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Estate of John F. Koons III, Petitioner vs. Commissioner of Internal Revenue, T.C. Memo 2013-94, Filed April 8, 2013.

The Facts:

The decedent, John F. Koons, III, died on March 3, 2005. Mr. Koons served as the president and CEO of Central Investment Corp. ("CIC"). CIC was a bottler and distributor of Pepsi soft drinks and was in the business of selling food and drinks from vending machines. Mr. Koons was CIC's largest shareholder, owning a 46.9% voting percentage interest and a 51.59% non-voting percentage interest. Mr. Koons' children also owned, directly and indirectly through trusts, substantial portions of the remaining CIC interests.

CIC and PepsiCo, Inc. filed lawsuits against each other in 1998 regarding the manufacture and sale of PepsiCo products in CIC's established territories. By December of 2004, CIC and PepsiAmericas, Inc. ("PAS") had entered into discussions to sell/buy the soft-drink business of CIC. This sale would also resolve the ongoing lawsuits between CIC and PepsiCo.

Prior to the sale of the soft-drink business to PAS, CIC formed CI LLC ("CI") as a wholly owned subsidiary. CI was formed to hold all CIC assets not subject to the PAS sale. Mr. Koons and his children owned the same percentage interests in CI as they did in CIC. Due to the substantial ownership of the Koons children in CIC, prior to consummation of the sale, the children's approval was required. The children's approval of the sale was conditional on the offer to redeem their ownership interest in CI within 90 days of the PAS transaction, which was ultimately provided.

The sale to PAS closed on January 12, 2005, and after the sale CIC was merged into CI. Thus, the assets of CI after the sale included $352.4 million (proceeds from the PAS sale); $50 million paid to settle the PepsiCo lawsuit; and other nominal assets that had not been included in the PAS sale.

By February of 2005, all of the Koons' children had agreed to redeem their CI ownership interests, and these redemptions were eventually completed on April 30, 2005 (after the date of death). After the redemptions, Mr. Koons' ownership in CI (through his Revocable Trust) was increased to a 70.42% voting interest and a 71.07% non-voting interest. At the time of Mr. Koons' death in March of 2005, CI's net worth was approximately $318 million, the total assets of CI of $350 million included cash of approximately $322 million, and liabilities of approximately $32 million included a $20 million note payable to Mr. Koons.

In February of 2006, CI loaned $10.75 million, with an interest rate of 9.75%, to the John F. Koons III Revocable Trust ("the Trust") to make a payment toward Mr. Koons' estate tax liabilities. The loans terms required no payments prior to August 31, 2024, with semi-annual payments of interest and principal between August 31, 2024, and February 28, 2031. Because the payment of the loan was deferred for 18 years, the total interest accrued on the $10.75 million loan was approximately $71.42 million. The trust anticipated repaying the loan using distributions from CI.

The issues for decision were: (i) whether or not the Estate of John F. Koons ("the Estate") was entitled to a deduction of approximately $71.4 million for claimed interest expense on the $10.75 million dollar loan from CIC to the Trust; and (ii) what is the estimated fair market value of the Trust's interest in CI as of the date of death of Mr. Koons – with the dispute over the fair market value of the interest(s) centered on the selection of an appropriate discount for lack of marketability ("DLOM").

The Arguments and Findings:

Both of the Court's rulings were largely influenced by the Court's decision as to whether the interest being appraised represents a minority interest (aka the ownership in CI before the redemptions) or a controlling interest (the ownership in CI after the April 2005 redemptions). The Court decided that the Estate's interest should be valued as an approximate 71% controlling interest because: (i) the redemption agreements were signed prior to the date of death; (ii) the redemption price could be easily ascertained (as most of the assets were cash); (iii) the members had expressed an interest in selling their interests in the LLC; (iv) the LLC manager wanted the stockholders removed from the LLC; (v) the LLC could have successfully sued the other members for breach of contract if they had reneged on the redemption; and (vi) a 71% owner of CI could make certain amendments to the LLC agreement, change the Board of Directors, and cause the LLC to distribute most of its assets. However, it is important to note that the Stock Purchase Agreement ("SPA") required that until January 10, 2012, CI was to own directly at all times cash, cash equivalents or marketable securities with an aggregate fair market value of at least $10 million, and to maintain a positive net worth at all times of at least $40 million.

Regarding the interest expense, the Court ruled that the projected interest expense of approximately $71.4 million was not a deductible expense of the Estate. The Court indicted that the interest expense on the $10.75 million loan was not deductible because the loan was not necessary to the administration of the estate because (i) the trust had sufficient liquid assets at the time, and the ability to force distributions of additional cash from CI (based on a 71% ownership interest). Furthermore, because the loan was to be repaid with cash received through CI distributions, CI was going to have to make the distributions anyway (albeit on a delayed schedule).

Secondly, regarding the value of the Trust's interest in CI and the appropriate DLOM, the analysis performed by the estate's expert assumed the interest owned by the Trust to be an approximate 50.5% non-controlling interest (as the voting ownership percentage was less than 50%). The analysis performed by the IRS's expert assumed the Trust's ownership (after the redemption of the children's interests) to be approximately 71% (a controlling interest).

Both the Estate's analyst and the IRS' expert utilized restricted stock transactions to estimate the DLOM. The Estate's analyst applied a regression formula to estimate the DLOM from the restricted stock transactions and estimated this discount to be approximately 31.7%, whereas the IRS' expert reviewed the data in the restricted stock transactions and determined that the appropriate DLOM is approximately 5% to 10%, selecting 7.5% as the appropriate DLOM. The Court found the testimony of the IRS' expert to be more persuasive, and agreed with the IRS expert because the IRS' expert correctly (in the Court's opinion) viewed the subject interest as a controlling interest. Thus, the Trust would have the ability to cause CI to distribute most of its assets once the redemptions closed (subject to the SPA's requirements to retain certain amounts of cash and net worth until January 10, 2012). Accordingly, the Court decided that the appropriate DLOM was 7.5%.

<u>Parting Thoughts:</u>

A few takeaways from this case are: (i) post-valuation date events should be considered in the valuation analysis if they are foreseen and reasonably likely to occur; (ii) the Court considered the ability to get to the subject company's assets as one of the most important DLOM features; and (iii) in this instance the Court sided with a more subjective approach towards determining the DLOM instead of more quantitative methods (a regression analysis). One interesting oversight that the Court didn't consider is that restricted stock studies are not appropriate to utilize when valuing a controlling interest (as it is a generally accepted consensus among business appraisers that is not appropriate to rely on data from transactions in noncontrolling ownership interests to estimate the DLOM for a controlling interest). Thus, the IRS expert relied upon data that should not have been used to determine the appropriate DLOM for a controlling interest.