Summary of Valuation Discounts 2000 – 2009

Specialty Tax - Estate and Gift

Foreword

This is a cumulative summary of most (if not all) of the decided cases involving valuation discounts during the period 2000 – 2009. Cases are listed in the following categories:

1. Family Limited Partnerships,
2. Corporations and Other Entities,
3. Real Estate and Other.

The descriptions and accounts (and editorial comments) with respect to the cases and rulings contained herein are mine and, as such, they suffer from whatever personal biases my interpretations may have. This summary of valuation discounts is intended only to provide a brief overview of each case or ruling. It is meant to provide a ready reference document and is not intended to provide a substitute for reading the actual decisions.

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Family Limited Partnerships

Ina F. Knight v. Commissioner, 115 T.C. 506 (2000)

A gift tax case in which the FLP held a family ranch, two homes, municipal bond funds and Treasury notes. The taxpayer claimed a 10% portfolio discount, a 10% minority interest discount and a 30% lack of marketability discount or a cumulative discount 44%. The court found no convincing reason why the partnership's mix of assets would be unattractive to a buyer and disallowed the 10% portfolio discount in full. The court reduced the minority interest and lack of marketability discounts to a total combined discount of only 15%, finding that the investment policy of the partnership closely resembled a closed-end bond fund, where discounts are normally about 15%.

J.C. Shepherd v. Commissioner, 115 T.C. 376 (2000)

Although technically not a family limited partnership case, this decision may have significant impact on the development of certain FLP cases. The Tax Court found that the taxpayer's transfer of land and bank stock to a general partnership in which his two sons each had a 25% interest represented separate, indirect gifts to his sons of interests in the land and bank stock, rather than gifts of partnership interests or enhancements thereto. Consequently, it disallowed the 33.5% minority and marketability discount that the taxpayer had claimed with respect to each son's 25% partnership interest. After determining the value of the gifted land, the court allowed a 15% fractional interest discount. It also allowed the 15% minority discount claimed on the bank stock that was not contested by IRS. Note that this decision was affirmed by the Eleventh Circuit in J.C. Shepherd v. Commissioner, 283 F.3rd 1258 (11th Cir. 2002).

Estate of W.W. Jones II v. Commissioner, 116 T.C. 121 (2001)

The decedent formed two partnerships with his children. All partners contributed property (primarily land) and received proportionate interests. The decedent then immediately transferred a 83% interest in the first partnership to his son and a 16.9% interest in the second partnership to each of his four daughters. With respect to transferred 83% interest, the court allowed only an 8% marketability discount. Under the terms of the partnership agreement, the 83% limited partnership interest had effective control of the partnership and could remove the general partner and force liquidation. The 8% discount was allowed to account for any costs and delays involved in such a forced liquidation. With respect to the transfer of the 16.9% interests in the other partnership, however, the court allowed a combined minority interest and lack of marketability discount of 40% based on secondary market sales of limited partnership interests plus an additional 8% marketability discount to account for the partnership's right of first refusal which would have a depressing effect on value. On the positive side, the court denied any discount for built-in capital gains on the grounds that a willing seller could negotiate with the other partners to agree to a §754 election since such an election would have no material or adverse impact on the remaining partners.

Estate of Elma M. Dailey v. Commissioner, T.C. Memo. 2001-263

Decedent created an FLP holding listed securities valued at approximately $1.0 million and then made gifts of 45% and 15% limited partnership interests which, along with the interests held at date of death, were discounted by 40%. The expert witness for the IRS (Dr. Mukesh Bajaj) argued for aggregate discounts of 15.72% as of the date of the gifts and 13.51% as of the date of death. Tax Court Judge Maurice Foley found Dr. Bajaj's testimony to be "contradictory, unsupported by the data, and inapplicable to the facts." The claimed 40% discount was allowed for gift and estate tax purposes.

Technical Advice Memorandum 200212006

A mother and her children executed a partnership agreement establishing a limited partnership funded with cash and marketable securities. The mother later transferred publicly traded municipal bonds to the partnership and filed a gift tax return reporting the resulting gifts to the other partners (i.e., her children) at a 45% valuation discount. The taxpayer argued that the amount of the contribution was initially allocated to her capital account. It was then treated as withdrawn and then allocated to her children's capital accounts. Relying on Gift Tax Regulations §25.2511-1(h)(1) and the Tax Court's decision in Shepherd, the Service held that the taxpayer's transfer was properly characterized as an indirect gift of the municipal bonds to her children. It found that the transitory allocation to the taxpayer's capital account was merely a step in an integrated transaction intended to pass the taxpayer's contribution to her children and that the taxpayer's capital account acted simply as a conduit for the transfer. Hence, no minority or marketability discounts were allowable.

Clarissa W. Lappo v. Commissioner, T.C. Memo. 2003-258

The donor and her daughter created a family limited partnership funding it with marketable securities valued at approximately $1.3 million and real estate valued at $1.86 million. The donor then made gifts of limited partnership interests. All parties agreed that the partnership should be valued at net asset value reduced by minority interest and lack of marketability discounts. The taxpayer's expert argued that a 7.5% for minority discount should be applied to the securities and a 35% minority discount should be applied to the real estate. He also utilized lack of marketability discounts of 35% for one of the gifts and 30% for the other. The IRS expert concluded that the minority discount should be 8.5% and the marketability discount should be 8.3% for both gifts. The court wasted little time in arriving at an 8.5% minority discount for the marketable securities. With respect to the minority discount for the real estate, both experts started with publicly traded real estate investment trusts (REITs) but the taxpayer's expert used only a sample of 7 comparable companies while the IRS expert had a sample of 52 companies. The court concluded that this "sample was sufficiently large to make tolerable any dissimilarities between the partnership and the REITs in his guideline group." Both experts made adjustments to the REIT sample averages but the court was critical of the "terse" explanation of the adjustments made by the taxpayer's expert. The IRS expert made adjustments based on Dr. Bajaj's study. The court was

unwilling "to rely on a single academic study – particularly one that [the government's expert] did not participate in preparing and could not elaborate upon first hand." The court eventually averaged the average discount observed in unregistered private placements in each of three different studies to arrive at a liquidity premium adjustment. The result of this analysis was a 19% minority interest discount for the real estate. The weighted average minority discount (based on asset class), therefore, was 15%. With respect to the marketability discount, the court noted that it approved the private placement approach utilized by the IRS expert over the restricted stock approach used by the estate's expert. It was again unwilling, however, to accept the Bajaj study, which concluded that the portion of private placement discounts attributable solely to impaired marketability, was 7.2%. Instead, it looked to the raw data in the Bajaj study that had an average discount of 22.21% and the Hertzel & Smith study cited by Bajaj that had a 20.14% discount. Using the average of these two studies (21%) plus a 3% upward adjustment for the particular circumstances of the partnership, it allowed a 24% lack of marketability discount, resulting in an overall cumulative discount of 35.4%.

Peter S. Peracchio v. Commissioner, T.C. Memo. 2003-280

The taxpayer made gifts of limited partnership interests in an FLP holding only cash and marketable securities, valuing the gifts based on net asset value of the FLP less a combined 40% discount for lack of marketability and lack of control. At trial, the taxpayer offered two experts, one of whom argued for a 7.7% minority interest discount and a 35% marketability discount and the other concluded that a 5% minority interest discount and a 40% lack of marketability discount were appropriate. IRS argued that the proper discounts should be 4.4% for lack of control and 15% for lack of marketability. All of the experts computed minority interest discounts by reference to shares of publicly traded, closed end investment funds (which typically trade at a discount relative to their share of fund net asset value). Based on the court's analysis of the various funds, it arrived at a weighted average minority discount (based on asset classes) of 6%. With respect to lack of marketability, the court was critical of one of the taxpayer's experts who concluded that, in Mandelbaum v. Commissioner, T.C. Memo. 1995-225 the Tax Court "established a benchmark lack of marketability discount range of 35% to 45%." It pointed out that, "[t]o the extent that [the appraiser] believes that the benchmark range of discounts we utilized in *Mandelbaum v. Commissioner, supra*, is controlling in this or any other case, he is mistaken." Unfortunately, the court was also not impressed with the conclusions of the government's expert. The court noted a statement in his written report that "a marketability discount above 25 percent would not be justified" and treated that as a concession that a marketability discount of up to 25% would be appropriate and that is the marketability discount it allowed. The resulting cumulative discount, therefore, was 29.5%.

Estate of Lea K. Hillgren, et al. v. Commissioner, T.C. Memo. 2004-46

Several months prior to her suicide, the decedent created a limited partnership with her brother. The decedent contributed several properties and held a 99.95% capital interest and a 75% profit interest. The decedent's brother, who was the general partner, contributed no property to the partnership and was given the remaining interests. Four of the properties were subject to a pre-existing business loan agreement between the decedent and her brother. Under the terms of the agreement, decedent's brother had the sole right to determine if the underlying property could be sold and, for one of them, he was entitled to 25% of any net cash proceeds from any such sale.

The court concluded that the properties transferred to the partnership by the decedent were includible under §2036(a), subject to the effect of the pre-existing loan business loan agreement. The court found that the business loan agreement had apparent business purpose and that it would not be ignored by a hypothetical buyer. For the property subject to the brother's 25% interest under the business loan agreement, the estate argued for a 50% combined discount for lack of marketability and lack of control while the IRS appraiser determined a 10% lack of control discount and a 35% lack of marketability discount. The court accepted the estate's claimed discount, finding that it was "reasonable and is not contradicted by reliable evidence."

For the three other properties not subject to the brother's 25% interest (but subject to the business loan agreement), the estate arrived at combined discounts for lack of marketability and control of 35%, 35% and 40% while the IRS appraiser had determined discounts of 30%, 30% and 40%. As the difference between the parties was "insubstantial", the court accepted the estate's discounts. Finally, the estate claimed an additional 5% discount on the 4 parcels for lack of voting rights. The IRS appraiser had testified such a discount would be in the range of 2.5% - 5%. Consequently, the court allowed the 5% discount used by the estate's appraiser.

Estate of Wayne C. Bongard v. Commissioner, 124 T.C. 95 (2005)

The decedent transferred operating company stock to an LLC holding company and then transferred the LLC units to an FLP in exchange for a 99% limited partnership interest. The 1% general partnership interest was transferred to an irrevocable trust for the benefit of the decedent's children in exchange for LLC units held in the trust. The court held that the value of the LLC units was includible in the gross estate under §2036(a).

With respect to the value of the transfer, the parties had stipulated to the value of the operating company stock and that was used as the starting point in the determination of the value of the decedent's interests in the LLC and the FLP. Valuation discounts (again by way of stipulation) were allowed with respect to the transfers of LLC units to the extent of 13% for lack of control and 17.5% for lack of marketability (representing a cumulative valuation discount of 28.225%). An additional 5% discount was allowed with respect to nonvoting units.

Estate of Charles Porter Schutt v. Commissioner, T.C. Memo. 2005-126

The decedent transferred large holdings of listed stock to two business trusts (partnerships) and the court held that under the unique circumstances of the case, the bona fide sale exception to the application of sections 2036 and 2038 applied. Further, the perpetuation of the decedent's buy and hold investment strategy was found to be a legitimate and significant nontax factor in the transfers. Hence, the transfers of stock were found to be not includible under sections 2036 and 2038. Pursuant to the stipulation of the parties, the includible value of the partnership interests reflected a cumulative valuation discount of 32.5%.

Estate of Albert Strangi v. Commissioner, 429 F.3d 1154 (5th Cir. 2005)

FLP holding over 98 percent of the decedent's wealth including real estate, securities, accrued interest and dividends, insurance policies, annuities, receivables, and partnership interests. In Estate of Albert Strangi v. Commissioner, 115 T.C. 478 (2000), the Tax Court determined that the claimed 43% discount for lack of marketability and lack of control was not reasonable and accepted the 31% combined discount proposed by the IRS's expert, noting that the result may still be "overgenerous" to the estate. Note that subsequently, in Estate of Albert Strangi, et al. v. Commissioner, T.C. Memo. 2003-145, the Tax Court found that the transfer of assets to the FLP met the tests under both §2036(a)(1) and §2036(a)(2) and ruled that the full amount of assets transferred must be included in the gross estate with no valuation discounts. On appeal, the Fifth Circuit affirmed the inclusion of the transferred assets under §2036(a)(1) but did not consider the Commissioner's alternative argument under §2036(a)(2).

Estate of Webster E. Kelley v. Commissioner, T.C. Memo. 2005-235

The decedent and his daughter and son-in-law formed an FLP to which the decedent contributed over $1 million in cash and certificates of deposits and the others contributed $50,000 in cash. The parties also formed an LLC that was owned by each of them equally that held a 1% interest (presumably, but not stated, the general partnership interest) in the FLP.

At date of death in 1999, the decedent held a 94.83% interest in the FLP and a 33.33% interest in the LLC. The net asset value of the FLP was approximately $1.2 million and consisted entirely of cash and certificates of deposits.

The case was tried strictly as a valuation case. All alternative arguments including those under §§2025, 2036, 2038 and 2703 were conceded by IRS prior to trial. The estate argued for a minority discount of 25% and a lack of marketability discount of 38% or a cumulative discount of 53.5% while the government's expert (whom I understand was an IRS Economist) countered with a 12% minority discount and a 15% lack of marketability discount (representing a cumulative discount of 25.2%).

The court was dissatisfied with the valuation experts on both sides and ended up allowing a 12% minority discount and a 23% lack of marketability discount. This represents a cumulative valuation discount of 32.24%.

Arthur Temple v. United States, 423 F.Supp. 2d 605, United States District Court for the Eastern District of Texas, 2006

This federal district court case (Eastern District of Texas) involved the valuation of certain 1997 and 1998 gifts of interests in four (4) entities described as follows:

- Ladera Land, Ltd. ("Ladera") formed to own and operate a Texas ranch.
- Boggy Slough West, LLC ("Boggy Slough") formed to own and operate a California winery.
- Temple Interests, L.P. ("Temple Interests") and Temple Partners, L.P. ("Temple Partners") both formed to hold the stock of two publicly traded corporations.

The gifts of interests in Ladera were valued using a minority interest (lack of control) discount of 25% and a lack of marketability discount of 45% and resulting in a cumulative discount of 58.75%. The minority interest discount was based on "the inverse of the premium for control" using a study of the inverse of premiums paid to acquire control of public companies published by the Mergerstat Review. The lack of marketability discount was based on the "Quantitative Marketability Discount Model" ("QMD Model") developed by Z. Christopher Mercer. Without explaining what it was, the court adopted the government's expert approach to determining the discounts. It appears that the government expert (Frances Burns) analyzed Partnership Spectrum data to determine average discounts for limited partnerships holding primarily real estate. The court concluded that "based upon a preponderance of the evidence, that Temple's Ladera Land gifts should be discounted by 33% for a combined lack of marketability and lack of control and that an additional incremental lack of marketability discount of 7.5% applies to Ladera's partnership interests because of their status as private and non-registered interests." Additionally, the court declined to allow a discount for built-in capital gain taxes because of the ability of a buyer to avoid future tax liability pursuant to an IRC §754 election. Hence, the cumulative valuation discount allowed for the gifts of interests in Ladera was 38%.

The next entity considered by the court was Boggy Slough. The donors' appraiser determined the same discounts that she had used for Ladera (i.e., a cumulative 58.75% discount). The gifts of interests in Boggy Slough included a gift of a 76.6% non-managing membership interest to a daughter along with some small gifts of non-managing membership interests to trusts for grandchildren. The government apparently argued that no lack of control discount was appropriate with respect to the 76.6% interest since the operating agreement for Boggy Slough provided that "[t]he Company shall dissolve upon . . . vote of Members holding at least fifty one percent (51%) of the Membership Interests." The court, however, reviewed applicable California law and found that a "liquidation of Boggy Slough is not clearly mandated" and that the property

could be sold or distributed as undivided interests in kind. At trial, the donors had presented another expert witness (appraiser) who testified with respect to the types of land involved, the zoning problems and the impact of partitioning the property. The appraiser presented "the numerous difficulties associated with valuing a concern like Boggy Slough, such as control (or lack thereof), relationships among partners, and the way the property is used." His conclusions apparently supported the discount determined by the first appraiser. In any event, the court found his analysis to be persuasive and concluded that the "76.6% Boggy Slough gifted interest should be subject to a 60% discount." In connection with the discount of this interest, the government apparently pointed out that the donee had listed this interest at an undiscounted value in a loan application. The court, however, found that, at the time she did this, "she had no discounting expertise." Further, the court noted that it "does not consider her bank loan documents for discount valuations, and instead relies upon the work of the experts retained to provide evidence in this matter." As with its valuation of the Ladera interests, the court declined to allow a discount for built-in capital gain taxes. Inexplicably, the court then allowed a 33% combined lack of control/lack of marketability discount and a 7.5% incremental lack of marketability discount (or a cumulative discount of 38%) for the 1.6% Boggy Slough gifted interests to the grandchildren. So the court, in its wisdom, allowed a 60% valuation discount on the gift of a 76.6% interest and a 38% discount on gifts of 1.6% interests.

With respect to Temple Interests and Temple Partners, the donors gave a 1% LP interest to a charity in 1997 and a 45% LP interest in Temple interests to their son and a 45% LP interest in Temple Partners to their daughter. These were followed by 1998 by gifts of a 44.24% LP interest to each of the son and daughter. These two entities each held the stock of one publicly traded corporation and each had a net asset value of almost $18 million. The discounts claimed by the taxpayers with respect to these gifts is unclear but, in any event, the court was persuaded by the government's expert (Burns) who determined appropriate minority interest discounts 7.5%, 10.1% and 3.3% (depending on the date of the gift) based on the average discounts from net asset values of closed end mutual funds. With respect to the discount for lack of marketability, Burns analyzed restricted stock studies and, importantly, "academic research that has been deemed relevant for computing a lack of marketability discount." In footnotes, the court indicated that the academic research was the Bajaj study [Mukesh Bajaj, David Denis, Stephen Feris and Atulya Sarin, "*Firm Value and Marketability Discounts*", Journal of Corporation Law, Vol. 27, No. 1 (2001)] and that it had been deemed relevant in Lappo v. Commissioner, T.C. Memo. 2003-258 and in McCord v. Commissioner, 120 T.C. 358 (2003). Based on the Burns analysis, the court decided that the 12.5% lack of marketability discount he determined was the proper approach. Finally, the court also agreed with Burns that no discount was allowable for built-in capital gains.

Sidney E. Smith III et al. v. United States, No. 02-264, United States District Court for the Western District of Pennsylvania, 2006

This case involved the 1998 gift tax value of transferred interests in an FLP. The donor gave approximately a 20% limited partnership interest to each of two donees at a total reported value of $1,025,400. On examination, the total value was adjusted to $1,828,600 and this resulted in additional tax of $360,800. The donor paid the additional tax and brought an action in U.S. District Court for a refund. The value of the transferred interests as determined by the jury resulted in a refund of $648,200. The government filed a motion for a new trial contending that the court erred in allowing one of the donees (a family member) to offer a lay opinion at trial as to the fair market value of the limited partnership. The government also moved to alter or amend the judgment so as not to exceed the amount of the taxpayer's claim for refund. Each of the motions was denied.

Prior to trial, the government had objected to the proposed testimony contending that, under the Federal Rules of Civil Procedure, it would have to be "specialized knowledge within the realm of an expert" and that the witness had not been qualified as an expert. The court overruled that objection on the grounds that there was precedent finding that "[a]n owner of a business is competent to give his opinion as to the value of his property."

As an example of the testimony allowed, the witness was asked for his opinion as to the fair market value of a 1% interest in the FLP: "Well, I think it was -- I don't know, somewhere between, I don't know, $10,000 to $12,000 per share. I could make a case for one share. I could make a case for $7,000, I could make a case for 15. But in the middle I'd say $10,000 to $12,000. Just do some simple mathematics and say okay, it was $5.2 million and there's how many shareholders, that's where I ended up. And we had significant bank debt."

In ruling against the government on the motion for a new trial, the court found that the opinions of the witness "were based on personal knowledge of and experience with the operations of the company" and that a sufficient basis was laid to establish his "particularized knowledge" of the business.

