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Parsing the *Estate of Richmond*

The Tax Court released its opinion in the *Estate of Richmond* in February and it discusses a number of interesting valuation and taxpayer issues including: discounts for built-in capital gains (BICG); valuation method selection for investment holding companies; and how to avoid undervaluation penalties. Although valuation experts are rarely in 100% agreement with Tax Court decisions addressing complex valuation issues, Judge Gustafson did a good job of detailing the reasoning behind his conclusions. Unfortunately, the valuation experts failed to bring to light factors that could have advanced the Tax Court's understanding of the broader tax disadvantages of investment holding companies that are C-corporations.

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The Pertinent Facts

The relevant valuation facts of the case are quite straightforward. Helen Richmond passed away on December 10, 2005 while the owner of a 23.44% interest in Pearson Holding Company (PHC), a C-corporation. PHC was founded in 1928 and had, since that time, been an investment vehicle for Fredrick Pearson and his descendants, including Helen Richmond.

PHC was invested almost exclusively in publicly-traded common stock, with four securities (General Electric, Merck, Pfizer, and Exxon Mobile) representing about 42% of total assets. PHC's purpose was "to preserve capital, to grow capital where possible, and to maximize dividend income." And it had paid out a stream of regular dividends, growing at about 5.0% annually since 1970. An unfortunate corollary of this successful investment history, was that the securities held by PHC had a very small tax basis. Upon immediate sale, the securities would have generated a capital gain of about $45.6 million. PHC had a net asset value (total assets less liabilities, or NAV) of $52.1 million.

The estate filed a return claiming the value of the 23.44% interest was $3,149,767, but at trial asserted the value was $5,046,500. The initial valuation relied upon by the estate was a draft report prepared by a CPA with no appraisal certifications, and limited valuation experience. The Commissioner filed a notice of deficiency valuing the interest at $9,223,658, but at trial asserted the value was $7,330,000.

Choice of Valuation Method

The first issue the Court addressed was selection of the appropriate valuation method. Ultimately, Judge Gustafson believed the asset approach (where assets and liabilities are restated to fair market value to indicate an equity value) was the most appropriate for an investment holding company like PHC.

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Before commenting on the Court's method selection, I must admit I'm somewhat puzzled in general by appraiser battles over which valuation method is most appropriate for a given company. Much of this disagreement can be avoided if valuation experts would only look to how other investors are valuing similar types of securities. For each type of company there are dozens of analyst reports that will specify which valuation methods are used for that industry. Industry analysts are usually also far more knowledgeable on the particular industry than the private company valuation expert, and, they know which valuation methods are commonly used.

For attorneys, it is important to understand that valuation methods can vary considerably between industries. For example oil and gas pipeline companies are usually organized as master limited partnerships and are valued on their dividend yield (dividend divided by stock price), with consideration of their dividend coverage (are they earning enough to comfortably support their dividend) and expected growth in the dividend. Software-as-a-service providers, or SaaS companies, are all C-corporations and are valued on a multiple of next year's revenues with consideration of revenue growth and gross margins. Valuations of SaaS companies at 10 to 15 times revenues is not uncommon, whereas the stock market as a whole trades at about 2 times revenues. In short, method selection can have a material impact on the valuation conclusion.

The valuation method for an industry can also change over time because of changes in the industry, or changes in investor preferences for certain

valuation methods. For example, the SaaS companies mentioned above are currently in a period of extraordinary growth and few are earning any money. Once their growth slows and they start earning money, it's likely they will be valued based upon more traditional measures, such as a price/earnings multiple. In addition, investor's preferences for a given method may change over long periods of time. For example, in the early 1900's the book or equity value of a company was a valid indicator of value. However, book value has long been abandoned for almost every industry in favor of earnings-based approaches. This may be because of the increasing value of intangible assets which aren't routinely captured in book value, but is also likely because book value proved a poor predictor of what minority investors really want - dividends and growth.

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If private company valuation experts don't use the same methods employed by industry analysts, can the conclusion really be said to represent fair market value? Put another way, is the *informed* hypothetical buyer really informed if he is using a method foreign to industry analysts? Valuation experts need to do a better job of supporting their method selection by looking to guideline company analyst reports. They don't need to fight battles over issues where there is ample evidence to resolve their differences.

In the *Estate of Richmond*, reliance on the asset approach was reasonable. One of the major considerations in selecting any approach is whether the valuation method and appropriate discounts can be reliably applied. The asset approach can only be reliably applied to a minority interest if there is sufficient market data to measure the discount for lack of control (DLOC). Publicly-traded closed end funds are actually one of the few (perhaps only) industries that reports net asset value regularly, and, as a result, would allow the reliable calculation and application of the DLOC. Unfortunately, based upon the Court's opinion, it doesn't look like the appraisers were particularly diligent in determining the DLOC.

