TRUGMAN Valuation

VALUATION Trends

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Improper Use of Active/Passive Framework Skewers Valuation

Bair v. Bair

When confronted with quantifying the appreciation of nonmarital property, it is common for valuators to first classify the change in value as "active" or "passive" and then to do the valuation. A Florida case shows that, when applied prematurely, this active/passive analysis may result in an improper valuation.

The parties fought over the valuation of the husband's interest in a boat dealership—a family business that was organized as an S corporation. The corporation also owned real property whose value had dropped significantly during the relevant portion of time.

The parties agreed that the husband's ownership interest was separate property. They also agreed that the husband's efforts had contributed to an increase in the company's value during the marriage. But they disagreed over how much the company had appreciated in value and how much of the appreciation was the result of the husband's marital labor. The trial court adopted the company valuation that the wife's expert proposed, which was about $1 million higher than the value determination of the husband's expert. Further, the court largely adopted the wife's expert's calculation of the marital labor.

On appeal, the husband contested a number of the trial court's valuation-related findings. The wife's expert had "refused to include" the value of the real property in his company valuation, arguing that the change in value of this asset was passive in nature, that is, the result of market forces rather than the husband's management.

The husband claimed that excluding a major asset of the corporation from the valuation was a serious error of law that necessitated a reversal of the equitable distribution decision. The Court of Appeal sided with the husband. Florida law requires that the valuation of a company include all of the company's assets and liabilities, the reviewing court explained. "In other words, the sum of all parts, not a select few, is what encompasses a business's 'value.'" Further, it is improper to exclude the appreciation or depreciation of certain company assets as "passive" when one party's marital labor contributed to the change in value of the company as a whole, as was the case here, the appeals court emphasized.

Had the husband, rather than the company, owned the real estate, the concept of active or passive appreciation might come into play, the appeals court said. In that situation, the passive appreciation or depreciation might be excluded from the term "marital assets." Here, however, the owner was the company, which the husband's marital labor "indubitably" increased. By excluding the real estate from the valuation of the company, the trial court overvalued the company by almost $1 million, the appeals court said.

The Court of Appeal also agreed with the husband that the trial court's valuation double-counted retained earnings in favor of the wife. The trial court had discretion to value the company by including the retained earnings and

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distributing that value. “But having done so, it could not then order distribution of the retained earnings while still valuing [the company] as if the retained earnings were retained as this would result in impermissibly including the same asset twice.”

The appeals court also noted the trial court did not seem to understand what retained earnings were; it considered them to be “some type of corporate savings account, which it is not.” The trial court acted as if the husband, “unquestionably a minority shareholder,” had a direct interest in the retained earnings and could simply order their distribution, when this was not the case, the appeals court said. The Court of Appeal remanded for a new valuation.

Eleventh Circuit Affirms Tax Court’s Valuation of Trust’s Interest in LLC

Estate of Koons v. Commissioner (Koons II)

The 11th Circuit Court of Appeals upheld a 2013 Tax Court ruling in an estate and generation-skipping tax case that centered on the fair market value of a revocable trust’s interest in an LLC. The crux of the valuation was the marketability discount.

In connection with a major asset sale in late 2004, the decedent formed a limited liability company (“LLC”) and made a will under which he left the residue of his estate to a revocable trust. At the time of death, the trust owned a 50.5 percent interest in the LLC. The decedent’s children who were shareholders in the company conditioned their agreement to the deal on the LLC’s redemption of their shares. All accepted the LLC’s redemption offer before the decedent died in March 2005. The offer closed in April 2005, which increased the trust’s interest to a 70.93 percent interest. The LLC’s net asset value was about $317.9 million.

The estate stated that the fair market value (“FMV”) of the trust’s interest in the LLC at the time of death as $117.2 million. The Internal Revenue Service found an estate tax deficiency of nearly $42.8 million and a generation-skipping transfer tax liability of nearly $15.9 million. It later increased the deficiency. The estate and the trust petitioned the Tax Court for review. Both sides presented testimony from highly experienced valuators.

