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REALITY VERSUS SCARY THEORY: WHAT'S REALLY GOING ON THESE DAYS IN ESTATE AND GIFT TAX AUDITS, AND APPROACHES TO AVOID TURNING A SUNNY DAY (GOOD RESULT) INTO A CLOUDY ONE (BAD RESULT)

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TABLE OF CONTENTS

1. PPT Presentation: It's Not The IRS Gift Tax Audit That Causes Anxiety

2. Avoiding the IRS on your Valuation Journey: The Art of Crafting Defensible Appraisals

3. Office of Chief Counsel Internal Revenue Service Memorandum

4. A Discussion of Chief Counsel Advice 202152018 and its Effect on the Administration of GRATs

5. Wandry v. Comm'r – 2012 Tax Ct. Memo (Wandry v. Commissioner of Internal Revenue)

6. Estate of Cecil v. Comm'r – 2023 T.C Memo (Cecil v. Commissioner of Internal Revenue)

7. Schlapfer v. Comm'r – 2023 T.C. Memo (Schlapfer v. Commissioner of Internal Revenue)

1

It’s Not the IRS Estate or Gift Tax Audit That Causes Anxiety

It’s how we perceive it

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- Reality versus Scary Theory: What’s really going on these days in audits, and approaches to avoid turning a sunny day (good result) into a cloudy one (bad result)

For Fun-Some Unusual Things We Are Seeing

And We Are Seeing the Usual Culprits as to Audits

- Discounts
- Easements
- Valuations
- Charitable
- Deductions
- Sloppiness

Not Seeing

Approaches to the 706 or 709 Audit

Experience Matters

If you have filed many 706 and 709s, then you know it is a combination of correct compliance and …

Example

- Discount partnership-where and how is the narrative on this one?

GST

Approaches: Example

Perfection is the Enemy of the Good

Approaches:

<u>Be careful of being a Lemming to the Coast</u>

- E.g., "we always use the *Wandry* formula to protect against gift tax exposure."
- Is *Wandry* the Law
- What's really happening with *Wandry*?

Approaches:

- **It's always better**
  - To avoid a fight than to win the fight.
  - How I learned this?

How to Conduct the Audit

- Different styles
- Ones I don't use but my partners have, and have used them effectively:
  - Delay and obfuscation
  - Slash and Burn

My Style: More Difficult

- But so far, in 40 years, with audits both for returns I have done and returns of others, we have not had an adjustment or an adjustment we didn't think was

I call it the Respect and Honesty approach:

Treat Agents with Respect

- They are lawyers.
- Respect their intelligence

Why We Fare Well

- Adopted that approach not because I thought it would play well
- But what a surprise when we hired the then Chicago Head of the IRS Estate and Gift Tax Division
- But here's why they settled or agreed to our position

He Said

- The two most important elements to an auditor are:
  - Being treated fairly
  - Is the agent being respected or dismissed?

What Cards are you Holding?

- The Law
- The Equities
- Neither

The Law

- Section 2036 (a)(2)
- GP of an LP
- CLT
- Zeroed out GRAT
- Tax affecting

Equities

- Estate Tax Payable on a discount partnership

Neither

- S corporation Tax affecting before *Cecil*
- The *Gross* case
- How it played out in reality

How do you Manage the Audit?

- F word

Gift Tax World: What is Being Audited, Not Surprising

- What we know is being audited
  - Discounts
  - Easements
  - Valuations
  - Deductions
  - Sloppiness

What is Surprising

- GRATs
- CLATs
- Lack of STGT
- Not 2701
- Prior Gifts

Let's do Some Examples in the Gift Tax World

Hypothesis Based on Actual Cases

- GRAT funded after I Bank hired, but before LOI
- Assume discounted value of interest transferred was $X, and that 30 % was transferred.
- Assumed 6 months later, business sold for $2X.

Examples with $X

- Value on minority interest valued was $50m.
- Value in GRAT after sale, 6 months later, was $100m.
- Do we win or lose?

Why We Should Lose

- GRAT done before LOI but clearly seller knew that there would be an LOI (probably being negotiated) and likely there was a sale.
- And there was a sale.
- And it was for 2x ($100m for this interest).
- And it is close in time.
- And see Advisory Memorandum.

Why We Should Win

- Done before an LOI
- Buyer, minority buyer, may not know of sale; and company has no fiduciary obligation to provide information.
- Conceptually, minority interest gets discount approximating 40 %. That's $100m down to $60m.

But, if $50m goes to $200m?

- More difficult on numbers.
- Am I missing something?

You bet I am

- Self adjustment clauses
- What exactly can the agent do here?
- On the GRAT, despite the ruling, not much
- On the STGT…

Results-No Change

How about with *Sorenson*

- Are Sales being audited, the first question?
- If so, is *Wandry* being respected, the second question?
- Therefore, can you tell me what to do at this point?

In Semi-Conclusion

Hopefully, I will be Close to Retirement

- One, two, three, four
  One, two (one, two, three, four)

2

"Avoiding the IRS on your Valuation Journey: The Art of Crafting Defensible Appraisals"

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"Overall, the entire valuation process is a fiction."

(Judge Cohn, concurring in part and dissenting in part in the 6th Circuit's opinion in Gross v. Comm'r)

What is a Heuristic: [In one sense, it is a concept that is anathema to attorneys because it is based on likelihood of occurring—aren't we all about covering the landscape and not speaking about probability. 5% of our estate planning time is spent on guardianship discussion. Why? It occurs less than 1% of1% of the time in reality?] These are rules of thumb—in valuation we as estate planners want to have rules to assist us. We don't need to be 100 % right in our review of business appraisals. Instead, we need to be knowledgeable about areas we want to focus on, that could give us trouble on audits, and in which we want to enter an opinion to the appraiser about a greater focus. We need rules of thumb to guide us in our review of business appraisals. So this presentation is all about Heuristics. [We will leave you with two items, the blueprint for improving your assessment of valuations, and a blueprint for improving your marital relationship…ahhh, you doubt me. Okay, we'll see on that second one.]

I. Valuation in Estate Planning.

A. Uses and Uncertainty.

For estate planners, valuation is a key variable in a substantial number of aspects of the planning process, both during life and post-mortem. For example, to effectuate numerous planning transactions, including those involving annual exclusion gifts, qualified personal residence trusts, grantor retained annuity trust, family limited partnerships, private annuities, and fractional interests in real estate valuation is a key component of the strategy.

Example 1: Annual exclusion gifts, $14,000 per donee per year, are often made with closely held business interests, and those interests need to be valued to determine how much to give to equal that $14,000 amount. One component of a qualified personal residence trust under section 2702 of the Code is the value of the residence (What is a 50% tenancy in common interest worth?). Grantor retained annuity trusts, also established under section 2702 of the Code, often involve closely held business interests, whose value is subject to interpretation; and further, the valuation of the gift to a grantor retained annuity trust is based on discounted present valuation techniques. Family limited partnerships are all about the valuation of limited partnerships, as exhibited by the no less than 50 cases discussing the valuation of these enterprises in the last twenty years. Private annuities work only if, inter alia, the value of the property transferred is equal to the value of the annuity received. Fractional interests in real estate are no doubt

worth less than their pro rata value of the fee simple real estate interest, but how much less, is the subject of numerous cases.

The Code prescribes precise methods for valuation with regard to these assets, with exceptions. See Treas. Reg. 26 C.F.R. § 20.2031-2 (valuation of stocks and bonds for example). As an example of how precise the Code can be, it even prescribes a method to value "cash," as if there could be any ambiguity on this point. Treas. Reg. 26 C.F.R. § 20.2031-5.

B. **Closely Held Businesses**.

Regardless of the specificity of Code rules as to the valuation of most assets, there is one asset type whose valuation methodology is still left uncertain: the closely-held business interest, defined to be an interest that is not traded on a public market. Closely held corporations are typically thought of as family businesses, but in reality, encompass a wider range of businesses and include all those business interests that are not publicly traded. The closely held business that has garnered the most attention of recent in the estate planning world is the so-called family limited partnership.

C. **Revenue Ruling 59-60**.

Attempts are given in the Code to prescribe variables and boundaries to value these closely-held business interests, but not much certainty is provided. For example, the operative revenue ruling, Rev. Rul. 59-60, 1959-1 C.B. 237, sets forth various factors to be considered in any valuation:

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock.

(d) The earning capacity of the company.

(e) The dividend-paying capacity of the company.

(f) Goodwill and other intangible value.

(g) The size of the block of stock to be valued.

(h) Market price of comparable traded companies.

D. Rubber Hits the Road. The ruling then goes on for 8 pages to explain considerations for each of these factors. The reality, however, is that even after 45 years of existence, the Revenue Ruling has not been a guiding light in determining the value of closely held businesses. Rarely has a Ruling had less impact, or more frequent citing, than Revenue Ruling 59-60. The reality is that despite the Jello-like guidance provided by this Ruling, significant advancements in valuation techniques over the last twenty years have provided substantial guidance and insights into proper methodology to value closely held business interests.

E. Importance to the Planner.

Incorrect valuations have tremendous effects, typically deleterious, to estate planning transactions. Inaccurate valuations can result in the ineffectiveness of various estate planning strategies, as well as the actual payment of gift taxes. Widely incorrect valuations could result in a wide array of potential penalties, ranging from underreporting, to valuation understatements. And the mere shrug of the estate planner's shoulder with the retort, "well, we relied on the business appraiser we hired," is a bit dangerous in this litigious environment. Instead, the attorney has to independently evaluate the propriety of a business appraisal, and understand the likelihood of success of the appraisal; and more importantly, the tension points in the valuation that could be the subject of IRS review.

> **Example 2**: Assume that a sale is made to a family member of a 50% interest in a closely held corporation valued at $3,000,000. The 50% interest is discounted by 33% to $1,000,000. No gift tax return is filed because the sale is for what the buyer and seller believe to be adequate and full consideration, thereby falling within the exception under Treas. Reg. § 25.2512-8. If, however, the Service on audit determines that no discount should have attached to the interest, or that the starting value of $3,000,000 for the corporation was incorrect (assume it was really $5,000,000), then there could be a taxable gift (depending on the seller's remaining unified credit). And the non filing of the gift tax return would result in an underreporting penalty under § 6651(a)(1) of 5% per month.

F. Definition of "Value".

The real value of the closely-held interest is what it would sell for to a third party on the relevant valuation date. Treas. Reg. 26 C.F.R. § 20.2031-1(b) and 26 C.F.R. § 25.2512-3. This is usually measured by what a similar interest in the same company has sold for to a third party on that date. But because the interest is not publicly-traded (a result that emanates from the definition of a closely-held interest), there is generally no comparable interest in the same company that has sold on that date.

Accordingly, in a conceptual sense, the taxpayer has to approximate what the interest would sell for to a third party on that date. And the reality is that there is typically a range of values as to what the interest might sell for. The taxpayer and the Internal Revenue Service (the "Service") have disparate objectives as to which point on the range they would desire.

Example 3: A closely held corporation is engaged in the business of distributing screws and bolts. On average, it buys screw, bolts and related hardware from China at 50¢, and sells them to end-users, Walmart and Home Depot, for $2 per item. Its gross profit is $1.50, and after all fixed and marginal expenses are taken into account, its net profit is 30¢ per item. On average, it sells 10,000,000 bolts per year, and has a net profit of $3,000,000 ($3M) per year. Dad has used his full estate and gift tax credit as to gifts during life.

The 100% owner of the business dies on January 1, 2004, and he has no surviving spouse. Consider the value of the business in this over-simplified example. (Many additional variables will need to taken into account, including a cash flow that is not going to be even, that there are different expenses, competition pressures, different margins, growth rates, and a host of other variables that will impact cash flow from year to year.)

Because there is estate tax, the father's estate would like a low value and the IRS would like a higher value.

If these cash flows were valued as if they would be achieved in perpetuity, then the value of the company that a hypothetical willing buyer would pay to this hypothetical willing seller, each being under no compulsion to buy or sell, would be the $3M cash flow divided by an interest rate attributable to the risk of these cash flows relevant to a risk-free interest rate over the same time period. Assume the relevant risk-free rate is 5%. At an 8% risk-adjusted rate, the value is ($3M/.08) = $37.5M. At a 10% risk adjusted rate, the value is ($3M/.10) = $30M. There is no definitive guideline as to what the risk adjusted interest rate should be. Accordingly, the possibility for controversy between the IRS and the taxpayer is clear. In this example, reducing the controversy to merely the risk factor to be used in valuing the cash flows to perpetuity, there is a $6 million divergence in value, resulting in an approximate $2.4 million in federal estate tax at controversy.

II. The Actor on the Valuation Stage: Your Role.

Ponder the attorney's role in the review of a valuation. Part of that universe is known: review the level and discussion of discounts for minority and lack of marketability. This area is the topic of 95% of discussions we have as estate planners.

The next part is more amorphous: how does the overall valuation looks in terms of avoiding an audit, and defending at the audit level, the appellate level, or the court level. What are we doing to add value in terms of changing the valuation.

And how are we bolstering the valuation to prepare for a defensive and believable audit. [What is it that you are doing when you pick up an audit report? Ask audience, pick up report; hmmm, this looks interesting. I think I will check my emails. Maybe I will read the first 10 pages about the state of the economy.]

We need, and herein provide, the heuristics, for the practitioner to conduct a review of the business or other valuation report. We can rely on experts, valuation professionals, to do the heavy lifting.

III. Oh Gee, Here is the Report. Great. You're handed a valuation report. Lou, hold one; what is it that you are looking for in this mass of paperwork? There are so many valuation methodologies reported in the cases and reports that it's a bit daunting, the market method, multiple of book value, dpv, dividend capacity, EBIT, ebitda, earnings, multiple of free cash flow, number of moles on my arm multiplied by pie.

It's daunting. It doesn't have to be this way. In fact, the reality is that there are only 3 methods that are truly relevant, balance shee/liquidation, multiple of EBITDA, and discounted present value of cash flows. And the last two should yield about the same numbers. Any other method in the report is hocus pocus.

The time has come for us as planners to have the cliff notes on how to review and make sure the appraisal makes sense. And because we are more erudite, instead of "cliff notes," we'll refer to these as heuristics, or rules of thumb.

Page ___*Heuristic: Develop a Gameplan.* Prior to reviewing the valuation, preconceive what you expect to se as the valuation method. 90 % of the landscape can be covered by the following rule of thumb If a flp with marketable securities, the balance sheet method is what you are expecting. If an operating business with value, then you expect to see DCF or multiple of EBITDA. That's it. The other stuff in there is extraneous.

And even before I look at the valuation, how about if I estimate my own value—why is this important Lou…to do so, let's start with the financials, page,

> [What is your first step in reviewing a valuation. Have you thought of a methodology as to how you are going to approach the valuation?] Prior to engaging the appraiser, take a walk through the financials, and a discussion with the client, and assess the likely method of valuation and approximate value. [The client usually knows how his business will be sold, EBITDA, financial institution is a multiple of book value; and a quick trip through the income statement will give you an idea of how the company is performing] You may want to let the client know your role here, and the time that you will be spending. How much time will you put in, can you put in—3 to 5 hours?

Heuristic: Beware False Leads.

Forget the terminology and start at the basics as to what really matters. And think logically—if someone offers you an investment that you do not understand, are you going to do it [answer: if you are a doctor "yes".] As attorneys, we need to take the same approach to valuation—if we do not understand what the appraiser is doing, probably because either it (the appraisal) is garbage or fraught with inconsistencies.

Is the valuation logical and easy to follow. If I do not understand it, what it is that the valuation professional can do to make me understand it. [As an aside, I no longer review valuations with this in mind; takes too much time.]

If something doesn't make sense, why is it in there? Does it need to be there?

Example 4: Yes or No:

1. Operating business valued on an EBITDA basis. We go to balance sheet to do add backs and subtractions. Do we need to add back to arrived at EBITDA number (* multiple), "good will," or [Why, what is good will? Isn't this the operating value of the business.] Capital equipment? Subtract unpaid Accounts Payables. [Yes, we owe them; and similarly, add back unpaid Accounts Receivables that will be received.] Short term liabilities, subtract? [Sure, makes sense.] Add back retained earnings? [Why? Is this an asset?] What does common sense tell you?

2. Marketable securities partnership: does the fact that the marketable stocks are paying 3 % in dividends factor into the valuation, directly? [Why would it? The underlying stocks already reflect that price. And as we said, using EBITDA or FCF to value a marketable securities partnership makes as much sense as thinking the Patriots had an advantage when Tom Brady was throwing with underinflated footballs.] [Use props?]

3. A Tax Court case says that dividends paid are probative and methodology to be followed. Hmmm. Does this make sense? [Of course not…] Which goes to show that even logic sometimes gets trounces with a well reasoned argument, since the Tax Court bought this one hook, line and sinker.

4. I have a buy sell that allows purchase and sale at "book value." I argue this is meets the 2703 comparability test. Logical? Unless it is a financial institution or other entity that truly sells as a multiple of book value (see section…), the answer is no.

See Exhibit B for answers.

Heuristic: You only need to review the Sports Section.

Status Quo Bias indicates that we will accept what we have, even if it doesn't make sense or is not what we need. Hence, think of our beneficiaries with single stock concentrations that they inherit. Hard for them to change and diversify, because it requires an actual action.

In reviewing valuation, our status quo bias is that we will usually review the report that is in front of us, without asking the question, "What is it that we should be reviewing."

Remember, it all starts with the financials.

[Which are relevant? Ask question]

IV. The Financials.

There are three relevant documents that make up a generic company's financial statements.

A. The Income Statement. This is the company's statement of earnings that have accrued on an accounting basis. This is (typically) not the cash flow generated by the business, but merely what the profits of the company are based on accounting principles. When valuation is based on a multiple of "earnings," it is this statement that provides the snapshot and relevant numbers.

A company's income statement provides a record of its accounting profits (losses) during a given time period. It shows all of the revenues and expenses during the time period, as well as the effects of some basic accounting principles, such as depreciation. But because accounting income does not accurately reflect the cash flow that have been and could be received (e.g., what if 30% of account receivables reflected on the balance sheet turn out to be uncollectible? This would certainly make the profits on the income statement, if recast to adjust for these uncollectables, quite a bit lower), it is not necessarily truly reflective of the free cash flow that has been generated by the company.

B. The Balance Sheet. The purpose of a balance sheet is to reflect the financial net worth of a company at a snapshot in time. This is a proxy to asset value, but just a proxy. The Balance Sheet lists the assets on hand for a company as of a particular time. The value of the assets on the Balance Sheet may reflect the book value of certain assets and fair market value of others of the Company.

Book Value is not the same as fair market value of the underlying assets. Book value is the accounting value of the assets held by a company, but there could be major discrepancies between that amount and what the Company's assets could actually sell for. Book value could overstate or understate the value of the underlying assets, depending on what assets are listed on the Balance Sheet. For example, if the Balance Sheet provides a value for good will, that may in actuality not really be an

asset available to the Company upon liquidation. Therefore, any value given for good will may overstate the value of the underlying assets. Conversely, real estate listed at its purchase price, less depreciation, may understate the value of the fair market value of the real estate, if sold to a third party, and therefore, may understate the liquidation value of the Company.

The attorney must evaluate the Balance Sheet and then adjust the values to accurately reflect real fair market value to determine the liquidation value of the company.

> **Example 5**: A real estate LLC invests in commercial real estate endeavors, and lists on its balance sheet the depreciated value of four shopping centers that are 10 years old. That depreciated value may substantially understate the true resale value of the shopping centers, valued based on what a third party would pay for the interest (using either a market approach or a discounted cash flow analysis).

C. Cash Flow Statement. While the income statement and balance sheet use the accrual basis of accounting to better reflect revenue sources and the expenses used to generate those sources of revenue, it is also helpful to analyze the actual levels of cash flowing through a business. Like the income statement, a cash flow statement measures performance over a given period of time. From the Income Statement and Balance Sheet of a Company, the Cash Flow Statement of a company can be determined. Essentially, this Statement sets forth the actual cash that was generated from the business operations, and how much cash was derived or used for financing, for reinvesting (in capital projects), and how much remains available for distribution to (equity) shareholders. For a company that is mature and producing available cash flow for distributions, this statement is very important, especially on a going forward and going backwards basis.

> **Example 6**: An operating company is in its 8th year of producing Formica desk tops. It invests very little in the way of new manufacturing processes. The net cash that it has generated the last three years, after financial costs have been subtracted, has been $900,000, $800,000, and $975,000. Discounting this cash flow, as expected cash flow in the future, would be a realistic starting point to value the company (assuming that the correct discount factor, discussed later, to account for the risk of these cash flows occurring, is included).

D. Tax Returns. Often times, the planner will obtain the tax returns more quickly than the financial statements (the financial statements containing the Income Statement, the Balance Sheet, and the Cash Flow Statement). The tax returns provide excellent proxies for these statements. An S corporation and partnership on a form 1120S and 1065, respectively, will report and contain the tax basis earnings and balance sheets. From these two statements, and using prior year's returns, the cash flow can be

generated. Therefore, the tax returns, independent of the financials, can provide similar information for the valuation process.

Now, create a heuristic for what you think the valuation will be.

V. Valuation Techniques of Relevance.

Heuristic: Estimate Spousal Value Prior to Marriage.

In planning for GRATs, or sales, or even straight taxable gifts to a grantor trust, you can estimate the business value before you have a formal valuation. You get the financials, or tax returns, and from those, use the techniques below to estimate value.

[You have a family limited partnership with marketable assets; is an EBITDA approach right? Discounted cash value?] [Aside: in planning for GRATs, or sales, or even straight taxable gifts to a grantor trust, you can do this before you have a formal valuation. You get the financials, or tax returns, and do the heuristic.]

[The 90% solution] For a holding company that is more reliant on underlying asset value—like a marketable securities partnership—a balance sheet, fair market value approach is more appropriate.

Heuristic: The Valuation Universe Has Only So Many Planets.

There are only so many valuation approaches. Of course, don't forget that if an interest in the business has been sold, that should be more probative than constructing any of the following approaches. Similarly, if there is a completely similar business (or businesses) that have been sold, that should be a good proxy for our company's valuation. [But really, are there any truly similar businesses]

Really, three approaches: market value on liquidation, EBIT or EBITDA, and free cash flow. They are masqueraded under various names, discussed below.

Heuristic: Cash is king. Cash flow is queen.

For an operating company, valuing "profit" [my term] under one of two accepted approaches, multiple of EBITDA, or discounting free cash flow, regardless of the name they are masqueraded under, is the right approach. Sure, on the fringes, other methods can be trotted out there [much like the suitors were jotted out to Penelope during Odysseus' absence. And Penelope didn't like any of those suitors; rejected them all].[1]

[1] Rarely is book value used though businesses do sell on an open market based on a multiple of book value (E.G., financial institutions). Courts have used dividend paying capacity as a measure. Why? I don't know. The "discounted dividend method" has been cited by courts as a valuation methodology. My opinion, that's sort of bull manure. For one thing, this model only captures the cash flow that is expected to be distributed to the equity

A. Liquidation Value. (also known as asset approach, cost approach, underlying asset method,[number of moles on my arm approach], and adjusted book value method). Essentially, this is the value of the enterprise if it were immediately wound up and the assets or proceeds distributed. For example, assume an S corporation is holding only vacant land suitable for development. And assume that the corporation is not renting the land, and is holding only that land for investment. No cash flow or earnings are generated. The value of the S corporation at any given time is the value of the land it holds, assuming the land was sold. An approach using "earnings" or "cash flow" discussed below, would render the S corporation's value at 0; and clearly does not approximate value.

> **Example 7**: A company that holds assets for investments, such as a publicly traded mutual fund, usually is valued based on the value of its underlying net assets. Family limited partnerships that hold publicly traded assets should be valued, initially before discounts, based on the underlying value of the assets, using this liquidation value approach.

Heuristic: Show me the money.

There are, heuristically speaking, two approaches to valuing operating companies that are generating income: multiple of EBITDA, and discounting future cash flows. To me, they should both be called VALUING OPERATING PROFIT.

