TAXATION

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2024 Estate and Gift Tax Conference

Panel 14: Tax Court Panel-Valuation

Friday, March 22, 2024

12:45pm - 2:15pm

Speakers: John Prokey, Sid Luckenbach, David Eckstein, and Judge Halpern

Conference Reference Materials

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California Lawyers Association
Taxation Section
2024 Estate and Gift Tax Conference

Tax Court Panel – Valuation

Presented By:

Honorable Judge James S. Halpern
David M. Eckstein, CFA, San Francisco, CA
Sid Luckenbach, ASA, San Francisco, CA
John W. Prokey, Esq., San Jose, CA

March 22, 2024
12:30 – 2:00 (1.5 Hours)

James S. Halpern

Chambers Telephone Number: (202) 521-0707

Biography:

Senior Judge. Born in New York. Hackley School, Tarrytown, NY, 1963; Wharton School, B.S., University of Pennsylvania, 1967; J.D., University of Pennsylvania Law School, 1972; LL.M., Taxation, New York University Law School, 1975; Associate Attorney, Mudge, Rose, Guthrie and Alexander, New York City, 1972-74; assistant professor of law, Washington and Lee University, 1975-76; assistant professor of law, St. John's University, New York City, 1976-78, visiting professor, Law School, New York University, 1978-79; associate attorney, Roberts and Holland, New York City, 1979-80; Principal Technical Advisor, Assistant Commissioner (Technical) and Associate Chief Counsel (Technical), Internal Revenue Service, Washington, DC, 1980-83; partner, Baker and Hostetler, Washington, DC, 1983-90; Adjunct Professor, Law School, George Washington University, Washington, DC, 1984-present; Colonel, U.S. Army Reserve (retired). Appointed by President Bush as Judge of the United States Tax Court; sworn in on July 3, 1990 for a term ending July 2, 2005. Reappointed by President Bush; sworn in on November 2, 2005 for a term ending November 1, 2020. Assumed senior status on October 16, 2015 and continues to perform judicial duties as Senior Judge on recall.

Last updated: May 29, 2020

DAVID M. ECKSTEIN, CFA

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PROFESSIONAL EXPERIENCE

Management Planning, Inc. (MPI), Managing Director

David is a Managing Director at MPI and leads the Seattle office. Over three decades he has valued companies across many industries, particularly food and beverage, and both traditional and alternative investment management. In addition to estate, gift, GST and income tax compliance valuations for some of the wealthiest families and largest privately held companies in the U.S., David has led valuation and transaction projects spanning a wide range of business and asset sizes and types for corporate and personal tax, transaction fairness and solvency, purchase/sale of a business, financial restructuring, bankruptcy, financial reporting, corporate planning, ESOP, litigation, and marital purposes. Furthermore, he has advised clients on valuation matters for litigation consulting and has provided expert testimony in the U.S. Tax Court and other courts.

Before joining MPI, David was a Managing Director and co-leader of the national private wealth tax valuation practice at Deloitte, and a co-founder and Managing Director of FMV Opinions, where he led the national business valuation practice. He is a former President of the Valuation Roundtable of San Francisco. David has published numerous articles, spoken on valuation topics to professional organizations and companies, lectured on valuation and business topics at Stanford, the University of California, and the University of International Business and Economics in Beijing, China, and co-edited a business textbook published in China.

EDUCATION

- Bachelor of Arts in Economics – Stanford University, 1982, with honors and distinction; selected to Omicron Delta Epsilon international economic honor society.
- Master's degree in Business Administration - Harvard University, 1986

ACCREDITATIONS

- Chartered Financial Analyst (CFA) designation – CFA Institute, 1988

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EDUCATION

- California State University at Northridge, BSBA (Finance and Real Estate)
- Indiana University, MBA (Finance and Management Information Systems)

AFFILIATIONS

- CFA Institute
- American Society of Appraisers
- San Francisco Estate Planning Council

Sid Luckenbach

Managing Director – San Francisco

Sid Luckenbach leads the Valuation practice for Andersen in the U.S. and globally and is a member of the U.S. Board of Directors. He has been actively involved in valuation for more than 30 years, serving clients ranging from small closely held businesses to large multinationals. He has participated in a wide variety of valuation engagements for tax planning and compliance, financial statement reporting, litigation and stockholder disputes, strategic planning, restructuring and bankruptcy.

Sid has extensive experience serving clients in many industries, including construction, financial services, healthcare, manufacturing, real estate, retail, technology, and telecommunications. His experience includes all aspects of valuation including business enterprises and intangible assets, debt instruments and derivatives, as well as real estate and capital equipment. Sid has also served as an expert witness on a variety of valuation issues.

Before joining Andersen, Sid was a Managing Director with Huron Consulting Group, where he managed the firm's valuation practices in Los Angeles and San Francisco. Before Huron, he was a Partner at Arthur Andersen, specializing in valuation services. Sid also holds the Chartered Financial Analyst (CFA) designation.

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John Prokey is a partner of Ramsbacher Prokey Leonard LLP. Mr. Prokey's law practice focuses on providing advice in wealth planning, estate and trust administration, and tax. His clients include individuals, private fiduciaries, institutions, and other business and non-profit entities. The wealth planning portion of Mr. Prokey's law practice emphasizes advising individuals and fiduciaries in estate planning, wealth preservation, tax, and business matters. Mr. Prokey also advises fiduciaries and beneficiaries in trust and probate administration matters, with emphasis in complex administrations. Mr. Prokey's law practice includes representing taxpayers in all levels of federal tax controversy, including IRS examination and Appeals, and before the U.S. Tax Court. Clients, their families, and other practitioners rely on Mr. Prokey for dispute resolution in these arenas, including serving as a mediator.

Mr. Prokey is a Fellow of The American College of Trust and Estate Counsel. He is also a member of the California Lawyers Association. He served on the Trusts and Estates Section Executive Committee and the Taxation Section Executive Committee of the California State Bar; and also served as Chair (2004-2005) of the Taxation Section's Estate and Gift Tax Sub-Committee. John is a member of the Silicon Valley, Santa Clara County, and American Bar Associations.

Mr. Prokey is a frequent lecturer and guest speaker at numerous seminars and conferences throughout California and elsewhere, and is an author on various tax and estate planning topics. Speaking engagements include the Heckerling Institute on Estate Planning, Jerry A. Kasner Estate Planning Symposium, AICPA Advanced Estate Planning Conference, CalCPA Advanced Estate Planning Institute, Annual Estate Planning Symposium, Tax and Update Planning Conference, the San Diego Tax and Estate Planning Forum, the Hawaii Tax Institute, CEB/UCLA Estate Planning Conference, Continuing Education of the Bar Estate Planning and Administration, San Francisco, San Mateo County, and Silicon Valley Bar Associations, East Bay, Orange County, Sacramento, Santa Clara County, Santa Cruz County, and Stanislaus County Estate Planning Councils, CPE Forum of the Central Coast, East Bay Trust & Estates Lawyers Seminar, and Paralegal Association of Santa Clara County.

Mr. Prokey received his Baccalaureate of Science degree from Santa Clara University in 1994 and his Juris Doctor degree from Santa Clara University School of Law in 1999, graduating *cum laude* in both undergraduate and law school studies.

ABC Equipment, Inc.

Valuation Analysis as of December 31, Year 5

Introduction

- Judge Halpern
- John Prokey
- Sid Luckenbach
- David Eckstein

Executive Summary

ABC
GENERIC COMPANY
A B C

- Two Valuation Experts:
  - Lowe-Bawl
  - Hye-Bawl
- Company Description:
  - S-Corp
  - Asset intensive
  - Heavy construction equipment (“yellow iron”) leasing company
  - Industry/Company experiencing a recession
  - Cyclical earnings with current earnings lower than trend
- Potentially Non-Operating Assets
  - Note receivable from related party

*The opinions express throughout by Mr. Lowe-Bawl and Mr. Hye-Bawl are not the professional opinions of David Eckstein and Sid Luckenbach. This is an exercise to demonstrate a hypothetical situation.

Executive Summary

- Major Valuation Issues
  - Treatment and Valuation of Note Receivable from Related Party
  - Asset Approach
  - Income Approach – projections
  - Market Approach – selecting multiples
  - Reconciliation – weight on Asset Approach versus Market and Income Approaches
  - Discount for Lack of Marketability

Financials

GENERIC COMPANY
A B C

ABC Equipment

Comparative Financials at the Fiscal Years Ended December 31, Year 1 - Year 5 (a)

	Historical				
Figures in Thousands of U.S. Dollars	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Balance Sheet					
Cash	280	90	600	350	80
Other Current Assets	1,730	2,250	3,500	1,000	800
Fixed Assets, Net	7,000	7,500	8,500	8,500	8,000
Notes Receivable	-	-	2,000	2,000	2,000
Total Assets	**9,010**	**9,840**	**14,600**	**11,850**	**10,880**
Total Current Liabilities (Excluding Debt)	1,730	2,250	3,500	1,000	800
Total Debt	890	1,250	970	800	1,100
Total Liabilities	**2,620**	**3,500**	**4,470**	**1,800**	**1,900**
Total Equity	6,390	6,340	10,130	10,050	8,980
Total Liabilities & Partners' Capital	**9,010**	**9,840**	**14,600**	**11,850**	**10,880**
Income Statement					
Total Revenues	9,600	11,200	13,400	8,800	7,800
EBITDA Unadjusted	1,200	1,760	2,080	960	680
EBIT Unadjusted	500	605	780	(165)	(280)
EBT	465	555	745	(195)	(325)

Notes:
(a) Source: Audited financial statements.

Summary Valuation Results – Note Receivable

ABC
GENERIC COMPANY
A B C

Note Receivable - Determination of Fair Market Value

Valuation Date 12/31/Year 5
Original Principal $ 2,000,000
Interest Rate (a) 1.26%
Current AFR (b) 4.82%
Market Rate (c) 10.00%

Payment Date	Beginning Principal	Interest Accrual	Principal Payment	Interest Payment	Total Payment	Ending Principal	Time Period	Present Value Factor	Present Value	Present Value Factor	Present Value
12/31/Year 5	$2,000,000	-	-	-	-	2,000,000	0.0	1.0000	$ -	1.0000	$ -
12/31/Year 6	2,000,000	25,200	-	25,200	25,200	2,000,000	1.0	0.9540	$ 24,041	0.9091	22,909
12/31/Year 7	2,000,000	25,200	-	25,200	25,200	2,000,000	2.0	0.9101	$ 22,935	0.8264	20,825
12/31/Year 8	2,000,000	25,200	-	25,200	25,200	2,000,000	3.0	0.8683	$ 21,881	0.7513	18,933
12/31/Year 9	2,000,000	25,200	-	25,200	25,200	2,000,000	4.0	0.8284	$ 20,876	0.6830	17,212
12/31/Year 10	2,000,000	25,200	-	25,200	25,200	2,000,000	5.0	0.7903	$ 19,916	0.6209	15,647
12/31/Year 11	2,000,000	25,200	-	25,200	25,200	2,000,000	6.0	0.7539	$ 18,998	0.5645	14,225
12/31/Year 12	2,000,000	25,200	-	25,200	25,200	2,000,000	7.0	0.7193	$ 18,126	0.5132	12,933
12/31/Year 13	2,000,000	25,200	-	25,200	25,200	2,000,000	8.0	0.6862	$ 17,292	0.4665	11,756
12/31/Year 14	2,000,000	25,200	-	25,200	25,200	2,000,000	9.0	0.6546	$ 16,496	0.4241	10,687
12/31/Year 15	2,000,000	25,200	-	25,200	25,200	2,000,000	10.0	0.6245	$ 15,737	0.3855	9,715
12/31/Year 16	2,000,000	25,200	-	25,200	25,200	2,000,000	11.0	0.5958	$ 15,014	0.3505	8,833
12/31/Year 17	2,000,000	25,200	2,000,000	25,200	2,025,200	-	12.0	0.5684	$ 1,151,124	0.3186	645,229
								PV of Loan Receivable	$ 1,362,436	PV of Loan Receivable	$ 808,903

(a) Interest rate on the note is equal to AFR rate as of Note issuance date.
(b) Discount rate of 4.82% based on current AFR as of DOV.

Lowe-Bawl's Income Approach analysis implicitly values the note at $323,000.
Lowe-Bawl's Market Approach analysis implicitly values the note at $150,000.

(c) Based on average of B and CCC coporate bond yields.

