

**Update of
Valuation Case Law**

2016



Prepared by Reginald A. Emshoff

*Capital Valuation Group, Inc.
One North Pinckney Street, Suite 200
Madison, WI 53703*

*Phone: (608) 257-2757
Fax: (866) 695-0870
remshoff@capvalgroup.com*

www.capvalgroup.com

ANNOTATED CASE LAW UPDATE

Recent Developments in Business Valuation

Table of Contents

I.	Valuation in General.....	3
A.	Introduction	3
B.	Fair Market Value and the Willing Seller/Willing Buyer	4
II.	The Valuation of a Business Enterprise.....	10
A.	Introduction	10
B.	Understanding the Business.....	10
C.	Business Enterprise Valuation Methods.	12
III.	Specific Issues in the Valuation of a Business Enterprise.....	19
A.	Built-in Capital Gains of a C Corporation.	19
B.	Life Insurance Proceeds.....	21
C.	Subsequent Events	21
D.	S Corporations and other Pass-Through Entities.....	22
E.	Goodwill	24
F.	Buy-Sell Agreements and Transfer Restrictions	25
IV.	Discounts	27
A.	Introduction	27
B.	In general	27
C.	Discount for lack of control	28
D.	Discount for lack of marketability	31
V.	Specific Gift Tax Valuation Issues.....	33
A.	Ineffective Transfers of Business Interests	33
B.	Indirect Gifts Because of Timing of Transactions.....	35
C.	Present Interests vs. Future Interest.....	36
D.	Transfer Restrictions	39

I. Valuation in General

A. Introduction

The valuation of an ownership interest in a business requires consideration of the purpose or intended use of the valuation, a clear understanding of the subject of the valuation, a definition of the value that is to be determined, and the date of the valuation.

The **purpose** or intended use of the valuation often dictates the required definition of value as well as the documentation needed to support the conclusion of value. For example, a valuation prepared for general ownership planning purposes may require only an oral presentation with accompanying schedules, while a valuation that will be submitted to the IRS as part of a gift tax return may require documentation that informs a reader who is not familiar with the business.

The **subject** of the valuation is a specific ownership interest, and this specific interest may also dictate some of the valuation analysis needed. For example, the valuation of a controlling ownership interest in a closely held operating business may require calculation of the net proceeds from liquidation of the business's assets, while the valuation of a minority interest in the same business may attribute less weight to the value determined from the business's assets because a minority owner lacks the voting power unilaterally to sell the business's assets. On the other hand, the organization of the business as a corporation or as a limited liability company will require consideration of different organizational documents and different governing statutes.

Every business has more than one "value," and the purpose of the valuation and the subject of the valuation will influence the **standard** of value determined. For example, "fair market value" is commonly determined for federal tax purposes. But in a sale of the entire business to a competitor, "strategic value" may be the appropriate standard, even though the same ownership interest is being valued.

The value of a business and ownership interests in that business change over time, but most investors are interested in the future prospects of the business. Therefore, it is important to establish the **date** of the valuation and to ignore events that were not foreseeable as of that date.

All of these considerations are important to the valuation of an ownership interest. The following discussion focuses on the valuation of an entire business enterprise (100% control) under the fair market value standard and issues that arise in business valuations, but it also considers the valuation of a minority interest in a business, which lacks unilateral voting control over the business and supports discounts from the pro rata allocation of the business enterprise value, and the effect of transfer restrictions upon a particular business interest.

B. Fair Market Value and the Willing Seller/Willing Buyer

The most common standard of business value is fair market value. It applies to valuations for estate, gift, and income tax purposes, and it is also the standard for valuations for divorce in Wisconsin.

“Fair market value” is defined for federal tax purposes in sec. 3.01 of Revenue Ruling 59-60 as “the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.” Rev. Rul. 59-60 also characterizes the willing buyer and seller as hypothetical persons: “Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.” Furthermore, fair market value assumes that the price is transacted in cash or cash equivalents. Rev. Rul. 59-60, while used in tax valuations, is also used in many nontax valuations.

Section 3.01 of Revenue Ruling 59-60 continues,

“A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.”

Court cases have further characterized the fair market value transaction and its willing buyer and seller.

1. *Morrissey v. Commissioner of Internal Revenue*, 243 F.3d 1145 (9th Cir. 2001) (also referred to as *Estate of Kaufman* by the Tax Court):

(Background: Merrill Lynch had been engaged to value a minority interest in Seminole, a business, and had issued an opinion letter as to the value of its stock. Based on this value, two shareholders sold their stock. The Tax Court rejected these sales as not at arm’s length and not similar to the estate’s block of stock because they were smaller blocks. The Tax Court accepted the IRS value, less a 20% discount for lack of marketability.) The Court of Appeals said:

The estate tax is levied not on the property transferred but on the transfer itself. *Young Men’s Christian Ass’n v. Davis*, 264 U.S. 47, 50, 44 S.Ct. 291, 68 L.Ed. 558 (1924). “The tax is on the act of the testator not on the receipt of property by the legatees.” *Ithaca*

Trust Co. v. United States, 279 U.S. 151, 155, 49 S.Ct. 291, 73 L.Ed. 647 (1929). Consequently we look at the value of the property in the decedent's hands at the time of its transfer by death, 26 U.S.C. §2033, or at the alternative valuation date provided by the statute, 26 U.S.C. § 2032(a). That the tax falls as an excise on the exercise of transfer underlines the point that the value of the transfer is established at that moment; it is not the potential of the property to be realized at a later date.

Fair market value 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 relevant facts." 26 C.F.R. § 20.2031-1(b). The willing buyer and willing seller are to be postulated, not as a particular named X or Y, but objectively and impersonally. *Estate of McClatchy v. Comm'r.*, 147 F.3d 1089, 1094 (9th Cir.1998); *Propstra v. United States*, 680 F.2d 1248, 1251-52 (9th Cir.1982). As the Tax Court itself has held, the Commissioner cannot "tailor 'hypothetical' so that the willing seller and willing buyer were seen as the particular persons who would most likely undertake the transaction." *Estate of Andrews v. Comm'r.*, 79 T.C. 938, 956, 1982 WL 11197 (1982). Actual sales between a willing seller and buyer are evidence of what the hypothetical buyer and seller would agree on. *See Estate of Hall v. Comm'r.*, 92 T.C. 312, 336, 1989 WL 10688 (1989); 26 C.F.R. § 20.2031-2(b).

No good reason existed [for the Tax Court] to reject the sales by Branch and Hoffman as evidence of the fair market value of Seminole stock on April 14, 1994. The sales took place close to the valuation date. The sellers were under no compulsion to sell. There was no reason for them to doubt Weitzenhoffer's report of the Merrill Lynch valuation. That the final report was delivered only in July did not undercut the weight of the formal opinion letter written in March. The sellers had no obligation to hire another investment firm to duplicate Merrill Lynch's work. (243 F.3d at 1147).

. . . The Tax Court also engaged in the speculation that the Estate stock could be sold to a non-family member and that, to avoid the disruption of family harmony, the family members or Seminole itself would buy out this particular purchaser. The law is clear that assuming that a family-owned corporation will redeem stock to keep ownership in the family violates the rule that the willing buyer and willing seller cannot be made particular. *See Estate of Jung v. Comm'r.*, 101 T.C. 412, 437-38, 1993 WL 460544 (1993). The value of the Seminole stock in Alice Friedlander Kaufman's hands at the moment she transferred it by death cannot be determined by imagining a special kind of purchaser for her stock, one positioning himself to gain eventual control or force the family to buy him out. (243 F.3d at 1148).

2. *Gross v. Commissioner of Internal Revenue*, 272 F.3d 333 (6th Cir. 2001)(petition for certiorari denied):

[T]he purpose of valuation is to determine what a willing buyer would pay, and what a willing seller would accept, for the stock on the date of the valuation; it is not to determine what methodology the willing buyer would apply. The willing buyer-willing seller rule presupposes that the price will be the fair market value. Valuation, through the use of expert methodology, is the means, not the end, to application of the willing buyer willing seller rule.

Overall, the entire valuation process is a fiction -- the purpose of which is to determine the price that the stock would change hands from a willing buyer and a willing seller. However, a court is not required to presume hypothetical, unlikely, or unreasonable facts in determining fair market value. See *Estate of Watts*, 823 F.2d 483, 487 n. 2 (11th Cir.1987). . . . The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction.

3. *Estate of Simplot v. Commissioner of Internal Revenue*, 249 F.3d 1191 (9th Cir. 2001):

(Background: The corporation had 76,445 total shares of Class A voting and 141,288,584 total shares of Class B nonvoting stock. The decedent owned 18 shares (23.55%) of Class A and 3,942,048 (2.79%) of Class B stock. The Estate obtained a valuation of its stock from Morgan Stanley & Co., and on this basis reported the Class A and Class B shares as worth \$2,650 per share. The Commissioner of Internal Revenue valued the Class A stock at \$801,994 per share and the Class B stock at \$3,585 per share.

(The Tax Court found the Class A shares on a per share basis to be "far more valuable than the Class B shares because of the former's inherent potential for influence and control." The Tax Court added that "a hypothetical buyer" of the shares "would gain access to the 'inner circle' of J.R. Simplot Co., and by having a seat at the Class A shareholder's table, over time, the hypothetical buyer potentially could position itself to play a role in the Company. In this regard, we are mindful that 'a journey of a 1,000 miles begins with a single step.' "

(The Tax Court went on to "consider the characteristics of the hypothetical buyer" and supposed the buyer could be a Simplot, a competitor, a customer, a supplier, or an investor. The buyer "would probably be well-financed, with a long-term investment horizon and no expectations of near-term benefits. The hypothetical buyer might be primarily interested in only one of J.R.

Simplot Co.'s two distinct business activities--its food and chemicals divisions--and be a part of a joint venture (that is, one venture being interested in acquiring the food division and the other being interested in acquiring the chemical division)." The Tax Court entertained the possibility that Simplot could be made more profitable by being better managed at the behest of an outsider who bought the 18 shares. The Tax Court went on to envisage the day when the hypothetical buyer of the 18 shares would hold the largest block because the three other Simplot children had died and their shares had been divided among their descendants; the Tax Court noted that, even earlier, if combined with Don and Gay's shares together, or with Scott's shares alone, the 18 shares would give control.

