also, since it is settled law in Wisconsin that, at a minimum, salable corporate goodwill is divisible, it may be that imposing a blanket prohibition on treating salable professional goodwill as divisible would conflict with the treatment of salable corporate goodwill.

F. Buy-Sell Agreements

i. *Ehlinger v. Hauser, 2010 WI 54 (Wis. 2010)*, ruling that the parties did not have a binding buy-sell agreement due to an undefined term in the agreement and the condition of the financial records.

> The buy-sell agreement for Evald Moulding provided that if one of the shareholders became totally disabled, the non-disabled shareholder was entitled to purchase his shares at "book value."

> The term "book value" could not be validated; additionally, the contract could not be enforced regardless of how the term could be defined. The Court found that it was impossible to verify Evald"s financial statements since computer summaries had been discarded and were otherwise unavailable; it could not be confirmed that the financial statements represented "book value."

> Regardless of whether the parties intended assets and liabilities to be computed on a cost basis, a tax basis, a fair market value basis, or any other basis, the unavailability of Evald's financial records prevented Ehlinger from exercising his right to examine the books in order to assess the accuracy of the buyout price. From both a practical and a legal standpoint, the unavailability of the records precluded the buy-sell agreement from being enforced.

IV. Discounts

A. In general

Estate of Mitchell v. Commissioner of Internal Revenue, T.C. Memo 2002-98:

In *Estate of Mitchell v. Commissioner,* T.C. Memo.1997-461, we began our analysis by placing a $150 million value on JPMS at the moment immediately prior to Mr. Mitchell's death. In determining this value, we considered all the evidence but gave the greatest consideration to Minnetonka's real-world $125 million offer in the fall of 1988 (which Mr. DeJoria found "a little short") and the Gillette offer of $150 million. This value represents the acquisition value of all the nonpublicly traded stock of JPMS.

In *Estate of Mitchell v. Commissioner,* 250 F.3d 696, 705, (*nonacquiescence by IRS*, as to burden of proof, 2005-23 IRB 1152), the Court of Appeals stated:

> Acquisition value and publicly traded value are different because acquisition prices involve a premium for the purchase of the entire

capital valuation group

> company in one deal. Such a lumpsum valuation was not taken into account when the minority interest value of the stock was calculated by the experts. In general, the acquisition price is higher, resulting in an inflated tax consequence for the Estate.

In reaching our valuation determination, we were, and are, mindful that, in general, a publicly traded value (determined under the comparable companies analysis) represents a minority, marketable value. Moreover, we were, and are, mindful that acquisition value, if determined by reference to acquisitions of publicly traded companies, reflects a premium over the publicly traded value. It produces a control, marketable value that is greater than the minority, marketable publicly traded value. If the acquisition price of publicly traded companies is used to value a minority interest in a closely held corporation, discounts for both lack of marketability and lack of control would apply.

The real-world acquisition value of $150 million we applied in this case is the acquisition value based on an offer to purchase all of the stock of JPMS, which is not publicly traded. The acquisition value based on that offer reflects the fact that there is no ready market for shares in JPMS, a closely held corporation. As we pointed out in *Estate of Andrews v. Commissioner,* 79 T.C. at 953, "even controlling shares in a nonpublic corporation suffer from lack of marketability because of the absence of a ready private placement market and the fact that flotation costs would have to be incurred if the corporation were to publicly offer its stock." The $150 million acquisition value reflects a control, nonmarketable value. Therefore, a discount for lack of marketability of JPMS stock from the value determined by reference to the offer to purchase the JPMS stock is not appropriate. . . .

We find that a 29-percent discount for decedent's 49.04-percent shareholding is appropriate to reflect some power but less than control. We also find that here the minority discount should be increased by 6 percentage points (a total of 35 percent) to reflect the additional lack of marketability attributable to a minority interest.

On the basis of a thorough review of the entire record before us, we believe that we correctly arrived at a 35-percent discount rate that combines the lack of control and any additional lack of marketability attributable to that lack of control that is not reflected in the $150 million control, nonmarketable acquisition value.