The court also denied the government's motion to alter or amend the judgment, finding that the taxpayer "carefully complied with our order barring any testimony about valuation methods other than those used in the reports submitted before the Commissioner." It held that the jury's ultimate finding as to the fair market value of the gifts was based on the same valuation theories set forth in the valuation reports submitted to the IRS (although it apparently determined significantly higher discounts).

The court also rejected the government's argument that the statute of limitations prevented a judgment in an amount greater than the amount claimed. The government argued that the taxpayer did not claim an amount in excess of $360,800 prior to trial and, because three years had passed since the claim was filed, the excess amount constituted

an additional claim that was barred by the statute. The court held that because the original tax and the deficiency had been paid within the 3-year period prior to the filing of the claim, the statute of limitations did not bar any portion of the judgment.

Succession of Charles T. McCord et al. v. Commissioner, 461 F.3d 614 (5th Cir. 2006

This case was tried in the Tax Court in 2003. The taxpayers and their children (the general partners) contributed securities, real estate, oil and gas interests and various closely held businesses to the FLP. The taxpayers sought a 22% minority interest discount and a 35% marketability discount while the IRS appraiser (Dr. Mukesh Bajaj) applied an 8.34% minority discount and a 7% marketability discount. All parties agreed that each asset category was subject to its own minority interest discount and that the overall minority discount would be the weighted average of the separate minority discount determined for each asset class. The court settled on minority discounts 10% on the equity portfolio and the bond portfolio and 23.3% for the real estate interests resulting in a weighted average minority discount of 15%. With respect to the lack of marketability discount, the taxpayer's expert relied on pre-IPO studies and restricted stock studies to support a 35% discount. Dr. Bajaj convinced the court that the IPO approach utilized by the taxpayer was unreliable and generated inflated estimates of marketability discounts. Although the court rejected Dr. Bajaj's quantification of the marketability discount, it did rely on his private placement study and concluded that a 20% lack of marketability discount was appropriate. The overall cumulative discount allowed, therefore, was 32%. See Charles T. McCord, Jr., et ux. v. Commissioner, 120 T.C. 358 (2003).

On appeal, the Fifth Circuit reversed, finding that the Tax Court erred in "confecting sua sponte its own methodology for determining the taxable or deductible values of each donee's gift" and that it violated "the long-prohibited practice of relying on post-gift events." Specifically, the Tax Court "used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts into percentage interests in [the FLP]." The Fifth Circuit held that the gifts were complete on January 12, 1996, that they had ascertainable value on that date and that value could not be changed based on the subsequent act by the donees in executing the Confirmation Agreement. Hence, it held that the values determined by the Tax Court, "being derived from its use of its own imaginative but flawed methodology, may not be used in any way in the calculation of the Taxpayers' gift tax liability."

With respect to the effect on the value of the gifts of potential estate taxes under §2035(b), the Tax Court had held that such a valuation reduction was too speculative to be recognized in the computation of the net gift. The Fifth Circuit found nothing speculative about the fact that, as of the date of gift, the non-exempt donees were legally bound to pay any additional estate tax that could result from the application of §2035(b). It held that "a willing buyer would insist on the willing seller's recognition that -- like the possibility that the applicable tax law, tax rates, interest rates, and actuarially determined life expectancies of the Taxpayer could change or be eliminated in the ensuing three

years -- the effect of the three-year exposure to *section 2035* estate taxes was sufficiently determinable as of the date of the gifts to be taken into account."

The Fifth Circuit, therefore, reversed the Tax Court on the grounds that it had erred in valuing the transferred interests by (1) using the Confirmation Agreement in its own calculations and (2) ignoring the potential §2035(b) estate tax liability. As a result of these errors, it held that the gift tax values were those determined by the taxpayers and not those determined by the Tax Court. The case was remanded to the Tax Court for entry of judgment in favor of the taxpayers and assessment of costs to the government.

Jane Z. Astleford v. Commissioner, T.C. Memo. 2008-128

Pine Bend Development Co. ("Pine Bend") was a general partnership formed by the decedent's husband and a third party in 1970. Each held a 50% interest. The partnership acquired several thousand acres of land near St. Paul, Minnesota including 1,187 acres known as the Rosemount property. Most of the Rosemount property was leased to local farmers. The donor's husband died in 1995 and left his estate to a marital trust for the benefit of the donor. In 1996, the donor formed the Astleford Family Limited Partnership ("AFLP"). She funded AFLP by transferring her interest in an assisted living facility valued at approximately $870,000. On the same date, she gifted a 30% interest in AFLP to each of her three children, retaining a 10% general partnership for herself.[1] On December 1, 1997, the donor made an additional capital contribution to AFLP by transferring her 50% interest in Pine Bend along with several other properties. As a result of this contribution, the donor's general partnership interest in AFLP increased significantly while her children's limited partnership interests decreased significantly. Simultaneously with the above contribution of property to AFLP, the donor gifted additional limited partnership interests to her three children that had the effect of reducing her general partnership interest in AFLP back down to 10% and increasing the children's interests correspondingly.

At issue in the Tax Court were (1) the value of the Rosemount property, (2) whether the 50% Pine Bend interest should be valued as a general partnership interest or as an assignee interest and (3) the lack of control and lack of marketability discounts that should apply to the 50% Pine Bend interest and to the gifted interests in AFLP. With respect to the value of the Rosemount property, the donor's expert[2] valued it based on comparable sales at $3,100 per acre or $3,681,000 but then applied an absorption discount that decreased the value to $1,817 per acre or a total fair market value of $2,160,000. The absorption discount was based on his opinion that a sale of the entire Rosemount property would overload the market and reduce the per-acre price. He concluded that it would be sold over a 4-year period and he performed a cash flow analysis based on a 4-year sell-off, 7% annual appreciation and a 25% present value discount rate. The government's expert also valued the Rosemount property on market

[1] There is no indication in the decision as to whether or not a Shepherd/Senda indirect gift issue was involved in the case.
[2] The donor actually had four experts at trial and the IRS had two experts, none of whom were identified.

data approach but arrived at a value of $3,500 per acre or a total fair market value of $4,156,000. The expert also concluded that the entire Rosemount property could be sold in one year without an absorption discount.[3] The court concluded that the government's expert "was particularly credible and highly experienced and possessed a unique knowledge" of property in the area and that his initial value of $3,500 per acre was correct. The court found, however, that it was unlikely that 1,187 acres of the Rosemount property could be sold in one year without a discount. The 25% present value discount rate utilized by the donor's expert was found to be unreasonably high by the court because it relied upon statistics relating to developers of real estate who expect greater returns because of greater risks. The court found that a present value discount rate is a function of the riskiness of a project and here the project was not land development but sale of farmland over 4 years. "Given the low level of risk involved in selling the Rosemount property over 4 years, the fact that most of the acreage was already leased, and the 9.2-percent return on equity earned by southeaster Minnesota farmers in 1997", the court concluded that an appropriate present value discount rate was 10%. Using the initial value of $3,500 per acre as determined by the government's expert and an absorption discount as determined by the court, the resulting value was approximately $2,786 per acre or a total of $3,308,575.

Next, the court considered whether the 50% Pine Bend interest transferred to AFLP should be treated as a general partnership interest or as an assignee interest. The donor treated the interest as an assignee interest and discounted it by 5% because an assignee would have no influence on management under state law. This position was based primarily on the argument that the other 50% partner in Pine Bend did not consent to the donor's transfer of her 50% interest to AFLP. The government argued substance over form[4] and the court agreed, finding that the donor was the sole general partner of AFLP and would be in the "same management position relative to the 50% Pine Bend interest whether she is to be viewed as having transferred an assignee interest (and thereby retaining Pine Bend management rights) or as having transferred those management rights to AFLP via the transfer of a Pine Bend general partnership interest (in which case she reacquired those same management rights as sole general partner of AFLP)." In either event, the donor continued to have and control management rights associated with the 50% Pine Ben general partnership interest.

The court then went on to consider the discounts applicable to the 50% Pine Bend general partnership interest transferred to AFLP and to the limited partnership interests in AFLP gifted by the donor to her children in 1996 and 1997. The donor's expert relied on comparability data from sales of registered real estate limited partnerships or RELPs

[3] The expert for the IRS also concluded that even if an absorption discount was appropriate, it should track the return on equity that farmers in the county actually earned and he determined that to be 9.2%

[4] Alternatively, IRS argued that if the 50-percent Pine Bend interest was treated as an assignee interest, the donor's voting and liquidation rights in the transferred Pine Bend interest would have lapsed on the date of her transfer and under §2704(a) the lapse would trigger an additional deemed taxable gift by the donor of those rights-effectively recapturing for federal gift tax purposes the value of the voting and liquidation rights (i.e., the difference in value between a Pine Bend general partnership interest and a Pine Bend assignee interest). Due to the court's acceptance of the substance over form argument, it did not address this alternative argument.

while the government's expert used data from sales of publicly traded real estate investment trusts or REITs. The court declined rule that either RELP or REIT data was superior to the other noting that courts have used both. It noted that RELPs more closely resembled both AFLP and Pine Bend but that "the large number of REIT sales transactions tends to produce more reliable data compared to the limited number of RELP sales transactions." The donor's expert had concluded that a combined 40% discount for lack of control and lack of marketability should apply to the 50% interest in Pine Bend transferred to AFLP by the donor. The expert for the IRS, however, concluded that the Pine Bend partnership interest was simply an asset of ASFLP and that there was no "need to apply an additional and separate discount at the Pine Bend level." The court, however, concluded that lack of control and lack of marketability discounts at both the Pine Bend level and AFLP level were appropriate. In a footnote, the court observed that:

> . . . this Court, as well as respondent, has applied two layers of lack of control and lack of marketability discounts where a taxpayer held a minority interest in an entity that in turn held a minority interest in another entity. See *Estate of Piper v. Commissioner, 72 T.C. 1062, 1085 (1979); Janda v. Commissioner, T.C. Memo. 2001-24; God v. Commissioner, T.C. Memo. 2000-93,* affd. *19 Fed. Appx. 90 (4th Cir. 2001); Gallun v. Commissioner, T.C. Memo. 1974-284.* However, we also have rejected multiple discounts to tiered entities where the lower level interest constituted a significant portion of the parent entity's assets, see *Martin v. Commissioner, T.C. Memo. 1985-424* (minority interests in subsidiaries comprised 75 percent of parent entity's assets), or where the lower level interest was the parent entity's "principal operating subsidiary", see *Estate of O'Connell v. Commissioner, T.C. Memo. 1978-191,* affd. on this point, revd. on other issues *640 F.2d 249 (9th Cir. 1981).*
>
> The 50-percent Pine Bend interest constituted less than 16 percent of AFLP's NAV and was only 1 of 15 real estate investments that on Dec. 1, 1997, were held by AFLP, and lack of control and lack of marketability discounts at both the Pine Bend level and the AFLP parent level are appropriate.

Based on median and mean discounts observed in the selected RELP transactions, the court held that a 30% combined lack of control and lack of marketability discount was appropriate for the 50% interest in Pine Bend that the donor transferred to AFLP.

With respect to the lack of control discount applicable to the 1996 and 1997 gifts of interests in AFLP, the court concluded that the RELP comparables utilized by the donor's expert were dissimilar to AFLP and that the claimed discounts of 45% (1996) and 40% (1997) were excessive. The expert for the IRS analyzed REIT transactions and arrived at lack of control discounts of 7.14% for 1996 and 8.34% for 1997. The court then proceeded to use the REIT data developed by the government's expert and, after certain adjustments to his methodology concluded that the allowable lack of control discounts were 16.17% for 1996 and 17.47% for 1997. As to the lack of marketability discount for

the 1996 gifts of limited partnership interests in AFLP, the donor's expert estimated a discount of 15% while the government's expert estimated a discount of 21.23%. Not surprisingly, the court could "perceive no reason not to use respondent's higher marketability discount of 21.23 percent" and that is what it did for the 1996 gifts. For the 1997 gifts of limited partnership interests, both parties arrived at a lack of marketability discount of approximately 22% and that is what the court allowed.

Thomas H. Holman Jr. et ux v. Commissioner, 130 T.C. No. 12

The taxpayers (husband and wife) transferred stock in Dell Computer Corp. to a newly formed family limited partnership and then made gifts of limited partnership units to a custodian for one of their children and in trust for the benefit of all of their children. A large gift was made in 1999 and smaller gifts were made in 2000 and 2001. The Tax Court first determined that the 1999 gift was properly treated as a direct gift of limited partnership units and not as an indirect gift of Dell stock.

Next, the court considered whether, in valuing the gifts of LP interests, certain restrictions on the donees' rights to sell those interests must be disregarded. The parties agreed that several provisions of the partnership agreement contained restrictions on the right of a limited partner to sell or assign her partnership interest. The court determined that §2703 did apply to the transaction and it went on to consider the valuation discount issues.

The taxpayers' expert witness was Troy D. Ingham, vice president and director of Management Planning, Inc. and the IRS expert was Francis X. Burns, vice president of CRA International, Inc. There was an initial valuation disagreement with respect to the 2000 and 2001 gifts involving the net asset value of the partnership. The taxpayers' expert used closing prices of Dell stock on the valuation dates while the IRS expert used the mean of the high and low prices on each of the valuation dates in accordance with Gift Tax Regulations §25.2512-2(b)(1). The taxpayers argued that, because the gifts being valued were gifts of partnership interests that do not trade in a public market, the regulation was inapplicable. The court, however, noted that the taxpayers had not provided any case supporting a contrary view and declined to disregard the regulation.

With respect the minority interest discount, both experts utilized samples of closed-end investment funds holding domestic equity securities. After a detailed examination of the specific methodologies used by the experts, the court found the government's expert to be more persuasive and allowed minority interest discounts of 11.32% in 1999, 14.34% in 2000 and 4.63% in 2001.

Finally, the court addressed the discount for lack of marketability. The taxpayers' MPI appraisal had claimed a lack of marketability discount of 35% while the government's expert concluded that the lack of marketability discount should be only 12.5%. Both appraisers utilized restricted stock transactions to arrive at their discounts but the government expert looked at studies of the mean discount on sales of restricted stock

during three periods: (1) before 1990; (2) from 1990 to 1997; and (3) during 1997 and 1998. The court pointed out that in 1972, the SEC adopted rule 144 imposing a 2-year holding period on the resale of restricted stock. In 1990, the SEC adopted rule 144A allowing institutional buyers to buy and sell restricted stock. In 1997, the SEC amended rule 144, reducing the required holding period to 1 year. For these 3 periods, the average discounts were determined to be 34% (before 1990), 22% (1990 – 1997) and 13% (1997 and 1998). In summary, the government's expert concluded that "a reasonable negotiation between a buyer and seller over the price of a limited partner interest in the partnership would result in a price concession for lack of marketability in the range of 10 to 15 percent." It was his position that traditional studies of unregistered shares of public companies suggest a price concession of 12 percent due to the lack of a ready market. He also argued that, "unlike restricted stock, a limited partner interest in the partnership is not burdened by prescribed holding period limitations on resale, nor does it carry the business or financial risk associated with the typical issuer of private placement shares." His final conclusion was a marketability discount of 12.5 percent.

After a complete analysis of the respective arguments, the court concluded that the government's expert had "persuaded us that a hypothetical purchaser of an LP unit would demand and get a price concession to reflect the market access component of the marketability discount but would get little if any price concession to reflect the holding period component of that discount." It found that, on the record and considering the expert testimony presented, it could not determine any better estimate of an appropriate marketability discount than the 12.5% determined by the government's expert and that is exactly what was allowed.

Bianca Gross v. Commissioner, T.C. Memo. 2008-221

In this case, the Tax Court first concluded that the donor made gifts of interests in the partnership to her daughters and did not make indirect gifts of securities. With respect to valuation, the parties had stipulated that, if the donor was found by the court to have made gifts of limited partnership interests on December 15, 1998, then the reported value of the gifts (reflecting a 35% cumulative valuation discount) was correct. Since the court found only that the donor made gifts of interests (not necessarily limited partnership interests) on December 15, 1998 to her daughters, it was necessary to consider the valuation issue. The donor's expert witness gave uncontradicted testimony that, if the partnership was a general partnership rather than a limited partnership and the donor and her daughters had agreed to be subject to the same restrictions as set forth in the FLP agreement, then the fair market value of the gifted interests would have been even less than the reported value that utilized a 35% discount. The donor, however, did not claim a value for the gifts any less than the reported value. On the basis of this uncontradicted testimony, therefore, the court held that the value of the gifted interests was as reported on the gift tax return (i.e., net asset value less a cumulative 35% valuation discount).

Estate of Valeria M. Miller v. Commissioner, T.C. Memo. 2009-119

The decedent died on May 28, 2003, a resident of Indiana. On the basis of her attorney's advice, the decedent at age 86 decided to form a family limited partnership known as the V/V Miller Family Limited Partnership ("MFLP"). On March 28, 2002, a revised MFLP agreement and certificates were signed. At that point, the decedent held 920 limited partnership units and Virgil held 10 general partnership units and 10 limited partnership units and his three siblings each held 20 limited partnership units. There no changes in this ownership prior to the decedent's death. The decedent funded the MFLP with transfers of marketable securities in April 2002 and May 2003. The Form 706 filed for the decedent's estate reported her 920 units in MFLP at net asset value less a 35% valuation discount. The Service argued that all of the assets transferred to the partnership by the decedent were properly includible in the gross estate under §2036 but did not raise an alternative argument contesting the 35% valuation discount claimed with respect to the decedent's 920 limited partnership units. The court concluded that the April 2002 transfers to the MFLP were bona fide sales for adequate and full consideration and that §2036 did not apply. With respect to the May 2003 transfers, however, it found that the decedent did not have legitimate and substantial nontax business reasons for the transfers and that "the driving force behind the May 2003 transfers was the precipitous decline in decedent's health in the weeks before the transfers." These transfers, therefore, were included under §2036 at full value.

Rayford L. Keller et al. v. United States, No. 6:02-cv-00062, United States District Court for the Southern District of Texas (2009)

In this case, the court validated an FLP that was funded by the decedent's estate a full year after the date of death. It also found that the estate's valuation expert used the correct standard to determine the value of the decedent's interests as of her date of death and that the government's expert "violated several of the tenets of the hypothetical buyer and seller standard, including considering the true identities of the buyer and seller, speculating as to events occurring after the valuation date, and aggregating the interests of different owners." The court's conclusions as to value appear to reflect a cumulative valuation discount of 47.5%.

Estate of Charles H. Murphy, Jr. v. United States, No. 07-CV-1013, United States District Court for the Western District of Arkansas (2009)

The court held that the decedent's transfer of assets to an FLP was a bona fide sale for adequate and full consideration in money or money's worth and that the transfer fell within the bona fide sale exception to §2036. Accordingly, the fair market value of these assets was not includible in the decedent's gross estate under §2036.

With respect to valuation, both experts utilized a net asset value approach. The court first reviewed the Rule 144/blockage discounts applied by both experts with respect to the various business assets known as the "Legacy Assets". The court found the estate's expert to be more credible because, in addition to the size of the block relative to daily

trading volume, he considered various qualitative factors "such as the volatility of the stock, the actual price change in the stock under recent and preceding market conditions, the company's current economic outlook, the trend of the price and the financial performance of the stock, the trend of the company's earnings and the existence of any resale restrictions on the stock." In addition to not considering these factors, the court found that the Service expert did not consider SEC sale restrictions on publicly traded Murphy Oil stock. Consequently, the court adopted the Rule 144/blockage discounts determined by the estate's appraiser in the amounts of 5% for the Murphy Oil stock, 10.6% for timber company stock and 1.3% for bank stock.

One of the non-Legacy Assets held by the FLP was approximately 17,300 acres of farmland and timberland that was held by Epps Plantation LLC (wholly owned by the FLP). With respect to the valuation of the timberland, the court found that the expert for the Service was more credible and adopted his value of approximately $6.3 million rather than the value of the estate's expert of $2.8 million[5]. As to the farmland, the court found the estate's appraiser to be more credible and adopted his value of $12.5 million rather than the $14.5 million determined by the Service appraiser.

With respect to the lack of control discount, each appraiser separated the FLP assets into the following categories: cash and cash equivalents, equities and fixed assets (Epps Plantation) and determined a discount for each asset category. Both appraisers relied on data from closed-end mutual funds and, with respect to Epps Plantation, data from Partnership Profiles, Inc. for real estate limited partnerships traded in secondary markets.