December 31, Year 5 -Corporates Sector Yields (a)

Tenor	BBB	BB	B	CCC
11Y	5.23%	6.22%	7.33%	13.01%
12Y	5.30%	6.29%	7.45%	13.05%
13Y	5.370%	6.369%	7.566%	13.094%

(a) Source: S&P Capital IQ

Summary Valuation Results – Asset Approach

ABC GENERIC COMPANY

ABC Equipment

Comparative Financials at the Fiscal Years Ended December 31, Year 1 - Year 5

Figures in Thousands of U.S. Dollars	Unadjusted Year 5	Market Value Balance Sheet: Lowe-Bawl Adjustment	Lowe-Bawl Adjusted	Hye-Bawl Adjustment	Hye-Bawl Adjusted
Balance Sheet					
Cash	80	-	80	-	80
Other Current Assets	800	-	800	-	800
Fixed Assets, Net (a)	8,000	800	8,800	800	8,800
Notes Receivable	2,000	-	2,000	(638)	1,362
Total Assets	**10,880**		**11,680**		**11,042**
Total Current Liabilities (Excluding Debt)	800	-	800	-	800
Total Debt	1,100	-	1,100	-	1,100
Total Liabilities	**1,900**		**1,900**		**1,900**
Total Equity	8,980	-	9,780	-	9,142
Total Liabilities & Partners' Capital	**10,880**		**11,680**		**11,042**
		Asset Approach Conclusion:	**9,780**		**9,142**

Notes:
(a) Provided by management based on Blue Book values.

Summary Valuation Results – Income Approach

ABC Equipment

Gordon Growth Model Discounted Cash Flow Analysis - Lowe-Bawl

(Figures in Thousands of U.S. Dollars)

Projected Cash Flows

Fiscal Year Ended December 31	Year 6	Year 7	Terminal
Total Revenues Collected	**8,200**	**8,600**	
EBITDA Before Interest Income	**820**	**950**	
Interest Income	25	25	
EBITDA Unadjusted	845	975	
Less: Depreciation & Amortization	(700)	(700)	
EBIT	**145**	**275**	
Less: Taxes @ 30.0%	(44)	(83)	
NOPAT	**102**	**193**	
Plus: Depreciation & Amortization	700	700	
Less: Capital Expenditures	(700)	(700)	
Less: (Inc) / Dec in Working Capital	-	-	
FCFF	**102**	**193**	
Terminal Value (a)			3,660
Total Free Cash Flows	**102**	**193**	**3,660**
Mid-Year Discount Factors @ 10.00%	1.0	0.9	0.9
PV of Free Cash Flows	**97**	**167**	**3,173**

Determination of Non-Controlling Marketable Enterprise Value

PV of Free Cash Flows	264
PV of Terminal Cash Flows	3,173
Non-Controlling Marketable Enterprise Value	**3,437**
Plus: Cash	80
Less: Debt	(1,100)
Plus: Note	-
Indicated Value:	**2,417**

Notes:

(a) Terminal value uses a capitalization rate of 5.5% (10.0% minus 4.5%).

Lowe-Bawl's analysis implicitly values the note at $323,000.

ABC Equipment

Gordon Growth Model Discounted Cash Flow Analysis - Hye-Bawl

(Figures in Thousands of U.S. Dollars)

Projected Cash Flows

Fiscal Year Ended December 31	Year 6	Year 7	Year 8	Terminal
Total Revenues Collected	**8,200**	**8,600**	**9,600**	
EBITDA Before Interest Income	**820**	**950**	**1,200**	
Interest Income	-	-	-	
EBITDA Adjusted	820	950	1,200	
Less: Depreciation & Amortization	(700)	(700)	(700)	
EBIT	**120**	**250**	**500**	
Less: Taxes @ 30.0%	(36)	(75)	(150)	
NOPAT	**84**	**175**	**350**	
Plus: Depreciation & Amortization	700	700	700	
Less: Capital Expenditures	(700)	(700)	(700)	
Less: (Inc) / Dec in Working Capital	-	-	-	
FCFF	**84**	**175**	**350**	
Terminal Value (a)				5,573
Total Free Cash Flows	**84**	**175**	**350**	**5,573**
Mid-Year Discount Factors @ 10.00%	1.0	0.9	0.8	0.8
PV of Free Cash Flows	**80**	**152**	**276**	**4,392**

Determination of Non-Controlling Marketable Enterprise Value

PV of Free Cash Flows	508
PV of Terminal Cash Flows	4,392
Non-Controlling Marketable Enterprise Value	**4,900**
Plus: Cash	80
Less: Debt	(1,100)
Plus: Note	1,362
Indicated Value:	**5,242**

Notes:

(a) Terminal value uses a capitalization rate of 6.5% (10.0% minus 3.5%).

Summary Valuation Results - Market Approach

ABC GENERIC COMPANY A B C

ABC Equipment

Guideline Public Company Analysis - Review of Market Value Ratios as of December 31, Year 5

Figures in Thousands of Local Currency Units for Each Company

I	II	III	IV	V	VI
Company	Market Value of Invested Capital ("MVIC")	3 Year Weighted Avg EBITDA	MVIC/3 Year Weighted Avg EBITDA	1 Year Projected EBITDA	MVIC/1 Year Projected EBITDA
GPC A	1,318,394	311,954	4.2	NA	NA
GPC B	1,158,740	297,658	3.9	NA	NA
GPC C	10,760,055	2,134,498	5.0	2,221,548	4.8
GPC D	25,397,420	4,357,662	5.8	4,733,809	5.4
GPC E	2,812,020	372,255	7.6	427,442	6.6
GPC F	3,620,550	505,992	7.2	538,230	6.7
GPC G	2,610,417	435,764	6.0	473,765	5.5
GPC H	10,590,592	1,422,487	7.4	1,420,392	7.5

Overall Group

	MVIC/3 Year Weighted Avg EBITDA	MVIC/1 Year Projected EBITDA
Coefficient of Variation	0.24	0.16
Low	3.9 x	4.8 x
25th Percentile	4.8 x	5.4 x
Overall Median	5.9 x	6.0 x
75th Percentile	7.2 x	6.7 x
High	7.6 x	7.5 x
Lowe-Bawl Selected Multiples	5.9 x	6.0 x

Best Comparables

	MVIC/3 Year Weighted Avg EBITDA	MVIC/1 Year Projected EBITDA
Coefficient of Variation	0.11	0.20
Low	6.0 x	5.5 x
25th Percentile	6.6 x	6.1 x
Overall Median	7.2 x	6.7 x
75th Percentile	7.3 x	7.1 x
High	7.4 x	7.5 x
Hye-Bawl Selected Multiples	7.2 x	6.7 x

Summary Valuation Results - Market Approach

ABC Equipment

Market Approach - Guideline Public Company Method

(Figures in Thousands of U.S. Dollars)

Lowe-Bawl

Measure of Performance	Selected Multiples	ABC Results	Indicated Value	Weight	Weighted Value
MVIC/3 Year Weighted Avg EBITDA	5.9x	1,007	$5,949	50.0%	$2,974
MVIC/1-Year Projected EBITDA	6.0x	845	5,109	50.0%	$2,554
				100%	**5,529**
				Plus: Cash	80
				Less: Debt	(1,100)
				Plus: Note	0
			Total Enterprise Value (a)		**$ 4,510**

Hye-Bawl

Measure of Performance	Selected Multiples	ABC Results	Indicated Value	Weight	Weighted Value
MVIC/3 Year Weighted Avg EBITDA	7.2x	981	$7,023	50.0%	$3,511
MVIC/1-Year Projected EBITDA	6.7x	820	5,516	50.0%	$2,758
				100%	**6,269**
				Plus: Cash	80
				Less: Debt	(1,100)
				Plus: Note	1,362
			Total Enterprise Value (a)		**$ 6,610**

Notes:

(a) On a non-controlling interest basis.

Lowe-Bawl's analysis implicitly values the note at $150,000.

Valuation Reconciliation

ABC Equipment

Conclusion of Non-Controlling Equity Value as of December 31, Year 5

(Figures in Thousands of U.S. Dollars)

	Lowe-Bawl			Hye-Bawl		
	Indicated Value	Weighting	Concluded Value	Indicated Value	Weighting	Concluded Value
Indicated Total Enterprise Value Based on Asset Approach (a)	$ 9,780	10%	$ 831	$ 9,142	60%	$ 4,663
Indicated Total Enterprise Value Based on Market Approach	$ 4,510	45%	$ 2,030	$ 6,610	20%	$ 1,322
Indicated Total Enterprise Value Based on Income Approach	$ 2,417	45%	$ 1,088	$ 5,242	20%	$ 1,048
Concluded Total Operating Enterprise Value (b)			$ 3,948			$ 7,033

Notes:

(a) Asset approach includes a discount for lack of control of (15.0%) in both analyses.

(b) On a non-controlling interest basis.

Lowe-Bawl's 10.0% weight on the asset approach increases his value $485 thousand (14%) from $3,463 thousand if he had applied zero weight.

Discount for Lack of Marketability

ABC Equipment

Discount for Lack of Marketability as of December 31, Year 5

Summary of Factors	Lowe-Bawl			Hye-Bawl	
	vs. RS	vs. Pre-IPO	Weight	Level	Specific
Marketability Considerations					
1 Financial Statement Analysis	↓	↓	**10.0%**	12.50%	1.3%
2 Company Dividend Policy	→	→	**20.0%**	20.00%	4.0%
3 Restrictions on Transferability	↑	↑	**10.0%**	20.00%	2.0%
4 Amount of Control in Transferred Interest	↑	↑	**10.0%**	20.00%	2.0%
5 Company Redemption Policy	→	→	**10.0%**	20.00%	2.0%
6 Exit Strategies	↑	↑	**20.0%**	20.00%	4.0%
7 Holding Period	↑	↑	**10.0%**	27.50%	2.8%
8 Nature and History of Company, Industry, Economic Outlook	→	→	**10.0%**	20.00%	2.0%
Benchmark / Indication	27.1%	50.4%	100.0%		20.0%
Conclusion (rounded) (a)	**38.0%**				**20.0%**

Assumptions	
Selected Mid Point	20.00%
Resulting Increments	
1 Very Low	5.00%
2 Low	12.50%
3 Neutral	20.00%
4 High	27.50%
5 Very High	35.00%

Notes:

(a) Lowe-Bawl's selected Discount for Lack of Marketability applies a weighted average of 75% RS and 25% Pre-IPO plus a net updward adjustment for the above factors.

Determination of Fair Market Value

ABC Equipment

Determination of Fair Market Value as of December 31, Year 5

(Figures in Thousands of U.S. Dollars)

Lowe-Bawl		
Non-Controlling Equity Value (a)	$	3,948
Less: Discount for Lack of Marketability (38.0%)		(1,500)
Concluded Fair Market Value (b)	$	2,448
Rounded	**$**	**2,400**

Hye-Bawl		
Non-Controlling Equity Value (a)	$	7,033
Less: Discount for Lack of Marketability (20.0%)		(1,407)
Concluded Fair Market Value (b)	$	5,626
Rounded	**$**	**5,600**

Notes:

(a) On a non-controlling interest basis.

(b) On a non-controlling, non-marketable interest basis.

California Lawyers Association
Taxation Section
2024 Estate and Gift Tax Conference

Tax Court Panel – Valuation

San Francisco, CA
March 22, 2023
12:30 p.m. – 2:00 p.m.

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I. Valuation Experts In Tax Court

II. Tax Affecting in E&G Valuation Cases

III. Valuing Fractional Interests

IV. How To Address Non-Operating Assets

V. Valuation of Promissory Notes

I. VALUATION EXPERTS IN TAX COURT

A. Generally. The Tax Court has very specific, and unique, rules for admitting appraisal reports into evidence. First, the appraiser is an expert. As such, the appraiser must "prepare a written report for submission to the Court and to the opposing party…" Tax Court Rule 143(g). The report must contain: "(A) a complete statement of all opinions the witness expresses and the basis and reasons for them; (B) the facts or data considered by the witness in forming them; (C) any exhibits used to summarize or support them; (D) the witness's qualifications, including a list of all publications authored in the previous 10 years; (E) a list of all other cases in which, during the previous 4 years, the witness testified as an expert at trial or by deposition; and (F) a statement of the compensation to be paid for the study and testimony in the case. The appraisal report will be admitted into evidence and be the direct testimony of the appraiser "unless the Court determines that the witness is not qualified as an expert." Tax Court Rule 143(g). Subject to limited exceptions, an appraiser's testimony will be excluded altogether for failure to comply with Rule 143(g).

An appraiser and his or her report (which is his or her direct testimony) must also meet the standards of Federal Rule of Evidence 702. That rule provides as follows:

> "A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:
> (a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;
> (b) the testimony is based on sufficient facts or data;
> (c) the testimony is the product of reliable principles and methods; and
> (d) the expert has reliably applied the principles and methods to the facts of the case."

See also Daubert V. Merrell Dow Pharm., Inc., 509 U.S. 579 (1993), whereby the United States Supreme Court made trial judges responsible to act as gatekeepers for excluding unreliable expert testimony. *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999) confirmed that the gatekeeper function applies to all expert testimony.

The Tax Court's practice is to have the appraiser appear at trial and be admitted as an expert by the presiding judge. Typically, the party advancing the appraiser as an expert will ask questions of the appraiser to establish, he or she is an expert, then ask the presiding judge to admit the appraiser's report into evidence as expert testimony. The presiding judge must consider the qualifications of the appraiser, the methodology used by the appraiser, and the opinions expressed.