The experts generally agreed that the most significant factors included the impact of Mr. Mitchell's death on the reputation of the company, the costs

of the DeJoria litigation, cashflow patterns, the marketability of the estate's minority (i.e. noncontrolling) interest of stock in the company, and the overall competition in the hair care industry. The $150 million acquisition price reflects the cashflow patterns and the overall competition in the hair care industry. We apply a 10-percent discount to the $150 million to reflect the impact of Mr. Mitchell's death on the value of the corporation (footnote omitted). We apply a 35-percent discount for lack of control and additional lack of marketability attributable to the minority interest. Finally, we reduce the value of the 49.04-percent ownership interest by $1,500,000 to account for the possibility of litigation with Mr. DeJoria. Thus, we find that the value of the shares of stock at the moment of decedent's death was $41,532,600.

B. Discount for lack of control

i. *Dunn v. Commissioner of Internal Revenue*, 301 F.3d 339 (5th Cir. 2002):

(**Background:** The Corporation actively operated its business from four locations in Texas and, on the valuation date, employed 134 persons, three of whom were executives and eight of whom were salesmen. Dunn Equipment owned and rented out heavy equipment and provided related services, primarily in the petroleum refinery and petrochemical industries. The personal property rented from the Corporation by its customers consisted principally of large cranes, air compressors, backhoes, manlifts, and sanders and grinders. The Corporation frequently furnished operators for the equipment that it rented to its customers, charging for both equipment and operators on an hourly basis.

(. . . the heavy equipment rental market became increasingly competitive, as equipment such as cranes became more readily available and additional rental companies entered the field. This in turn caused hourly rental rates to decline and flatten. In fact, increased competition prevented Dunn Equipment from raising its rental rates at any time during the period of more than ten years preceding the valuation date. These rates remained essentially flat for that 10-year period. The same competitive factors forced the Corporation to replace its equipment with increasing frequency, reaching an average new equipment expenditure of $2 million per annum in the years immediately preceding the valuation date.
In addition to the increased annual cost and frequency of replacing equipment during the years of flat rental rates that preceded the

capital valuation group

Decedent's death, the Corporation's operating expenses increased significantly, beginning in 1988, and continued to do so thereafter: The ratios of direct operating expenses to revenue escalated from 42% in 1988 to 52% in the 12-month period that ended a week before the Decedent's death. The effect of the increase in direct operating expenses on the Corporation's cash flow and profitability was exacerbated by a practice that Dunn Equipment was forced to implement in 1988: meeting its customers' demands by leasing equipment from third parties and renting it out to the Corporation's customers whenever all of its own equipment was rented out to other customers. Although this practice, which continued through the valuation date, helped Dunn Equipment keep its customers happy and retain its customer base, the Corporation was only able to break even on these re-rentals, further depressing its profit margin.

(Based on the foregoing factors, the Tax Court concluded that the Corporation had no capacity to pay dividends during the five years preceding the death of the Decedent. In fact, it had paid none.) The Court of Appeals said . . . .

The Tax Court also found that, even though the Decedent's 62.96% of stock ownership in the Corporation gave her operational control, under Texas law she lacked the power to compel a liquidation, a sale of all or substantially all of its assets, or a merger or consolidation, for each of which a "super-majority" equal to or greater than 66.67% of the outstanding shares is required (footnote omitted). The Court further concluded that, in addition to lacking a super-majority herself, the Decedent would not have been likely to garner the votes of additional shareholders sufficient to constitute the super-majority required to instigate liquidation or sale of all assets because the other shareholders were determined to continue the Corporation's independent existence and its operations indefinitely. The court based these findings on evidence of the Corporation's history, community ties, and relationship with its 134 employees, whose livelihoods depended on Dunn Equipment's continuing as an operating business. (301 F.3d at 346).

ii. *Estate of Godley v. Commissioner of Internal Revenue*, 286 F.3d 210 (4th Cir. 2002).

In this case, the Tax Court determined that the value of the partnership interests was subject to a discount for lack of

marketability, but not for the alleged lack of control. This finding was not clearly erroneous. As the evidence demonstrates, there was little to be gained by having control of these partnerships and little risk in holding a minority interest.