Lack of control discounts were determined by each expert as follows:

Lack of Control Discount		
	Estate Expert	**IRS Expert**
Asset Category		
Cash/cash equivalents	5.0%	2.0%
Equities	11.0%	6.9%
Fixed assets	26.3%	35.0%
Weighted average discount	**12.5%**	**10%**

It was interesting that the IRS expert concluded that a 35% lack of control discount was appropriate for the fixed asset portion of the assets while the estate's expert determined that a 26.3% discount was more appropriate.

[5] This appears to be the only issue, valuation or otherwise, with respect to the FLP for which the court agreed with the position of the Service.

For reasons not explained by the court, it found the estate's valuation analysis with respect to the lack of control discount more credible than the Service expert's analysis. Accordingly, it allowed a 12.5% lack of control discount.

With respect to the lack of marketability discount, both experts looked to studies of restricted stock transactions. The estate's expert concluded that the holding period for the decedent's partnership interest "was substantially longer than that of restricted stock (one to two years)" and determined that an appropriate lack of marketability discount was 32.5%. In addition to restricted stock studies, the Service expert also considered studies of sales of restricted stocks before the enactment of Rule 144A (easing the trading of restricted stock among qualified institutional buyers) and after its enactment that showed a 12% decline in the average discount after the enactment of Rule 144A. The expert concluded that this decline reflected the discount that investors require for having virtually no resale market. The Service expert determined that the appropriate discount for lack of marketability was 10%. The court, again with little explanation, concluded that the estate's valuation analysis was more credible and it, therefore, allowed a 32.5% discount for lack of marketability.

The court then went on to consider the valuation of the decedent's interest in the LLC holding the general partnership interests in the FLP. Again, the experts differed in their determinations of appropriate discounts. In determining the value of the LLC's general partnership interest in the FLP, the estate's expert concluded that a combined 20% lack of control/lack of marketability discount was appropriate while the Service expert determined that a combined 14.5% lack of control/lack of marketability discount was more appropriate. Once again, the court found that the estate's expert's report and testimony were more credible and it allowed the combined 20% valuation discount.

Next, the court considered the valuation of the decedent's 49% member interest in the LLC. The estate's expert concluded that an 11.1% lack of control discount and a 32.5% lack of marketability discount should be applied while the Service's expert determined that a 5% lack of control discount and a 10% lack of marketability discount should be allowed. Perhaps needless to say, the court found that the estate's expert's valuation analysis was more credible and it accepted his discounts. The combined discount for this tiered entity allowed by the court was 52%. The LLC's general partnership interest was discounted by a combined 20% and the decedent's 49% interest in the LLC was discounted by 11.1% for lack of control and 32.5% for lack of marketability resulting in a cumulative valuation discount of 52.02%.

Corporations and Other Entities

Estate of Beatrice Ellen Jones Dunn v. Commissioner, T.C. Memo. 2000-12

This case involved the determination of the FMV of the decedent's 63% interest in a closely held corporation. The estate's experts (including Shannon P. Pratt) valued the company based on a combination of capitalized net income and liquidation value, using a 50% weight for each factor. The IRS argued for straight net asset value. The court adopted the combination approach but allocated 65% to net asset value and 35% to earnings value. Finally, the court allowed a valuation discount of 22.5% consisting of a lack of marketability discount of 15% that the parties had agreed upon and a 7.5% discount for lack of super-majority control (because the decedent's holding was less than 66-2/3%). On appeal, the Fifth Circuit was extremely critical of the IRS and the Tax Court and held that the built-in capital gains tax liability should be considered as a dollar-for-dollar reduction (at a rate of 34%) when calculating net asset value and that the 65% weighting that the Tax Court had assigned to the asset approach should be reduced to 15% and the 35% weighting assigned to the income approach should be increased to 85%. See Estate of Beatrice E. Dunn, et al. v. Commissioner, 301 F.3rd 339 (5th Cir. 2002). Note that in its appeal, the estate had stipulated that it was not contesting the Tax Court's decision to allow a lack of marketability discount of 15% and a 7.5% discount for lack of super-majority control.

Estate of Etta H. Weinberg v. Commissioner, T.C. Memo. 2000-51

Decedent had a 25.235% interest in a limited partnership that owned an apartment complex. The estate claimed a 35% lack of marketability discount while the IRS expert argued for 15%. The court disagreed with the experts on both sides and allowed a lack of marketability discount of 20%.

Estate of Fred O. Godley v. Commissioner, T.C. Memo. 2000-242

Decedent and his son owned five general partnerships equally. Four of the partnerships owned and operated housing projects (housing partnerships), and the fifth partnership was formed to manage the operations of the housing partnerships. With respect to discounts, the court rejected the estate's claim that the irrevocable designation of the decedent's son as managing partner warranted a lack of control discount for the decedent's 50% interests. The court found that the partnership agreements contain restrictions on a partner's right of liquidation, termination and withdrawal, but the restrictions applied equally to all partners. While day-to-day management decisions are in the hands of the managing partner, major decisions required the approval of partners owning 75% of the interests. The claimed 15% lack of control discount, therefore, was disallowed in full and the claimed 25% lack of marketability discount was reduced to 20%. The Tax Court decision was affirmed by The Fourth Circuit in Estate of Fred O. Godley v. Commissioner, 286 F.3rd 210 (4th Cir. 2002).

Estate of Charles A. Borgatello v. Commissioner, T.C. Memo. 2000-264

This case involved the valuation of an 83% interest in a real estate holding company. After determining the value of the underlying real estate, the Tax Court considered the discount for lack of marketability. The estate claimed 35% while the IRS argued for 27%. The IRS appraiser had arrived at his 27% discount by using a build-up method, the principal component of which was potential capital gains taxes (19%). The IRS appraiser utilized a 10-year holding period, a 2% growth rate, a 9.3% state capital gains tax rate and a 34% federal capital gains tax rate to estimate a future tax which was then discounted back to the date of death at 8.3% (long-term AFR + 2% for added risk) to arrive at the 19% figure. After correcting what it believed to be an error in this computation, the court determined that the discount attributable to the tax on built-in capital gains would be 20.5% under the IRS approach. The estate's appraiser did not engage in this type of discount analysis, rather he computed that an immediate tax on the built-in gains would warrant a 32.3% discount to net asset value. Thus, there was a range of discount values attributable to the tax on the built-in gains of 20.5% (if the assets were held for 10 years) to 32.3% (if the assets were to be immediately liquidated. The court found that "(a)lthough there is no evidence that a willing buyer . . . would immediately liquidate the assets, there is also not much support for the respondent's contention that a buyer would wait 10 years before liquidating the assets. In reaching a middle ground, therefore, we find it reasonable to discount the net asset value by 24% to account for the tax liability inherent in (the company's) assets." After consideration of other marketability factors (including the transaction costs associated with the eventual sale of the assets, which was allowed in the amount of 6%), the court arrived at a final discount of 33% for lack of marketability.

Donald Janda, et ux. v. Commissioner, T.C. Memo. 2001-24

The donors owned a holding company that, in turn, owned the majority of outstanding shares in a small mid-western bank. They made gifts of stock in the holding company to their four children. At trial, the only issue was the size of the valuation discount. The taxpayers applied a 65.77% discount for lack of marketability based on the Quantitative Marketability Discount Model (the "QMDM") proposed by Z. Christopher Mercer in his book *Quantifying Marketability Discounts* (1997). Under this approach, an appraiser is theoretically able to quantify the impact of the factors that influence marketability discounts in real-life settings. In Estate of Weinberg v. Commissioner, T.C. Memo. 2000-51, the Tax Court pointed out that "slight variations in the assumptions used in the [QMDM] model produce dramatic differences in results." In this case, the court found that the use of the QMDM model by the taxpayer's appraiser to be of no help in its determination of the marketability discount. The court stated that it had "grave doubts about the reliability of the QMDM model to produce reasonable discounts, given the generated discount of over 65 percent." The government's expert, on the other hand argued for a 20% discount for lack of marketability based on "generalized studies which did not differentiate marketability discounts for particular industries and based on a study asserting that marketability discounts allowed by the Tax Court over the past 36 years

averaged 24%. The court, after pointing out the weaknesses of both appraisals, allowed a combined 40% discount for lack of control and lack of marketability.

John E. Wall, et ux. v. Commissioner, T.C. Memo. 2001-75

Taxpayer gifted nonvoting stock in his closely held corporation to several trusts for the benefit of his children. The stock was valued on the gift tax return at $221.75 per share and by the IRS at $260.13 per share, a difference of only 17%. The determined deficiency was $73,789 on each of the split-gift tax returns. Each side based its value on an outside fee appraisal and both appraisers agreed on many points including the appropriateness of a 40% lack of marketability discount. The court was obviously dismayed over the parties' inability to settle their differences and, after invoking Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441 (1980), the court sustained the IRS valuation of the stock.

Estate of Paul Mitchell v. Commissioner, 250 F.3d 696 (9th Cir. 2001). The decedent, a noted hair stylist with a highly successful line of styling products, died in 1989. At issue was the value of the decedent's minority interest (49%) in the company, which was returned at $28.5 million. IRS hired Martin Hanan (Business Valuation Services, Inc.) who determined a value of $81 million for the decedent's interest. In a 1997 decision (T.C. Memo. 1997-461), the Tax Court, after an extensive review of the facts and arguments, dismissed the opinions of the experts and placed a value of $150 million on the entire company (based on purchase offers prior to death). It then reduced this value by 10% to reflect the loss of the decedent's creativity and the decedent's interest was then discounted by 35% for lack of marketability and minority interest. The resulting value was approximately $41 million. On appeal, the Ninth Circuit found that the Tax Court didn't explain how it determined the stock value or the discounts. It held that "it is the obligation of the Tax Court to spell out its reasoning and to do more than enumerate the factors and leap to a figure intermediate between petitioner's and the Commissioner's." The case was, therefore, remanded to the Tax Court. On remand and in a very lengthy opinion that explains its reasoning in great detail, the Tax Court in 2002 reaffirmed its original holding in the case. See Estate of Paul Mitchell v. Commissioner, T.C. Memo. 2002-98. In Patrick T. Fujieki v. Commissioner, 83 Fed. Appx. 987 (9th Cir. 2004), the Ninth Circuit affirmed.

Estate of Helen B. Jameson v. Commissioner, 267F.3d 366 (5th Cir. 2001)

The primary issue in a 1999 trial (T.C. Memo. 1999-43) was the fair market value of the decedent's 98% interest in a closely held corporation holding a large tract of timberland in Louisiana. IRS sought a value of $77 per share while the estate argued for $51 per share. The central issue was involved the determination of an adjustment for built-in capital gain. The discount to be applied, the court held, was the net present value of the capital gain tax liability incurred over time as the timber was cut. The Tax Court also applied a 3 percent discount for lack of marketability in arriving at a value of value of $70.85 per share. Since a 98% shareholder had the right to liquidate, the court concluded that a lack of marketability discount would be warranted only if the underlying assets

suffered from a lack of marketability. It concluded that only 3% of the assets were unmarketable and, therefore, allowed only a 3% lack of marketability discount. On appeal, the Fifth Circuit vacated the judgment of the Tax Court and remanded the case for, among other things, reconsideration of the amount of the capital gains discount. The court found that the Tax Court should not have assumed that the existence of a buyer that would continue to operate the company for timber production. It said that "(w)hile it may be true that the [property's] best use is for sustainable yield timber production, this does not mean that the first, or economically rational, purchaser of [the stock] would so operate or lease the property." Hence, the court concluded, the purchaser would have to take into account the substantial built-in tax liability on the property.

Patricia M. Adams, et al. v. United States, 2001 USTC ¶60,418 (N.D. Tex. 2001)

In this well-traveled case, the decedent and three siblings formed a partnership to hold the family's ranch land, securities, and oil and gas interests. On the decedent's death, the partnership was dissolved under local (Texas) law. Rather than wind up the partnership's affairs, the remaining partners continued its business. The estate filed an estate tax return listing the FMV of the estate's 25 percent partnership interest as $ 7.5 million. The IRS set the FMV at $ 7.6 million. In 1999, the District Court, finding that the estate improperly applied various discounts to the interest, set the FMV at $ 7.8 million and entered judgment in the government's favor. It allowed only a 5.4% discount to reflect liquidation costs, agreeing with the IRS that state law gave an assignee the same rights as the assignor/partner and could receive the partner's share of the dissolved partnerships surplus. In 2000, the Fifth Circuit reversed, finding that the district court erred in not applying more discounts. The court held that the value of the estate's interest had to be discounted to reflect the effect that uncertain liquidation rights would have on the value. It remanded the case for the District Court to consider evidence from both parties on the liquidation rights issue and to determine what discounts were available. On remand, the District Court allowed all of the discounts claimed by the estate – a 20% minority interest discount, a 10% portfolio discount and a 35% lack of marketability discount. The District Court, however, declined to allow an additional discount based on the legal uncertainty surrounding the rights of an assignee that the Fifth Circuit had directed it to consider. It reasoned that this discount was not justified because it had already taken into account the other discounts that were premised on the assumption that a partner's assignee had no right to receive 25% of the partnership's net asset value. This decision resulted in a value for the decedent's 25% interest of $3.9 million and a refund of $5.2 million (including interest). Remember that the interest was originally returned at $7.5 million!

Walter L. Gross, Jr., et ux., et al. v. Commissioner, 272 F.3d 333 (6th Cir. 2001)

The issue involved in this case was the fair market value of certain shares of stock in a Subchapter S corporation that had been gifted by the donors. At trial, both parties relied upon expert testimony. The donors' expert argued that the corporation's projected future income should be "tax affected" by deducting hypothetical income taxes. The

government's expert (Dr. Mukesh Bajaj) did not tax affect the stock at all. The experts also disagreed as to the amount of the lack of marketability discount. The taxpayers' expert cited various studies and concluded that a 35% discount was appropriate while Dr. Bajaj, relying upon his own study, determined that the lack of marketability discount should be 13%. Dr. Bajaj, however, then considered other factors (including the fact that the corporation paid out most of its earnings to shareholders) and arrived at a final discount of 25%. In Walter L. Gross, Jr., et ux., et al. v. Commissioner, T.C. Memo. 1999-254, the Tax Court sustained the IRS and determined that the stock should be discounted using a tax affect of 0% and that the lack of marketability discount should be 25%. On appeal, the taxpayers contested the admissibility of Dr. Bajaj's testimony on the grounds that it was scientifically unreliable. The Sixth Circuit, however, affirmed, finding that the Tax Court did not clearly err in concluding that it was appropriate not to tax affect the stock in determining its fair market value.

Estate of Richie C. Heck v. Commissioner, T.C. Memo. 2002-34

Decedent owned a 40% interest in F. Korbel & Bros., Inc. ("Korbel"), a sub-chapter S corporation that produced champagne under an exclusive distribution agreement with another company that also had a right of first refusal on any sale of Korbel stock outside the family. The IRS expert (Dr. Herbert T. Spiro) valued the stock using a combination market approach and discounted cashflow approach and then subtracted a 15% "liquidity discount" and a 10% discount for "additional risks associated with S corporations including the potential loss of S corporation status and shareholder liability for income taxes." To the operating value, Dr. Spiro added the value of excess land (reduced by a 25% minority discount and a 25% liquidity discount) and excess cash (reduced by a 25% liquidity discount, resulting in a final value of $48,100 per share. The estate's expert (Dr. Mukesh Bajaj) used only the income approach (i.e., discounted cashflow) to value the operating assets and then added the value of the nonoperating assets and subtracted interest-bearing debt. He then applied a 25% marketability discount and a 10% discount to reflect the right of first refusal and the inability of a purchaser of the decedent's interest to influence dividend distributions, resulting in a final value of $29,694 per share. The court first held that the IRS's use of the market approach (which utilized only two guideline companies) was not appropriate. Although the Tax Court had previously allowed the use of only two comparables when they were in the same line of business, the two guideline companies used by the IRS here were found to be not sufficiently similar to Korbel to permit the use of a market approach. With respect to the discounted cash flow valuations of the experts, the Tax Court said, "We find neither of the experts totally persuasive." It then proceeded to accept portions of the testimony of each. As to discounts, the court was critical of the IRS expert's 15% marketability discount since he had acknowledged that average discounts were often in excess of 35%. The court accepted the taxpayer's 25% marketability discount and 10% lack of control discount, combining them into a 35% total discount which it then applied to both the operating assets and the nonoperating assets.

Estate of William G. Adams, Jr. v. Commissioner, T.C. Memo. 2002-80

Decedent owned approximately 62% of the stock in a Subchapter S insurance agency that was returned at $920,800. IRS argued that the value was $1,746,000. The court found that the estate's expert's approach was more thorough than that of the IRS expert but that the estate's expert improperly increased the capitalization rate to reflect a before corporate tax rate. It held that there should be no adjustment of the capitalization rate to account for imputed income taxes on the S corporation's income. Citing Gross v. Commissioner, 272 F.3rd 333 (6th Cir. 2001), the court held that it is appropriate to use a zero corporate tax rate to estimate net cashflow when the stock being valued is stock of an S corporation. With respect to a discount for lack of marketability, the estate's expert derived a 32.89% discount by averaging the discounts found in various restricted stock studies. He then reduced the claimed discount to 20% based on his belief that the insurance industry was more stable than the general market. The IRS expert, however, initially proposed a 35% discount but changed this to 45% after he became aware of pending rate litigation. The court disagreed with both experts and settled on a 35% marketability discount, which was more than the estate sought but less than the IRS proposed!

Jeffrey L. Okerlund, et al. v. United States, 53 Fed. Cl. 341 (2002). This was a gift tax (and income tax) refund case involving the valuation of Schwan's Sales Enterprises, Inc. ("SSE"). The taxpayers were seeking refunds of 1992 and 1994 gift tax based on a redetermination of the fair market value of the SSE stock. In a lengthy decision, the court ended up accepting the valuation methodology of the government's expert (Dr. Herbert Spiro). With respect to discounts, both the taxpayers' expert (Dr. Shannon Pratt) and the government's expert relied on 2 sources of empirical data: (1) studies of discounts on sales of restricted shares of publicly traded companies; and (2) studies of discounts on private transactions prior to initial public offerings. Dr. Spiro concluded that a 30% discount for lack of marketability was appropriate and Dr. Pratt concluded that a 45% discount was warranted. The court allowed 40% for lack of marketability and the additional 5% discount for lack of voting rights that both experts had applied. In Jeffrey L. Okerlund, et al. v. United States, 365 F.3rd 1044 (Fed. Cir. 2004), this decision was affirmed.

Estate of Helen A. Deputy, et al. v. Commissioner, T.C. Memo. 2003-176

The decedent held an interest in a family limited partnership that owned approximately 20% of a recreational boat building company. The parties agreed on the discounts (which were not disclosed) to be applied to the FLP and disagreed only as to the value of the operating company. The court used a weighted average earnings approach that resulted in normalized income in between the amounts determined by each expert and accepted the 10% capitalization rate determined by the IRS expert. With respect to discounts, the taxpayer sought a 44% combined discount for lack of control and marketability while the IRS expert argued for no minority discount and a 25% discount for lack of marketability. The court allowed a 30% combined valuation discount.

Johann T. Hess, et ux. v. Commissioner, T.C. Memo. 2003-251

This case involved the valuation of a closely held "C" corporation. The taxpayer's expert utilized a discounted cashflow analysis and a market approach to arrive at his value of $128,000 per share. The IRS expert used a weighted average of 4 valuation approaches – net asset value method, prior stock transactions method, stockholder agreement method and guideline public company method – in arriving at his value of $269,000 per share. Both appraisers used a 15% minority discount but the estate's appraiser argued for a 30% lack of marketability discount while the IRS expert used 25%. Where appropriate (depending upon the particular valuation method), the court utilized a 15% minority discount and a 25% lack of marketability discount. After considering all of the valuation methods, the court found that the value of the stock "falls somewhere in the middle of the range of values" and held that the value was $200,000 per share. It is noted that the average of the estate's value ($128,000) and the IRS value ($269,000) is $198,500 per share.