B. EBIT or EBITDA. Earnings before Interest, Taxes, (EBIT), Depreciation and Amortization (EBITDA) (also known as the Market Approach). [Of course, EBITDA is operating income, so why it is called the Market Approach is a bit of a misdirection—perhaps because in reality private companies ON THE MARKET are sold this way. Ask question.]

Heuristic: Earnings is to EBITDA as Law School is to Being a Lawer.

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holders. No value is ascribed to the capital appreciation of the security. Start-up companies usually are an option approach, something akin to a pro forma discounted cash flow with substantial discount rate. Accountants sometimes use a multiple of earnings approach, as does the public stock market often trot this out as a measure. These include the oft-cited prices based on: multiple of revenues or earnings. Hence, publicly traded stock whose value is based on PE multiple of say 8, is a short way of saying that it trades at a price equal to 8 times its recent earnings. Price could also be determined based on other accounting items, such as a multiple based on book value. These are accounting items because they do not necessarily represent cash received by the company and are based on accrual concepts. Prices based on accounting multiples are often used as proxies for cash flow pricing in the public market, as these multiples are readily and easily obtainable. In an appraisal, then, the accounting multiple can provide a starting point for valuation, but is often not used as the sole determinative of price. **Example**: Section C, Column 7 of the Wall Street Journal lists the following as the P/E ratios of the Walgreen's, Amazon, and Microsoft, respectively: 30, 58 and 36 (as of 9/8/04).

Earnings on a tax return or a financial statement is not EBITDA. EBITDA adjusts earnings to lead to a number that is valuable to a buyer. [For example, let's say I sell hot dogs in front of the University of Alabama football games. My cost for dogs is $10,000. I get revenue of $20,000 per game. As a buyer, I see net profit in thereof $10,000, so I may be willing to pay 10 * net profit of $10,000, or $100,000. However, I look at the income of Mr. Hot Dog vender and it says $3/year. That is because he bought a $200,000 shop to sell the dogs out of, that he is depreciating $10,000 per year on an income statement.

It essentially starts with an accounting figure, earnings (E), and adds back significant accounting items, interest expense (I), taxes (T), depreciation (D), and amortization (A) to determine the available cash flow generated by the company, irrespective of capital structure. The multiple of EBIT(DA) in which publicly traded comparable companies trade also provides a starting point for a valuation based on multiples.[2]

C. Free cash flow (also referred to as "discounted cash flow" or the Income Approach).

And "I married my Cousin Betty Lou Approach] [Of course, it has nothing to do with income as we estate planners think about. It is really cash flow.] This essentially determines the cash generated and to be generated from the business, and available to be distributed to shareholders, after setting aside reserves for capital expenditures and net working capital.

It is often based on pro forma projections going forward of how the company will perform, assumes a growth rate for the cash generated, and discounts future cash flows based on the cost of capital concept, roughly, what level of return investors would require for investing in this type of business.

Valuation based on cash flow analysis is reasonable if the business is actually generating cash (e.g., a partnership holding marketable assets is not really generating cash flow on an annual basis), and a review of the "reasonableness" of the cost of capital assumption should be made in the appraisal. Usually free cash flow is, in the investment world, determined after taxes are paid. However, because many of the valuations are in the S corporation context, courts have discussed whether the cash flow must be before taxes are taken into account, and then subject to the discount rate. See, e.g., Adams v. Comm'r, T.C. Memo 2002-80 (2002) and discussion below.

Heuristic: Focus on what is it that we should know about EBITDA and FCF approaches.

[2] The financial statement or public companies either lists EBIT or provides sufficient financial data for EBITDA to be evaluated.

First and foremost, you don't have to know how to do it [though everyone in this room could get there easily.] You need to know the key variables that we, as planners, can use to most influence valuation. [And the keyset is] The Multiple or Discount Rate is one focus. For EBITDA, adjustments to earnings is another factor. For free cash flow, the build-up of the cash flows offers opportunities [creative drafting.]

But the starting point is the multiple or discount rate. For EBITDA, we use a multiple. For DCF, we use a discount rate.

V. Discount Rates and Multiples.

Heuristic: The discount rate and the multiple are the heads and tails of the same coin, i.e., the same thing.

In the Wall Street Journal reporting of prices of stocks, there is often listed the price of the stock based on a P/E. The P/E is the Price- to- Earnings ratio, meaning that the stock selling at $20, based on a recent earnings report of $1.00 for the last fiscal year of the Corporation, would have the Corporation selling at 20 times earnings. In that regard, the multiple used against earnings to value that Corporation, as implied by its market price, is 20.

Conversely, that multiple can be expressed as a discount rate. For example, if an expectation of $1 is being priced at a multiple of 20, this could also be written as a percentage, or $1/5% (which equals $20). This means that an investor requires a 5% return on its investment in that Company's cash flow. (ASSUMING CASH FLOW TO REMAIN CONSTANT AND NO EXPECTED GROWTH IN EARNINGS.).[i]

Accordingly, whether the valuation is expressed as a multiple or discount rate, the same concept underlies the chosen number: what rate of return does the investor desire for the expected cash flows to compensate the investor for the risk that the investor's principal will be eroded or eliminated? See Exhibit A.

Heuristic: Pre-valuation, intuit what do you think the discount rate or multiple should be.

> **Example 8:** Given the uncertainty of distributions to me of cash flow/or call it earnings, what multiple of current earnings am I will to pay. For example, a start-up company in its 5th year now produces $2,000,000 of net profits a year. After reserving a certain amount for capital expenditures, and other cash reserves, and to account for timing differences between recognizing income and expense, and receiving or paying cash for that revenue or expense, there is about $1,700,000 of free cash at the end of the year. The Company is now experiencing substantial competition, future cost increase, and is not expanding in a way that makes one think that revenues and profits are going up. How much will you pay for the

business based on this 1.7m of cash flow? [Well, ignoring synergistic or expansion plans I may have, and focusing only on this cash flow, I may be willing to pay 3 to 5 times the $1,700,000 for the business.] That equates to a discount rate of 33% to 20%.

As you look at your client's business, before the appraisal, you will have in mind what the multiple (and therefore the discount rate) will be; likely in the 3 to 12 range, or 33% to 8% in discount rate.[3]

Example 9: Aside: think of rental apartments that are selling at a 4 % discount rate. That is a 25 times multiple. In other words, the buyer, the market in this case, believes the rental revenue stream carries minimal risk, will continue at that rate or higher in the future. [How risk free?} That discount rate is only …% higher than a long term Treasury Bond, an asset whose income is as risk free as possible.[4]

Heuristic: The riskier the likelihood of cash flows, the lower the multiple, and therefore the higher the discount rate in valuing a business.

Intuitively, the multiple or discount rate refers to the risk inherent in an investment, and the type of return that an investor would want in order to justify that type of risk.

A. **30 Day Treasury Bill**. Ponder how risky a 30 day Treasury Bill is in the market. First, the debt obligation gets paid off in 30 days, so the investor's money (his investment) is not being held outside of the investor's hands for a long period of time. Second, the promise to pay off the debt obligation is being issued by the United States Government. The United States Government has better credit than any financial institution (I hope), and certainly has one of the best, if not the best, creditworthiness of any government in the world. The current odds of the United States defaulting on a short term obligation are very remote. Because of these two factors, it would be

[3] What does the Concept of Applying a Multiple Mean? A Company that is being valued based on future expected profit (free cash flows or earnings) is, in its simplest form, being priced based on an expected annual cash flow or profit (X) times a certain number of years expected for that cash flow (Y). This is often expressed in different ways. **Example:** When Amazon first went into business, it spent a number of years generating quite a bit of revenues, but no profitable cash flows that could be distributed to shareholders as dividends. Nevertheless, shareholders were willing to pay $10, or $15, or $20, to own that stock. A pessimist (or gambler) might say that the shareholders were willing to pay that solely because they believed other future shareholders would pay more. Alternatively, there may have been a belief by those current shareholders that Amazon would soon start producing free cash flow per share of $.5 per year, or $1.00 per year, for a number of years, and that this cash flow would be available to them in the form of dividends. In that way those shareholders, at $1.00 per share, were in essence valuing Amazon at $1.00 * 20 (the multiple to earnings), to arrive at a $20/share valuation.

[4] Risk free here does not mean that the principal is risk free if interest rates change. It means that the income the bond is producing is free of risk.

safe to assume that the risk inherent in this investment, in terms of an investor getting back her initial investment at the end of 30 days, is close to zero. One could argue that it approximates a "risk-free" investment. Therefore, the expected return that the investor would want from the United States government for this debt obligation could be very small. And it is. Current 30 day Treasury Bill rates are way less than ½% to 1%.

As investments get more removed from short-term government debt, the risk of the investment (in terms of getting the principal back at some time in the future) increases, and the rate of return that the investor desires increases. Risks associated with an investment can be tied to longevity, illiquidity, enterprise risk, or idiosyncratic risks with the investment.

B. 20 Year Treasury Note. If the 30-day Treasury Bill was instead a 20 year Treasury Note, two new risks emerge. First, there is a longer period of time in which the U.S. government could default on its obligations. This is still a very small risk. Second, there is a risk that interest rates may increase, meaning that the interest rate provided in the bonds are too small. These risks need to be reflected in the pricing of the bond. And they are. A 20-year Treasury Note currently provides interest at approximately 4.25%, and an intermediate measure of the risk free rate of return.

C. United States Stock Market. An investment in the United States stock market carries with it risk greater than an investment in the United States government. Accordingly, an investor would want to be compensated for this risk, by having a greater rate of return expected for holding investments in the stock market. Backing out what historically has been the return expected by investing in large capital stocks, the heuristic is that an investor expects 8%, annually, in capital growth (spread over a period of time) for holding stock investments. [ii] (Pre the late 90s stock boon, that equity premium was 7.03%. 1995 Ibbotson, cited in Adams v. Comm'r, T.C. Memo 2002-80 (2002)).

D. Small Closely Held Business with One Customer. [How about 20 %, 30 %, ..., something, a lot] Investors would look for a sizeable rate of return here, in excess of 15, 20%.

Heuristic: Use comps as starting point for EBITDA multiple, but adjust for business reality.

EBITDA multiples can be determined by reference to public companies.

For example, let's go back to the common sense concept. There is always much talk about the stock market, with public companies trading at 15 to 20 times earnings, and some even

greater.[5] Intutitively, we may be thinking that a comparison to public companies will result in the multiples being this high.

But EBITDA will be greater than earnings. Interest on debt is added back to earnings; depreciation is added back to earnings; amortization [good will on the balance sheet] is added back to earnings; taxes are added back.

As EBITDA increases, the price/earnings multiple decreases. So we should see this expected 15 to 20 be decreased to 8 to 15 as the appraiser adjusts public companies multiples on an EBITDA basis.

Then, adjustments can be made based on characteristic differences between the public company and the private firm being valued. The two things that impact multiples are risk and growth. Every investment attribute falls into one of these two categories. Investors pay more for growing companies with lower perceived risk. For example, larger billion dollars in revenue companies are more diversified, have greater access to capital, are generally more profitable, and are perceived to be less risky than small $100 million closely held businesses. The publicly traded billion dollar company also typically has greater growth projections.

Manufacturing companies typically trade at lower multiples (e.g., 4 or 5x EBITDA) because they are subject to more risk (e.g., automotive suppliers getting squeezed by the oems for price reductions, give-backs, and so on.), and are typically more asset intensive. By being more asset intensive, more cash flow needs to be reinvested to support capital expenditures to achieve growth, or simply to stay in business. [EBITDA is an earnings metric that excludes depreciation. If annual capital expenditures equal or exceed depreciation, resulting cash flow is negatively impacted. Therefore] Investors will pay a lower EBITDA multiple for a company that is constantly replacing fixed assets.

[Because of the need to adjust EBITDA multiples by size, that is, a larger public company should have a substantially greater multiple than a smaller one, we should review the distinction carefully in the report. Where the company being valued is a relatively small company (e.g.< $100 mm in revenue) and comps are derived from $5 billion dollar in revenue companies, the billion dollar companies tend to be different enough (i.e., diversified) such that the analysis is not persuasive, or the adjustments to the multiples applied (reduce 10x EBITDA to 5x EBITDA) is so significant that the analysis looks too subjective.]

Heuristic: Value added. There is always a good story as to the Multiples Should B Lower, or the Discount Rate Higher.

Comparables are too high because there is risk [look at case] related to specific company [1 key employee, rest are schlubs], industry [plastic injection], location in US, all business is

[5] As an aside, a Company trading at 40 or 50 times earnings is truly expected to grow, essentially double its earnings, very quickly. If earnings are doubled, that Price to Earnings ratio will in essence be halved. [Lou test]

going to Mexico], category [manufacturing, all business to Mexico], size (too small, cannot compete with big guys; too large, not flexible enough to change to changing environment) or lack of growth.

Specifically by way of example, publicly traded companies may be growth oriented (food, drugs, health related services), and a reduction can be made there because the subject company is not in growth mode. Or the public companies can be greater capitalized, larger, and therefore less subject to idiosyncractic risk.

These differences can further adjust the EBITDA multiple down to around 4 to 6.[6] Perhaps this is why courts do not like this metric. At 4 to 6 times EBITDA, companies often have attractive valuations for our GRAT and sales strategies. [further, with multiples like these, 5 to 7 year GRATS will be successful in transferring 100 % of the equity of an operating company with cash flow out of the estate, every time.]

[Multiples of publicly traded companies can be very high. For example, companies in the food industry – specifically in the niche of health food/organic can trade at values indicating EBITDA multiples in the range of 15x to 20x.]

Heuristic: Really Focus on Obtaining and Justifying the Highest Discount Rate.

If an investment is to be valued by using a cost of capital (discount rate) to discount future cash flows, there needs to be an assessment of what that discount rate should be. The closely held operating business is intuitively more risky than an investment in publicly traded stock. First, it is an investment in one business (not a diversified portfolio), has idiosyncratic risk associated with its own business, usually is capitalized at the lower end of the spectrum, and lacks ready marketability. All of these variables need to be taken into account in determining the discount rate used to value future expected cash flows.

Courts seem to be enamored with a discount rate tied to a "weighted average cost of capital," a capital formation based on a percentage of equity and a percentage of debt. Using debt in the equation reduces the risk (debt is cheaper than capital), and therefore the discount rate.

One could argue that if a Company has no debt, that the discount rate should be tied merely to the risk of equity. In that equation, it would work as follows.

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[6] *See, e.g., Furman, infra*, in which the Court denied the taxpayer's expert's multiple of 5 times EBITDA, and instead adopted a 6 times EBITDA multiple.

For an operating company (other than a real estate holding company), this typically starts with the risk free rate of return (proxied by the 10 year return on Treasury Notes), plus the stock market equity premium (e.i., 7 to 8%). *See, e.g., Gross v. Comm'r*, T.C. Memo 1999-254.

Thereafter, the valuation needs to either justify additional risk factor components, such as company specific risk (e.g., small customer base), small capitalization risk premium, or built-in liabilities; or use a more generic model, such as a weighted average cost of capital,[7] that takes into account more generic pricing based on the company's expected movement with the stock market, and its lower, after-tax cost of borrowing. Courts are not consistent in which method they will accept over another. *Cf. Gross, infra*, with *Adams v. Comm'r*. T.C. Memo 2002-80.

> **Example 10:** An S Corporation manufactures cleaning supplies and has net revenues of $20M, and free cash flow of $2,000,000. It has three major customers that account for 90% of its revenues. In valuing future cash flows, assume that each of these risk factors is additive. The buyer looks at the cash flow, and conservatively estimates that it can continue at the current rate but will not increase. But that continuation is based on a number of factors. One is the idiosyncratic problems represented by the specific business: will that business continue operating as well under a new shareholder arrangement? Assume that the buyer requires a 5% return to account for that risk. Another is that it is an operating company, and all operating companies can be affected by macro concerns. The stock market has, as noted above, traditionally returned 8% on large capital stocks, and therefore has impliedly created a desired 8% return on stock. Small capitalization stocks have often yielded an additional 4% premium over large capital stocks because of the greater risk associated with small cap stocks continuing. And with only three customers accounting for a majority of its business, this could be a substantial problem if one customer were to leave. The investor requires a 4% risk premium to account for that risk. And finally, the investor could invest in 10 year treasury notes, essentially at a risk free rate of 3%, so that should be the benchmark for which it starts its investments. The

[7] Courts tend to prefer the weighted average cost of capital approach, WACC, over a pure cost of capital with no debt. *See, e.g, Heck, infra*. However, if the Company had no debt structure, than there is an argument that WACC is not appropriate, then the discount rate should be based on an all equity cap structure. That argument is consistent with valuing an S corporation without tax adjusting; that is, looking at the structure of the seller, and not what a buyer would transmogrify the structure to be after the purchase.

sum of these is 24%, so the investor could value this company at a 25% cost of capital (or 4 about times expected cash flow).

Building a discount rate based on WACC is by reference to an optimal or industry capital structure (let's say 60% equity, 40% debt). The reason for using the industry capital structure is that it allows you to compare apples-to-apples value indications derived from the DCF Method and the Guideline Public Company Method, which allows for an easier reconciliation process. To the extent the sub-optimal capital structure is used in calculation the discount rate on a DCF (e.g., no debt), the analysis is essentially using a discount for lack of control.

VI: Adjust EBITDA and Cash Flow

Heuristic: Pick low hanging fruit when adjusting and reviewing variables in a DCF or EBITDA valuation.

[LHF is metaphor for life and happiness. High hanging leads to failure and frustration. Low hanging is achievable and you are happy]

There are certain adjustments that one can focus on that will adjust valuations correctly (lower), are reasonable, and will anchor the valuation where one wants it to be anchored.

For EBITDA, the key here is the term earnings. Are earnings trending up, or down, and what is one's starting point for earnings.

> **Example 11**: Boffo Manufacturing has 2012 earnings of $1,250,000; 2013 earnings of $1,500,000, and 2014 earnings of $2,000,000. In determining the E in EBITDA, what would you like your starting point to be? [Answer: the trend is upwards; rather than taking the last year, how about Management saying, although the trend is upward, we just got nailed with a price increase and expect downward earnings; hence, take average earnings.] An average versus the last year is preferable. Is Management justifying an average.
>
> **Converse Example 12**: Assume Boffo in the above example has earnings in reverse, $2,000,000, $1,500,000, and $1,250,00. Starting point? Preferably the last year. [Management: looking bad: prices have gone up from suppliers and customers are compressing our prices because of competition.]

Also for EBITDA, make sure salaries and other costs look right and can be justified, so that they are not added back to earnings and do not thereby cause a higher starting point. In many instances, there will be some add back.

For Free Cash Flow (DCF), if there is a pro forma of future cash flows, or current cash flow is normalized, how can cash flow be reduced? Capital expenditures for new equipment,

increase in costs and salaries, hidden liabilities, increase in uncollectable Account Payables are all examples.

> **Example 13:** Taxes, Waxey, and Wise law firm has generated NIPP (net income per partner on a cash basis) of $450,000, and overall free cash flow its last three years of $4,000,000, $4,300,000, and $4,600,000 respectively. What is the law firm's value? One way to determine this is to look at its last year, $4,600,000 of free cash flow, and do a projection of free cash flows for the succeeding two years. Assume they result in cash flow of $4,300,000 (substantial capital expenditures in technology are expected in the first year), and then $5,200,000. Assume that cash flow is then expected to grow at 4%, and that given the competitive nature of the law industry, and expected new legislation and competition, these cash flows are quite risky, that is, riskier than the stock market, plus the small corporation premium. Assume that a cost of capital at 15% is arrived at by this analysis. Assuming last year's cash flow of $4,600,000 was not yet distributed to partners, the valuation of the law firm is: 4.6M/1.15 + 4.3M/(1.15)^2 + 5.2M/1.15^3 + (5.2M/(.15-.04))/1.15^3.

Heuristic: EBITDA and DPV are only the beginning of the valuation date. We still need to close it out by reference to the balance sheet.

Value based on EBITDA or DPV is the beginning and close to the end. But not the end. [I often say, if one is a Romantic, the first kiss is the end of the beginning; to the Pessimist, the kiss is the beginning of the end].

We have to go to the Balance Sheet. For us, the adjustments that should be made are three fold, balance sheet adjustments, tax adjustments, and discounts for illiquidity and lack of control (and other schtuff, like key person and the " I need to be paid more so I am making this us" discount).

Heuristic: Logic controls on balance sheet adjustments.

There are really only certain adjustments that should be made on the balance sheet. One is excess cash. If there is cash that is not needed for fund the business, that is excess cash and should be added to value. Ponder the justification that cash and marketable assets on the balance sheet are needed as working capital (the obvious is to figure out 3 month expenses and indicate the Company needs that reserve; or 6 months; or perhaps the Company is international and needs marketable assets to hedge currency risk; or assets are needed to manage commodity price risks; and so forth).

Another obvious adjustment is debt. That should be subtracted from the arrived at value.

How about PPE (property, plant and equipment)?

$0 [There is some salvage value, but discounted to present value, should be zero. You cannot operate a manufacturing business and sell its key equipment at the same time.]

Good will?

$0 [Good will is the value of the business as an operating business; you are already valuing the operations pursuant to DPV or EBIDTA; good will need not be valued]

VII: Tax Adjusting Needs Understanding, and Creativity, and Patience, and Further Understanding. There is no universality of treatment here.

Heuristic: Adjustments for Taxes are Taxing.

A. Confusion on Tax Affecting for S Corporations.

In using public company comparables for our closely held valuations, the business appraisal, in looking at minority interests in these public companies, are by implication starting with a variable related to earnings on an after-tax basis. C corporations pay tax at the entity level.

With S corporations, there is no corporate-level tax. Earnings for S corporations will then always start off with a before tax number. In valuing minority interests in S corporations, appraisers will seek to "tax affect" S corporation earnings.

"Tax affecting" takes a variable in the S corporation valuation, like net cash in the discounted present value calculations, and fictitiously reduces its value by C corporation taxes. This could have the effect of reducing the overall valuation by 35% (the C corporation tax rate). This is a substantial reduction, and every bit as important as marketability and minority discounts.

The cases on whether valuations can tax affect S corporation earnings continue to arise, as does the confusion of what the right approach should be. The most recent case in the estate and gift tax area, *Estate of Gallagher v. Comm'r*, T.C. Memo 2011-148 (2011), again points out the Tax Court's (or at least certain Tax Court Judge's) antipathy to a non-quantitative approach to this area. There is also intellectual debate in the appraiser area as to how to approach this area. And between the Tax Court not allowing tax affecting in S corporation valuations, and appraisers providing different theories as to how to tax affect, the landscape out there is difficult.

In *Estate of Gallagher*. The taxpayer's expert applied a 39 % income tax rate in calculating future cash flows to the S corporation income.[8] Judge Halpern, who is no rookie when it comes to valuation issues, indicated that the expert "failed to explain his reasons for tax affecting PMG's earnings." This is probably not the complete story. Judge Halpern likely found the (taxpayer's) expert's approach neither reasoned nor quantitative.

In disallowing tax affecting, Judge Halpern focused on the need to attribute a benefit to the potential tax savings with an S corporation. Citing *Gross*, T.C. Memo 1999-54, Judge Halpern noted that to allow tax affecting, an expert has to logically provide an adjustment for "the principal benefit that shareholders expect from an S corporation election," that being, "a reduction in the total tax burden imposed on the enterprise."

The takeaway from *Gallagher* and *Gross* is not that tax affecting is to be disallowed. Rather, that a valuation must accurately consider and quantify the tax detriments and benefits of S corporation (and for that matter, LLC and partnership) status. The way to quantify is subject to a bit of disagreement among appraisers.

B. The Tax Reality of S Corporations (and LLCs and other Passthrough Entities).

In a valuation's most simple incarnation, a buyer of assets will value the company based on an approach tied to earnings. Whether earnings are actual accounting earnings or cash flow, and whether represented by a multiple or discount rate, the starting point is always the net profits (or cash flow) produced by the company, in a single year, and going forward, <u>on an after-tax basis</u>.

