Tax Court Case Update: What an Appraiser Needs to Know

GIBRALTAR BUSINESS APPRAISALS, INC.

Chris D. Treharne, ASA, MCBA, BVAL
Gibraltar Business Appraisals, Inc.
1325 Dry Creek Drive, Suite 201
Longmont, CO 80503
303.532.2545

American Society of Appraisers ASA

Today's presenter is neither an attorney nor a CPA; so he is not providing legal or tax advice.

This material is offered for educational purposes only. The author and his employer expressly disclaim any liability, including incidental or consequential damages, arising from the use of this material or any errors or omissions that may be contained in it.

American Society of Appraisers ASA

Wandry v. *Commissioner* T.C. Memo 2012-88

- Taxpayers made FLP gifts based on a specified dollar amount (a "defined value" gift, one form of a "formula clause")
- Appraised value determined after the gift was made

IRS assertions:

- Taxpayers transferred fixed percentage interests (as opposed to a fixed dollar amount).
- Taxpayers' transfer documents were contrary to public policy.

The court ruled for the taxpayers on both issues.

For additional direction on the topic of formula gifts, see:

- *Hendrix* v. *Commissioner*, T.C. Memo 2011-133
- *Succession of McCord* v. *Commissioner*, 461 F.3d 614 (5th Cir. 2006), revg. 120 T.C. 358 (2003)
- *Commissioner* v. *Proctor*, 142 F.2d 824 (4th Cir. 1944)

James Hendrix, et al, v. *U.S.*
Case No. 2:09-cv-132
United States District Court,
Southern District of Ohio Eastern Division

Taxpayers claimed a charitable deduction for a real property donation.

Expert's report said, "[t]he intended use of this appraisal is to assist the owner in estimating the fair market value of the subject property."

What's missing?

2012 ASA ADVANCED BUSINESS VALUATION CONFERENCE

Taxpayer's expert:

- Included her license number, but failed to include her qualifications in the appraisal.
- Failed to provide the terms of the agreement between the taxpayers and the city as well as the expected date of the donation.

The court ruled:

- Taxpayer-expert's inclusion of her real estate appraisal license number was not an adequate substitute for inclusion of her qualifications and did not constitute substantial compliance.

- Taxpayer's failure to adequately explain how the charitable deduction was determined (i.e., subtracting the value of the land from the appraised value) failed to "show the work," which a qualified appraisal would do.

- The Taxpayers were required by 26 U.S.C. § 170(f)(8)(B) to file a contemporaneous acknowledgement of the contribution by the donee organization. The court found that the Taxpayers failed to produce such documents.

2012 ASA ADVANCED BUSINESS VALUATION CONFERENCE

Based on the preceding, the court disallowed the deduction.

Scheidelman v. *Commissioner* (T.C. Memo. 2010-151, No. 15171-08) also denied a charitable deduction for a façade easement because the taxpayer's appraisal did not meet the requirements of a qualified appraisal.

Estate of Gallagher v. *Commissioner* T.C. Memo 2011-148

- Decedent owned a 15% minority interest in Paxton Media Group, LLC, a multi-media (daily newspapers, weekly publications, specialty publications and a TV station) pass-through tax entity generating $169 million in sales.
- The LLCs owners agreed to maintain their pass-through status.

Valuation date: July 5, 2004

- The IRS expert used PMG's June 27, 2004, financial statements and second quarter SEC 10-Q reports.
- Taxpayer's expert used PMG's May 20, 2004, financial statements and first quarter SEC 10-Q.

Over the taxpayer's objection, the court accepted the IRS expert's reliance on both company and public stock financial data which had not been published as of the valuation date.

According to the court, the taxpayer's expert failed to adequately explain numerous adjustments to historical income. Citing previous rulings, the court then stated,

> "Because we fail to understand his adjustments, we shall disregard them."

Both experts included a market approach in their reports, but only the IRS expert relied upon it.

The IRS expert initially identified 13 guideline transactions, and then narrowed the list to four based on size limitations, which the court rejected for the following reasons:

- Size - PMG's assets and revenue were 1/3rd and 1/4th of the public companies' sizes.
- Products – PubCo's had daily and weekly newspapers plus specialty publications versus PubCos' "wide variety of classified, specialty, shoppers and niche publications" plus online services.
- 5-year EBITDA growth - PMG's rate was greater.
- Leverage - PMG had more debt.

The court noted that one of the guideline transactions was "arguably of sufficient similarity" to the subject company, but "a single comparable company is insufficient on which to base the valuation method."

Both experts and the court considered the DCF method.

- The court considered an extensive review of both appraiser's cash flow projections and adopted parts of both.

The next issue considered by the court was tax affecting PMG's income since it was a pass-through entity.

- Taxpayer's expert tax affected income.
- IRS expert disregarded income taxes.

The court criticized the taxpayer's tax affecting:

- "Absent an explanation for tax affecting PMG's projected earnings and discount rate, we decline to do so."
- "... we will not impose an unjustified fictitious corporate tax rate burden on PMG's future earnings."

The court rejected taxpayer-expert's estimate of capital expenditures, saying he failed to support his projection and PMG's financial statements don't support his estimates.