Estate of Mildred Green, et al. v. Commissioner, T.C. Memo. 2003-348

Decedent held a 5.09% interest in a bank holding company that was returned at $50 per share. On audit, IRS argued for a value of $320 per share but reduced it to $263 per share at trial. The estate adjusted its value for trial to $200 per share. The pre-discounted value of the experts on both sides was very close and, not surprisingly, the court settled on a value in between the two. With respect to discounts, the estate's expert determined a 17% minority discount and a 40% lack of marketability discount while the IRS expert determined a 15% minority discount along with a 25% discount for lack of marketability. The court allowed the claimed 17% lack of control discount and a 35% lack of marketability discount.

Estate of Helen M. Noble v. Commissioner, T.C. Memo. 2005-2

The decedent owned 116 shares (11.6%) of the common stock of a closely held bank. It was returned at book value less a 45% minority interest discount or approximately $900,000. As of the date of death, the balance of the stock was owned by a holding company that was in turn owned by unrelated individuals. In the 15 months prior to the date of death, the holding company had purchased 10 shares (at $1,000 per share) and 7 shares (at $1,500 per share) from other shareholders. After the date of death, the holding company offered to purchase the decedent's shares at an appraised value of $7,569 per share or $878,000. The estate declined to sell at this price but eventually negotiated a sale at $9,483 per share or $1.1 million some 14 months after the date of death.

The government's expert ascertained the fair market value of the decedent's stock by considering four valuation methods (book value method, discounted cashflow method, public guideline market method, and private guideline market method) and applying a 15-percent minority interest discount and a 30-percent lack of marketability discount to the values derived under those methods. The average of the resulting values was $1,067,450. The taxpayer presented 3 experts (including Z. Christopher Mercer) and

argued for a fair market value of $841,000. With respect to the actual sales of stock, the taxpayer argued that sales may be probative of fair market value only if they occur within a reasonable time before the valuation date.

The court disagreed, finding that actual sales made in reasonable amounts at arm's length, in the normal course of business, within a reasonable time before or after the basic date, are the best criterion of market value as long as no intervening events drastically changed the value of the property. It also was unpersuaded that either of the two sales prior to the date of death was made by a knowledgeable seller who was not compelled to sell or was made at arm's length. The estate argued that sale of its stock was made to a strategic buyer who bought the shares at greater than fair market value in order to become the sole shareholder of the bank while the government argued that the sale was negotiated at arm's length and was the most relevant. The court disagreed. It found that "[t]he fact that decedent's 11.6-percent interest may have included a unique attribute that added value to that interest vis-a-vis another 11.6-percent interest in [the bank] does not detract from the fair market value of decedent's interest. That attribute would continue to be retained by the hypothetical buyer in our analysis following our hypothetical sale just as it had been retained by decedent at the time of her death."

The court concluded that the "sale occurred sufficiently close to the applicable valuation date and that the record does not reveal any material change in circumstances that occurred between that date and the date of the third sale that would have affected the fair market value of the subject shares, we conclude on the basis of the limited evidentiary record before us that the third sale is the best indicium of the fair market value of decedent's shares at the time of her death." To account for inflation between the date of death and the date of sale, the court adjusted the actual sale price by 3% to arrive at its determined value of $1,067,000.

Note – The difference between the returned value of the stock ($903,988) and the value determined in the statutory notice of deficiency ($1.1 million) in this case was only $196,012.

Estate of George C. Blount v. Commissioner, 428 F.3d 1338 (11th Cir. 2005)

This decision affirms (in part) the Tax Court decision in Estate of George C. Blount v. Commissioner, T.C. Memo. 2004-116. The primary issue in this case was the FMV of closely held stock. The decedent and his brother-in-law each owned 50% of the outstanding shares and in 1981 they entered into a buy-sell agreement with the corporation that restricted transfers of the stock during lifetime and at death. Lifetime transfers required the consent of the other shareholders and, at death, the shareholder's estate was required to sell and the corporation was required to buy at a price set in the agreement. Later, both shareholders transferred shares to an ESOP that the company had established. The brother-in-law died in 1996 and his shares were redeemed pursuant to the agreement, leaving the decedent and the ESOP as the only remaining shareholders and the decedent and the company as the only remaining parties to the agreement. Also in 1996, the decedent and the company (without obtaining the ESOP's consent) modified

the agreement, specifying a value of $4 million as a lump-sum payment for the decedent's shares and it was to be controlling only at death. The company had been appraised annually for ESOP purposes and, in 1996 and 1997, the ESOP appraisals showed a FMV of approximately $8 million.

The Tax Court first determined that a buy-sell agreement that purported to fix the estate tax value of the shares should be disregarded because the decedent (by virtue of his controlling interest) had the unilateral ability to modify the agreement. Consequently, the agreement was not binding during his lifetime as required by Estate Tax Regs. §20.2031-2(h) and thus did not fix the value of the shares. The court next considered §2703, finding that this section applied to the modified agreement because a 1996 modification was a substantial modification. It went on to find that the modified agreement was to be disregarded under §2703 because its terms were not comparable to similar arrangements entered into by persons in arm's length transactions. Finally, the court determined the FMV of the shares, making adjustments that resulted in a total value of $9.9 million (only $200,000 less than the IRS expert's value). It is interesting to note that none of the experts involved in this case applied any discounts or premiums to the decedent's 83.2% ownership interest and the court found this to be appropriate.

In the current decision, the Eleventh Circuit affirmed the Tax Court's holding that that the buy-sell agreement was substantially modified, was not binding during the decedent's life, and that the estate must include the shares at fair market value.

W.G. Anderson et al. v. United States, No. 02-2168-S, United States District Court for the Western District of Louisiana, 2006

The decedent died in 1997 with a $38 million estate and the issue before the U.S. District Court for the Western District of Louisiana on a claim for refund was the fair market value of the decedent's minority interests in 4 limited liability companies. The parties apparently agreed on the value of the underlying mineral interests held by the LLCs. The court found that the estate was "part of a closely-held interlocking network of family businesses" and that its "holdings are more likely to be liquidated at some point than sold on the open market." For that reason, the court accepted the government expert's combination of a net asset value approach (weighted at 33.3%) and a market approach (weighted at 66.7%). The parties agreed on how to apply the net asset value approach but disagreed with respect to certain financial measures to be applied in the market approach.

The court agreed with the estate's appraiser and held that "a combination of price-to-cash flow averages and price-to-appraised worth are the appropriate financial measures for use with evaluating comparable companies." It also concluded that the multiples utilized by the estate's experts were "more reflective of the privately-held LLCs when compared to the publicly-held comparables and should be used to establish values under the market approach." The court noted that the government expert's use of "acquisition prices for publicly-held versus privately-held companies as reported in a Mergerstat publication" was not sound because "the publication's data was not sufficiently detailed to allow

comparison of the oil and gas industry and small companies we have before us, but was instead a general study of acquisition values in all companies."

Finally, the court held that the valuation discounts determined by the estate's experts "more accurately reflect the realities of the market and these minority interests." Although the opinion does not indicate what discounts were determined by the government's expert, it held that "a marketability discount of 40% is proper for both the market and net asset approaches, and a 10% discount for liquidation costs and a 10% minority discount is proper for the net asset approach."

Note – The above ruling was amended by a memorandum ruling in W.G. Anderson et al. v. United States, No. 5:02-cv-02168, United States District Court for the Western District of Louisiana, 2006 for the sole purpose of correcting the name of the rebuttal expert from "Carl Pratt" to "Shannon Pratt".

Ian G. Koblick et ux. v. Commissioner, T.C. Memo. 2006-63

The taxpayers transferred a 45% interest in a closely held corporation to a qualified charity in exchange for $90,000. Other shareholders (holding a 45% interest and a 10% interests, respectively) also transferred their interests to the charity at the same time. On their joint income tax returns, the taxpayers claimed that the stock had a fair market value of $810,000 and claimed a charitable deduction of $810,000 less $90,000 or $720,000. IRS argued that the FMV of the interest was only $360,000. The valuation was based on liquidation value and the principal asset of the corporation was a submersible vessel that was used primarily as an undersea hotel. Based on a replacement cost approach, the court found that the vessel had a FMV of $1,060,000. The taxpayers' 45% interest, therefore, was valued at $477,000 before discounts.

The taxpayers' argued that no minority discount should be applied because the charity received 100% of the stock. Notwithstanding the fact that the gift tax is an excise tax on the transfer and is not imposed upon the receipt of property by the donee, the court found that "there is authority for us to take into consideration that petitioners transferred their 45-percent interest in Sealodge as part of a prearranged plan to transfer a 100-percent controlling interest in the company." The court cited N. Trust Co. v. Commissioner, 87 T.C. 349 (1986), in which four shareholders agreed to transfer each of their 25-percent noncontrolling interests in their closely held corporation to certain long-term trusts. The court in that case allowed a 25% discount, finding that "the taxpayers, by following a prearranged agreement to transfer the shares simultaneously, "marched in lockstep" and that "[s]o marching, their position was no different than that of a single majority shareholder."

On the basis of the N. Trust Co. decision, the court found that the 22% minority discount argued by IRS was too high. Based on the 25% discount allowed by the court in N. Trust Co. for a 25% interest, the court concluded that a 10% discount was appropriate for the 45% interest involved in this case. The court noted that a 6% discount would be sufficient to sustain the adjustment in the statutory notice of deficiency. Since the

taxpayers' 45% interest was valued at $477,000 before discounts, a 6% discount would reduce this value to $448,380 and, after reduction by the $90,000 payment, the charitable gift would be valued at $$358,380 and the statutory notice had proposed a value of $360,000. Hence, the court sustained the adjustment and did not address the issue of the lack of marketability discount.

Michael W. Huber et ux. et al. v. Commissioner, T.C. Memo. 2006-96

The issue in this case was the fair market value for gift tax purposes of stock in a closely held printing business. The company had 250 shareholders (primarily members of the family) and 3,000 to 5,000 employees. Annual sales exceeded $500 million. A majority of the board of directors consisted of non-family members. The corporate bylaws authorized the company to redeem its stock from shareholders and, during the relevant period (1996 – 2000), the board a number of such redemptions, all at a price determined annually by Ernst & Young ("E&Y"). The 1996 redemptions were at the E&Y value while the later redemptions took place at the E&Y value less 5%. The redemptions were from family shareholders who wished to liquidate their shares and from various charitable organizations that had received donations of shares. The opinion noted that E&Y did not perform any other auditing functions for the company and had consistently used the same valuation methodology – using guideline companies and applying a 50% lack of marketability discount. For their gift tax returns, the taxpayers based the values on the E&Y reports and at trial they relied principally on two actual sale transactions. The government apparently agreed with the pre-discounted value of the shares as determined by E&Y but its expert argued (for unexplained reasons) for lack of marketability discounts of 30% (1997), 25% (1998), 45% (1999) and 30% (2000). The government also argued that the actual sales at the E&Y values were not arm's length sales and this was the threshold issue in the trial.

The taxpayers cited Morrissey v. Commissioner, 243 F.3d 1145 (9th Cir. 2001), revg. Estate of Kaufman v. Commissioner, T.C. Memo. 1999-119, to support the proposition that the transactions at issue were arm's-length sales. In that case, the Ninth Circuit found that the sales relied upon "satisfied the requirements of an arm's-length sale because (1) family connections were not particularly close; (2) sellers were under no compulsion to sell; (3) sellers had no reason to doubt an independent valuation of the shares by a reputable firm; and (4) there was evidence that there was no intention to make a gift to the buyer." In the instant case, the Tax Court followed this framework in its analysis, reviewing each of these elements in turn.

With respect to family connections, the court concluded that "the existence of close family relationships between parties of some of the 90 sales transactions in the record is neutralized by the fact that many of the transactions took place between parties that were hardly related or unrelated and who had fiduciary obligations to obtain the best price." It found that the variety of relationships among the corporation's shareholders was a "positive indicator of the existence of arm's-length sales." Additionally, it found that the sellers were under no pressure or compulsion to sell.

Next, the court addressed the third element in Morrissey – whether the sellers had any reason to doubt the E&Y valuation. The government had argued that the parties involved in the specific sale transactions were not reasonably informed because they did not even see a copy of the E&Y report. This did not matter to the court since "the modus operandi of [the company] gave plenty of opportunity for shareholders to educate themselves about the company and the E&Y methodology, and the evidence shows that many of the parties to the sales at issue in fact did just that." Finally, the court found no evidence of donative intent in the sale transactions and, in fact, much evidence inconsistent with such intent.

The court also considered the government's argument that the lack of negotiation in the actual sale transactions showed that there was "a lack of intent to realize the best price for the value of the shares." It concluded that there is no authority for the proposition that "negotiation is a necessary element of an arm's-length transaction." The government also argued that the sales should not be considered arm's-length because the shareholders, "by not offering their shares for share to the public, failed to obtain the optimum price." The court rejected this argument, finding that "(c)ourts have long recognized the rights of shareholders in closely held companies to remain private."

The court held, therefore, that the sales of the corporation's stock discussed in the record were arm's-length sales that best evidenced the value of the gifted shares.

Herbert V. Kohler, Jr. et al. v. Commissioner, T.C. Memo. 2006-152

This case involved the valuation of closely held stock in Kohler Company, a manufacturer of plumbing products. Two months after the decedent's death, the corporation completed a reorganization that replaced the old shares of common stock with new classes of shares that had various voting rights and dividend preferences. All of the new shares were subject to transfer restrictions and a purchase option. The estate valued the decedent's stock at $47 million as of the alternate valuation date while IRS argued that it had a fair market value of $144.5 million.

IRS first argued that the court "should value the pre-reorganization stock on the alternate valuation date, or, alternatively, that [it] should ignore the transfer restrictions and the purchase option in valuing the post- reorganization stock." The court held that stock exchanged for stock in the same corporation in a reorganization is not treated as distributed, exchanged, sold, or otherwise disposed of within the meaning of IRC §2032. Hence, it was properly valued on the alternate valuation date and not on the reorganization date. As to the argument that it should value the pre-reorganization stock as of the alternate valuation date, the court found nothing in the §2032 regulations that "requires us to disregard the tax-free reorganization when valuing the property." IRS argued alternatively that the post-reorganization stock should be valued as of the alternate valuation date without regard to the transfer restrictions and purchase option. Once again, the court disagreed. It found that there was no ambiguity and that "[t]he regulations specify that "otherwise disposed of" does not include transactions under *section 368(a)* where no gain or loss is recognizable." It held, therefore, that it would

"value the post-reorganization stock on the alternate valuation date, including the transfer restrictions and the purchase option."

With respect to the actual valuation, the court provided a strong signal of where it was going when it discussed the government's expert, Dr. Scott Hakala. The court noted that, although he had a doctorate and was a chartered financial analyst, he was not a member of the American Society of Appraisers or the Appraisal Foundation. It further pointed out that his report was not submitted in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP) and that it did not "provide the customary USPAP certification, which assures readers that the appraiser has no bias regarding the parties, no other persons besides those listed provided professional assistance, and that the conclusions in the report were developed in conformity with USPAP." Additionally, the court observed that his background research was limited, that he spent only 2 ½ hours meeting with management and that his report contained an $11 million error that was corrected at the last minute. The court was also "concerned by Dr. Hakala's choice to ignore any dividend-based method for Kohler, a privately owned company that periodically and historically has paid large dividends as a return to its shareholders, recognizing that no ready market exists for a shareholder wishing to sell." Dr. Hakala utilized a discounted cash flow (DCF) approach along with a transaction method and guideline company method, weighting the indicated values and then applying a 25% lack of marketability discount to arrive at his value of $144.5 million. The court found "Dr. Hakala's conclusions to be incredible."

On the other hand, the court found the reports of the estate's two experts to be "thoughtful and credible". The first expert used an income approach and a market approach. He applied a 45% lack of marketability discount to the values resulting from his DCF method and capital market method and a 10% lack of marketability discount to the discounted dividend method value and the capitalization of dividends value. Additionally, he applied a 26% discount for lack of control to the DCF value. He then weighted each of the valuation methods and arrived at a value of $47 million.
The estate's second expert used the income approach and the market approach in reaching his appraised value of $63.4 million. The court repeated its belief that the estate's experts "provided thoughtful, credible valuations strongly supporting the value the estate reported on its tax return." It also found that their "appraisals are more thorough and consistent with traditional appraisal methodologies for closely held companies like Kohler." It concluded, therefore, to "give significant weight to their valuations" while giving "no weight to respondent's expert's valuation of the estate's stock." Notwithstanding the valuation range of the estate's experts ($47 million - $63.4 million), the court concluded that the fair market value of the stock was $47 million as returned. Finally, as a result of this valuation determination, the court had no need to address the accuracy-related penalty that had been asserted by IRS.

Note - In a 2008 Action on Decision (AOD 2008-01), the IRS announced that it would not acquiesce in the Tax Court's decision in Herbert V. Kohler Jr. et al. v. Commissioner, T.C. Memo 2006-152 on the issue of whether §2032 allows a discount for transfer restrictions and a purchase option imposed on closely-held corporate stock under a post-

death tax-free reorganization in determining the fair market value of the decedent's stock on the alternate valuation date.

Robert Dallas v. Commissioner, T.C. Memo. 2006-212

In 1999 the taxpayer transferred 4,000 shares of nonvoting stock in his Subchapter S manufacturing company to each of two trusts established for his two sons. The stock was valued at $620 per share by Empire Valuation Consultants, Inc. ("Empire"). In exchange, each trust transferred cash in the amount of $248,000 and a $2,232,000 promissory note to the taxpayer. The sales agreement contained a share adjustment clause to reduce the number of shares transferred to reflect any valuation increase by IRS and the promissory notes contained a cancellation provision on the death of the taxpayer.

In 2000 the taxpayer transferred 2,956 shares of nonvoting stock to each of the two trusts. The stock was valued at $650 (based on an adjustment to the 1999 Empire valuation). Each trust transferred cash of $192,140 and a promissory note in the amount of $1,729,260 to the taxpayer in payment for the stock. The sales agreement for this transaction included a similar share adjustment clause but the promissory notes did not provide for cancellation on the death of the taxpayer.

During the course of a 2001 audit of the taxpayer's 1999 gift tax return, the ETA advised the taxpayer that, because the promissory notes were self-cancelling, they were worth less than face value. At that point, the taxpayer and the trustees of the trusts executed new promissory notes that were not self-cancelling.

The gift tax examination resulted in a determination that the transferred stock was worth $907 per share in 1999 and $906 in 2000. Additionally, the 1999 promissory notes were found to be worth $1,687,704 (rather than the face amount of $2,232,000). Hence, there was gift tax liability as a result of these bargain sales.

The court started with the presumption that intrafamily transfers are gifts and found that the taxpayer had not overcome this presumption. The court noted that the self-cancellation provision and the share adjustment clause showed that the transactions were for estate planning purposes. It also pointed out that the sons were not represented by counsel and that they did not negotiate the terms of the agreements. Citing Estate of Thompson v. Commissioner, 382 F.3d 367 (3rd Cir. 2004), affg. T.C. Memo. 2002-246, it found that this was a factor suggesting lack of arm's-length transactions. The court held, therefore, that the prices the sons agreed to pay for the stock were not arm's-length.

At trial, the taxpayer offered appraisal reports by Empire and Management Planning, Inc. ("MPI") while Appraisal Economics, Inc. ("AE") presented a valuation report for the government. The primary valuation issues were (1) whether or not the corporation's earnings should be "tax affected", (2) whether the corporation's income stream should be increased on the assumption that its executive compensation would decrease after a hypothetical sale and (3) the extent of any allowable discounts for minority interest, lack of voting power and lack of marketability.

At the outset, the court noted that the government's valuation report by AE and the testimony of its experts were more convincing than the Empire and MPI reports and testimony. With respect to the tax-affecting issue, the court found insufficient evidence to establish that a hypothetical buyer and seller would tax affect the company's earnings and it held that tax-affecting was not appropriate. The opinion contains a helpful discussion of this issue.

With respect to executive compensation, total salary and bonuses paid to the taxpayer and his two sons totaled almost $8 million in the period 1998 – 2000 and the government argued that this was unreasonable and should be reduced for valuation purposes. The court found that the record did not contain the kind of financial analysis customarily used by courts in deciding unreasonable compensation cases and that there was nothing to suggest that the company would change how it paid the taxpayer and his sons. Hence, it declined to allow a valuation adjustment for compensation.

