



Recent Developments in the Valuation of Closely Held Entities

Presentation by

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Closely Held and Flow-Through Entities Conference

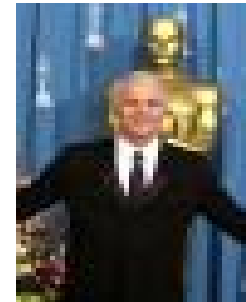
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Order of Business

- ◆ Tax Court Cases concerning Closely Held and Pass-Through Entities (Estate & Gift)
- ◆ Valuation Discounts
- ◆ Academic Thoughts on Imputing Taxes to an “S” Corporation
- ◆ Tying the Threads Together

Valuation Issues

- ◆ **Steve Martin, Comedian and Estate Planner**
 - How to make a million dollars and not pay taxes
 - First, make a million dollars
 - Next, don't pay taxes
 - If the IRS has a problem with this, tell them two words:
 - "I forgot."



Valuation Issues

- ◆ **Albert Strangi v Commissioner, No. 03-60992, US Court of Appeals (5th Circuit), July 15, 2005**
 - Mr. Strangi enjoyed benefit of residential property subsequent to transfer to the FLP, effectively rent-free
 - Mr. Strangi had few assets outside of the FLP
 - Mr. Strangi depended upon distributions from the FLP to meet living expenses
 - Court found “no bona fide sale” of assets to the FLP
 - Bona fide sale means the transfer must serve a “substantial business or other non-tax purpose”
 - Conclusion:
 - Mr. Strangi did not give up possession of the assets even after transferring them to the FLP
 - The assets transferred to the FLP are brought back into the estate and subject to estate tax

Valuation Issues

- ◆ Estate of Jelke, TCM 2005-131, May 31, 2005
 - Decedent owned 6% interest in holding company (C corp.)
 - Holdings consisted primarily of large, well-known “blue chip” public companies
 - Portfolio was managed by experienced outside management group
 - 10% Discount for Lack of Control
 - Court say strong historical returns implies lower discount and less demand for control; look at the way an investor in mutual funds would look at it
 - 15% Discount for Lack of Marketability
 - Lower than typical LOMD attributable to diversified holdings of marketable securities, history of long term appreciation, no restrictions on share transferability and acceptance of a BICG (C Corp, however)
 - Tax Court not satisfied with taxpayer’s proposed 35% discount based upon standard restricted stock studies

Valuation Issues

- ◆ Santa Monica Pictures v Commissioner, TCM 2005-105, May 11, 2005
 - Expert Witness “Survivor”
 - Three experts at trial – only one survived
 - Big Four CPA with 20 years of experience
 - Ph. D. in Economics; Professor in US & Overseas; Author; Prior expert testimony
 - Entertainment attorney
 - The Taxpayer is not laughing

Valuation Issues

- ◆ Estate of Bigelow, TCM 2005-65, March 30, 2005
 - FLP formed to hold real property of Decedent's trust
 - Post-transfer, Decedent left with insufficient income to meet her living expenses or property debt service
 - Decedent's sole purpose in establishing the FLP was to reduce estate tax
 - Taxpayer loses: Real property includable in Decedent's gross estate under 2036

Valuation Issues

- ◆ Estate of Bongard, 124 TC No. 8, March 15, 2005
 - Empac stock to WCB Holdings, LLC: OK
 - Better position for corporate liquidity event
 - Enhance ability to raise capital and govern the company
 - TC holds bona fide sale (“legitimate and significant non-tax reason for the transfer”)
 - Form Bongard FLP to hold WCB Holdings Class B member interests
 - Gift of 7.72% Bongard FLP LP interest
 - Transfer of Class B member interests to Bongard FLP did not satisfy bona fide sale exception under 2036: includable in gross estate