(In the light of "all of these factors," the Tax Court assigned a premium to the Class A stock over the Class B stock equal to 3% of the equity value of the company, or \$24.9 million. Dividing this premium by the number of Class A shares gave each Class A share an individual premium of \$325,724.38, for a total value of \$331,595.70, subject to a 35% discount for lack of marketability with a resultant value of \$215,539. The Class B stock was valued at \$3,417 per share.) The Court of Appeals said

The Tax Court in its opinion accurately stated the law: "The standard is objective, using a purely hypothetical willing buyer and willing seller.... The hypothetical persons are not specific individuals or entities." The Commissioner himself in his brief concedes that it is improper to assume that the buyer would be an outsider. The Tax Court, however, departed from this standard apparently because it believed that "the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect value." Obviously the facts that determine value must be considered.

The facts supplied by the Tax Court were imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with Simplot children or grandchildren and what improvements in management of a highly successful company an outsider purchaser might suggest. "All of these factors," i.e., all of these imagined facts, are what the Tax Court based its 3% premium upon. In violation of the law the Tax Court constructed particular possible purchasers. (249 F.3d 1195).

4. Fair market value is often the standard for divorce, but the definition and interpretation of this standard varies from state to state.

- a. In Wisconsin, fair market value is defined for divorce purposes as “the price that property will bring when offered for sale by one who desires but is not obligated to sell and bought by one who is willing but not obligated to buy.” *Liddle v. Liddle*, 140 Wis.2d 132, 138, 410 N.W.2d 196, 199 (Ct. App. 1987).
- b. This definition of “fair market value” is similar to the definition of fair market value for purposes of federal gift and estate taxes. This definition also views the buyer and seller as hypothetical individuals and “requires consideration of what factors buyers and sellers find relevant when negotiating a deal.” In addition, “. . . all factors which have a bearing on the value of property must be considered to determine its fair market value.” *Ibid.*
- c. The fair market value of a property in a Wisconsin divorce should be determined from an objective investment perspective, not the perspective of the couple who own the property and are getting divorced. “[A] valuation based on utility to one person rather than market value would inject more uncertainty into an already uncertain area.” *Corliss v. Corliss*, 107 Wis. 2d 338, 320 N.W.2d 219 (Ct. App., 1982). It should be noted, however, that some states determine an investment value in divorce that considers the actual owners of the property rather than hypothetical buyers and sellers.

5. Also see

- a. *Estate of Litchfield v. Comm’r.*, T.C. Memo 2009-21 (T.C. 2009), for another discussion of fair market value, the willing seller/willing buyer, and valuations for estate tax purposes.
- b. *Estate of Blount v. Commissioner of Internal Revenue*, 428 F.3d 1338 (11th Cir. 2005), for a discussion of IRS regulations regarding an exception to the fair market value standard when property is subject to a buy-sell agreement.
- c. *Estate of True v. Commissioner of Internal Revenue*, T.C. Memo 2001-167, 82 T.C.M. (CCH) 27, affirmed by *Estate of True v. Commissioner of Internal Revenue*, 390 F.3d 1210 (10th Cir. 2004), for a detailed discussion of valuations for gift and estate tax purposes.

C. Other standards of value

- 1. “Fair value” is the standard of value applicable in many dissenting stockholder actions. It is similar to fair market value but differs in the applicability of discounts for lack of control and lack of marketability. It is also state specific. See, e.g., *HMO-W*

Incorporated v. SSM Health Care System, 234 Wis.2d 707, 611 N.W.2d 250 (2000), and *Swope v. Siegel-Robert, Inc.*, 243 F.3d 486 (8th Cir. 2001).

- a. Fair value is a court-determined value generally provided by statute. In certain states, if a corporation agrees to a merger, sale, or other action and the minority stockholders believe they will not receive adequate consideration for their ownership interest, they have the right to have their shares valued to receive the fair value for their shares. Legal input is needed when performing a fair value assignment to make certain that the specific state's interpretation of fair value is applied.
 - b. Wisconsin Statute chapter 180.1301 describes a dissenter's rights in Wisconsin and the purchase of the stockholder's interest in a corporation. Chapter 180.1301(4) describes "fair value, with respect to a dissenter's shares other than in a business combination, [as] the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable. "Fair value", with respect to a dissenter's shares in a business combination, means market value, as defined in secs. 180.1130 (9)(a) 1 to 4.
 - c. Under section 180.1130 (9)(a)(4), if there is no public trading price available, then "market value" is "the fair market value as determined in good faith by the board of directors of the resident domestic corporation."
2. "Investment value" determines value to a specific or particular investor, unlike fair market value, which determines value to a hypothetical buyer and seller. A specifically identified investor may perceive different economic returns from an investment, propose alternative capital structures, and accept different levels of risk, all factors that are reflected in the price the investor will pay for a particular business interest. See, e.g., *Holston Investments Inc. B.V.I. v. LanLogistics, Corp.*, 766 F.Supp.2d 1327 (S.D. Fla. 2010). Some states have also adopted investment value as the appropriate standard of value for divorce purposes.
 3. "Intrinsic value" is similar to investment value but is based on an analyst's conclusions of value for the investing public rather than the attributes of a specific buyer or seller. Intrinsic value is sometimes referred to as fundamental value, and it is the basis for

a recommendation to buy or sell a particular publicly traded security.

4. “Liquidation value” assumes that a business’s operations cease and its individual assets are sold. Liquidation value is further defined to be either an orderly liquidation or a forced liquidation. An orderly liquidation implies that the assets are sold over a period of time that allows for the highest price to be recognized for each asset. Forced liquidation is similar to a fire sale – the assets are sold as quickly as possible regardless of the price received.
5. “Book value” is an accounting term that refers to an asset’s historical cost reduced by any allowances for unrealized losses or depreciation, impairment, and amortization. Book value, as it relates to a company, refers to owners’ equity, or the difference between total assets and total liabilities as reported on the balance sheet. In general, “book value” is often loosely defined and a confusing reference to value. See, e.g., *Ehlinger v. Hauser*, 2010 WI 54 (Wis. 2010), 785 N.W.2d 328.

II. The Valuation of a Business Enterprise

A. Introduction

The valuation of a business enterprise requires a clear understanding of the business and its outlook but also the application of appropriate valuation methods.

B. Understanding the Business

1. *Delaware Open MRI Radiology Associates, P.A., v. Kessler*, 898 A.2d 290 (Del. Ch. 2006) – understanding the business plan:

(Background: This case involved a dissenting stockholder action, in which the value of the dissenting, minority stockholders’ pro rata interest in an expanding magnetic resonance imaging business was at issue. One expert considered only the two open MRI centers; the other expert considered these two centers plus three more that were in the planning stages as of the date of valuation.) The court said

Delaware law is clear that “elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered.” (footnote omitted). Obviously, when a business has opened a couple of facilities and has plans to replicate those facilities as of the merger date, the value of its expansion plans must be considered in the determining fair value [sic.]. To hold otherwise would be to subject our appraisal

jurisprudence to just ridicule. The dangers for the minority arguably are most present when the controller knows that the firm is on the verge of break-through growth, having gotten the hang of running the first few facilities, and now being well-positioned to replicate its success at additional locations – think McDonald's or Starbucks. Here, the business plan of Delaware Radiology involved the strategy of opening additional MRI Centers in Delaware with Edell. This strategy was part of what the Supreme Court would call the “operative reality” of Delaware Radiology on the merger date and must be considered in determining fair value.

2. *Polack v. Commissioner of Internal Revenue*, T.C. Memo 2002-145 (footnote 8), affirmed by *Polack v. CIR*, 366 F.3d 608 (8th Cir.2004) – understanding the business’s operations:

Petitioner contends we should accept his expert's testimony because his expert is significantly more experienced than respondent's expert. As our discussion indicates, our conclusion turns on factual disputes and reflects our finding that petitioner's conclusions regarding disputed factual issues are not grounded on credible evidence. An expert, no matter how skilled, can only work with the factual record he is given by his client or obtains through his own efforts. In this case, petitioner's expert relied primarily on petitioner's unsupported opinion regarding the disputed factual matters.

3. *Owen v. Lynn Cannon, Bryn Owen and Energy Services Group, Inc.*, (Del. Ch., June 17, 2015) discussed appropriate projections to be used in a discounted cash flow (DCF) analysis – there were several different sets of projections for the company – and whether to tax effect the earnings of the subject S corporation. The Court concluded that the projections that should be reflected in the valuation should be “management’s best estimates of what was known or knowable about [the company’s] future performance as of the Merger. . . . ‘[M]ethods of valuation, including a discounted cash flow analysis, are only as good as the inputs to the model.’ [citation omitted] When performing a DCF analysis to determine the fair value of stock, Delaware courts tend to place great weight on contemporaneous management projections because ‘management ordinarily has the best first-hand knowledge of a company's operations.’ [citation omitted] Management also typically ‘has the strongest incentives to predict the company's financial future accurately and reliably.’ [citation omitted] That said, it may be appropriate to reject a DCF analysis based on management-created projections ‘where the company's use of such projections was unprecedented, where the projections were created in anticipation of litigation, or where the projections were created for the purpose of obtaining benefits outside the company's ordinary course of business.’ [citation omitted]

Delaware courts are generally skeptical of projections created by an expert during litigation.”

4. *Longpath Capital, LLC v. Ramtron Int'l Corp.* (Del. Ch., 2015), also criticized projections prepared by management: “In summary, the Management Projections suffer from numerous flaws. Specifically, they: (1) were prepared by a new management team, (2) in anticipation of future disputes and of shopping the Company to potential white knights, (3) using a new methodology, and (4) were for a significantly longer period of time than previous forecasts. In addition, I note the following problems: (5) management's track record at forecasting was questionable even under their standard method of forecasting; (6) the final projections incorporate speculative elements relating to ROHM, (7) rely on distorted base year figures that resulted from customer allocation issues and channel stuffing, and (8) predict growth out of line with historical trends; and, finally, (9) management itself was providing other, ‘more accurate’ projections to the Company's bank. None of the indicia that often justify deferring to management projections are present in this case. Thus, Petitioner has not proven that the Management Projections are reliable, and I conclude that they are too questionable to form the basis of a reliable DCF valuation.” (citation omitted).
5. Also see, *S. Muoio & Co. LLC v. Hallmark Entertainment Investments Co., et al.*, 2011 Del. Ch. LEXIS 43, *aff'd*. 35 A.3d 419 (2011), criticizing the valuation expert's rejection of management's contemporaneous projections and using his own hypothetical and overly optimistic set of projections, and *In re Dole Food Co.*, 2015 Del. Ch. (*Dole III*)(August 27, 2015), for criticism of projections that purposely lowered value.