With respect to a discount for lack of voting power, the taxpayer had contended that nonvoting stock was worth less than a minority interest because minority shareholders could pool their votes to influence corporate decisions. The court found this to be speculative and held that no separate discount was allowable for lack of voting power.

Both AE for the government and Empire for the taxpayer agreed that a 15% minority interest discount on nonoperating assets was appropriate and the court agreed. It also accepted AE's 20% minority discount on operating assets. With respect to the discount for lack of marketability, AE argued for 20% while MPI sought a 40% discount. MPI based its discount on analysis of restricted stock transactions and based on these studies, it found that the lack of marketability discount was 34.2% in transactions before 1990, 20.7% from 1990 to 1997 and 13% from 1997 to the present. The court held that MPI should have used the discount from the studies for the period in issue here or 13%. It allowed, however, the 20% lack of marketability discount conceded by AE. Based on its valuation analysis, the court held that the fair market value of the stock was $751 per share in1999 and $801 per share in 2000.

With respect to the valuation of the 1999 notes, the court rejected the taxpayer's arguments that the self-cancellation clause was ambiguous and should be disregarded and that it was the result of a drafting error. It held that clause must be given effect and that the value of each of the notes was $1,687,704 as determined by IRS.

In a footnote, the court pointed out that the government had argued that the share adjustment clauses were void as against public policy and that the taxpayer had not responded to this argument. The court concluded, therefore, that the issue was conceded by the taxpayer.

Estate of Josephine T. Thompson et al. v. Commissioner, 499 F.3d 129 (2nd Cir. 2007)

In Estate of Josephine T. Thompson, et al. v. Commissioner, T.C. Memo. 2004-174, the Tax Court valued the decedent's interest in a closely held corporation but declined to sustain an accuracy-related penalty. The decedent held a 20% interest in a very successful company involved in the production and sale of business guides and directories including the *Thomas Register*. Although the decedent resided in New York City and the company was located in New York City, the executors retained an attorney in Alaska (George E. Goerig) for the purposes of representing decedent's estate in connection with the anticipated audit by respondent of the estate's federal estate tax return and for handling the anticipated negotiations with IRS over the fair market value of decedent's interest in the company. The Tax Court pointed out that the acknowledged reason the estate hired Goerig to value the stock owned by decedent and to represent the estate as administrator was to have the audit of decedent's federal estate tax return conducted not by IRS's New York City office but by its Alaska office, where Goerig believed and apparently represented to the estate's representative that he would be able to obtain for the estate a more favorable valuation of the estate's TPC stock.

The estate's experts valued the company at approximately $1.75 million. The IRS expert valued decedent's interest at approximately $32.4 million. The Court found this large disparity between the parties' valuations to be "startling". The estate's valuation was based on a 30% capitalization rate, a minority discount of 40% and a 45% lack of marketability discount. The IRS expert argued that the discounted cash flow valuation method inherently reflects a minority interest and that no separate minority interest discount was warranted. He did, however, incorporate a 30% discount for lack of marketability. The court found fault with both experts (finding their valuations to be "deficient and unpersuasive') and valued the decedent's interest based on an 18.5% capitalization rate, a 15% minority interest discount and a 30% lack of marketability discount, resulting in a value of approximately $13.5 million. The court noted that, but for the fact that the IRS expert allowed a 30-percent discount for lack of marketability, "we might have been inclined to reduce this discount."

It is noted that the estate's attempt in this case to keep the examination out of New York City was unsuccessful. The case was assigned to ETA Gerard Mullaney in Manhattan who was authorized to (and did, in fact) travel to Alaska to conduct the examination. It is interesting to note that the attorney in Alaska representing the estate (and who also valued to stock for the estate) was a former IRS Estate Tax Attorney.

The Tax Court valued the decedent's interest in the company at approximately $13.5 million. The interest had been returned at about $1.8 million. Additionally, the court found the experts for the estate to have been "aggressive" in their relatively low valuation. Notwithstanding that, however, it believed that it was "inappropriate" to impose the accuracy-related penalty. It noted that the valuation was difficult and unique and that even the government's expert made errors in his calculations. It also pointed

out that the determined value was closer to the estate's valuation than to the government's valuation.

The estate appealed the valuation determination and the IRS appealed the failure of the Tax Court to sustain the accuracy-related penalty. Under §7491, "[i]f . . . a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer . . ., the Secretary shall have the burden of proof with respect to such issue." It was stipulated that the estate had submitted "credible evidence" in support of its valuation and, therefore, the burden of proof shifted to the Commissioner. On appeal, the estate argued that "the Tax Court's rejection of the valuation proffered by the Commissioner required the Court to adopt the Estate's competing valuation." The Second Circuit rejected this argument, finding that the IRS not only presented evidence in support its own valuation, it also cited record evidence to rebut the estate's valuation. Additionally, the court held that, notwithstanding the enactment of §7491, the Tax Court was not bound by the opinions of expert witnesses and may reach its own determination of value.

The court then affirmed the Tax Court's valuation in all respects but one. The parties agreed that the Tax Court made an error in calculation. The company had $68 million in short-term investments that were treated as non-operating assets and added to the capitalized income value. The capitalized income, however, included the income produced by the short-term investments resulting in an overstatement of value of approximately $1.2 million. The case was remanded to the Tax Court for correction of this computational error.

With respect to the accuracy-related penalty, the Tax Court had invoked the reasonable cause exception based on its findings that the valuation "was particularly difficult and unique"; the valuation "involved a number of difficult judgment calls"; the valuation was "difficult and imprecise" because of "the difficult question as to how the Internet and the risks and opportunities associated therewith should be regarded as affecting TPC"; and while "the experts for the estate were aggressive in their relatively low valuation of TPC," the Court's own valuation was "closer to the estate's valuation than to [the Commissioner's] valuation." The Second Circuit found the Tax Court's findings insufficient to support a determination of reasonable cause under §6664. It ruled that "[t]he factors set out in the regulations search the good faith of the taxpayer -- either in assessing its own liability or in relying on an expert to do so. But the Tax Court made no finding as to whether the Estate's reliance on its experts was reasonable and in good faith, or whether the Estate knew or should have known that they lacked the expertise necessary to value the Company." It held that a determination as to the good faith of the estate was required and, therefore, it vacated the Tax Court's decision not to impose an accuracy-related penalty and remanded the case so that the Tax Court can determine whether the estate's reliance on its valuation experts was reasonable and in good faith.

Note - The estate filed a petition for writ of certiorari arguing that the court should have accepted the estate's valuation because it met its burden of proof under §7491. On June 16, 2008, the Supreme Court denied the estate's petition.

Estate of Frazier Jelke III et al. v. Commissioner, 507 F.3d 1317 (11th Cir. 2007)

In Estate of Frazier Jelke III v. Commissioner, T.C. Memo. 2005-31, the Tax Court considered the valuation of a 6.44% interest in a closely held corporation holding a portfolio of marketable securities. As of the date of death in 1999, the net asset value of the corporation was approximately $189 million. The only issues for consideration by the Tax Court were (1) the allowable reduction for built-in capital gains tax liability, (2) the discount for lack of control and (3) the discount for lack of marketability.

With respect to the reduction for built-in capital gains tax liability, the estate argued that the reduction should be the entire amount of such tax liability that would be due if all of the securities were sold as of the date of death. This was computed to be approximately $52 million. The estate's position was based on the holding in Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002) which, the estate argued, requires that an asset-based approach (as opposed to an income approach) include the assumption that the assets were sold on the valuation date, regardless of whether the company was contemplating liquidation. The court pointed out that the case under consideration would not normally be appealable to the Fifth Circuit and that, under the Golsen rule, it was not bound by the holding of a Court of Appeals to which its decision was not appealable. See Golsen v. Commissioner, 54 T.C. 742 (1970), affd. 445 F. 2d 985 (10th Cir. 1971).

Additionally, the Tax Court found that the current case was factually and legally distinguishable from the holding in Dunn since that case involved a majority interest and the current case involved as minority interest that was insufficient to cause liquidation. The estate also argued that the corporation's relatively low earnings and modest dividends would prompt a buyer to prefer liquidation. The court rejected this argument, finding that the corporation performed well and kept pace with the S&P 500. Consequently, the court held that "neither the circumstances of this case nor the theory or method used to value the minority interest in [the corporation] requires an assumption of complete liquidation on the valuation date."

The court then went on to consider the proper amount of the reduction in value for built-in capital gains tax liability. The IRS expert started with the total amount of the tax liability computed as of the date of death ($52 million) and discounted it for the time value of money. Specifically, his approach was to first determine the corporation's average annual securities turnover rate. This was determined to be 5.95% and that resulted in a determination that the capital gains tax would be incurred over a 16.8 year period (100% divided by 5.95%). The entire date of death capital gains tax liability of $52 million was then divided by 16 to arrive at an average annual capital gains tax liability. This average annual liability was then converted to present value by using a 13.2% discount rate derived from the average annual rate of return for large-cap stocks during the period 1926 – 1998. The resulting present value of the tax liability was determined to be about $21 million which was the amount of the reduction argued by the government. The estate argued that "irrespective of the unlikelihood of liquidation there should be a dollar-for-dollar decrease for the built-in capital gain tax liability, representing the present value of that liability because the liability will increase over

time." For this reason, the estate argued, the government's expert incorrectly assumed that the stock would not appreciate. In response to this argument, the Tax Court held as follows:

> Because the tax liabilities are incurred when the securities are sold, they must be indexed or discounted to account for the time value of money. Thus, having found that a scenario of complete liquidation is inappropriate, it is inappropriate to reduce the value of [the corporation] by the full amount of the built-in capital gain tax liability. See Estate of Davis v. Commissioner, 110 T.C. at 552-553. If we were to adopt the estate's reasoning and consider future appreciation to arrive at subsequent tax liability, we would be considering tax (that is not "built in") as of the valuation date. Such an approach would establish an artificial liability. The estate's approach, if used in valuing a market-valued security with a basis equal to its fair market value, would, in effect, predict its future appreciated value and tax liability and then reduce its current fair market value by the present value of a future tax liability.

The estate also argued that the government, in other valuation cases, had presented experts who computed capital gains tax based on future appreciated value of assets and discounted the tax to a present value for purposes of valuing a corporation. In response, the Tax Court stated that it was not bound to follow the same approach used by experts in other cases and, further, that such an approach was not appropriate in this case. The court found that the government expert's approach was reasonable and it accepted his computation of the appropriate reduction for built-in capital gains tax of approximately $21 million. The court pointed out that this reduction results in an 11.2% reduction in value for built-in capital gains tax liability.

With respect to the discount for lack of control, the estate's expert utilized a 25% discount while the government's expert used a 5% discount. Both experts started with an analysis of closed-end mutual funds to arrive at their final discounts but the court found flaws in each expert's report and, after consideration of all relevant factors, concluded that a 10% lack of control discount was appropriate.

Finally, the court considered the discount for lack of marketability. The estate claimed 35% while the IRS expert used 10%. The estate's expert utilized studies of operating companies with a minimum restriction on resale of at least 2 years and, although he acknowledged that operating companies have inherently more risk than holding companies, he believed that the marketability discount for the subject company was comparable to those of operating companies because it "was not expected to liquidate for at least 20 years." With respect to this argument, the court responded in a footnote as follows:

> We must note that Mr. Frazier reduces [the company's] asset value by the entire $51,626,884 built-in capital gain tax liability on the assumption of a liquidation on the valuation date, whereas for purposes of his lack of

> marketability analysis he relies on the premise that [the company] will not be liquidated for at least 20 years. In each instance, the approaches, although internally inconsistent, produce the best results for his client (the estate).

The IRS expert started with the assumption that 20% was an average lack of marketability discount and then applied the Mandelbaum factors to arrive at a 10% discount. The court found that both sides made critical errors in their assumptions and analysis concerning the appropriate marketability discount and, therefore, it used its own analysis and judgment. It noted that the Mandelbaum factors are a helpful guide in considering the amount of a marketability discount and that it was "unable to give any weight to studies involving the companies [the estate's expert] deemed comparable, because they were not sufficiently similar to provide us with meaningful guidance regarding [the corporation]." It concluded that the marketability discount should be lower than average because the company had a successful history of long-term appreciation, notwithstanding that the fact that its dividends were lower than similar companies. The court reviewed the other Mandelbaum factors and concluded that they indicated a lower-than-average discount for lack of marketability. It then held that the appropriate discount was 15% and noted that this resulted in a cumulative lack of control and lack of marketability discount of 23.5%

On appeal, the 11th Circuit vacated the judgment of the Tax Court and remanded with instructions to recalculate net asset value using a dollar-for-dollar reduction of the entire built-in capital gains tax. In a footnote, the court noted that "we are satisfied that the Tax Court did not clearly err when it determined and discounted the value of [the interest] for lack of control by 10%, and lack of marketability by 15%." These two issues were affirmed without further discussion.

With respect to the built-in capital gains tax issue, the court went through an historical analysis of the repeal of the General Utilities doctrine in 1986 and the development of the case law involving the issue. The court pointed to the Fifth Circuit in the Dunn case as "the first court to emerge with a precise valuation approach as to the amount of the reduction and how to calculate it." It found that "[t]he rationale of the Fifth Circuit in the Estate of 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." In a startling admission, the court said that it was "a welcome road map for those in the judiciary, not formally trained in the art of valuation." Further, the Fifth Circuit announced that the "dollar-for-dollar approach also bypasses the unnecessary expenditure of judicial resources being used to wade through a myriad of divergent expert witness testimony, based upon subjective conjecture, and divergent opinions." The court found that the "100% approach settles the issue as a matter of law, and provides certainty that is typically missing in the valuation arena." It remanded the case with instructions to the Tax Court to recalculate the net asset value of the corporation on the date of death, "using a dollar-for-dollar reduction of the entire $51 million in built-in capital gains tax liability, under the assumption that [the corporation] is liquidated on the date of death and all assets sold."

In a dissenting opinion, Circuit Judge Carnes wrote that "[t]he tax code is nowhere near the center of my intellectual life, and generally I find estate tax law about as exciting as Hegel's metaphysical theory of the identity of opposites." Notwithstanding this prelude, Judge Carnes concluded that the majority opinion was unrealistic. He noted that, although "the real value approach is not perfect and itself makes some assumptions -- such as the past rate of liquidation continuing in the future -- it produces a more accurate result than the arbitrary assumption method because it more closely reflects the economic interests of those who control the company." He was critical of the majority approach that assumes the company was liquidated on the date of death and the entire built-in capital gains tax was incurred. He noted that historically the company sold less than 6% of its investments every year, that it was earning more than 23% on its portfolio and that the board of directors had no plans to liquidate. The dissent pointed out that "[n]o rational seller would accept a price that subtracted the entire amount of the future tax liability as though it were due immediately, when that liability will almost certainly be spread out over future years instead -- the next 16.8 years if existing practices continue." For these and other stated reasons, Judge Carnes dissented "from the majority's perilous delusion."

Note - The government filed a petition for writ of certiorari based on the following questions: (1) whether determination of the fair market value of property for purposes of the federal estate tax, including selection of the appropriate valuation methodology, is a question of fact, reviewed for clear error and (2) whether the court of appeals erred in holding, as a matter of law, that whenever a company's fair market value for estate tax purposes is determined based on its net asset value, there must be a dollar-for-dollar discount for any built-in capital gains tax liability based on an arbitrary assumption that the company was liquidated on the valuation date.

On October 6, 2008, the Supreme Court denied the government's petition for writ of certiorari. The decision of the Eleventh Circuit, which held that the Tax Court used an inappropriate valuation method and remanded the case, instructing the court to use the valuation method used by the Fifth Circuit, therefore, was allowed to stand.

Bradley J. Bergquist et al. v. Commissioner, 131 T.C. No. 2 (2008)

The primary issue involved in this income tax case was the fair market value of stock in a medical professional service corporation that was donated to a charitable professional service corporation. There were actually several cases consolidated for purposes of the trial and another 20 nonconsolidated cases stipulated to be bound by the court's decision. For various business reasons, University Anesthesiologists P.C. (UA) and a number of other professional service corporations decided to consolidate into a single medical practice group affiliated with the Oregon Health & Science University Hospital (OHSU). OHSU formed the OHSU Medical Group (OHSUMG) as a §501(c)(3) tax-exempt professional service corporation to serve as the single consolidated medical group into which all of the medical practice specialty groups would be consolidated. At some point in the process, an accountant for UA attended a conference at which he learned that

"some doctors throughout the country apparently were claiming substantial charitable contribution deductions relating to donations to academic-affiliated institutions of stock in their medical professional service corporations." The potential tax benefits of donating stock to OHSUMG were subsequently described at a stockholders meeting as a "huge [tax] windfall" of "150K" to each stockholder.

The plan progressed and Houlihan Valuation Advisors (Houlihan) was retained to value the stock to be donated. The donations were made on September 14, 2001 and Houlihan appraised the stock at almost $400 per share resulting in charitable deductions of approximately $175,000 for each shareholder. This valuation was based on the valuation of the corporation as a going concern because they viewed the scheduled January 2002 consolidation as "uncertain".[6] On advice from its own legal and accounting advisors, OHSUMG entered a value of zero for the donated stock that it received. It had determined that as the business affairs of the professional service corporation were wound up, projected cash disbursements would approximate projected cash receipts, leaving no unencumbered value.

In advance of a January 2002 stockholders meeting, the stockholders were each given a Form 8283, Noncash Charitable Contributions that reflected Houlihan's appraised value for the donated stock. The stockholders were also advised not to bring their own tax advisors to the meeting. At the meeting, some stockholders apparently got cold feet and suggested that they might claim lower deductions. These stockholders were advised not to attract the attention of the IRS by deviating from the amounts shown on the Forms 8283 and not to discuss the donations if they were contacted by the IRS. Charitable contribution deductions based on the Houlihan appraisal were claimed by 26 of the 28 stockholders. The remaining two claimed no charitable deduction with respect to the donated stock.

On audit, IRS determined that the stock had no value and disallowed the charitable deductions. Before trial and on the basis of an expert appraisal, IRS valued the stock at approximately $35 per share and agreed that charitable deductions were allowable to that extent. The valuation by the IRS expert used an asset-based approach based on the expert's opinion that it was known or knowable on September 14, 2001 that the corporation would no longer be operating on January 1, 2002. The total equity value thus determined was then reduced by a 35% lack of control discount and a 45% lack of marketability (representing a cumulative discount of 64.25%). The 35% lack of control discount was based on a study of mergers and acquisition of publicly traded companies in the health care industry. This study compared the difference in an entity's share price just before an announced acquisition to the price paid per share by the acquiring business and it demonstrated that in 1999 and 2000 share prices of stock in health care companies before a merger traded at an average discount of approximately 35 percent relative to their postacquisition share prices. The IRS expert attributed that discount to a lack of control. The 45% lack of marketability discount was based on a study of restricted stock

[6] The court pointed out that "[i]n their expert reports neither of the petitioners' experts explain how or why they selected a going concern premise of value, and they conveniently and incredibly make no mention of the scheduled Jan.1, 2002, consolidation."

health care companies and a study of initial public offerings. The restricted stock study demonstrated that from 1983 to 2000 restricted stock of health care companies traded at a mean and median discount of approximately 39% relative to their unrestricted counterparts and the IRS expert attributed this to a lack of marketability. The IPO study utilized by the IRS expert demonstrated that from 1975 to 1997 pre-IPO stock traded at mean and median discounts of approximately 44 and 46 percent, respectively, relative to the post-IPO stock prices and, again, the IRS expert attributed this discount to lack of marketability. The valuation by the IRS expert resulted in a value of $37 per share for the voting stock. An additional 5% discount was then applied to account for the lack of voting rights of the nonvoting stock, resulting in a value of $35 per share.

The court concluded, after careful consideration of the trial testimony and other evidence (including letters, emails, minutes of meetings, financial statements and handwritten notes) that the corporation should not be valued as a going concern. It found that "[t]he donation of UA stock was driven by the imminent consolidation of UA (along with the other medical groups) into OHSUMG. On the evidence, it is beyond any reasonable question that petitioners would not have donated their UA stock to OHSUMG had there existed any realistic possibility that the consolidation would not occur by year-end 2001 or soon thereafter." Because the taxpayers' experts erred in treating the corporation as a going concern, the court chose not to rely on their valuation reports. Finally, since the taxpayers did not identify (and the court did not find) any significant flaws in the valuation report of the IRS expert, the court adopted his discounts and conclusions of value.