B. Make Sure Expert Shows at Trial. The expert's report must follow the procedures to be admitted into evidence. In the Judge Halpern estate tax case of Tanenblatt v. Commissioner, T.C. Memo 2013-263, Petitioner attached a copy of its expert witness appraisal to its petition. The parties stipulated to copies of the petition and the answer, but in doing so stated that the pleadings are not admitted into evidence. Petitioner asked the Tax Court to allow the appraisal into evidence and consider it expert testimony. Why this unorthodox approach? Well, apparently Petitioner's expert would not appear at trial due to a fee dispute. In denying Petitioner's request, the Tax Court looked to Tax Court Rule 143. The expert witness appraisal must be identified and adopted by the

witness, the witness must be qualified as an expert, and the report must be admitted into evidence. Further, a copy of the report must be submitted to the Tax Court and served on the other party at least 30 days before the call of the trial calendar. Note the Tanenblatt case also addresses the issue of whether the estate's interest in an LLC was a membership interest or assignee interest. The Tax Court found it was a membership interest and not an assignee interest.

II. TAX AFFECTING IN E&G VALUATION CASES

A. Tax Cases where the Court allowed tax affecting:

1. Estate of Cecil v. Commissioner, T.C. Memo 2023-24. (2/28/2023)
2. Estate of Jones v. Commissioner, T.C. Memo. 2019-101. (8/19/2019)
    a. Tax-affecting applied in valuation of a partnership and an S Corporation
    b. Court found that taxpayer's expert provided evidence of tax affecting whereas Respondent's experts did not provide evidence against the inclusion of tax affecting.
3 James F. Kress, et ux v. US, (2019) E.D. Wisconsin, 2019-1 U.S.T.C. (3/26/2019)
4 Both experts in all three cases tax affected the earnings of pass throughs.

B. Tax Cases where the Court disallowed tax affecting:

1. Gross v. Commissioner, T.C. Memo. 1999-254, aff'd 272 F.3d 333 (6th Cir. 2001).
    a. Court found that:
        i. There was disagreement among professional appraisers as to the propriety of employing tax affecting; and
        ii. There was no evidence that the corporation would lose its Subchapter S status.
    b. Court found that it is appropriate to use a zero corporate tax rate to estimate net cashflow when valuing S corporation
2. Heck v. Commissioner, T.C. Memo. 2002-34.
    a. Respondent's expert applied a 10% discount for additional risks associated with an S corporation, including possible loss of Subchapter S status.
    b. Court did not allow the discount and settled on a combined 35% for DLOM and DLOC
3. Adams v. Commissioner, T.C. Memo. 2002-80.
    a. When Petitioner's expert applied a capitalization rate to the S-corporation's earnings, Petitioner's expert converted the capitalization rate from a post-tax capitalization rate (20.53%) to a pre-tax capitalization rate (31.88%)
    b. Court rejected this approach stating that the S-corporation's earnings are post-tax, albeit a 0% tax rate. Thus, Petitioner's expert should have just used the post-tax capitalization rate (not the pre-tax capitalization rate)
4. Dallas v. Commissioner, T.C. Memo. 2006-212.
    c. Court found there were insufficient facts to conclude that:
        i. The corporation would lose its favorable tax treatment as an S Corp.; and

ii. A hypothetical willing buyer would tax-affect earnings in valuing the stock.

5. Estate of Gallagher v. Commissioner, T.C. Memo. 2011-148, supp'd by T.C. Memo. 2011-244.
   a. Court rejected tax-affecting because the taxpayer's expert did not justify it but again acknowledged that the benefit of a reduction in the total tax burden borne by S Corporation owners should be considered when valuing an S Corporation.
6. Estate of Giustina v. Commissioner, T.C. Memo. 2011-141, rev'd and remanded, 14 AFTR 2d 2014-xxxx (9th Cir. Dec. 5, 2014). T.C. Memo, 2016-114.
   a. Court found that that the taxpayer's expert's method was faulty – he used a pretax discount rate to present value post tax cashflow.
7. Wall v. Commissioner, 81 T.C. M. 1425, 1432–33 n.19 (2001).
   a. The Court noted that taxpayer's expert acknowledged that appraisers disagree on whether it is appropriate to tax-affect the income of an S Corporation.
      i. Both experts tax-affected here
      ii. Taxpayer's expert undervalued the S Corporation (did not use correct projections, undervalued shares)
      iii. Respondent's expert overvalued the S Corporation (did not apply a minority discount, used very few performance measures/comparable companies)
   b. The Court noted that, because S Corporation stockholders are generally not subject to a second level of tax when income is distributed to them, this could make an S Corporation more valuable than an equivalent C Corporation.
   c. The Court was critical of an approach that decreased the value of the S Corporation for taxes but failed to add a premium from not having a second layer of tax.
8. Estate Of Jackson v. Commissioner, T.C. Memo 2021-48
   a. Petitioner's experts applied tax affecting – but different appraisers used different rates. Respondent objected to tax affecting.
   b. After citing some aspects of tax affecting, the Court rejected tax affecting in this case, stating: "This all leads us to find that tax affecting is inappropriate on the specific facts of the case."

C. Estate Cecil v. Commissioner, T.C. Memo. 2023-24 (2/28/23).

This case consolidates two similar actions, each involving valuation of property transferred by gift.

During the late 19th century George W. Vanderbilt built the Biltmore House, located in Asheville, North Carolina's Blue Ridge Mountains. The Court noted that the Biltmore House is a French Renaissance chateau spanning over four acres of floor space, and that it remains the largest privately owned house in the United States.

Mr. Vanderbilt died in 1914, survived by his only child, Cornelia Cecil née Vanderbilt. His will left the Biltmore House and its surrounding acreage to Cornelia. During 1932, that property was transferred by gift during to TBC, Inc, a Delaware corporation ("TBC").

In 1982, TBC made an election to be treated as a Subchapter S Corporation ("S Corporation), under Code Section 1361. At a later point in time, each shareholder made gifts of TBC common stock, including gifts to family members, as well as gifts to several Qualified Subchapter S trusts set up to benefit descendants.

The shareholders later entered into an agreement that aimed to keep control of TCP within the family.

At issue was valuation of the S corporation stock for purposes of the federal gift tax. Several expert witnesses testified as to valuation; each applied tax effecting. The Court observed:

> Where, as here, the data used to value an S corporation are largely based on the data from C corporations, proponents of tax affecting believe that the mismatch from pretax cashflows and after-tax discount rates must be adjusted through tax affecting to ascertain the fair market value of the S corporation.

But the two sides differed as to what extent valuation discounts applied, giving regard to tax effecting valuation of S corporation stock.

Tax effecting was deemed appropriate by the Court, based on the specific facts of the case before it. However, the Court's opinion warns that that the Court was not adopting tax affecting as a matter of course in all cases, stating: "We emphasize, however, that while we are applying tax affecting here, given the unique setting at hand, we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation."

Contrast that statement to the pronouncement in the Jackson case (T.C. Memo. 2021-48), where Judge Holmes stated, "And we find, as we have done consistently in the past apart from Estate of Jones, that by a preponderance of the evidence tax affecting is not appropriate here because the Estate has failed to persuade us that a C corporation would be the hypothetical buyer of any of the three contested assets… We do not hold that tax affecting is never called for. But our cases show how difficult a factual issue it is to demonstrate even a reasonable approximation of what that effect would be. In Estate of Jones, there was expert evidence on only one side of the question, and that made a difference."

The Court concluded that the following percentage discounts were appropriate--

- Discount for tax affecting at the rate of 17.6 percent
- Discount of 20% for lack of control
- No discount was appropriate for lack of voting rights beyond the discount for lack of control
- Discount 27% for lack of marketability.

The valuation reduction resulting from all discounts was thus nearly 52 percent, as follows:

Value before discounts		100.000%
Less	17.60%	-17.600%
Balance		82.400%
Less	20%	-16.480%
Balance		65.920%
Less	27%	-17.798%
Balance after all discounts		48.122%
Net percentage decrease		51.878%

D. IRS Job Aid Position Tax Affecting. "A Job Aid For IRS Valuation Analysts," dated October 29, 2014. "This Job Aid is not Official IRS position and was prepared for reference purposes only; it may not be used or cited as authority for setting any legal position." Here is a quote from that Job Aid:

> "With respect to the question of pass-through taxation, no entity level tax should be applied in the valuation analysis of a non-controlling interest in an electing S Corporation, absent a compelling demonstration that independent third parties dealing at arms-length would do so as part of a purchase price negotiation. In a similar manner, the personal income taxes of a potential interest buyer or interest seller are not relevant in determining the fair market value of an interest in an electing S Corporation. The application of investor level characteristics such as personal tax rates results in an investment value to an assumed candidate buyer rather than a fair market value based on the informed, competing interests of the hypothetical willing and financially able parties contemplated by the fair market value standard."

E Select Non-Tax Cases Addressing Tax Affecting

1. Delaware Open MRI Radiology Associates, P.A. v. Kessler, 898 A.2d 290 (Del. Ch. 2006). Shareholder Dispute.
    a. There are favorable tax benefits of a profitable S corporation that should be considered in valuing stock in the corporation.
    b. Not tax affecting earnings S corporation earnings at all results in an artificial inflation of the value of the corporation.
    c. Applied tax-affecting because the Court found that it is necessary to use a method that considers the difference between the value as a C corporation and the value as an S corporation.
    d. Other factors in this case: Small entity, no indication there would be a loss of Subchapter S status, distributes cash in excess of the shareholder level taxes shareholders must pay, and S corporation tax status is a highly valuable attribute to the shareholders.

e. Court discussed differences between *Adams*, *Heck*, and *Gross* – this Delaware shareholder dispute case is a "fairness" value. Court wanted to consider benefits and detriments on cash received by shareholders.

2. Bernier v. Bernier, 449 Mass. 774 (2007). Family Court Divorce and Separation.
   a. Applying C corporation tax rates to an S corporation severely understates fair market value by ignoring existence inherent tax benefits of an S corporation, and thus fails to compensate the seller accordingly
   b. However, failure to tax affect S corporation earnings entirely will artificially inflate its value by overstating the rate of return that the retaining shareholder could hope to achieve
   c. "[T]he metric employed by the *Kessler* court provides a fairer mechanism for accounting for the tax consequences of the transfer of ownership of the [S corporations] from one spouse to the other in the circumstances of record." Thus, the case was remanded to the trial judge to employ the tax affecting approach adopted in Kessler.

III. VALUING FRACTIONAL INTERESTS

A. Joint Tenancy - Young

The court in Young held that section 2040 is not concerned with quantifying the value of the fractional interest held by the decedent (as would be the case under section 2033). The fractional interest discount, as applied in section 2033, is based on the notion that the interest is worth less than its proportionate share, due in part to the problems of concurrent ownership. These problems are created by the unity of interest and unity of possession. However, at the moment of death, the co-ownership in joint tenancy is severed, thus alleviating the problems associated with co-ownership. Therefore, joint tenancy property is not entitled to a fractional interest discount.

B. Real Property Tenants-In-Common

1. Fractional Interest Valuation Cases.

a. Propstra. In Propstra, 680 F.2d 1248 (9th Cir. 1982), the court applied a 15% discount on residential property owned as community property. Note IRS argued that discount should limited to cost of partition (which the court found inappropriate) and taxpayer only asked for 15%.

b. Brocato. In Brocato, T.C. Memo 1999-424, the court applied a 20% fractional interest discount applicable to 8 apartment buildings. Taxpayer's expert provided eight comparable sales of fractional interests. Court found this more appropriate measure than the limited analysis of the IRS's expert that based the fractional discounts on the costs to partition the properties. Note the Tax Court concluded an 11% blockage discounts was appropriate in addition to the fractional interest discount.

c. Busch. In Busch, T.C. Memo 2003-3, the court applied a 10% fractional interest discount was found to apply to unimproved land the Tax Court believed would be sold to a housing developer because none of the owners were interested in farming the land. The Tax

Court rejected Petitioner's asserted 40% percent discount. See the discussion of the Busch case herein where voters would not allow the property to be developed.

d. Stevens. In Stevens, T.C. Memo 2000-53, the court applied a 25% fractional interest discount applied to fractional interests in leased commercial properties. Cost to partition was not used because that approach does not account for the factors of control and marketability.

e. Baird. In Baird, T.C. Memo 2001-258, the court applied a 60% fractional interest discount applied to fractional interests in timberland. Note that the IRS maintained the cost of partition analysis and Petitioner was awarded attorney's fees. See Baird v. Commissioner, 416 F3d 442 (5th Cir. 2005), rev'g T.C. Memo. 2002-299.

f. Youle. In Youle, T.C. Memo 1989-138, the taxpayer's claim to a 12.5% fractional interest discount was upheld. Appraiser for taxpayer discussed the difficulties associated with tenancy in common as well as the difficulty and undesirability of partition the underlying property. Furthermore, the appraiser pointed out that a 12.5% sum was rather small given that difficulties found in similar cases often warranted a 20-25% discount. The Service countered that a partition was a simple process but provided no expert testimony.