Here, the Housing Partnerships were guaranteed a long-term, steady income stream under the HUD contracts. The Housing Partnerships had little risk of losing the HUD contracts and the management of the properties did not require particular expertise. Indeed, the HUD contracts allowed the Housing Partnerships to collect above-market rents, and there was no other use for the partnerships that would increase their profits. Therefore, control of the Housing Partnerships did not carry with it any appreciable economic value. Nor did a lack of control reduce the value of a fifty percent interest such that a minority discount was required. The Estate argues that a minority discount was required because "the record supports a finding that the managing partner had significant latitude in determining the extent of partnership distributions and the amounts set aside in reserve." However, each partnership agreement required the partnership to distribute its "net cash flow" annually and set forth a specific calculation of that net cash flow. There was no risk that Godley, a fifty percent partner, would not realize an annual payout. Although the agreements also granted the managing partner the power to set aside reserves, that power was characterized as one of "day-to-day management." It appears unlikely that this "set aside" power could be used to defeat the requirement of an annual distribution. At a minimum, Godley could exercise his power under the partnership agreements to prevent any change to the guarantee of an annual distribution. Thus, as the Tax Court determined, Godley was effectively guaranteed a reasonable annual distribution of partnership income. And while an inability to force a distribution of income may under other circumstances warrant a discount for lack of control, the Tax Court correctly found that this factor was not relevant in this case.

Similarly, the Estate contends that Godley's fifty percent interest made it impossible for him to compel liquidation or sell partnership assets. However, neither Godley nor Godley, Jr. could compel liquidation or make any "major decision" without the affirmative vote of seventy-five percent of the partnership shares. Moreover, given the passive nature of the business and the almost certain prospect of steady profits, the ability to liquidate or sell assets was of little practical import. Thus, as the Tax Court reasoned, the guarantee of above-market rents and other factors unique to the Housing Partnerships meant that the power to

liquidate the partnership or to sell partnership assets would have minimal value to an investor. (286 F.3d at 216).

iii. Also see *Estate of Simplot v. Commissioner of Internal Revenue*, 249 F.3d 1191 (9th Cir. 2001):

(**Background:** "In the light of "all of these factors," the Tax Court assigned a premium to the Class A stock over the Class B stock equal to 3% of the equity value of the company, or $24.9 million. Dividing this premium by the number of Class A shares gave each Class A share an individual premium of $325,724.38, for a total value of $331,595.70, subject to a 35% discount for lack of marketability with a resultant value of $215,539. Class B stock was valued at $3,417 per share.") The Court of Appeals said:

The Tax Court committed a third error of law. Even a controlling block of stock is not to be valued at a premium for estate tax purposes, unless the Commissioner can show that a purchaser would be able to use the control "in such a way to assure an increased economic advantage worth paying a premium for." *Ahmanson Foundation v. United States,* 674 F.2d 761, 770 (9th Cir.1981). Here, on liquidation, all Class B shareholders would fare better than Class A shareholders; any premium paid for the 18 Class A shares [sic] be lost. Class A and B had the right to the same dividends. What economic benefits attended 18 shares of Class A stock? No "seat at the table" was assured by this minority interest; it could not elect a director. The Commissioner points out that Class A shareholders had formed businesses that did business with Simplot. If these businesses enjoyed special advantages, the Class A shareholders would have been liable for breach of their fiduciary duty to the Class B shareholders. *See Estate of Curry v. United States,* 706 F.2d 1424, 1430 (7th Cir.1983). (249 F.3d at 1195).

C. Discount for lack of marketability

i. *Okerlund v. U.S.*, 53 Fed.Cl. 341, *aff'd.*, 365 F.3d 1044 (Fed.Cir. 2004):

