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Tax Court Sends Message On Valuation in *Richmond*

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In *Estate of Richmond*, the Tax Court determined the proper value for estate tax purposes of a minority interest in a family-owned corporation holding mostly appreciated securities. The court also sustained an accuracy-related penalty against the estate, finding that it used an unsigned draft report by a noncertified appraiser as the basis for the stock valuation reported on Form 706.

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Estate of Helen P. Richmond[1] involved the valuation of an interest in a family-owned personal holding company for estate tax purposes. Helen Richmond died in 2005, owning a 23.44 percent interest in Pearson Holding Company (PHC), a subchapter C corporation, formed in 1928 to provide income to the descendants of Frederick Pearson.[2] As of the date of death, PHC held a $52 million portfolio consisting mostly of large-cap, high-yield stocks.[3] PHC's investment philosophy included preserving capital and maximizing dividend income for the family shareholders.[4]

This case is significant for three reasons: (1) It rejects an income-based approach for valuing an entity holding mainly publicly traded securities; (2) it reaffirms the Tax Court's commitment to using a present value approach in calculating the discount for the built-in capital gains (BICG) tax liability of a C corporation; and (3) it imposes an accuracy-related valuation penalty on an estate that used a nonspecialized accountant to value a decedent's stock interest.

Valuation of PHC

Value for estate tax purposes is 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 to sell and both having reasonable knowledge of the relevant facts.''[5] On Form 706, the estate reported the decedent's interest in PHC at $3.1 million.[6] A notice of deficiency, issued by the IRS on June 12, 2009, valued the PHC stock at $9.2 million.[7] At trial, the commissioner and the estate argued that Richmond's interest in PHC was worth $7.3 million and $5 million, respectively.[8]

The court first addressed the proper method to use in valuing the decedent's 23.44 percent interest in PHC. The commissioner's expert used a discounted net asset value (NAV) approach, whereas the estate employed an income-based (capitalization-of-dividends) method to value the stock.[9] Judge David Gustafson held that the NAV technique was the proper one for valuing a holding company such as PHC, the assets of which consisted largely of easy-to-value marketable securities.[10] The court suggested that the dividend capitalization method was more appropriate for valuing an operating business with many difficult-to-value assets.[11]

Both sides agreed that if the NAV method was used, there should be valuation discounts to reflect PHC's contingent BICG tax liability and the lack of control and marketability associated with the decedent's PHC interest. The parties disagreed on the proper amount of these discounts.

Discount for BICG Tax Liability

Since the repeal of the *General Utilities* doctrine, it is widely accepted that in valuing a C corporation, some adjustment is appropriate to reflect any BICG

[1]T.C. Memo. 2014-26.
[2]*Id.* at *6.
[3]*Id.* at *11 (about one-half of the stock was concentrated in four companies: Exxon Mobil, Merck & Co. Inc., General Electric Co., and Pfizer Inc.).
[4]*Id.* at *5-*6.
[5]Reg. section 20.2031-1(b).
[6]*Richmond* at *13.
[7]*Id.* at *14.
[8]*Id.* at *3-*4.
[9]*Id.* at *14, *16.
[10]*Id.* at *26.
[11]*Id.* at *23.

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tax liability.[12] In terms of the estate tax valuation standard, a willing buyer and a willing seller would take a potential tax liability into account in arriving at a purchase price for the stock. Approximately 87.5 percent of PHC's portfolio value consisted of unrealized appreciation that would generate an $18 million tax liability if sold on the date of death.[13]

The federal courts are split on how to adjust the value of corporate stock to reflect the capital gains burden that inheres in its appreciated assets. The Eleventh and Fifth circuits require, as a matter of law, that the NAV of a corporation be reduced on a dollar-for-dollar basis by any BICG tax liability.[14] This approach recognizes that the starting point for the NAV method is a presumed liquidation that would "give rise to a current tax liability reducing value."[15] The Tax Court and the Second and Sixth circuits, on the other hand, suggest that in many cases, the corporation will not be immediately liquidated when it is sold but will remain intact, allowing for indefinite deferral of the capital gains tax.[16]