g. Pillsbury. In Pillsbury, T.C. Memo 1992-425, the taxpayer's claim to a 15% fractional interest discount was upheld. Here, a marital trust owned an undivided 77 percent interest in residential real property with the remaining 23 percent interest being held by the trustee of the same trust for the benefit of the children of the decedent's spouse. The trustee of the trust for the benefit of the decedent and the trustee for the benefit of the children were the same bank. The estate's expert provided evidence that a discount was warranted due to a lack of general control, a lack of marketability, illiquidity, and potential partitioning expenses. When the taxpayer asked for a 15% discount, the Service countered that a discount was inappropriate because the same trustee bank held all of the property. The court, however, dismissed this argument, saying that this "unity of ownership argument" is inconsequential in a "willing buyer-seller" analysis.

h. LeFrak. In LeFrak, T.C. Memo 1993-487, the taxpayer's claim to a 30% total discount was upheld. Taxpayer gifted interests in income producing property to his children and trusts for their benefit but argued that such gifts should be discounted because they were minority interests and thus not readily marketable. The Service contended that discounts were not appropriate because the donor and donees were all members of the same family; however, the Tax Court rejected this argument, stating that the donees' family ties should not preclude the allowance of a minority discount when dissension and discontent could alienate them from one another at any time. As such, the court granted a 20 percent discount for minority and a 10 percent discount for lack of marketability.

i. Estate of Cervin. In Estate of Cervin, T.C. 1994-550, the taxpayer's claim to a 25% discount was reduced to 20% by the court. Decedent owned an undivided 50 percent interest in a farm and an undivided 50 interest in a homestead. His son and daughter owned the rest. While the Estate argued that petitioning was impossible and a 25 percent discount as warranted, the Service contended that the costs of partitioning would only result in a 6.54 percent discount for the farm and an 8.20 percent discount for the homestead. Though the court refused to value the property as a whole, it permitted a discount of 20% based on what it saw as the substantial costs of a hypothetical partitioning.

j. Estate of Williams. In Estate of Williams, the taxpayer's claim to a 44% discount was upheld. Decedent owned undeveloped rural timberland and farmland, a one-half

interest of which was transferred to the petitioner in this case. Petitioner showed that banks would not provide loans to the owner of a fractional interest in real property without the consent of the other owner, and petitioner's expert stated that fractional interest in the property were not marketable and no comparable sales could be identified; as such, a 44 percent discount was justified. The Service contended that because the property had many potential uses and the petitioner had not shown evidence of actual sales of fractional interests in real property, only a 5 percent discount was warranted. Siding with the petitioner, the court was persuaded that the inability to present evidence of sales adduced the conclusion that there was no market for fractional interests in such property, thus necessitating the discount.

k. Estate of Forbes. In Estate of Forbes, T.C. Memo 2001-72, the court sided with one of taxpayer's two experts who called for a 30% discount. Decedent's husband owned property held in a limited partnership and placed in a QTIP trust for the benefit of the decedent during her lifetime. The taxpayer's first expert used, in the eyes of the court, faulty reasoning and did not fully articulate the present value calculations. However, the taxpayer's second expert persuasively argued that a 30 percent discount was appropriate given the minority interests of the parties and that the corresponding market for such interests would shrink given the limited pool of potential buyers, the difficulty in finding financing, and the costs of partitioning the parcels. The Service's expert tried to use a comparable sales approach, but after such "comparables" indicated discounts ranging from 25 to 64 percent, the Service without explanation concluded that a 19 percent discount was appropriate. Ignoring the Service's approach, the court stated the taxpayer's second expert was reasonably justified given the properties' specific characteristics, the possible familial conflicts that would make a hypothetical sale more problematic, and other factors regarding marketability.

l. Ludwick. In Ludwick, T.C. Memo 2010-104, the court dismissed the arguments of both experts, yielding a discount of 10%. Favoring the cost-to-partition approach, the judge asked the following question: "Why would a buyer of an undivided interest in a piece of property consider the interest worth any less than a proportional share of the fair market value of the whole property reduced by partition costs?" While both experts agreed that the lack of marketability of the interest, as well as the illiquidity resulting from the risk, uncertainty, and time lapse of the partition process were clearly relevant and required consideration, the two side's experts differed sharply in the corresponding discount from the fair market value. The taxpayer's expert foresaw a partition time frame of 2-3 years, $10K in appraisal costs, and $70K in litigation costs, whereas the Service's expert painted no timeframe but listed only the "judicial costs", including $10K for filing fees, 4-6% broker fees, and 1% closing costs. Rejecting both analyses, the judge used his own inputs. To the judge, if the partition was contested, it would take two years, but if not, it would only take one year to partition the property. Further, the judge decided on litigation costs equal to $72,500, selling costs of 6 percent, operating costs of $350,000, a growth rate for the property of 3 percent, and a discount rate for the present value of calculation of 10 percent.

2. IRS Rulings

a. PLR 9336002. The Service held that in valuing an undivided interest in property, a party should be allowed a discount only to the extent of the costs incurred in partitioning the property. In looking at the definition of fair market value, the Service noted that it required a hypothetical buyer and seller to act in their "own best economic interests." It then pointed out two

instances in which courts have pointed to the alternative of partitioning as resulting in a greater economic benefit to the holder of an undivided interest. See Estate of Frank Fittl v. Commissioner, T.C. Memo 1986-542 (1986) and Kennedy v. Commissioner, 804 F.2d 1332 (7th Cir. 1986).

b. TAM 199943003. The Service found that the fair market value of a party's undivided interests in real property is the price at which the property would change hands between a willing buyer and a willing seller with neither party being under any compulsion to buy or sell, and with both having reasonable knowledge of all relevant facts. Looking once more at Fittl, supra, the Service noted that an accurate way to deduce the fair market value of an undivided interest was to subtract the costs to partition the property (specifically those proportionally allocable to the interest itself) from the undiscounted fair market value of that party's particular interest.

3. Valuation Approaches

a. Fractional Interest Discounts. For both gift and estate tax cases, fractional interest discounts have attracted close IRS scrutiny. IRS commonly asserts the fractional interest discounts are limited to costs of partition. See PLR 9336002 and TAM 199943003.

Fractional interest discounts still generate a lot of controversy. In most cases, fractional interest discounts are applicable to real estate holdings. Propstra, 680 F.2d 1248 (9th Cir. 1982), in the Ninth Circuit, and many other cases make this a certainty. The amount of applicable discount is a facts and circumstances test applied in each case, not one size fits all!

i. Cost of Partition. The IRS often argues that a fractional interest discount should be limited to costs of partition. An important consideration here is the value of the property as it relates to the costs of partition. With a low-value property, the costs of partition could be tremendous in relation to the value of the property, yielding a very high discount. With a high value property, costs of partition in relation to the value of the property could be minor, perhaps 3% or less.

ii. What is the Fractional Interest Discount? A fractional interest discount is made up of lack of control and lack of marketability factors. Typically, a single discount is determined by appraisal to reflect both of these factors. Each property will have a different factual background enhancing or reducing each factor.

iii. Lack of Control. In a co-tenancy relationship, no one co-tenant has control. For example, if the property is to be leased, all tenants must approve the lease (otherwise the prospective tenant would not obtain exclusive use and possession of the property). If one small owner does not agree, then no owner is making money. For these and other reasons, many practitioners and appraisers believe a lack of control discount is warranted.

iv. Lack of Marketability. There is no ready market for fractional interests in real estate. As a result, generating liquidity can take some time, more time than a 100% interest in the same real estate. Further, lenders typically will not secure loans with fractional interests in real estate. Thus, in the case of larger interests (by value) financing is unavailable, thereby shrinking the pool of possible buyers (and buyers know that if they later need to sell, they will be hard pressed to find another buyer).

A right to partition is not liquidity. A hypothetical buyer does not buy a fractional interest to file a lawsuit to partition. Reasonable people first try to work things out, which adds to delay. Further, courts often grant extensions and other delays in court proceedings. If the property is located in a falling real estate market, what is the cost then? Some real estate markets fell 40% or

more during the recent economic recession. What a market will do over the next 6 months to 2 years cannot be known, and thus a significant discount is warranted.

b. Co-Tenancy Interests: Current Thinking on the Valuation and Use in Estate Planning.

The following discussion details some of the more common methods used to derive the fractional interest discount.

i. Undivided Interest Studies. The most obvious source for co-tenancy valuation data is the small group of co-tenancy discount studies that have been published over the years. While the studies are the most on-point data source for valuation information, it's important to conduct a thorough comparative analysis between the subject interest and the types of undivided interests that are included in each study. For example, if the subject interest is a cash-flowing rental apartment complex, it may not be directly comparable to studies focusing on undeveloped land assets. It's imperative that the appraisal report shows the proper nexus between the comparables used in its analysis and the subject interest. Unfortunately, it's easy to simply apply central tendencies from these studies without truly understanding the applicability to the subject interest.

ii. Partition Analysis. If partition is a viable path for the interest holder to achieve liquidity, the valuation professional must look at the cost and time required to go through a partition action. This analysis is set up as an income approach, in which the estimated future value of the real estate at the completion of the partition action is valued together with interim cash flows. Interim cash flows include any net income generated during the time from the date of valuation through the conclusion of the partition action, as well as all costs associated with the partition action. The discount rate should, at a minimum, be the real estate capitalization rate plus the long-term rate of appreciation in real estate value. However, there is theoretical support for using a higher rate to reflect the minority features of a co-tenant.

iii. Partnership Studies. Assuming there is a co-tenancy agreement in place in which the co-tenants waive the right to partition, a good case can be made for using LP transactions as a proxy for the valuation discounts. When developing discounts based on LP transactions, a thorough comparison should be made between a typical traded LP interest and the subject co-tenancy interest. Neither type of interest affords the holder control over the underlying assets. A limited partner has even less control than a co-tenant. On the other hand, while a limited partner has limited liability, a co-tenant has unlimited liability and is often jointly and severally obligated for any debt held by the co-tenancy. Based on the comparison, appropriate adjustments to the indicated discount should be made.

iv. Minority Premium Method. An IRS engineer presented this new methodology in 2011. With this methodology, the appraiser assumes a majority holder would pay a minority owner a premium to buy out his or her interest. IRS has applied this methodology in certain cases at exam but is it untested in the courts. There are legal issues inherent in this method when applied in the context of the tax valuation hypothetical willing buyer and willing seller. As discussed above, the actual owners must be considered, not hypothetical owners. If all owners say they would not pay any premium, the method could not be used. Further, assuming what a hypothetical person would do is legally impermissible (see Mitchell, and the rejected lease buy-out). These and other valuation and legal aspects have most appraisers rejecting the approach.

4. Summary of Case Discount Results & Accepted Methodologies (Discount Focus)

The following is a more detailed discussion of methodologies used in select cases. The purpose of the following discussion is to provide the reader with a flavor of how the courts have applied and discussed various methodologies to derive the fractional interest discount. Universally, the courts found: (i) the cost of partition is not the only factor to consider; (ii) the facts of each case drive the analysis; and (iii) ultimately the court will apply its judgment to determine the appropriate discount. That the court will apply its judgment to the facts of a subject case, and not apply a formula or discounts from prior cases, highlights the risks of taking valuation cases to trial.

a. Propstra. In Propstra, infra, the court started its analysis by noting that upon requesting summary judgment, the estate submitted affidavits from two qualified appraisers. Their testimony showed that the value of an undivided, fractional interest in real property would be less than a proportionate share of the fair market value of the whole. One appraiser estimated the value of the interest in question at $1,639,500; the other made no specific estimate. The Government submitted no countervailing facts regarding the value of the undivided one-half interest in the parcels. Instead, IRS argued that, although it failed to tender any evidence that raised a genuine issue of fact, the estate failed to meet its burden of proof. Specifically, the Government contended that, not only must the estate prove the value of the interest if sold separately, but it must also prove that the interests in question were likely to be sold apart from the other undivided one-half interest in the property. The Government argued that, in the absence of such a showing, one can reasonably assume that the interest held by the estate will ultimately be sold with the other undivided interest and that interest's proportionate share of the market value of the whole will thereby be realized.

After considering the language of sections 2031 and 2033 of the Internal Revenue Code of 1954 (I.R.C.) and their accompanying regulations, the Court was unwilling to impute to Congress an intent to have "unity of ownership" principles apply to property valuations for estate tax purposes. To the court, sections 2031 and 2033 provide that the value of a decedent's gross estate shall include the value of all property to the extent of his interest therein at the time of his death. Treas. Reg. Section 20.2031-1(b) defines "value" for the purposes of Sections 2031 and 2033 as "fair market value at the time of decedent's death." It then defines "fair market value" as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." By no means, in the eyes of the court, is this language an explicit directive from Congress to apply unity of ownership principles to estate valuations. In comparison, Congress has made explicit its desire to have unity of ownership or family attribution principles apply in other areas of the federal tax law. See, e.g., I.R.C. Sections 267, 318, and 544. In the absence of similarly explicit directives in the estate tax area, the court decided to not apply these principles when computing the value of assets in the decedent's estate.