C. Business Enterprise Valuation Methods.

Three traditional approaches can be used to value an interest in an operating business: the income approach, the market approach, and the cost or asset approach.¹ Each valuation method is applied in light of the general economic and specific industry conditions and outlook as of the valuation date.

The **income** approach determines the value of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated benefits into a present single amount. The application of the income approach establishes value by methods that discount or capitalize earnings and/or cash flow by a discount or capitalization rate that reflects market rate of return expectations, market

¹ Definitions for the Income, Market, and Asset approach are taken from the International Glossary of Business Valuation Terms.

conditions, and the relative risk of the investment. Generally, this can be accomplished by the capitalization of earnings or cash flow method or the discounted cash flow method.

The **market** approach calculates the value of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold. Generally, this can be accomplished by a comparison to publicly traded guideline companies or by an analysis of actual transactions of similar businesses sold. It may also include an analysis of prior transactions involving an ownership interest in or the assets of the business, if any.

The **asset** approach calculates the value of a business, business ownership interest, or security by using one or more methods based on the value of the assets of that business net of liabilities. This approach can include the value of both tangible and intangible assets. However, this approach is often unnecessary in the valuation of a profitable operating company as a going concern, as the tangible and intangible assets are included, in aggregate, in the market and income approaches to value. Further, an asset approach to value is less relevant when valuing a minority ownership interest in a business because a minority owner lacks the voting power in the business unilaterally to force the sale of the business's underlying assets and distribution of the net proceeds from the sale. If the subject of the valuation is a controlling interest, an asset approach to value may be relevant because the controlling owner could force the sale of the underlying assets and the distribution of the net proceeds.

1. In *Zerby v. Comm'r. (Estate of Richmond)*, (U.S.T.C. 2014) the court had to choose between net asset and capitalization of earnings valuation methodologies in the valuation of a company that primarily owned marketable securities. The court said, “. . . [B]y definition, the capitalization-of-dividends valuation method is based entirely on estimates about the future--the future of the general economy, the future performance of PHC, and the future dividend payouts by PHC--and even small variations in those estimates can have substantial effects on the value determined (citation omitted). The estate's valuation method therefore ignores the most concrete and reliable data of value that are available--i.e., the actual market prices of the publicly traded securities that constituted PHC's portfolio. Of course, the net-asset-value method comes with its own difficulties and uncertainties (in this case, determining the amounts of the discounts discussed below), but the NAV [net asset valuation] method does begin by standing on firm ground--stock values that one can simply look up.”
2. *Dunn v. Commissioner of Internal Revenue*, 301 F.3d 339 (5th Cir. 2002) – an asset-based approach is based on the sale of a business's assets and the ability to sell those assets:

The Tax Court made a more significant mistake in the way it factored the “likelihood of liquidation” into its methodology, a quintessential mixing of apples and oranges: considering the *likelihood* of a liquidation sale of assets when calculating the *asset-* based value of the Corporation. Under the factual totality of this case, the hypothetical assumption that the assets will be sold is a foregone conclusion -- a given -- for purposes of the asset-based test (footnote omitted). The process of determining the value of the assets for this facet of the asset-based valuation methodology must start with the basic assumption that all assets will be sold, either by Dunn Equipment to the willing buyer or by the willing buyer of the Decedent's block of stock after he acquires her stock. By definition, the asset-based value of a corporation is grounded in the fair *market* value of its assets (a figure found by the Tax Court and not contested by the estate), which in turn is determined by applying the venerable willing buyer-willing seller test. By its very definition, this contemplates the consummation of the purchase and sale of the property, i.e., the asset being valued. Otherwise the hypothetical willing parties would be called something other than “buyer” and “seller.”

In other words, when one facet of the valuation process requires a sub-determination based on the value of the company's assets, that value must be tested in the same willing buyer/willing seller crucible as is the stock itself, which presupposes that the property being valued is in fact bought and sold. It is axiomatic that an asset-based valuation starts with the gross market (sales) value of the underlying assets themselves, and, as observed, the Tax Court's finding in that regard is unchallenged on appeal: When the starting point is the assumption of sale, the “likelihood” is 100%!

This truism is confirmed by its obverse in today's dual, polar-opposite approaches (cash flow; assets). The fundamental assumption in the income or cash-flow approach is that the assets are *retained* by the Corporation, i.e., *not* globally disposed of in liquidation or otherwise. So, just as the starting point for the asset-based approach in this case is the assumption that the assets are sold, the starting point for the earnings-based approach is that the Corporation's assets are retained -- are *not* sold, (other than as trade-ins for new replacement assets in the ordinary course of business) -- and will be used as an integral part of its ongoing business operations. This duly accounts for the value of assets – unsold -- in the active operations of the Corporation as one inextricably intertwined element of the production of income. (301 F.3d at 353).

3. *Estate of Heck v. Commissioner of Internal Revenue*, 83 T.C.M 1181 (USTC 2002) – guideline public companies and discounted cash flow methods (see full case for application of discounted cash flow method and discussion of different assumptions by the experts):

Even if we were to accept that Dr. Spiro relied on both Canandaigua and Mondavi as guideline companies, as respondent argues, we would still reject Dr. Spiro's use of the market approach in this case. Respondent points out that we have approved the use of the market approach based upon as few as two guideline companies. See *Estate of Desmond v. Commissioner*, T.C. Memo.1999-76. But in that case, all three companies were in the *same*, and not just a *similar*, line of business (manufacture and sale of paint and coatings). Here, Mondavi and Canandaigua were, at best, involved in similar lines of business. Under section 2031(b) and section 20.2031-2(f), Estate Tax Regs., publicly held companies involved in similar lines of business may constitute guideline companies, and we have so held. See, e.g., *Estate of Gallo v. Commissioner*, T.C. Memo.1985-363, where, in valuing the stock of the largest producer of wine in the United States, we approved the use by taxpayer's experts of comparables consisting of companies in the brewing, distilling, soft drink, and even food processing industries. But, in that case, the experts used at least 10 companies as guideline companies. See also *Estate of Hall v. Commissioner*, *supra* at 325, where we adopted an expert report utilizing a market approach based upon a comparison with six somewhat similar companies. As similarity to the company to be valued decreases, the number of required comparables increases in order to minimize the risk that the results will be distorted by attributes unique to each of the guideline companies. In this case, we find that Mondavi and Canandaigua were not sufficiently similar to Korbelt to permit the use of a market approach based upon those two companies alone (footnote omitted)

This Court considers the discounted cashflow (DCF) method employed by both experts to be an appropriate method for use in valuing corporate stock. See, e.g., *N. Trust Co. v. Commissioner*, 87 T.C. 349, 379, 1986 WL 22171 (1986). Moreover, where we have rejected use of the market approach as unreliable, we have based the value of a closely held corporation on the DCF approach alone. See *Estate of Jung v. Commissioner*, 101 T.C. 412, 433, WL 460544 (1993).

4. *In re Young Broad., Inc.*, 430 B.R. 99, (Bankr. S.D.N.Y. 2010), ruling that a leveraged DCF approach was not acceptable:

A DCF analysis arrives at a value for a company by performing the following steps: (1) determining the projected distributable cash flow of a company within a forecast period of time; (2) determining the company's terminal value by the end of a forecast period, by applying a selected metric of value, which is usually a company's EBITDA, to an appropriate multiple; (3) determining the present value of both free cash flow and the terminal value of the company by applying an appropriate discount rate; and (4) calculating the sum of the present value of cash flow and present value of

terminal value, which represents the total enterprise value of the company.

The expert for the Debtors (Kuhn), on the other hand, performed the following steps in his analysis: (1) determined zero projected distributable cash flow because the Committee assumed all cash will be accumulated to pay off the Debt upon maturity in November 2012; (2) determined the approximate value of equity in 2012 and assumed a sale of the Company at that value; (3) subtracted net debt and preferred stock outstanding from the projected sale value and labeled it "terminal value"; and (4) applied a discount rate, that accounts for only the cost of equity, to determine the present value of the common equity.

The Court found that, although the expert used DCF terminologies, there were practically no substantive similarities between the generally accepted DCF method and the levered DCF method. Kuhn had made multiple novel assumptions that do not exist in the DCF analysis and altered the way a company's terminal value should be calculated.

Additionally, the Levered DCF fails to meet any of the *Daubert* factors: it is not a method that has been tested or relied upon by other experts; it had never been subjected to peer review or discussed in any publication; the potential rate of error is unknown; and there is no evidence that this method was ever employed, discussed, and certainly not generally accepted in any academic or professional community.

Kuhn's explanation on the issue does not give him free rein to employ a brand new valuation method that he conceded has never been used by any valuation expert in court. In light of the significant missteps and speculative assumptions in Kuhn's novel valuation approach, the Court found that he did not conduct an appropriate DCF analysis.

5. *In re Sunbelt Bev. Corp. S'holder Litig.*, 2010 Del. Ch. LEXIS 1 (Del. Ch. Jan. 5, 2010), discussing the determination of small-firm and company-specific risk premia:

An independent basis should be used for determining the risk premium because an issue of circularity exists: knowing the value of the company is necessary to obtain the risk premium; however, knowing the risk premium is necessary to calculate the value of the company. The Court ultimately selected the small-firm risk premium (3.47%), a weighted balance between the ninth and tenth decile premiums, to account for the possibility that the company is on either side of the line.

The Court ruled that a company-specific risk premium was unwarranted because the reasons given by the defendant to use it were either a) applicable to the industry as a whole or b) based on Sunbelt's management projections, which were not deemed by

the Court to be excessively optimistic. Additionally, defendants provided no specific, quantitative explanation for why 3% was the appropriate level for a company-specific risk premium.