In line with the Eleventh and Fifth circuits, the estate argued that PHC's value should be reduced by 100 percent of the BICG tax liability.[17] Noting that its opinion is appealable to the Third Circuit,[18] the Tax Court denied this discount because a rational hypothetical willing buyer would not likely liquidate PHC on purchase.[19] Accordingly, the inherent tax liability would be deferred, rather than immediately due and payable. In the court's view, "The seller of [a] company with [a] contingent future liability would demand a higher price than the seller of a company with [an] unconditional current liability. As a result . . . we find that a 100 percent discount would be unreasonable because it would not reflect the economic realities of PHC's situation."[20] In arriving at its proffered discount, the government's expert analyzed the correlation between the built-in gain and NAV discounts for closed-end funds.[21] Although the Tax Court dismissed this method as "not supported by the facts," it viewed the resulting discount (15 percent of NAV or $7.8 million) as a concession by the commissioner.[22]

After rejecting both parties' approaches, Gustafson made his own calculation of the BICG tax discount, stating that "the most reasonable discount is the present value of the cost of paying off that liability in the future."[23] Rather than an immediate liquidation, the present value method assumes that the corporation's assets will be sold in the future, and it discounts the prospective tax liability back to the valuation date.[24] To calculate present value, a turnover rate for the corporation's assets must be estimated.[25] Based on PHC's historically slow rate for selling its securities, the government's expert suggested 70 years as an appropriate holding period.[26] Gustafson rejected that estimate as allowing PHC's "unique, subjective investment goals to dictate the value of the company."[27] A rational actor, the court said, would heed the advice previously given to PHC to diversify its holdings. The court accepted as reasonable the testimony of the Service's expert that "a potential investor would expect that a portfolio like PHC's would turn over within a period of 20 to 30 years." Using 20 and 30 years, alternatively, as the proper holding period, Gustafson calculated a range of present values for PHC's BICG tax liability.[28] Since the government's $7.8 million concession fell within this range, the court accepted that as the proper discount.[29]

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[12]*See generally* Scott Andrew Bowman, "Built-In Gain Discounts for Transfer Tax Valuation: A Resolution for the BIG Debate," 24 *Akron Tax J.* 117 (2009); Robert P. Schweihs, "Valuation Adjustment for Built-In Capital Gains in a C Corporation," *Willamette Management Associates Insights* 25 (Summer 2012), *available at* http://www.willamette.com/insights_journal/12/summer_2012_4.pdf; Louis A. Mezzullo, "Built-In Capital Gains Tax Discount: A Tale of Two Theories," Bloomberg BNA, *available at* http://www.bna.com/builtin-capital-gains-n8589935011/.

[13]*Richmond* at *8.

[14]*Estate of Jelke v. Commissioner*, 507 F.3d 1317 (11th Cir. 2007); *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002).

[15]*Richmond* at *29-*30.

[16]*Estate of Davis v. Commissioner*, 110 T.C. 530 (1998); *Estate of Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998); *Estate of Welch v. Commissioner*, 208 F.3d 213, 2000 WL 263309 (6th Cir. 2000).

[17]*Richmond* at *29.

[18]The Third Circuit has not yet opined on the issue. Under the *Golsen* rule, the Tax Court gives effect to its "own views in cases appealable to courts whose views have not yet been expressed." *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970).

[19]*Richmond*, T.C. Memo. 2014-26, at *32. Although the court does leave open the possibility that on different facts, a dollar-for-dollar reduction could be warranted. According to Gustafson, We "do not face here a circumstance in which the facts about the assets and the market would make it inevitable that any informed buyer would expect to liquidate the company immediately and thus immediately bear the tax liability for the built-in gain." *Id.* *31, n.19.

[20]*Id.* at *32.

[21]*Id.* at *33.

[22]*Id.* at *35.

[23]*Id.* (citing *Estate of Jensen v. Commissioner*, T.C. Memo. 2010-182; *Estate of Litchfield v. Commissioner*, T.C. Memo. 2009-21).

[24]*See* Schweihs, *supra* note 12, at 26-27.

[25]*See* Mezzullo, *supra* note 12.

[26]*Richmond* at *36.

[27]*Id.*

[28]*Id.* at *38-*39 (using the different discount rates employed in various contexts in the case ranging from 7 to 10.27 percent).

[29]*Id.* at *39.

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Discounts for Lack of Control and Marketability

A willing buyer would demand a discount for the lack of control associated with Richmond's minority interest in PHC. Both parties used data from closed-end mutual funds to estimate the discount for lack of control. The government's expert chose the mean of the data set (6.7 percent),[30] while the estate's expert picked the median (8 percent). After adjusting for outliers, the court selected the average of the revised data set (7.75 percent) as a reasonable discount for lack of control.