Furthermore, the court saw good reason to consider the "willing seller" mentioned in Treas. Reg. Section 20.2031-1(b) as a hypothetical seller rather than the estate or any of decedent's beneficiaries. Defining fair market value with reference to hypothetical willing-buyers and willing-sellers provides an objective standard by which to measure value. The use of an objective standard avoids the uncertainties that would otherwise be inherent if valuation methods attempted to account for the likelihood that estates, legatees, or heirs would sell their interests together with

others who hold undivided interests in the property. Executors will not have to make delicate inquiries into the feelings, attitudes, and anticipated behavior of those holding undivided interests in the property in question.

b. Brocato. The petitioner's appraiser examined eight comparable sales of fractional interests and the fractional interest discounts applied in each sale. In three of the comparable sales, no fractional interest discount was applied because the buyer was acquiring a controlling interest with the purchase of the fractional interest. However, in four others, there were fractional interests ranging from approximately 1 to 20 percent with discounts ranging from 6 to 50 percent. The appraiser adjusted three of the comparables downward and one upward to arrive at a 20–percent fractional interest discount. In making these adjustments, the appraiser examined the size of the comparable interests, lack of a market for the interests, special circumstances surrounding their sale, and whether there was a forced sale.

The parties' arguments center upon the correct method for determining a fractional interest discount. Courts have often looked at costs to partition in determining an appropriate fractional interest discount. Courts, however, consider other factors, such as the historical difficulty in selling these interests and lack of control. See Estate of Pillsbury v. Commissioner, T.C. Memo.1992–425.

As compared with the limited scope of the other appraiser, the court found the petitioner's appraiser to be more persuasive in determining the fractional interest discount.

c. Busch. Hulberg, petitioner's first appraiser, used four different approaches to arrive at the amount of discount he used to account for decedent's partial interest. First, he discussed a "Company Survey Method", which Hulberg described as a "survey of companies in the business of purchasing and selling partnerships." The court's review of Hulberg's analysis indicated that the partnerships involved were dissimilar to the Busch property situation. The information was derived from the purchase and sale of general partnership interests, a format different from the Busch property ownership, which was simply a coownership in real property with no partnership business or operational type activity. Accordingly, the discount percentages represented by that type of transaction are inapposite.

Next, Hulberg called upon the "Fractional Discounting Method". That method was set out in an April 1992 journal article, Davidson, "Fractional Interests in Real Estate Limited Partnerships, The Appraisal Journal, Apr. 1992, at 184–194, in which 10 factors were used to analyze the amount of a fractional interest discount. The factors employed, include: "Relative risk of the assets held, Historical consistency of distributions, Condition of the assets, Market's growth potential, Portfolio diversification, Strength of management." Those factors, to which Hulberg assigned values to arrive at an estimated 41–percent discount, appear to be the type of factors that are used in analyzing a going partnership business and not the simple coownership of raw land. The remaining four factors address the control aspects, or lack thereof, of a fractional or partial interest. Of the cumulative 41–percent discount reached by Hulberg, only 12 percent of it was attributable to the lack of marketability/control factors. The remaining factors depended heavily on the fact that the entity was a going partnership (income sources, etc.) and would, therefore, not be applicable to measure the partial interest discount in this case.

Then, Hulberg used a "REIT Survey Method" that "involves an analysis of discounts found in real estate investment trust (REIT's)." Hulberg indicated that the average discount was 39 percent with a range from 30 percent to 40 percent. Here, again, Hulberg's explanation reflected that REIT's are operating real estate entities that are dissimilar from the simple coownership of realty that we consider. The REIT is an entity in which investors purchase a percentage as an investor in the activity or business operation in which the REIT is involved. Accordingly, the REIT-based approach to calculate a discount is not appropriate.

Finally, Hulberg referred to his four proposed comparable sales that he admits "are not highly similar to the subject property but they do indicate discounts are being taken by the [purchasers] of * * * fractional interests, and that there is a market for partial interests in a property." The range of discounts was 29 percent to 41 percent. The sales selected by Hulberg included a produce terminal, undeveloped unapproved land, an office building, and ranchland. The undeveloped unapproved land was described as "Standard Oil Pond Grizzly Island (Solano Co.)", and Hulberg explained that the property was valued at $800,000 for a fee and a 25–percent interest was sold for $130,000. No further information is provided, and it is not apparent that this property is comparable or how the $800,000 and $130,000 values relate to each other. Accordingly, the court found none of these examples to be helpful.

Hulberg then proceeded to conclude that the various referenced approaches resulted in discounts approximating 40 percent and that 40 percent is therefore appropriate. Hulberg, in addition to addressing the lack of approval for residential development, factored in the lapse of time in arriving at a 40–percent discount rate. The court did not find any of Hulberg's approaches to be fitting or appropriate, though the court did admit that some discount would be appropriate. In summary, Hulberg first discounted by as much as 80 percent, and then discounted the resulting amount by an additional 41 percent reflecting various factors, including lack of control, passage of time, and factors that would only be relevant in the consideration of a going partnership.

On the other hand, DeVoe, petitioner's appraiser who was used to provide a value for the estate tax return, started with a $137,500–per–acre value and discounted it by 40 percent to account for the partial interest. That approach resulted in a $3,810,000 value being reported on the estate tax return. The court concluded that the per acre cash value is $150,000 and discounted that amount to account for the passage of time and, to some extent, for the risk associated with the possibility that approval for development might not be obtained. That discount resulted in reducing the value of decedent's one-half interest from $6,805,500 ($150,000 x 90.74 x .50) to $4,656,496 (see present value computations, supra, p. 28) or a reduction of 31.6 percent. Based on the court's evaluation of the evidence, it appeared to the court that DeVoe's valuation appraisal was conservatively performed favoring decedent's estate. The court reached that conclusion because he used a per acre value at the lower ranges of the true comparables and a discount rate at the highest end of the spectrum when considering the facts in our record.

According to the court, a smaller partial interest discount than used by petitioner's appraisers would be appropriate in the circumstances of the case. As already noted, as of decedent's death, there were no owners or potential owners who, like decedent and his deceased brother/co-owner were solely interested in farming the land. The heirs of both owners were interested in selling or developing the land in light of the substantial difference in its value for that use. At the date of decedent's death, his co-owner was a trust for a 97–year–old woman, and there was no doubt that the highest value of the land was as residential property. Under these circumstances a 10–percent discount would be sufficient to account for the partial interest represented by a simple

coownership in unimproved land. As already discussed, 10 percent would also be more than adequate to accommodate reasonable costs of partition (10 percent of the rounded one-half interest ($4,660,000) or $466,000) in the event that either set of heirs of the then-current co-owners might not be interested in selling the property for its highest and best use (residential development). As such, the court found that the fair market value of decedent's one-half interest in the *Busch* property at his date of death is $4,190,496 ($9,312,992 x .50 = $4,656,496—$466,000 = $4,190,496).

d. Stevens. Hulberg, the same appraiser from Busch, used the same appraisal methods as in Busch: the "Company Survey Method," the "Fractional Discount Method," and the "Comparable Sales Method." Considering the parties' experts' reports and opinions, the court found that the appropriate discount amount should be neither as low nor as high as those suggested. The court saw a 25–percent discount as appropriate for all three of the properties. To the court, this figure was supported by the factor analysis for fractional interests, which gave them a figure between 25 percent and 27 percent. The court did not limit the discount to the costs of partitioning because such a discount does not account for the factors of control and marketability in the circumstances of the case. An interest in income-producing, improved real property without control and in a closely held family property may be difficult to sell.

e. Baird. The court began by noting that the evidence, experts' reports, and other testimony reflect that the market for partial interests was extremely limited. One of petitioners' experts reflected that partition under the facts of these cases would have been difficult, protracted, and expensive.

The court then noted that while it may have been appropriate to consider the amounts of discounts decided by courts in prior cases, those discounts were not intended as minimum or maximum limits for certain types of discounts. The amount of discount in each case must be determined ad hoc, and the facts in each case must provide the basis for the proper amount of discount. The facts in a case, along with the court's understanding of the actual marketplace, must drive the analysis.

After considering the record and the experts' reports and testimony, the court held that the estates have established 55 percent as a mean and/or average amount by which fractional interests in Louisiana timberland which do not result in control are discounted. The court was also convinced that the peculiar circumstances shown to exist with respect to the decedents' remaining family members support an increased discount.

The court noted how it placed reliance in the appraiser's expertise and actual practical experience. His report and testimony were based on his personal knowledge and experience in the very marketplace under consideration. Mr. Steele's "at least 55–percent discount" in his written report comported with the other experts' findings and conclusions. However, the appraiser's trial testimony suggesting a 90–percent discount, however, was unfounded and without support in the record. The court could not accept that a willing seller would accept 10 cents on the dollar for a partial interest in timberland, and no such comparables were shown to exist.

5. Comment on Appraisal Methods. IRS is attacking the appraisal methodology used by appraisers. The goal appears to be to discredit all approaches, so we are left with cost to partition. In several recent cases, IRS asserted real estate partnership data is not appropriate to determine the fractional interest discount. The case cited for this proposition is Busch, infra. A

careful reading of Busch reveals no such conclusion. In Busch, the Tax Court analyzed the approach for determining fractional discounts that relies upon real estate limited partnerships. The methodology looked at 10 factors, 6 of which the Tax Court found inappropriate to co-ownership of property because they depended heavily on the entity as a going partnership (income sources, etc.). The other 4 factors dealt with lack of marketability/control factors and yielded a discount of 12 percent according to Petitioner's expert. The court did not say the method could not be used, only that its application in this case was not appropriate. Petitioner's expert also looked at real estate investment trust (REIT's) data and the Tax Court found that REITs are not similar to simple co-ownership and accordingly, the REIT-based approach to calculate a discount was not appropriate.

Note the Busch case was a Judge Gerber opinion. The Stevens, infra, case, also a Judge Gerber opinion released in year 2000 relied upon the "factor analysis" which was used by Petitioner's expert. Judge Gerber did not find the real estate partnership data unreliable.

Actual sales data is the best evidence of the fractional interest discount. However, in many cases that data is not available due to geographic region or reasonably close time period to the valuation date. In one case, IRS asserted the comparable sales were not comparable due to geographic location and instead wanted to rely upon a Florida law partition analysis to determine the cost of partition in California! Talk about picking and choosing.

C. Approaches in the Valuation of Artwork Held as Tenants-In-Common

Valuing fractional interests in tangible personal property poses unique questions and problems. There are very few cases in this arena and the law will continue to develop over time. As discussed below, the type of appraiser is an important consideration. In light of Elkins, infra, the identity of the other co-owners perhaps is more important (or perhaps the analysis an attempt to re-introduce concepts of family attribution). The law in this area will continue developing as taxpayers learn how to address the appraisal mistakes made in prior cases.

An important tenant of valuation is to use an appraiser with knowledge and skill in valuing the type of property being valued. This is confirmed by Federal Rule of Evidence 702, which provides as follows:

"A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:
(a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;
(b) the testimony is based on sufficient facts or data;
(c) the testimony is the product of reliable principles and methods; and
(d) the expert has reliably applied the principles and methods to the facts of the case."

Thus, the appraiser must have knowledge, skill, and experience valuing the type of property being valued. This includes, of course, the type of business being valued. If valuing a plumbing company, an appraiser with knowledge, skill, and experience in valuing plumbing companies should be retained. There is a lingering question regarding who should value fractional interests in real estate. Should it be a business appraiser or a real estate appraiser? There are arguments that support both.

Fractional interests in tangible personal property are another matter entirely. Sales of fractional interests in tangible personal property are hard to come by. Further, very few people have experience valuing such interests. Business appraisers, while perhaps appropriate for valuation fractional interests in real property, may not be best suited for valuing fractional interests in tangible personal property. While this is not to say that no business appraiser could do the work, only such an appraiser with the appropriate knowledge, skill, experience, training, or education in this area should be retained.

The following discussion reviews some of the approaches used by taxpayers in the few cases in this arena.

1. The Business Appraiser. In Stone v. United States, No. C06-0259, (No. Dist. Ca., 5/25/2007), the taxpayer retained a business appraiser to value fractional interests in artwork. The decedent owned a 50% interest in 19 expensive paintings. At trial the business appraiser admitted he could find no data regarding sales of undivided interests in art. As a result, he based his valuation (and the contended corresponding discount) of the Estate's interest in the collection in part on sales data for undivided interests in real estate and limited partnerships holding real property.

The court rejected this approach finding that the art market differs markedly from the real estate or business market. Namely, the court noted, art is simply not fungible, and found troubling the lack of evidence that sales of partial interests in artwork have been sold at a discount. As such, the court instead concluded that a hypothetical willing seller of an undivided fractional interest in art would likely seek to sell the entire work of art and split the proceeds, rather than seeking to sell his or her fractional interest at a discount. According to the court, at a minimum, "because an undivided interest holder has the right to partition, a hypothetical seller under no compulsion to sell would not accept any less for his or her undivided interest than could be obtained by splitting proceeds in this manner." Thus, the court found that the discount "floor" in this context is the cost to partition.

The court next considered costs of actually selling artwork, such as "commissions and sales" fees inherent in the process by which artwork is sold. The court also considered uncertainties involved in waiting to sell the art until after the partition action is resolved. In the Stone case, the court found that such considerations resulted in a 5% fractional interest discount, of which 2% was attributed to the costs to partition and the uncertainties involved in waiting to sell after the resolution of the hypothetical partition action.