Valuation Issues

- ◆ Estate of Noble, TCM 2005-2, January 6, 2005
 - Estate values 11.6% interest in Glenwood State Bank (“GSB”) at \$904k (BV less 45% MID)
 - GSB is a small, privately-held bank in rural Iowa (\$81mm in assets; low ROE; minimal growth prospects)
 - Judge Laro rejects expert reports of Taxpayer and IRS
 - Judge concludes value based upon transaction 14 months after the DOD (shares were sold for \$1,100k to the parent company and owner of the remaining 88.4% interest), less 3% inflation, or \$1,067k
 - Valuation camp not happy
 - Issue of theory, not practical result
 - Transaction premium?
 - Trend in bank values over the 14-month period?
 - Facts of case; ROE

Valuation Issues

- ◆ Estate of Thompson, TCM 2004-174, July 26, 2004
 - Decedent held 20.57% interest in Thompson Publishing
 - Estate value: \$1.8mm
 - IRS value: \$32.4mm
 - Want to “split the baby?”
- ◆ Tax Court reviews are in:
 - Both sides’ Experts were “marginally credible, barely qualified, deficient and unpersuasive, lacked training and certification, inexperienced, biased” [you get the picture]

Valuation Issues

- ◆ Estate of Thompson, July 26, 2004
 - Estate expert proposed 40% MID & 45% DLOM
 - IRS proposed 30% DLOM (MID implicit in valuation methodology)
 - Tax Court applied a 15% MID & 30% DLOM (TC would have gone with a lower DLOM – attractive company, outside investor, good distribution history - but for IRS position), and concluded a \$13.5mm value for the interest
- ◆ Section 6662 Penalty, since Estate below 25% of FMV?
 - No, Thompson stock valuation was a “difficult & unique” assignment (TC rejected suggested Comps), Internet risks & opportunities hard to gauge, IRS themselves made significant errors

Valuation Issues

- ◆ Mark & Michele Senda, TCM 2004-160, July 12, 2004
 - Two FLPs with MCI Worldcom stock
 - Taxpayer forms the FLP after attending a 1998 Arthur Andersen Financial Planning Seminar
 - You already know there's going to be a problem
 - TP says partnerships had economic substance & valid under State law – look at discounted LP interest values
 - IRS says “step” transaction – value stock not LP interests
 - Tax Court finds that taxpayers gave indirect gifts of stock rather than gifts of LP interests
 - IRS alleged gift value of \$2,755,000 in total
 - Taxpayer valued gifts at \$660,000

Valuation Issues

◆ Mark & Michele Senda, July 12, 2004

- Partnership capital accounts did not reflect contribution of the Stock
- No evidence of consideration for children's receipt of FLP interests
- No Partnership books & records
- Financial statements never prepared & partner meetings never held, despite requirement to do so in Partnership agreement
- Taxpayers paid all legal & filing fees on behalf of Partnership
- No evidence that TPs contributed the Stock to the Partnership before they transferred the Partnership interests to their children
- Children's LP interests enhanced by [subsequent] contribution of Stock, therefore, TC finds indirect gift of stock to children
- Result: "Return to Senda"- TPs socked with big Federal gift tax (\$488,000); MCI not worth much post-bankruptcy [Ouch!]
- Silver Lining: IRS stipulated to combined Discounts of 39% - 46% if TC found that LP interests to be valued

Valuation Issues

- ◆ Kimbell v US, Fifth Circuit, May 20, 2004
 - LP with \$2.5mm cash, oil & gas, securities, other
 - Trust, as LP, no right to withdraw or receive return until Partnership terminated (unanimous consent)
 - 70% of LPs can remove GP
 - Majority in interest of LPs to elect new GP
 - Estate claimed 49% discount for LOM & LOC
- ◆ IRS claims that under IRC 2036, transfer was not a bona fide sale for full & adequate consideration