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Both appraisers applied a discount for lack of control to PHC's net asset value with reference to a median number of 6-8% from a large sample of closed-end funds invested in publicly-traded equities. A quick look at current markets for similar closed-end funds shows discounts of up to 21.5% and premiums of up to 23.1%. The question for the analysts really is: What is driving the premiums and discounts? Could dividend levels, total return history, or the levels of management fees be impacting the values relative to NAV? It's very likely. Appraisers need to provide more analysis to support DLOCs, similar to how discounts for lack of marketability are now supported.

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Treatment of Built-In Capital Gain

The estate's expert took the position that 100% of the tax payable on the BICG should be deducted from the net asset value, relying on the *Estate of Jelke* and the *Estate of Dunn*. The IRS' expert, through some rather unconvincing analysis, thought only about 43% of the BICG tax should be deducted. The Court could not get comfortable with deducting the full BIGC tax because it wasn't payable on the valuation date, and it would likely be paid over a long period of time. Presented with two unconvincing positions, the Court ultimately does its own analysis of the likely present value of the BICG, and adopts the conclusion, though not the reasoning, of the expert for the IRS. As far as he goes, Judge Gustafson was correct.

Putting the conclusion aside for a moment, the Court's discussion of the hypothetical investor's perspective when evaluating the BICG was encouraging. The Court said that the investor evaluating the PHC interest would demand a discount for the BICG because, absent a discount, he could simple buy the stocks and be better off. This highlights precisely the perspective of investors - that they have investment options and they evaluate them side by side. The investment that they believe represents the best value, is selected. Selection of more attractive options increases demand for that investment and therefore the price increases. Prices increase until investors are indifferent between investments and the market is said to be efficient, taking into account all the relevant information that is available, and pricing the securities accurately. And this brings us to the biggest missed opportunity by the experts in this case.

A Missed Opportunity

None of the experts highlighted that investors take into account the tax payable on *future* income and capital gains when evaluating investment alternatives. What both experts failed to recognize was that PHC as a C-corporation subjects its investors to double taxation on both *future* income and *future* capital gains. Faced with the option of investing through a pass-through entity like a closed-end fund (or even hiring PHC's investment manager and replicating the same portfolio of stocks and holding the securities personally) or buying the interest in PHC, the investor would always choose the pass-through entity because of its *future* tax advantages. This issue is distinct from the BICG issue, which relates to double-taxation of *historical* gains.

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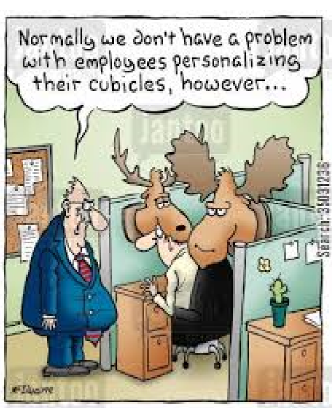

To highlight this point, let me indulge in an analogy. Suppose new attorneys starting a job at a law firm are taxed at different rates depending on which desk they sit at. All the desks are the same. Nobody gets a view, or is closer to the bathroom, water cooler, or coffee room (although I can't see any of the later three being a perk). If the new hire sits in desk A, her earnings are taxed at 60%. If she sits in desk B, her earnings are taxed at 20%. I know where we would all like to sit. Investors are generally rational, and would behave exactly the same when selecting investments with different tax attributes.

Taking the analogy a little further, at a starting salary of $100,000 the B desk attorney would take home $80,000. In order for the law firm to get anyone to sit at desk A, they would need to offer the same salary for half the hours ($100,000 less $60,000 in tax at 60% is $40,000). The new attorney working in desk A has adjusted down what she'd give up (or what she'd pay) for the position based on what she could receive elsewhere. The market would adjust C-corporation values in a similar manner. Investors pay less for tax-disadvantaged investments.

PHC investors, like the desk A attorney, are subject to more taxes on income and capital gains than would be paid if they held the stock portfolio directly, or through a pass-through entity. Investors in PHC would have many options to invest more "tax efficiently" as almost no investment holding companies are structured as C-corporations. Sellers of PHC shares would have no choice but to adjust their selling price. Our estimates indicate PHC would need to be discounted a further 12% to 40% from net asset value.

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Avoiding Penalties

The Tax Court did ultimately end up assessing a 20% penalty for a *substantial* valuation understatement. The Court evaluated the taxpayer's position relative to the "reasonable cause and good faith" provision but found that merely obtaining an appraisal was insufficient. The appraisal was lacking in the Court's eyes because it was in draft form and conducted by a CPA who was not trained in valuation. The lesson is simple – executors should get appraisals conducted by experts trained in valuation and get the final report issued before filing the estate tax return.

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