Earnings are taxed. In a C corporation, the C corporation pays them. In an S corporation, the shareholder pays them. But that 35 % tax rate (or 39.6% if we are talking the taxpayer) is a reality and will reduce the earnings.

> **Example 14:** If Corporation 1 is a C corporation and has $1,000,000 of earnings, then it faces a 35 % tax rate, and net earnings are $650,000. If Corporation 2 is an S corporation and has $1,000,000 of earnings, then the shareholder could face a 39.6% tax rate, and in essence net earnings are $610,000. In the C corporation, the income tax is paid by the corporation. In the S corporation, the income tax is paid by the shareholder. But the amount available for enjoyment by the shareholder is after tax on the earnings, regardless of who pays it. On the surface, tax affecting is legitimate and seems straightforward.

[8] The Tax Court Judge also indicated that the taxpayer's expert "assumed a 40-percent marginal tax rate in calculating the applicable discount rate." Here, I am not sure what was done, in that the applicable discount rate should not involve the marginal tax rate. But this dichotomy between 39 % and 40 % really peeved the Judge.

But if the story ends there, the Tax Court will not be happy.

> **Example 15**: In Corporation 2, an S corporation, with $1,000,000 of earnings, the shareholder has $10,000,000 of NOLs. Hence, the shareholder will pay no tax for a number of years on the $1,000,000 of earnings. Tax affecting the earnings to arrive at an after-tax cost seems wrong in this example. Importantly, this shareholder with NOLs is not the hypothetical willing buyer. It is an idiosyncratic one; and the hypothetical willing buyer will be paying taxes on this income. The example does illustrate the beginning of the dilemma in the tax affecting area – there is a wide array of variables that changes the actual benefit or detriment of S corporation earnings. The Tax Court expects appraisers to account for these variables.

C. The Benefits of an S Corporation for Tax Purposes to be Taken into Account in Valuations.

Assuming the hypothetical purchaser will be an S corporation shareholder,[9] there are benefits that need to be quantified in an appraisal with S corporations.

First, as to earnings that are distributed, those earnings, net of the payment of income taxes, pay no further taxes. In a C corporation, those earnings, distributed as dividends, pay an additional dividend tax. A valuation premium could be applied for the S corporation shareholder, and the value of the dividends passing free of income tax needs to be quantified.

Second, as to undistributed earnings, those are added to basis, and the S corporation shareholder will not have to pay capital gain taxes on that additional basis. This advantage needs to be quantified.

Appraisers will be more at ease doing the two-step approach, tax affecting, and then adding an S corporation premium. And this is empirically pure.

[9] Important distinction: tax adjusting will always be the case in a control case valuation; the purchaser is purchasing the Company, and is not likely to care about the tax status and will not give a premium for an S corporation. The hypothetical purchaser is not likely to be a qualified S corporation shareholder. Further, if there were discounts for S corporation status, this would result in arbitrage opportunities that do not exist in the marketplace. That is, buy a C corporation for $X dollars, convert it to an S corporation, and then sell it for $X dollars plus the S corporation premium. This does not happen in the marketplace. Hence, the tax adjusting concern is a concern only when minority interests in S corporations are valued.

D. What, Then, is the S Corporation Premium.

Much debate has existed in the professional literature about how to arrive at the S corporation premium.[10] Though valuation experts agree that the premium must be applied on a case-by-case basis, the percentage of and process to arrive at the premium is subject to debate.

A heuristic is that there is up to a 20 % tax savings (under say assumed federal capital gains rates), either attributable to the dividend not being subject to tax, or an increased basis step up. However, this 20 % can be adjusted on the margins for a variety of reasons, including discounting at a greater discount rate to account for uncertainty of dividends being paid, the value of the capital gains saved is in the future, and that benefit needs to be discounted to current value, or other idiosyncratic risk. Each appraisal must have a specific and quantitative rationale for the tax value of the S corporation status.

> **Example 16**: Assume that S corporation earns $600,000 per year, but makes no distributions to its shareholders. Is there really a 20% current tax savings to the S corporation shareholders if the Company makes no dividend payment? Probably not; hard to say a shareholder is saving taxes on funds that shareholder does not receive currently.[11] That 20% should be adjusted downward to account for no dividends being paid, and to discount the future value of the capital gains savings to present value.

E. The Practical Approach to the Lawyer.

From a practical perspective, when the practitioner has a valuation that has tax affected earnings, what should he or she do? The practitioner is left in a delicate position knowing that (1) the Tax Court has to date ruled against tax affecting earnings to arrive at a valuation, and (2) the agent can as a result simply refuse to tax affect the earnings.

This is a far more difficult conundrum than how to deal with a marketability or minority discount. On the discounting question, the practitioner knows that a 42% discount could be negotiated to a 35% or 32% or 30% discount on audit, or defended at 42%. On the tax affecting question, if disallowed, the valuation increases by say 35%.[12]

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[10] *See, e.g*, Paschall, "Some Observations on Tax Affecting," 24 The Quarterly Journal of the Business Valuation Committee of the ASA (March, 2005)

[11] There would in that case be a 20 % capital gains savings, at some point in the future, as the basis to the S corporation shareholder is increased by these undistributed earnings.

[12] Though this should be reduced by the percentage of premium afforded by the valuation to the S corporation status.

The purest and most defensible approach is for the appraisal to tax affect the earnings but also give a premium for the S corporation value. Using this approach, the appraisal must indicate why tax affecting makes sense – e.g., taxes will be paid by the hypothetical buyer out of earnings – and the value of the S corporation premium – e.g., saving on tax-free dividends, reduced to present value, is X%, and savings on undistributed earnings that add to basis, reduced to present value, is Y%.

Heuristic: Sins of omission sometimes go unnoticed.

Ponder which method may be easier to explain, or not to have to deal with, when it comes to tax adjusting, EBITDA, or DPV? [Answer, EBITDA, because taxes are already out; no further adjustments need to be made for taxes; EBITDA is a C corp or S corp concept. But with DPV, there will be a line item to "tax adjust." Sort of like thumbing one's nose and say, "Nah, nah, try me." Hence if the valuation is primarily EBITDA based, tax adjusting becomes easier.[13]

Conclusion

As estate planners, we may not like professionals (like, say, financial planners) venturing into our territory and offering drafting suggestions, or estate planning recommendations. One wonders if we are doing the same by being well versed in valuations and offering suggestions on business appraisals. But there is one critical difference—we are first in the firing line in defending these appraisals on audit, and first on the firing line in structuring the appraisals for planning purposes. Whether we like it or not, we need to be well versed in this area as part of our estate planning practice.

[13] With an EBITDA approach, there could be a premium applied to account for the beneficial tax attributes of an s corporation. Given the manner in which the tax rate differences are determined, the s corp premium needs to be applied to a "publicly traded equivalent value of equity". As a proxy, we could convert cash flow, or even value after balance sheet adjustments, to a multiple of 1.154.

Exhibit A

MOTO PART ONE: Multiple versus Discount Rate

1/discount rate=multiple.

Discount rate of 4 % is a multiple of ___.

1/multiple = discount rate

4 times EBITDA is an implied discount rate of ____.

1

MOTO part two

- Lower multiple is a lower valuation.
- Higher discount rate is a lower valuation. This one is not as obvious. And, in economic terms, a high discount rate means: ____
- Key point in considering your justification for the discount rate.

28

Spending time on the DR or M is important

Example: Manufacturing business has EBITDA of $1.5MM. Appraiser values business, based on similarly situated companies, at 6 times EBITDA, OR 9M. Appraiser also takes a 45 % discount. Value is 4.95. Gift tax is made using *Wandry* approach.

1

What is the linear equation?

Your value is reduced, in percentage , by 1/first earnings multiple. This is important cause you need to visualize where you are going.

Example: earnings at 10 X. Reduction by 1 results in entity value being reduced by 10 %.

Example: If you are at 4 times, reduction by 1 results in entity value reduction of 25 %.

32

3

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **202152018**
Release Date: 12/30/2021

CC:PSI:4:HLDamazo
POSTS-104366-21

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 2512.00-00, 2702.01-02

date: October 04, 2021

to: Mimi M. Wong
Associate Area Counsel
(Manhattan, Group 1)
(Small Business/Self-Employed) CC:SB:1:MAN:1

Attn: Frederick C. Mutter

from: Leslie H. Finlow
Senior Technician Reviewer, Branch 4
Associate Chief Counsel
(Passthroughs & Special Industries)

---

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Donor	=
Investment Advisors	=
Company	=
Corporation A	=
Corporation B	=
Corporation C	=
Corporation D	=
Corporation E	=
Trust	=
a	=
b	=
Year 1	=

Year 2	=
Year 3	=
Year 4	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
w	=
x	=
y	=
z	=

ISSUES

1. Whether, under the circumstances described below, the hypothetical willing buyer and willing seller of shares in a company would consider a pending merger for purposes of valuing stock for gift tax purposes.

2. Whether Donor retained a qualified annuity interest in Trust when Donor used an outdated appraisal that did not take into account all the facts and circumstances of a pending merger.

CONCLUSIONS

1. Yes. Under the fair market value standard, the hypothetical willing buyer and willing seller of a company would consider a pending merger when valuing stock for gift tax purposes.

2. No. The retained interest is not a qualified annuity interest under § 2702 of the Internal Revenue Code (Code) because Donor used an outdated appraisal that did not take into account all the facts and circumstances of a pending merger.

FACTS

Donor is the founder of a very successful company, Company. At the end of Year 1, Donor contacted two Investment Advisors to explore the possibility of finding an outside buyer. The facts indicate that, "[T]he Company was marketed through outreach by investment bankers to potential strategic buyers, some of which had previously expressed an interest in partnering with [Company]. Meetings were then scheduled to introduce [Company] and determine if there was additional interest." Potential buyers were expected to purchase a minority stake of Company with a call option after several years to acquire the remainder of Company at a formula valuation.

In Year 2, approximately six months later and within a two-week period concluding on Date 1, the Investment Advisors presented Donor with an offer from each of Corporation

A, Corporation B, Corporation C, Corporation D, and Corporation E (collectively, the Corporations).

Three days later, on Date 2, Donor created Trust, a two-year grantor retained annuity trust (GRAT), the terms of which appeared to satisfy the requirements for a qualified interest under § 2702 and the corresponding regulations. Under the terms of Trust, the trustee was to base the amount of the annuity payment on a fixed percentage of the initial fair market value of the trust property. Donor funded Trust with a shares of Company. The value of the shares of Company was determined based on an appraisal of Company on December 31, Year 1, a date approximately seven months prior to the transfer to Trust. The appraisal, which was obtained in order to satisfy the reporting requirements for nonqualified deferred compensation plans under § 409A of the Code, valued the shares of Company at $w per share.

Additional time was granted to the Corporations to submit final offers. The last offer was received on Date 3, almost three months after the initial offers. Corporations A through D raised their offers, while Corporation E withdrew from the bidding, expressing no further interest.

On Date 4, Donor gifted Company shares to a separate charitable remainder trust and valued those shares at $x per share pursuant to a qualified appraisal.[1] This per share value was equal to the tender offer value described below.

Three months after the new offers were received and several weeks after the transfer to his charitable remainder trust, Donor accepted Corporation A's offer, which represented a 10 percent increase over its initial offer. Per the final offer, an initial cash tender offer was made of $x per share, an amount that was nearly three times greater than $w (the value determined as of December 31, Year 1). During the tender period, Donor tendered b shares, while Donor's charitable remainder trust also took advantage of the tender offer.

On December 31, Year 2, Donor again had Company appraised for purposes of § 409A and the new appraised value was $y per share, which was almost twice the previous year's value of $w per share.[2] These steps were repeated for a December 31, Year 3 appraisal with similar results. The December 31, Year 2 and Year 3 appraisals both included the following language: "[a]ccording to management, there have been no other recent offers or closed transactions in Company shares as of the Valuation Date." There was no such declaration in the December 31, Year 1 appraisal.

In Year 4, approximately six months after the end of Trust's two-year GRAT term, Corporation A purchased the balance of the Company shares for $z per share, a price almost double the value of $y.

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[1] This appraisal was prepared by a qualified appraiser as required by § 170(f)(11).

[2] The per share value of $y excluded the value of a spin-off entity created to operate a certain geographic area.

The record as compiled to date supports the proposition that, as of Date 1, the hypothetical willing buyer of the Company stock could have reasonably foreseen the merger and anticipated that the price of Company stock would trade at a substantial premium over $w per share. When asked to explain the use of the outdated appraisal (as of December 31, Year 1) to value the transfer to the GRAT, as well as the use of a new appraisal to value the transfers to charity, the company that conducted the appraisal stated only that "[t]he appraisal used for the GRAT transfer was only six months old, and business operations had not materially changed during the 6-month period . . . For the charitable gifts, under the rules for Form 8283, in order to substantiate a charitable deduction greater than $5,000, a qualified appraisal must be completed. Because of this requirement an appraisal was completed for the donations of [Company] stock to various charities on [Date 4]."

LAW

Section 2512(a) of the Code provides that if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

Section 25.2512-1 of the Gift Tax Regulations provides, in part, that if a gift is made in property, its value at the date of the gift shall be considered the amount of the gift. The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts.

Section 25.2512-2(a) generally provides that the value of stocks and bonds is the fair market value per share or bond on the date of the gift.

Section 25.2512-2(b)(1) provides, in relevant part, that if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market or otherwise, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond.

Section 25.2512-2(e) provides, in relevant part, that in cases in which it is established that the value per bond or share of any security determined on the basis of the selling or bid and asked prices as provided under § 25.2512-2(b) does not represent the fair market value thereof, then some reasonable modification of the value determined on that basis or other relevant facts and elements of value shall be considered in determining fair market value.

The value of property for Federal transfer tax purposes is a factual inquiry wherein the trier of fact must weigh all relevant evidence and draw appropriate inferences to arrive at the property's fair market value. Bank One Corp. v. Commissioner, 120 T.C. 174 (2003), rev'd on other grounds, 458 F.3d 564 (7th Cir. 2006) (citing Commissioner v. Scottish Am. Inv. Co., 323 U.S. 119 (1944)). For this purpose, fair market value is the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of

relevant facts. Treas. Reg. § 25.2512-1; Rev. Rul. 59-60, 1959-1 C.B. 237. The valuation of property is a question of fact. See Estate of Simplot v. Commissioner, 112 T.C. 130 (1999); Redstone v. Commissioner, T.C. Memo. 2015-237.

The willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the donor and the donee. See Estate of McCord v. Commissioner, 120 T.C. 358 (2003), rev'd on other grounds, 461 F.3d 614 (5th Cir. 2006); Estate of Newhouse v. Commissioner, 94 T.C. 193 (1990). The hypothetical willing buyer and willing seller are presumed to be dedicated to achieving the maximum economic advantage. Newhouse, 94 T.C. at 218.

The principle that the hypothetical willing buyer and willing seller are presumed to have "reasonable knowledge of relevant facts" affecting the value of property at issue applies even if the relevant facts at issue were unknown to the actual owner of the property. Estate of Kollsman v. Commissioner, T.C. Memo. 2017-40, aff'd, 777 Fed. Appx. 870 (9th Cir. 2019). In addition, both parties are presumed to have made a reasonable investigation of the relevant facts. Id. Thus, in addition to facts that are publicly available, reasonable knowledge includes those facts that a reasonable buyer or seller would uncover during negotiations over the purchase price of the property. Id. Moreover, a hypothetical willing buyer is presumed to be "reasonably informed" and "prudent" and to have asked the hypothetical willing seller for information that is not publicly available. Id.

Generally, a valuation of property for Federal transfer tax purposes is made as of the valuation date without regard to events happening after that date. Ithaca Trust Co. v. United States, 279 U.S. 151 (1929). Subsequent events may be considered, however, if they are relevant to the question of value. Estate of Noble v. Commissioner, T.C. Memo. 2005-2 n.3. Federal law favors the admission of probative evidence, and the test of relevancy under the Federal Rules of Evidence is designed to achieve that end. Id. Thus, a post-valuation date event may be considered if the event was reasonably foreseeable as of the valuation date. Trust Services of America, Inc. v. U.S., 885 F.2d 561, 569 (9th Cir. 1989); Bank One Corp., 120 T.C. 174, 306. Furthermore, a post-valuation date event, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller for the subject property as of the valuation date. See Estate of Gilford v. Commissioner, 88 T.C. 38, 52-55 (1987).

In Silverman v. Commissioner, T.C. Memo. 1974-285, aff'd, 538 F.2d 927 (2d Cir. 1976), cert. denied, 431 U.S. 938 (1977), the petitioners gifted shares of preferred stock while in the process of reorganizing with the intent to go public. The Tax Court rejected the expert testimony presented by the petitioners because the expert failed to take into account the circumstances of the future public sale.

In Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999), aff'g 108 T.C. 244 (1997), the appellate court considered the issue of whether the Tax Court correctly held that taxpayers were liable for gain in appreciated stock under the anticipatory assignment of income doctrine. In Ferguson, taxpayers owned 18 percent of AHC and served as officers and on the board of directors. In late 1987 and early 1988, the AHC board of directors contacted and eventually authorized Goldman, Sachs & Co. to find a purchaser of AHC and to assist in the negotiations. By July 1988, Goldman, Sachs had found four prospective purchasers. Shortly thereafter, AHC entered into a merger agreement with DCI Holdings, Inc. With the taxpayers abstaining from the vote, the AHC board unanimously approved the merger agreement. On August 3, 1988, the tender offer was started. On August 15, the taxpayers, with the help of their broker, executed a donation-in-kind record with respect to their intention to donate stock to a charity and two foundations. On September 9, 1988, the charity and the foundations tendered their stock. On September 12, 1988, the final shares were tendered and on or about October 14, 1988, the merger was completed.

The Court of Appeals affirmed the Tax Court's conclusion that the transfers to charity and the foundations occurred after the shares in AHC had ripened from an interest in a viable corporation into a fixed right to receive cash and the merger was "practically certain" to go through. In particular, the 9th Circuit noted that "[t]he Tax Court really only needed to ascertain that as of [the valuation] date, the surrounding circumstances were sufficient to indicate that the tender offer and the merger were practically certain to proceed by the time of their actual deadlines - several days in the future." Ferguson, 174 F.3d at 1004. Consequently, the assignment of income doctrine applied and the taxpayers realized gain when the shares were disposed of by the charity and foundations.

Section 2702(a) provides generally that solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member shall be determined as provided in § 2702(a)(2).

Section 2702(a)(2)(A) provides that the value of any retained interest which is not a qualified interest shall be treated as being zero.

Section 2702(b)(1) provides that a "qualified interest" means any interest which consists of the right to receive fixed amounts payable not less frequently than annually.

Section 25.2702-2(a)(6) defines a "qualified interest" to include a qualified annuity interest and § 25.2702-2(a)(7) defines "qualified annuity interest" as an interest that meets all the requirements of § 25.2702-3(b) and (d).

Section 25.2702-3(b)(1)(i) provides that a qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually.

Section § 25.2702-3(b)(1)(ii)(B) provides, in part, that a fixed amount means a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually.

Section 25.2702-2(b)(2) provides that the value(s) of a qualified annuity interest and a qualified remainder interest following a qualified annuity interest are determined under § 7520. The value(s) of a qualified unitrust interest and a qualified remainder interest following a qualified unitrust interest are determined as if they were interests described in section 664.[3]

Section 25.2702-3(b)(2) provides that if the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iii) of this chapter (relating to adjustments for any incorrect determination of the fair market value of the property in the trust).

Section 25. 2702-3(b)(3) provides, in part, that the annuity may be payable based on either the anniversary date of the creation of the trust or the taxable year of the trust, in annual or more frequent payments.

Section 25.2702-3(b)(5) provides that the governing instrument must prohibit additional contributions to the trust.

Section 25.2702-3(d)(1) provides that to be a qualified annuity interest, an interest must be a qualified annuity interest in every respect. Further, to be a qualified interest, the interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust.

In Atkinson v. Commissioner, 115 T.C. 26, 32 (2000), aff'd, 309 F.3d 1290 (11th Cir. 2002), a donor created a charitable remainder annuity trust (CRAT) but no payments were actually made from the trust to the donor during the two-year period between the creation of the trust and the donor's death. The Commissioner argued that the trust was not a valid CRAT under § 664(d)(1) and the corresponding regulations because the required annual annuity amount was never paid. The Tax Court agreed, concluding that although the terms of the trust met the letter of the statutory requirement providing for five percent annual distributions, the trust did not operate in accordance with those terms. Specifically, the Tax Court determined that the trust did not meet the express five percent requirement of the statute and could not qualify for treatment as a

---

[3] In 1990, the Senate Budget Committee determined that "the valuation problems inherent in trusts and term interests in property are best addressed by valuing retained interests at zero unless they take an easily valued form-as an annuity or unitrust interest. By doing so, the bill draws upon present law rules valuing split interests in property for purposes of the charitable deduction." Informal Senate Report on S. 3209, 136 CONG. REC. 15629, 15681 (1990). The Senate report further noted that "[t]hese interests are similar to those permitted in charitable split interest trusts under section 664." Id. at n.30.

charitable remainder trust. On appeal, the estate argued that the deduction was being denied because of a "foot fault," or a minor mistake. The Court of Appeals disagreed, however, and affirmed the Tax Court, holding that the trust failed to comply with the rules governing CRATs throughout its existence. Because these rules in § 664(d)(1) and the corresponding regulations were not scrupulously followed throughout the life of the trust, a charitable deduction was not appropriate. Atkinson, 309 F.3d at 1295.

The current case shares many factual similarities with Ferguson, supra, for example, the targeted search by Donor to find merger candidates, the exclusive negotiations with Corporation A immediately before the final agreement, the generous terms of the merger, and an agreement that was "practically certain" to go through. While the Ferguson opinion deals exclusively with the assignment of income doctrine, it also relies upon the proposition that the facts and circumstances surrounding a transaction are relevant to the determination that a merger is likely to go through. See Bank One and Kollsman, supra.

Further, the current case presents an analogous issue, that is, whether the fair market value of the stock should take into consideration the likelihood of the merger as of the date of the transfer of the shares to Trust. The Ferguson and Silverman opinions, as considered by the Tax Court and the Ninth Circuit and Second Courts of Appeal, respectively, support the conclusion that the value of the stock in Company must take into consideration the pending merger. Accordingly, the value determined in the December 31, Year 1 appraisal does not represent the fair market value of the shares as of the valuation date. Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of Date 2, would be reasonably informed during the course of negotiations over the purchase and sale of the shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger undermines the basic tenets of fair market value and yields a baseless valuation, and thereby casts more than just doubt upon the bona fides of the transfer to the GRAT.

In addition, although the governing instrument of Trust appears to meet the requirements in § 2702 and the corresponding regulations, intentionally basing the fixed amount required by § 2702(b)(1) and § 25.2702-3(b)(1)(i) on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from the creation of the trust. The trustee's failure to satisfy the "fixed amount" requirement under § 2702 and § 25.2702-3(b)(1)(ii)(B) is an operational failure because the trustee paid an amount that had no relation to the initial fair market value of the property transferred to the trust; instead, the amount was based on an outdated and misleading appraisal of Company, at a time when Company had received offers in the multi-billion dollar range. When asked about the use of the outdated appraisal, the company that conducted the appraisal stated only that business operations had not materially changed during the 6-month period. In contrast, in valuing the transfer to the charitable trust, the company that conducted the appraisal focused only on the tender offer, and accordingly gave little weight to the business operations for valuation purposes.

The operational effect of deliberately using an undervalued appraisal is to artificially depress the required annual annuity. Thus, in the present case, the artificial annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, Donor did not retain a qualified annuity interest under § 2702. See Atkinson.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

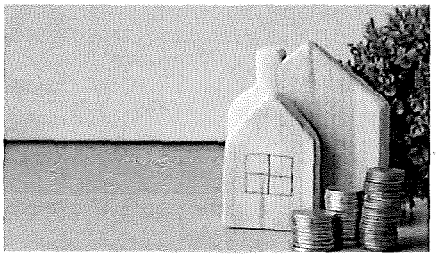
Please call (202) 317-4628 if you have any further questions.

