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VALUATION ISSUES™

KLARIS, THOMSON & SCHROEDER, INC.

2014-2

United States Tax Court Case Summary T.C. Memo 2014-26

Estate of Helen P. Richmond, Petitioner Versus Commissioner of Internal Revenue, Respondent Judge Gustafson

By: Mr. John A. Thomson, ASA, MAI

Subject

A 23.44% interest in a Family-Owned personal holding company (“Pearson Holding Company” or “PHC”), whose assets consisted primarily of publicly traded stock. The subject interest was PHC’s second largest shareholder (The largest was 23.61%). There were 25 shareholders and it was a “C” corporation.

Issues:

1. *Method of Value*

Capitalization of dividends or Net Asset Value (NAV).

2. *Accuracy-related penalty*

Opinion

NAV is the correct method. The value is \$6,503,804 and a 20% accuracy-related penalty is applicable.

Background

PHC was incorporated in Delaware in January 1928. It originated as, and continues to be, a family-owned investment holding company. PHC is a “C” corporation.

Because the subject company is a “C” corporation and built-in capital gains tax (“BICG”) is a significant issue, the court pointed out that if the subject case was appealed, it would be in the third circuit not the 5th or 11th circuits².

As of December 2005, PHC had 2,238 shares of common stock outstanding. Those shares were held by 25 shareholders whose interests ranged from 0.17% to 23.61%, the three longest and largest shareholders (including the decedent) owned a total of 59.20% of the shares. The turnover of PHC’s securities had been slow for the 10-year period ending December 31, 2005, it was 1.4% per year. At that rate, a complete turnover of the securities would take 70 years. However, in 2005 a potential investor would have observed that the mindset of the Shareholders, owning a family Company, would more and more give way to an attitude that regards the PHC shares simply as an investment. The Court found, as the Commissioner’s expert

witness testified, a potential investor who considered purchasing PHC and would likely expect that approximately 20-30 years would pass before a complete turnover of the portfolio or a liquidation of the Company would occur.⁽¹⁾ As of December 2005, 87.5% of the value of the PHC’s portfolio consisted of appreciation on which capital gain tax would eventually become due upon sale of the appreciated securities.

The parties stipulated that, as of December 10, 2005, PHC held a portfolio with a value of \$52,159,430⁽³⁾ The parties also agreed that the capital gain tax liability “built-in” to that appreciation (but not yet due) was \$18,113,083. The NAV after deducting outstanding liabilities of \$45,389⁽⁴⁾ was \$52,114,041.

- (1) Mostly common stocks in 10 major industries.
- (2) Excluding BICG,

The estate retained a local CPA with limited valuation experience and no appraisal certification for the estate return valuation. Using a capitalization of dividends method, the CPA concluded \$3,149,767, which was reported with the Federal estate tax return. The IRS issued a statutory notice of deficiency on June 12, 2009 claiming that the value was

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\$9,223,658 but the IRS did not explain their methodology.

The Trial

At trial the commissioner offered John A. Thomson as an expert in business valuation. The court accepted Mr. Thomson as a business valuation expert and received his written report into evidence as his direct testimony. Mr. Thomson valued the decedent's interest in PHC by the cost approach, using a discounted Net Asset Method. Using PHC's stipulated NAV.

Mr. Thomson calculated the decedent's 23.44% interest of PHC to be \$12,214,925. He then applied a discount of 6% for lack of control and a 36% discount for lack of marketability (which included 21% for lack of marketability of private shares and 15% for BICG tax). Overall, Mr. Thomson applied a 40% discount resulting in a value of \$7,330,000 for the decedent's 23.44% interest in PHC.

The estate offered Robert Schweih as an expert in valuation. Additionally, the estate call Mr. Winnington (The CPA who prepared the valuation used for the Estate Tax return) as a fact witness but not a valuation expert.

Mr. Schweih valued the decedent's interest in PHC by relying primarily on the capitalization of dividends method, an income approach. Mr. Schweih concluded \$5,046,500 for the decedent's 23.44% interest in PHC.

Opinion

I Choice of Valuation Method

To value the decedent's interest in PHC, the Commissioner used the net-asset-value approach and the estate used the capitalization of dividends approach. The court stated, "we believe that the NAV approach better determines PHC's value."

The court believed the capitalization of dividends approach was entirely based on future estimates (economy, dividends, and performance) and a small change in growth could result in a large change in value.