As with any case, the results are heavily driven by the evidence presented. Valuation cases are heavily driven by what the appraiser can bring to the table. The question from Stone is whether an art appraiser would have been more persuasive to the court. Of course, the answer to that question is based, at least in part, on what the art appraiser could have brought to the table.

2. The Multi-Appraiser Approach. Using multiple appraisers can alleviate uncertainties inherent in valuation cases. Costs are always a concern, but in larger valuation cases (and cases involving more difficult valuation questions) the additional costs are justifiable.

The taxpayer in Elkins, 767 F.3d 443 (5th Cir. 2014), *aff'g in part and rev'g in part* 140 T.C. 86, brought three experts to court to prove its case regarding fractional interests in 64 pieces of artwork includible in the decedent's gross estate for estate tax purposes. Each expert had a different background and philosophy with regard to valuing fractional interests in artwork.

a. Appraiser and Seller of Fine Art (Mr. Nash). Mr. Nash supported a deep discount, summarizing "key factors" which made the decedent's fractional interests "unappealing" to potential buyers:

i. the inability to sell the art at auction houses;
ii. the lack of exclusive possession and the inability to force a sale of the art without litigation against the Elkins children as co-owners;
iii. possible litigation involving time of possession and proper care, storage, or transportation of the art;
iv. the difficulty or impossibility of insuring the purchased interest or using it as collateral for a loan.

b. Property Lawyer (Mr. Miller). According to Mr. Miller, while the right to partition is absolute, cotenants may expressly or impliedly agree not to partition. Even if the cotenants so agree, however, such an agreement is not enforceable forever, and eventually a party will be able to bring suit to partition an interest from the whole.

When that party does so, Mr. Miller noted, any partition action with respect to any single piece of art would start with a trial to determine (1) the enforceability of the cotenants' agreement, (2) whether partition by sale or in kind is appropriate, (3) the co-owners' interests, (4) whether the art is susceptible to partition, and (5) whether to appoint a receiver for any sale of the art. Then, a second trail would be held to determine (1) the terms of any proposed sale, (2) the property to be sold, (3) the method of sale, and (4) the distribution of proceeds among the co-owners.

c. Valuation Consultant (Mr. Mitchell). Mr. Mitchell started with the proposition that there are two options for the holder of an undivided interest in art to monetize his holding (absent unanimous consent of all undivided interest holders):

Option 1: A sale of his undivided interest.

In this scenario, the holder and the hypothetical willing buyer would consider a number of adverse factors in arriving at a price for the holder's undivided interest subject to an amended cotenant's agreement. These include the following:

i. the need to obtain unanimous consent of all cotenants to sell the work of art
ii. limited possession of the art and, hence, reduced psychic benefit
iii. the cost of transporting the art from another cotenant
iv. joint responsibility for the insurance, maintenance, or restoration costs with respect to the work of art, and
v. risk of damage to the art by other cotenants

Together, all of these would induce a prospective collector-buyer to demand a substantial return premium (discount) related to the reduction of both the buyer's psychic and financial returns

attributable to fractional ownership. Given this enhanced return premium, there would necessarily entail a substantial reduction in value from the pro rata fair market value.

Option 2: A successful partition action ultimately leading to a sale of the work and pro rata distribution of the proceeds among all interest holders.
In this scenario, the dollar amount of any discount must exceed the anticipated partition litigation costs to make the investment worthwhile. Because a partition action would most likely provide a strictly financial outcome (share of proceeds of a court-ordered sale of the art), the buyer will have abandoned any psychic benefit and, therefore, is necessarily a speculator and not a collector.

d. Court's Holding. The court held that there was no bar, as a matter of law, to an appropriate fractional interest discount. However, a hypothetical willing buyer and seller of decedent's interests would agree upon a price at or fairly close to the pro rata fair market value of those interests. Given the circumstances of the case, the court held that a hypothetical buyer and seller of all or a portion of decedent's interests would agree to a 10% discount from the pro rata fair market value in arriving at a purchase price for those interests. Such a 10% figure, in the eyes of the court, would assure a hypothetical buyer a reasonable profit on a resale of those interests to the Elkins children.

e. Appeal to the Fifth Circuit. On Appeal to the Fifth Circuit Court of Appeals, IRS continued to assert that no discount should apply because there is no market in fractional interests in art. In fact, at trial the only expert IRS brought was one that testified as much. IRS took an aggressive position and did not have support in the event its position was thrown out. IRS' position was founded on Treas. Reg. Section 20.2031-1, which states in relevant part as follows: "The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate." IRS took the opposite of the multi-appraiser approach. The Fifth Circuit affirmed the Tax Court's rejection of IRS's argument that no fractional interest discount should apply and affirmed the Tax Court's conclusion that some level of discount is warranted.

The Fifth Circuit then looked into how the Tax Court arrived at the 10% discount. IRS failed to provide any evidence as to the "quantum" of the discount. Only taxpayer provided such evidence. As a result, the burden of proof shifted to IRS. Since IRS chose not to produce any evidence whatsoever as to the quantum of the discount, the case should have ended at that point in favor of the taxpayer. Instead, the Tax Court made a mistake in concluding a nominal 10% discount applied and found the Tax Court's conclusion constitutes reversible error under "any standard of review." The Fifth Circuit held that "the correct quantums of the fractional-ownership discounts applicable to the [taxpayer's] pro rata share of the stipulated FMVs of the various works of art are those determined by the [taxpayer's] experts." The result is an approximate 45% fractional interest discount on artwork!

3. <u>Art Appraiser's Point of View</u>. When seeking a business appraiser, many practitioners are looking for the appraiser to have an "ASA" designation from the American Society of Appraisers. The ASA designation is available for many other categories of appraisal work, including personal property. In fact, there are twenty-six (26) specialties from fine arts to

oriental rugs to Numismatics to fine wine. Thus, when looking for an appraiser it is advisable to look into appraisal specialties to make the best match between property and appraiser.

When considering fractional interests in artwork, there are many ASA designated art appraisers. Further, there is at least one who has written on fractional interests in artwork. Elin Lake-Ewald, President of O'Toole-Ewald Art Associates, Inc. and an esteemed appraiser of art, was approached in the mid-90's for her input on how to value a fractional interest in artwork. Though analyzed through a case-specific lens, Ms. Lake-Ewald cites the following factors in choosing to apply a substantial fractional interest discount in artwork:

a. There is no control over the sale or date of sale;
b. There is no control as to the marketing of the paintings;
c. There is no identifiable market for partial interests in paintings;
d. There is limited value in utilizing the fractional interest as collateral because of illiquidity;
e. There may be restrictions placed on transferring the interest;
f. The fractional interest does not include the entire bundle of rights associated with 100% ownership;
g. The potential purchaser of the fractional interest would be the single non-family member in an association of owners;
h. Because only two works of art are involved, there is little opportunity for risk-spreading;
i. The condition of the paintings in question mitigates against an easily facilitated sale;
j. The volatility of the art market, in particular at the date of valuation, leads to the assumption that the process of attempting to reach agreement among a group of co-owners as to the most advantageous sale date would likely prolong the disposal of the art-works.

For more information, see the article, entitled Viewpoint: Determining the Fair Market Value of Fractional Interests in Works of Article, Elin Lake-Ewald.

IV. VALUATION METHODS MUST BE CAREFULLY CONSIDERED

A. **Estate of Giustina v. Commissioner**, T.C. Memo 2011-141 (6/22/2011), reversed and remanded, 586 F. App'x 417 (9th Cir. 2014), on remand T.C. Memo 2016-114.

In Giustina, Decedent died owning a 41.128% limited partnership interest in Giustina Land & Timber Co. (the "Partnership"), which owned and operated timberland in Oregon. Decedent held no management control over the company and there were strict transfer, withdrawal, and dissolution provisions requiring 2/3 consent to dissolution. The issue for trial was the fair market value of Decedent's 41.128% limited partnership interest.

The Estate reported a $12,678,117 fair market value for the 41.128% limited partnership interest. The IRS issued a notice of deficiency claiming the value was $35,710,000. For trial, the Estate increased its asserted value to $12,995,000 and the IRS reduced its asserted value to $33,515,000.

The Partnership owned the following assets, with the indicated stipulated values:

48,000 Acres Timberland:	$142,970,000
Remaining Assets:	$7,700,000
Total Assets:	$150,670,000

Importantly, the value of the timberland reflects a stipulated 40% market absorption discount to adjust for the delays attendant to selling such a large land holding.

Looking at an asset-based approach, the pro rata value of Decedent's 41.128% limited partnership interest was $61,967,558. If one applied a fairly typical combined 30% discount for lack of control and lack of marketability, the fair market value of the interest would be $43,377,290. So how did the Estate reasonably assert a $13,000,000 value at trial? The answer is rather simple: an asset-based approach is not the only approach to value – especially for an operating business, such as the Partnership.

At trial, the Estate argued that the Partnership should be valued using exclusively an income-based approach and as a "going concern." The IRS used both an income-based analysis and an asset-based analysis to derive its value. Note, that an asset-based approach generally assumes a liquidation and sale of the assets. The subject interest was not sufficient to force a liquidation.

The Tax Court (Judge Morrison) concluded that the subject partnership interest should be valued with a combination of an income approach and an asset approach. The Tax Court stated: "In our view, the cashflow method is appropriate to reflect the value of the partnership as if operated as a timber company, and the asset method is appropriate to reflect the value of the partnership if its assets are sold. Accordingly, the percentage weight to be accorded the cashflow method should be equal to the probability that the partnership would continue to be operated as a timber company." And thus, the Tax Court undertook an analysis of the probability that the Partnership would liquidate its assets.

Here are the factors the Tax Court considered:

i. The Guistina family had a long history of acquiring and retaining timberlands;
ii. The Tax Court assumed that the owner of the subject minority interest would seek the maximum economic advantage from the asset;
iii. The optimal strategy to maximize value would be to sell the timberland and get $143,000,000 today;
iv. The owner of the subject minority interest could not alone cause the Partnership to sell its assets;
v. There are various ways in which a voting block could dissolve the Partnership;
vi. There is uncertainty how many partners would share the view that the timberland should be sold;
vii. The uncertainty does not prevent the Tax Court from estimating the probability of the sale;
viii. People tend to prefer $143,000,000 to $52,000,000 (the cashflow based value).

Based on these factors and citing a law review article instead of binding cases such as <u>Simplot</u> or <u>Morrissey</u> (where the Ninth Circuit gave clear valuation guidance) or <u>Estate of Mitchell</u>

or Estate of Elkins (where it is clear the actual other owners of the property must be considered, not speculated about), the Tax Court concluded there was a 25% chance the Partnership assets would be sold and the Partnership liquidated.

Turning next to the income approach to value, the Estate's expert, and the IRS' expert both used the cash flow method in determining the value of the subject interest. The cash flow estimates of the IRS' expert were found not persuasive, so the Tax Court gave little weight to the expert's cash flow analysis. Looking at the Estate expert's analysis, the Tax Court found that the discount rate (the rate at which cash flows are discounted to present value) used was too high. The Estate's expert used an 18% rate and the Tax Court found he should have used a 16.25% rate. The Tax Court found that the specific company risk of 3.5% was too high and reduced that portion of the discount rate to 1.75% (thereby reducing the total discount rate to 16.25%). The rationale for this reduction was "[u]nique risks do not justify a higher rate of return. Inventors can eliminate such risks by holding a diversified portfolio of assets."

The Tax Court next looked at the marketability discount that should be applied to the income-based approach. The Estate asserted a 35% discount, and the IRS asserted a 25% discount. The Tax Court adopted the IRS' 25% discount because the Estate's expert testified that 25% was reasonable and because the Estate's expert relied more on pre-IPO studies than restricted-stock studies. While there are specific reasons in this case why the Tax Court went this direction, the Tax Court has consistently questioned the reliability of the pre-IPO studies as the primary method of determining the lack of marketability discount. Note, no lack of control discount was determined or applied because the cash flow method applies a non-controlling discount rate and results in a non-controlling value of the cash flows.

The Tax Court next turned to the asset-based approach, or assumption of liquidation. The net asset value of $150,670,000 was agreed to by the parties. Thus, the issue was application of lack of control and lack of marketability discounts. In finding no discount for lack of control should apply, the Tax Court stated: "it is not appropriate to subtract a discount for the inability of the owner to control the affairs of the partnership…our calculations already assume that there was a 75-percent chance that the owner of the interest would have been unable to garner enough support from the other limited partners to sell the timberland. The inability to cause the sale of the timberland is an aspect of the lack of control. Thus, lack of control is already reflected by the 75/25 percentage weighting. No additional discount is needed."

The Tax Court also concluded that no discount for lack of marketability should apply. The Court stated, "[a] discount for lack of marketability reflects the inability of the owner of a business enterprise to quickly sell the interest. But in valuing the partnership interest as if there were a sale of the timberlands, we have assumed that the timberland could be sold for $143,000,000, a stipulated value that includes a 40-percent discount to reflect the delays in selling the land. It would be a double discount to reduce the value further to reflect delays in selling the partnership interest."