Valuation Issues

- ◆ Kimbell v US, Fifth Circuit, May 20, 2004
 - Fifth Circuit finds bona fide sale
 - Decedent had adequate assets outside the LP for support
 - No commingling of LP & personal assets
 - Partnership properly established (legal, title, etc.)
 - LP assets (oil & gas) required active management
 - Non-tax business reasons for Partnership
 - Decedent did not have majority interest or management control over Assets: no IRC 2036 issue

Valuation Issues

- ◆ Blount v Commr, TCM 2004-116, May 12, 2004
 - 1981: Buy/Sell agreement, Value = BV
 - 1992: Company forms ESOP
 - 1996: Brother-in-law dies – shares redeemed based upon BV of \$8mm
 - Later 1996: Decedent (w/terminal cancer) enters into B/S w/Company - \$4mm for his 83.2% interest, at death
 - 1996 & 1997 ESOP valuations at >\$8mm
- ◆ It doesn't look good...

Valuation Issues

- ◆ Blount v Commr, TCM 2004-116, May 12, 2004
- ◆ And it wasn't...
 - Second B/S agreement did not comply with Chapter 14
 - Decedent could unilaterally modify the agreement
 - Failed IRC 2703 “arm’s length” test
 - “Goofus & Gallant” as Experts
 - Goofus for the Estate: ignored Excess Assets, Comps weren’t comparable (value range: \$4.5mm – \$6.0mm)
 - Gallant for the IRS: included non-operating assets of \$2.3mm and life insurance proceeds of \$3mm (value: \$10.1mm)
- ◆ Tax Court concludes value of \$9.9mm (OUCH!)
 - Insurance proceeds receivable not offset by stock redemption payable, since B/S agreement was disregarded

Valuation Issues

- ◆ Okerlund v US, Ct. of Appeals, Federal Circuit, April 9, 2004
 - Decedent (prior to death, of course) gifted [non-voting] stock in his food distribution company as of Dec 31, 1992
 - He dies unexpectedly on May 9, 1993
 - Death of key person and salmonella outbreak led to material decline in earnings
 - Taxpayer contended that Ct of Fed Claims failed to consider actual 1993 & 1994 results
 - TP 1992 valuation report identified both events as risk factors

Valuation Issues

- ◆ Okerlund v US, Ct. of Appeals, April 9, 2004
 - On Appeal, TP argued that (i) IRS appraiser underestimated *ex ante* probability of these events, and (ii) IRS was wrong to classify consideration of actual 1993 & 1994 results “inappropriate appraisal practice”
 - Court of Appeals says valuation should primarily rely on *ex ante* information; *ex post* data to be used sparingly; closer the profile of later date co. to val date co., more likely relevant – greater significance of unforeseen events between val date and later date, less likely that *ex post* evidence is relevant.
 - Note Polack, TCM 2002-145, upheld by Eighth Circuit (May 2004): correct to ignore *ex post* actual financials

Valuation Issues

- ◆ Estate of Hillgren, TCM 2004-46, March 3, 2004
- ◆ Tax Court disregards partnership under 2036
 - General ledger of LP mixed partnership & personal assets
 - Partnership certificate filed after date of death
 - Decedent dependent upon LP distributions to meet living expenses; decedent also received 100% of distributions
 - LP “invisible” to outside world
- ◆ But, some good news:
 - Tax Court allows Estate appraiser’s discounts for lack of control & marketability of 40% - 55% on properties subject to a Business Loan Agreement (“BLA”)

Valuation Issues

- ◆ Estate of Hillgren, TCM 2004-46, March 3, 2004
- ◆ Combined discounts of 40% - 55%
 - Court found appraisers qualified
 - Tax Court approved of Appraisers use of discounts from net asset value on comparable partnership sales – consider size, level of debt, distributions (yield), and subject vs. comp adjustments
 - Prof. Mitchell Gans (Hofstra Law) notes that Tax Court sustaining BLA – had apparent business purpose & hypothetical buyer (see definition of FMV) would not disregard – differs from “old Strangi” and Knight, in which business purpose not critical, but just need to hold up under State Partnership Law
 - Obviously, things have changed!