6. *Dunn v. Commissioner of Internal Revenue*, 301 F.3d 339 (5th Cir. 2002) – weighting results from different valuation approaches or methods:

(Background: “Having painted this clear and detailed valuation-date portrait of Dunn Equipment, the Tax Court proceeded to confect its valuation methodology. The court selected two different approaches to value, one being an income-based approach driven by net cash flow and the other being an asset-based approach driven by the net fair market value of the Corporation's assets. The court calculated the Corporation's "earnings-based value" at \$1,321,740 and its net "asset-based value" at \$7,922,892, as of the valuation date. The latter value was calculated using a 5% factor for built-in gains tax liability, not the actual rate of 34% that the Corporation would have incurred on sale to a willing buyer.) The Court of Appeals continued

Given the stipulated or agreed facts, the additional facts found by the Tax Court, and the correct determination by that court that the likelihood of liquidation was minimal, our expectation would be that if the court elected to assign unequal weight to the two approaches, it would accord a minority (or even a nominal) weight to the asset-based value of the Corporation, and a majority (or even a super-majority) weight to the net cash flow or earnings-based value. Without explanation, however, the Tax Court baldly - - and, to us, astonishingly -- did just the opposite, assigning a substantial majority of the weight to the *asset*-based value. The court allocated almost two-thirds of the weight (65%) to the results of the asset-based approach and only slightly more than one-third (35%) to the results of the earnings-based approach. We view this as a legal, logical, and economic non sequitur, inconsistent with all findings and expressions of the court leading up to its announcement of this step in its methodology. We also note that the Tax Court's ratio roughly splits the difference between the 50:50 ratio advanced by the Estate and the 100:0 ratio advocated by the Commissioner.

Throughout its comprehensive and logical background analysis, the Tax Court recognized that Dunn Equipment is an *operating* company, a going business concern, the Decedent's shares in which would almost certainly be purchased by a willing buyer for continued operation and not for liquidation or other asset disposition. For purposes of valuation, Dunn Equipment is easily distinguishable from true asset-holding investment companies, which own properties for their own intrinsic, passive yield and appreciation -- securities, timberland, mineral royalties, collectibles, and the like. For the Tax Court here to employ a

valuation method that, in its penultimate step of crafting a weighting ratio assigns only one-third weight to this operating company's income-based value, defies reason and makes no economic sense (footnote omitted). Our conclusion is all the more unavoidable when viewed in the light of the Tax Court's disregard of the ubiquitous factor of dividend paying capacity -- in this case, zero -- which, if applied under customarily employed weighting methods, would further dilute the weight of the asset-value factor and reduce the overall value of the Corporation as well. The same can be said for the effect on cash flow of the underpayment of officers' compensation.

Bottom Line: The likelihood of liquidation has no place in either of the two disparate approaches to valuing this particular operating company. We hasten to add, however, that the *likelihood of liquidation* does play a key role in appraising the Decedent's block of stock, and that role is in the determination of the relative *weights* to be given to those two approaches: The lesser the *likelihood* of liquidation (or sale of essentially all assets), the greater the *weight* (percentage) that must be assigned to the earnings (cash flow)-based approach and, perforce, the lesser the weight to be assigned to the asset-based approach.

We hold that the correct methodology for determining the value of Dunn Equipment as of the valuation date requires application of an 85:15 ratio, assigning a weight of 85% to the value of the Corporation that the Tax Court determined to be \$1,321,740 when using its "earnings-based approach" and a weight of 15% to the value that the court determines on remand using its "asset-based approach" but only after recomputing the Corporation's value under this latter approach by reducing the market value of the assets by 34% of their built-in taxable gain -- not by the 5% as previously applied by that court -- of the built-in gain (excess of net sales value before taxes over book value) of the assets, to account for the inherent gains tax liability of the assets.)

7. Also see
 - a. *Okerlund v. U.S.*, 53 Fed.Cl. 341, *aff'd.*, 365 F.3d 1044 (Fed. Cir. 2004) – weighting of results from different methods – income approach weighted 70% and market approach weighted 30%.
 - b. Also see footnote 36 in *Dunn v. Commissioner of Internal Revenue*, 301 F.3d 339 (5th Cir. 2002):

Fomented in significant part by myriad valuation challenges instituted by the IRS over the past decades, a full-fledged profession of business appraisers, such as the American Society of Appraisers, has emerged, generating its own methodology and lexicon in the process; which in turn have contributed to the profession's respect and

mystique. Because -- absent an actual purchase and sale -
- valuing businesses, particularly closely held corporations,
is not a pure science replete with precise formulae and
susceptible of mechanical calculation but depends instead
largely on subjective opinions, the writings and public
pronouncements (including expert testimony) of these
learned practitioners necessarily contain some vagaries,
ambiguities, inexactitudes, caveats, and qualifications. It is
not surprising therefore that from time to time
disagreements of diametric proportion arise among these
practitioners. As the methodology we employ today may
well be viewed by some of these professionals as
unsophisticated, dogmatic, overly simplistic, or just plain
wrong, we consciously assume the risk of incurring such
criticism from the business appraisal community. In
particular, we anticipate that some may find fault with (1)
our insistence (like that of the Estate's expert) that, in the
asset-based approach, the valuing of the Corporation's
assets proceed on the assumption that the assets are sold;
and (2) our determination that, in this case, the *likelihood*
of liquidation or sale of essentially all assets be factored
into the weighting of the results of the two valuation
approaches and not be considered as an integral factor in
valuing the Corporation under either of those approaches.
In this regard, we observe that on the end of the
methodology spectrum opposite *oversimplification* lies
over-engineering.

III. Specific Issues in the Valuation of a Business Enterprise

A. Built-in Capital Gains of a C Corporation.

1. *Dunn v. Commissioner of Internal Revenue*, 301 F.3d 339 (5th Cir.2002), discusses when taxes arising from built-in capital gains on assets should be considered in establishing the value of a business interest:

The Tax Court's fundamental error in this regard is reflected in its statement that -- for purposes of an asset-based analysis of corporate value -- a fully-informed willing buyer of *corporate shares* (as distinguished from the Corporation's assemblage of assets) constituting an operational-control majority would *not* seek a substantial price reduction for built-in tax liability, absent that buyer's intention to liquidate. This is simply wrong: It is inconceivable that, since the abolition of the *General Utilities* doctrine and the attendant repeal of relevant I.R.C. sections, such as §§ 333 and 337, any reasonably informed, fully taxable buyer (1) of an operational-control majority block of stock in a corporation (2) *for the purpose of acquiring its assets*, has not insisted that all (or essentially all) of the latent tax liability of assets

held in corporate solution be reflected in the purchase price of such stock.

We are satisfied that the hypothetical willing buyer of the Decedent's block of Dunn Equipment stock would demand a reduction in price for the built-in gains tax liability of the Corporation's assets at essentially 100 cents on the dollar, regardless of his subjective desires or intentions regarding use or disposition of the assets. Here, that reduction would be 34%. This is true "in spades" when, for purposes of computing the *asset*-based value of the Corporation, we assume (as we must) that the willing buyer is purchasing the stock to get the assets (footnote omitted), whether in or out of corporate solution. We hold as a matter of law that the built-in gains tax liability of this particular business's assets must be considered as a dollar-for-dollar reduction when calculating the *asset*-based value of the Corporation, just as, conversely, built-in gains tax liability would have no place in the calculation of the Corporation's *earnings*-based value (footnote omitted). (301 F.3d at 352)

2. *Estate of Jelke v. Commissioner of Internal Revenue*, 507 F.3d 1317 (11th Cir. 2007), *cert. denied*, 129 S. Ct. 168, 172 L. Ed. 2d 43, 77 U.S.L.W. 3197 (U.S. 2008) builds on *Dunn* and accepts the dollar-for-dollar deduction for the amount of the built-in gain tax.

The subject company in *Jelke* was essentially a portfolio of publicly traded stocks, and the estate's interest was a minority block of stock that could not unilaterally force the sale of any of the underlying securities. The court concluded that the approach in "*Dunn* eliminates the crystal ball and the coin flip and provides certainty and finality to valuation as best it can, already a vague and shadowy undertaking" (1332).

3. *Estate of Marie Jensen v. Commissioner*, T.C. Memo 2010-182, also adopted the dollar-for-dollar discount for embedded capital gains tax liability:
 - a. Tax Court adopted the taxpayer's dollar-for-dollar discount for embedded capital gains tax liability based on 2nd Circuit precedent and its own present-value analysis, but specifically declined to adopt the per se rule of the 5th and 11th Circuits.
 - b. The estate's expert concluded that a dollar-for-dollar discount for the built-in LTCG [long-term capital gain] tax was appropriate because the adjusted book value method was based on the inherent assumption that the assets will be liquidated, which automatically gives rise to a tax liability predicated upon the built-in capital gains that result from appreciation in the assets.

c. The court accepted the estate's value for the built-in LTCG tax discount (a 100% discount) because it is within the range of values that may be derived from the evidence.

4. But see: *Zerby v. Comm'r.* T.C. Memo 2014-26, and *Estate of Litchfield v. Comm'r.*, T.C. Memo 2009-21, which determined the discount associated with the tax on the built-in capital gains but used a method approved in cases before *Estate of Jelke v. Commissioner of Internal Revenue*, 507 F.3d 1317 (11th Cir. 2007). Footnote 10 in *Litchfield* acknowledges the 2007 *Jelke* decision and notes that its decision in *Litchfield* might have been different if a dollar-for-dollar discount had been argued.

B. Life Insurance Proceeds

1. Life insurance proceeds payable to a business may be part of the business's ongoing value or be a nonoperating asset separate from the day-to-day cash needs of the business.
2. *Estate of Blount v. Commissioner of Internal Revenue*, 428 F.3d 1338 (11th Cir. 2005), discusses the treatment of life insurance proceeds in the valuation of a business when the proceeds are committed to the purchase of a decedent's stock pursuant to a buy-sell agreement: "We conclude that such nonoperating 'assets' should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets."

C. Subsequent Events

1. Valuations are typically done as of a specific date. In some instances, subsequent events may be considered to establish value as of an earlier date. In *Estate of Noble v. Commissioner of Internal Revenue*, T.C. Memo 2005-2, the price at which the Estate's stock was sold nearly fourteen months after the valuation date was used to establish the fair market value as of the date of death. The court stated

Generally speaking, a valuation of property for Federal tax purposes is made as of the valuation date without regard to any event happening after that date. See *Ithaca Trust Co. v. United States*, 279 U.S. 151, 49 S.Ct. 291, 73 L.Ed. 647 (1929). An event occurring after a valuation date, however, is not necessarily irrelevant to the determination of fair market value as of that earlier date. An event occurring after a valuation date may affect the fair market value of property as of the valuation date if the event was reasonably foreseeable as of that earlier date. [citations omitted] An event occurring after a valuation date, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a

hypothetical willing buyer would have paid a hypothetical willing seller for the subject property as of the valuation date. [citations omitted] Unforeseeable subsequent events which fall within this latter category include evidence, such as we have here, “of actual sales prices received for property after the date [in question], so long as the sale occurred within a reasonable time . . . and no intervening events drastically changed the value of the property.” [citations omitted].