Ultimately, the Tax Court found that the subject interest was worth $27,454,115. This amount was derived as follows:

Income Approach:	$51,702,857	x.75	=	$38,777,143
Asset Approach:	$150,680,000	x.25	=	$37,670,000
				$76,447,143
DLOM (solely from income approach):				($9,694,286)
100% Value:				$66,752,857

41.128% Interest	x .41128
Fair Market Value:	$27,454,115

Comparison of trial positions and Tax Court conclusion:

Estate:	$12,995,000
IRS:	$33,515,000
Tax Court:	$27,454,115

Ninth Circuit Holdings. The Ninth Circuit reviewed the Tax Court's valuation analysis for clear error and came up with the following holdings:

- The Tax Court clearly erred in assigning a 25% likelihood of liquidation of the partnership because it relied on hypothetical events that were not supported by the record. Even though the Tax Court recognized that the owner of the 41.125% interest could not unilaterally force liquidation, it speculatively concluded that the owner of this interest could form a 2/3 voting bloc to force liquidation. The Tax Court made a number of unsupported assumptions and used "imaginary scenarios" that were not "reasonably probable." The Ninth Circuit remanded to the Tax Court to determine the value of the interest based only as if the partnership would remain in existence.
- The Tax Court did not clearly err by using pretax cash flows in its income-based analysis (as set forth in IRS' analysis).
- The Tax Court also did not clearly err in applying the IRS' 25% discount rather than the taxpayer's 35% discount.
- The Tax Court clearly erred by failing to adequately explain its basis for cutting in half the taxpayer's expert's company-specific risk premium. The Tax Court stated only that "[i]nvestors can eliminate such risks by holding a diversified portfolio of assets," and the Ninth Circuit found that the Tax Court failed to consider "the wealth a potential buyer would need in order to adequately mitigate the risk through diversification."

The Ninth Circuit reversed and remanded the case back to the Tax Court for recalculation of value as a going concern.

Ultimate Disposition. On remand, the Tax Court changed the weight accorded to the value of the partnership's assets. In the first opinion, the Tax Court assigned a 25% weight to the value of the partnership's assets and a 75% weight to the present value of the cash flows from the continued operation of the partnership. Based on the Ninth Circuit opinion, the Tax Court re-determined that the going-concern value is the present value of the cash flows the partnership would receive if it were to continue its operations. Therefore, the Tax Court changed the weight it accorded the present value of cash flows from 75% to 100%. This caused the adjusted valuation of the 41% limited-partner interest to be entirely based on the partnership's value as a going concern.

Second, the Tax Court determined that a hypothetical buyer of the 41% limited-partner interest would be unable to diversify the individual risks associated with the partnership. Without diversification, the buyer would demand the full 3.5% risk premium assigned to the interest by the estate's expert. In the first opinion, it was determined that the discount rate should be 16.25%, which corresponds to a direct capitalization rate of 12.25%. On remand the Tax Court determined

that the discount rate should be 18%, which corresponds to a direct capitalization rate of 14%. Increasing the discount rate from 16.25% to 18% caused the value of the partnership's cash flows to decrease to $45,240,000

Finally, after the two changes discussed above (eliminating any weight attributed to the value of the partnership's assets and applying the 3.5% partnership-specific risk premium), the valuation of the 41% interest was found to be $13,954,730. Here is a summary of values:

Estate:	$12,995,000
IRS:	$33,515,000
Tax Court:	$27,454,115
Tax Court:	$13,954,730 (on remand)

B. <u>Estate of Jones v. Commissioner,</u> T.C. Memo. 2019-101. (August 19, 2019).

This gift tax case involves valuation of interests in a partnership holding timber lands (SJTC) and an affiliated S corporation producing lumber (SSC). IRS asserted a gift tax deficiency of nearly $45 million. On May 28, 2009, Mr. Jones gifted 10,267.67 limited partner units to each of his three daughters. Each gift represented approximately 18.5% of SJTC. Also on May 28, 2009, Mr. Jones gifted shares in SSC as follows: (i) 1,300 shares of Class A voting stock to a voting trust (about 2.5% of SSC); (ii) 4,800 shares of Class B non-voting to each of three trusts, one such trust for each daughter and her descendants (each about 9.4% of SSC); and (iii) 5,456 shares of Class B non-voting to each of three trusts, one such trust for daughter (each about 10.7% of SSC). The questions for the Court were focused on valuation and included the following: (i) whether an asset based approach or an approach that uses the income and market based approaches should be used to value the 100% going concern value of SJTC; (ii) whether the 2009 revised financial projections for SJTC should be used; (iii) whether tax-affecting or a zero tax rate approach should be used in valuing SJTC and SSC; (iv) when valuing SSC, whether loans to SJTC and a 10% general partner interest in SJTC should be considered operating assets; and (v) what is the proper discount for lack of marketability.

The Court began by determining what valuation approaches should be applied to SJTC, a partnership holding timberlands. Both parties used market based approached – guideline public company method. Where they differed is on the second approach. Petitioner's expert used an income approach while Respondent's expert used an asset approach. After the Court concluded that SJTC had aspects of both an operating company (income approach) and an investment or holding company (asset-based approach), the Court then went on to analyze which approach (or weighting of approaches) should be used under these circumstances.

The Court looked to the likelihood that that timberlands would be sold. Respondent argued that circumstances could arise resulting in SJTC selling its timberlands. Petitioner argued that SJTC should be considered as part of SSC, and that the subject block of limited partner units could not force a sale of the timberland. Further, SSC would never exercise its authority as general partner of SJTC to sell the timberland. The Court ultimately found that an income approach (DCF) was more appropriate for SJTC than an asset-based approach (NAV approach).

In reviewing Petitioner's income (DCF) approach for SJTC, the court addressed two issues: (i) whether to use revised financial projections; and (ii) whether to tax-affect SJTC's earnings in the DCF model. SJTC issued annual reports that included yearly projections for SJTC. Two months after issuing its annual report, SJTC issued revised projections. Petitioner's expert relied on the revised projections and Respondent argued that the revised projections were unreliable. The

Court found that the revised projections (made in April 2009) were the most current as of the valuation date and thus appropriately used.

The Court then turned to tax affecting SJTC's earnings. The discussion, while under the DCF heading, also included a discussion of the market approach used by Petitioner's expert. "Tax-affecting" is adjusting earnings to account for taxes. When valuing a pass-through entity, such as a partnership or an S corporation, the earnings of the entity do not reflect any tax being paid. Yet, a DCF model is designed to capture the cash received from the entity's operations. Market approaches are designed to compare the subject company to public companies that are subject to C corporation taxes. Here, Petitioner's expert used a 38% combined federal and state income tax rate as a taxable C corporation (although he used individual rates, not corporate rates). After adjusting earnings for taxes, Petitioner's expert applied the discount rate the tax-affected earnings. Similarly, Petitioner's expert also used the tax-affected earnings when applying multiples derived from the guideline public company approach. After weighting the DCF approach and the guideline public company approach, Petitioner's expert applied a 22% premium to the weighted enterprise value of SJTC to reflect the benefit of SJTC's tax structure.

In a typical situation, the value of an enterprise run as a pass-through entity is lower if the earnings are tax-affected. This is true even after application of a premium to address the tax benefits of the pass-through entity. Respondent's position is that there should be no tax-affecting of earnings. Respondent argued that there is no evidence it is used in arms-length transactions, and the proper way to reflect the benefits of a pass-through entity structure is to not tax-affect earnings. In several tax cases discussed above, courts rejected tax-affecting earnings. Here, petitioner's expert presented evidence of tax-affecting. Respondent's experts were according to the Court, Respondent's experts "are noticeable silent." This led to the Court's observation, "Thus, we do not have a fight between valuation experts but a fight between lawyers."

The Court distinguished Jones from prior cases that rejected tax affecting earnings. With respect to *Gross*, the Court stated, "on the record of that case, a zero-percent corporate tax rate properly reflect those tax savings rejecting the expert's offered justifications." In a footnote, the Court further clarified that the expert in Gross tax-affected earnings using a 40% tax rate but did not apply a premium to reflect the tax benefits. With respect to *Gallagher*, the Court stated, "we again rejected tax-affecting because the taxpayer's expert did not justify it but again acknowledged that the benefit of a reduction in the total tax burden borne by S corporation owners should be considered when valuing an S corporation." With respect to *Giustina*, the Court stated, "we rejected tax-affecting in the valuation of a partnership because we found taxpayer's expert's method to be faulty: He used a pretax discount rate to present value post tax cashflow."

In valuing SSC, the Court addressed intercompany debt ($32.7 million debt owed by SJTC to SSC), SSC's general partner interest in SJTC, and tax-affecting SSC's earnings. On the intercompany debt ($32.7 million), the Court found that Petitioner's expert properly treated the debt as part of SSC's operations that produced operating income (instead of adding the debt to the value of SSC). The Court also found that Petitioner's expert properly used expected distributions to represent the value of the 10% general partner interest (instead of simply adding the value of a 10% general partner interest to the enterprise value of SSC). On tax-affecting SSC's earnings, the Court accepted the tax-affecting applied by Petitioner's expert for the same reasons it accepted tax-affecting for SJTC. This was the case because the expert used the same methodology as with SJTC (and even though used the same methodology yielded a different rate for the dividend tax avoided for the implied benefit of pass thought tax treatment).

In terms of incorporating other non-operating assets, SSC's 10% general partner interest in SJTC was included based on its expected distributions to SSC (not as an addition to value based on its value as an asset).

C. Kress v. United States, 372 F. Supp. 3d 731 (E.D. Wis. 2019)

In Kress v. United States, the Kress family members were shareholders of a closely held S-corporation, Green Bay Packing. The bylaws contained a Family Transfer restriction that allowed the Kress family to gift or sell their stock to their children and grandchildren. In 2006, 2007, and 2008, the Kresses' gifted minority shared to their children and grandchildren and reported it on their gift tax returns.

In 2014, the IRS sent notices of deficiency, challenging the valuation of the gifted shared. The taxpayer's expert represented an in-depth understanding of the company and a wide range of comparable companies in his analysis. The IRS's expert valued the company using the guideline public company as a C corporation and applied an S corporation premium. Accordingly, the U.S. District Court of Eastern District of Wisconsin concluded:

1) The taxpayer's expert appropriately valued the S-Corporation's stock.
2) The IRS's expert analysis of the market approach and income approach resulted in a higher estimate of the stock's fair market value because it did not consider the minority interest in evaluating the non-operating assets and stock as a whole.

IRC Section 2703(a) provides the valuation of any stock shall be determined without considering restrictions to sell the stock unless: (1) the transaction is a "bona fide business arrangement;" (2) the transaction is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration; and (3) the transaction's terms are comparable to similar arrangement entered into by persons in an arms' length transaction shall be considered when valuing such property.

Taxpayer's expert considered transfer restrictions in the Bylaws when valuing the company. The government argued that the restrictions on the transfer of stock in the company should have been disregarded under Section 2703 and thereby omitted during the valuation. The court analyzed the three-prong exception to I.R.C. Section 2703(a):

1) The first prong was satisfied because it was a bona fide business arrangement consistent with the goals of maintaining a family business, providing for the family members to make a living, and ensuring the interest of employees and the community.
2) The second prong was satisfied because the gifts were lifetime, not on death transfers. Surprisingly, the court held that this prong can only be failed if the valuation is in an estate tax context, it is automatically satisfied in lifetime transfers.
3) The third prong was not satisfied because the taxpayers did not prove that the transfer restrictions were comparable to similar arrangements.

Because third prong was failed, the court determined that the company specific transfer should not affect the marketability discount.

However, this did not alter the persuasiveness of the taxpayers' expert valuation since the court adjusted the marketability discount by merely three percent. The taxpayers' expert analysis

of the fair market value approach was more accurate. This is because it considered the company's financial position, the 2008 recession, non-operating assets to the extent the assets contributed to the overall earnings, payment of dividends, the company's management, possibility of any future public offerings, and its status as an S-corporation.

It is important to note that Green Bay Packing held the following non-operating assets:

1. Hanging Valley Investments LLC – a wholly-owned subsidiary of Green Bay Packing manage long-term investments in mezzanine financing obligations, private equity funds, real estate investment funds, gas, oil, and other commodities. The assets of this LLC ranged from $65million to $77 million across the valuation dates.
2. Group Life Insurance Policies – these policies were on key employees and shareholders and had substantial cash values as of the valuation dates. The cash surrender value of these policies, less certain obligations against them, ranged from $86 million to $111 million across the valuation dates.
3. Two Private Aircraft – on average, the planes were used half of the time for business purposes and the other half for the Kress family's personal purposes.

When considering how to account for these non-operating assets in the valuation approach, the Court rejected what many see as a common approach. That is, the Court rejected an approach that would separate these non-operating assets out of the corporations operating financials, value them independently, and then add the values back to the business' operating value. Instead, the Court held that when valuing a minority position in the corporation, non-operating assets should be considered to the extent that those assets contributed to Green Bay Packing's overall earnings. This is because a minority owner could not access their value.

