



## Tax Court Rejects Market Approach, Refines Income Approach in Valuing FLP

*Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141, 2011 WL 2516168 (U.S. Tax Court) (June 22, 2011)

To value the estate's minority interest in a family limited partnership (FLP) that held large tracts of timberland, the Tax Court ruled that there were only two appropriate methods: the discounted cash flow (DCF) and net asset value (NAV). The court also accepted the parties' stipulation that the NAV of the partnership's property was \$143 million, which included a 40% discount for the inherent delays in selling the assets.

But the court rejected the DCF approach by the IRS expert, because he relied on the most recent year of cash flows and assumed that the partnership's expenses would remain fixed even though its revenues would rise. In contrast, the taxpayer's expert had relied on historic cash flows, but the court rejected his tax-affecting the same at 25% and reduced his partnership-specific premium (in the calculation of the discount rate) by half, finding that the FLP's lack of diversity did not justify a higher rate of return, particularly when investors *could* diversify. Finally, the court rejected the 35% marketability discount by the taxpayer's expert, finding that his reliance on pre-IPO data may have overstated the discount. It adopted the 25% discount by the IRS expert instead, to reach a total DCF value of approximately \$52 million for the FLP.

The court rejected the weighting of the DCF by both experts, saying that they failed to reflect "the

probability that the partnership" would continue. Based on its own findings that the likelihood of a minority interest holder forcing liquidation was 25%, the court assigned a 75% weight to its DCF analysis. In assessing the 25% weight accorded to the NAV method, the court rejected a discount for lack of control (12%, as applied by the IRS expert) because its weighting already factored in the ability of a minority interest holder to force a sale. Likewise, the court declined to apply a marketability discount, because the stipulated asset value already included a discount related to its sale.

After applying all of its adjustments, the court determined the "correct value" of the taxpayer's 41.1% interest was \$27.45 million. Notably, the court rejected

any application of the market approach in this case, because neither party expert appropriately considered that the guideline public company comparables held assets other than timberland and earned income from sources other than timber sales.

Lastly, the court declined to impose accuracy-related penalties under IRC §6662, because the estate relied in good faith on the original appraisal (\$12.7 million), even though it used the market and income approaches and excluded NAV, and amounted to less than 50% of the court's "correct" value. "The partnership had been in operation for 15 years," the court said, and thus it was "reasonable" for the estate's appraiser to conclude that it would not liquidate.

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# New Tax Case Tackles Key Aspects of Private Company Value

*Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, 2011 WL 2559847 (U.S. Tax Court) (June 28, 2011)

The decedent owned 15% in a private Subchapter S corporation that held various newspaper assets. When she died in July 1994, her estate valued her 15% share at \$35 million based on an appraisal by its CEO, but the IRS said it was worth closer to \$50 million. At trial before the Tax Court, both sides enlisted new appraisers and closed the gap slightly: \$28 million for the taxpayer versus \$41 million for IRS. In particular, they disputed four broad aspects of the valuation:

1. *Date of financial information.* The IRS expert relied on second quarter 2004 financial information, even though it was published after the July 2004 valuation date. In contrast, the taxpayer's expert relied on the most recently published financial data (March 2004), claiming that a willing buyer and seller would be unaware of any subsequent information. The court found the second quarter data more accurately depicted market conditions as of the valuation date, and that a hypothetical buyer was likely to elicit the non-public information in its due diligence.

2. *Adjusted financial statements.* The court disregarded any adjustments to financial statements for non-recurring expenses which the taxpayer's expert failed to adequately explain or support.

3. *Market approach.* Both experts used the guideline public company method (GPCM), but the taxpayer expert ultimately rejected it, due to the lack of sufficient comparables, while the IRS accorded it equal weight. The GPCM is "generally accepted" for valuing a private company, the court found. But in this case, only one of the comparables was arguably similar enough, and a "single company is insufficient on which to base the valuation method," the court ruled.

4. *Adjustments to the DCF.* Overall, the court agreed with the taxpayer's expert that the discounted cash flow (DCF) analysis was the more appropriate for valuing the closely held company. But it rejected his

growth rates because they were based on industry data, preferring the IRS expert's rate (4.5%) based on company-specific revenues.

Not surprisingly, the IRS expert declined to tax-affect the S corporation's earnings, but the taxpayer's expert applied a 39% rate. He failed to adequately explain his reasons, however, and, based on prior case law, the court declined to impose "an unjustified fictitious corporate tax rate burden on [the company's] future earnings." For the same reasons, it rejected the taxpayer's expert's cost of equity that used a 40% corporate tax rate and his DCF adjustments based on "S shareholder tax savings."

As for the company's weighted average cost of capital (WACC), the court once again criticized the taxpayer's expert for failing to explain his calculations, particularly his determinations of a firm-specific risk premium and a control premium. The court also observed that WACC might be an improper rate to assign to a company that was planning to pay down its debt, but nevertheless adopted the debt/equity ratio (75/25) used by the IRS expert to conclude an overall WACC of 10%.