2. Also see *Okerlund v. U.S.*, 53 Fed.Cl. 341, 2002 WL 1969642 (Fed.Cl.), 90 A.F.T.R.2d 2002-6124, *aff'd.*, 365 F.3d 1044, 93 A.F.T.R.2d 2004-1715 (Fed. Cir. 2004), for assessing future risks when subsequent events prove their accuracy.

D. S Corporations and other Pass-Through Entities

1. Background cases:
 - a. *Wall v. Commissioner of Internal Revenue*, 81 T.C.M. 1425 (USTC 2001) (footnote 19, questioning imputing a tax on an S corporation).
 - b. *Gross v. Commissioner of Internal Revenue*, 272 F.3d 333 (6th Cir. 2001)(petition for certiorari denied)(conclusion that tax affecting an S corporation was not appropriate)
 - c. *Heck v. Commissioner of Internal Revenue*, T.C. Memo 2002-34 – The underlying company, F. Korbel & Bros., Inc., had elected S corporation income tax status. Neither expert imputed a corporate income tax in his valuation. (Note: Dr. Bajaj, the expert for the taxpayer, was the expert for the government in *Gross*.)
 - d. *Estate of Adams v. Commissioner of Internal Revenue*, 83 TCM 1421 (USTC 2002) – The underlying company had elected S corporation income tax status, and the expert did not tax affect the projected income and cash flows. The court concluded that because the company had elected S corporation income tax status, the projected income and cash flows were after a zero-percent corporate income tax rate.

2. *Delaware Open MRI Radiology Associates, P.A., v. Kessler*, 898 A.2d 290 (Del. Ch. 2006):

(Background: The minority stockholders in a corporation owning magnetic resonance imaging (MRI) facilities brought combined entire fairness and statutory appraisal actions against the majority stockholders, who served as directors of a new entity established as an acquisition entity, and against the surviving S corporation in a squeeze-out merger, alleging breach of fiduciary duty by effecting the merger in a procedurally and substantively unfair manner.)

. . . In undertaking this analysis, I embrace the reasoning of prior decisional law that has recognized that an S corporation structure can produce a material increase in economic value for a stockholder and should be given weight in a proper valuation of the stockholder's interest. (footnote omitted). That reasoning undergirds not only holdings of the *Adams*, *Heck*, and *Gross* cases in the U.S. Tax Court, but an appraisal decision of this court, which coincidentally also involved a radiology business. (citation omitted). The opinion in *In re Radiology Associates* noted that “under an earnings valuation analysis, what is important to an investor is what the investor ultimately can keep in his pocket.”

The amount that should be the basis for an appraisal or entire fairness award is the amount that estimates the company's value to [plaintiffs] as S corporation stockholders paying individual income taxes at the highest rates - an amount that is materially more in this case than if Delaware Radiology was a C corporation. In coming to a determination of how [plaintiff's] interest in Delaware Radiology would be valued in a free market comprised of willing buyers and sellers of S corporations, acting without compulsion, it is essential to quantify the actual benefits of the S corporation status. That is also essential in order to determine the value of what was actually taken from the Kessler Group as continuing stockholders. . . . Assessing corporate taxes to the shareholder at a personal level does not affect the primary tax benefit associated with an S Corporation, which is the avoidance of a dividend tax in addition to a tax on corporate earnings. (footnote omitted). This benefit can be captured fully while employing an economically rational approach to valuing an S corporation that is net of personal taxes. (footnote omitted). To ignore personal taxes would overestimate the value of an S corporation and would lead to a value that no rational investor would be willing to pay to acquire control (footnote omitted). This is a simple premise – no one should be willing to pay for more than the value of what will actually end up in her pocket

3. Also see, *Bank of Am., N.A., v. Arun Veluchamy, et. al. (In re Veluchamy)*, 524 B.R. 277 (Bankr. N.D. Ill, 2014), which states: “Purchasers of S corporations would in fact experience a reduction in the value of the corporations’ earnings because of the need to pay personal income taxes on those earnings, and recognizing that tax effect in valuing S corporations is appropriate,” and *Owen v. Lynn Cannon, Bryn Owen and Energy Services Group, Inc.*, (Del. Ch., June 17, 2015), which states: “[The plaintiff is] ‘entitled to be paid for that which has been taken from him.’ [citation omitted] A critical component of what was ‘taken’ from Nate in the Merger was the tax advantage of being a stockholder in a Subchapter S corporation. As then-Vice Chancellor Strine reasoned in *Kessler*, ‘[a]n S corporation structure can produce a material increase in economic value for a

stockholder and should be given weight in a proper valuation of the stockholder's interest.' [citation omitted] The Court thus concluded that 'when minority stockholders have been forcibly denied the future benefits of S corporation status, they should receive compensation for those expected benefits and not an artificially discounted value that disregards the favorable tax treatment available to them.' [citation omitted]."

4. *Dallas v. Commissioner of Internal Revenue*, 92 TCM (U.S.T.C. 2006), elaborates further on the valuation of S corporations. This gift tax case highlights the importance of evidence that characterizes the hypothetical willing buyer and seller and that supports the conclusion that the buyer would, or would not, continue the S- corporation election. *Dallas* follows the earlier cases – *Gross*, *Heck*, and *Delaware Open MRI Radiology Associates* – that did not impute an income tax at the corporate level when valuing an S corporation.
5. *In re Sunbelt Bev. Corp. S'holder Litig.*, 2010 Del. Ch. LEXIS 1 (Del. Ch. Jan. 5, 2010), concluded that there was no basis for an upwards adjustment of the per-share value of Sunbelt on the basis of Sunbelt's post-merger conversion to an S corporation. While Delaware Open MRI was an S corporation at the time of its merger, Sunbelt, in contrast, converted to an S corporation post merger. Delaware law clearly excludes from the valuation of the shares any enhanced value stemming from Sunbelt's post-merger conversion to S-corporation status.

E. Goodwill

1. The intangible asset "goodwill" is often valuable to an on-going business, but there may be dispute as to whether the business or an individual actually owns this asset. As stated in *Estate of Adell v. Comm'r* (U.S.T.C 2014), "Goodwill is often defined as the expectation of continued patronage by existing customers. Network Morning Ledger Co. v. United States, 507 U.S. 546, 572-573 (1993). A key employee may personally create and own goodwill independent of the corporate employer by developing client relationships. Martin Ice Cream Co. v. Commissioner, 110 T.C. 189, 207-208 (1998). The corporation may benefit from using the personally developed goodwill while the key employee works for the entity, but the corporation does not own the goodwill and therefore it is not considered a corporate asset. Id. at 208. The employee may, however, transfer any personal goodwill to the employer through a covenant not to compete or other agreement that transfers the relationships to the employer. See id. at 207; H&M, Inc. v. Commissioner, T.C. Memo. 2012-290. Absent such an agreement, the employer cannot freely use the asset and the

value of the goodwill should not be attributed to the corporation.” Also see, *Boss Trucking*, Tax Ct. Memo, 2014-107.

2. *McReath v. McReath*, 2011 WI 66, 800 N.W.2d 399:

McReath, a Wisconsin divorce case, similarly defines “goodwill” as that element of value “which inheres in the fixed and favorable consideration of customers arising from an established and well-conducted business.” “Professional goodwill” (or “personal goodwill”) varies from “corporate goodwill” (or “business goodwill,” “going concern value,” “commercial goodwill,” and “enterprise goodwill.”).

One of the primary mechanisms through which professional goodwill is sold is a non-compete agreement. The Appeals Court held that no reasonable buyer would purchase the orthodontist’s practice without an agreement preventing him from competing in the two communities where his offices were located. There was no dispute that the hypothetical willing buyers would demand a non-compete agreement. Additionally, there was no serious dispute that, if a sale occurred, the non-compete aspect of the sale would be a mechanism for the transfer of some portion of the orthodontist’s professional goodwill to the buyer.

There was also no dispute that the professional goodwill at issue here was salable. *Holbrook*, 103 Wis. 2d 327, 309 N.W.2d 343, supports the proposition that non-salable professional goodwill is not a divisible asset. However, *Holbrook* declined to adopt a blanket rule excluding salable professional goodwill from divisible property.

The Wisconsin Supreme Court agreed: “. . . we conclude today that when valuing a business interest that is part of the marital estate for purposes of divorce, a circuit court shall include the value of the salable professional goodwill attendant to the business interest.”

F. Buy-Sell Agreements and Transfer Restrictions

1. Buy-sell agreements may or may not establish the value of an interest in a business. As summarized in *Estate of Blount v. Comm’r. of Internal Revenue*, 428 F.3d 1338 (11th Cir. 2005), regarding valuations for estate tax purposes,

“. . . the IRS has promulgated regulations to define the calculation of fair market value. See Treas. Reg. § 20.2031-2. Courts have refined the guidance in the regulations into an exception to the general rule for property that is subject to a valid buy-sell agreement. See generally *Estate of True v. Comm’r.*, 390 F.3d 1210, 1218 (10th Cir. 2004)(collecting cases). The exception has three requirements: (1) the offering price must be fixed and determinable under the agreement; (2) the agreement must be

binding on the parties both during life and after death; and (3) the restrictive agreement must have been entered into for a *bona fide* business reason and must not be a substitute for a testamentary disposition. *Id.*

This exception was codified and further limited in the Omnibus Budget Reconciliation Act of 1990 This law applies to all agreements created or substantially modified after 8 October 1990. . . . Under OBRA, the agreement must (1) have a *bona fide* business purpose, (2) not permit a wealth transfer to the natural objects of the decedent's bounty, and (3) be comparable to similar arrangements negotiated at arm's length."