D. **Estate of Cecil v. Commissioner**. T.C. Memo. 2023-24 (2/28/23).

Cecil involves gifts of shares of The Biltmore Company (TBC). The gifted shares represented minority positions in TBC. TBC is a privately held company that made an election to be taxed as an S corporation election. TBC operates mainly lines of businesses, including owning and operating the Biltmore House, the largest privately owned residence in the United States built by George W. Vanderbilt. The business generates significant revenue (approximately $70 million in 2010) and is consistently profitable.

The taxpayers had two experts value the gifted shares, both experts used an income approach and two market approaches (guideline public company method and transaction method). IRS' expert valued the gifted shares using an asset approach (10% weighting) and an income approach (90% weighting).

IRS's expert derived a net asset value of $146.6m. After discounts for lack of control and lack of marketability, the approach yielded a value of $92m for the entire business. IRS' expert determined that the entire business was worth $36m based on the income approach. The Tax Court rejected use of an asset-based approach stating, "an operating company whose existence does not appear to be in jeopardy, and not a holding company, we believe that [TBC's] earnings rather than its assets are the best measure of the subject stock's fair market value."

In determining the value of TBC, the Tax Court disregarded IRS' expert and one of taxpayers' experts, relying on taxpayers' other expert stating, "While there are issues with Mr. Adams's application of the GPC and similar transactions methods, we find that his valuation

(exclusive of the discounts discussed below), with one adjustment, is the truest value of the subject stock's prediscount fair market value."

With respect to discounts, one of taxpayers' experts (Mr. Adams) determined a 30% discount for lack of marketability on all classes and all blocks of gifted stock. Interestingly, the Tax Court rejected Mr. Adams use of restricted-stock studies and pre-IPO studies finding that the studies were too old ("the latest study looks at data from 1969 to 1992, and most of the studies look at data from the 1970s and 1980s") and unreliable (Mr. Adams admitted "that the pre-IPO studies are unreliable and may overestimate or underestimate actual marketability discounts").

Ultimately, the Tax Court accepted the 20% discount for lack of control determined by one of taxpayers' experts (Mr. Adams), and accepted to 19%, 22% and 27% discounts for lack of marketability determined by IRS' expert (there were different classes and blocks of stock gifted).

E. Built-in Capital Gains.

1. C Corporations.

a) Davis v. Commissioner, 110 T.C. 530 (1998). Parties agreed there should be an adjustment, but not to the amount. Tax Court: since no evidence of planned liquidation, only allowed $9 million of $25.4 million tax liability as a reduction in fair market value.

b) Eisenberg v. Commissioner, 155 F.3d 50 (2d Cir. 1998). C Corporation held commercial building. Cross motions for summary judgment. Tax Court: taxpayer could not establish that C Corporation would liquidate, so no discount allowed. Second Circuit on appeal: "We believe … an adjustment for … capital gains tax … should be taken into account … even though no liquidation or sale … was planned at the time of the gift." Id. at 59. Subsequent to the repeal of the General Utilities doctrine a tax liability for built-in capital gains is not speculative.

c) Jameson v. Commissioner, 267 F.3d 366 (5th Cir. 2001). At issue was the estate tax value of a 97% interest in a C Corporation holding timber land. Tax Court: allowed discount for capital gains because a hypothetical buyer would have taken that into account because he would have continued the business of selling timber thereby triggering the capital gains tax. Fifth Circuit: "the court's misplaced emphasis on a purchaser engaged in long-run timber production led to its peremptory denial of a full discount for the accrued capital gains liability."

d) Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002). At issue was the estate tax value of a 63% interest in a C Corporation owning a heavy equipment business. Tax Court: weighted approach of 35% earnings based and 65% asset based. There was a low probability of liquidation, thus the Tax Court only allowed 5% of capital gains tax liability as a deduction. Fifth Circuit: likelihood of liquidation goes to weighting of methods, not extent of built-in gains discount.

(1) "It is inconceivable [that] … any reasonably informed, fully taxable buyer (1) of an operational-control majority block of stock in a corporation (2) for the purpose of acquiring its assets, has not insisted that all … of the latent tax liability … be reflected in the purchase price." Id. at 352.

(2) Asset based approach assumes liquidation of assets!

e) Jelke v. Commissioner, 507 F.3d 1317 (11th Cir. 2007), rev'g Jelke v. Commissioner, T.C. Memo. 2005-131. At issue was the estate tax value of a 6.44% interest of a C Corporation holding $180 million of marketable securities with $51 million of built-in tax. Tax Court: performance followed just below S&P 500 at 6% annual turnover of stocks. Would incur all built-in tax over a sixteen year period and allowed the present value of projected tax liability of $21 million, as a discount. Eleventh Circuit reversed: as a matter of law, when applying the asset-based approach assume a complete liquidation and a dollar-for-dollar discount for 100% of the capital gains tax that would be incurred. "This 100% approach settles the issue as a matter of law and provides certainty that is typically missing in the valuation arena." Id. at 1333.

f) Estate of Richmond v. Commissioner, T.C. Memo. 2014-26 (2/11/2014). At issue was the value of decedent's 23.44% interest in a family-owned investment holding company, holding mostly publicly traded stock. Taxpayer's expert used an income approach to value (capitalization of dividends) and IRS' expert used an asset approach (net asset value). The Tax Court found that as an asset holding company with easy to value assets that inherently reflected the company's future income stream, only the asset approach should apply. Within the asset approach, the Tax Court rejected taxpayer's dollar-for-dollar reduction to value for built in capital gains, and instead relied on the present value analysis determined by IRS' expert that resulted in a 15% discount for built in capital gains. Despite Jelke, the Tax Court still will apply a dollar-for-dollar reduction for built in capital gains in every case (although may if the case is appealable to the 11th Circuit).

2. S Corporations. The relationship between the fair market value of an S Corporation's assets and the S Corporation's income tax basis in those assets affects value, particularly when applying an asset- based approach to value. The dilemma at this point is how to measure that impact. The economic impact may be felt in either the operations of the S Corporation through the normal turn-over of assets through sale and reinvestment or in liquidation of the S Corporation.

The economic reality of built-in capital gains in the S Corporation context can be illustrated through simple examples. Consider a buyer who purchases a 20% interest in an S Corporation that owns total assets with an aggregate fair market value of $100,000 and an aggregate basis of $0. After the purchase, the S Corporation sells its assets and acquires replacement assets in the ordinary course of business (but does not qualify for section 1031). The buyer will lose economic value through taxes. The smart buyer will take that economic

reality into account. The bottom line is that faced with two identical investments, except for tax characteristics, the buyer will pay less for the investment with less favorable tax characteristics.

If the approach in Dunn and Jelke are the law of the land, then an appraiser must assume a corporate liquidation when applying an asset-based valuation approach. If an S Corporation liquidates, it is deemed to have sold all of its assets. Thus, if a hypothetical buyer purchases stock in an S Corporation that holds appreciated assets, the buyer will recognize capital gains tax upon liquidation of the S Corporation. There is no equivalent to a partnership section 754 election allowing a basis adjustment to the S Corporation's underlying assets upon a sale of stock or the death of a shareholder. The only way the author knows of liquidating an S Corporation without triggering capital gains tax is as follows: decedent dies owning 100% of the stock in an S Corporation and the S Corporation liquidates within days of death. A knowledgeable buyer would adjust the purchase price to consider such an outcome.

Now consider a buyer who may purchase a 20% interest in S Corporation A or a 20% interest in S Corporation B. Both A and B are identical, except A has an income tax basis in its assets of zero and B has an income tax basis in its assets equal to the fair market value of the assets. All else being equal, the buyer will purchase the interest in Corporation B, meaning the interest in Corporation A has less value.

Also consider the conclusions in the partnership arena discussed below. The rationale for no built-in capital gains discount in partnerships is that a section 754 election would be negotiated. S Corporations cannot make section 754 elections. Thus, by deduction, valuation of an interest in an S Corporations should include such a discount.

Until the Tax Court issued Litchfield v. Commissioner, T.C. Memo. 2009-21, the Tax Court had held that no discount for built-in capital gains will apply unless it can be shown the subject corporation will lose its S election. See Dallas v. Commissioner, T.C. Memo. 2006-212.

Litchfield is the first case allowing a discount for built-in capital gains in an S Corporation. At issue was the fair market value of minority interests in the corporation for estate tax purposes. The subject corporation held farm land and marketable securities. The corporation recently made an S election and was therefore still within the 10-year recognition period under section 1374.

The estate's expert determined the built-in capital gains liability by reference to expected asset turn-over rates, plus projected with appreciation. This is similar to the approach adopted by the Tax Court in Jelke (but overturned by the 11th Circuit). The Tax Court in Litchfield noted that, "Herein, the estate's expert does not assume that [the corporation's] appreciated, nonoperating assets would be sold on the valuation date, and the estate does not ask us to apply a full dollar-for-dollar valuation discount for estimated built-in capital gains taxes." Since the estate did not ask for a dollar-for-dollar reduction, the Tax Court did not address the issue.

The estate's expert determined an estimate of the built-in capital gain that would be triggered during the remaining 10-year period (including assumed appreciation). The estimated tax was used as a discount (applied before application of lack of control and lack of marketability discounts). The Tax Court determined that a discount for built-in capital gains was appropriate. It also found that the approach used by the estate's expert was

credible and reasonable and thus adopted it to apply a discount for built-in capital gains. The court further noted that "The facts herein are unique and not all S corporations will be allowed a built-in capital gains discount."

Litchfield, by its own indication, is not a landmark case. The built-in capital gains discount in the S Corporation arena still has litigation ahead. It is inescapable, however, that tax characteristics such as built-in capital gains, has a negative value impact in the asset-based valuation approach.

3. Partnerships – 754 Elections. So far, courts have been unwilling to allow any discounts for built-in capital gains related to assets owned by a partnership.

a) Estate of Jones v. Commissioner, 116 T.C. 121 (2001). (August 19, 2019). "We are persuaded that, in this case, the buyer and seller of the partnership interest would negotiate with the understanding that an election would be made, and the price agreed upon would not reflect a discount for built-in gains." Note the interest valued here was an 83.08% partnership interest.

V. VALUATION OF PROMISSORY NOTES

A. Loan or Gift?

Estate of Bolles v. Commissioner, (2020) T.C. Memo 2020-71 [June 1, 2020] involves intrafamily loans. Mom transferred $1,063,333 to her son between 1985 and 2007. Son did not pay any amounts back after 1988. In 1995 mom started work on her estate plan. As part of that work, she changed her trust from eliminating son as a beneficiary, to including him in a formula that accounted for the "loans." Also signed a 1-page document acknowledging loans to son, but also stating, son has neither the assets nor the earning capacity to repay all or any part of the amount previously loaned. IRS took position that all amounts were gifts. Petitioner took position that all amounts were loans. Tax Court holds amounts through 1989 were loans and amounts in 1990 and later were gifts. Son had no ability to repay, and thus no expectation of repayment, on amounts in 1990 and later years.

B. Valuation.

In the gift tax context, a "below-market loan" can trigger gift tax and IRC § 7872 prescribes the exclusive valuation methodology. Such gift, if any, is equal to the amount necessary to pay the difference between the interest on the loan as stated and the applicable federal rate ("AFR"). IRC § 7872(b)(1). A loan bearing interest at AFR falls outside the definition of a "below-market loan" and is not subject to gift tax. IRC § 7872(e)(1).

Gifts of notes outside the preview of IRC § 7872 should be subject to the same valuation rules applicable to valuation of notes in an estate. This would include notes payable by someone other than the donee. In that context, we look first to the general "willing buyer, willing seller" estate tax valuation rule for all assets is found in Treas. Reg. § 20.2031-1(b). Morrissey v.

Commissioner, 243 F.3d 1145, 1148-49 (9th Cir. 2001). "The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate and gifts taxes themselves...." United States v. Cartwright, 411 U.S. 546, 551 (1973).

When it comes to valuation of promissory notes includible in an estate, Treas. Reg. 20.2031-4 is directly on point, and provides as follows:

> "The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.

Thus, Treas. Reg. 20.2031-4 creates a presumption that the fair market value of a note is presumed the amount of unpaid principal. However, the executor may establish that the value is lower. A valuation report is sufficient to rebut the Treas. Reg. 20.2031-4 presumption. See for example, Hughes v. Commissioner, T.C. Memo. 2005-296 (rebutting the presumption using the "willing buyer" standard in a case appealable to the Ninth Circuit), and Freidberg v. Commissioner, T.C. Memo. 1992-310 (rebutting the presumption with valuation report expert testimony). Moreover, Treas. Reg. 20.2031-4 specifically lists "interest rate" and "date of maturity" as factors to rebut the presumption, which are factors many appraisers use when valuing promissory notes in an estate.

Importantly, Treas. Reg. 20.2031-4 is not like other valuation-based Treasury Regulations that generally in substitution of the "willing buyer, willing seller" rule. See, for example, Treas. Reg. § 20.2031-2 (providing stand-alone valuation method for marketable securities); Treas. Reg. § 20.2031-2 (providing specific valuation method for cash); and Treas. Reg. § 20.2031-7 (providing unique valuation rules for annuities). Treas. Reg. 20.2031-4, by contrast, creates a presumption and invites the executor to rebut that presumption and details data points to consider.