**Discounts need supporting data.** The IRS expert derived a 17% minority discount based on the inverse of control premium data for the newspaper publishing industry. Interestingly, the taxpayer's expert declined to apply one, because his DCF already resulted in a minority interest value, he said. The court rejected this approach and adopted a 23% discount, based on its findings that, this time, the IRS expert failed to adequately support his selection from industry data.

The experts were only 1% apart on their discounts for lack of marketability, and the court adopted the 31% used by the taxpayer's expert, given his slightly better review of the data and the holding periods at issue. Based on all its findings, the court held that the decedent's 15% share in the company was worth \$32.6 million as of the valuation date—notably, not too far off from the CEO's original appraisal.

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## Is a Buy-Sell at Book Value Unconscionable, When FMV is 60x Greater?

*Estate of Cohen v. Booth Computers*, 2011 WL 2694288 (N.J. Super)(July 13, 2011)

A father created an income-producing partnership on behalf of his three grown children, funded in part with Palm Beach property originally purchased for \$750,000. In keeping with its closely held nature, the partnership agreement provided that, on a partner's divorce or death, the remaining partners "shall" repurchase the divorced/deceased partner's shares at the "true value" of the partnership, defined as "net book value" based on the most recent financial statement, plus \$50,000.

In 1997, one of the partners died, and the partnership paid the estate \$97,650 for the decedent's interest, based on the buyout provision. By the time one of the two remaining partners died in 2007, the oceanfront property had appreciated to \$45 million. An appraiser for the deceased partner's estate estimated the "full" or fair market value of the partnership at just over \$23 million, based on the net asset approach, which, when added to the appraised value of all the partnership's properties, exceeded \$68 million.

Nevertheless, the partnership paid the deceased partner's estate just over \$177,800, based on the buyout provision and the financial information as of the date of death. The estate sued the partnership, requesting specific performance of the buyout provision at its "true value" of \$68 million. Given the gross disparity between fair market value and net book value, any other interpretation was unconscionable and voided the buy-sell provision, the plaintiffs said.

At trial, the partnership presented a CPA expert, who concluded that the purchase price of \$177,800 accurately reflected the partnership's book value. Moreover, the partnership's books shouldn't have reflected the fair market value of the Palm Beach property, the CPA expert explained, because the tax code and generally accepted accounting principles require investment property to be recorded at cost.

The trial court agreed, finding that the partnership had always booked its assets at cost rather than

market value. This historic treatment comported with the "plain language" of the partnership agreement, which clearly pegged the buy-out price to book value (as it did when one partner died in 1997). Under these facts, there was nothing "inherently offensive" in the buyout formula, the trial court held, and the estate appealed.

"We recognize the disparity between net book value and fair market value," the appellate court observed, yet the disparity, alone, was not sufficient to "shock the judicial conscious." The controlling factor is the language of the partnership agreement, which in this case was clear and comported with standard definitions of book value, the court held, and affirmed the buyout at net book value.

## CPAs Differ by More than 50% on Fair Value of Firm

*Peterson v. Jackson*, 2011 WL 14519606 (Utah App.)(April 14, 2011)

When three shareholders in a CPA firm couldn't agree on a buyout price for a departing partner, they sought judicial dissolution and appraisal under the applicable statutory scheme (Utah). At trial, the partnership's expert used the market, income, and asset approaches to reach a range of value from \$581,000 to \$713,000 for the entire firm, but then rejected all but the asset approach to value the shareholder's 37.6% interest at just over \$224,000.

In contrast, the departing shareholder's expert assigned zero weight to the asset approach and under a combined capitalization of cash flow and market approach, reached a total value in excess of \$1.26 million. After adding a pro-rata portion of undistributed cash and declining to deduct the value of personal goodwill (due to a non-compete), he valued the departing shareholder's interest at \$505,000. The trial court also heard evidence that one of the partners had bought into the practice in 2001 at a multiple of 90% of gross sales—which, when applied to the departing partner's shares, would have yielded a value of nearly \$518,000.

Given the more than 50% difference between the two sides, the trial court was tempted to take a "Solomon approach and split the difference." Rather

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than “picking a number out of thin air,” however, the court credited the departing shareholder’s expert, including his opinion on goodwill, and criticized the firm’s expert for relying solely on the asset approach without any evidence of liquidation. He also valued the company in the hands of a specific owner rather than a “fair value concept in which the ownership interest is valued as if it were placed on the open market for sale,” the trial court said. Using the 2001 buy-in price as an additional “guidepost,” it found the firm’s fair value was \$1.26 million, excluding any undistributed cash, yielding roughly \$459,000 for the departing partner.

On appeal, the appellate court confirmed that the departing partner’s expert provided the more reliable estimate of value while the company’s expert “strayed from the clear guidance” of fair value precedent. The trial court was also correct to exclude any *personal* goodwill from its valuation, the appellate court said, with emphasis, because the non-compete effectively “converted personal goodwill, if any, to enterprise goodwill.” Finally, although the departing partner’s expert reduced the cash in his income approach to avoid double-counting an award of the undistributed cash reserves, he did not offer an alternate calculation of value that included reserves—which were substantial (\$138,000) but not clearly outside of the firm’s historic practice. The trial court’s unwillingness to recalculate the expert’s income approach “was not error,” the appellate court found, and affirmed its fair value determination in all respects.



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