The Court finds Dr. Pratt's analysis of the appropriate discount for lack of marketability more persuasive than that of the government's

expert. First, Dr. Spiro's speculation about the pressure to go public created by the 3G Trust may not be considered under the objective standard applicable to valuation of closely held stock. The court is precluded from considering imaginary scenarios as to "who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with [ ] children or grandchildren and what improvements in management of a highly successful company an outsider purchaser might suggest." *Estate of Simplot v. Comm'r* 249 F.3d 1191, 1195 (9th Cir. 2001). Dr. Spiro's imaginary scenario, however plausible, may not be considered in valuing what a hypothetical willing buyer and willing seller would pay for closely held stock. Second, the factors identified in the AVG Report that weigh against a high liquidity discount relating to company performance and competitiveness were already taken into account in determining the appropriate pricing multiples under the market approach. Thus, the re-emphasis of these factors in the liquidity discount analysis may result in overstatement. Finally, the Court finds Dr. Pratt's analysis of the relevant empirical studies and shareholder risks more persuasive than the AVG report's rather truncated analysis. In particular, the Court is persuaded that the Marvin Schwan estate plan provisions would deter investment to a greater extent than Dr. Spiro suggests.

However, rather than accepting Dr. Pratt's estimate of 45 percent, the Court holds that a 40 percent discount for lack of marketability is warranted for the December 31, 1992 valuation date. The Court agrees that the company's dividend payment history, restrictive stock transfer provision, the 3G Trust and the redemption agreement constitute significant deterrents to investment because of the restraints they impose on short or long term returns. However, in 1992 the estate plan provisions, although in place, had neither been triggered nor anticipated in the immediate future. In other words, they were prospective concerns rather than actual concerns as of the 1992 valuation date. It is well-established that "valuation of the stock must be made as of the relevant dates without regard to events occurring subsequent to the crucial dates." *Bader v. United States,* 172 F.Supp. 833, 840 (S.D.Ill.1959); *accord Hermes Consol., Inc. v. United States,* 14 Cl.Ct. 398, 415, n. 28 (1988), *Fehrs v. United States,* 223 Ct.Cl. 488, 620 F.2d 255, 264 n. 6 (1980), *Central Trust Co. v. United States,* 158 Ct.Cl. 504, 305 F.2d 393, 403 (1962) (footnote omitted). In 1992, the major shareholder risks identified in the Willamette Report, and in Dr. Pratt's testimony, were in place, but had not yet been triggered by Marvin Schwan's death. The difference between potential versus

actual deterrents to investment supports a 5 percent disparity between the appropriate discount for lack of marketability in 1992 (40 percent) and in 1994 (45 percent).

ii. Also see

a. *Mandelbaum v. Commissioner of Internal Revenue*, T.C. Memo 1995-255, *aff'd.*, 91 F.3d 124 (3rd Cir. 1996).

b. *Mandelbaum* determined a discount for lack of marketability that started with a benchmark discount of 35% to 45%. Subsequent cases indicate that this benchmark was appropriate based on the facts of the case but should not be viewed as a legal standard for all cases. The benchmark, or starting point, must be based on the facts of each case. See, for example, *Lappo v. Comm'r.*, T.C. Memo 2003-258, and *Peracchio v. Comm'r.*, T.C. Memo 2003-280.

V. Specific Gift Tax Valuation Issues

A. Ineffective Transfers of Business Interests

i. Several recent cases have focused on whether a transfer of a business interest to another entity constitutes a bona fide sale; if not, the business interest may be included in a decedent"s estate under Internal Revenue Code sec. 2036(a). *Kimbell v. U.S.*, 371 F.3d 257 (5th Cir. 2004), discusses factors considered in determining whether a transfer was made for adequate and full consideration, thus constituting a bona fide sale:

> In summary, what is required for the transfer by Mrs. Kimbell to the Partnership to qualify as a bona fide sale is that it be a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange. In order for the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition, when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of

objective facts that would confirm or deny the taxpayer's assertion that the transaction is bona fide or genuine.

The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid--a classic informed trade-off.

The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

ii. *Harper v. Commissioner of Internal Revenue*, T. C. Memo 2002-121 illustrates an ineffective transfer of the business interest:

On the facts before us, HFLP's formation at a minimum falls short of meeting the bona fide sale requirement. Decedent, independently of any other anticipated interest-holder, determined how HFLP was to be structured and operated, decided what property would be contributed to capitalize the entity, and declared what interest the Trust would receive therein. He essentially stood on both sides of the transaction and conducted the partnership's formation in absence of any bargaining or negotiating whatsoever. It would be an oxymoron to say that one can engage in an arm's-length transaction with oneself, and we simply are unable to find any other independent party involved in the creation of HFLP.

