Biltmore Estate Dodges "Net Asset Value Attack" by IRS

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The Biltmore House

The *Estate of Cecil v. C.I.R.* opinion made for compelling reading as the assets under consideration for several 2010 gifts included the Biltmore House - the largest privately-owned home in the US. From a gift tax perspective, the case is also appealing because Judge Ashford spent a good deal of his opinion explaining why the IRS's weighting of the net asset value method was inappropriate. The Judge's reasoning lays out a good framework to defend against such attacks by the IRS. Judge Ashford also did a good analysis of a very difficult issue – adjusting the values of pass-through entities for their tax status. Now that the Tax Court has got the basics of this issue correct, we think it's time it moved on to the more nuanced aspects of this adjustment.

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Estate of Cecil Case Summary
On November 18 & 19, 2010, Mr. and Mrs. Cecil made gifts of voting and non-voting common shares of the Biltmore Company (TBC, an S corporation) to their two children (Bill Cecil and Dini Pickering) and five grandchildren. Mr. Cecil is the grandson of George W. Vanderbilt, the builder of the Biltmore House. TBC held the Biltmore House and owned and leased thousands of acres of surrounding land. The home itself is over 174,000 square feet and housed fine art, antiques and other collectibles valued at $13.25 million. TBC operated in the historic tourism and hospitality industry, offering visitors the opportunity to experience life as it was in the Gilded Age. To that end, much of the surrounding property was improved with hotels, restaurants, retail stores and other buildings to facilitate outdoor activities which included house and garden tours, a Land Rover driving experience, river rafting, fly fishing, and equestrian training. The property was also used to grow grapes and produce wine, as well as for timber harvesting. The IRS's expert determined the net asset value (the FMV of all assets, less liabilities) was $146.587 million.

The gifted shares were subject to a 2009 Shareholders' Agreement which provided for the continuous ownership and control of TBC with the lineal descendants of the Cecil's. In addition, the agreement provided rights of first refusal on a proposed transfer outside of the family. Prior to the 2009 Shareholders' Agreement, the shares were subject to a 1989 Shareholders' Agreement, as well as a 1999 Voting Trust. Under the Voting Trust, any sale of material assets of TBC required approval by 2/3rds of *each* side of the family. In addition, the family also started a Family Business Preservation Program in 2003 that designed policies and educational programs for the benefit of the family members, which were intended to help them become effective owners of TBC. Three of the five grandchildren testified they had no intent of ever selling any shares they owned or may receive.

Petitioner's first expert applied only earnings-based valuation methods (discounted cash flow, guideline public companies and guideline transactions) to value TBC because, he reasoned, the interest under consideration could not force a liquidation of the company, and no liquidation or sale was expected by the controlling shareholders. After discounts, the first expert determined an equity value of $9 million to $12.2 million, assuming C-corporation taxes. His analysis of the pass-through tax status appears rudimentary, and he simply opined that if TBC wasn't taxed the value would be about $16.1 million. The Petitioner's second expert applied an income capitalization and guideline public companies approach and arrived at a value of $10.9 million to $11.2 million, after discounts. He also considered, but would not apply, the net asset value method (NAVM) to TBC because he didn't think a buyer of the interests would do so as a liquidation of TBC was speculative. He applied the "S Corporation Economic Adjustment Model" (SEAM) to adjust the value up 24.6% for S-corporation status.

Judge Ashford assigned zero weight to the IRS's expert opinion because he weighted the NAVM in his conclusion. The Judge leaned most heavily on the fact that TBC was an operating company, not a holding company, and as such, should be valued based upon its earnings.

The IRS used only one expert at trial to value TBC (although they had an appraiser for the fine art) and he applied both the net asset value method and a discounted cash flow. As mentioned above, the net asset value method indicated an equity value, before discounts, of $146.6 million. It doesn't take much imagination to see why the IRS is attracted to the use of this method. Although the disparity between the earnings-based approaches and the net asset value in this case is very large, it is not uncommon in situations where the assets of the company provide modest income relative to their value (e.g., fine art, Napa vineyards, luxury properties). His discounted cash flow resulted in a value indication of about $36 million after discounts. The IRS expert did admit his application of the NAVM didn't warrant much weight (only 10%) in reaching his conclusion, as TBC doesn't "seek to maximize its assets." He determined a pass-through status premium of 17.6% using the SEAM model.