Valuation Issues

- ◆ Estate of Trompeter, TC Memo 2004-27, February 4, 2004
 - Judge Laro values jewelry and collectibles at retail (\$4.5mm), not auction values
 - Judge Laro may have been annoyed at the Estate's underreporting of assets
 - Cites McGuire, 44 TC 801 (1965)
 - Judge Laro valued approximately \$3mm (face value) of Preferred stock using a 4% discount rate
 - Preferred accrued dividends at 8.5% - 12.5%pa
 - Judge Laro only considered "time value of money"

Valuation Issues

- ◆ Estate of Trompeter, TC Memo 2004-27, February 4, 2004
 - Court of Appeals, Ninth Circuit politely remands and asks Judge Laro to reconsider 4% discount rate
 - Judge Laro reconsiders and chooses a 12.5% discount rate
 - Note: Subject company had significant leverage, including senior and subordinated debt ahead of the Preferred; no consideration given to market comparable preferred dividend yields; Judge Laro rejects DLOM – states that his 12.5% is not a freely traded value

Valuation Issues

- ◆ Estate of Mildred Green, TC Memo 2003-348, December 29, 2003
 - Decedent held 5% of a St. Louis, MO bank (assets \$173mm, SHE \$17mm)
 - Nov 1998, Estate values stock at \$164,000
 - IRS claims value of \$1,048,000
 - At trial, Estate @ \$655k (\$200ps), IRS @ \$860k (\$263ps)
 - Minority interest discounts: Estate 17%, IRS 15%
 - Interesting, because 2 of 3 valuation approaches (income & guideline co. vs. transactions) are not Control
 - Estate expert relied on generic Mergerstat premiums, with no explanation – Court hates this

Valuation Issues

- ◆ Estate of Mildred Green, December 29, 2003
 - IRS relied on Midwest bank transaction premiums, but their own data showed a discount range of 18.4% - 19.6%!
 - Court unhappy with both experts, chooses 17% MID
- LOM Discount: Estate 40%, IRS 25%
 - Estate: restricted stock studies 35%, pre-IPO studies 44%
 - Estate also looked at 7 prior transactions, 6 more than 3 years old
 - No indication if arms length
 - No viable benchmark for comparison (ie, contemporaneous values)
 - IRS cites restricted stock studies at 30% - 35%, as well as Hall/Polacek (1994) study – average discount: 23%
 - Court notes that H/P study actually reflects 30% - 40% for small companies like subject bank! – concludes 35% based upon size

Valuation Issues

- ◆ Peracchio v Commissioner, TCM 2003-280, September 25, 2003
 - TP forms FLP with \$2mm of cash & mktable securities
 - TP claims discount of 40% for LOM & MI, combined
 - IRS Position One
 - Disregard FLP: no economic substance [dropped]
 - Standard restrictions on transfer violate Sect. 2703(a)(2) [dropped]
 - Restriction on ability to withdraw is an applicable restriction under Sect. 2704(b) to be disregarded [dropped]
 - FMV of transferred interests should recognize no discounts
 - IRS Revised Position: 4.4% MID, 15% DLOM
 - Court favorably cites McCord (2003): treat like closed end fund

Valuation Issues

- ◆ Lappo v Commissioner, TCM 2003-258, September 3, 2003
 - FLP consisting of muni bonds (\$1.3mm) and lumberyards (\$1.9mm) leased to Wickes Lumber (15-yr lease)
 - IRS withdrew “economic substance” and Section 2703(a)(2) contentions from Notice of Deficiency
 - Muni Bond Minority Interest Discount
 - TP says 8.5%, IRS 7.5%; Court accepts 8.5%
 - Real Estate Minority Interest Discount
 - TP Expert concludes 30-35% based upon a sample of 7 (out of 400!) REITs & REOCs; Court says sample too small and skewed to maximize discount; “adjusted” raw data revealed discounts of 20-29%; removing 4 REITs that the Court didn’t like resulted in discount range of only 0-5%!