Furthermore, lack of a bona fide sale aside, we believe that to call what occurred here a transfer for consideration within the meaning of section 2036(a), much less a transfer for an adequate and full consideration, would stretch the exception far beyond its intended scope. In actuality, all decedent did was to change the form in which he held his beneficial interest in the contributed property.

iii. Also see

a. *Harper* is discussed in *Estate of Thompson v. Commissioner*, T.C. Memo 2002-246, *aff'd.*, 382 F3d 367 (3rd Cir. 2004), in which the Tax Court concluded that sec. 2036(a) required inclusion of assets in an estate because the decedent had not given up control over the assets, even though the partnership was valid under state law.

b. *Harper* is also discussed in *Estate of Bongard v. Commissioner of Internal Revenue*, 124 T.C. 95 (2005), in which the court found one transaction a bona fide sale for adequate and full consideration but another transaction as not a bona fide sale because there was an implied agreement that the decedent would retain enjoyment over the property that was transferred; therefore, under section 2036(a)(1) of the Internal Revenue Code, the decedent"s gross estate included the value of the property from the second transfer.

c. *Bigelow v. Commissioner of Internal Revenue*, T.C. Memo 2005-65, discusses *Kimbell*, *Harper*, *Thompson*, and *Bongard* in concluding that "the decedent and her children had an implied agreement that decedent could continue during her lifetime to enjoy the economic benefits of, and retain the right to the income from, the . . . property after she conveyed the property to the partnership, and that the transfer was not a bona fide sale for adequate and full consideration. Thus, the value of the . . . property is included in decedent"s gross estate [under] sec. 2036(a)(1).

d. Also see *Strangi v. Commissioner of Internal Revenue*, 417 F.3d 468 (5th Cir. 2005), also finding that the decedent retained the possession and enjoyment of the transferred property.

e. Also see *Keller v. United States*, 2009 U.S. Dist. LEXIS 73789 (S.D. Tex. 2009), finding that decedent did not retain possession and enjoyment of the transferred property, thus resulting in a bona-fide sale. A Partnership was

created for a legitimate business purpose: to alter the legal relationship between Mrs. Williams and her heirs that would facilitate the administration of family assets. Mrs. Williams‟ transfer of assets to the Partnership was "real, actual, genuine, and not feigned," supporting the conclusion that the transfer was made pursuant to a bona fide sale.

B. Indirect Gifts Because of Timing of Transactions

i. In *Holman v. Comm'r.*, 130 T.C. 170 (2008), the taxpayers formed and funded a limited partnership with publicly traded securities and, 6 days later, made a series of gifts of limited partnership interests. The IRS argued that the taxpayers‟ "formation and funding of the partnership should be treated as occurring simultaneously with . . . [the gift] since the events were interdependent and the separation in time between the first two steps (formation and funding) and the third (the gift) served no purpose other than to avoid making an indirect gift under section 25.2511-1(h), Gift Tax Regs." The court rejected this characterization, concluding that ". . . the taxpayers bore a real economic risk of a change in value of the partnership for the 6 days that separated their transfer of the shares to the partnership and the gift. . . . . We shall not disregard the passage of time and treat the formation and funding of the partnership and the subsequent gifts as occurring simultaneously under the step transaction doctrine." *Holman* at 190-191.

ii. Also see: *Gross v. Comm'r*., T.C. Memo 2008-221.

iii. Also see: *Heckerman v. United States*, 2009 U.S. Dist. LEXIS 65746 (W.D. Wash. 2009), asserting the step transaction doctrine. The Court found that the two-step transaction was an integrated transaction because Plaintiff could not establish that he contributed assets to the LLC before he gifted the minority interests in the LLC to his children. The Court also held that Plaintiff clearly had a subjective intent to convey property to his children while minimizing his tax liability. Also, it is clear that but for the anticipated discount in calculating gift taxes, Plaintiffs would not have transferred the cash to the LLC. Also see: *Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009).