II Discount for BICG Liability

The parties agreed that PHC's unrealized appreciation on its assets was \$45,576,677, which if the assets had

been sold on the date of death would have triggered a capital gain tax liability of \$18,113,083, assuming a 39.74% combined Federal and State Tax rate. The parties further agreed that the value of PHC should be discounted to some extent to account for the BICG Tax attributable to the unrealized appreciation. They disagreed on the amount of the discount.

The taxpayer's expert believed that the discount should be 100% of the BICG tax liability based on cases tried in the 5th and 11th circuit, (1) This would equate to 34.8% of the NAV. The IRS's expert believed the discount should be less than 100%. Mr. Thomson concluded the BICG tax to be 15% of NAV or \$7.8 million.

The court noted a 100% discount, illogically treats a potential liability that is susceptible of indefinite postponement as if it were the same as an accrued liability due immediately. As a result, despite contrary holding by some courts, we find that a 100% discount would be unreasonable because it would not reflect economic realities.

The court accepted Mr. Thomson's 15% discount (\$7.8 million dollars) but was not convinced of his methodology.

They looked at a reasonable holding period for the Portfolio of 20 to 30 years (as testified by Mr. Thomson) and discounted the tax liability at discount rates between 7% to 10.27% (based on the data in the expert reports). The Court's range of discounts was \$5.5 to \$9.6 million. This, they stated, supports Mr. Thomson's \$7.8 million, so we conclude \$7.8 million.

Discount for Lack of Control

The Commissioner's expert (Mr. Thomson) used a data set consisting of the Net Asset Values and trading prices of 59 closed-end funds for the week of December 9, 2005. He then analyzed the percentage difference between the net asset value and trading price (if negative, a discount; if positive, a premium). Overall, this methodology is sound and appears to be a reasonable way to calculate an appropriate discount associated with Lack of Control. The mean discount of all 59 data points was a 6.7% discount. Mr. Thomson concluded 6% based partially on the size of the interest and what he believed was outside management. The court adjusted the mean of

a discount of 6.7% to a discount of 7.75% based on removing three outliers and pointed out that PHC did not necessarily follow their outside advisors advice and therefore the court concluded 7.75%.

Discount for Lack of Marketability

Mr. Thomson used seven restricted stock studies for his basis for the marketability discount of 21%, the range of discounts being 26.4% to 35.6% with an overall mean of 32.14%. The estate unsuccessfully argued the higher IPO studies should be used. Although, the court accepted the restricted stock studies, the court was unconvinced the discount should be other than the average or 32.1%.

(1) Jelke, Dunn and Jameson.

Summary

The values in the case were as follows:

1. CPA's value filed with tax return \$3,149,767.
2. Taxpayer's revised opinion for trial \$5,046,500 (based on expert report of Schweih's).
3. IRS original opinion of \$9,223,658.
4. IRS revised opinion (based on expert report of Thomson) of \$7,330,000.
5. Court's Opinion of \$6,503,804.

On top of this, the court concluded that there was an additional 20% undervaluation penalty. The court noted that we cannot say 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. The CPA (Mr. Winnington) was not a certified appraiser.

We find a substantial valuation under statement for which there was no reasonable cause. □

¹As of December 2005, 87.5% of the value of the PHC's portfolio consisted of appreciation on which capital gain tax would eventually become due upon sale of the appreciated securities.

²Both of these circuits held 100% of the built-in capital gain taxes should be deductible.

Spotlight on the Los Angeles Office of Klaris, Thomson & Schroeder, Inc.

Published by: Anita Thomson

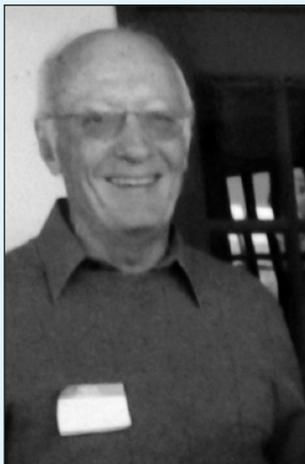


The Los Angeles office of Klaris, Thomson & Schroeder, Inc. is proud to announce Mr. Charles DeVinney, ASA, (Picture 1, on left, above), formerly with Grant Thornton, LLP, as the newest member of our team in Los Angeles, California.