2. *Estate of Amlie*, 91 T.C. M. 1017 (U.S.T.C.2006), and *Holman v. Comm'r.*, 601 F.3d 763 (8th Cir., 2010) discuss provisions that do or do not qualify as *bona fide* business purposes under IRC sec. 2703(b)(1). Whether there was a *bona fide* business arrangement is a question of fact. The court in *Holman*, regarding a limited partnership that held highly liquid publicly traded stock, concluded: "In answering the question of whether a restriction constitutes a *bona fide* business arrangement, context matters. Here that context shows that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions. Simply put, in the present case, there was is no 'business,' active or otherwise. The donors have not presented any argument or asserted any facts to distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash. We and other courts have held that 'maintenance of family partnerships and control of a business' may be a *bona fide* business purpose [citations omitted] We have not so held, however, in the absence of a business."
3. Buy-sell agreements may or may not be controlling for purposes of divorce in Wisconsin. As summarized in *In re Marriage of Sharon v. Sharon*, 178 Wis. 2d 481, 504 N.W.2d 415 (Wis. App. 1993): "We agree that a transaction made pursuant to a buy-sell agreement . . . may provide the basis for establishing the fair market value of a partnership interest. Contrary to Mark's position, however, such a transaction does not as a matter of law establish the fair market value of the partnership. Rather, it is one available method that the trial court in its discretion may rely on. *Ondrasek* merely stands for the proposition that a buyout agreement *may* provide the trial court with a method of determining the value of a partner's interest, not that such an agreement *per se* determines the value of the withdrawing partner's interest."

IV. Discounts

A. Introduction

The value of an entire business enterprise includes the value of control, which carries with it the choice to sell the entire business or its assets, change the business's capital structure, or change the business plan. A non-controlling ownership interest, which is often a minority interest, lacks the voting power unilaterally to effect these changes. For these and other reasons, the value of a minority ownership interest in a closely held business is typically less than the pro rata allocation of the controlling value in the same business. This diminished economic value is often determined through discounts for lack of control over the business enterprise and, if appropriate under the valuation methodology, a discount for the ownership interest's lack of marketability.

B. In general

Estate of Mitchell v. Commissioner of Internal Revenue, 83 T.C.M. 1524 (U.S.T.C. 2002):

In *Estate of Mitchell v. Commissioner*, T.C. Memo.1997-461, we began our analysis by placing a \$150 million value on JPMS at the moment immediately prior to Mr. Mitchell's death. In determining this value, we considered all the evidence but gave the greatest consideration to Minnetonka's real-world \$125 million offer in the fall of 1988 (which Mr. DeJoria found "a little short") and the Gillette offer of \$150 million. This value represents the acquisition value of all the nonpublicly traded stock of JPMS.

In *Estate of Mitchell v. Commissioner*, 250 F.3d 696, 705, (9th Cir. 2001) (*nonacquiescence by IRS*, as to burden of proof, 2005-23 IRB 1152), the Court of Appeals stated:

Acquisition value and publicly traded value are different because acquisition prices involve a premium for the purchase of the entire company in one deal. Such a lumpsum valuation was not taken into account when the minority interest value of the stock was calculated by the experts. In general, the acquisition price is higher, resulting in an inflated tax consequence for the Estate.

In reaching our valuation determination, we were, and are, mindful that, in general, a publicly traded value (determined under the comparable companies analysis) represents a minority, marketable value. Moreover, we were, and are, mindful that acquisition value, if determined by reference to acquisitions of publicly traded companies, reflects a premium over the publicly traded value. It produces a control, marketable value that is greater than the minority, marketable publicly traded value. If the acquisition price of publicly traded companies is used to value a minority interest in a closely held corporation, discounts for both lack of marketability and lack of control would apply.

The real-world acquisition value of \$150 million we applied in this case is the acquisition value based on an offer to purchase all of the stock of JPMS, which is not publicly traded. The acquisition value based on that offer reflects the fact that there is no ready market for shares in JPMS, a closely held corporation. As we pointed out in *Estate of Andrews v. Commissioner*, 79 T.C. at 953, "even controlling shares in a nonpublic corporation suffer from lack of marketability because of the absence of a ready private placement market and the fact that flotation costs would have to be incurred if the corporation were to publicly offer its stock." The \$150 million acquisition value reflects a control, nonmarketable value. Therefore, a discount for lack of marketability of JPMS stock from the value determined by reference to the offer to purchase the JPMS stock is not appropriate. . .

We find that a 29-percent discount for decedent's 49.04-percent shareholding is appropriate to reflect some power but less than control. We also find that here the minority discount should be increased by 6 percentage points (a total of 35 percent) to reflect the additional lack of marketability attributable to a minority interest.

On the basis of a thorough review of the entire record before us, we believe that we correctly arrived at a 35-percent discount rate that combines the lack of control and any additional lack of marketability attributable to that lack of control that is not reflected in the \$150 million control, nonmarketable acquisition value.

The experts generally agreed that the most significant factors included the impact of Mr. Mitchell's death on the reputation of the company, the costs of the DeJoria litigation, cashflow patterns, the marketability of the estate's minority (i.e. noncontrolling) interest of stock in the company, and the overall competition in the hair care industry. The \$150 million acquisition price reflects the cashflow patterns and the overall competition in the hair care industry. We apply a 10-percent discount to the \$150 million to reflect the impact of Mr. Mitchell's death on the value of the corporation (footnote omitted). We apply a 35-percent discount for lack of control and additional lack of marketability attributable to the minority interest. Finally, we reduce the value of the 49.04-percent ownership interest by \$1,500,000 to account for the possibility of litigation with Mr. DeJoria. Thus, we find that the value of the shares of stock at the moment of decedent's death was \$41,532,600.

C. Discount for lack of control

1. *Dunn v. Commissioner of Internal Revenue*, 301 F.3d 339 (5th Cir. 2002):

(Background: The Corporation actively operated its business from four locations in Texas and, on the valuation date, employed 134 persons, three of whom were executives and eight of whom were salesmen. Dunn Equipment owned and rented out heavy equipment and provided related services, primarily in the petroleum refinery and petrochemical industries. The personal

property rented from the Corporation by its customers consisted principally of large cranes, air compressors, backhoes, manlifts, and sanders and grinders. The Corporation frequently furnished operators for the equipment that it rented to its customers, charging for both equipment and operators on an hourly basis.

(. . . the heavy equipment rental market became increasingly competitive, as equipment such as cranes became more readily available and additional rental companies entered the field. This in turn caused hourly rental rates to decline and flatten. In fact, increased competition prevented Dunn Equipment from raising its rental rates at any time during the period of more than ten years preceding the valuation date. These rates remained essentially flat for that 10-year period. The same competitive factors forced the Corporation to replace its equipment with increasing frequency, reaching an average new equipment expenditure of \$2 million per annum in the years immediately preceding the valuation date. In addition to the increased annual cost and frequency of replacing equipment during the years of flat rental rates that preceded the Decedent's death, the Corporation's operating expenses increased significantly, beginning in 1988, and continued to do so thereafter: The ratios of direct operating expenses to revenue escalated from 42% in 1988 to 52% in the 12-month period that ended a week before the Decedent's death. The effect of the increase in direct operating expenses on the Corporation's cash flow and profitability was exacerbated by a practice that Dunn Equipment was forced to implement in 1988: meeting its customers' demands by leasing equipment from third parties and renting it out to the Corporation's customers whenever all of its own equipment was rented out to other customers. Although this practice, which continued through the valuation date, helped Dunn Equipment keep its customers happy and retain its customer base, the Corporation was only able to break even on these rentals, further depressing its profit margin.

(Based on the foregoing factors, the Tax Court concluded that the Corporation had no capacity to pay dividends during the five years preceding the death of the Decedent. In fact, it had paid none.) The Court of Appeals said

The Tax Court also found that, even though the Decedent's 62.96% of stock ownership in the Corporation gave her operational control, under Texas law she lacked the power to compel a liquidation, a sale of all or substantially all of its assets, or a merger or consolidation, for each of which a "super-majority" equal to or greater than 66.67% of the outstanding shares is required (footnote omitted). The Court further concluded that, in addition to lacking a super-majority herself, the Decedent would not have been likely to garner the votes of additional shareholders sufficient to constitute the super-majority required to instigate liquidation or sale of all assets because the other shareholders were determined to continue the Corporation's independent

existence and its operations indefinitely. The court based these findings on evidence of the Corporation's history, community ties, and relationship with its 134 employees, whose livelihoods depended on Dunn Equipment's continuing as an operating business. (301 F.3d at 346).

2. *Estate of Godley v. Commissioner of Internal Revenue*, 286 F.3d 210 (4th Cir. 2002).

In this case, the Tax Court determined that the value of the partnership interests was subject to a discount for lack of marketability, but not for the alleged lack of control. This finding was not clearly erroneous. As the evidence demonstrates, there was little to be gained by having control of these partnerships and little risk in holding a minority interest.

Here, the Housing Partnerships were guaranteed a long-term, steady income stream under the HUD contracts. The Housing Partnerships had little risk of losing the HUD contracts and the management of the properties did not require particular expertise. Indeed, the HUD contracts allowed the Housing Partnerships to collect above-market rents, and there was no other use for the partnerships that would increase their profits. Therefore, control of the Housing Partnerships did not carry with it any appreciable economic value. Nor did a lack of control reduce the value of a fifty percent interest such that a minority discount was required. The Estate argues that a minority discount was required because "the record supports a finding that the managing partner had significant latitude in determining the extent of partnership distributions and the amounts set aside in reserve." However, each partnership agreement required the partnership to distribute its "net cash flow" annually and set forth a specific calculation of that net cash flow. There was no risk that Godley, a fifty percent partner, would not realize an annual payout. Although the agreements also granted the managing partner the power to set aside reserves, that power was characterized as one of "day-to-day management." It appears unlikely that this "set aside" power could be used to defeat the requirement of an annual distribution. At a minimum, Godley could exercise his power under the partnership agreements to prevent any change to the guarantee of an annual distribution. Thus, as the Tax Court determined, Godley was effectively guaranteed a reasonable annual distribution of partnership income. And while an inability to force a distribution of income may under other circumstances warrant a discount for lack of control, the Tax Court correctly found that this factor was not relevant in this case.

Similarly, the Estate contends that Godley's fifty percent interest made it impossible for him to compel liquidation or sell partnership assets. However, neither Godley nor Godley, Jr. could compel liquidation or make any "major decision" without the affirmative

vote of seventy-five percent of the partnership shares. Moreover, given the passive nature of the business and the almost certain prospect of steady profits, the ability to liquidate or sell assets was of little practical import. Thus, as the Tax Court reasoned, the guarantee of above-market rents and other factors unique to the Housing Partnerships meant that the power to liquidate the partnership or to sell partnership assets would have minimal value to an investor. (286 F.3d at 216).