The IRS asserted the 40% accuracy-related penalty under §6662(h)(2)(A). The court found that the taxpayers did not act in good faith and did not make a good faith investigation of the value of the donated stock. It held, therefore, that each taxpayer was liable for the 40-percent accuracy-related penalty.

Estate of Marjorie deGreeff Litchfield et al. v. Commissioner, T.C. Memo. 2009-21

The decedent died in 2001. She held interests in two closely held corporations – a 43.1% interest in Litchfield Realty Co. (LRC) and a 22.96% interest in Litchfield Securities Co. (LSC). LRC held farmland valued at $22.6 million and marketable securities valued at $9.7 million. LSC held marketable securities valued at almost $50 million. Both LRC and LSC had been originally incorporated as C corporations but, on January 1, 2000, LRC elected to convert to an S corporation. For 10 years after this date, LRC would incur corporate-level income tax on the sale of any assets that it owned prior to the election. As of the valuation date, LRC had almost $29 million in built-in capital gains and LSC had $39 million in built-in capital gains. The only issues before the court were the allowable discounts for built-in capital gains taxes, lack of control and lack of marketability. See the chart at the end of this summary for the positions of the parties along with the court's determination of the discounts.

With respect to the valuation issues, the court made clear that a determination of fair market value generally involves questions of fact. It cited CSX Transportation. Inc. v.

Georgia State Board of Equalization, 552 U.S. ___ (2007) where the 11th Circuit had upheld as a matter of law a state-mandated particular valuation method for railroad real property. The Supreme Court reversed, finding that valuation of property is "an issue of fact about possible market prices." The court cited several other cases for this proposition along with Rev. Rul. 59-60 in which fair market value "is to be determined through a commonsense application of all the relevant facts and circumstances with appreciation for the fact that valuation is an inexact science." The court found that, in this case, "[a] hypothetical buyer would be willing to pay fair market value for the LRC and LSC stock, which would take into account and would reflect the millions of dollars in untaxed appreciation over the years in the values of LRC's and LSC's underlying assets." It said that knowledgeable buyers "would negotiate discounts in the price of the stock to estimate, on the basis of current tax laws, the corporate capital gain tax liabilities due on that very same appreciation when the assets are sold or otherwise disposed of by the corporation." The court also observed that "[t]he minority interest or lack of control (discount) involves the inability to control corporate action, select management, determine timing and amounts of distributions, arrange financing, and make decisions about liquidation, merger, and asset sales. The lack of marketability (discount) is based primarily on the fact that there is no public market for LRC and LSC stock."

In determining the discount for built-in capital gains taxes, the estate's expert projected holding periods and sale dates for the appreciated assets based on historical asset sales and discussions with corporate officers. He then estimated appreciation for those assets during the holding periods, calculated the capital gains taxes that were estimated to be due and discounted them to present value. The projected average asset holding period for LRC was determined to be only 5 years so the estate's expert did not have to consider the effect of the Subchapter S election made by this corporation.

For the lack of control discounts, the estate's expert utilized closed-end funds along with real estate investments trusts (REITs) and real estate limited partnerships (RELPs). For the lack of marketability discount, the estate's expert reviewed restricted stock sales along with a number of other factors to arrive at his discounts.

The Service's expert used turnover rate estimates based solely on historical asset sales by the corporations to arrive at his discounts for built-in capital gains taxes. The court noted that he did not talk to management of the corporations. He then calculated capital gains taxes due on the assets and discounted them back to present value. For LRC, the Service's expert projected an asset holding period in excess of 53 years. "Because LRC, as a result of its S election, beginning in 2010 would no longer be required to pay corporate-level capital gains taxes, respondent's expert did not include in his calculation of a capital gains tax discount any capital gains taxes which under his method were projected to be incurred beyond 2009." With respect to the lack of control discount, the Service's expert also used closed-end funds but he "trimmed the mean, or eliminated from his review the top and bottom 10 percent of observed lack of control discounts for closed-end funds, resulting in a trimmed average lack of control discount for closed-end funds of 5.2 percent." Also, he did not break down his discount analysis by asset class. Finally, the Service's expert utilized restricted stock sales (including three unidentified

studies from the late 1990s that the estate's expert had not used) and private placement studies.

The court concluded that "a willing buyer and a willing seller would negotiate and agree to significant discounts to net asset values relating to the estimated corporate capital gains taxes that would be due on the sale of LRC's and LSC's nonoperating assets." In Footnote 10, the court reviewed many of the built-in capital gains tax cases including Dunn and Jelke which held that "an assumption, as a matter of law, was appropriate that all corporate investment nonoperating assets would be liquidated on the valuation date and therefore that a built-in capital gains tax discount equal to 100 percent of the built-in capital gains taxes that would be due on a sale of the appreciated assets should be allowed." The court went on to say in the footnote that, in this case, the estate's expert did not assume that the appreciated assets would be sold on the valuation date and did not ask the court to apply a full dollar-for-dollar discount for estimated built-in capital gains taxes. For that reason, the court said that it "need not decide herein whether such an approach would be appropriate in another case where that argument is made."

The court then found that the estate's expert's assumptions relating to asset turnover, because they were based on historical and recent data and conversations with management were more accurate than the Service's expert's assumptions that were based only on historical data. Additionally, the court noted that the Service's expert did not consider appreciation in asset value during the holding period. Consequently, the court accepted the built-in capital gains discounts as determined by the estate's expert – 17.4% for LRC and 23.6% for LSC. It also concluded that the estate's lack of control discounts were appropriate.

Finally, with respect to lack of marketability discounts, the court regarded the estate's expert's respective 36-percent and 29.7-percent discounts, particularly when combined with the 14.8- and 11.9-percent lack of control discounts it allowed, to be high. It noted that he used some outdated data relating to restricted stock discounts and that his discounts were higher than marketability discounts reflected in benchmark studies that included all components of a lack of marketability discount. Further, the court pointed out that the same expert concluded for gift tax purposes in 2000 that the estate's interest in LSC was appropriately discounted by 21.4% for lack of marketability which was significantly lower than the 29.7% he determined in this case. The court concluded that the decedent's interest in LRC should be discounted by 25% and that its interest in LSC should be discounted by 20% for lack of marketability.

The chart below shows the positions of the parties with respect to the discounts along with the holdings of the court:

Estate of Marjorie deGreeff Litchfield et al. v. Commissioner, T.C. Memo. 2009-21

Summary of Discount Positions and Court's Conclusions

	Estate	IRS	Court
LRC			
Net asset value	33,174,196	33,174,196	33,174,196
Net asset value of decedent's			
43.1% interest	14,298,078	14,298,078	14,298,078
Discounts:			
Built-in capital gains taxes	17.4%	2.0%	17.4%
Lack of control	14.8%	10.0%	14.8%
Lack of marketability	36%	18%	25.0%
FMV of decedent's interest	6,475,000	10,069,886	7,546,725
LSC			
Net asset value	52,845,562	52,845,562	52,845,562
Net asset value of decedent's			
22.96% interest	12,133,341	12,133,341	12,133,341
Discounts:			
Built-in capital gains taxes	23.6%	8.0%	23.6%
Lack of control	11.9%	5.0%	11.9%
Lack of marketability	29.7%	10.0%	20.0%
FMV of decedent's interest	5,748,000	9,565,535	6,530,790

Real Estate

Estate of William Busch v. Commissioner, T.C. Memo. 2000-3

Decedent had a one-half (½) interest in 90 acres of vacant land that was discounted by 40% for a fractional interest. Although IRS argued that no fractional interest discount should be allowed, the court found that some discount for the partial interest was warranted. It found, however, that a 10% discount was sufficient to account for the partial interest represented by a simple co-ownership in unimproved land and would also be more than adequate to accommodate the reasonable costs of partition.

Estate of Eileen Kerr Stevens v. Commissioner, T.C. Memo. 2000-53

The Tax Court sustained the estate's reported fair market value of the decedent's one-half interest in 4 commercial properties subject to lease. The estate then argued for fractional interest discounts ranging from 30% to 35% while the IRS expert maintained that such discounts should be limited to the costs of partition, which he estimated to be 3% to 4%. Without any clear explanation, the IRS expert then increased his partition cost estimate to a range of 10% to 20%. It was the IRS position that the need to discount for control or marketability was minimized because partitioning would cure any control problem. The court found, however, that the use of partition cost alone does not give adequate weight to other reasons for discounting a fractional interest such as the significance of the control factor and the historic difficulty of selling an undivided fractional interest in real estate. The court ultimately allowed a 25% fractional interest discount.

J.C. Shepherd v. Commissioner, 115 T.C. 376 (2000)

See discussion of this case under **Family Limited Partnerships** above. As part of its decision, the Tax Court allowed a 15% fractional interest discount for approximately 9,000 acres of land that was under a long-term timber lease). This decision was affirmed by the Eleventh Circuit in J.C. Shepherd v. Commissioner, 283 F.3rd 1258 (11th Cir. 2002).

Estate of John L. Baird, et al. v. Commissioner, T.C. Memo. 2001-258

Decedent died in 1994 and his wife died in 1995. Decedent owned a 14/65 (21.54%) interest and his wife owned a 17/65 (26.15%) interest in a family trust owning 16 noncontiguous parcels of Louisiana timberland. The issue for the court was the extent of the allowable fractional interest discount. The estates offered three expert witnesses, all of whom were found by the court to be qualified. The IRS expert (who was not identified by name or profession), however, "was found not to be specifically qualified to assist the trier of fact (Court) on the question of the discount to be applied, if any, to a fractional interest in timberland." The first expert for the estates, relying on comparable sales, concluded that a discount of at least 50% was appropriate. The estates' second expert also utilized comparable sales and concluded that a 55% discount was appropriate. The third expert was heavily involved in the business of buying and selling undivided

interests in Louisiana farm and timberland and was clearly favored by the court. This expert's report concluded that a discount of at least 55% would be appropriate but, in his trial testimony, he expressed the opinion that the fractional interests should be discounted by 90%. Although the court found "it hard to accept that a willing seller would accept 10 cents on the dollar for a partial interest in timberland", it apparently found it not hard to accept that a willing seller would accept 40 cents on the dollar since it allowed a 60% fractional interest discount in each estate.

Note – The Tax Court denied the estates' motion for an award of reasonable litigation costs and administrative expenses, holding that the position taken by the IRS in the administrative and judicial proceedings was substantially justified. The estates appealed the denial of this motion. In Estate of John L. Baird v. Commissioner, 416 F.3d 442 (5th Cir. 2005), the Fifth Circuit reviewed the entire history of negotiations and found that "before the IRS issued the notices of deficiency, the estates had provided enough information to the IRS to alert it to the fact that the in-kind partition described in the [forester's] report was not viable, and that his estimate of the costs of a hypothetical partition in kind was speculative and unsupported." It held that the IRS is charged with knowledge of relevant legal authorities and with knowledge of local law relating to the partition of real property. It noted that "the IRS had locked into its story and was sticking to it." The case was, therefore, remanded to the Tax Court for a determination of the fees to be awarded. In Estate of John L. Baird et al. v. Commissioner, T.C. Memo. 2006-140, the Tax Court held that all of the fees (including fees for an attorney called as an expert witness) were reasonable and allowable.

Estate of Nora Kolczynski v. Commissioner, T.C. Memo. 2005-218

The decedent owned some 2,100 acres in the low country of South Carolina known as "Dawn Plantation" and consisting of timberlands and open fields with access to a shallow branch of a local river. For the filing of Form 706, the estate retained an appraiser who determined a mixed highest and best use of agriculture and recreation, including hunting. Using comparable sales, the appraiser arrived at a fair market value of $2,825,000 for the land. The estate also secured a valuation of the standing timber by a registered forester who determined that the value of the merchantable timber was $2,665,992.

The resulting aggregate value of the two appraisals ($5,490,992), however, was not used by the attorney-CPA who prepared the Form 706. Rather, the representative adjusted the value of the timber down to $2,440,263 and he valued the land at 100% of its assessed value or $1,837,750. Along with improvements valued at $100,000, this resulted in the returned value of $4,378,013 for Dawn Plantation.

In the statutory notice, IRS valued the property at $5,490,992 which was the aggregate value of the estate's original land appraisal of $2,825,000 and its timber valuation of $2,665,992.

At trial, the estate presented a third expert who concluded that, although the highest and best use was mixed, recreation was the primary use and timber management was only the

means to cover the expenses of the property. He than used a sales comparison approach to determine a fair market value that was slightly less than the returned value.

A forester who qualified as the IRS expert concluded in his report that the highest and best use of the property was a mixed use of recreation and agriculture. At trial, however, he concluded that timberland was its only profitable use. Hence, he applied a summation approach (land value plus timber value).

The court first took notice of the discrepancy in highest and best use between the IRS expert's report and his testimony and, consequently, gave little weight to his testimony on highest and best use. Based on the factual record and the lack of any evidence that Dawn Plantation could be used successfully for commercial or residential development, the court found that the highest and best use of the property was a mixed one of recreation and timberland with selective timber farming supporting the recreational value. The court then held that a comparable sale valuation method provided a more accurate basis of valuation than the summation approach advocated by the IRS.

The estate's appraiser had identified 5 comparables sales but gave greatest weight to only two of them and the court reviewed those two sales in detail. IRS argued that one of the sales was unreliable because it involved a §1031 exchange transaction, the facts of which were not fully known. The court agreed and concluded that it would rely on the remaining sale. This sale, which occurred two years before the valuation date and was contiguous to the Dawn Plantation, involved substantially less land (only about 450 acres).

The estate's appraiser considered 5 adjustments to the sale price of this comparable sale and the court accepted 4 of them (a downward adjustment for improvements, upward adjustments for timber and the time differential and no adjustment for location). The last adjustment was a 35% downward adjustment of the comparable's sale price for size. The court thought this was too high and reduced it to 20%. This resulted in a value of $2,305 per acre and a total value for Dawn Plantation of $4,829,252.

Of particular interest in this decision is the fact that the court effectively used only one comparable sale to determine the fair market value of the land. Additionally, there was a footnote reference to the fact that the estate intended to perfect its protective §2032A election if the court determined a fair market value in excess of the returned value (as it did). The footnote also indicated that IRS intends to deny such an election. The special use valuation dispute apparently turns on Estate Tax Regulations §20.2032A-8(b) that requires (in cases of protective elections) a formal notice of election 60 days after the date the values are "finally determined". The IRS position appears to be that the value as finally determined is the value set forth in the notice of deficiency while the estate's position is that it is the court's determination of value.

Roger Wortmann v. Commissioner, T.C. Memo. 2005-227

This case involved the fair market value of certain real estate for purposes of the charitable deduction under IRC §170. Father Stevens, a Catholic priest, organized a not-for-profit corporation to construct and run a monastery on the property that ultimately consisted of 240 acres, a monastery and a chapel. After several years, the nonprofit organization began experiencing financial difficulty and, in 1996, Father Stevens sold 210 acres of the property for $63,000. This left only 30 aces and the two structures. Father Stevens also began communicating to people in the community that the property was for sale to buyers who would use it for religious purposes. The sale price was to be in an amount sufficient to cover the debts of the nonprofit corporation that approximated $75,000. In connection with any such sale, Father Stevens insisted on a contractual right giving the nonprofit organization the first opportunity to repurchase the land if the purchaser wanted to resell it.

A group of four families formed an LLC and, in 1997, this corporation purchased the property for $75,000 and granted the nonprofit organization a right of first refusal on the property. The LLC then leased the property to a qualified charitable organization for $1. Some 17 months later, the LLC donated the property to the charitable organization and, based on an appraisal, claimed a charitable deduction of $475,000. Each of the four family owners of the LLC claimed a proportionate share of the $475,000 on their joint income tax returns for 1998, 1999 and 2000.

IRS valued the donated property at $76,200 and the Tax Court agreed. The court first noted that evidence of what property sold for within a reasonable time before the valuation date generally is competent, substantial, and persuasive evidence of its fair market value on the valuation date. It concluded that the actual purchase price of $75,000 was persuasive evidence of the fair market value of the subject property. It found that the petitioners were willing buyers, and the nonprofit organization was a willing seller and that the purchase of the subject property was within a reasonable time, approximately 17 months, before the donation to the charitable organization. Further, the court found no evidence of a material change in the subject property between the valuation date and the date of purchase that would cause it to diminish the weight of this evidence. The court rejected the petitioners' argument that the purchase price was not persuasive because it was a "forced sale" because there was no evidence of any foreclosure activity or that any creditor had begun any collection action.

At trial, the IRS expert (an MAI appraiser) valued the property at $90,000 and the court found his appraisal to be credible and placed significant weight on his conclusions. To the contrary, it found the petitioners' expert's methodology to be troubling. Additionally, the court placed great weight on the $70,424 assessed value of the property because it corroborated the actual sale and the government's expert.

The court found that "the most persuasive evidence of the subject property's value as of the contribution date is the actual sale of the subject property 17 months before the contribution." It also found that the record justified a slight upward adjustment to

account for the minor maintenance and upkeep that occurred between the purchase date and the contribution date and, therefore, valued the property at $76,200.

Estate of Pearl I. Amlie v. Commissioner, T.C. Memo. 2006-76

Among other issues, this case involved the valuation of four parcels of farmland returned at a total value of $753,000. The IRS value (as determined by the ETA) was $932,000 and, at trial, the estate offered an expert who concluded that the value was $860,000. The ETA was called to testify concerning his methodology and the court found it to be similar to the estate's expert and "theoretically sound." However, while the court found the ETA's conclusions to be supportable, it concluded that, because he was not qualified as an expert appraiser, his conclusions were "less reliable than those of the estate's expert." The court then accepted, with two changes, the values determined by the estate's expert. The expert had made a downward adjustment on one comparable sale because it took place in a public auction between two bidders with special interests in the property. The court found that this adjustment was not justified. Additionally, with respect one parcel, the expert utilized only one comparable sale and the court concluded that this departure from his methodology of using the average of six comparable sales was not appropriate.

The decedent held only partial interests in two of the parcels – a 7/12 interest in one and one-half (½) in another – and at trial the estate's expert argued for fractional interest discounts of 25%-30% for the first interest and 30%-35% for the second. The court found "considerable shortcomings" in the expert's data (even though a fractional interest discount is "consistent with common sense and precedent"). The IRS, however, presented no evidence with respect to fractional interest discounts. The court held that the evidence of fractional interest discounts provided by the expert to be "too fraught with infirmities to constitute cogent proof that the reported values are erroneous." It concluded, therefore, that the estate was entitled to a discount no greater than the amount necessary to reduce the values to the amount as originally reported on the return. This amount was approximately 15%.

Other

Technical Advice Memorandum 200247001

Decedent owned several individual retirement accounts (IRAs) that were funded with marketable securities and money market accounts. An appraisal firm retained by the estate valued the IRAs for estate tax purposes with a discount for (1) the potential income tax payable by the beneficiary, (2) delays that might occur between the time a request for distribution was made and the actual payment and (3) prohibitions on the transfer or assignment of the accounts prior to distribution. In Estate of Robinson v. Commissioner, 69 T.C. 222 (1977), the taxpayer sought a valuation discount on the value of a promissory note to reflect the potential income taxes that would be payable on receipt of subsequent installment payments. The court concluded that under the "willing buyer-willing seller" standard of the regulations, property is to be valued at the price a hypothetical willing buyer would pay a willing seller and not the intrinsic value of the property in the hands of the individual decedent or his beneficiaries. The fact that the willing seller might incur income tax on the sale of the note does not impact on the sales price. Accordingly, a willing buyer would not take potential income tax into account in determining what he would be willing to pay for the note, and a willing seller would not accept any discount for potential income tax in determining the price of sale. The court also noted that taking potential income tax into account would require consideration of many factors that are peculiar to the individual decedent, the decedent's estate and the beneficiaries. Consideration of these subjective factors would not be consistent with the "willing buyer-willing seller" standard that looks to hypothetical parties. Perhaps more importantly, however, the court pointed out that, in cases where income tax is inherent in certain assets included in the gross estate, section 691(c) provides an income tax deduction determined by reference to the estate tax attributable to the assets. The court held that: "Congress chose to ameliorate the impact of the income taxation of the property by allowing an income tax deduction under *section 691(c)*" and that "there was no basis for supplementing this income tax relief with additional estate tax relief." The Service concluded that the court's rationale in Robinson was equally applicable to this case involving discounted IRAs and held that the section 691(c) deduction "functions as a statutory substitute for the valuation discount" and "any additional reduction in estate tax for the potential income tax would be unwarranted." Finally, the ruling concluded that there should be no discount for lack of marketability because there were no restrictions preventing the distribution of assets to the beneficiaries after the decedent's death and that short administrative delays in processing a request for distribution do not warrant a discount.