Valuation Issues

◆ **Lappo v Commissioner, September 3, 2003**

- Real Estate Minority Interest Discount
 - IRS Expert selects 52 REITs out of sample of 62 that comprised 80% of total public REIT market capitalization
 - Court prefers IRS Expert approach conceptually, but alters it dramatically and concludes 19% MID on the Real Estate
- Marketability Discount
 - TP Expert selects 39 private placement transactions (in restricted stock in public companies) as “guideline” out of 197 transactions
 - Median discount among the 39 was 29%; Expert proposes 35%
 - Court notes that if eliminate the 13 high tech companies from the 39, median discount is 19%
 - IRS Expert cites Bajaj study to support 7.2% DLOM
 - Court notes that avg discount in Bajaj study is 22.2% (raw data); a Hertzell & Smith study reported an avg private placement discount of 20%
 - Court takes avg of 21% and adds 3% to account for FLP specifics: 24%

Valuation Issues

◆ Threads

- Raw data preferred to “skewed” adjusted data
- More attention to quality & content of valuation work
- Failure to explain & justify work loses
- Tax Court becoming increasingly comfortable with sophisticated statistical techniques (we must, too)
- Tax Court demanding more from Experts
- Economic substance critical
 - Hillgren, supra, was ahead of its time
- Tax Court “comfort zone” on discounts may have peaked
- Consider the economics of S Corporations: taxes & distributions
 - Greater distributions likely imply lower discounts

Introduction to Empire Valuation Consultants

- ◆ One of largest East Coast independent valuation firms
- ◆ Started 1988
 - Originated as “Chase Manhattan Valuation Consultants” in 1982
- ◆ Offices in New York City, Rochester, West Hartford and Atlanta
- ◆ Senior staff has more than 100 years of valuation experience

Empire's People

- ◆ Over 50 highly trained professionals
 - MBAs
 - Credentials (CFA, ASA, CPA, CBA, ABV)
 - National recognition as:
 - Chairman of Board of Examiners of ASA
 - Valuation Committee of ASA
 - Valuation Subcommittee of ESOP Association
 - Various Committees of the NYSSCPA, AICPA & NYSSA

- ◆ 8 Support Staff
 - Research Assistants & clerical

Empire's People (cont'd)

- ◆ Senior staff members have qualified as valuation experts in several jurisdictions:
 - U.S. Tax Court
 - U.S. Bankruptcy Court
 - N.Y. Supreme Court (Several throughout State)
 - N.Y. Surrogates Court (Several throughout State)
 - State Jurisdictions including California, Connecticut, Georgia, New Hampshire, New Jersey, Tennessee, Virginia
 - American Arbitration Association



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Mark Shayne is an Accredited Senior Appraiser (ASA) of the American Society of Appraisers and Accredited in Business Valuation (ABV) by the American Institute of Certified Public Accountants. Mr. Shayne is a Managing Director with Empire Valuation Consultants, LLC.

Mr. Shayne has 20 years of experience providing financial consulting, appraisal, due diligence, and expert witness testimony on valuation matters. His areas of expertise include valuation of common and preferred stock, employee and incentive stock options, partnership interests, intangible assets and intellectual property.

Mr. Shayne holds a Bachelor of Science degree from The Wharton School, University of Pennsylvania, and earned an MBA with Distinction from the Stern Graduate School of Business at New York University.

Mr. Shayne has testified as an expert witness in Federal and State Courts and before the American Arbitration Association. He has lectured on business valuation, the valuation of intellectual property, estate & gift tax valuation issues, and SFAS 141 and 142 in front of accounting, appraisal, legal and technology organizations. He is also a Professor of Finance (Business Valuation) at Fordham University's Graduate School of Business.