The estate’s expert used a regression analysis involving 88 companies that produced an initial DLOM of 26.6 percent. Based on differences the expert perceived between the LLC and the 88 companies, he increased the DLOM rate to 31.7 percent, which reduced the FMV to about $110 million.

The IRS’s expert found that a regression analysis was not a reliable tool in this instance. Instead, he considered the characteristics of the LLC and determined that a 7.5 percent DLOM was appropriate. Importantly, he assumed the risk the redemptions would not go through was small. Owning a majority interest, the revocable trust would be able to force the LLC to distribute most of its assets once the redemptions closed. The Tax Court agreed with this key assumption. A hypothetical seller would expect to be able to force a distribution of most of the LLC’s assets, the court concluded. The majority interest holder would receive about $140 million in a distribution, the court found. Since the estate’s expert valued the interest below that amount, the IRS expert’s $148.5 million valuation was more credible.

On appeal, the estate challenged the Tax Court’s value conclusion on various grounds. One argument was that the valuation was based on the mistaken assumption that the decedent’s children would redeem their LLC interests. The Court of Appeals agreed with the Tax Court that there was sufficient evidence that the redemption was virtually certain at the time of the decedent’s death.

Further, the estate contended that the Tax Court had improperly disregarded the estate expert’s regression analysis, “a proven and scientifically valid method for determining marketability,” and ignored other flaws in the IRS’s valuation.

According to the 11th Circuit, the Tax Court’s assessment of expert testimony was less concerned with the specifics of methodology (though the court considered them) than with a larger issue: whether a hypothetical seller would anticipate being able to force a distribution of the majority of the LLC’s assets. The IRS expert held this view, as did the Tax Court. The estate’s expert did not. The estate failed to show that the Tax Court was wrong regarding this issue, the Court of Appeals said.

New Jersey Court's Inadequate Goodwill Ruling Triggers Rebuke and Remand

Slutsky v. Slutsky

A New Jersey appellate court rebuked the trial court for its defective valuation rulings surrounding the goodwill component attached to the owner spouse's equity interest in a law firm.

The husband, who specialized in complex tax matters, became an equity partner in 1984. He did not generate work but distinguished himself by working hard and accumulating billable hours. The firm calculated the value of the partners' interests by way of a termination credit account (TCA). Once a partner turned 65, the board had discretion to decide whether the partner could continue to participate in the allocation of the firm's excess income system or was moved to senior status, which meant to a salaried position.

The wife's expert decided that there was a separate goodwill interest in the husband's firm ownership of about $1.18 million. The husband's expert disagreed. Instead, he concluded that the husband's TCA alone represented the "true" value of the husband's interest.

The trial court said it was "incredible" there was no goodwill in the firm and adopted the value conclusions the wife's expert had submitted in his initial report, but had later corrected because of admitted errors. The appellate court called down the trial court for failing to analyze the facts and support its conclusions, as well as for obvious inconsistencies in the trial court's findings. Further, the trial court seemed to misunderstand the conclusion that the husband's expert reached regarding goodwill. It wasn't that the firm had no goodwill, but that there was no additional goodwill component to the husband's interest, the appellate court explained.

The appellate court reversed and remanded. Goodwill is a "complex question," and this case in particular required a "nuanced methodology," the reviewing court said. To "aid" the lower court on remand, the appellate court provided a review of New Jersey goodwill jurisprudence and alerted the lower court to crucial differences between the instant case and the controlling case law. It also ordered the case reassigned to a new trial judge.

In Controversial Move, Tax Court Tackles 'Double Inclusion' Problem

Estate of Powell v. Commissioner

Given the unfavorable optics of a recent case, the Tax Court's finding that the value of assets transferred from the decedent to a family limited partnership was includible in the value of the decedent's gross estate is not surprising. What makes the decision noteworthy is that a majority of judges, on their own, came up with a novel theory of calculating the includible amount, ostensibly to prevent double inclusion. A group of judges, concurring in the result only, opposed the majority's activist approach.