4

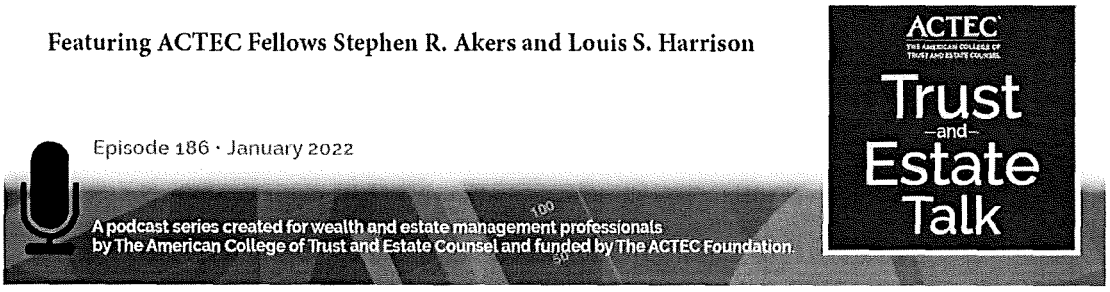
A Discussion of Chief Counsel Advice 202152018 and its Effect on the Administration of GRATs

JAN 25, 2022 | GENERAL ESTATE PLANNING, IRS / TAX GUIDANCE, PODCASTS, T&E ADMINISTRATION

A Discussion of Chief Counsel Advice 202152018 and its Effect on the Administration of GRATs



Featuring ACTEC Fellows Stephen R. Akers and Louis S. Harrison



ACTEC TRUST & ESTATE TALK
A Discussion of Chief Counsel Advice 202152018 and its Effect on the

"A Discussion of Chief Counsel Advice 202152018 and its Effect on the Administration of GRATs," that's the subject of today's ACTEC Trust and Estate Talk.

Transcript/Show Notes

This is Travis Hayes, ACTEC Fellow from Naples, Florida. In Chief Counsel Advice 202152018, the IRS issued a very surprising ruling about GRATs. The IRS plowed new ground in taking an unprecedented and very harsh position on GRATs. This ruling seems to be contrary to their own regulation. Today, ACTEC Fellows Steve Akers of Dallas, Texas and Lou Harrison of Chicago, Illinois will discuss this recently issued IRS ruling. Welcome to Steve and Lou.

The Background of Final Position of CCA 202152018

Thank you, Travis. In CCA 202152018, the donor who was the founder of a very successful company, transferred shares of the company to a two-year Grantor Retained Annuity Trust. We refer to that as a GRAT. As is very often done with GRATs, the annuity amounts were specified in terms of a percentage

of the initial fair market value of the trust. In determining what that initial fair market value was, to determine the annuity payments of each of those two years, they used an appraisal that was dated seven months prior to the time of the transfer into the GRAT. The appraisal actually had been done for a nonqualified deferred compensation plan arrangement.

In the meantime, after that appraisal had been done seven months earlier, the donor began merger discussions with other people about the possibility of buying the company. And he actually had four offers in hand at the time that the transfer was made into the GRAT. Even so, they used that seven-month prior appraisal amount. Well, after the transfer into the GRAT, there were some updates on the offers. Six months later, bottom line, they accepted one of the offers that came in at three times the value that was used for the GRAT purpose of determining those annuity amounts.

Another interesting little fact, right before the closing on the tender offer, the donor also made a transfer into a Charitable Remainder Trust and, for that purpose, used the actual tender offer price for determining the transfer into the Charitable Remainder Trust and, therefore, the amount of the income tax deduction. Two issues arose in this Chief Counsel Advice. And keep in mind what a Chief Counsel Advice is: that's just advice from the IRS Chief Counsel from the attorneys to the agents of a litigating position. It is just an IRS position – an unpublished, unofficial position. Two issues: the first was that the value should take into consideration a pending merger and the discussions of that. This was very similar to a ruling that we got in 2019, CCA 201939002, where the IRS took a very similar position of an ongoing merger that you ought to take that into account because a hypothetical buyer would know about that and would do so. And indeed, that part of the Chief Counsel Advice is almost, word for word, what the 2019 one was, except that, in this one they added the phrase, "And thereby casts more than just doubt on the bona fide to the transfer to the GRAT."

The CCA went on to look by analogy to the *Atkinson Case*, which was a charitable remainder annuity trust case. One of the requirements of a Charitable Remainder Annuity Trust is that there must be at least 5% annual distributions. Although, apparently, that CRAT was created appropriately, they never actually made any annuity payments. And so, the court concluded that,

because of this operational failure, no deduction at all, was permitted for the CRAT in the *Atkinson Case*.

The CCA used that to rationalize that this would not be treated as a qualified annuity interest. And therefore, the value of the retained annuities was zero. So, the donor made a gift equal to the full value transferred into that CRAT. The conclusion in the CCA is that the operational effect of deliberately using an undervalued appraisal is to artificially depress the required annual annuity.

"Thus, in the present case, the artificial annuity to be paid was 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, the donor did not retain a qualified annuity interest under § 2702."

Discussion of Current and Future Impact

I understand the IRS' reaction. One of the features we like best about the GRATs is that the regulations tell us we can have this "savings feature" in it. We can say the annuity amount is the percentage of the finally determined gift tax value. So, if it's finally determined to be a different value, it just automatically adjusts the annuity amount, and the remainder value may go from $10 to $11. It's just wonderful. But the IRS' concern is for cheaters, unscrupulous taxpayers. I think they're concerned with defined value clauses, generally, that someone would use just an outrageously unreasonably low appraisal.

If they don't get caught, they got by with it. If they do get caught, they just adjust it and life goes on. And so, the IRS, in this case, took the totally unprecedented position – they've never done this before – to say that using an improper appraisal of the hard-to-value amount of the annuity payments causes the annuity interest not to be a qualified interest and to be valued at zero. So, a huge gift was made when the GRAT was created. Okay, I understand the IRS concern, BUT. Lou, let me just pitch it to you at that point.

Okay. Well, Steve, I don't want to be the practitioner calling the client indicating that the client's made a 100% taxable gift. And I look at these CCAs and I think the sole purpose of them is to terrify me, and this one definitely terrifies me. It feels like the old Revenue Ruling 79-353 which, when it came

out, seemed absolutely incorrect. That revenue ruling said that an ability of a grantor to remove a corporate trustee and replace that corporate trustee with another corporate trustee was a retained right to designate the assets under 2036 (a)1 – or 2036(a)2, rather.

And that revenue ruling sat out there and also terrified me and other practitioners for a long time, until, ultimately, the *Wall Case* invalidated it, essentially, and then the IRS was forced to revoke that revenue ruling. I think, ultimately, if this type of case gets to a court, if they (the IRS) take this position, I think the court invalidates it (the IRS position). But we don't want to be there (in court having to invalidate the Service's position), right? So, if we don't want to be there, what is it we're going to do knowing that CCA's out there and that an audit could, theoretically, invoke the reasoning in the CCA, i.e., if we violate the facts, we have 100% taxable gift with a GRAT.

Ideas on Steps to Take

Well, number one, the global for all of us is: let's stop getting too cute with transactions. Let's go back to the trite phrase and recognize that pigs get larger and hogs get slaughtered. And the fact pattern in this CCA is definitely a hog fact pattern. We don't want to be there. So, when you have difficult-to-value assets – and in particular — let's just talk about GRATs, although the reasoning of this CCA could apply to *Wandry* formulas in sales, as well, and *Wandry* formulas in gifts (*Joanne Wandry v. Commissioner*, T.C. Memo. 2012-88). But let's say we have GRATs.

When you have difficult-to-value assets and you may have a corporate transaction that's going to occur after the GRAT setup, at a minimum, have your valuation as of the date of the GRAT. That is, have the valuation be that date. It can be done after the GRAT's in place, but have it be that date based on facts and knowledge that existed on that date. Facts and knowledge in this CCA would include the understanding that there have been some offers out there. Have your valuation expert take that into account. Do not ignore that. And, if you can take that step, you can essentially avoid the concept and the reasoning in the CCA. So, we have to be, again, a little less cute with some of the valuations that are going on and a little more timely (accurate valuation date) in terms of the valuation itself. This valuation, in this CCA, was done months before the actual GRAT was put in place, and that's the one that was used. So, that's my major takeaway from this. And, again, we're going to have to

see, ultimately, what the court would do if this reasoning is applied to future GRATs or sales. Steve, you want to add to that, please?

Lou, I agree that the CCAs typically come about in an actual case and the agent will submit an issue to the Chief Counsel Office of what position to take. And so, hopefully, this actual case will come to a different conclusion. The concern of this case is that it basically puts all GRATs involving hard-to-value assets at risk. If you use an appraisal that ends up being the wrong value, do you risk that the full amount transferred to the GRAT is a gift? The whole point of – the major advantage of GRATs is that we can shift future appreciation, but not make a huge gift upfront.

Well, that just puts every GRAT involving a hard-to-value asset under the rationale of this CCA at risk of having a large gift. And, it is just totally egregious, particularly in light of the fact that the regulations not only allow us to define the annuity amount in terms of the finally determined gift tax value going in, but it also has a provision that the instrument can say that: "In the event of an incorrect determination of the value, this is what you do after the fact." (Regulation §25.2702-3(b)(1)(ii)(B) & §25.2702-3(b)(2).)

And so, the IRS approach of saying that it's using the *Atkinson Case* to say an inaccurate appraisal just totally blows up the GRAT, resulting in the full gift amount going in — is just really an outrageous position. And I agree that, I certainly hope, the case doesn't go that way. But, I certainly also agree with Lou. You have very good ideas on steps to take so that we don't have the IRS viewing our situation as an abusive cheater sort of situation, and not to take this sort of position. But, this is a very surprising result from this CCA and troubling, in the event that it should be upheld by the courts.

I completely agree.

Thank you, Steve and Lou, for discussing this recently issued IRS ruling and its effect on the administration of GRATs holding hard-to-value assets.

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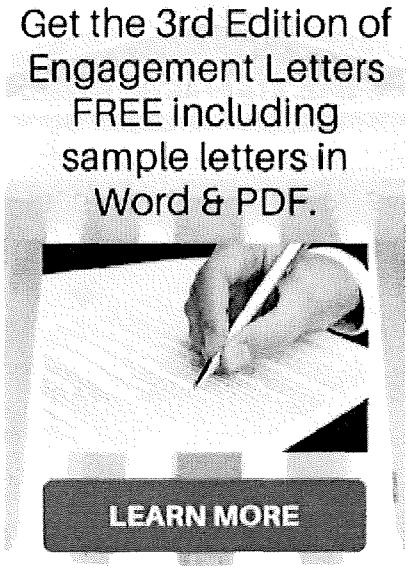

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Wandry v. Comm'r

United States Tax Court

March 26, 2012, Filed

Docket Nos. 10751-09, 10808-09

Reporter

2012 Tax Ct. Memo LEXIS 89 *; T.C. Memo 2012-88; 103 T.C.M. (CCH) 1472

JOANNE M. WANDRY, DONOR, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent; ALBERT D. WANDRY, a.k.a. A. DEAN WANDRY, DONOR, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Disposition: [*1] Decisions will be entered for petitioners.

Case Summary

Procedural Posture

Petitioner taxpayers sought a redetermination of their gift tax liability determined in a notices of deficiency by respondent, the Commissioner of Internal Revenue (IRS). Taxpayers completed valid gifts to family member donees, where the gift documents essentially expressed the gifts as a mathematical formula.

Overview

Taxpayers instituted a tax-free gift-giving plan through transfers of partnership interests by using their annual gift tax exclusions of $11,000 per donee under *26 U.S.C.S. § 2503(b)*. IRS argued that petitioners were liable for the tax imposed by *26 U.S.C.S. § 2501* because they transferred completed gifts of fixed percentage interests to the donees, and the gifts exceed taxpayers' federal gift tax exclusions. Taxpayers argued that they did not transfer fixed percentage interests to the donees, but transferred percentage interests to the donees equal in value to the amounts set forth in the gift documents. At all times, taxpayers understood, believed, and claimed that they gave gifts equal to $261,000 and $11,000 to each of their children and grandchildren, respectively. The court found that taxpayers' formula clause was valid, as distinguished from a savings clause, which a taxpayer could not use to avoid the tax imposed by *26 U.S.C.S. § 2501*. The ascertainable dollar value of stock transferred was a fixed set of rights even though the units themselves had an unknown value. Public policy was not implicated.

Outcome

Decision was entered for taxpayers.

Counsel: William N. Krems, Steven R. Anderson, and Richard D. D'Estrada, for petitioners.

Patricia A. Komor and Philip E. Blondin, for respondent.

Judges: HAINES, Judge.

Opinion by: HAINES

Opinion

MEMORANDUM OPINION

HAINES, Judge: These cases arise from petitions for redetermination filed in response to notices of deficiency (deficiency notices) issued to petitioner Albert Wandry and petitioner Joanne Wandry for 2004. The issues for decision are: (1) whether petitioners transferred gifts of a specified dollar value of membership units or fixed percentage interests in Norseman Capital, LLC, a Colorado limited liability company, to their children and grandchildren in 2004; and (2) whether petitioners' transfer documents are void for Federal tax purposes as against public policy.

Background

The parties submitted these cases fully stipulated pursuant to *Rule 122*. [1] The stipulations of facts and the attached exhibits are incorporated herein by this reference. At the time they filed their petitions, petitioners lived in Colorado.

In 1998 petitioners formed the Wandry Family Limited Partnership, a Colorado limited liability limited partnership (Wandry LP), contributing cash and marketable securities. Petitioners sought the advice of their tax attorney regarding the gift tax consequences of making transfers to their children and grandchildren (donees). They were advised that they could institute a tax-free gift-giving plan through transfers of Wandry LP partnership interests by using their annual gift tax exclusions of $11,000 per donee under *section 2503(b)* and additional gifts in excess of their annual exclusion of up to

[1] All section references are to the Internal Revenue Code (Code), as amended and in effect for the year at issue, and all Rule references are to the Tax Court Rules **[*2]** of Practice and Procedure, unless otherwise indicated. Amounts are rounded to the nearest dollar.

$1 million for each petitioner under *section 2505(a)* (Federal gift tax exclusions). Petitioners' tax attorney was also a certified public accountant (C.P.A.) with 9 years of practice in public accounting and 19 years of practicing law.

On January 1, 2000, petitioners began a gift-giving program using Wandry LP partnership interests. Petitioners' tax attorney informed them that the number of partnership units equal to the desired value of their gifts on any given date could not be known until a later **[*3]** date when a valuation could be made of Wandry LP's assets. As a result, petitioners' tax attorney advised them to give gifts of a specific dollar amount, rather than a set number of Wandry LP partnership units. He further advised them that all gifts should be transferred on December 31 or January 1 of a given year so that a midyear closing of the books would not be required. The Wandry LP partnership interest transfers are not at issue in these cases.

In April 2001 petitioners and their children started a family business. As part of this new business, on August 7, 2001, petitioners and their children formed Norseman Capital, LLC, a Colorado limited liability company (Norseman). The Norseman operating agreement provided that Mr. Wandry was its initial manager charged with managing its business and affairs and that the profits and losses of the company would be allocated in proportion to each member's capital account.

By 2002 all of Wandry LP's assets had been transferred to Norseman. As a result, petitioners continued their gift-giving program through Norseman. As with the gift-giving program with Wandry LP, petitioners' tax attorney advised them that: (1) the number of Norseman membership **[*4]** units equal to the desired value of their gifts on any given date could not be known until a later date when a valuation could be made of Norseman's assets; (2) all gifts should be given as specific dollar amounts, rather than specific numbers of membership units; and (3) all gifts should be given on December 31 or January 1 of a given year so that a midyear closing of the books would not be required.

On January 1, 2004, petitioners executed separate assignments and memorandums of gifts (gift documents). Each gift document provides:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000

Name	Gift Amount
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000
	1,099,000

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift **[*5]** but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

The paragraph following the list of the donees [2] and their gift amounts is hereinafter referred to as the adjustment clause. Petitioners' tax attorney drafted the gift documents.

The only gifts with respect to Norseman membership units that petitioners ever intended to give were of dollar amounts equal to their Federal gift tax exclusions. At all times petitioners understood and believed that the gifts were of a dollar value, not a specified number of membership units. Petitioners' tax attorney advised them that if a subsequent determination revalued membership units granted, no membership units would be returned to them. Rather, accounting entries to Norseman's capital accounts would reallocate each member's membership units to conform to the actual gifts.

Petitioners hired Kreisman & Williams, P.C. (K&W), an independent appraiser, to value Norseman's assets as of January 1, 2004. On July 26, 2005, K&W issued its report, concluding that a 1% Norseman membership interest was worth $109,000.

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[2] Because each of petitioners' grandchildren is a minor, their names have been redacted from the record. We therefore list **[*6]** them as grandchild A-E.

An undated and handwritten ledger from Norseman's C.P.A., titled "Norseman Capital, LLC 1998-2007 Gifts" (capital account ledger), indicates that certain accounting entries were made to Norseman's capital accounts in 2004. Specifically, the capital account ledger states that petitioners' combined capital accounts decreased by $3,603,311 in 2004. The **[*7]** capital account ledger indicates that this decrease is attributable to petitioners' combined gifts to the donees, resulting in increases to the Norseman capital accounts of each of petitioners' children and grandchildren of approximately $855,745 and $36,066, respectively. The only other evidence on record of Norseman's capital account adjustments in 2004 is Norseman's 2004 Form 1065, U.S. Return of Partnership Income, which includes each member's Schedule K-1, Partner's Share of Income, Deductions, Credits, etc., listing each of their beginning and end of year capital account balances.

Petitioners' C.P.A. prepared a 2004 Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for each petitioner (gift tax returns). Consistent with the gift documents, each gift tax return reported total gifts of $1,099,000 and the schedules supporting the gift tax returns reported net transfers from each petitioner of $261,000 and $11,000 to their children and grandchildren, respectively. However, the schedules describe the gifts to petitioners' children and grandchildren as 2.39% and .101% Norseman membership interests, respectively (gift descriptions). Petitioners' C.P.A. derived **[*8]** the gift descriptions from the dollar values of the gifts listed in the gift documents and the gift tax returns and the $109,000 value of a 1% Norseman membership interest as determined by the K&W report.

In 2006 the Internal Revenue Service (IRS) examined petitioners' gift tax returns. The IRS determined that the values of the gifts exceeded petitioners Federal gift tax exclusions. The deficiency notices were issued on February 4, 2009, determining a deficiency that was based on gifts of 2.39% and .101% Norseman membership interests to each of petitioners' children and grandchildren, respectively, valued at $366,000 and $15,400, respectively. The IRS and petitioners now agree that as of January 1, 2004, 2.39% and .101% Norseman membership interests were worth $315,800 and $13,346, respectively.

Discussion

I. Framing the Issues

Section 2501 imposes a tax on the transfer of property by gift by an individual. This tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or

intangible. *Sec. 2511*. The Federal gift tax exclusions apply to reduce the tax imposed by *section 2501*. More specifically, **[*9]** *section 2503(b)* provides that in computing gifts for the taxable year, a donor may exclude the first $10,000 of gifts, [3] other than gifts of future interests in property, made to any person during the calendar year. For 2004 *section 2505(a)* provided for an additional lifetime exclusion of $1 million for each donor.

Respondent argues that petitioners are liable for the tax imposed by *section 2501* because they transferred completed gifts of fixed percentage interests to the donees and the gifts exceed petitioners' Federal gift tax exclusions. Respondent presents three arguments to support this conclusion: (1) the gift descriptions, as part of the gift tax returns, are admissions that petitioners transferred fixed Norseman percentage interests to the donees; (2) Norseman's capital accounts control the nature of the gifts, and Norseman's capital accounts were adjusted to reflect the gift descriptions; and (3) the gift documents themselves transferred fixed Norseman percentage interests to the donees. Respondent further **[*10]** argues that the adjustment clause does not save petitioners from the tax imposed by *section 2501* because it creates a condition subsequent to completed gifts and is void for Federal tax purposes as contrary to public policy. See *Commissioner v. Procter, 142 F.2d 824, 827-828 (4th Cir. 1944)*, rev'g a Memorandum Opinion of this Court.

Petitioners argue that they did not transfer fixed Norseman percentage interests to the donees. Rather, they transferred Norseman percentage interests to the donees equal in value to the amounts set forth in the gift documents. They further argue that respondent's public policy concerns do not apply to the adjustment clause. We review each of respondent's arguments in turn.

II. Defining the Gifts

A. Gift Descriptions as Admissions

Statements made in a tax return signed by a taxpayer may be treated as admissions. *Lare v. Commissioner, 62 T.C. 739, 750 (1974)*, aff'd without published opinion, *521 F.2d 1399 (3d Cir. 1975)*. In *Estate of Hall v. Commissioner, 92 T.C. 312, 337-338 (1989)*, we held that amounts reported on a Federal estate tax return are admissions and that lower values could not be substituted absent "cogent proof" that the reported values were erroneous. **[*11]** We have applied this same principle to cases involving Federal gift tax returns. See *Mooneyham v. Commissioner, T.C. Memo. 1991-178*. This cogent

[3] The annual exclusion amount is subject to a cost-of-living adjustment. See *sec. 2503(b)(2)*. For 2004 the annual exclusion was $11,000. See *Rev. Proc. 2003-85, 2003-2 C.B. 1184*.

proof principle is essentially synonymous with the general burden of proof set forth in *Rule 142(a)*. See generally *Frazee v. Commissioner, 98 T.C. 554, 561-562 (1992)*.

Respondent argues that the gift descriptions, as part of petitioners' gift tax returns, are binding admissions that petitioners transferred fixed Norseman percentage interests to the donees. Respondent cites *Knight v. Commissioner, 115 T.C. 506 (2000)*, as controlling. In Knight, as in the cases at hand, the taxpayers entered into a gift-giving plan for the benefit of their children using a partnership. The transfer document in Knight stated that the taxpayers transferred gifts to their children of partnership interests with a value of $300,000. However, on the taxpayers' gift tax returns, they reported gifts to each of their children of 22.3% interests in the partnership. The taxpayers' gift tax returns did not report a dollar value associated with the partnership interests. The Commissioner determined the fair market value of a 22.3% interest in the partnership to be greater **[*12]** than $300,000 and issued a notice of deficiency. At trial the taxpayers claimed that their gifts were actually worth less than $300,000.

In Knight, we held that by arguing at trial that the gifts were worth less than $300,000, the taxpayers opened the door to our consideration of the Commissioner's argument that the gifts were worth more than $300,000. As a result, we held that the taxpayers' gift tax returns showed their disregard for the transfer document and that they intended to give their children 22.3% interests in the partnership.

Petitioners have not similarly opened the door to respondent's argument. At all times petitioners understood, believed, and claimed that they gave gifts equal to $261,000 and $11,000 to each of their children and grandchildren, respectively. In *Knight*, the taxpayers' gift tax returns did not report dollar value gifts. In the cases at hand, although respondent relies on the gift descriptions as the basis for the alleged admissions, petitioners' gift tax returns were consistent with the gift documents. Petitioners' gift tax returns reported gifts with a total value equal to $1,099,000, and the schedules supporting petitioners' gift tax returns reported **[*13]** net transfers with a value of $261,000 and $11,000 to petitioners' children and grandchildren, respectively. Petitioners' C.P.A. merely derived the gift descriptions from petitioners' net dollar value transfers and the K&W report. Therefore, petitioners' consistent intent and actions prove that dollar amounts of gifts were intended.