The court also rejected taxpayer-expert's estimates of working capital because they were not supported.

Both experts used a WACC.

Even so, the court cited previous rulings and said, "We have previously held that WACC is an improper analytical tool to value a 'small, closely held corporation with little possibility of going public.'"

Even so, it used the WACC in its analysis because both experts did and neither party objected.

Taxpayer's expert used CAPM to determine the equity discount rate, which the court rejected, saying:

"The special characteristics associated generally with closely held corporate stock make CAPM an inappropriate formula to use in this case."

IRS expert used an Ibbotson based build-up method, converted the discount rate to a cap rate and then added:

- "a 20-percent premium for control"
- "a 4-percent firm specific risk premium"
- "a 2-percent premium to account for PMG's 'S' corporate status."

Citing the procedures outlined in the traditional Ibbotson build-up model, the court found the addition of a company specific risk premium to the adjusted cap rate to be an error.

2012 ASA ADVANCED BUSINESS VALUATION CONFERENCE

IRS expert used a weighted average cost of existing debt and considered the current interest rate environment.

Taxpayer expert gave consideration to similar factors but arrived at a different rate.

The court criticized both appraisers procedures but accepted the IRS expert's conclusion because it was larger and yielded a lower PV.

Turning to the weighted contribution of debt and equity to the WACC, the court acknowledged the weighting should be based on market values of both metrics.

Even so, the court used book values of debt and equity in its analysis but made it clear that it does not intend "to establish a general rule in doing so."

Even though a minority interest was being valued, taxpayer's expert made an adjustment for a working capital deficiency based on sales/work capital ratios derived from the previously determined PubCo guideline companies.

The court rejected his adjustment citing an inconsistency between his unwillingness to use the market approach and ultimate reliance on the PubCo's sales/working capital ratios.

Taxpayer's expert also adjusted his value for dividend taxes avoided when distributions in excess of the personal income tax associated with S corporation income are paid.

The court disregarded the taxpayer's position.

Taxpayer's expert asserted a 17% DLOC.

IRS expert asserted no DLOC was appropriate because his DCF determined a minority, nonmarketable value.

The court was critical of the inconsistencies between taxpayer-expert's choice of a 17% DLOC and the Mergerstat data upon which he relied; so it selected a larger 23% DLOC.

Taxpayer's expert asserted a 31% DLOM.

IRS expert used a 30% DLOM.

While citing prior reluctance to rely on the restricted stock studies, the court determined a 31% DLOM because both experts relied on the restricted stock studies.

The IRS originally asserted a value of $49,500,000 and revised it to $40,863,000.

The taxpayer originally asserted $26,606,940 and revised the value to $28,200,000.

In a supplement to its original ruling (which corrected an improper terminal value PV calculation in its DCF), the court ruled the value of the taxpayer's interest was $35,761,760.

The Ringgold Telephone Company v. *Commissioner* T.C. Memo 2010-103

- Company converted from C corp to S corp January 1, 2000
- Company owned 25% interest in a partnership

After its conversion to an S corp, the company and IRS disagreed as to the built-in gain associated with the sale of the 25% partnership interest.

While not discussed in the ruling, the taxpayer's expert confirmed that both experts tax affected the partnership's income using C corporation income tax rates.

The trial occurred during December 2008, well after the controversial Tax Court decisions asserting that tax affecting S corporation income is inappropriate, yet the issue was not discussed at trial.

Estate of Miller v. *Commissioner* T.C. Memo 2009-119

- In 2001, decedent formed FLP (which owned marketable securities) after her husband's death
- Decedent made additional capital contributions to the FLP during April 2002 and May 2003
- Decedent died in May 2003

IRS asserted decedent's April 2002 additional capital contributions to FLP were not *bona fide* transfers.

Court ruled in taxpayer's favor: Decedent's desire was to continue management of the FLP's assets using her deceased husband's investment strategies. Evidence:

- FLP actively managed portfolio and collected dividends and interest.
- Decedent's son spent 40 hours per week managing the FLP's assets and was compensated for his services.

IRS asserted decedent's age and failing health were other evidence that the April 2002 capital contributions were not *bona fide* transfers.

Court ruled in taxpayer's favor:

- While suffering from chronic old age conditions, her health was generally good and no decline was expected in April 2002
- Contributions were for legitimate nontax business reasons (as identified above, continuing her husband's portfolio management strategy)

IRS asserted decedent failed to hold sufficient assets outside her estate at the time of the capital contribution.

Court ruled in taxpayer's favor:

- Decedent didn't need to rely on FLP distributions to pay for daily living expenses
- Decedent had access to funds in QTIP trust formed at time of husband's death

IRS asserted May 2003 FLP capital contribution was not a *bona fide* transfer due to decline in taxpayer's health.

Court ruled in IRS's favor:

- Unlike the April 2002 transfers, taxpayer's health was clearly declining (hip fracture, pacemaker, brain injury).
- If her motive was to continue husband's investment strategy, she could have transferred her personal assets at the time of the April 2002 transfers.
- Decedent didn't have sufficient personal assets.