Mr. DeVinney has experience in valuations for business combinations and purchase price allocations, stock based compensation, goodwill impairment, estate & gift tax planning, debt restructuring, and intangible assets. Litigation support engagements include economic damages analysis and shareholder disputes. In addition, he has experience in various industries including technology, medical devices, healthcare, financial services, manufacturing, and wholesale distribution.

Specialties include valuation of closely held and thinly traded securities, and intellectual property. In addition, Mr. DeVinney, ASA, also has strong skills in corporate finance, cash flow forecasting and financial modeling and has served as an expert witness on valuation and economic damages matters.

The Los Angeles office of Klaris, Thomson & Schroeder, Inc. is also proud to announce Mr. Douglas E. Braunstein (Picture 2, on right, above), JD, ASA, has been assisting and supporting many Los Angeles Business Valuation assignments. Mr. Braunstein has prepared controlling and minority interest valuations for numerous types of closely held businesses for purposes of estate planning, estate taxes, gift taxes, employee stock ownership plans (ESOPs), marital dissolution, business dissolution and corporate planning. Mr. Braunstein also has experience valuing intangible assets such as patents, royalties and website & domain names. □



In Memory

Published by: Anita Thomson

It is with great sadness that Klaris, Thomson & Schroeder, Inc. announces the passing of Mr. Tony Abel. Tony was a valued member of our team since 2003, and he will be missed.

Before joining Klaris, Thomson & Schroeder, Inc., Mr. Abel had been a Principal with the Valuation Services Group of Arthur Andersen LLP in their Los Angeles office. This association began in 1983. Prior to Arthur Andersen, Mr. Abel was a Valuation Consultant with Marshall & Stevens, Inc. He joined Marshall & Stevens in 1973. From 1965 to 1973, Mr. Abel was an Assistant Vice President in the Commercial Banking Division of Security Pacific Bank, which was subsequently merged into the Bank of America.

Mr. Abel was formerly certified by the American Society of Appraisers as an Accredited Senior Appraiser (ASA) specializing in business valuation. He is past President of the Los Angeles Chapter of the American Society of Appraisers (1989-1990).

Please keep Tony and his family in your thoughts as they go through this difficult time.

RIP Tony you will be missed but not forgotten. □

Recent Seminars and Speaking Engagements:		KTS Recent Engagements
8/28/14	Presentation-“Three Approaches to Valuing Closely Held Orthodontic Practices: Asset, Income, and Market,” Gary Schroeder, St. Louis University, St. Louis, MO	Valuation of the common stock of a turf farm for estate planning purposes.
9/6/14	Valuation of Automotive Service Providers at the Alliance of Automotive Service Providers (AASP) Convention, Gary Schroeder, St. Charles, MO	Valuation of intangible assets of a large coffee company for SFAS No. 141 purposes.
9/10/14	Joint Meeting-St. Louis Business Valuation Roundtable/St. Louis Chapter of ASA-“Family Law Cases Every Appraiser and Accountant Needs to Know.”	Valuation of a partial interest in a billiard association for trust and estate purposes.
10/15/2014	Presentation -Inside View of U.S. Tax Court with discussion on two Current Tax Court Cases (Estate of Diane Tanenblatt and the Estate of Helen P. Richmond.), John A. Thomson, ASA, MAI, Marriott Hotel, Long Beach, California for the LA ASA Chapter.	Valuation of a minority interest in a beach resort for estate tax purposes.
11/19/14	Joint Meeting-St. Louis Business Valuation Roundtable/St. Louis Chapter of ASA-“Partial Interest Valuation: Common and Not Common.”	Valuation of Class A voting and Class B non-voting common stock of a pipeline construction and maintenance company.
		Valuation of a fast food delivery franchise for SBA financing.
		Valuation of a candle company for SBA financing.
		Valuation of restricted stock and warrants for a medical device company.
		Valuation of an insurance agency and tax preparation agency for divorce purposes.
		Valuation of an excavating/landscaping company for divorce purposes.



**KLARIS,
THOMSON &
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is a national full service valuation and consulting company specializing in business valuations, intangible asset valuations, financial consulting, expert testimony and litigation support. In addition, we also perform real estate valuations, machinery and equipment valuations, and international transfer pricing analyses.

For more information or a free valuation seminar for your firm or professional group, please call Anita Thomson at (877) 587-7008, or e-mail your request to ktsinc@verizon.net.

– Henry Ford
*“Coming together is a beginning;
 keeping together is progress;
 working together is success.”*



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