B. Capital Accounts

Respondent next argues that Norseman's capital accounts control the nature of the gifts transferred from petitioners to the donees, and that Norseman's capital accounts reflect gifts of fixed percentage interests. In applying a provision of

Federal tax law, State law controls in determining the nature of a taxpayer's legal interest in property. *United States v. Nat'l Bank of Commerce, 472 U.S. 713, 722, 105 S. Ct. 2919, 86 L. Ed. 2d 565 (1985)*; *United States v. Mitchell, 403 U.S. 190, 197, 91 S. Ct. 1763, 29 L. Ed. 2d 406 (1971)*. State law creates legal interests, while Federal law determines when and how those interests shall be taxed. *Mitchell, 403 U.S. at 197*.

Under Colorado law, the elements of a valid inter vivos gift are: (1) a clear and unmistakable intention to make the gift and (2) the consummation of such intention by those acts which the law requires to divest the donor and invest the donee with **[*14]** the right of property. *Thomas v. Thomas, 70 Colo. 29, 197 P. 243 (Colo. 1921)*. Acceptance by the donee is also an essential element even though it is often presumed and need not always be proved. *Bunnell v. Iverson, 147 Colo. 552, 364 P.2d 385 (Colo. 1961)*.

The parties do not dispute that petitioners completed valid gifts to the donees on January 1, 2004. However, respondent argues that we must look to Norseman's capital accounts to determine just what property rights were divested from petitioners and invested in the donees. Respondent cites Thomas, a stock ownership dispute between a husband and wife. Mr. Thomas claimed that he was the owner of corporate stock which was listed on the books of the corporation as belonging to Mrs. Thomas. He claimed that he had previously transferred the stock to his wife for convenience only but he was still the owner. The court held that Mr. Thomas gave a completed gift to Mrs. Thomas because when shares have been transferred on the corporate books, title has passed.

Respondent argues that Colorado law would view partnership interests similarly and that Norseman's capital accounts control the transfer. Because the capital accounts control the transfer and Norseman's capital account **[*15]** adjustments reflected a transfer consistent with the gift descriptions, respondent argues that we are compelled to conclude that petitioners transferred fixed Norseman percentage interests to the donees. Respondent supports this argument with the general principle that many of the rights a partner is entitled to in a partnership flow from that partner's capital account. In fact, the Norseman operating agreement provides that its members' shares of profits and losses are allocated according to their capital accounts. Respondent argues that a determination that the gifts were inconsistent with Norseman's capital accounts would be contrary to fundamental principles of the Federal tax system because it would render Norseman's capital accounts "tentative" until a final adjudication. Respondent correctly observes that Norseman's operations were not suspended on January 1, 2004, and that its capital accounts controlled its allocations, distributions, voting rights, and tax reporting. Respondent argues that if petitioners prevail it will likely require the preparation and filing of numerous corrective returns.

Respondent's reliance on *Thomas* is misplaced. Thomas is a case about whether and **[*16]** when a gift of corporate stock is complete, and it has no bearing on the nature of petitioners' gifts. We do not find respondent's argument to be persuasive. The facts and circumstances determine Norseman's capital accounts, not the other way around. Book entries standing alone will not suffice to prove the existence of the facts recorded when other more persuasive evidence points to the contrary. See *Stralla v. Commissioner, 9 T.C. 801, 819 (1947)* (partnership interests designated as belonging to certain individuals on the partnership books and records found to belong to someone else on the basis of facts and circumstances); *Offord v. Commissioner, T.C. Memo. 1961-159* (capital account entries on the books of a partnership were not sufficient to prove the existence of a partner). In fact, the Commissioner routinely challenges the accuracy of partnership capital accounts, resulting in reallocations that affect previous years. If the Commissioner is permitted to do so, it can be said that a capital account is always "tentative" until final adjudication or the passing of the appropriate period of limitations. Accordingly, Norseman's capital accounts do not control the nature of petitioners' **[*17]** gifts to the donees.

Even if we agreed with respondent's capital accounts argument, respondent has failed to provide any credible evidence that the Norseman capital accounts were adjusted to reflect the gift descriptions. The only evidence in the record of any adjustments to Norseman's capital accounts in 2004 is the capital account ledger and the Norseman's members' Schedules K-1, neither of which provides credible support to respondent's argument. The capital account ledger is undated and handwritten. There is no indication that it represents Norseman's official capital account records, and it does not reconcile with any of petitioners' or respondent's determinations. The capital account ledger is unofficial and unreliable. With respect to the Schedules K-1, they do not provide any information outside of each member's beginning and end of year capital account balances. They do not account for the portions of these adjustments attributable to petitioners' gifts. Therefore, respondent's argument fails in both law and fact.

C. The Gift Documents

Respondent's final argument raises an old issue that has evolved through a series of cases where the Commissioner has challenged a taxpayer's **[*18]** attempt to use a formula to transfer assets with uncertain value at the time of the transfer. Respondent relies on Procter, which we have previously described as the "cornerstone of a body of law" regarding impermissible transfer clauses. *Estate of Petter v. Commissioner, T.C. Memo. 2009-280*, aff'd, *653 F.3d 1012 (9th Cir. 2011)*. In Procter, the donors assigned gifts of remainder interests in two trusts to their children pursuant to the following clause:

> [I]n the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of [the taxpayer] * * *

Commissioner v. Procter, 142 F.2d at 827.

The Court of Appeals for the Fourth Circuit held that the clause at issue operated to reverse a completed transfer in excess of the gift tax. *Id. at 827-828*. The clause was therefore invalid as a condition subsequent to **[*19]** the donor's gift. Id. The Court of Appeals further held that the clause was contrary to public policy because: (1) any attempt to collect the tax would defeat the gift, thereby discouraging efforts to collect the tax; (2) the court would be required to pass judgment upon a moot case; and (3) the clause would reduce the court's judgment to a declaratory judgment. *Id. at 827.*

We have since invalidated other attempts to reverse completed gifts in excess of the Federal gift tax exclusions. See *Ward v. Commissioner, 87 T.C. 78 (1986)* (invalidating a clause that provided for a retroactive adjustment to the completed transfer of a fixed number of shares of corporate stock to escape any imposition of gift tax); *Harwood v. Commissioner, 82 T.C. 239 (1984)* (giving no effect to a clause requiring an adjustment to a completed gift of an 8.89% partnership interest if it is "finally determined" for gift tax purposes that the gift was worth more than $400,000), aff'd without published opinion, *786 F.2d 1174 (9th Cir. 1986).*

On the other hand, Federal Courts have held valid formulas used to limit the value of a completed transfer. See *Estate of Christiansen v. Commissioner, 130 T.C. 1 (2008)* (holding **[*20]** valid a clause disclaiming a beneficiary's rights to the value of her mother's estate in excess of $6,350,000, with the disclaimed amounts going to charitable organizations), aff'd, *586 F.3d 1061 (8th Cir. 2009)*; *Estate of Petter v. Commissioner, T.C. Memo. 2009-280*; see also *McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006)* (holding that a gift is valued on the date of the gift and subsequent events are off limits, the Court of Appeals for the Fifth Circuit respected the plain language of a clause transferring partnership interests to the taxpayers' children having a "fair market value" of $6,910,933; anything in excess of that up to $134,000 to a local symphony, and the remainder to a charity), rev'g *120 T.C. 358 (2003)*.

In *King v. United States, 545 F.2d 700 (10th Cir. 1976)*, the Court of Appeals for the Tenth Circuit held for a taxpayer who used a formula similar to the one used in Procter. The clause at issue in King adjusted the purchase price of a specified number of corporate shares sold from a taxpayer to trusts created for the benefit of his children if the IRS determined the fair market value of those shares to be different from that determined on the sale date. Under **[*21]** the rule laid down in *Golsen v. Commissioner, 54 T.C. 742 (1970)*, aff'd, *445 F.2d 985 (10th Cir. 1971)*, we must follow Tenth Circuit precedent. However, we do not believe that King is squarely on point, and therefore we do not believe it is controlling in the cases at hand. Most notably, the "price adjustment" clause in King provided for an adjustment to the consideration the trusts paid in the sale, not the stock transferred. Further, because the transaction was a sale, and not a gift, the Court of Appeals did not address the public policy arguments.

In *Estate of Petter v. Commissioner, T.C. Memo. 2009-280*, we held valid a clause transferring gifts totaling 940 membership units in a family LLC to a trust and a charitable foundation. The operative language of the transfer documents provided that the transferor:

> "assigns to the Trust as a gift the number of Units * * * that equals one-half the minimum dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code *Section 2010(c)*. Transferor currently understands her unused applicable exclusion amount to be $907,820, so that the amount of this gift should be $453,910; and
>
> * * * **[*22]** assigns to * * * [the charitable foundation] as a gift to the * * * [charitable foundation] the difference between the * * * [940 Units] and the number of Units assigned to the Trust * * *"

Id. [4]

The transfer documents further provided that if the value of the membership units the trust initially receives is "finally determined for federal gift tax purposes" to exceed $453,910, the trust must transfer the excess units to the charity. Id. If, on the other hand, the value of the membership units the trust initially receives is "finally determined for federal gift tax purposes" to be less than $453,910, the charity will transfer the excess units to the trust. Id.

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[4] The taxpayers also executed similar transfer documents executing a sale and gift of 8,459 total membership units. An unknown number of membership units with a value equal to $4,085,190 were sold to the trust, rather than granted as a gift, and the remaining membership units were granted as gifts to the charities.

In Estate of Petter we examined Procter and other relevant cases to draw a distinction between a "savings clause", which a taxpayer may not use to avoid the tax imposed by *section 2501*, and a "formula clause", which is **[*23]** valid. Id. A savings clause is void because it creates a donor that tries "to take property back". Id. On the other hand, a "formula clause" is valid because it merely transfers a "fixed set of rights with uncertain value". Id. The difference depends on an understanding of just what the donor is trying to give away. Id.

In Estate of Petter we held that the plain language of the transfer documents provided that the donors transferred an "ascertainable dollar value of stock" and not "a specific number of shares or a specific percentage interest" in the LLC. Id. In other words, the clauses at issue were valid formula clauses because the "ascertainable dollar value of stock" transferred was a fixed set of rights even though the units themselves had an unknown value.

On appeal, the Commissioner argued only that the taxpayers were not entitled to a charitable contribution deduction for any additional units transferred to the charities pursuant to *section 25.2522(c)-3(b)(1)*, Gift Tax Regs., which provides that no deduction is allowed if a transfer "is dependent upon the performance of some act or of the happening of a precedent event in order that [the transfer] might become effective". *Estate of Petter v. Commissioner, 653 F.3d at 1018*. **[*24]** The Commissioner argued that the IRS audit was a condition precedent to the completed transfer.

The Court of Appeals for the Ninth Circuit disagreed, holding that although the value of each membership unit was unknown on that date, the value of a membership unit on any given date is a constant. *Id. at 1023*. Therefore, under the terms of the clauses at issue, the charities received a fixed number of membership units, and there were no contingencies for the transfers to be effective. *Id. at 1019*.

Respondent argues that the cases at hand are distinguishable from Estate of Petter. Rather than transferring a fixed set of rights with an uncertain value, respondent argues that petitioners transferred an uncertain set of rights the value of which exceeded their Federal gift tax exclusions. Respondent further argues that the clauses at issue are void as savings clauses because they operate to "take property back" upon a condition subsequent.

Respondent does not interpret Estate of Petter properly. The Court of Appeals described the nature of the transfers and the reallocation provision of the clause at issue in Estate of Petter as follows:

> Under the terms of the transfer documents, the foundations **[*25]** were always entitled to receive a predefined number of units, which the documents essentially expressed as a mathematical formula. This formula had one unknown: the value of a LLC unit at the time the transfer documents were executed. But though unknown, that

value was a constant, which means that both before and after the IRS audit, the foundations were entitled to receive the same number of units. Absent the audit, the foundations may never have received all the units they were entitled to, but that does not mean that part of the Taxpayer's transfer was dependent upon an IRS audit. Rather, the audit merely ensured the foundations would receive those units they were always entitled to receive. * * *

Id. at 1023. We apply each part of the Court of Appeals' description above to petitioners' gifts:

Part I: "Under the terms of the transfer documents, the foundations were always entitled to receive a predefined number of units, which the documents essentially expressed as a mathematical formula."

Here, under the terms of the gift documents, the donees were always entitled to receive predefined Norseman percentage interests, [5] which the gift documents essentially expressed as a mathematical **[*26]** formula. For each of petitioners' children, this formula was expressed as:

x = $261,000/FMV of Norseman

Similarly, for petitioners' grandchildren this formula was expressed as:

x = $11,000/FMV of Norseman

Part II: "This formula had one unknown: the value of a LLC unit at the time the transfer documents were executed. But though unknown, that value was a constant"

Petitioners' formula had one unknown, the value of Norseman's assets on January 1, 2004. But though unknown, that value was a constant. The parties have agreed that as of January 1, 2004, the value of a 2.39% Norseman membership interest was $315,800. Accordingly, the total value of Norseman's assets on January 1, 2004, was approximately $315,800 divided by 2.39%, or approximately $13,213,389. This value was a constant at all times.

Part III: "[B]efore and after the IRS audit, the foundations **[*27]** were entitled to receive the same number of units."

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[5] Because the record does not disclose the total number of Norseman membership units or the number of Norseman membership units equal to a 2.39% or .101% Norseman membership interest, we have substituted Norseman membership interests into the Court of Appeals for the Ninth Circuit's description. This substitution does not alter the analysis.

Before and after the IRS audit the donees were entitled to receive the same Norseman percentage interests. Each of petitioners' children was entitled to receive approximately a 1.98% Norseman membership interest.

1.98% = $261,000/$13,213,389

Similarly, each of petitioners' grandchildren was entitled to receive approximately a .083% Norseman membership interest.

.083% = $11,000/$13,213,389

Part IV: "Absent the audit, the foundations may never have received all the units they were entitled to, but that does not mean that part of the Taxpayer's transfer was dependent upon an IRS audit. Rather, the audit merely ensured the foundations would receive those units they were always entitled to receive."

Absent the audit, the donees might never have received the proper Norseman percentage interests they were entitled to, but that does not mean that parts of petitioners' transfers were dependent upon an IRS audit. Rather, the audit merely ensured that petitioners' children and grandchildren would receive the 1.98% and .083% Norseman percentage interests they were always entitled to receive, respectively.

It is inconsequential that the adjustment clause **[*28]** reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to "take property back". Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the K&W report understated Norseman's value. The clauses at issue are valid formula clauses.

III. Public Policy

Respondent argues that the public policy concerns expressed in *Procter* apply here. We disagree. As we have previously stated, the Supreme Court has warned against invoking public policy exceptions to the Code too freely, holding that the frustration caused must be "severe and immediate". See *Commissioner v. Tellier, 383 U.S. 687, 694, 86 S. Ct. 1118, 16 L. Ed. 2d 185 (1966)*. In *Estate of Petter v. Commissioner, T.C. Memo. 2009-280*, we held that there is no well-established public policy against formula clauses. The Commissioner's role is to enforce tax laws, not merely to maximize tax receipts. See *Estate of Christiansen v. Commissioner, 586 F.3d at 1065*. **[*29]** Mechanisms outside of the IRS audit exist to ensure

accurate valuation reporting. Id. For instance, in the cases at hand the donees and petitioners have competing interests because every member of Norseman is entitled to allocations and distributions based on their capital accounts. Because petitioners' capital accounts were understated, the donees were allocated profits or losses that should have been allocated to petitioners. Each member of Norseman has an interest in ensuring that he or she is allocated a fair share of profits and not allocated any excess losses.

With respect to the second and third Procter public policy concerns, a judgment for petitioners would not undo the gift. Petitioners transferred a fixed set of interests to the donees and do not seek to change those interests. The gift documents do not have the power to undo anything. A judgment in these cases will reallocate Norseman membership units among petitioners and the donees. Such an adjustment may have significant Federal tax consequences. We are not passing judgment on a moot case or issuing merely a declaratory judgment.

In Estate of Petter we cited Congress' overall policy of encouraging gifts to charitable organizations. **[*30]** This factor contributed to our conclusion, but it was not determinative. The lack of charitable component in the cases at hand does not result in a "severe and immediate" public policy concern.

The Court, in reaching its holdings, has considered all arguments made, and, to the extent not mentioned, concludes that they are moot, irrelevant, or without merit.

To reflect the foregoing,

Decisions will be entered for petitioners.

End of Document

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Estate of Cecil v. Comm'r

United States Tax Court

February 28, 2023, Decided; February 28, 2023, Filed

Docket Nos. 14639-14, 14640-14

Reporter

T.C. Memo 2023-24 *; 2023 Tax Ct. Memo LEXIS 24 **; 2023 WL 2256148

ESTATE OF WILLIAM A.V. CECIL, SR., DONOR, DECEASED, WILLIAM A.V. CECIL, JR., CO-EXECUTOR, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent;ESTATE OF MARY R. CECIL, DONOR, DECEASED, WILLIAM A.V. CECIL, JR., CO-EXECUTOR, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Disposition: Decisions will be entered under *Rule 155*.

Case Summary

Overview

HOLDINGS: [1]-There were flaws with petitioners' experts analyses, and while there were issues with a third expert's application of similar transactions methods, his valuation was the truest value of the subject stock's pre-discount fair market value; the single adjustment was that tax affecting should be reflected at a rate of 17.6%; [2]-The court declined to apply a discount for a lack of voting rights because it was logical that the smaller blocks of class B common stock would be more easily marketed than the larger blocks of the class B common stock; different discount rates should apply to the two classes of stock because the voting rights that attached to the class A stock made that class of stock more marketable.

Outcome

Decisions were entered.

Counsel: [1]** David D. Aughtry and John W. Hackney, for petitioners.

Joel D. McMahan, Christopher A. Pavilonis, and A. Gary Begun, for respondent.

Judges: ASHFORD, Judge.

Opinion by: ASHFORD

Opinion

MEMORANDUM FINDINGS OF FACT AND OPINION

ASHFORD, *Judge*: William A.V. Cecil, Sr., and Mary Ryan Cecil (collectively, petitioners; respectively, Mr. Cecil and Mrs. Cecil) petitioned the Court separately to redetermine respondent's determination of a $13,022,552 deficiency in his or her federal gift tax **[*2]** for 2010.[1] On November 18 and 19, 2010 (valuation dates), Mr. Cecil caused a transfer of his revocable trust's class B (generally nonvoting) stock in the Biltmore Company (TBC) to petitioners' five grandchildren, and Mrs. Cecil transferred class A (voting) stock in TBC to petitioners' two children. Petitioners timely reported to the Internal Revenue Service (IRS) on Forms 709, United States Gift (and Generation-Skipping Transfer) Tax Return, that these transfers were gifts during 2010, and they reported a fair market value for each gift as of the time of the corresponding transfer.

The deficiencies result from respondent's determination that petitioners' reported fair market values were too low. Petitioners allege in their Petitions that **[**2]** the values were actually too high and, accordingly, that they are entitled to refunds. We consolidated the cases for trial, briefing, and opinion and now decide the fair market value of the transferred TBC stock (subject stock) on the valuation dates.

FINDINGS OF FACT

The parties have stipulated some facts, and the stipulated facts are so found. The Stipulation of Facts and the attached Exhibits are incorporated herein by this reference. Petitioners, now deceased, were husband and wife during all relevant times, and they resided in North Carolina when their Petitions were timely filed.

I. *Family Background*

Petitioners have two adult children, Bill Cecil and Diana Cecil Pickering (Dini Pickering). Bill Cecil and his wife, Virginia Rott Cecil, have three children: Ryan Jordan Vanderbilt Cecil, Aubrey Lea Amherst Cecil, and Willam Robert Vanderbilt Cecil. We refer to these five individuals collectively as the Cecil family. Dini Pickering and her husband, George W.

[1] Petitioners later died and were substituted for this proceeding by their co-executor, William A.V. Cecil, Jr. (Bill Cecil). Additionally, some monetary amounts are rounded to the nearest dollar.

Pickering II, have two children: Chase Kennedy Cecil Pickering and Devon Lee Cecil Pickering. We refer to these four individuals collectively as the Pickering family.

[*3] II. *TBC*

A. *Background*

1. *The Biltmore House*

Between 1889 and 1895, **[**3]** George W. Vanderbilt built the Biltmore House in the Blue Ridge Mountains in Asheville, North Carolina. The Biltmore House is a French Renaissance chateau that consists of over four acres of floor space and remains the largest privately owned house in the United States. Mr. Vanderbilt died in 1914, and he left the Biltmore House and its surrounding acreage to his only child, Cornelia Cecil née Vanderbilt (Mr. Cecil's mother).

2. *TBC*

TBC, a Delaware corporation, was formed on March 30, 1932, by Cornelia Cecil and others, and during the same year, it became eligible to conduct business in North Carolina. Also in 1932 the Biltmore House and its surrounding acreage (Estate) were contributed to TBC. In 1979 Mr. Cecil and his brother, George Cecil, then TBC's owners, disagreed on TBC's future. They ended up breaking up TBC, with George Cecil surrendering all of his shares in TBC in exchange primarily for TBC's dairy operations inclusive of 3,000 acres of the Estate. TBC elected to be taxed as an S corporation in 1982 and continues to be characterized as such.

B. *Operations and Relevant Financial Information*

1. *Roles of Dini Pickering and Bill Cecil*

Dini Pickering is vice chairman of TBC's board **[**4]** of directors. She has worked for TBC for approximately 32 years and has served in that position over approximately the last 15 of those years.

Bill Cecil is TBC's (and its related entities') president and chief executive officer. He has served in those positions for over 20 years.

2. *Business Operations*

TBC operates primarily in the travel and tourism/historic hospitality industry. The heart of its business is offering its guests the opportunity to go back in time and experience the Gilded Age. Originally, TBC only offered tours of the Biltmore House and the **[*4]** adjoining gardens, and the tours were considered a roadside attraction. In 1995 TBC instituted a long-range plan to become a multiday destination and eventually expanded the Estate to include hotels, restaurants, retail stores, and various outdoor activities. During 2010 TBC operated at least 17 lines of business and employed 1,304 employees (over 1,800 combined full-time and part-time employees including associated businesses).

3. *Revenue Sources*

TBC's paying visitors may access five main areas of the Estate: the Estate entrance, including the Gate House Shop, Lodge Gate, Group Sales Office, and Reservations and Ticket Center; Biltmore **[**5]** House and Gardens; Antler Hill Village and Winery; Inn on Biltmore Estate; and Deerpark, including the Deerpark Restaurant, Lioncrest, and carriage and trail ride barns. TBC generates revenue from five retail outlets; eight restaurants, one of which is a catering facility; landscaping; tickets and tours (including segway tours); Land Rover driving experience and school; river rafting; fly fishing; equestrian training; timber production; and farming. During 2010 TBC generated most of its revenue from admissions to its premises and from restaurant and merchandise sales.

With the exception of 2008, a year within the Great Recession of 2007 through 2009 and for which TBC realized a $1,459,000 loss, TBC has realized a profit every year since 1995. During its fiscal year ended June 30, 2010, adult visitors paid between $35 and $69 for admission depending on the time of the year. In 2010 TBC reported that it realized approximately $70 million in revenue. Of that total revenue, TBC realized $38,437,950 from admission tickets.

4. *Estate's Ranges*

The Estate has a West Range (approximately 3,000 acres of land) and an East Range. The West Range contains all the forestry and farming, and it is used **[**6]** for agricultural, forestry, and recreational activities. Busbee Mountain, one of TBC's operating and income-generating assets, is on the West Range. Busbee Mountain is the main source of water for the Estate, and it generates annually 28 million gallons of water and $110,000 in water savings. TBC also conducts timber operations and leases cell phone towers on Busbee Mountain.

In 1993 TBC sold the West Range to Bill Cecil and Dini Pickering for $6 million and as part of that sale leased back the West Range. This transaction was meant to ensure that the West Range remained in **[*5]** petitioners' extended family

forever. TBC received a 30-year installment note as payment for the sale. On the valuation dates, $2,700,000 of that note's principal remained unpaid.