The Court's Impressions of the Experts

Judge Ashford assigned zero weight to the IRS expert's opinion because he weighted the NAVM in his conclusion (although the Judge did accept the SEAM adjustment and discounts in his opinion). The Judge leaned most heavily on the fact that TBC was an operating company, not a holding company, and as such, should be valued based upon its earnings. To support this view, he cited *Estate of Ford v. Commissioner* which said "[p]rimary consideration is generally given to earnings in valuing the stock of an operating company, while asset values are generally accorded the greatest weight in valuing the stock of a holding company." He also noted that if a liquidation was possible with the purchase of the interest, or was reasonably anticipated, then the NAVM may be considered. But since none of the other shareholders planned to liquidate (and testified to such) and the company had a governance history that supported that assumption, a liquidation was highly unlikely, and weighting of the NAVM was inappropriate. While disregarding the IRS's expert on weighting the NAVM, he also tossed out his discounted cash flow analysis, which had been weighted 90%!

The court's conclusion regarding how to address TBC's S-corporation status, although ultimately a step in the right direction, did not inspire confidence that the issue is yet well understood by the Tax Court. The adjustment was again presented as a false choice between taxing the company as a C-corporation, or not at all. To my mind, that is like asking if the color gray is white or black? The reality is the answer is somewhere in between. Presenting the problem as an "either-or" leaves no correct answer. Ultimately, the court accepted taxing TBC as a C-corporation, despite the fact that many precedent cases were cited that concluded that was incorrect. Judge Ashford did this because *all* the experts testified that it was correct in this case. After taxing TBC as a C-corporation (i.e., "tax-affecting"), the court accepted an upward adjustment to the value of 17.6% to account for the tax savings of an S-corporation using the SEAM model.

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Key Takeaways
The court's discussion and conclusion regarding the weighting of the NAVM was very good in this case. For estate planners, I think the decision supports providing clients with corporate and shareholder documentation which provide for limitations on i) share sales outside the family and ii) the ability to liquidate. Judge Ashford also seemed to think the Family Business Preservation Program that trained the grandchildren how to operate the family business, supported the view that the business would continue to operate. It also seems a good effort to head off future disputes between family members that could lead to a liquidation or sale.

The other key to avoid application of the NAVM seems to be characterizing the subject company as an operating entity, not a holding company. Operating companies tend to sell products, have employees, enter contracts; in essence, do something. In contrast, holding companies tend to acquire and hold assets. They sometimes lease or trade those assets (e.g., commercial real estate owners and equity investment companies), and they often have employees and enter contracts too, but to a lessor extent than the operating company. Some companies straddle these two definitions, like a wine grape grower or timber production company. In both, the primary asset is real estate. But both do much more than just lease it – they are active in managing the asset (e.g., trying to increase yields), they have many employees and enter contracts. The product isn't the real

The Biltmore Vineyards

estate, it's what is produced from the real estate. In these types of companies, I think the balance of evidence supports an earnings-based approach as well (provided no sale or liquidation is planned).

There are circumstances, however, where a company would be classified as a holding company (e.g., they hold and only lease real estate), but application of the NAVM would likely result in an overstated value for a minority/non-controlling interest. This happens in cases where the income generated by the entity is well below industry norms. This occurs in private real estate holding companies relatively frequently when the lease rates are below market rates. There is no compelling reason for the family to change the lease rate because what isn't earned in the real estate entity is simply earned in the other family entity that is the lessee. Depressed earnings can occur for other reasons as well, such as high expense levels. To a hypothetical buyer of the minority interest in the real estate holding company however, on-going depressed earnings can severely impact value. This is an issue that can theoretically be addressed in the discount for lack of control (DLOC), but it is difficult finding comparable public entities that have *long-term* depressed earnings *and* report an accurate net asset value. This is likely to lead to an under-estimated DLOC and higher value. But depressed earnings can also be addressed by applying an earnings-based approach as publicly traded real estate entities do report, and are valued by investors, based on their earnings and distributions. In this circumstance, an earnings-based approach is likely more accurate than using the NAVM and DLOC.

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Finally, Judge Ashford reached a better conclusion than many prior Tax Court cases on the pass-through tax status issue. His wording in the opinion, though, left me wondering if he fully grasped the key concepts. I'll spare you an in-depth discussion of the complex valuation issues, but I would like to highlight that the SEAM model used and accepted by the court, is still quite a blunt instrument. First, it assumes that the tax basis increase benefit for reinvestment in a pass-through entity is realized *when the reinvestment takes place*. This is obviously an incorrect assumption; the benefit is only realized when the investor sells the shares – perhaps years later, making it less valuable. Second, the SEAM model assumes that the pass-through tax status of the subject company is perpetual. This is often not the case. Third, the model (as presented) does not take into consideration state taxes. Finally, estate planners should know that the model is very sensitive to changes in tax rates. Because of the recent reduction in the *total* tax burden of C-corporation shareholders relative to pass-through entity shareholders, the "best case" premium for pass-through tax status is much reduced from 2004 when the SEAM model was proposed.

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