3. Also see *Estate of Simplot v. Commissioner of Internal Revenue*, 249 F.3d 1191 (9th Cir. 2001):

(Background: "In the light of 'all of these factors,' the Tax Court assigned a premium to the Class A stock over the Class B stock equal to 3% of the equity value of the company, or \$24.9 million. Dividing this premium by the number of Class A shares gave each Class A share an individual premium of \$325,724.38, for a total value of \$331,595.70, subject to a 35% discount for lack of marketability with a resultant value of \$215,539. Class B stock was valued at \$3,417 per share.") The Court of Appeals said

The Tax Court committed a third error of law. Even a controlling block of stock is not to be valued at a premium for estate tax purposes, unless the Commissioner can show that a purchaser would be able to use the control "in such a way to assure an increased economic advantage worth paying a premium for." *Ahmanson Foundation v. United States*, 674 F.2d 761, 770 (9th Cir.1981). Here, on liquidation, all Class B shareholders would fare better than Class A shareholders; any premium paid for the 18 Class A shares [sic] be lost. Class A and B had the right to the same dividends. What economic benefits attended 18 shares of Class A stock? No "seat at the table" was assured by this minority interest; it could not elect a director. The Commissioner points out that Class A shareholders had formed businesses that did business with Simplot. If these businesses enjoyed special advantages, the Class A shareholders would have been liable for breach of their fiduciary duty to the Class B shareholders. See *Estate of Curry v. United States*, 706 F.2d 1424, 1430 (7th Cir.1983). (249 F.3d at 1195).

D. Discount for lack of marketability

1. *Okerlund v. U.S.*, 53 Fed.Cl. 341, *aff'd.*, 365 F.3d 1044 (Fed. Cir. 2004):

The Court finds Dr. Pratt's analysis of the appropriate discount for lack of marketability more persuasive than that of the government's expert. First, Dr. Spiro's speculation about the pressure to go public created by the 3G Trust may not be considered under the objective standard applicable to valuation of closely held stock. The court is precluded from considering

imaginary scenarios as to "who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with [] children or grandchildren and what improvements in management of a highly successful company an outsider purchaser might suggest." *Estate of Simplot v. Comm'r.* 249 F.3d 1191, 1195 (9th Cir. 2001). Dr. Spiro's imaginary scenario, however plausible, may not be considered in valuing what a hypothetical willing buyer and willing seller would pay for closely held stock. Second, the factors identified in the AVG Report that weigh against a high liquidity discount relating to company performance and competitiveness were already taken into account in determining the appropriate pricing multiples under the market approach. Thus, the re-emphasis of these factors in the liquidity discount analysis may result in overstatement. Finally, the Court finds Dr. Pratt's analysis of the relevant empirical studies and shareholder risks more persuasive than the AVG report's rather truncated analysis. In particular, the Court is persuaded that the Marvin Schwan estate plan provisions would deter investment to a greater extent than Dr. Spiro suggests.

However, rather than accepting Dr. Pratt's estimate of 45 percent, the Court holds that a 40 percent discount for lack of marketability is warranted for the December 31, 1992 valuation date. The Court agrees that the company's dividend payment history, restrictive stock transfer provision, the 3G Trust and the redemption agreement constitute significant deterrents to investment because of the restraints they impose on short or long term returns. However, in 1992 the estate plan provisions, although in place, had neither been triggered nor anticipated in the immediate future. In other words, they were prospective concerns rather than actual concerns as of the 1992 valuation date. It is well-established that "valuation of the stock must be made as of the relevant dates without regard to events occurring subsequent to the crucial dates." *Bader v. United States*, 172 F.Supp. 833, 840 (S.D.Ill.1959); accord *Hermes Consol., Inc. v. United States*, 14 Ct.Cl. 398, 415, n. 28 (1988), *Fehrs v. United States*, 223 Ct.Cl. 488, 620 F.2d 255, 264 n. 6 (1980), *Central Trust Co. v. United States*, 158 Ct.Cl. 504, 305 F.2d 393, 403 (1962) (footnote omitted). In 1992, the major shareholder risks identified in the Willamette Report, and in Dr. Pratt's testimony, were in place, but had not yet been triggered by Marvin Schwan's death. The difference between potential versus actual deterrents to investment supports a 5 percent disparity between the appropriate discount for lack of marketability in 1992 (40 percent) and in 1994 (45 percent).

2. In 2009, the IRS released a Job Aid for IRS Valuation Professionals "meant to provide a background and context for the discount for lack of marketability as such is commonly applied in

business valuation analyses and reports. [The Job Aid] reviews past and existing practices and attempts to provide insight into the strengths and weaknesses of these practices. It is not meant to provide a cookbook approach to evaluating a marketability discount as proposed by a taxpayer or to setting a proposed marketability discount in the case of an independent governmental appraisal. It is emphasized that, all background and existing practices aside, the establishment of a Discount for Lack of Marketability is a factually intensive endeavor that is heavily dependent upon the experience and capability of the valuator.”

3. Also see *Mandelbaum v. Commissioner of Internal Revenue*, T.C. Memo 1995-255, *aff'd.*, 91 F.3d 124 (3rd Cir. 1996), which determined a discount for lack of marketability that started with a benchmark discount of 35% to 45%. Subsequent cases indicate that this benchmark was appropriate based on the facts of the case but should not be viewed as a legal standard for all cases. The benchmark, or starting point, must be based on the facts of each case. See, for example, *Lappo v. Comm’r.*, T.C. Memo 2003-258, and *Peracchio v. Comm’r.*, T.C. Memo 2003-280.

V. Specific Gift Tax Valuation Issues

A. Ineffective Transfers of Business Interests

1. Several recent cases have focused on whether a transfer of a business interest to another entity constitutes a bona fide sale; if not, the business interest may be included in a decedent’s estate under Internal Revenue Code sec. 2036(a). *Kimbell v. U.S.*, 371 F.3d 257 (5th Cir. 2004), discusses factors considered in determining whether a transfer was made for adequate and full consideration, thus constituting a bona fide sale:

In summary, what is required for the transfer by Mrs. Kimbell to the Partnership to qualify as a bona fide sale is that it be a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange. In order for the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition, when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer’s assertion that the transaction is bona fide or genuine.

The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser’s ability to turn right around and sell the newly acquired limited partnership

interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid -- a classic informed trade-off.

The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

2. *Estate of Harper v. Commissioner of Internal Revenue*, 83 T.C.M. 1641 (U.S.T.C. 2002) illustrates an ineffective transfer of the business interest:

On the facts before us, HFLP's formation at a minimum falls short of meeting the bona fide sale requirement. Decedent, independently of any other anticipated interest-holder, determined how HFLP was to be structured and operated, decided what property would be contributed to capitalize the entity, and declared what interest the Trust would receive therein. He essentially stood on both sides of the transaction and conducted the partnership's formation in absence of any bargaining or negotiating whatsoever. It would be an oxymoron to say that one can engage in an arm's-length transaction with oneself, and we simply are unable to find any other independent party involved in the creation of HFLP.

Furthermore, lack of a bona fide sale aside, we believe that to call what occurred here a transfer for consideration within the meaning of section 2036(a), much less a transfer for an adequate and full consideration, would stretch the exception far beyond its intended scope. In actuality, all decedent did was to change the form in which he held his beneficial interest in the contributed property.

3. Also see
 - a. *Harper* is discussed in *Estate of Thompson v. Commissioner*, T.C. Memo 2002-246, *aff'd.*, 382 F.3d 367 (3rd Cir. 2004), in which the Tax Court concluded that sec. 2036(a) required inclusion of assets in an estate because

the decedent had not given up control over the assets, even though the partnership was valid under state law.

- b. *Harper* is also discussed in *Estate of Bongard v. Commissioner of Internal Revenue*, 124 T.C. 95 (U.S.T.C. 2005), in which the court found one transaction a bona fide sale for adequate and full consideration but another transaction as not a bona fide sale because there was an implied agreement that the decedent would retain enjoyment over the property that was transferred; therefore, under section 2036(a)(1) of the Internal Revenue Code, the decedent's gross estate included the value of the property from the second transfer.
- c. *Bigelow v. Commissioner of Internal Revenue*, 89 T.C.M. 954 (U.S.T.C. 2005), discussed *Kimbell*, *Harper*, *Thompson*, and *Bongard* and concluded that "the decedent and her children had an implied agreement that decedent could continue during her lifetime to enjoy the economic benefits of, and retain the right to the income from, the . . . property after she conveyed the property to the partnership, and that the transfer was not a bona fide sale for adequate and full consideration. Thus, the value of the . . . property is included in decedent's gross estate [under] sec. 2036(a)(1).
- d. *Strangi v. Commissioner of Internal Revenue*, 417 F.3d 468 (5th Cir. 2005), also found that the decedent retained the possession and enjoyment of the transferred property.
- e. *Keller v. United States*, 2009 U.S. Dist. LEXIS 73789 (S.D. Tex. 2009), *aff'd*. 697 F.3d 238 (5th Cir.), found that decedent did not retain possession and enjoyment of the transferred property, thus resulting in a bona-fide sale. A Partnership was created for a legitimate business purpose: to alter the legal relationship between Mrs. Williams and her heirs that would facilitate the administration of family assets. Mrs. Williams' transfer of assets to the Partnership was "real, actual, genuine, and not feigned," supporting the conclusion that the transfer was made pursuant to a bona fide sale.

B. Indirect Gifts Because of Timing of Transactions

- 1. In *Holman v. Comm'r.*, 130 T.C. 170 (2008), the taxpayers formed and funded a limited partnership with publicly traded securities and, 6 days later, made a series of gifts of limited partnership interests. The IRS argued that the taxpayers' "formation and funding of the partnership should be treated as occurring simultaneously with . . . [the gift] since the events were interdependent and the separation in time between the first two steps (formation and funding) and the third (the gift) served no

purpose other than to avoid making an indirect gift under section 25.2511-1(h), Gift Tax Regs.” The court rejected this characterization, concluding that “. . . the taxpayers bore a real economic risk of a change in value of the partnership for the 6 days that separated their transfer of the shares to the partnership and the gift. . . . We shall not disregard the passage of time and treat the formation and funding of the partnership and the subsequent gifts as occurring simultaneously under the step transaction doctrine.” *Holman* at 190-191.

