

## **TAX COURT CASE UPDATE**

### **Citation:**

*Estate of Helen P. Richmond, et al. v. Commissioner*, T.C. Memo 2014-26, February 11, 2014.

### **Overview:**

The Tax Court, using a net asset value method and then applying various discounts, has determined that a decedent's 23.44 percent interest in a family-owned personal holding company was worth over \$6.5 million for estate tax purposes. The Court rejected the estate's lower value, which was determined using a capitalization of dividends method.

### **The Facts:**

At the time of her death on December 10, 2005, Helen P. Richmond (the decedent) owned a 23.44 percent interest (consisting of 548 shares) in Pearson Holding Co. (PHC). The estate reported the value of this interest at \$3,149,767. Before the Tax Court, the estate asserted that the proper value was \$5,046,500, while the IRS claimed that the correct value was \$7,330,000 (the notice of deficiency claimed a value of \$9.2 million rounded). The IRS also asserted a 40 percent gross valuation penalty, which was reduced to a 20 percent substantial valuation penalty at trial.

As of December 2005, PHC had 2,338 shares of common stock outstanding. Those shares were held by 25 members whose interests ranged from 0.17 percent to 23.61 percent. The three largest shareholders (which included the decedent) owned a total of 59.20 percent of the shares.

Through the date of the decedent's death, PHC followed its stated philosophy of maximizing dividend income, and PHC paid dividends reliably at a rate that, in the years from 1970 through 2005, had grown slightly more than 5 percent per year. Because of this philosophy, PHC did not "churn" its portfolio and at the date of death, 87.5 percent of its gross portfolio value of approximately \$52 million was unrealized (built-in) gains.

The estate retained an accounting firm to value the PHC stock for estate tax purposes. After examining information provided by the estate and other information, the estate's accountant prepared a draft report that valued the decedent's interest in PHC at \$3,149,767, using a capitalization of dividends method. He provided the unsigned draft of the valuation report to the executors and to the return preparer, but he was never asked to finalize his report. Without further consultation with the accountant, the estate reported the value of the decedent's interest in PHC as \$3,149,767 on the estate tax return. The accountant had performed 10 to 20 valuations, but did not have a business valuation credential.

At trial, the IRS's expert presented the decedent's interest in PHC by using a discounted net asset method. Using PHC's stipulated net asset value (NAV) of \$52,114,041, he calculated the decedent's 23.44 percent interest by applying a discount of 6 percent for lack of control, and a 36 percent discount to adjust for both the lack of marketability and the built-in capital gain tax

(BIG tax).<sup>1</sup> Overall, he applied a 40 percent discount, resulting in the value of the decedent's 23.44 percent interest in PHC of \$7,330,000.

At trial, the estate put forth a new expert. He relied solely on the capitalization of dividends method and then deducted an 8 percent discount for lack of control, a 35.6 percent discount for lack of marketability and 100 percent of the built-in gains tax (approximately \$18.1 million). The computations resulted in a value of approximately \$5 million.

### **Discussion:**

The Court observed that the theory behind the income capitalization valuation method is that if an asset produces a predictable income stream, the market value of the asset can be ascertained by calculating the present value of that future income stream. PHC did have a history of reliably paying out dividends, and, over the preceding 35 years, its distributions had increased by about 5 percent per year. However, the Court said that dividend capitalization is only one method for valuing a business, and that such a method may be entirely appropriate where a company's assets are difficult to value. But in this case, that method ignored the most concrete and reliable data of value that were available, i.e., the actual market prices of the publicly traded securities that constituted PHC's portfolio, which the Court believes are valued by the market based on the income approach.

Furthermore said the Court, the estate's method assumed that the only thing a potential investor would consider when contemplating whether to buy PHC stock was the present value of the dividend stream that the stockholder could expect to receive. However, in December 2005, a potential investor would have known that, as the parties had stipulated, PHC's portfolio consisted primarily of securities whose values could have been computed without controversy to total \$52 million. Therefore, the Court relied solely on the net asset value method.

In computing the final value, the Court looked at the computations of both experts and agreed with neither. The IRS's expert used a methodology based on closed-end funds to calculate the BIG tax that the Court found "questionable," and therefore, did not accept.

Despite both the 5<sup>th</sup> and 11<sup>th</sup> Circuit Courts of Appeals accepting dollar-for-dollar discounts, the Court stated the following:

The seller of the company with the contingent future liability would demand a higher price than the seller of a company with the unconditional current liability. As a result, despite contrary holdings by some courts, we find that a 100% discount would be unreasonable, because it would not reflect the economic realities of PHC's situation.

The Court's analysis was based on recommendations to PHC to sell its assets on a more regular basis. The IRS's expert testified, and the Court agreed, that a potential investor would expect PHC's portfolio to turn over within 20 to 30 years, and calculated the tax liability based on this assumption (by discounting the future annual tax liabilities). The Court's calculation approximated the calculation of the IRS's expert, so the Court deducted a 15 percent discount for the BIG tax.

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<sup>1</sup> Consists of a 26.4 percent discount for lack of marketability and a 15 percent discount for the built-in gains tax.

Both experts used closed-end funds to support their discounts for lack of control. The IRS's expert used the average discount of 6.7 percent and reduced it to 6.0 percent based on specific factors related to PHC. The estate's expert selected the median discount of 8.0 percent. The Court disagreed with both experts, removed three outliers from the same dataset and used the average discount of 7.75 percent.

For the discount for lack of marketability, both experts used restricted stock and pre-IPO studies and found a range of discounts from 26.4 to 35.6 percent. The IRS's expert selected a discount at the low end of the range, while the estate's expert selected a discount at the high end of the range. The Court selected the average discount of the range of 32.1 percent.

In its analysis of the understatement penalty, the Court stated:

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

The Court concluded, "even by the estate's lights, the value on the estate tax return needed explaining, but no explanation was given."

**Conclusion:**

The Tax Court ruled that the fair market value of a holding company is better determined using a net asset value method rather than an income approach method, and assessed a 20 percent accuracy-related penalty under Internal Revenue Code Section 6662.