C. Present Interests vs. Future Interest

i. *Christine and Albert Hackl v. Commissioner*, 118 T.C. 279 (2002), affirmed, *Hackl v. C.I.R.*, 335 F.3d 664, 92 A.F.T.R.2d 2003-5254

(7th Cir. 2003)(rehearing denied) illustrates the importance of gifts of present interests for purposes of the annual exclusion from gift taxes:

(**Background: "**Section 2501 imposes a tax for each calendar year "on the transfer of property by gift" by any taxpayer, and section 2511(a) further clarifies that such tax "shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible". The tax is computed based upon the statutorily defined "taxable gifts", which term is explicated in section 2503. Section 2503(a) provides generally that taxable gifts means the total amount of gifts made during the calendar year, less specified deductions. Section 2503(b), however, excludes from taxable gifts the first $10,000 "of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year". In other words, the donor is entitled to an annual exclusion of $10,000 per donee for present interest gifts.

(Regulations promulgated under section 2503 further elucidate this concept of present versus future interest gifts, as follows:
Future interests in property.--(a) No part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the "calendar period" * * *. "Future interest" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future. But a future interest or interests in such contractual obligations may be created by the limitations contained in a trust or other instrument of transfer used in effecting a gift. (b) An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property. * * * [Sec. 25.2503-3, Gift Tax Regs.]

(The primary business purpose of all three of the above entities has been to acquire and manage plantation pine forests for long-term income and appreciation for petitioners and their heirs and not to produce immediate income. Petitioners anticipated that all three entities would operate at a loss for a number of years, and

therefore, they did not expect that these entities would be making distributions to members during such years. Treeco reported losses in the amounts of $42,912, $121,350, and $23,663 during 1995, 1996, and 1997, respectively. Hacklco reported losses of $52,292 during 1997. Treesource reported losses in the amounts of $75,179, $153,643, and $95,156 (footnote omitted) in 1997, 1998, and 1999, respectively. Neither Treeco nor its successors had at any time through April 5, 2001, generated net profits or made distributions of cash or other property to members.) The Tax Court continued:

Nonetheless, while State law defines property rights, it is Federal law which determines the appropriate tax treatment of those rights. (citations omitted) It thus is Federal law which controls whether the property rights granted to the donees as LLC owners under State law were sufficient to render the gifts of present interests within the meaning of section 2503(b) (118 T.C. at 290). . . .

Accordingly, we are satisfied that section 2503(b), regardless of whether a gift is direct or indirect, is concerned with and requires meaningful economic, rather than merely paper, rights. (118 T.C. at 291). . . .

To recapitulate then, the referenced authorities require a taxpayer claiming an annual exclusion to establish that the transfer in dispute conferred on the donee an unrestricted and noncontingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom. In other words, petitioners must prove from all the facts and circumstances that in receiving the Treeco units, the donees thereby obtained use, possession, or enjoyment of the units or income from the units within the above-described meaning of section 2503(b) (118 T.C. at 293) . . . .

Concerning the specific rights granted in the Operating Agreement, we are unable to conclude that these afforded a *substantial* economic benefit of the type necessary to qualify for the annual exclusion. While we are aware of petitioners' contentions and the parties' rather conclusory stipulations that Treeco was a legitimate operating business entity and that restrictive provisions in the Agreement are common in closely held enterprises and in the timber industry, such circumstances (whether or not true) do not

alter the criteria for a present interest or excuse the failure here to meet those criteria.