One day after doctors declared the decedent incapacitated, one of her sons acting as trustee, transferred cash and securities to a family limited partnership ("FLP") in exchange for a 99 percent limited partner ("LP") interest. That same day, under a power of attorney, the son then transferred the decedent's 99 percent LP interest to a charitable lead annuity trust. The decedent died a week after the transactions. There were no business operations. The parties stipulated the transferred assets were worth $10 million.

In Tax Court, both sides filed summary judgment motions to resolve the dispute pretrial. The IRS presented a number of theories about why the value of the transferred assets was includible in the gross estate. The Tax Court ultimately found section 2036(a)(2) of the Internal Revenue Code applied because the decedent, acting with her sons, had the ability to dissolve the partnership and designate the beneficiary of the transferred property or the income from it.

The court's majority then launched into an extended discussion of how much value was includible. Concerned over "double inclusion," the majority invoked section 2043(a) to limit the amount includible under section 2036(a). It held that section 2036(a), when applicable, would include only the excess of the value of the transferred assets over the value of the partnership interest issued in return in the decedent's estate. Under this formula, it is not the full $10 million that would be brought back into the estate but only "the amount of any discounts allowed in valuing the partnership interest," the

court said. Here, the estate valued the decedent's limited partner interest at $7.5 million based on a prior appraisal that applied a 25 percent discount for lack of marketability and lack of control.

Writing for those who only supported the result achieved in the case, one judge said he saw no "double inclusion" problem. In the past, the court took a "straightforward path," which was to disregard a "transfer with a string" and simply include the value of the property before the transfer. This should have been done here. The majority's new theory was unnecessary in that neither party had advocated for it. This was "a solution in search of a problem."

Court in *Brundle* Case Sticks to Earlier ESOP Liability and Damages Rulings

Brundle v. Wilmington Trust N.A. (Brundle II)

Three months after ruling that the ESOP trustee was liable for causing the plan to overpay, the court had a chance to revisit its decision in the context of the trustee's motion for reconsideration. While the court admitted to some valuation-related errors, it concluded that those were nonconsequential. The most recent opinion does, however, suggest that a stronger trial presentation on the trustee's part might have made a difference.

In late 2013, the owners of a private security company sold their company stock by way of an unusual ESOP that allowed them to buy back equity in the company and keep control of it. The independent trustee and valuator had extensive ESOP experience, but the transaction has come under investigation by the Department of Labor.

In its March 2017 opinion, the court agreed with the plaintiff that the trustee had engaged in a prohibited transaction by causing the plan to pay more than fair market value for the stock. Had the trustee performed a more thorough review of the financial advisor's valuation, it would have questioned parts of the analysis and the value conclusion. The trustee should have picked up on red flags related to the reliability of management projections and the valuator's risk assessment, reflected in the 0.7 beta, as well as the use of a control premium in its guideline public-company analysis, the court said.

Only the plaintiff's expert had provided a comprehensive damages calculation, the court said. Lacking an alternative methodology from the trustee, the court adopted the plaintiff's calculation with modifications. It awarded the ESOP nearly $30 million in damages.

In its post-trial motion, the trustee assigned errors to the court's liability and damages findings. One error centered on the concept of beta, which the court initially took to mean a method "to assess the risk of [the company] relative to that of the industry overall." The trustee pointed out that three valuation experts at trial had explained that beta measured the risk of a particular industry relative to the risk of the market as a whole.

The court conceded error. At the same time, it noted its own understanding of beta was based on testimony by one of the trustee's key people, the person "most intimately involved" in the ESOP. He had said beta was "a measure of a company's volatility compared to the market." That this witness had not known any better "reinforces the Court's conclusion on liability, rather than undermining it," the court said. The trustee was equally unsuccessful in challenging the court's damages calculation. The trustee belatedly tried to introduce a new theory on damages that would result in a methodological dispute that should have played out at trial, "rather than afterwards," the court said. To explore this dispute at this late stage in the litigation would require the court to reopen the fact-finding process, which it declined to do.

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