2. Also see:

- a. *Gross v. Comm’r.*, T.C. Memo 2008-221. “The step transaction doctrine embodies substance over form principles; it treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. Where an interrelated series of steps are taken pursuant to a plan to achieve an intended result, the tax consequences are to be determined not by viewing each step in isolation, but by considering all of them as an integrated whole.”
- b. *Heckerman v. United States*, 2009 U.S. Dist. LEXIS 65746 (W.D. Wash. 2009), asserting the step transaction doctrine. The Court found that the two-step transaction was an integrated transaction because Plaintiff could not establish that he contributed assets to the LLC before he gifted the minority interests in the LLC to his children. The Court also held that Plaintiff clearly had a subjective intent to convey property to his children while minimizing his tax liability. Also, it is clear that but for the anticipated discount in calculating gift taxes, Plaintiffs would not have transferred the cash to the LLC. Also see: *Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009).

C. Present Interests vs. Future Interest

1. *Christine and Albert Hackl v. Commissioner*, 118 T.C. 279 (2002), affirmed, *Hackl v. C.I.R.*, 335 F.3d 664, 92 A.F.T.R.2d 2003-5254 (7th Cir. 2003)(rehearing denied) illustrates the importance of gifts of present interests for purposes of the annual exclusion from gift taxes:

(Background: “Section 2501 imposes a tax for each calendar year” on the transfer of property by gift” by any taxpayer, and section 2511(a) further clarifies that such tax “shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible”. The tax is computed based upon the statutorily defined “taxable gifts”, which term is explicated in section 2503. Section 2503(a) provides generally that taxable gifts means the

total amount of gifts made during the calendar year, less specified deductions. Section 2503(b), however, excludes from taxable gifts the first \$10,000 "of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year". In other words, the donor is entitled to an annual exclusion of \$10,000 per donee for present interest gifts.

(Regulations promulgated under section 2503 further elucidate this concept of present versus future interest gifts, as follows:

Future interests in property.--(a) No part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the "calendar period" * * *. "Future interest" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future. But a future interest or interests in such contractual obligations may be created by the limitations contained in a trust or other instrument of transfer used in effecting a gift. (b) An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property. * * * [Sec. 25.2503-3, Gift Tax Regs.]

(The primary business purpose of all three of the above entities has been to acquire and manage plantation pine forests for long-term income and appreciation for petitioners and their heirs and not to produce immediate income. Petitioners anticipated that all three entities would operate at a loss for a number of years, and therefore, they did not expect that these entities would be making distributions to members during such years. Treeco reported losses in the amounts of \$42,912, \$121,350, and \$23,663 during 1995, 1996, and 1997, respectively. Hacklco reported losses of \$52,292 during 1997. Treesource reported losses in the amounts of \$75,179, \$153,643, and \$95,156 (footnote omitted) in 1997, 1998, and 1999, respectively. Neither Treeco nor its successors had at any time through April 5, 2001, generated net profits or made distributions of cash or other property to members.) The Tax Court continued . . .

Nonetheless, while State law defines property rights, it is Federal law which determines the appropriate tax treatment of those rights. (citations omitted) It thus is Federal law which controls whether the property rights granted to the donees as LLC owners under State law were sufficient to render the gifts of present interests within the meaning of section 2503(b) (118 T.C. at 290). . .

Accordingly, we are satisfied that section 2503(b), regardless of whether a gift is direct or indirect, is concerned with and requires meaningful economic, rather than merely paper, rights. (118 T.C. at 291). . . .

To recapitulate then, the referenced authorities require a taxpayer claiming an annual exclusion to establish that the transfer in dispute conferred on the donee an unrestricted and noncontingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom. In other words, petitioners must prove from all the facts and circumstances that in receiving the Treeco units, the donees thereby obtained use, possession, or enjoyment of the units or income from the units within the above-described meaning of section 2503(b) (118 T.C. at 293)

Concerning the specific rights granted in the Operating Agreement, we are unable to conclude that these afforded a *substantial* economic benefit of the type necessary to qualify for the annual exclusion. While we are aware of petitioners' contentions and the parties' rather conclusory stipulations that Treeco was a legitimate operating business entity and that restrictive provisions in the Agreement are common in closely held enterprises and in the timber industry, such circumstances (whether or not true) do not alter the criteria for a present interest or excuse the failure here to meet those criteria.

As we consider potential benefits inuring to the donees from their receipt of the Treeco units themselves, we find that the terms of the Treeco Operating Agreement foreclosed the ability of the donees presently to access any substantial economic or financial benefit that might be represented by the ownership units. For instance, while an ability on the part of a donee unilaterally to withdraw his or her capital account might weigh in favor of finding a present interest, here no such right existed. According to the Agreement, capital contributions could not be demanded or received by a member without the manager's consent. Similarly, a member desiring to withdraw could only offer his or her units for sale to the company; the manager was then given exclusive authority to accept or reject the offer and to negotiate terms. Hence some contingency stood between any individual member and his or her receipt from the company of economic value for units held, either in the form of approval from the current manager or perhaps in the form of removal of that manager by joint majority action, followed by the appointment of and approval from a more compliant manager. Likewise, while a dissolution could entitle members to liquidating distributions in proportion to positive capital account balances, no donee acting alone could effectuate a dissolution. Moreover, in addition to preventing a donee from unilaterally obtaining the value of his or her units from the LLC, the

Operating Agreement also foreclosed the avenue of transfer or sale to third parties. The Agreement specified that "No Member shall be entitled to transfer, assign, convey, sell, encumber or in any way alienate all or any part of the Member's Interest except with the prior written consent of the Manager, which consent may be given or withheld, conditioned or delayed as the Manager may determine in the Manager's sole discretion." Hence, to the extent that marketability might be relevant in these circumstances, as potentially distinguishable on this point from those in indirect gift cases such as *Chanin v. United States*, 393 F.2d at 977, and *Blasdel v. Commissioner, supra* at 1021-1022 (both dismissing marketability as insufficient to create a present interest where the allegedly marketable property, an entity or trust interest, differed from the underlying gifted property), the Agreement, for all practical purposes, bars alienation as a means for presently reaching economic value. Transfers subject to the contingency of manager approval cannot support a present interest characterization, and the possibility of making sales in violation thereof, to a transferee who would then have no right to become a member or to participate in the business, can hardly be seen as a sufficient source of substantial economic benefit. We therefore conclude that receipt of the property itself, the Treeco units, did not confer upon the donees use, possession, or enjoyment of property within the meaning of section 2503(b) (118 T.C. at 296 - 298).

D. Transfer Restrictions

1. *Kerr v. Commissioner of Internal Revenue*, 292 F.3d 490 (5th Cir. 2002) concerns the applicability of sec. 2704(b) of the Internal Revenue Code for gift tax purposes:

(Background: In establishing the valuation for gift tax purposes, the Internal Revenue Code disregards certain "applicable restrictions" on liquidation in a partnership agreement if the gift is made to a family member. I.R.C. § 2704(b). . . . The Commissioner took the position that Code § 2704(b) barred them from applying a marketability discount to the values of the interests they transferred. The Tax Court ruled summarily for the taxpayers, holding that the special rule in § 2704(b) did not bar their marketability discounts. The Commissioner now appeals the Tax Court's decision, arguing that certain partnership agreement restrictions were "applicable restrictions" on liquidation within the meaning of § 2704(b) and should be disregarded, thus precluding a marketability discount in valuing the gifts.

(Baine P. Kerr and Mildred C. Kerr ("taxpayers") created two family limited partnerships in 1993, the Kerr Family Limited Partnership (KFLP) and Kerr Interests, Ltd. (KIL), pursuant to the Texas Revised Limited Partnership Act. Taxpayers made capital contributions to KFLP and KIL. The interests were allocated so

that in KFLP, taxpayers and their children were general partners; taxpayers were also Class A and Class B limited partners. In KIL, KFLP was the general partner; taxpayers were Class A limited partners; and KFLP, taxpayers, and their children were Class B limited partners.

(In June 1994 taxpayers transferred Class A limited partnership interests in KFLP and KIL to the University of Texas (UT). In December 1994, the KIL partnership agreement was amended to admit UT as a Class A limited partner. In December 1994 and December 1995, taxpayers each donated Class B partnership interests in KIL to their children.") The Court of Appeals said . . .

The Commissioner argues that the restrictions in the agreements were removable by the family, because there is evidence that UT, the only non-family partner, (footnote omitted) would not oppose their removal if proposed by the Kerr family (footnote omitted). The parties have stipulated that UT would convert its interests into cash as soon as possible, so long as it believed the transaction to be in its best interest and that it would receive fair market value for its interest. The Commissioner argues that, because UT would have no reason to oppose their removal, the partnership restrictions should be treated as capable of being removed by the Kerr family after the transfers.

We disagree. For a restriction to be considered removable by the family, the Code specifies that "[t]he transferor or any member of the transferor's family, either alone or collectively," must have the right to remove the restriction. I.R.C. § 2704(b)(2)(B)(ii). The Code provides no exception allowing us to disregard non-family partners who have stipulated their probable consent to a removal of the restriction. The probable consent of UT, a non-family partner, cannot fulfill the requirement that the family be able to remove the restrictions on its own. (292 F.3d at 494).

2. As summarized in a concurring opinion in *Pierre v. Comm'r.*, 133 T.C. 24, 37 (2009), "Transfer tax disputes, including this one, more frequently involve differences over the fair market value of property, and fair market value is determined by applying the "willing buyer, willing seller" standard to the property transferred. See majority op. pp. 8-11. Where the property transferred is an interest in a single-member LLC that is validly created and recognized under State law, the willing buyer cannot be expected to disregard that LLC. See, e.g., *Knight v. Commissioner*, 115 T.C. 506, 514 (2000) ("We do not disregard * * * [a] partnership because we have no reason to conclude from this record that a hypothetical buyer or seller would disregard it.").

Of course, Congress has the ability to, and on occasion has opted to, modify the willing buyer, willing seller standard. See, e.g., secs. 2032A, 2701, 2702, 2703, 2704; *Holman v. Commissioner*, 130 T.C. 170, 191 (2008) (applying section 2703 to disregard restrictions in a partnership agreement). In *Kerr v. Commissioner*,

113 T.C. 449, 470-474 (1999), aff'd. 292 F.3d 490 (5th Cir. 2002), we explained that the special valuation rules were a targeted substitute for the complexity, breadth, and vagueness of prior section 2036(c). We reaffirmed the willing buyer, willing seller standard, *Kerr v. Commissioner, supra* at 469, and concluded that the special provision in section 2704(b) did not apply to disregard the partnership restrictions in issue, *id.* at 473; see also *Estate of Strangi v. Commissioner*, 115 T.C. 478, 487-489 (2000), aff'd. on this issue, rev'd. and remanded on other grounds 293 F.3d 279 (5th Cir. 2002).