

FCG VALUATION CASE E-FLASH

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Issue 15:2**

Estate of John F. Koons III, Deceased, A. Manuel Zapata, Personal Representative, Petitioner v. Commissioner of Internal Revenue, Respondent

John F. Koons III, revocable Trust, Estate of John F. Koons III, Deceased, A. Manuel Zapata, Personal Representative, William P. Martin II, A. Manuel Zapata, Robert W. Maxwell II, Keven E. Shell, Michael S. Caudill, and D. Scott Elliott, Trustees, Petitioners v. Commissioner of Internal Revenue, Respondent

T.C. Memo. 2013-94, Docket Nos. 19771-09, 19772-09, Judge: Richard T. Morrison, Filing date April 8, 2013

The Estate of John F. Koons III claimed an interest expense deduction of \$71,419,497 on a \$10,750,000 loan related to estate administration. Further, it asserted the fair market value of the John F. Koons III Revocable Trust's (Revocable Trust) interest in Central Investment LLC (CI LLC) on March 3, 2005, was \$117,197,442.72. Disputing the preceding, the IRS issued a notice of deficiency in 2009.

TAKEAWAY

The Revocable Trust owned a 70.42% voting interest (implying a control level of value) in a company having 92% of its assets in cash, and the court accepted a 7.5% discount for lack of marketability. In part, the discount was justified by contractual restrictions imposed on the company's net worth, a potential lawsuit, and the need to get the approval of a 75% supermajority of owners to transfer member interests.

THE FACTS

On January 10, 2005, CIC Holding LLC sold all shares of Central Investment Corp. (CIC) to PepsiAmericas, Inc. (PAS) for approximately \$352.4 million. After the closing, CIC Holding LLC was merged with CI LLC. The merger was part of the same transaction as the sale of CIC shares to PAS.

After the merger, CI LLC owned \$352.4 million associated with the sale to PAS, \$50 million received from PepsiCo to settle a lawsuit, and the assets formerly owned by CIC (except for its soft-drink and vending machine assets). In addition, CI LLC was owned by the former shareholders of CIC in the same proportions as their respective shareholdings in CIC before the sale.

Pursuant to section 9.3 of the stock purchase agreement, CI LLC was required to (a) own directly at all times cash, cash equivalents, or marketable securities with an aggregate fair market value of at least \$10 million, and (b) maintain a positive net worth at all times of at least \$40 million until January 10, 2012.

On December 21, 2004, CI LLC issued a letter to each of the Koons children in which it offered to redeem their member interests. By February 27, 2005, all of the children had agreed to redeem their interest in CI LLC. Shortly thereafter, John F. Koons III died on March 3, 2005.

DISCUSSION

The IRS asserted the interest deduction was inappropriate, citing [26 C.F.R. sec. 20.2053-3 \(a\) \(2009\)](#): "Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions." Although the loan was not necessary, the petitioners argued it was preferable to a distribution of cash because a distribution would leave CI LLC with less cash to buy businesses. However, the court noted that lending the money was inconsistent with the petitioners' assertion because it also depleted the company's cash. In addition, the Revocable Trust would have to rely on future distributions to repay the loan.

The ruling also noted that the loan repayments were due 18 to 25 years into the future, which would hinder “proper settlement” of the Estate.

Regarding the parties’ determination of the fair market value of the Revocable Trust’s interest in CI LLC as of the date of death, the primary dispute centered on the marketability discount. More specifically, the petitioner’s expert contended the marketability discount was 31.7%, while the IRS expert contended it was 7.5%.

One factor which affected the marketability discount was the size of the Revocable Trust’s interest in CI LLC. The taxpayer’s expert disagreed with the IRS expert regarding the ability of Koons’ children to affect a partial liquidation and distribution of assets. More specifically, all the children had signed letters offering to redeem their interests before their father’s death. Assuming the redemptions occurred; the Revocable Trust’s voting interest increased to 70.42% from 46.94%. While section 9.3 of the stock purchase agreement prevented the company from “dissolving and distributing all assets of its Members until January 10, 2012” [underline not in original], the Revocable Trust could make CI LLC distribute most of its assets. Thus, the holder of the trust’s 50.50% diluted interest (which was a 70.42% voting interest) in CI LLC could receive about \$140 million in distributions, which the court concluded would be the minimum fair market value for the subject interest.

CONCLUSION

The court ruled that the loan made to the Revocable Trust was not necessary to the Estate’s administration. Therefore, the projected interest to be paid was not a deductible administrative expense.

Further, the court declined to rely on the taxpayer expert’s regression equation to determine the value of the Revocable Trust’s 50.50% diluted interest in CI LLC because the minimum threshold associated with liquidation of the company’s assets (net of the minimum net worth required by section 9.3 of the stock purchase agreement) was about \$140 million. Instead the court accepted the IRS value of \$148,503,609.

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