As we consider potential benefits inuring to the donees from their receipt of the Treeco units themselves, we find that the terms of the Treeco Operating Agreement foreclosed the ability of the donees presently to access any substantial economic or financial benefit that might be represented by the ownership units. For instance, while an ability on the part of a donee unilaterally to withdraw his or her capital account might weigh in favor of finding a present interest, here no such right existed. According to the Agreement, capital contributions could not be demanded or received by a member without the manager's consent. Similarly, a member desiring to withdraw could only offer his or her units for sale to the company; the manager was then given exclusive authority to accept or reject the offer and to negotiate terms. Hence some contingency stood between any individual member and his or her receipt from the company of economic value for units held, either in the form of approval from the current manager or perhaps in the form of removal of that manager by joint majority action, followed by the appointment of and approval from a more compliant manager. Likewise, while a dissolution could entitle members to liquidating distributions in proportion to positive capital account balances, no donee acting alone could effectuate a dissolution. Moreover, in addition to preventing a donee from unilaterally obtaining the value of his or her units from the LLC, the Operating Agreement also foreclosed the avenue of transfer or sale to third parties. The Agreement specified that "No Member shall be entitled to transfer, assign, convey, sell, encumber or in any way alienate all or any part of the Member's Interest except with the prior written consent of the Manager, which consent may be given or withheld, conditioned or delayed as the Manager may determine in the Manager's sole discretion." Hence, to the extent that marketability might be relevant in these circumstances, as potentially distinguishable on this point from those in indirect gift cases such as *Chanin v. United States,* 393 F.2d at 977, and *Blasdel v. Commissioner, supra* at 1021-1022 (both dismissing marketability as insufficient to create a present interest where the allegedly marketable property, an entity or trust interest, differed from the underlying gifted property), the Agreement, for all practical purposes, bars alienation as a means for presently reaching economic value. Transfers subject to the contingency of manager approval cannot support a present interest characterization, and the possibility of making sales in violation thereof, to a transferee who would then have no right to become a member or to participate in the business, can hardly be seen as a

sufficient source of substantial economic benefit. We therefore conclude that receipt of the property itself, the Treeco units, did not confer upon the donees use, possession, or enjoyment of property within the meaning of section 2503(b) (118 T.C. at 296 - 298).

D. Transfer Restrictions

i. *Kerr v. Commissioner of Internal Revenue*, 292 F.3d 490 (5th Cir. 2002) concerns the applicability of sec. 2704(b) of the Internal Revenue Code for gift tax purposes:

(**Background:** In establishing the valuation for gift tax purposes, the Internal Revenue Code disregards certain "applicable restrictions" on liquidation in a partnership agreement if the gift is made to a family member. I.R.C. § 2704(b). . . . the Commissioner's position that Code § 2704(b) barred them from applying a marketability discount to the values of the interests they transferred. The Tax Court ruled summarily for the taxpayers, holding that the special rule in § 2704(b) did not bar their marketability discounts. The Commissioner now appeals the Tax Court's decision, arguing that certain partnership agreement restrictions were "applicable restrictions" on liquidation within the meaning of § 2704(b) and should be disregarded, thus precluding a marketability discount in valuing the gifts.

(Baine P. Kerr and Mildred C. Kerr ("taxpayers") created two family limited partnerships in 1993, the Kerr Family Limited Partnership (KFLP) and Kerr Interests, Ltd. (KIL), pursuant to the Texas Revised Limited Partnership Act. Taxpayers made capital contributions to KFLP and KIL. The interests were allocated so that in KFLP, taxpayers and their children were general partners; taxpayers were also Class A and Class B limited partners. In KIL, KFLP was the general partner; taxpayers were Class A limited partners; and KFLP, taxpayers, and their children were Class B limited partners.

(In June 1994 taxpayers transferred Class A limited partnership interests in KFLP and KIL to the University of Texas (UT). In December 1994, the KIL partnership agreement was amended to admit UT as a Class A limited partner. In December 1994 and

December 1995, taxpayers each donated Class B partnership interests in KIL to their children.") The Court of Appeals said . . .

The Commissioner argues that the restrictions in the agreements were removable by the family, because there is evidence that UT, the only non-family partner, (footnote omitted) would not oppose their removal if proposed by the Kerr family (footnote omitted). The parties have stipulated that UT would convert its interests into cash as soon as possible, so long as it believed the transaction to be in its best interest and that it would receive fair market value for its interest. The Commissioner argues that, because UT would have no reason to oppose their removal, the partnership restrictions should be treated as capable of being removed by the Kerr family after the transfers.

We disagree. For a restriction to be considered removable by the family, the Code specifies that "[t]he transferor or any member of the transferor's family, either alone or collectively," must have the right to remove the restriction. I.R.C. § 2704(b)(2)(B)(ii). The Code provides no exception allowing us to disregard non-family partners who have stipulated their probable consent to a removal of the restriction. The probable consent of UT, a non-family partner, cannot fulfill the requirement that the family be able to remove the restrictions on its own. (292 F.3d at 494).