TAX COURT CASE UPDATE

Citation:

Estate of Louise Paxton Gallagher v. Commissioner, T.C. Memo 2011-148, June 28, 2011.

Overview:

The Tax Court determined the value of 3,970 membership units in a closely-held limited liability company after applying discounts for lack of control and marketability.

The Facts:

The decedent passed away on July 5, 2004. Included in her assets were 3,970 membership units in Paxton Media Group, LLC ("PMG" or "The Company"), a Kentucky limited liability company. The estate reported the value of these units at $8,800 per unit or $34,936,000 by relying on a valuation performed by PMG's president. The IRS issued a deficiency notice stating that the value of the units at the date of death was $49,500,000.

PMG was formed in 1896 as a newspaper publishing company that published one paper. By July 2004, The Company published 28 daily newspapers, 13 paid weekly publications, several specialty publications and it operated a television station. This was all accomplished by acquiring underperforming companies and improving their financial performance. The Company operated in small markets and dominated the print media in those markets reporting mostly local news.

After the IRS began its examination, both sides hired appraisers. The IRS's expert used a market and an income approach. He applied a discount for lack of control ("DLOC") of 17 percent to the income approach and a 31 percent discount for lack of marketability ("DLOM") to both approaches reaching a conclusion of value of $10,293 per unit, or $40,863,000. The estate hired two experts but only relied on the second for expert testimony. The estate's expert primarily relied on an income approach, to which he applied a DLOM of 30 percent. His market approach was used solely to support the value derived under the income approach. The estate's expert derived a value of $7,100 per unit, or $28,200,000.

There were a number of disagreements between the two experts and the decision consists of Judge Halpern's criticisms of both experts and his ultimate cobbling together of a final conclusion of value.

Discussion:

Date of financial information: The valuation date was July 5, 2004. The estate's expert used financial statements as of May 31, 2004 and guideline company data as of March 31, 2004 since the June 30 results would not have been known at the date of death. The IRS's expert used the June 30 company data as well as guideline company data. The Court agreed with the IRS's expert.

Adjustments to financial information: The IRS's expert made one adjustment for a gain on a divested newspaper. The estate's expert made this adjustment as well as several others that the Court found were unsupported and did not accept.

Guideline company method: The IRS's expert located 13 potential guideline companies and narrowed his selection to four companies. The Court did not accept this analysis as the companies selected were not "sufficiently comparable publicly held companies to warrant application of the guideline company method herein." Further, he stated, "As similarity to the company to be valued decreases, the number of required comparables increases in order to minimize the risk that the guidelines will be distorted by attributes unique to each of the guideline companies." In conclusion he stated, "We find that Mr…. improperly relied on the guideline company method because the four guideline companies alone were not similar enough to PMG to warrant its application." Since the estate's expert did not rely on this methodology, there was no discussion of it.

Discounted cash flow method: Both experts used this method in their valuations, however there were many differences between them. They disagreed on the projections, whether to tax-effect the earnings, cash flow adjustments, the amounts to be included in the rate of return, earnings adjustments to PMG's enterprise value, and the nature and amount of applicable discounts.

Overall, the judge disregarded almost all of what the estate's expert did in his report, and he stated throughout his decision that certain decisions and conclusions were unsupported. One area of great interest to readers is the issue of tax-effecting Subchapter S corporations. The estate's expert applied a tax rate to the income stream and added a premium to the overall value conclusion for the benefits of owning an interest in a Subchapter S corporation. However, he provided no support or explanation for these adjustments. The IRS's expert did not tax-effect at all. Needless to say, due to the lack of support provided by the estate's expert and the position taken by the IRS's expert, Judge Halpern stuck with the position that the Tax Court has taken in all of these cases – tax-effecting is not appropriate.

Although the judge did not agree with all of the decisions made by the IRS's expert, overall he seemed to find his valuation more credible. As a matter of fact, he accepted the IRS's expert's use of a discount for lack of control, but the judge increased the amount from 17 percent to 23 percent due to the judge's interpretation of the data. Regarding the discount for lack of marketability, both experts relied on restricted stock studies: one expert used a 30 percent discount while the other used a 31 percent discount. Although the judge did not approve of the use of the restricted stock studies for the discount, he allowed a 31 percent discount given both experts' reliance on the data and similar conclusions.

Conclusion:

Based on the evidence submitted and the changes that the judge made, he ruled that the value of the shares was $32,601,640. Ironically, despite his disappointment with the estate's expert's valuation, his final conclusion of value was closer to the estate's amount than the IRS's amount.