There is no ready market for selling stock in PHC because it is a family-owned, non-publicly traded corporation. All parties agreed that a valuation adjustment for lack of marketability was warranted, but they disagreed on the amount of that discount. Both sides examined seven studies of restricted stock that produced lack of marketability discounts ranging from 26.4 to 35.6 percent.[31] The IRS selected the figure at the absolute bottom of this range and the estate argued for the value at the very top of the range. The court chose 32.1 percent as the proper marketability discount, a number that represented the average of the discounts in the data set.

Accuracy-Related Penalty

Most surprisingly, the Tax Court sustained the commissioner's imposition of a 20 percent penalty for a substantial estate tax valuation understatement.[32] Mechanically applying the statute, Gustafson noted that the estate's reported valuation of PHC ($3.1 million) was less than 65 percent of PHC's value as determined by the court ($6.5 million).[33] Accordingly, the burden shifted to the estate to show that the underpayment of tax was made in good faith and due to reasonable cause.[34]

The estate failed to carry this burden. According to the court, clients cannot rely blindly on advisers or an appraisal to establish good faith.[35] Rather, taxpayers must analyze both the appraisal and the appraiser.[36] The estate's executors (one of whom was a CPA) retained Peter Winnington of the accounting firm Belfint, Lyons & Shuman to value the decedent's PHC stock. Based on the company's history and financials, information about stock transactions in the 1990s, and prior estate tax valuations, Winnington valued PHC at $3.1 million, providing an unsigned draft of his valuation report to the executors.[37] Without ever asking him to finalize it, the estate used Winnington's draft report as its basis for the PHC valuation reported on Form 706.

The estate did not offer Winnington as an expert at trial and did not explain or defend Winnington's report. Instead, the estate argued that PHC was difficult to value, as evidenced by the fact that four different professionals (Winnington, the IRS auditor, and the experts offered at trial by each of the parties) reached four different conclusions. Gustafson agreed but considered that fact as an argument in favor of hiring a qualified valuation professional. In the court's opinion, to invoke the reasonable cause exception, the ''estate needed to have the decedent's interest in PHC appraised by a certified appraiser.''[38] Although Winnington did not meet this standard, he did have prior valuation experience (10 to 20 valuation reports and testified in court).[39] Furthermore, he was a CPA and financial planner with a bachelor's degree in accounting and a master's degree in taxation.[40] Winnington also had 20 years of experience in public accounting involving audits, management advice, litigation support, and tax services.[41]

Ultimately, the court concluded that the estate failed to act with reasonable cause and 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.''[42] What is left unclear by this holding is how much each of the following contributed to the imposition of the penalty: (1) the use of an unsigned draft report by the estate as its basis for PHC's reported value; (2) Winnington's lack of valuation expertise; and (3) the estate's failure to explain why at trial it abandoned the value reported on the estate tax return.

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[30]The commissioner's expert then rounded that number down to 6 percent in order to reflect that ''though the decedent did not control the company, the decedent's 23.44 percent interest was a large and influential block.'' *Id.* at *41. The court rejected this adjustment. *Id.*

[31]*Id.* at *44.

[32]Section 6662(a), (b)(5), (g).

[33]Section 6664(c)(1). The court noted that the ''$3.1 million value reported on the estate tax return was less than 65 percent of even the $5 million defended by the estate's own expert.'' *Richmond* at *50.

[34]Section 6664(c)(1).

[35]*Richmond* at *48.

[36]Reg. section 1.6664-4(b)(1) (providing that factors to be considered in determining good faith and reasonable cause include ''the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, and the appraisers relationship to the taxpayer or to the activity in which the property is used'').

[37]*Richmond* at *13.

[38]*Id.* at *50.

[39]*Id.* at *13.

[40]*Id.*

[41]*Id.*

[42]*Id.* at *49.

Conclusion

There are two key issues to track should the estate decide to appeal this ruling. First, what will the Third Circuit's position be in the existing BICG tax liability valuation discount debate? The approach of the Eleventh and the Fifth circuits is simple and consistent. The Tax Court's approach, on the other hand, is more complex but may be more accurate. Second, will the substantial valuation penalty hold up on appeal? Will Winnington's credentials, deemed substandard by the Tax Court, nevertheless impress the Third Circuit? Even if they do, will the penalty be sustained because the estate used an unsigned draft report as the basis for PHC's reported value? Whether *Richmond* is appealed or not, it sends a clear message to practitioners about the danger of using a noncertified appraiser to report an aggressive valuation on an estate tax return.

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