FCG Valuation Case E-Flash

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Issue 16:1

Estate of Helen P. Richmond, Deceased, Amanda Zerbey, Executrix, Petitioner v. Commissioner of Internal Revenue, Respondent
T.C. Memo. 2014-26, Docket No. 21448-09, Judge: Hon. David Gustafson, Filed February 11, 2014

To determine the value of the decedent's 23.44% interest in Pearson Holding Co. ("PHC") at the time of death, the court resolved the following disputes:

- Whether the capitalization-of-dividends method or net asset value ("NAV") method should be used, and
- The appropriate discounts applicable to the NAV method.

TAKEAWAY
The 20% accuracy-related penalty under section 6662(a), (b)(5), and (g) could have been avoided if the estate demonstrated that it acted with reasonable cause and in good faith with respect to the under valuation. However, using an unsigned draft report prepared by its accountant as its basis for value failed to meet the burden of proof for exclusion from the penalty because the accountant did not have any appraisal certifications, was not used as an expert at trial, and the taxpayer did not demonstrate the accountant was qualified as a valuation expert.

THE FACTS
PHC is a family-owned investment holding company that was incorporated in Delaware in January 1928. The company's philosophy is to maximize dividend income. As a holding company subject to tax on undistributed income, PHC has a strong incentive to pay out most of the dividend income, with the objective to provide a steady stream of income to the descendants of Frederick Pearson while minimizing taxes and preserving capital. The court also found it noteworthy that PHC's dividends grew slightly more than 5% per year from 1970 through 2005.

As of December 2005, Helen P. Richmond owned 548 shares in PHC, a 23.44% minority interest. The decedent had no right to "put" her stock to the company, and the company could not "call" her stock.

Historically, the capitalization of dividends approach was used for nine transactions involving the sale or redemption of PHC stock between 1971 and 1993, and once more in 1999 when a shareholder died. For the 1999 estate, the Federal estate tax return relied upon the capitalization of dividends method.

Ultimately, the IRS issued a statutory notice of deficiency with a valuation adjustment from $3,149,767 to $9,223,658, which increased the estate tax liability by $2,854,729. Additionally, a 40% gross valuation misstatement penalty of $1,141,892 was asserted pursuant to section 6662(h). No other adjustments were made to the gross estate.

DISCUSSION
While there were discrepancies about which valuation method should be used to calculate the value of the decedent's interest, the parties agreed that the NAV of PHC's portfolio was $52,159,430 and its built in capital gains tax ("BICG") was $18,113,083. Yet the parties disagreed about the size of the applicable discounts when using the NAV method.

The accountant who provided the original value in the estate tax return, used the capitalization of dividends method to calculate the value of the decedent's interest. Although the accountant had appraisal experience, he did not have any appraiser certifications and was not used as an expert. Instead, the taxpayer used someone else as an expert in court. The taxpayer's expert valued the decedent's interest using the capitalization of dividends method but came up with a value of $5,046,500. Furthermore, the taxpayer's expert considered the NAV method, while the accountant who provided the value in the estate tax return did not.

In the deficiency notice, the valuation method used by the IRS auditor was not specified and no explanation was given to what extent, if any, his method allowed discounts. In his notice of deficiency, the Commissioner valued the decedent's interest at $9,223,658, but at trial, the testimony of the Commissioner's expert was relied upon to argue a revised value of $7,330,000.

Using the court's consistent precedent for valuing holding companies like PHC, the court chose the NAV method for valuing the estate.

Although the taxpayer's expert considered the NAV method, his valuation differed from the Commissioner's expert by the discounts he used in association with the BICG tax, discount for lack of control, and discount for lack of marketability. The following table depicts the values each party used for discounts, as well as the values determined by the court.

	Taxpayer's Expert	Commissioner's Expert	Court Ruling
BICG tax discount	34.8%	15%	15%
Discount for lack of control	8%	6%	7.75%
Discount for lack of marketability	35.6%	21%	32.1%
Value of decedent's interest	$4,721,962	$7,330,000	$6,503,804

CONCLUSION

Absent direction from the Third Circuit (where the current dispute might be appealed) and in spite of contrary rulings in the Fifth and Eleventh Circuit Courts (which ruled in favor of 100% BICG discounts), the court decided that the most reasonable discount for PHC's BICG tax liability was the present value of its future liability. Since the Commissioner's discount fell with the court's range of values, it was considered reasonable.

To determine the discount for lack of control, the court used the Commissioner expert's data set of 59 funds and removed the outliers to determine a mean discount of 7.75%.

Relying upon the range of marketability discounts that the parties agreed was between 26.4% and 35.6%, a discount of 32.1% was selected by the court.

Concluding that the value of the decedent's interest was $6,503,804 compared to the $3,149,767 reported on the estate tax return, the asserted deficiency summary was upheld. In addition, the court ruled the estate failed to demonstrate it acted with reasonable cause. Therefore, the court upheld the accuracy related penalty under section 6662(a), (b)(5), and (g), as well.

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