TBC owns the East Range. The East Range includes places for equestrian, hiking, biking, farming, and timber activities. Also on the East Range are the Biltmore House, formal gardens, Antler Hill Village, a vineyard, the Inn on Biltmore Estate, Deerpark, retail shops, restaurants, and a ticket center. TBC uses all of the East Range to generate earnings.

5. *2010 Assets and Liabilities*

TBC's reported assets and liabilities were $53,580,000 and **[**7]** $33,349,000, respectively, on November 30, 2010. Included in its assets were agricultural land in North Carolina and a multimillion dollar portfolio of fine art, antiques, and other collectibles. Its artwork included the following valuable paintings: (1) the Portrait of Frederick Law Olmsted by John Singer Sargent; (2) the Waltz by Anders Zorn; (3) Mrs. George W. Vanderbilt by Giovanni Boldini; (4) Rosita by Ignacio Zuloaga y Zabaleta, and (5) Angelique and Roger on the Hippogriff by Antoine-Louis Barye.

TBC has 46 trademarks and a trade name registered with the U.S. Patent and Trademark Office.

III. *Ownership and Related Agreements*

A. *1989 Ownership and 1989 Shareholders' Agreement*

Mrs. Cecil, Bill Cecil, and Dini Pickering were three of TBC's shareholders on December 26, 1989, each owning 1 share of its then class B common stock. On that day, they entered into a Shareholders' Agreement. As of that time, TBC had three classes of stock.

B. *1997 Amendment to Certificate of Incorporation*

On August 8, 1997, TBC's Certificate of Incorporation was amended to reclassify TBC's three existing classes of stock into two classes of common stock inclusive of seven issued shares of class A common stock **[**8]** and 9,993 issued shares of class B common stock. These two classes of stock differ only in their voting rights. The amendment states as to their voting rights:

> **[*6]** Class A Common: Each holder of class A Common Stock shall be entitled to one vote for each share of such stock standing in his name on the books of the Corporation. Said voting rights shall be with respect to all matters that may be subject to a vote of stockholders under the Bylaws of the Corporation, under the General Corporation Law of the State of Delaware, or otherwise.

> Class B Nonvoting Common: The holders of class B Nonvoting Common Stock of the Corporation shall not be entitled to vote on any matter except as to matters in respect of which they shall be indefeasibly vested by statute with such right.

C. *Voting Trust Agreement*

On June 30, 1999, TBC, petitioners, Bill Cecil, and Dini Pickering, as the corporation and its shareholders, respectively, and Henry P. Hoffstot, Jr., as an "independent trustee," entered into a Voting Trust Agreement (1999 Voting Trust Agreement). The 1999 Voting Trust Agreement was meant:

> to secure continuity and stability in the Company's policies and management and to coordinate the Company's policies **[**9]** and management with other Biltmore Estate Business Entities, the stock of which is owned by some or all of the Shareholders, and in order to provide that the four Shareholders who sign this Agreement and the lineal descendants of these four Shareholders, will control for the maximum time legally permissible all the development, use and management of the Company as well as policy and management decisions pertaining to other Biltmore Estate Business Entities, these Shareholders have determined to place all their shares of voting stock in the Company with the Trustees and their successors in Trust as hereafter provided.

In accordance with the 1999 Voting Trust Agreement, each signatory shareholder deposited his or her stock in a trust and acted as trustee. The only persons eligible to later become a trustee were lineal descendants of Bill Cecil and Dini Pickering. While petitioners are trustees, all decisions had to be made by a majority of the trustees. If petitioners were not trustees, decisions would be made by a majority of **[*7]** each side of the two families (the Cecils and the Pickerings) with each family having a 50% voting strength. The trust had a ten-year term.

Any decision to sell **[**10]** any land, structure, assets or stock of TBC or any present or future Estate business entity required the vote of two-thirds of the Cecil family trustees and two-thirds of the Pickering family trustees. The trustees set TBC's policies and general operating procedures relating to the operation of TBC and the Estate. The Trustees elected the board of directors and confirmed the appointment of senior officers.

IV. *Family Business Preservation Program*

A. *Background*

In or around 2000 or 2001 Dini Pickering met Craig Aronoff, a consultant with the Family Business Consulting Group. Mr. Aronoff encouraged Dini Pickering to hold family meetings and to create a structure for her family that would

allow them to operate TBC more efficiently. Dini Pickering began exploring family business planning. She read books on the subject as well as material from the Family Business Consulting Group.

Dini Pickering later started the Family Business Preservation Program for TBC in 2003. As a part of the program, petitioners, the Cecil family, and the Pickering family would hold two meetings annually. During these meetings they would work on policies and educational programs for the benefit of their families, which **[**11]** were intended to help them become more effective owners of TBC. The children of Bill Cecil and Dini Pickering attended these meetings. Those children were 8 to 15 years old as of the first meeting.

In the early years Dini Pickering strived innovatively to keep the children focused in the meetings and participating in the business discussions. As the children grew older, they attended educational seminars that focused on topics such as financial literacy or family-based money management. These meetings and seminars were intended to prepare the next generation to take over TBC's management.

[*8] B. *Policies*

Petitioners, the Cecil family, and the Pickering family adopted the following three policies as a result of these meetings. The first policy, the premarital policy, requires that each family member enter into a prenuptial agreement before marriage. The prenuptial agreement must ensure that all separate property remain separate during the marriage and not be subject to a division in the event of a divorce. This policy is intended to ensure that all TBC stock remain in the Cecil and the Pickering families. The second policy, the family employment policy, requires that any Cecil or Pickering **[**12]** family member seeking employment in TBC must have a four-year college degree and at least one year of outside employment. The third policy, a family code of conduct, requires that members of the Cecil and the Pickering families treat others with respect, act ethically, obey the law, respect confidentiality, avoid conflicts of interest, protect family business property, represent the best interests of the family and family business, and practice open, honest, and effective communication. The three oldest of the five children of the Cecil and the Pickering families have adhered to these policies. None of these three children has any desire to ever sell the TBC shares he or she would later receive (see further discussion *infra* p. 28), or to vote to liquidate TBC's assets.

V. *2009 Shareholders' Agreement*

On December 16, 2009, the shareholders that owned all issued and outstanding shares of TBC stock entered into the 2009 Shareholders' Agreement. The 2009 Shareholders' Agreement states:

> [T]he Parties agree that the success of the Corporation requires the active interest, support, and the personal attention of the Shareholders and for that reason it is not advisable to permit the stock of the **[**13]** Corporation to go upon the open market for sale except as otherwise permitted under the terms of this Agreement.

TBC and its shareholders confirmed the purpose of the 2009 Shareholders' Agreement as providing (i) the continued ownership and control of all issued and outstanding TBC shares; (ii) the harmonious and future conduct of the business; and (iii) a stock transfer mechanism to operate when a shareholder dies, becomes incapacitated, or otherwise needs to sell company stock.

[*9] Under the terms of the 2009 Shareholders' Agreement, a shareholder may transfer, with or without consideration, his or her shares to any other shareholder who is a party to the agreement or to any of the shareholder's lineal descendants. As to a proposed transfer to a nonfamily member, the transferor must first notify the other shareholders and TBC of the proposed transfer and receive a notice of consent from each shareholder. If a shareholder receives an offer from a nonfamily member to buy shares from the shareholder, the shareholder must notify the other shareholders and TBC within ten days at which point the other shareholders may purchase all but not less than all of the shares at the lesser of the purchase **[**14]** price or the price set forth by a valuation method contained in the 2009 Shareholders' Agreement. As a condition of a transfer to any person who is not bound by the 2009 Shareholders' Agreement, the transferee must agree to be bound by the terms of that agreement.

VI. *Gift Transfers*

A. *2010*

Immediately before November 18, 2010, TBC's outstanding stock was owned as follows:

Owner	***Number of Shares***	***Percentage***[2]
Class A Common Stock		
Mr. Cecil, Trustee under the William A.V. Cecil Revocable Trust Agreement dated August 13, 1999	3	42.86%
Mrs. Cecil	1	14.29%
Bill Cecil	1	14.29%
Dini Pickering	1	14.29%
Bill Cecil and Dini Pickering, as	1	14.29%

[2] These percentages are the percentages which the parties stipulated.

Owner		***Number of Shares***	***Percentage***[2]
tenants in common			
	Total Shares	7	
	Class B Common Stock		
Mr. Cecil, Trustee under the William A.V. Cecil Revocable Trust Agreement dated August 13, 1999		9,337	93.37%
Bill Cecil		328	3.28%
Dini Pickering		328	3.28%
	Total Shares	9,993	

[*10] B. *Gifts*

On November 18, 2010, Mrs. Cecil transferred, by gift and in undivided equal shares, her interest in one share of TBC class A common stock to Bill Cecil and Dini Pickering. Two new stock certificates were created for Bill Cecil and Dini Pickering, each certificate stating that "[t]he sale, transfer, assignment or pledge of this stock certificate is restricted **[**15]** pursuant to the terms of a Shareholder Agreement dated the 16 day of December 2009."

On November 19, 2010, Mr. Cecil, in his capacity as trustee of the William A.V. Cecil Revocable Trust, transferred 9,337 shares of TBC class B common stock to himself. On the same day, he transferred by gift his interest in those shares to petitioners' five grandchildren, in separate trusts, as follows:

Donee		***Class B Common Stock***	
		Shares	***Percentage***[3]
William A.V. Cecil Irrevocable Qualified Subchapter S Trust for Ryan Cecil		1,556.16 and 2/3	15.57%
William A.V. Cecil Irrevocable Qualified Subchapter S Trust for Aubrey Cecil		1,556.16 and 2/3	15.57%
William A.V. Cecil Irrevocable Qualified Subchapter S Trust for Robert Cecil		1,556.16 and 2/3	15.57%
William A.V. Cecil Irrevocable Qualified Subchapter S Trust for Chase Pickering		2,334.25	23.36%
William A.V. Cecil Irrevocable Qualified Subchapter S Trust for Devon Pickering		2,334.25	23.36%
	Total Shares	9,337	

Each stock certificate stated that "[t]he sale, transfer, assignment or pledge of this stock certificate is restricted pursuant to the terms of a Shareholder Agreement dated the 19th day of November 2010." This Shareholder Agreement added the trusts for the grandchildren as signatories. **[**16]**

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[3] These percentages are the percentages which the parties stipulated.

Each gift of the class A and B common stock imposed upon the shareholder the obligation to pay tax on his or her distributive share of TBC's income, with no guaranty of sufficient dividend distributions to pay that tax.

[*11] VII. *Voting Rights and Stock Transfer Restrictions*

TBC's Articles of Incorporation, TBC's Amended and Restated By-Laws as of August 21, 2009 (By-Laws), and the 2009 Shareholders' Agreement set out rights and powers with respect to the TBC stock as of the valuation dates.

The By-Laws regulate how shareholders, board members, and executives control TBC. Each class A common stock shareholder receives one vote per share, with decisions made by the majority of the votes cast. A quorum generally requires the presence of two-thirds of all outstanding class A common stock to be present in person or by proxy.

TBC's board of directors (Board) manages its business and affairs. Class A common stock shareholders elect directors by a majority vote. The presence in person of a majority of the Board constitutes a quorum to transact business. The Board generally acts by a majority vote of the directors. The Board elects officers by majority vote. By majority vote, the Board decides when **[**17]** and whether to make the accounts, books, minutes, and other records of TBC available to stockholders. The Board declares dividends by majority vote.

VIII. *Notices of Deficiency*

Each petitioner timely filed Form 709 for 2010. On the Forms 709, petitioners properly elected to treat the transfers of their stock as split gifts under *section 2513*.[4] Each form included as an attachment an appraisal of the gifts by Dixon Hughes based on a weighted average of the subject shares (using an asset approach and an income approach). Petitioners commissioned the Dixon Hughes appraisal for purposes of reporting their gift tax liabilities on their Forms 709. Petitioners reported a value of $3,308 per share for class A common stock and $2,236 per share for class B common stock. Each petitioner reported total taxable gifts of $10,438,766.

Petitioners' Forms 709 were selected for audit, and respondent ultimately issued petitioners separate notices of deficiency on March 24, 2014. The notices of deficiency disregarded the existence of TBC and attributed no weight to

[4] Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the Tax Court Rules of Practice and Procedure.

its going-concern value. The numerical **[*12]** adjustments in the notices of deficiency reflect the enterprise value of TBC based solely on an asset liquidation assumption. **[**18]**

OPINION

I. *Burden of Proof*

Except as otherwise provided by statute or determined by the Court, the Commissioner's determinations are presumed correct, and taxpayers bear the burden of proving that the determinations are erroneous. *Rule 142(a)*; *Welch v. Helvering, 290 U.S. 111, 115, 54 S. Ct. 8, 78 L. Ed. 212, 1933-2 C.B. 112 (1933)*. The burden of proof (or a portion thereof) may sometimes shift to the Commissioner. *See, e.g.*, *§ 7491(a)* (providing that the burden of proof in a gift tax setting such as here may shift to the Commissioner as to discrete factual issues if certain conditions are met); *Helvering v. Taylor, 293 U.S. 507, 515, 55 S. Ct. 287, 79 L. Ed. 623 (1935)* (holding that the burden of going forward with evidence to establish the amount of a deficiency may shift to the Commissioner where determination is arbitrary and excessive). The record at hand allows us to decide these cases on the basis of a preponderance of the evidence, without regard to which party bears the burden of proof. We therefore proceed to do so and need not and do not decide which party actually bears the burden of proof. *Cf. Blodgett v. Comm'r, 394 F.3d 1030, 1039 (8th Cir. 2005)*, *aff'g T.C. Memo. 2003-212*; *Polack v. Comm'r, 366 F.3d 608 (8th Cir. 2004)*, *aff'g T.C. Memo. 2002-145*; *Knudsen v. Comm'r, 131 T.C. 185, 189 (2008)*, *supplementing T.C. Memo. 2007-340*; *Deskins v. Commissioner, 87 T.C. 305, 322 n.17 (1986)*.

II. *Gift Valuation*

A. *In General*

A tax is imposed on the transfer of property by gift during a calendar year. *§ 2501*. The value of a gift made in property is "the value thereof **[**19]** at the date of the gift." *§ 2512(a)*. That value is "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." *Treas. Reg. § 25.2512-1*; *see also Rev. Rul. 59-60, 1959-1. C.B. 237*. The willing buyer and the willing seller are hypothetical persons rather than specific individuals or entities, and the characteristics of these hypothetical persons are not necessarily the same as the personal characteristics of the actual seller or a particular buyer. *Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990)*. The valuation of stock is **[*13]** ultimately a question of fact in which the trier of fact must weigh all relevant evidence and draw appropriate inferences. *CSX Transp., Inc. v. Ga. State Bd. of Equalization, 552 U.S. 9, 18, 128 S. Ct. 467, 169 L. Ed. 2d 418 (2007)*; *Hamm v.*

Commissioner, 325 F.2d 934, 938 (8th Cir. 1963), *aff'g T.C. Memo. 1961-347*; *Bank One Corp. v. Comm'r, 120 T.C. 174, 306 (2003)*, *aff'd in part, vacated in part on other grounds, and remanded in part sub nom. JPMorgan Chase & Co. v. Commissioner, 458 F.3d 564 (7th Cir. 2006)*.

B. *Valuation Approaches*

1. *Overview*

Generally, three approaches are used to determine the fair market value of property: (1) the market approach, (2) the income approach, and (3) the asset-based approach. The question of which of these approaches to apply in a given case is a question of law. *Bank One Corp., 120 T.C. at 306-07*.

2. *Market Approach*

The market approach compares the subject property with similar property sold in an arm's-length **[**20]** transaction in the same timeframe. *Id. at 307*. This approach values the subject property by taking into account the sale price of the comparable property and the differences between the comparable property and the subject property. *Id.* This approach measures value properly only when the comparable property has qualities substantially similar to those of the subject property. *Id.*

3. *Income Approach*

The income approach capitalizes income and discounts cashflow. *Id.* This approach values property by computing the present value of the estimated future cashflow as to that property. *Id.* The estimated cashflow is ascertained by taking the sum of the present value of the available cashflow and the present value of the residual value. *Id.*

4. *Asset-Based Approach*

The asset-based approach generally values property by determining the cost to reproduce it. *Id.* One example of an asset-based approach in the setting of a nonpublicly traded corporation is to value the corporation on the basis of the fair market value of its net assets (i.e., the fair market value of its assets less its liabilities). **[*14]** *See, e.g., Estate of Jones v. Commissioner, T.C. Memo. 2019-101, at *29*; *Estate of Noble v. Commissioner, T.C. Memo.* ***[**21]*** *2005-2, *2*.

C. *Split Gifts*

Section 2513(a) provides: "A gift made by one spouse to any person other than his spouse shall, for the purposes of this chapter, be considered as made one-half by him and one-half by his spouse," as long as both spouses have properly

signified their consents to that treatment. *Section 2512*, which governs the valuation of gifts, is found in *chapter 12 of subtitle B of the Internal Revenue Code*, which is the chapter containing *section 2513*. Consistent with petitioners' proper election to treat each gift here as a split gift under *section 2513*, we consider those gifts as made one half by Mr. Cecil and one half by Mrs. Cecil.

III. *Experts*

A. *General*

The parties dispute the value of the subject stock, and each party has retained and at trial called experts to testify in support of their or his proffered value of the stock. In deciding valuation cases, courts often hear the views of expert witnesses. *See generally Rule 143(g)* (providing that an expert's direct testimony in a proceeding in this Court is generally "heard" by way of his or her expert report). We are not bound by the opinion of an expert witness, and we may accept or reject expert testimony in the exercise of our sound judgment. *Helvering v. Nat'l Grocery Co., 304 U.S. 282, 295, 58 S. Ct. 932, 82 L. Ed. 1346, 1938-1 C.B. 279 (1938)*; *Bank One Corp., 120 T.C. at 332*; *Estate of Newhouse, 94 T.C. at 217*. We may accept the opinion of one expert over that of another, *see Buffalo Tool & Die Mfg. Co. v. Commissioner, 74 T.C. 441, 452 (1980)*, and **[**22]** we may select what portions of each expert's opinion, if any, to accept, *Parker v. Commissioner, 86 T.C. 547, 562 (1986)*. Because valuation involves an approximation, the figure at which we arrive need not be directly traceable to specific testimony if it is within the range of values that may be properly derived from consideration of all the evidence. *Estate of True v. Commissioner, T.C. Memo. 2001-167, slip op. at 171* (citing *Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976)*, *aff'g T.C. Memo. 1974-285*), *aff'd*, *390 F.3d 1210 (10th Cir. 2004)*.

[*15] B. *Petitioners' Experts*

Petitioners' experts are David Adams and George Hawkins.

1. *Mr. Adams*

a. *Overview*

Mr. Adams works for Adams Capital, Inc., as a business valuation appraiser. He founded Adams Capital, Inc., and beforehand was engaged in business valuation services with Coopers & Lybrand, LLP, and KPMG Peat Marwick, LLP. He has a master's in business administration from Georgia State University and is a member of the American Society of Appraisers. He appraised the subject stock relying exclusively on TBC's representations and financial documentation.

Mr. Adams appraised the stock using the income approach and the market approach. As to the former, he applied the discounted cashflow (DCF) method. As to the latter, he applied the guideline public company (GPC) method **[**23]** and the similar transactions method. He rejected the asset-based approach of valuing TBC's assets directly because the number of shares was too small to force a liquidation and he had heard from TBC's owners and management that TBC would not be liquidated in the foreseeable future. He concluded that TBC is unlikely to be sold within the next 30 years.

b. *DCF*

Mr. Adams concluded for purposes of his DCF analysis that a discount rate of 15% was appropriate based on TBC's weighted average cost of capital. He predicted that TBC would grow by 1% in 2010, 5% in 2011, 5% in 2012, 5% in 2013, 4% in 2014, and 3% in 2015. He totaled his forecasted cashflows, subtracted interest-bearing debt, added back the value of any nonoperating asset, and applied a 30% discount for a lack of marketability to arrive at $9,030,059.

c. *GPC*

The GPC is used to calculate the fair market value of a business on the basis of comparison to publicly traded companies in similar lines of business. The conditions and prospects of companies in similar lines of business depend on common factors such as overall demand for their products and services. Comparable company values are measured on the basis of stock prices. The comparable **[**24]** company value is divided by **[*16]** an earnings parameter (e.g., sales, net income, earnings before interest and taxes (EBIT)) or balance sheet parameter (e.g., total shareholder's equity, assets) to arrive at a valuation multiple. The resulting multiple is applied to the subject company to arrive at its fair market value.

Mr. Adams identified five companies as comparable companies. One company, Peak Resorts, Inc., operates 13 ski resorts in the Midwest and Northeast United States. It offers activities, services, and amenities, such as skiing, snowboarding, dining, lodging, equipment rental and sales, and ski and snowboard instruction. It manages hotels in New Hampshire and Vermont and a restaurant in Pennsylvania. The second company, Pairi Daiza SA, operates a park in Belgium that houses approximately 4,000 animals. It also participates in approximately 30 scientific programs for the conservation of endangered species. The third company, Premier Exhibitions, Inc., presents museum quality touring exhibitions to the public worldwide. It also develops, deploys, operates, and presents exhibition products in exhibition centers, museums, and nontraditional venues; sells merchandise through the **[**25]** internet; publishes exhibition catalogs; and provides ancillary services such as audio tours. The fourth company, Vail Resorts, Inc., operates mountain resorts and urban ski areas in the United States. Its resorts offer various winter and summer recreational activities (such

as skiing, snowboarding, sightseeing, and guided hiking), and offer skiing and snowboarding lessons, equipment rentals, retail merchandise services, dining services, and private club services. Vail Resorts, Inc., also owns and leases commercial real estate and provides real estate brokerage services, and owns and/or manages various luxury resorts and condominiums. The fifth company, Whistler Blackcomb Holdings, Inc., operates a four season mountain resort in Canada and offers a variety of summer and winter activities such as mountain biking, hiking, fishing, golfing, kayaking, tennis, snowmobiling, cross-country skiing, and horseback riding. It also operates 18 bars and restaurants, 19 retail shops, and 22 rental shops.

Mr. Adams's GPC analysis looked at the size, growth, and liquidity of TBC and his comparable companies. It used the last 12 months' (LTM) earnings before income tax, depreciation, and amortization **[**26]** (EBITDA) and LTM EBIT multiples because, he rationalized, TBC is less profitable than the comparable companies because of their larger scale. He applied a 15% discount to the multiples because of TBC's lack of diversification and resistance to technological development. He added cash and subtracted debt from the enterprise **[*17]** value to arrive at a 100% equity value on a noncontrolling, marketable basis and then applied a 30% discount for a lack of marketability to arrive at $10,540,694 on a noncontrolling, nonmarketable basis.

d. *Similar Transactions*

Under the similar transactions method, a value estimate for the subject company is developed by using information obtained from various databases on actual sales of closely held and public businesses. The goal is to define the market for companies operating in the same industry as a subject company by considering the data as a statistical ensemble of value multiples that are representative of the entire market. These valuation multiples are ratios that compare the numerator or the price paid for a controlling interest in a closely held corporation with various measures of operating results in the financial position in the denominator.

Mr. Adams **[**27]** selected six acquisitions as similar transactions. The first acquisition was that of USJ Co., Ltd., which operated a theme park in Japan. Its amenities included restaurants, riding and show attractions, hotels, and shopping and entertainment facilities. The second acquisition was that of Paramount Canada's Wonderland Park, which owns and operates an amusement park. It offers thrill rides, family rides, shopping, splash works, live entertainment, and dining activities. The third acquisition was that of Festival Fun Parks, LLC, which owns and operates family entertainment centers and water parks in the United States. The fourth acquisition was that of American Golf Corp., which owns 22 fee simple and 6 leasehold golf clubs. The fifth acquisition was that of Northern Racing, PLC, which

acquires, manages, and develops horseracing courses in the United Kingdom. The company's nine horseracing courses stage various events ranging from large-scale conferences and banquets to business meetings and music events. The sixth acquisition was that of Sydney Attractions Group, Pty Ltd., which offers management and operation of the Sydney Aquarium in Australia. It also operates Manly Oceanworld, an **[**28]** aquarium; Skywalk, an outdoor viewing adventure; Wildlife World, a zoo; and Koala Gallery, a small wildlife park; and it offers Shark Dive Xtreme, a product for scuba divers to swim with sharks, and OzTrek, a virtual reality ride through Australia's cultural history and geography.

