John G. Mack, ASA, MCBA, ABAR
Mack Business Appraisals, LLC
26956 N. 90th Lane
Peoria, Arizona 85383
(888) 789-2401 (Toll Free) (623) 340-6770 (Direct) (623) 476-5405 (Fax)
john@mackbusinessappraisals.com
www.mackbusinessappraisals.com

Estate of Helen P. Richmond, Petitioner vs. Commissioner of Internal Revenue
T.C. Memo 2014-26, Filed February 11, 2014.

The Facts:

Ms. Helen Richmond passed away in December of 2005. At the time of her death, Ms. Richmond owned a 23.44% interest in a family-owned personal holding Company, Pearson Holding Company ("PHC"). As of December 2005, PHC has 2,338 shares of common stock outstanding held by 25 shareholders whose interests ranged from 0.17% to 23.61%. Ms. Richmond owned 548 of those shares (making Ms. Richmond the second largest shareholder with a 23.44% interest).

PHC's primary assets were shares of publicly traded stocks, primarily consisting of stocks in 10 major industries, with approximately 42.8% of their holdings concentrated in four companies; Exxon Mobil, Merck & Co. Inc., General Electric CO., and Pfizer, Inc. PHC operated as a C-Corporation with its ultimate objective to provide a steady stream of income for the descendants of Frederick Pearson, while minimizing taxes. Between 1970 and 2005, PHC made regular annual dividend payments and the dividends paid to its shareholders increased at a rate of just over 5% per year. The turnover rate for PHC's securities was slow, approximately 1.4% per year. PHC's asset values included a significant capital appreciation element with approximately 87.5% (approximately $45,576,677) of the total assets consisting of unrealized appreciation with a net unrealized built-in gain tax liability of approximately $18,113,000.

Ms. Richmond's executors hired an accounting firm to perform a valuation of Ms. Richmond's shares of PHC upon her death to attach to the 706 filing. The individual who performed the initial valuation was a CPA but was not a credentialed business appraiser. However, the CPA had prepared approximately 10-20 valuation reports during his career. The valuation was performed using only the capitalization of dividends method, and indicated that the value of Ms. Richmond's 23.44% interest in PHC was $3,149,767. The estate was provided with an unsigned draft copy of the valuation report and never asked for or received a final signed copy of the report. However, the estate used and attached the unsigned draft version to the 706 filing.

The IRS disputed the value as determined by the Estate's appraiser and determined the value of Ms. Richmond's 23.44% interest to be $9,223,658.

<u>The Arguments and Findings:</u>

At trial, the IRS's expert utilized a net asset value method as his sole methodology in arriving at his value of $7,330,000. The IRS's expert indicated that a 6% DLOC and a 36% DLOM were appropriate, and indicated that the 36% DLOM was comprised of a 15% discount to account for the built-in gain tax liability of PHC, and 21% for lack of marketability of the minority interest valued.

The estate of Ms. Richmond hired a second valuation expert for purposes of trial. The estate's trial expert utilized a capitalization of dividends method and a net asset value method in his analysis. Under the capitalization of dividends method, the value of the 23.44% interest was determined to be $5,046,500 (which was approximately $1,900,000 higher than the 706 filing). Under the net asset value method, the value was determined to be $4,721,962. The estate's trial expert utilized a dollar for dollar reduction to account for the unrealized built-in gain tax, and utilized an 8% DLOC and a 35.6% DLOM.

The Court rejected the dollar for dollar reduction of the tax liability put forth by the estate's expert, and faulted the IRS expert's 15% discount as being without basis. The Court agreed that a potential buyer of a company would be willing to pay more for a company with a contingent liability of $18.1 million than he would pay for a company otherwise equal but with an unconditional liability of $18.1 million currently payable. The Court reviewed holding periods of 20-30 years and supported their selection with the fact that PHC's advisors had been encouraging PHC to sell shares to help diversify their portfolio. In determining the amount of the unrealized built-in gain discount, the Court then utilized rates of return used by the Estate's experts in the dividend capitalization method and PHC's historic rates of return. The Court noted that the various indications of value for the built-in gain tax liability concluded at amounts that, when averaged, were close to the IRS's expert's discount amount. Thus, the Court accepted the IRS's $7.8 million deduction and reduced the net asset value by this amount to account for the net unrealized built-in gain tax liability.

After reviewing both expert's opinions, the Court rejected the use of the capitalization of dividends method stating "where the assets themselves are thus easily valued, valuing the holding company instead by the income approach would essentially overlook that fact, surely a relevant and helpful fact, which we think an investor was not likely to overlook but was instead likely to take as his starting point" and determined that a net asset value method was the most appropriate methodology to determine the value of the interest in question. The Court determined that in order to account for the capital gain tax liability built in to its assets, PHC's net asset value of $52,114,041 should be discounted by $7,817,106 (i.e., the Commissioner's concession of 15% of PHC's NAV) to $44,296,935. The Court further found that the decedent's 23.44% interest should be further discounted by 7.75% for lack of control and by 32.1% for lack of marketability, so that the decedent's interest in PHC had a fair market value of $6,503,804 at the decedent's date of death.

In addition, since the initial value reported on the 706 of $3,149,767 was less than 65% of the value of $6,503,804 determined by the Court, the Court had to determine if the 20% accuracy related penalty should be upheld. In determining whether a taxpayer acted reasonably and in good faith with regard to the valuation of property, the Court indicated that the factors they considered included: (1) the methodology and assumptions underlying the appraisal; (2) the appraised value; (3) the circumstances under which the appraisal was obtained; and (4) the appraiser's relationship to the taxpayer or to the activity in which the property is used. The Court indicated that although the estate's first appraisal was prepared by an individual who had some appraisal experience, he did not have any appraiser credentials or certifications. The Court noted that "we cannot say that the estate acted with reasonable cause and in good faith in using an unsigned draft report prepared by its accountant as its basis for reporting the value of the decedent's interest in PHC on the estate tax return. The Estate's initial appraiser is not a certified appraiser". Thus, the Court upheld the 20% accuracy related penalty to the estate in relation to the filing of form 706 for Ms. Richmond.

<u>Parting Thoughts</u>:

A very interesting case where the Court weighted in on many issues. The Court ruled upon: (i) the selection of business valuation methodology; (ii) the treatment of the built-in capital gains liability, (iii) how to apply valuation discounts (i.e. the built-in capital gain liability must be first be subtracted from net asset value as it is an entity level discount, with the discount for lack of control being applied second and the discount for lack of marketability applied last); and (iv) selecting a discount from a data asset by scrutinizing the data.

Overall, the Estate still ended up with a very healthy discount being applied to a C-corporation that held highly appreciated marketable securities. Using a Net Asset Value of $52,114,041, the pro rata value of a 23.44% interest is $12,215,531, and the Court determined the fair market value to be $6,503,804 after reduction for the built-in capital gains liability, discount for lack of control and discount for lack of marketability. Thus, including the built-in capital gain deduction, the total discount from net asset value was almost 46.8%.