Mack Business Appraisals, LLC

Estate of Webster E. Kelley v. Commissioner T.C. Memo 2005-235

The Facts: On April 6, 1999, decedent, his daughter Patricia Louden and son-in-law John Louden organized Kelley-Louden Business Properties, LLC (KLBP, LLC), and Kelley-Louden, Ltd., a Texas limited partnership (KLLP). Decedent contributed $1,101,475 in cash and certificates of deposit to KLLP between June 6, 1999, and September 11, 1999. On September 13, 1999, the Louden's contributed $50,000 cash to KLLP. Mr. Kelley died on December 8, 1999, owning a 94.83% equity interest in KLLP and a 33.33% equity interest in KLBP, LLC. The sole asset of KLBP, LLC was a 1% equity interest in KLLP. On the date of death, KLLP held assets totaling $1,226,421 (consisting of $807,271 in cash and $419,150 in certificates of deposit). KLLP had no liabilities. The Estate return reported that decedent's 94.83% equity interest was valued at $521,565 and his interest in KLBP, LLC was valued at $1,833.33. The discount used by the Estate totaled approximately 53.5% for both equity interests (consisting of a minority interest discount of 25% and marketability discount of 38%). The IRS issued a notice of deficiency stating that the discounts claimed by the estate were too high and lower discounts were appropriate. The IRS indicated that a total discount of 25.2% was more appropriate (12% for minority interest and 15% lack of marketability) for both equity interests.

The Arguments:

The Estate's appraiser relied 80% on a net asset value approach and 20% on an income approach. He then applied a discount for lack of control based on general equity closed-end mutual funds. He divided the closed end funds into four quartiles (the first quartile representing funds high in demand and the fourth quartile representing funds low in demand). The Estate's appraiser determined that the fourth quartile was most comparable after reviewing several factors of KLLP and KLBP, LLC including small size, no professional management, less diversification and lack of performance history. The discount range for the fourth quartile was 21.8 to 25.5%. He also then further adjusted the discount based on several factors and restrictions inherent in the partnership agreements and through reliance on a partnership study published by Partnership Profiles, Inc.—ultimately determining a minority interest discount of 25%. The Estate's appraiser based his discount for lack of marketability on restricted stock studies. He also discussed eight (8) factors that provided barriers to marketability for limited partnership interests and determined a 38% discount for lack of marketability was appropriate.

The IRS's appraiser solely used the net asset value approach. He applied a discount for lack of control of 12% which was determined using an arithmetic mean of the entire data set for closed-end funds (not only the fourth quartile). He stated that it is essential to use the whole array of closed-end funds as this calculation removed the marketability element contained in the discount. The IRS's appraiser based his discount for lack of marketability on a private placement study by Dr. Mukesh Bajaj. This study states that private placements of unregistered shares trade at a discount of about 14.09% higher than the average discount on registered placements. Accordingly, he determined that a discount for lack of marketability of 15% was appropriate based on the low risk of the partnership's portfolio.

The Findings:

The Court indicated that the net asset value method is generally an appropriate method to apply when computing the value of a nonoperating entity. Both parties agreed on the asset values and the Court agreed that KLLP's net asset value on the valuation date was $1,226,421 (consisting of $806,271 in cash and $419,150 in certificates of deposit).

Regarding the discount for lack of control (or minority interest discount), the Court was not persuaded by the Estate appraiser's use of the fourth quartile of closed-end funds or the analysis of the Partnership Profiles partnership study. The Court indicated that they felt that these studies contained some element of a marketability discount and were thus overstating the minority interest discount. The Court agreed that a correct analysis is to take an arithmetic mean of all of the closed-end funds. The Court also stated that "they find neither expert particularly persuasive on this issue, but will apply a 12% discount on the grounds that (1) the IRS's appraiser has effectively conceded that a discount factor of 12% would be appropriate and (2) the Estate's appraiser has failed to prove that a figure greater than 12% would be appropriate."

Regarding the discount for lack of marketability, the Court was not persuaded by the Estate appraisers' use of restricted stock studies as this study primarily referred to operating companies and not investment companies. However, the Court was also not persuaded by the IRS appraisers' recommendation of a 15% marketability discount. The Court agreed that the Bajaj study was an appropriate tool for determining the discount for lack of control, but stated that the IRS appraiser did not properly apply the study. The Bajaj study divided the discount into three groups with the middle group having a discount of 20.36%. The Court relied on *McCord v. Commissioner* (120 T.C. No. 13), which used this middle group and rounded it to 20%. The Court further cited the analysis of marketability in *Lappo v. Commissioner* (T.C. Memo 2003-258) in which an additional 3% marketability discount was allowed because of characteristics specific to the partnership. Thus, the Court determined a total discount for lack of marketability of 23%.

The Court allowed the same discounts for the decedent's 33.33% equity interest in KLBP, LLC as this entity only owned a 1% equity interest in KLLP.

Parting Thoughts:

This was a great victory for taxpayers. The Court ultimately determined a combined discount of 32.2% on a partnership that contained cash and certificates of deposit. It also appears that if the Estate's appraiser had a better argument for more than a 12% minority interest discount the Court may have granted it. One slight surprise to me was that the Court thought that a private placement study by Bajaj was more appropriate than restricted stock studies for the marketability discount determination (most experienced business appraisers would disagree with this determination).