Mr. Adams analyzed and computed purchase price multiples from the revenue, EBITDA, and EBIT of these six companies. After applying **[*18]** the multiples, he added cash and subtracted debt from the indicated enterprise value to arrive at the indicated equity value of 100% on a controlling, marketable basis. He applied a 20% discount for a lack of control and a 30% discount for a lack of marketability to arrive at a 100% equity noncontrolling, nonmarketable basis of $12,161,048.

e. *Final Values*

Mr. Adams chose a combination of the income and market approaches to ascertain the fair market value of the subject stock because, he concluded, a buyer of a restricted minority interest would assume continuation of TBC based on existing dividend trends, rather than assume any liquidation in the face of the opposition to liquidation. He gave each of his methods a weighted average. He gave the DCF method a weighted average of 50% **[**29]** because it was based on TBC's financial projections, expectations, and risk factors. He gave each of the GPC and the similar transactions methods an equal weighted average of 25%. His analysis also included looking at various methods to apply "tax affecting" (discussed *infra* pp. 25-27), and he arrived at one value for each class of stock if he took tax affecting and the 2009 Shareholders' Agreement into account and another value if he did not. His final values included a 30% discount for a lack of marketability and a 20% discount for a lack of control. He concluded that the class A common stock and the class B common stock had a fair market value of $1,019 per share on November 18, 2010, with tax affecting and the shareholder agreement in effect, and that the class B shares of TBC were worth $1,614.71 per share without tax affecting and the shareholder agreement in effect.

2. *Mr. Hawkins*

a. *Background*

Mr. Hawkins of Bannister Financial in Charlotte, North Carolina, specializes in business valuation of closely held companies and the type of stock interest at issue. He holds a bachelor's in economics from the University of North Carolina at Chapel Hill and a master's in business administration **[**30]** from Wake Forest University. He is an accredited senior appraiser in business valuation and a chartered financial analyst.

b. *Capitalization of Net Cashflow*

Mr. Hawkins valued the subject stock using the income approach's capitalization of net cashflow method. This method **[*19]** measures the dividend or distribution paying capacity of the company being valued by applying an appropriate capitalization rate that incorporates the investor's required rates of return for risk and a factor for future growth in earnings (or net cashflow). He ascertained that TBC has a net cashflow of $1,162.60 and a capitalization rate of 0.107. Dividing the net cashflow by the capitalization rate rendered a preliminary value of equity of $10,865.40 as if TBC was a C corporation.

Mr. Hawkins then tax affected the preliminary value using the S Corporation Economic Adjustment Model (SEAM). The SEAM values the S corporation's shares as if the S corporation paid the same level of taxes as a C corporation. He used TBC's dividend/distribution payout ratio, the taxes that would be paid on its income, dividends, and any capital gains on shares to calculate the difference in the net tax benefit realized by the company as a **[**31]** C corporation and as an S corporation. He ascertained that there would be a 24.6% greater after tax benefit of an S corporation in these cases. He tax affected what he had ascertained was the preliminary value of equity by a rate of 24.6% to arrive at an adjusted S corporation value of common equity of $13,638.30. After dividing the adjusted S corporation value of common equity by the number of outstanding shares, he arrived at a preliminary fair market value per share of $1,353.83.

c. *GPC*

Mr. Hawkins also used the market approach's GPC method to value the subject shares. He used Cedar Fair, L.P. (Cedar Fair), as a comparable company because theme parks are a competitor of TBC and it is similarly aligned with the services offered. Cedar Fair operates in the United States 11 amusement parks, 6 water parks, and 5 hotels. Of Cedar Fair's total 2009 revenues, 58.2% came from admissions, 34.5% from food, drink, and games, and the remaining 7.3% from accommodation and other. He viewed these percentages as similar to TBC's 2009 revenues from admissions, restaurants and merchandise, and from all other sources, respectively.

After comparing the size, profitability, return on equity, growth trends, **[**32]** business opportunities, diversification, financial strength, and distributions of Cedar Fair and TBC, Mr. Hawkins selected the Market Value of Invested Company to Earnings Before Income Taxes, Depreciation, and Amortization (MVIC/EBITDA) value multiple. He applied the MVIC/EBITDA value multiple to two time frames: (1) the EBITDA of the trailing 12 months (TTM) of the valuation date and **[*20]** (2) the median of 2006 to TTM. He applied the multiples to TBC's adjusted EBITDA to arrive at the preliminary values of $1,508.10 and $1,661.53.

He applied a 25% discount for a lack of marketability and a 2% discount for a lack of voting rights to the GPC method. He concluded that the applicable fair market value of the class A common stock was $1,131 per share and that the applicable fair market value of the class B common stock was $1,108 per share.

d. *Asset-Based Valuation*

Mr. Hawkins chose not to value the subject stock on the basis of TBC's assets because he was valuing a minority issue with no power to force a liquidation. He rationalized that TBC's shareholders would not liquidate given that TBC had survived through four generations of the family of Cornelia Cecil and was the subject of the 2009 **[**33]** Shareholders' Agreement. He concluded that a willing buyer with knowledge of these facts would assume that it was too speculative to believe that he or she would realize anything significant from the underlying assets.

C. *Respondent's Experts*

Respondent's experts are Gretchen Wolf and Robert Morrison.

1. *Ms. Wolf*

Ms. Wolf appraises art for the IRS Office of Art Appraiser Services. She has a certification in appraisal studies for fine and decorative arts from George Washington University and attended programs at the University of Virginia's Rare Book School and Georgetown University for continuing coursework in rare books and fine arts. She has completed valuation training with the American Society of Appraisers.

Ms. Wolf valued the five aforementioned works of art owned by TBC using the market comparison approach. She looked at comparable sales that had taken place in high-end auction houses and the retail market where private sales

take place. She did not value the artwork using the income approach because the artwork has little income-producing **[*21]** value to TBC. She appraised the artwork at a total of $13,250,000 as of November 19, 2010.[5]

2. *Mr. Morrison*

a. *Background*

Mr. Morrison works **[**34]** for Morrison Valuation and Forensic Services as a forensic accountant and business appraiser. He has a bachelor's of science in finance from Miami University (Ohio) and a master's in business administration from the University of Central Florida. He has an accredited senior appraisers certification and an intangible asset certification.

b. *NAVM*

Mr. Morrison appraised the subject stock using the asset-based approach's net asset value method (NAVM). The general premise of the NAVM is that value equals the sum of the market values of all assets, including those assets which may not be recorded on the company's balance sheet, less the share of the market values of liabilities. He applied the NAVM in two steps. First, he identified all assets and liabilities of TBC regardless of whether they were recorded on the balance sheet and ascertained the fair market value of the assets and liabilities identified. Second, he ascertained an appropriate adjustment to reflect the noncontrolling nature of the subject stock.

TBC's reported assets were $53,580,000 and its liabilities were $33,349,000 on November 30, 2010. The difference of $20,231,000 is the net asset value (NAV) before adjustments. Mr. Morrison **[**35]** made two types of adjustments: reclassification adjustments (which do not affect the NAV) and valuation adjustments. He made the following valuation adjustments.

Real Estate. Mr. Morrison relied on a real estate appraisal report prepared by Ducksworth, Jacobs, Naeger, Swicegood & Thrash, LLC (Duckworth Appraisal). The effective date of the Duckworth Appraisal is December 31, 2009, almost 11 months before the valuation date. During those 11 months, the value of agricultural land in North Carolina declined approximately 2%. Mr. Morrison adjusted the Duckworth Appraisal downward by 2% which resulted in a real estate **[*22]** value of $95,922,000. This resulted in an increase of $71,652,000 to his NAV.

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[5] As indicated *infra* p. 22, Mr. Morrison, in taking into account TBC's collectible portfolio, relied on Ms. Wolf's appraisal.

Collectible Portfolio. Mr. Morrison took into account TBC's portfolio of fine art, antiques, and other collectibles. He relied on an appraisal report from Christie's Appraisal, Inc., which estimated that those items had a total fair market value of $37,947,000 on December 31, 2009 (Christie's Appraisal). The appraisal was later supplemented to include additional collectibles valued at $3,474,000 (Christie's Supplement). He also relied on Ms. Wolf's appraisal. His combining the Christie's Appraisal **[**36]** value (unadjusted for Ms. Wolf's appraisal value) with the Christie's Supplement value resulted in a total value of $41,421,000 for TBC's collection. This resulted in an increase of $41,421,000 to his NAV.

Installment Note Receivable. TBC reported on its balance sheet that the installment note that it received in the West Range sale/leaseback transaction had a value of $554,000, the amount deferred on the gain. Mr. Morrison adjusted the value of the note to $2,700,000, the amount of the remaining payments. This resulted in an increase of $2,146,000 to his NAV.

Trademarks and Trade Name. Mr. Morrison employed the Relief from Royalty Method (RFRM) to value TBC's trademarks and trade name. The premise of the RFRM is that the value of the asset is equal to the present value of future royalties to license and use the asset as if it did not own the asset (hence, relief from royalty). Using the RFRM, he estimated the value of TBC's trademarks and trade name was $9,514,000. This resulted in an increase of $9,514,000 to his NAV.

Workforce-in-Place. Mr. Morrison estimated that TBC had 1,700 workers in place and rationalized that, while many of these workers were unskilled, hourly employees, the **[**37]** assemblage of this workforce-in-place had value. He ascertained the value using the replacement cost method (RCM). The premise of the RCM is that the value today equals the cost to reproduce/replicate the asset. He ascertained that the value of the workforce-in-place was $1,624,000. This resulted in an increase of $1,624,000 to his NAV.

After he made the valuation adjustments, the NAV was $146,587,000. The NAVM assumes a marketable, liquid, and controlling interest whereas the subject stock is nonmarketable, illiquid, and noncontrolling. To adjust for this, Mr. Morrison looked in markets **[*23]** for noncontrolling interests and chose real estate limited partnerships (RELP) and closed-end funds (CEF). He rationalized that his observed prices to NAV (P/NAV) of RELPs and CEFs that held assets similar to TBC's provided some guidance as to a proper adjustment. For purposes of this analysis, he considered all of the operating assets (excluding real estate) as a portfolio of assets, then considered each asset individually. After he estimated the P/NAV of RELPs and CEFs, the value indicated by the NAVM is $92 million on a noncontrolling but marketable and liquid basis.

c. *DFBM*

Mr. Morrison also valued **[**38]** the subject stock using the income approach's discounted future benefits method (DFBM). The DFBM values a company at the present value of expected future periodic income benefit stream during a discrete time plus residual value at the end of the period and discounts for the relative risk of expected future returns. He employed the following seven steps to ascertain value under the DFBM: (1) selected the benefit stream to be used; (2) projected the future annual benefit streams until the company reaches stabilization; (3) estimated the residual or terminal value of the company at the end of the discrete projection period; (4) estimated an appropriate discount rate for the company that compensates both the equity holders and the debt holders of the company and a stabilized long-term rate of growth; (5) discounted all future benefit streams, including the residual value, to present value; (6) adjusted, as appropriate, for nonoperating assets and/or liabilities; and (7) applied any necessary valuation adjustment.

Mr. Morrison chose an after-tax net cashflow to equity (NCF) benefit stream because the data used to develop capitalization rates and discount rates are based on after-tax cashflows. **[**39]** After projecting the future annual benefit streams, he used the single-period capitalization model (SPCM) to estimate the residual or terminal value. He opined that the premise of the SPCM is that the stabilized NCF at the end of the discrete projection period will grow into perpetuity at some stabilized level of annual growth. He ascertained that the terminal value as of the end of the discrete period is determined by capitalizing that stabilized NCF; and by using a growth rate of 3%, he ascertained that the stabilized benefit stream of the last year of the discrete projection period was $1,773,000. He used a 16% cost of equity as his discount rate. After discounting the future benefits streams, the sum of all present values of all cashflows is $12,931,000. Because TBC is an S corporation, Mr. Morrison used the SEAM method to tax affect at a **[*24]** premium of 17.6%. He next added the values for various nonoperating assets. Using the DFBM, he reached a value of $36 million.

d. *Reconciliation of Two Approaches*

In reconciling his two approaches, Mr. Morrison concluded that the P/NAVs may not actually reflect TBC's circumstances because TBC, contrary to RELPs and CEFs, does not seek to maximize **[**40]** its assets. He also recognized that the DFBM is superior but chose to incorporate the NAVM into his final evaluation. Ultimately, he assigned a 90% weight to the DFBM and assigned a 10% weight to the NAVM. He also ascertained and took into account discounts for a lack of marketability of 19% for the class A common stock, 22% for the smaller block of class B common stock, and 27% for the larger block of class B common stock. His resulting values were $4,000 per share for

the class A common stock, $3,066 per share for the 2,334.25 larger block of class B common stock, and $3,276 per share for the 1,556.16 2/3 smaller block of class B common stock.

D. *Summary*

Below is a summary of the fair market values ascertained by each expert less Ms. Wolf (three relevant experts):

Class of Stock	**Adams**	**Hawkins**	**Morrison**
Class A Common	$1,019.00 (with tax affecting)	$1,131 (with tax affecting)	$4,000 (with tax affecting)
Class B Common (Smaller Block)	1,019.00 (with tax affecting) 1,614.71 (without tax affecting)	1,108 (with tax affecting)	3,276 (with tax affecting)
Class B Common (Larger Block)	1,019.00 (with tax affecting) 1,614.71 (without tax affecting)	1,108 (with tax affecting)	3,066 (with tax affecting)

[*25] IV. *Tax Affecting*

With the exception **[**41]** of Ms. Wolf, whose appraisal was limited to the five pieces of artwork, all experts agree that "tax affecting" must be considered to ascertain the fair market value of the subject stock because an S corporation such as TBC, unlike a C corporation, generally does not pay income tax. Where, as here, the data used to value an S corporation are largely based on the data from C corporations, proponents of tax affecting believe that the mismatch from pretax cashflows and after-tax discount rates must be adjusted through tax affecting to ascertain the fair market value of the S corporation. *See* *Dallas v. Commissioner, T.C. Memo. 2006-212, slip op. at 7 n.3* (stating that "in the context of valuation of stock of an S corporation, 'tax affecting' is the discounting of estimated future corporate earnings on the basis of assumed future tax burdens imposed on those earnings, such as from the loss of S corporation status and imposition of corporate-level tax").

In *Gross v. Commissioner, T.C. Memo. 1999-254*, *aff'd*, *272 F.3d 333 (6th Cir. 2001)*, we held that tax affecting was improper in valuing an S corporation. There, the taxpayer sought tax affecting and the Commissioner argued against it. We held

that "[a]s a theoretical **[**42]** matter, we do not believe that 'tax-affecting' an S corporation's projected earnings is an appropriate measure to offset that potential burden associated with S corporations." *Id. T.C. Memo 1999-254*. We concluded that

> the principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation.

Id. T.C. Memo 1999-254.

We continued to reject applying tax affecting to determine an S corporation's fair market value. *See Estate of Gallagher v. Commissioner, T.C. Memo. 2011-148, slip op. at 32*, *supplemented by T.C. Memo. 2011-244* (finding tax affecting not appropriate where appraiser failed to explain his reasoning for tax affecting); *Dallas, T.C. Memo. 2006-212* (finding tax affecting not appropriate when the taxpayer presumed that an S corporation would lose its S corporation status after a sale); *Wall v. Commissioner, T.C. Memo. 2001-75, slip op. at 27 n.19* ("[T]ax-effecting an S corporation's income, and then **[*26]** determining the value of that income by reference to the rates of return on taxable investments, means **[**43]** that an appraisal will give no value to S corporation status."); *see also Estate of Giustina v. Commissioner, 586 F. App'x 417 (9th Cir. 2014)*, *rev'g and remanding T.C. Memo. 2011-141*.

In *Estate of Jones, T.C. Memo. 2019-101*, however, we concluded that tax affecting was appropriate in that setting. There, the parties agreed that a hypothetical buyer and seller would take into account the entity's business form when determining the value of a limited partner interest; they simply disagreed on how to account for it. The Commissioner argued that a zero percent tax rate should apply. The Commissioner disagreed with his experts, who were largely silent except to point out that the taxpayer's tax affecting was improper, not because the business paid entity level tax, but because the nature of the business meant that its rates of return were closer to the property rates of tax. Thus, we did "not have a fight between valuation experts but a fight between lawyers." *Id. 2019 Tax Ct. Memo LEXIS 108 at *39*.

Most recently, in *Estate of Jackson v. Commissioner, T.C. Memo. 2021-48*, we did not find tax affecting appropriate. There, all of the estate's experts agreed that the buyer would be a C corporation and that the value should be tax affected to account for the tax liability of the C corporation. **[**44]** Each expert, however, used a different tax rate. The Commissioner's experts strongly disagreed that tax affecting was appropriate. We distinguished *Estate of Jones* by noting that *Estate of Jones* was a situation where the experts agreed to take into account the form of the business entity and

agreed on the entity type. We held that tax affecting would not be appropriate because the estate's experts had not persuaded us that the buyers would be C corporations. *Id. 2021 Tax Ct. Memo LEXIS 74 at *82*. We also stated, though, that

> [w]e do not hold that tax affecting is never called for. But our cases show how difficult a factual issue it is to demonstrate even a reasonable approximation of what that effect would be. In *Estate of Jones*, there was expert evidence on only one side of the question, and that made a difference.

*Id. 2021 Tax Ct. Memo LEXIS 74 at *82-83*.

Here, experts on both sides agree that tax affecting is necessary to value the subject stock. Messrs. Morrison and Hawkins also agree **[*27]** that the SEAM method is the appropriate method to employ in the setting at hand to account for tax affecting and that a factor of at least 17.6% applies here for that purpose. As we observed in *Estate of Jackson*, there is not a total bar against the use **[**45]** of tax affecting when the circumstances call for it. Now given that each side's experts (with the exception of Ms. Wolf who did not opine on this point) totally agree that tax affecting should be taken into account to value the subject stock, and experts on both sides agree on the specific method that we should employ to take that principle into account, we conclude that the circumstances of these cases require our application of tax affecting. While Messrs. Morrison and Hawkins do not agree on the specific rate that applies here to implement tax affecting (Mr. Hawkins determined the rate to be 24.6% while Mr. Morrison determined the rate to be 17.6%), we consider it appropriate on the basis of the record (and relying on Mr. Morrison's opinion in this regard) to set that rate at 17.6%. We emphasize, however, that while we are applying tax affecting here, given the unique setting at hand, we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation.

V. *Our Impression of the Experts*

A. *Mr. Morrison*

We are unpersuaded by Mr. Morrison's opinion on the fair market value of the subject stock. In that TBC is an **[**46]** operating company whose existence does not appear to be in jeopardy, and not a holding company, we believe that TBC's earnings rather than its assets are the best measure of the subject stock's fair market value. *See Estate of Ford v. Commissioner, T.C. Memo. 1993-580, T.C. Memo 1993-580, 1993 Tax Ct. Memo LEXIS 595, at *14 (1993)* ("[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."), *aff'd*, *53 F.3d 924 (8th Cir. 1995)*.

Mr. Morrison's reliance on the asset-based approach also appears to be inconsistent with the Uniform Standards of Professional Appraisal Practice (USPAP). USPAP Standards Rule 9-3 states:

> In developing an appraisal of an equity interest in a business enterprise with the ability to cause liquidation, an appraiser must investigate the possibility that the business enterprise may have a higher value by liquidation **[*28]** of all or a part of the enterprise . . . . However, this typically applies only when the business equity being appraised is in a position to cause liquidation.

That is not the setting here. The liquidation of TBC is most unlikely (if likely at all) in that a hypothetical buyer and seller would need to (1) acquire additional shares in order to cause TBC's liquidation; (2) **[**47]** convince other shareholders to vote for a liquidation; or (3) wait until the shareholders or their heirs decide to liquidate TBC, and we consider each of these three events unlikely to occur. Bill Cecil, Dini Pickering, Chase Pickering, Aubrey Cecil, and Ryan Cecil all credibly testified that they had no intention of selling their TBC stock or liquidating TBC, and we find that testimony as a fact. In so doing, we decline respondent's request to disregard that testimony as self-serving. The mere fact that a witness's testimony may serve his or her interests does not necessarily mean that we will disregard that testimony as untrustworthy. *See, e.g.,* *Diaz v. Commissioner, 58 T.C. 560, 564 (1972)*. Our acceptance of their credible "self-serving" testimony is even more appropriate here, where documentary and other evidence supports that testimony. The 2009 Shareholders' Agreement and the 1999 Voting Trust sufficiently established that petitioners, their children, and their grandchildren aspired to keep TBC in their family by restricting the transfer of stock outside of the family. We also understand the family's holding of the annual meetings to serve strategically to minimize and control business disputes that could occur within the **[**48]** family, to obviate any TBC shareholder's rogue attempt to sell his or her TBC shares to an outsider, and to make most unlikely any breakup of TBC similar to the breakup effected by Mr. Cecil and his brother in 1979. These meetings also serve to groom TBC's shareholders to manage TBC as a family asset. The fact that TBC has been in the family since its incorporation in 1932 also speaks loudly to the fact that the Cecil and the Pickering families are committed to maintaining TBC as a family business.

We assign zero weight to Mr. Morrison's valuation opinion.

B. *Mr. Hawkins*

We also have concerns with the thrust of Mr. Hawkins's valuation opinion. In using the GPC method to value the subject stock, he relied on a single company, Cedar Fair. We have previously held that it is inconceivable that a hypothetical buyer would consider only a single alternative comparable. *See Estate of Hall v. Commissioner, 92 T.C. 312, 339-40 (1989)*. Although Cedar Fair does operate competitors of TBC, **[*29]** the lack of multiple comparable companies renders his GPC appraisal suspect. Furthermore, TBC lacks the traditional features of its competitors such as diversification. Cedar Fair is larger, more diversified, and more profitable than TBC.

Nor did we view Mr. Hawkins during **[**49]** his trial testimony to express much confidence in his GPC analysis. He acknowledged that Cedar Fair operates at a national level while TBC operates at a regional level. He acknowledged that Cedar Fair's 2009 admissions revenue is significantly greater than TBC's 2009 admissions revenue. He acknowledged that Cedar Fair's 2009 pretax profit was significantly greater than TBC's 2009 pretax profit. While multiples could be found that would have made Cedar Fair more comparable, the fact that Cedar Fair is the only comparable company Mr. Hawkins used and that it is so different renders questionable his decision to give the GPC method a 50% weight.

We also find fault with Mr. Hawkins's application of the capitalization of net cashflow method. In his calculations, he used TBC's median 2006 to TTM 2010 EBT. Between 2007 and 2009, the United States and much of the world experienced the Great Recession, the worst economic downturn since the Great Depression. Given the timing of the Great Recession and TBC's loss for 2008, the only year since 1995 that TBC had realized a loss, we consider the 2008 loss to be an aberration in TBC's financial operations and do not think it was appropriate for Mr. **[**50]** Hawkins to have included TBC's 2008 financial information in his analysis. While we recognize that his use of the median rather than the average helps mitigate the distortion caused by the Great Recession, the distortion is large enough that it renders his analysis on this point unpersuasive.

C. *Mr. Adams*

Mr. Adams's application of the GPC and similar transactions methods also has flaws. In his GPC valuation, he found five comparable companies. Two of those companies are not comparable at all. TBC is in the business of historic hospitality. Its guests enjoy retail shopping, restaurants, and various outdoor activities in an environment reminiscent of the Gilded Age. While Peak Resorts, Inc., Vail Resorts, Inc., and Whistler Blackcomb Holdings, Inc., operate resorts that similarly offer various outdoor activities in the hospitality business, the same is not true as to Pairi Daiza SA and Premier Exhibitions, Inc. The former operates a park which houses thousands of animals, and it does **[*30]** so at a location (in Belgium) that is vastly different from western North Carolina. The latter presents museum exhibitions

outside of the hospitality industry and does that worldwide while TBC's operation **[**51]** is limited to a single city, Asheville, and the surrounding area.