Technical Advice Memorandum 200303010

The decedent bought Series E U.S. savings bonds during her life and these bonds passed to her revocable trust under the terms of her will. The estate included the bonds in the gross estate with a discount for lack of marketability. It argued that "[t]he contractual limitation on U.S. Savings Bonds, that they are only redeemable by the United States Treasury, does not change the definition of a hypothetical willing buyer." According to

the estate, "a hypothetical willing buyer of the bonds would consider the built-in income tax liability in determining the amount he would be willing to pay for those bonds." In support of this position, the estate relied on Eisenberg v. Commissioner, 155 F.3d 50 (2d Cir. 1998) and Estate of Davis v. Commissioner, 110 T.C. 530 (1998). This argument was rejected based on the reasoning of United States v. Cartwright, 411 U.S. 546 (1973). In Cartwright, the Supreme Court valued shares of a mutual fund at their redemption price since the fund was obligated to redeem the shares at the redemption price. In this case, IRS found that the government is the only willing buyer of the bonds because of the bond contract and that the bonds would be redeemed by the U.S. Treasury at the redemption price. The Service found that the hypothetical willing buyer would not take the seller's income tax liability into consideration in determining the purchase price of the bonds and, accordingly, the estate was not entitled to discount the bonds for the income tax due on the accrued interest.

Estate of Paul C. Gribauskas, et al. v. Commissioner, 342 F.3d 85 (2nd Cir. 2003)

In a 2001 decision (Estate of Paul C. Gribauskas, et al. v. Commissioner, 116 T.C. 142), the Tax Court held that installment payments from a state lottery prize must be valued as a term certain annuity under §7520 and the relevant actuarial tables in Estate Tax Regulations. §20.2031-7. In its decision, the Tax Court expressed its disagreement with the decision in Estate of Shackleford v. U.S., 99-2 USTC ¶60,356 (E.D. Cal. 1999), finding that: (1) the cases don't support that opinion; (2) deviation from the tables for nuances in a case would unjustifiably weaken the congressional intent embodied in section 7520 in favor of standardized actuarial valuation; (3) the annuity, a fixed stream of payments, is distinct from interests subject to market fluctuations; and finally, (4) Estate Tax Regulations §20.7520-3(b) would apply when the facts show a clear risk that the payee will not receive the anticipated return -- unlike this situation, in which the payments are backed by the full faith and credit of a state government. On appeal, the Second Circuit found that Shackleford "serves as a useful guidepost for deciding the case at hand." Both cases involved anti-assignment restrictions and the court agreed with the Shackleford holding that "departure from the actuarial tables was appropriate when the taxpayer provided a more realistic and reasonable valuation method." Here, the parties had stipulated that the transferability restrictions on the prize had an adverse impact on its market value and the Commissioner agreed that the estate's valuation of the winnings, a figure over $ 900,000 below that prescribed by the section 7520 standardized valuation tables, accurately reflected the market discount attributable to those restrictions. The court held, therefore, that valuing the winnings pursuant to the tables was erroneous.

Note – In **Gladys J. Cook, et al. v. Commissioner, 349 F.3d 850 (5th Cir. 2003)**, the Fifth Circuit affirmed the Tax Court's determination that a lottery prize is a private annuity. The court concluded that the value reached using the valuation tables was not sufficiently unreasonable to warrant the use of a different method of valuation. It found that it was "unreasonable to apply a non-marketability discount when the asset to be valued is the right, independent of market forces, to receive a certain amount of money annually for a term certain." As a result of this decision, there is now a split in the

circuits on the lottery valuation issue between the Ninth Circuit (Shackleford) and Second Circuit (Gribauskas) on one hand and the Fifth Circuit (Cook) on the other hand.

John D. Smith v. United States, 391 F.3d 621 (5th Cir. 2004)

In this case, the estate sought a refund of estate tax based on the claimed overvaluation of the decedent's retirement accounts. The claim for refund discounted the accounts (comprised entirely of marketable securities) by 30% to reflect the federal income tax liability triggered upon distribution of the accounts to the beneficiaries. The district court concluded that it must apply the willing buyer-willing seller test to the valuation of the accounts and then found that the potential tax to be incurred by the seller would not affect the sales price of the securities and would not factor into negotiations between the hypothetical buyer and seller. The court also noted that the apparent taxation of the full value of the accounts for both estate and income tax purposes was addressed by Congress with the adoption of Internal Revenue Code §691(c). The government's motion for summary judgment was, therefore, granted by the court. See Estate of Louis R. Smith v. United States, 300 F. Supp. 2d 474 (S.D. Tex., 2004). The estate appealed and the Fifth Circuit affirmed, finding that a hypothetical buyer would pay the value of the securities as reflected by the applicable securities exchange prices and that a hypothetical seller would likewise sell the securities for that amount. The court held that a hypothetical buyer would not consider the income tax liability to a beneficiary on the income in respect of a decedent since he is not the beneficiary and thus would not be paying the income tax. Finally, the court abstained from considering the estate's lack of marketability argument since it was raised for the first time on the appeal.

Estate of John R. Donovan Jr. v. United States, 2005-1 USTC ¶60,500 (D. Mass. 2005)

In this case, the decedent collected only the first of twenty annual $100,000 lottery payments before his death. Under Massachusetts law, he could not have assigned the winnings. The remaining payments were valued by the estate's appraiser at $367,482 but IRS valued them based on the annuity tables at $1,091,553. Since the Tax Court had previously upheld the Service position with respect to the valuation of lottery payments in Gribauskas v. Commissioner, 116 T.C. 142 (2001), the estate paid the deficiency and brought this action in U.S. District Court following disallowance of a claim for refund. Relying on Gribauskas, the court first determined that the lottery payments constituted an annuity and not a "restricted beneficial interest" within the meaning of §7520 and the related regulations. Although it found that restrictions that limit a decedent's assurance in receiving the full payments potentially might warrant diverging from the annuity tables through the regulation's exception for restricted beneficial interests, it concluded that this was not the situation here. Consequently, the court held that the lottery income stream was an annuity presumptively governed by §7520.

The court next found that the actuarial tables must be used "unless it is shown that the result is so unrealistic and unreasonable that either some modification in the prescribed method should be made, or complete departure from the method should be taken, and a

more reasonable and realistic means of determining value is available." The court took note of the current split on the this valuation issue, with the Second and Ninth Circuits holding that non-marketability should be factored into the valuation of such interests, Gribauskas v. Commissioner, 342 F.3d 85 (2d Cir. 2003); Shackleford v. United States, 262 F.3rd 1028 (9th Cir. 2001), and the Fifth Circuit and the Tax Court finding that to do so would not be appropriate. Cook v. Commissioner, 349 F.3d 850 (5th Cir. 2003); Gribauskas, 116 T.C. 142 (2001). It concluded that the approach adopted by the Second and Ninth Circuits put misplaced reliance on the valuation impact of the "right to transfer." The court conceded that "most property has little ascertainable value (for tax purposes) apart from some reference to what a willing (whether real or hypothetical) buyer would pay for it." As an example, the court found that, "without reference to a real or hypothetical market, it would be difficult to determine what value a tractor might have for purposes of imposing a tax." A tractor, however, is not "a steady stream of income from a party that is highly unlikely to go insolvent." The court went on to find that the willing buyer/seller approach is appropriate for valuing most property (including tractors) because "the property interest the buyer will hold upon purchasing the property will be identical (or nearly identical) to that held by the seller." With respect to lottery payments, however, the court found that the interest a buyer would acquire would be of a very different sort than what the seller held. See Gribauskas, 116 T.C. at 164 ("Decedent died owning an enforceable right to a series of payments. Yet any purchaser buys only an unenforceable right and so is necessarily valuing a different species of interest.").

The court concluded that the subject interest in this case was income, "a property interest manifested through a contractual right with the state to payments of a liquidated amount" and that "(t)he unassignable nature of that right does not lessen its worth to the decedent's estate in any way significant for tax purposes, or, more precisely, in a way not already contemplated by the annuity tables." Consequently, the court thought it "unreasonable to apply a non-marketability discount when the asset to be valued is the right, independent of market forces, to receive a certain amount of money annually for a certain term." Cook, 349 F.3d at 856.

Estate of Doris F. Kahn v. Commissioner, 125 T.C. 227 (2005)

The decedent owned two individual retirement accounts holding marketable securities with a combined value of $2.6 million. The estate discounted the value of one of the IRAs by 21% and the other by 22.5% to reflect the anticipated income tax liability that would be incurred by the beneficiaries upon distribution of the accounts. The estate argued that the "willing buyer–willing seller" test required a reduction in the includible value of the IRAs. It said that the IRAs themselves were not transferable and, therefore, were not marketable. Further, the estate argued that "the only way that the owner of the IRAs could create an asset that a willing seller could sell and a willing buyer could buy is to distribute the underlying assets in the IRAs and to pay the income tax liability resulting from the distribution." Since the beneficiary must pay income tax on distribution, it is a "cost" necessary to "render the assets marketable." In support of its position, the estate cited cases from several different areas of tax law that have allowed a reduction in value

to account for the costs necessary to make an estate's assets marketable or that have otherwise considered the tax impact of a disposition of assets.

The estate attempted to convince the court "that nontransferable IRAs are similar in nature (1) to unassignable lottery payments, (2) stock in a closely held corporation, (3) stock that is subject to resale restrictions, (4) contaminated land, and (5) land that needs to be rezoned to reflect the highest and best use." The court, however, distinguished all of the cases cited by the estate "based on the same common denominator -- the fact that the built-in capital gains liability and/or marketability restriction of the listed assets will still remain in the hands of a hypothetical buyer, while in our case, the hypothetical sale of marketable securities will not transfer any built-in tax liability or marketability restriction to a willing buyer."

The court found that the estate was "trying to draw a parallel where one does not exist by comparing this situation to situations where a reduction in value is appropriate because a willing buyer would have to assume whatever burden was associated with that property -- paying taxes, zoning costs, lack of control, lack of marketability, or resale restrictions." In the subject case, however, a willing buyer would be obtaining the securities free and clear of any burden. Hence, the court held that the value of the IRAs could not be reduced by the anticipated income tax liability that would be incurred by the beneficiaries upon distribution of the accounts.

Note – The above case contains a very thorough discussion of the court's rejection of all of the taxpayer's arguments in support of the claimed valuation discounts. The decision is in accord with Estate of Smith v. United States, 391 F.3d 621 (5th Cir. 2004) and Estate of Robinson v. Commissioner, 69 T.C. 222 (1977) and provides an excellent analysis of the valuation issue.

Estate of Georgina T. Gimbel et al. v. Commissioner, T.C. Memo. 2006-270

The decedent owned approximately 3.6 million shares of Reliance Steel and Aluminum Company, a metals processing and distribution company. The stock was traded on the New York Stock Exchange and the mean trading price at the date of death was $20.8125 per share. Almost all of the decedent's holdings consisted of unregistered shares and, in addition, the decedent was considered an "affiliate" of Reliance and, therefore, the public resale of her stock was restricted. Under SEC Rule 144, the amount of stock that could be sold to the public in any 3-month period was limited to 1% of the outstanding stock or the average weekly trading volume for the previous four weeks. The 1% limitation applied to the estate and, under that limitation, it would take 39 months to sell the estate's holdings. The company had a stock repurchase plan in place and two weeks prior to the date of death, the CEO announced that Reliance had a "record year" and that it would consider repurchasing shares at around $19.00 per share. In fact, within 5 months of the date of death, the company repurchased 2.27 million shares from the estate for $19.35 per share. This represented 63% of the estate's total holdings.

On the estate tax return as filed, the stock was returned at mean trading price on the date of death of $20.8125 per share less a 20.7% discount to reflect lack of marketability and liquidity relating to the SEC resale restrictions. This resulted in a value of $16.50 per share. On audit, the discount was reduced to 8%, resulting in a value of $19.15 per share. For trial, both the estate and the IRS retained new valuation experts. The estate's new expert valued the stock at the mean trading price less a 17% discount or $17.27 per share while the government's expert arrived at a 9% discount or $18.94 per share.

With respect to the actual sale of 63% of the estate's holdings less than 5 months after the date of death for $19.35 per share, the court cited Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929) and Succession of McCord v. Commissioner, 461 F.3d 614, 626 (5th Cir. 2006), revg. 120 T.C. 358 (2003) for the proposition that "[p]roperty included in an estate is valued as of the date of the decedent's death, and subsequent post-death events relating to the property being valued generally are to be disregarded." The court then noted that "subsequent events which are reasonably foreseeable as of the valuation date may be considered because they would be foreseeable by a willing buyer and a willing seller, and they therefore would affect the valuation of the property as of the date of death."

The court noted that the four valuation methods utilized by the various experts were (1) a secondary public offering of the estate's Reliance shares, (2) a private placement with a third party or a sale under SEC Rule 144A (hereafter private placement), (3) a Reliance repurchase, and (4) open market public sales subject to the SEC Rule 144 sales restriction (dribble out). For various reasons, the court rejected the first two methods, finding that "as of the valuation date a disposition of the estate's Reliance shares through either a secondary public offering or a private placement was not likely."

With respect to the third valuation method, the court agreed that a repurchase by Reliance was reasonably foreseeable but that, contrary to the view of the government's expert, it did not believe that it was reasonably foreseeable that Reliance would purchase 50% of the estate's shares. The court concluded that, "[a]fter evaluating the history of Reliance's repurchases and the valuation date financial and business conditions of Reliance, and understanding that valuation is inherently imprecise", it was reasonably foreseeable that Reliance would be willing and able to repurchase only 20% of the estate's shares. The court did, however, utilize the 13.9% repurchase discount that was determined by the government's appraiser.

Finally, the court determined that the balance of the estate's shares (approximately 2.9 million) should be valued under the "dribble-out" method. After adjusting for its holding that 20% of the estate's shares would be repurchased, the dribble-out period for the reduced number of shares was shortened from 39 months to 31 months. The court valued these shares at the mean trading price at the date of death plus estimated dividends that would be paid during the dribble-out period less a 13.2% discount. This actually represented a 14.2% discount from the date of death value. The repurchase valuation of 20% of the stock and the dribble-out valuation of the balance represented an overall 14.2% discount from the mean trading price at the date of death value. This contrasts

with the 20.7% discount from the mean trading price claimed on the return as filed, the 8% discount allowed on audit, the 17% discount determined by the estate's 2nd appraiser and the 9% discount determined by the government's expert.

Note – With respect to the actual sale of 63% of the estate's holdings less than 5 months after the date of death, compare Estate of Helen M. Noble v. Commissioner, T.C. Memo. 2005-2 where the court held that a sale of closely held stock to a strategic buyer 14 months after the date of death was determinative (after a 3% inflation adjustment) of fair market value at the date of death where there were no material changes in circumstances.

Mary C. Davis v. United States, 491 F.Supp.2d 192, United States District Court for the District of New Hampshire (2007)

The decedent had the good fortune to win the Massachusetts lottery but died a resident of New Hampshire after receiving 10 out of 20 annual payments of $209,220. On audit, the estate agreed that the remaining lottery payments were properly valued under §7520 and the published annuity tables at a total present value of approximately $1.6 million. The estate, however, subsequently filed a claim for refund on the grounds that the annuity tables fail to take into account the non-transferable character of the right to receive the future payments. It sought to reduce the includible value of the future lottery payments to approximately $800,000 based on a 50% discount to account for the lack of marketability of the annuity.

The case first came before the U.S. District Court for the District of New Hampshire in 2005 on cross-motions for summary judgment. At that time, the court found that "the annuity tables (1) do not take into account a "lack-of-marketability" factor in calculating an annuity's present value, (2) that the fair market value of a nonmarketable annuity is necessarily less, to some degree, than its present value, and (3) that the IRC annuity tables are not necessarily an accurate measure of a non-marketable annuity's fair market value." The court was unwilling, however, to conclude that an alternate method of valuing the lottery payments must be used. It found that the use of the annuity tables to value the lottery payments is not necessarily improper and, in fact, that the tables must be used unless "the difference between the value yielded by the IRC tables and the value determined by an alternate valuation method is sufficiently substantial to warrant the conclusion that the IRC annuity tables produce an "unreasonable and unrealistic" value." Since the parties had not agreed upon a value under a different method of valuation, there was a material and genuinely disputed fact (i.e., the FMV of the payments under another valuation method). Hence, both motions for summary judgment were denied and the resulting trial produced this decision.

The court first pointed out that the "property" subject to valuation was "the estate's enforceable and virtually risk-free (albeit non-assignable) right to receive 10 annual payments of approximately $209,000 from the Commonwealth." The question, therefore, was "[h]ow much would a willing and fully informed hypothetical buyer pay for a legally enforceable, virtually risk-free, right to receive 10 annual payments of roughly $209,000 that cannot be assigned to a third party?" The court found that the estate's appraiser did

not attempt to answer that question. Rather, the appraiser attempted to calculate the amount for which the estate could sell the annuity. The court found that the assumptions underlying the appraiser's report were incorrect and that the question that should be addressed is "how much that hypothetical buyer would pay to stand in the shoes of the estate."

The government's experts argued persuasively that the hypothetical buyer "of a virtually risk-free, but non-assignable, right to receive 10 annual payments from the Commonwealth would be willing to pay something very close to the present value of those 10 payments." Actually, one of the government's experts argued that, because the income stream from the annuity is "as close to a risk-free investment as one might imagine, a hypothetical buyer might even pay more than value computed under the annuity tables.

The experts for the government also argued that the right to receive the lottery payments is substantially similar to annuities sold by insurance companies and, despite the lack of a secondary market for these annuities, this "lack of liquidity does not appear to affect the price at which insurance companies sell those annuities or the price that annuity buyers are willing to pay." Additionally, the experts pointed out that the "tables provide an accurate estimation of the fair market value of an annuity, taking into consideration the many variables that would affect an individual annuity's value (e.g., financial strength of the issuing company, risk of default, etc.) and, if anything, those tables may actually *under*-estimate the fair market value the estate's annuity."

Based on the record, therefore, the court concluded that "the non-assignable nature of the estate's annuity has a minimal (if any) effect on its fair market value." The court found that the lack of assignability of the lottery annuity would result at most in a 5% discount but it ruled that this was not sufficient to render the IRS computation "unrealistic and unreasonable." Thus, the case was distinguishable from both Shackleford v. United States, 262 F.3d 1028 (9th Cir.2001) where the court found that the value of the lottery annuity was 50% less than the value determined under the tables and Estate of Gribauskas v. Comm'r of Internal Revenue, 342 F.3d 85 (2d Cir.2003) where the government inexplicably conceded that the estate's 30% discount accurately reflected the market discount attributable to the transfer restrictions. In the instant case, the government made no such concession and, additionally, it "introduced two expert reports that credibly conclude that the fair market value of the estate's annuity is *not* substantially reduced by virtue of its lack of marketability."

The court held, therefore, that "[e]ven if the IRC tables are, in this particular case, off by as much as five percent (5%), plaintiff has failed to demonstrate that such a relatively minor discrepancy is sufficient to warrant the conclusion that the value those tables ascribe to the decedent's annuity is "unrealistic and unreasonable." Hence, the plaintiff s "failed to carry her burden of demonstrating that the estate's annuity should be valued by some method other than reference to the IRC tables." Accordingly, the lottery annuity was found to be includible at the value computed under the tables or $1,607,164.

Tincy Anthony v. U.S., No. 07-30098, U.S. Court of Appeals for the Fifth Circuit (2008)

As a result of serious injuries sustained in an automobile accident, the decedent had agreed to a structured settlement under which he became the beneficiary of three non-assignable annuities. On the decedent's death in 1996, his estate reported the value of the remaining payments due under the annuities at some $2.3 million based on valuations using the annuity tables prescribed by IRC §7520. The estate subsequently filed a claim for refund alleging that the annuities should have been valued without regard to the annuity tables because the non-transferability provisions rendered the annuities subject tom a restriction within the meaning of Treas. Regs. §20.7520-3(b)(1)(ii). The claim was denied and in 2002 the district court granted the government's motion for summary judgment, holding that the prohibitions on assignment of the annuities did not justify a departure from the tables. The district court also found that the result produced by the annuity tables was not unreasonable or unrealistic. Therefore, the district court found that the annuities were properly valued under the tables and no tax refund was due.

In an opinion that relied extensively on its prior decision in Cook v. Commissioner, 349 F.3d 850, 854 (5th Cir. 2003), the Fifth Circuit affirmed. The court noted that the fair market value of an annuity is generally determined under the annuity tables and that, in requiring valuation by use of the actuarial tables, "Congress displayed a preference for convenience and certainty over accuracy in the individual case." The court observed that there are certain limited situations when the tables result in a value that is unrealistic and unreasonable in which other valuation methods may be used. In addition to this case law exception to the use of the tables, Treas. Regs. §20.7520-3(b)(1)(ii), effective with respect to estates of decedents dying after December 13, 1995, provide an exception to the tables for "restricted beneficial interests." A "restricted beneficial interest" is defined as "an annuity, income remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances."

The court noted that its decision in Cook is the Fifth Circuit's "definitive interpretation of the law governing departure from the annuity tables as it existed prior to December 13, 1995" and that decision pointed out that courts had departed from the valuation tables under the "unrealistic and unreasonable" standard "only when individual cases involved facts substantially at variance with factual assumptions underlying the tables." In Cook, the court declined to depart from a rule requiring valuation under the tables unless a case involved facts that disproved the assumptions underlying the tables.

The estate argued that, even though Cook addressed a nearly identical issue, its appeal should be governed by the "restricted beneficial interest" exception to the tables. The court then embarked on a detailed review the language of Treas. Regs. §20.7520-3(b)(1)(ii) and the Treasury Decision (T.D. 8630) that accompanied the final publication of the regulation. It concluded that, in promulgating the regulation, the Treasury

Department formalized existing case-law exceptions that applied to valuation under the annuity tables.

The court explicitly declined to adopt a non-marketability exception to the use of the annuity tables and stated that it would follow the Tax Court's rationale in Estate of Gribauskas v. Commissioner, 116 T.C. 142, 164 (2001), rev'd, 342 F.3d 85 (2d Cir. 2003), endorsed by Cook, that "a restriction within the meaning of the regulation is one which jeopardizes receipt of the payment stream, not one which merely impacts on the ability of the payee to dispose of his or her right thereto." It held, therefore, that the decedent's annuities were not "restricted beneficial interests under the regulation.

Finally, the estate argued that, even if the "restricted beneficial interest" exception does not apply, the valuation of the annuities under the tables was still inappropriate because the tables produced an "unrealistic and unreasonable" result. The estate's valuation was approximately 50% less than the value under the tables. The court found that the estate relied entirely on the "marketability restrictions to demonstrate a disparity between the alleged fair market value and the value under the tables." It held that this basis for departure under the "unrealistic and unreasonable" standard -- for purposes of valuing a private annuity -- was foreclosed by Cook where the court refused to depart from the annuity tables despite a significant disparity between the result under the tables and the alleged market value. It noted that its refusal to do so in Cook was due to the same non-marketability factor that was present in this case. Hence, the results produced by the tables were not "unrealistic and unreasonable" and the district court's decision was affirmed.

Note - Following the decision, the estate filed a petition for writ of certiorari, arguing that the Fifth Circuit's decision in this case along with its prior decision in Cook v. Commissioner of Internal Revenue, 349 F.3d 850 (5th Cir. 2003), conflict with the Ninth Circuit's decision in Shackleford v. United States, 262 F.3d 1028 (9th Cir. 2001), and with the Second Circuit's decision in Estate of Gribauskas v. Commissioner of Internal Revenue, 342 F.3d 85 (2nd Cir. 2003). The Justice Department then filed a brief with the U.S. Supreme Court arguing that the Fifth Circuit correctly affirmed the district court's holding that the annuity tables in §7520 were properly used to value nontransferable private annuities for estate tax purposes and has insisted that Supreme Court review is unwarranted.

On October 6, 2006, the Supreme Court denied the estate's petition for writ of certiorari.

Revenue Ruling 2008-35

The taxpayer entered into a restricted management account ("RMA") agreement with a bank. During the term of the agreement, the bank would have complete discretion regarding investment of the RMA assets. All dividends, interest and other income would be retained and reinvested and no distributions of income or principal would be made during the term of the agreement. The term of the agreement was 5 years and was subject to extension at any time by agreement of the taxpayer and the bank. During the term of

the agreement, the taxpayer, with the consent of the bank, could assign or transfer all or any part of the RMA to a "permitted transferee" (i.e., a spouse, parent or descendant of the taxpayer). In the event of any such assignment, the bank would create a separate RMA in the name of the transferee and would select the assets (equal in value to the amount designated by the taxpayer) to be transferred. The terms of the original agreement would apply to any such new RMA. In the second year following the creation of the RMA, the taxpayer assigned 1/6 of the RMA to a child. In the third year, the taxpayer and the bank agreed to a 2-year extension of the original 5-year term of the RMA and, in the fourth year of term, the taxpayer died.

After first summarizing §§2511, 2512, 2031, 2036 and 2703, the Service then cited Smith ex. rel. Estate of Smith v. United States, 391 F.3d 621, 628 (5th Cir. 2004) in which the court concluded that, in determining the estate tax value of retirement accounts that could not be sold, "[a]pplying the [willing buyer-willing seller] test appropriately . . . entails looking at what a hypothetical buyer would pay for the assets in the Retirement Accounts." Accordingly, no discount was allowed for the anticipated income tax that would be incurred if the assets were distributed to the account beneficiaries. The ruling also noted Estate of Kahn v. Commissioner, 125 T.C. 227, 237-240 (2005) in which the court reached a similar conclusion and denied a marketability discount with respect to an individual retirement account.

The Service then concluded that the interposition of the RMA agreement to manage the taxpayer's assets did not reduce either the fair market value of the transferred property for gift tax purposes or the fair market value of the property included in the gross estate for estate tax purposes. It found that the taxpayer at all times retained a property interest under applicable law in the assets in the RMA and that the bank had no such interest in any of the assets. Notwithstanding the restrictions on the taxpayer's ability to withdraw assets from the RMA and on the taxpayer's ability to terminate or transfer an interest in the RMA (in this case, to anyone other than the natural objects of the taxpayer's bounty), the taxpayer remained as the sole and outright owner of the assets in the RMA and the income from those assets. The taxpayer did not change the nature of his property by entering into the RMA agreement. Consequently, the assets held in the RMA constitute the property to be valued for gift and estate tax purposes.

The Service found that any restrictions imposed by the RMA agreement related primarily to the performance of the management contract (e.g., by establishing and ensuring a long-term investment horizon to be pursued by the manager, and an appropriate fee in light of this circumstance), rather than to substantive restrictions on the underlying assets held in the RMA. Any restrictions on the ability to withdraw assets, terminate the agreement, or transfer interests in the RMA did not impact the price at which those assets would change hands between a willing buyer and a willing seller and, thus, did not affect the value of the assets in the RMA. In this regard, the Service concluded that the RMA was comparable to the retirement fund and the individual retirement account at issue in the Smith and Kahn cases in which the fair market value of assets within a particular type of account was held to not be affected by the value of those assets in the hands of the ultimate beneficiary. The Service also found that the situation presented with respect to

the RMA was similar to that presented where the owner of a parcel of rental real estate enters into a contract with a property manager relating to the management of that property. The existence of the management contract has no effect on the fair market value of the real property subject to that contract.

In addition to the above analysis under §§2511, 2512, and 2031, the Service found that other Internal Revenue Code sections applied in determining that the amount subject to federal transfer tax is the fair market value of the assets in the RMA. Specifically, §2036 applied to the taxpayer's retained interest in the assets of the RMA and §2703(a)(2) applied to disregard the restrictions on the sale or use of property for federal transfer tax valuation purposes. Further, to the extent that the taxpayer has the ability to terminate the relationship with the bank under state law principles of agency, the amount subject to federal transfer tax is the fair market value of the assets in the RMA.

Based on the above analysis, the Service ruled that the fair market value of an interest in an RMA for gift and estate tax purposes is determined based on the fair market value of the assets held in the RMA without any reduction or discount to reflect restrictions imposed by the RMA agreement on the transfer of any part or all of the RMA or on the use of the assets held in the RMA.

Estate of Charles H. Murphy, Jr. v. United States, No. 07-CV-1013, United States District Court for the Western District of Arkansas (2009)

See prior discussion of this case at page 18 herein under **Family Limited Partnerships**.
Among the other issues before the court was the valuation of four (4) pieces of fine art. For these valuations, the estate had appraisals by two different appraisers while the Service had the fair market value conclusions of the Commissioner's Art Advisory Panel and appraisals by an outside expert. The valuations of each were as follows:

	Estate #1	Estate #2	Art Panel	IRS Expert	Court
Piece #1	150,000	170,000	185,000	850,000	185,000
Piece #2	50,000	45,000	100,000	150,000	50,000
Piece #3	42,000	30,000	150,000	350,000	42,000
Piece #4	50,000	85,000	90,000	275,000	90,000

The court found that the valuations of the Service's outside expert to be "out of line" with the other appraisals and "problematic". Consequently, it gave them "considerably less weight in determining the fair market value of the four works in dispute." As indicated above, the court accepted the Art Panel valuations of two of the pieces and the valuations of one of the estate's appraisers for the other two pieces.

Carol Negron et al. v. United States, No. 07-4460, United States Court of Appeals for the Sixth Circuit (2009)

Decedent #1 and Decedent #2 and another person won the Ohio Super Lotto. The two decedents died within one month of each other. At the time of their deaths in 1991, each decedent was entitled to receive 15 remaining payments. Under state law, the remaining lottery payments could not be assigned or used as collateral by the decedents. Each estate had the same executor and each returned the value of the remaining lottery payments at $2,275,867 based upon the amount it received as a lump sum distribution from the Ohio Lottery Commission which used a 9.0% discount rate in computing the amount of the distribution. The actual amount of the distribution to each estate was the net amount of $1,547,045 which was the gross amount of the distribution less withholding for federal and Ohio income taxes. IRS valued the remaining lottery payments at $2,775,209 for Decedent #1 and $2,668,118 for Decedent #2. These valuations were both based on §7520. The estates paid the additional the tax and filed claims for refund. The government and the estates filed cross-motions for summary judgment on the proper method of valuation.

In Carol Negron et al. v. United States, 502 F.Supp. 2d 682, the U.S. District Court for the Northern District of Ohio framed the issue as whether or not the annuity tables account for the fact that the estates' right to receive the annual lottery payments was a non-marketable asset. The court went on to take note of the split in the circuits on this issue. The 2nd Circuit and the 9th Circuit have each held that "the annuity tables do no accurately reflect the fair market value of future lottery payments because the tables fail to account for the annuities' lack of marketability." See Shackleford v. United States, 262 F.3d 1028 (9th Cir. 2001) and Estate of Gribauskas v. Commissioner, 342 F.3d 85(2d Cir. 2003). On the other hand, the 5th Circuit has ruled that lottery annuity payments are properly valued by reference to the IRC annuity tables. See Cook v. Commissioner, 349 F.3d 850 (5th Cir. 2003) and Estate of Donovan v. United States, 2005 WL 958403 (D. Mass. April 26, 2005) and Anthony v. United States, 2005 WL 1670697 (M.D. La. June 7, 2005).

The district court was "more convinced by the reasoning" of the 2nd and 9th Circuits on the issue, finding that "it makes fundamental economic sense that the transferability of an annuity would affect its fair market value." It ruled, therefore, that the estates successfully demonstrated that the valuation of the remaining lottery payments under the actuarial tables was "unrealistic and unreasonable." The court also found, however, that the estates had not yet satisfied the second requirement – "that there is a more reasonable and realistic means to determine fair market value." The court, therefore, granted the estate's motion in part and denied the government's motion. The government appealed.

The Sixth Circuit considered all of the lottery valuation the cases decided both before and after the December 13, 1995 effective date of Treasury Regulation §20.7520-3(b). It found that Anthony v. United States, 520 F.3d 374 (5th Cir. 2008) was the only circuit court case to consider whether a decedent's right to receive structured settlement payments, similar to non-assignable lottery payments, was a "restricted beneficial

interest" for the purposes of Treas. Reg. section 20.7520-3(b). In that case, the Fifth Circuit followed the Tax Court's interpretation of the regulation in Estate of Gribauskas v. Commissioner, 116 T.C. 142 (2001) and held that "annuities were not 'restricted beneficial interests' under Section 20.7520-3(b)." Additionally, the Sixth Circuit also found that the district court of Massachusetts has also agreed with the Tax Court's interpretation of Treas. Reg. section 20.7520-3(b) in Gribauskas and found that "[t]he 'restriction' on marketability of lottery earnings is not one which justifies characterizing the proceeds as a 'restricted beneficial interest' under the regulations." See Estate of Donovan v. United States, supra. In Donovan, the court found that the IRS annuity tables must be used unless they produce unrealistic and unreasonable results. It agreed with "the basic economic tenet that an asset subject to marketability restrictions is worth less than an identical asset without marketability restrictions." On the other hand, it agreed with Cook that "the IRS annuity tables did not produce an unreasonable result because non- marketability is an assumption underlying the IRS annuity tables."

The Sixth Circuit here concluded that "[t]he IRS properly used the IRS annuity tables to value the remaining lottery payments for estate tax purposes. The tables do not result in an unrealistic or unreasonable valuation, and departure from the tables is not justified or required." The court found that "[t]he "unrealistic and unreasonable results exception" ensures that the Treasury Regulations are given proper deference but are not applied when they would be arbitrary, capricious, or manifestly contrary to the statute." It ruled that the "district court incorrectly reasoned that the IRS annuity tables produced an unrealistic and unreasonable result because the transfer restrictions would affect fair market value." The court agreed with the Fifth Circuit decision in Cook "that the non-marketability of annuities is an assumption underlying the IRS annuity tables." It noted that the property right at issue was a legally enforceable, virtually risk-free right to receive annual payments that could not be assigned to a third party and that a marketability factor was not necessary to determine the value of a guaranteed income stream. The court found that the value of the decedent's interest at the time of death was readily ascertainable and fairly reflected by the present value of the remaining payments using the IRS annuity tables in effect on the date of death. The district court decision was, therefore, reversed and the case was remanded for proceedings consistent with this opinion.

Note – There is now an even split in the circuits on the issue of whether nonassignable lottery payments are properly valued under the IRS actuarial tables or whether that value needs to be reduced due to nonmarketability. The Fifth Circuit (Cook and Anthony) and Sixth Circuit (Negron) have upheld the use of the actuarial tables while the Second Circuit (Gribauskas) and the Ninth Circuit (Shackelford) have ruled that that the actuarial tables fail to account for lack of marketability.

Robert Grove Stone et al. v. United States, No. 07-17068, United States Court of Appeals for the Ninth Circuit (2009)

The estate had a 50% interest in 19 pieces of fine art that were returned at 50% of the values determined by Sotheby's less a 44% fractional interest discount based on an

opinion from FMV Opinions, Inc. (Carsten Hoffman, Managing Director). IRS adjusted the values of two of the paintings based on the findings of the Commissioner's Art Advisory Panel. The resulting deficiency was paid and the estate sought a refund claiming that IRS improperly valued the two paintings and improperly failed to apply a fractional interest discount.

In Robert Grove Stone et al. v. United States, No. 3:06-cv-00259 (United States District Court for the Northern District of California 2007), the court upheld the IRS values of the two paintings in dispute. The court was obviously impressed by the Commissioner's Art Advisory Panel and found the "panel's valuations based on comparable sales of similar paintings near the date of valuation to be extremely credible, as well as unbiased."

Next, the considered the claimed fractional interest discount. The government's expert witnesses were Michael Findlay (an art dealer and member of the art panel) and Karen Carolan[7] (Chief, Art Appraisal Services) and both testified that "while they were aware of sales of undivided interests in art occurring, none of these had ever occurred at a discount." Based on Mr. Findlay's long history of buying, selling and appraising art and Ms. Carolan's extensive art experience, the court found this to be "persuasive evidence that a hypothetical willing seller would not sell a fractional interest in art at a discount." The estate's expert, who was also unable to find any data concerning sales of fractional interests in art, based his discount determination partially on sales of undivided interests in real estate and limited partnerships holding real estate. The court, however, found this analysis to be unpersuasive and concluded that "a hypothetical willing seller of an undivided fractional interest in art would likely seek to sell the entire work of art and split the proceeds, rather than seeking to sell his or her fractional interest at a discount." Further, it held that the owner of a fractional interest "who, as dictated by the governing regulation, is under no compulsion to sell would either seek to sell the entire work of art -- with the consent of other co-owners or via an action to partition -- and take his or her appropriate share of the proceeds, or sell the partial interest at a price equivalent to his or her fair share of the proceeds of such a sale." It ruled that a "hypothetical willing seller would know that he or she had the right to partition and would therefore not accept any less for his or her undivided interest than could be obtained via partition."

The court concluded that the cost-to-partition discount must reflect legal fees to bring the partition action and, in the absence of any contrary evidence, it accepted the estate's $50,000 estimate. It also accepted Karen Carolan's testimony that an auction house would likely waive any appraisal fees because such fees "generally are recouped by charging a higher premium to buyers." Based on this testimony, the court found that appraisal costs should not be reflected in a cost-to-partition discount.

In summary, the court found that "a hypothetical willing seller who is under no compulsion to sell would seek to gain consent from other co-owners to sell the collection and divide the proceeds or, barring such consent, would bring a legal action to partition." Since the court concluded that it could not consider whether the co-owners would consent

[7] Karen Carolan retired from the Internal Revenue Service in 2009. Joseph Bothwell succeeded her as Chief, Art Appraisal Services.

to a sale, a "small discount" was appropriate for legal fees involved in a partition action but no appraisal fees should be allowed. It ruled that a 2% discount was appropriate for the actual costs of sale and that "some discount is appropriate to account for the uncertainties involved in waiting to sell the art until after the partition action is resolved."

After court-ordered negotiations failed, the estate asserted a total discount of 35% while the government argued that no discount was appropriate but agreed to a 5% discount "in a spirit of compromise." The court again pointed out that the "art market differs from that for micro-cap companies and other equity offerings" and that "collectors of art are often drawn to the aesthetics of a particular work of art, rather than viewing art simply as an investment vehicle." The court concluded that the estate had failed to meet its burden of proof and accepted the 5% overall discount (including the 2% in selling expenses and the $50,000 in legal fees) conceded by the government in its supplemental brief. It noted that this discount "appears to be relatively low" but that the estate failed to present any evidence that would support a larger discount. The court held, therefore, that the estate was entitled to only a 5% fractional interest discount.

The legal fees of $50,000 constituted approximately 1.8% of the estate's 50% interest in the art collection so, after allowance of this amount and 2% in selling expenses, only 1.2% of the remaining overall 5% discount was allocable to the uncertainties involved in waiting for the partition action to become resolved.

On appeal, the Ninth Circuit affirmed. It noted that the taxpayer bears the burden of proof in establishing entitlement to a fractional interest discount and that the district court had concluded that the estate's evidence "was neither probative nor convincing." The district court had pointed out the estate's expert's "total lack of experience with the art market; the dissimilar motives driving purchasers to acquire art, on one hand, and real estate or limited-partnership shares, on the other; and the unreasonably low appreciation rate and unreasonably high present-value discount rates [the expert] used in his cost-of-partition analysis." The Ninth Circuit concluded that the district court had not clearly erred in adopting the government's 5% discount rate.

Further Questions:

If you have additional questions or wish to discuss this topic further, you can contact: Ronald J. Adams, CPA, CVA, ABV, CBA, CFF, FVS, CGMA, Managing Director – Valuations, at (774) 719-2236 – office; or at (508) 878-8390 – mobile; or e-mail him at: **adams.r@foxboro-consulting.com .**

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