With regard to Mr. Adams's similar transactions valuation, two of the six transactions occurred during the Great Recession. American Golf Corp. was acquired on October 29, 2008, and Sydney Attractions Group, Pty Ltd., was acquired on February 29, 2008, and we find it most likely that the Great Recession affected the purchase prices in those two transactions. We also add that American Golf Corp. and Sydney Attractions Group, Pty Ltd., are not in the same hospitality industry as TBC. The former owns and operates golf courses. The latter primarily operates the Sydney Aquarium. We fault Mr. Adams for including those two transaction in his analysis.

Notwithstanding the flaws in Mr. Adams's applications of the GPC and similar transactions methods, however, we do not find those flaws to be fatal to his overall opinion. It is abundantly clear that TBC is a unique company and finding an exact match would be near to impossible. We consider it noteworthy that Mr. Adams assigned only a 25% weight to each method, which as we see it, adds a degree of reliability to his application of the GPC and similar transactions method.

Most importantly, **[**52]** the thrust of his overall opinion is his application of the DCF method, an application with which we find no fault. Indeed, on brief, respondent urges us to adopt Mr. Adams's valuation based on his DCF analysis with one correction. After determining the MVIC, Mr. Adams added back the value of TBC's nonoperating asset, which was TBC's excess debt-free working capital. Respondent contends that the installment note from the West Range transaction, accounts receivable from the shareholders, and Busbee Mountain were nonoperating assets whose value should also be added back. We disagree. Mr. Adams included the excess debt-free working capital because it added value to the TBC stock in that TBC funds would be available for distribution to the shareholders at the end of the year. TBC's underlying assets did not add any value to the TBC stock.

D. *Conclusion*

We find flaws with Mr. Hawkins's and Mr. Morrison's analyses that lead us to disregard the thrust of their opinions on the fair market **[*31]** value of the subject stock. While there are issues with Mr. Adams's application of the GPC and similar transactions methods, we find that his valuation (exclusive of the discounts discussed below), with one **[**53]** adjustment, is the truest value of the subject stock's prediscount fair market value. The single adjustment, as discussed above, is that tax affecting should be reflected at a rate of 17.6%.

VI. *Applicable Discounts*

A. *Discount for a Lack of Control*

Mr. Adams applied a discount for a lack of control to the similar transactions method because, he surmised, a prudent investor would not pay full value for a noncontrolling interest. TBC's owners also made no effort to sell TBC in the marketplace and had previously rejected overtures to sell TBC. Mr. Adams reviewed publicly announced transactions of noncontrolling interests and arrived at a 20% discount for a lack of control.

Mr. Morrison looked at various RELPs and CEFs, which often trade at discounts for a lack of control, and arrived at a 38% discount. We disagree with Mr. Morrison's discount because his analysis focused on businesses holding investments rather than on operating companies like TBC. We accept Mr. Adams's discount rate of 20% for a lack of control.

B. *Discount for a Lack of Voting Rights*

Mr. Hawkins applied a 2% discount in valuing the class B common stock because, he concluded, that stock lacked voting rights. That conclusion **[**54]** is not totally accurate in that class B shareholders can vote in limited circumstances. Mr. Hawkins also misrelied on two studies which analyzed data from 1994 and 1999. Those data are too old. Furthermore, in arriving at their values, each of the three relevant experts already accounted for the fact that he was valuing a nonvoting minority interest. We decline to apply a discount for a lack of voting rights.

C. *Discount for a Lack of Marketability*

Each of the three relevant experts applied a discount for a lack of marketability because the shares are not registered for public sale or sold on public markets. Mr. Adams applied a discount rate of 30% to each method he used. Mr. Hawkins applied a 25% discount rate. Mr. **[*32]** Morrison applied a discount rate of 19% to the class A common stock, of 22% for the smaller block of class B common stock, and of 27% for the larger block of class B common stock.

In arriving at his discount rate, Mr. Adams looked at studies of the sales of temporarily restricted shares of otherwise publicly traded companies (letter stock) and sales of closely held companies before subsequent initial public offerings (IPO). He also conducted a put option analysis. We are **[**55]** not sold on that process. The studies that Mr. Adams relies on analyze data that are too old, e.g., the latest study looks at data from 1969 to 1992, and most of the studies look at data from the 1970s and 1980s. He also admits that the pre-IPO studies are unreliable and may overestimate or

underestimate actual marketability discounts. And as for his put option analysis, which produced a range of discount rates from 11.6% to 22.6%, we cannot fathom how that analysis supports his final discount rate of 30%.

We turn to the discount rates ascertained by Mr. Hawkins and Mr. Morrison. We conclude that the appropriate discount rates are the three rates that Mr. Morrison ascertained. It is logical for us to conclude that the smaller blocks of class B common stock would be more easily marketed than the larger blocks of the class B common stock. We also agree with Mr. Morrison that different discount rates should apply to the two classes of stock because the voting rights that attach to the class A stock should make that class of stock more marketable than the class B common stock.

VII. *Conclusion*

We accept the valuation reached by Mr. Adams before he took into account any tax affecting and before **[**56]** he applied any discounts. We accept Mr. Adams's 20% discount for a lack of control and Mr. Morrison's discount rates of 19%, 22%, and 27% for a lack of marketability.

We have considered all of the arguments made by the parties and, to the extent they are not addressed herein, we find them to be moot, irrelevant, or without merit.

To reflect the foregoing,

Decisions will be entered under Rule 155.

End of Document

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Schlapfer v. Comm'r

United States Tax Court

May 22, 2023, Decided; May 22, 2023, Filed

Docket No. 419-20.

Reporter

T.C. Memo 2023-65 *; 2023 Tax Ct. Memo LEXIS 67 **

RONALD SCHLAPFER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Subsequent History: Summary judgment granted by, Summary judgment denied by, Motion denied by, As moot

Schlapfer v. Comm'r, 2023 U.S. Tax Ct. LEXIS 2445 (T.C., May 23, 2023)

Disposition: An appropriate order and decision will be entered.

Case Summary

Overview

HOLDINGS: [1]-Pursuant to *I.R.C. § 6501*, a taxpayer adequately disclosed a gift of a life insurance policy on his 2006 gift tax return such that the period of limitations to assess the gift tax commenced when the return was filed, and the Commissioner of Internal Revenue was barred from assessing a gift tax thereon because the Commissioner issued the notice of deficiency more than three years after the disclosure; [2]-In particular, the documents that the taxpayer attached to and referenced in his 2006 gift tax return provided the Commissioner with enough information to satisfy the adequate disclosure requirement, and as the Commissioner issued the notice of deficiency more than three years after the filing, the Commissioner was barred from assessing a gift tax.

Outcome

Taxpayer's motion granted.

Counsel: [1]** Scott D. Michel, Ross R. Sharkey, Christopher S. Rizek, and Jeffrey S. Stephens, for petitioner.

Blake J. Corry, William Benjamin McClendon, and Randall S. Trebat, for respondent.

Judges: BUCH, Judge.

Opinion by: BUCH

Opinion

MEMORANDUM OPINION

BUCH, *Judge*: This case is before the Court on Cross-Motions for Summary Judgment. Ronald Schlapfer was the policyholder of a life insurance policy issued in 2006. The policy was funded by stock and cash from European Marketing Group, Inc. (EMG), an entity solely owned by Mr. Schlapfer. Mr. Schlapfer assigned ownership of the policy to his mother, aunt, and uncle.

In 2013, Mr. Schlapfer submitted a disclosure packet to the Internal Revenue Service (IRS) Offshore Voluntary Disclosure Program (OVDP). In this packet, he included a gift tax return for 2006 that informed the IRS that he had made gifts of EMG stock to his mother, aunt, and uncle. The IRS concluded that he made the gifts in 2007, not 2006, and that because he failed to file a gift tax return for that year, he did not adequately disclose the gift to commence the period of limitations on assessment.

[*2] The Commissioner generally has three years from the filing of a gift tax return to assess additional tax. If no return is **[**2]** filed, or if the gift is not adequately disclosed on or with the gift tax return, then the Commissioner may assess at any time. But the adequate disclosure of a completed gift on a gift tax return will commence the running of the period of limitations for assessment of gift tax on the transfer even if the transfer is ultimately determined to be an incomplete gift.

Mr. Schlapfer adequately disclosed the gift on his 2006 gift tax return. The documents he attached to, and referenced in, his return provided the Commissioner with enough information to satisfy adequate disclosure. Therefore, the period of limitations to assess the gift tax commenced when the return was filed; and because the Commissioner issued the notice of deficiency more than three years after the filing, the Commissioner is barred from assessing gift tax.

Background

Ronald Schlapfer has ties to both the United States and Switzerland. He was born in Switzerland in 1950 and remained there until 1978. While in Switzerland, he began a career in banking and finance, working at Bank Vontobel and then Citibank. In 1979 he moved to the United States with his first wife, whom he met while working in Tokyo. He moved

to the United **[**3]** States to continue his career at Citibank. Through Citibank, Mr. Schlapfer obtained a nonimmigrant visa, which required a declaration that he did not intend to permanently reside in the United States. He later obtained a U.S. green card. Other than his wife, Mr. Schlapfer's immediate family, which included his mother, brother, aunt, and uncle, remained in Switzerland.

Mr. Schlapfer and his first wife had two daughters, who were born in 1979 and 1981. They all lived together in the United States until 1989 when Mr. Schlapfer and his first wife divorced. Thereafter, his first wife and their two daughters moved to Switzerland. His daughters returned to the United States in the mid-1990s for school.

Mr. Schlapfer married his current wife, Linda Schlapfer (Mrs. Schlapfer), in 1990. Like Mr. Schlapfer, she had been married previously. She and her first husband moved to the United States in 1978 and had a daughter in 1979. They divorced in the late 1980s. Mrs. Schlapfer married Mr. Schlapfer in 1990, and they had a son together in 1992.

[*3] After leaving Citibank in 1998, Mr. Schlapfer started his own businesses. First, he started a currency trading company in the United States called Tradex. Then **[**4]** in 2002, he formed EMG. EMG was a Panamanian corporation that managed investments, holding marketable securities and cash. Mr. Schlapfer owned all of its issued and outstanding shares (namely, 100 shares of common stock).

On May 18, 2007, Mr. Schlapfer applied for U.S. citizenship, and in 2008 he became a U.S. citizen.

I. *The Life Insurance Policy*

On July 7, 2006, Mr. Schlapfer applied for a LifeBridge Universal Variable Life Policy (UVL Policy) offered by swisspartners Insurance Company SPC Ltd. (Swisspartners). Mr. Schlapfer's stated purpose for doing so was to create and fund a policy that his mother, aunt, and uncle could use to benefit his nephews, whose dad (Mr. Schlapfer's brother) had died in 1994. The application listed Mr. Schlapfer as the policyholder, his mother, aunt, and uncle as the insured lives, Mr. Schlapfer and Mrs. Schlapfer as the primary beneficiaries, and Mr. Schlapfer's three children and stepchild as the secondary beneficiaries. It also indicated that AIG Private Bank, Zurich (AIG) had been selected as custodian, meaning policy assets would be held there. On September 22, 2006, UVL Policy No. XXX-X03-06 was issued bearing the same policyholder, insured lives, **[**5]** primary and secondary beneficiaries, and custodian as requested in the application.

Mr. Schlapfer funded the UVL Policy premium with $50,000[1] and 100 shares of EMG.[2] The assets were held in an account at AIG titled "swisspartners Insurance Company SPC Ltd. Rubric: XXX-X03-06" (AIG Account). The initial premium payment was made on August 21, 2006, when EMG transferred $50,000 to the AIG Account. The next premium payment was made on September 22, 2006, when EMG issued a share certificate showing the AIG Account as the owner of all 100 shares of **[*4]** EMG stock. Those shares were transferred to the AIG Account on November 8, 2006.

Mr. Schlapfer eventually substituted his mother, aunt, and uncle for himself as the policyholders. On January 23, 2007, Mr. Schlapfer initially requested that Swisspartners assign the policy to his mother as the policyholder with immediate effect. The next day, his mother signed a revised term sheet that made her the policyholder. Then on April 23, 2007, Mr. Schlapfer and his mother jointly requested that Swisspartners assign the policy so that Mr. Schlapfer's mother, aunt, and uncle would be joint policyholders. They also requested that the beneficiary designations **[**6]** be made irrevocable. These changes were executed on May 31, 2007. All other terms of the policy remained the same.

II. *The Offshore Voluntary Disclosure Program*

In 2012, Mr. Schlapfer entered into the OVDP. The OVDP "offered U.S. taxpayers with undisclosed income from offshore assets a compliance avenue to resolve income tax liabilities" and "tax information reporting obligations." *See* *Internal Revenue Manual 4.63.3.1* (Apr. 27, 2021). When disclosing assets, the OVDP required that taxpayers disregard all entities through which undisclosed assets were held. It also required taxpayers to pay all tax, interest, and penalties related to undisclosed assets during the most recent eight years, regardless of the statute of limitations. *See* I.R.S., *Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers 2012*, Q7, Q9, Q42, https://www.irs.gov/individuals/international-taxpayers/offshore-voluntary-disclosure-program-frequently-asked-questions-and-answers-2012 (last updated June 27, 2021).

On November 20, 2013, Mr. Schlapfer, through counsel, submitted a disclosure packet to participate in the OVDP. The submission included the following items:

- Original Forms 1040, U.S. Individual **[**7]** Income Tax Return, for tax years 2004 through 2009;

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[1] All monetary amounts are shown in U.S. dollars and rounded to the nearest dollar. Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C. (I.R.C.), in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] Shares of an entity called FX Funds, Ltd., were also contributed to the UVL Policy. However, because FX Funds is a dormant entity with no assets, those shares are not relevant.

• Forms 1040X, Amended U.S. Individual Income Tax Return, for tax years 2004 through 2009;

• Forms CT—1040, Connecticut Resident Income Tax Return, and Forms CT—1040X, Amended Connecticut Income Tax Return for Individuals, for tax years 2004 through 2009;

[*5]

• Forms 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations;

• Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for 2006;[3]

• Reports of Foreign Bank and Financial Accounts (FBARs) for tax years 2004 through 2009;

• Bank Statements;

• Foreign Account or Asset Statements;

• A completed Penalty Computation Worksheet;

• A copy of OVDI Prepayment Check No. 2318 to the Department of the Treasury for $6 million for tax years 2004 through 2011;

• Consents, (i) Form 872, Consent to Extend the Time to Assess Tax, and (ii) Consent to Extend the Time to Assess Civil Penalties Provided by *31 U.S.C. § 5321* for FBAR Violations;

• An Offshore Entity Statement;

• An Offshore Voluntary Disclosure Letter with Required Attachments; and

• Copies of Forms 2848, Power of Attorney and Declaration of Representative, for Ronald Schlapfer and Linda Schlapfer.

With this submission, **[**8]** Mr. Schlapfer attempted to comply with applicable U.S. tax laws. For 2004, 2005, and 2006, he provided amended income tax returns that included Forms 5471 for EMG. Those forms provided information regarding the number and type of issued and outstanding shares, the number of shares held by Mr. Schlapfer, and EMG's income statement, balance sheet, and earnings and profits for the respective tax years. Mr. Schlapfer also provided an Offshore Entity Statement detailing his control over EMG, which stated:

> EMG was established by the Taxpayer in 2003, and was beneficially owned by the Taxpayer until July 6, 2006, at **[*6]** which time the Taxpayer gifted his entire interest in EMG to his mother. The Taxpayer is taking into account

[3] The gift tax return was attached to Mr. Schlapfer's 2006 amended return.

all of the income earned by the accounts underlying EMG in the enclosed Amended U.S. Individual Tax Returns during the years he controlled and beneficially owned EMG.

Mr. Schlapfer also included a Form 709 for 2006 with his submission. Attached to the Form 709 was a protective filing that stated:

A PROTECTIVE FILING IS BEING SUBMITTED. ON JULY 6, 2006, TAXPAYER MADE A GIFT OF CONTROLLED FOREIGN COMPANY STOCK VALUED AT $6,056,686.

PER *U.S. TREASURY REGULATION 25.2501-1(B)*, THE TAXPAYER IS NOT SUBJECT TO U.S. GIFT **[**9]** TAX AS HE DID NOT INTEND TO RESIDE PERMANENTLY IN THE UNITED STATES UNTIL CITIZENSHIP WAS OBTAINED IN 2008.

This gift stemmed from Mr. Schlapfer's assignment of the UVL Policy. He reported the gift as stock rather than the UVL Policy because the 2012 OVDP instructions required taxpayers to disregard certain entities that hold underlying assets, and he believed the policy was such an entity.[4] He also contends that he prepared the 2006 gift tax return in accordance with the investor control doctrine. The Commissioner does not dispute that Mr. Schlapfer filed a gift tax return for 2006 when he submitted the disclosure packet to the OVDP.

On June 4, 2014, after reviewing the 2006 gift tax return in Mr. Schlapfer's OVDP submission, an IRS revenue agent issued him an information document request (IDR). The IDR asked Mr. Schlapfer to provide documentation (1) of the gift of EMG to his mother, including the transfer of ownership of the entity as well as the transfer of the ownership of foreign accounts related to the entity, and (2) to substantiate his claim that in 2006 he did not have an intent to remain in the country and is therefore exempt from paying gift tax.

[*7] Mr. Schlapfer promptly responded. **[**10]** He provided the following documents to show the transfer of his entire ownership interest in EMG to the AIG Account:

(1) a copy of the September 22, 2006, share certificate showing the AIG Account as the owner of all issued and outstanding shares in EMG;

(2) a copy of an AIG statement dated August 8, 2006, showing the initial premium payment of $50,000 to the AIG Account;

(3) a copy of an AIG statement showing EMG's portfolio valuation as of September 22, 2006; and

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[4] The Commissioner does not consider a life insurance policy an "entity" as defined under the 2012 OVDP instructions.

(4) a copy of the Bearer Share of FX Fund, Ltd., which was held in the AIG Account.

He provided the following additional documents to show that he made a gift to his mother:

(5) a copy of the updated UVL Policy term sheet signed by his mother on January 24, 2007;

(6) a copy of Mr. Schlapfer's signed instructions to Swisspartners to change the policyholder of the UVL Policy to his mother; and

(7) copies of the UVL Policy chart.

In addition to providing these documents, with his response Mr. Schlapfer explained his position as to the date of the gift transfer. He asserted that the gift was made on July 6, 2006, when he instructed Swisspartners to transfer ownership of the UVL Policy to his mother, aunt, and uncle as soon as the policy **[**11]** was issued. However, he also agreed to a revised gift date of September 22, 2006, the date the policy was issued. He explained that Swisspartners' naming him as a policyholder was a scrivener's error, and that the requests made in January and April 2007 were merely intended to correct that error. After his initial response to the IDR, Mr. Schlapfer quickly followed up with documents to substantiate his claim that he did not intend to remain in **[*8]** the United States, in the form of affidavits from family members and business partners, in July 2014.[5]

Following his response to the IDR, the IRS had little contact with Mr. Schlapfer about his 2006 gift tax return until 2016, when it opened an examination of the return. On January 6, 2016, an IRS estate tax attorney notified Mr. Schlapfer of the examination and requested to meet with him to discuss his claim of nondomiciliary status in the United States for 2006. On May 17, 2016, an IRS estate tax attorney interviewed Mr. Schlapfer. Although most of the questions related to Mr. Schlapfer's domicile, there were also questions regarding the nature of the gift, when it was made, and the reported value of the gift. On June 14, 2016, Mr. Schlapfer **[**12]** signed a Form 872 for his 2006 gift tax return. He agreed to extend the time to assess tax to November 30, 2017.

In August 2016, the IRS issued Mr. Schlapfer a Form 3233, Report of Gift Tax Examination, for his 2006 gift tax return. In that report, the IRS concluded that there was no taxable gift in 2006 because Mr. Schlapfer made an incomplete transfer. It explained that because Mr. Schlapfer failed to relinquish dominion and control of the UVL Policy as the policyholder until May 31, 2007, the gift was not completed in 2006. Because Mr. Schlapfer refused to concede that the gift was made in 2007, he was given the choice to opt out of or be removed from the OVDP. He withdrew.

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[5] For purposes of this Opinion, we need not resolve Mr. Schlapfer's domiciliary status.

After Mr. Schlapfer formally withdrew from the OVDP, the Commissioner prepared a substitute gift tax return for 2007 pursuant to *section 6020(b)*. On October 17, 2019, the Commissioner issued Mr. Schlapfer a notice of deficiency for 2007 determining a gift tax liability of $4,429,949, and additions to tax under *section 6651(a)(2)* and *(f)* of $4,319,200. While residing in Florida, Mr. Schlapfer filed a Petition challenging the Commissioner's determinations.

The Commissioner filed a Motion for Summary Judgment asking the Court to find as a matter of law **[**13]** that (1) Mr. Schlapfer made a taxable gift of an insurance policy in 2007 and (2) that he is liable for additions to tax under *section 6651(f)*, or in the alternative *section 6651(a)(1)* and *(2)*. Mr. Schlapfer filed a Cross-Motion for Summary Judgment asking the Court to find as a matter of law that the Commissioner's period of limitation to assess the gift tax expired before the notice of deficiency **[*9]** was issued because Mr. Schlapfer adequately disclosed the gift on his 2006 gift tax return. Mr. Schlapfer supplemented his Motion, and the Commissioner responded to the Supplement.

Discussion

Before the Court are the parties' Cross-Motions for Summary Judgment. We are asked to decide whether the period of limitations to assess the 2007 gift tax expired before the Commissioner issued the notice of deficiency. To answer this question, we must decide whether Mr. Schlapfer adequately disclosed his gift on his gift tax return.

I. *Summary Judgment Standard*

We may grant summary judgment when there is no genuine dispute as to any material fact and a decision may be rendered as a matter of law. *Rule 121(a)(2)*; *Sundstrand Corp. v. Commissioner, 98 T.C. 518, 520 (1992)*, *aff'd*, *17 F.3d 965 (7th Cir. 1994)*. The moving party bears the burden of showing that there is no genuine dispute as to any material fact. *Sundstrand Corp., 98 T.C. at 520*. When a motion for summary **[**14]** judgment is properly made and supported, an opposing party may not rest on mere allegations or denials. *Rule 121(d)*. Rather, the party's response, by affidavits or declarations, or as otherwise provided in *Rule 121*, must set forth specific facts showing there is a genuine factual dispute for trial. *Id.* In deciding whether to grant summary judgment, we view the facts and make inferences in the light most favorable to the nonmoving party. *Sundstrand Corp., 98 T.C. at 520*.

II. *Gift Tax*

Section 2501(a)(1) imposes a tax on the transfer of property by gift. A gift is generally defined as any transaction where property is gratuitously passed to or conferred upon another for less than full and adequate consideration. *I.R.C. §*

2512(b); Treas. Reg. § 25.2511-1(c)(1). The amount of tax imposed is based on the value of the property transferred on the date the gift is complete.[6] I.R.C. § 2512(a); Treas. Reg. § 25.2511-2(a). The gift tax applies to a transfer regardless of whether the gift is direct or indirect, whether the property is real or personal, whether the property is tangible or intangible, or whether the transfer is in a trust or otherwise. I.R.C. § 2511(a). Individuals subject to the gift **[*10]** tax who make a transfer by gift must file a gift tax return, Form 709, for the year the transfer is made. I.R.C. § 6019; Treas. Reg. § 25.2501-1(a)(1).

Mr. Schlapfer filed Form 709 for 2006 on which he reported **[**15]** a transfer of stock by gift, but the Commissioner disagrees as to the characterization of the transferred property (EMG stock vs. UVL Policy) and the timing of the transfer (2006 vs. 2007). For purposes of this Opinion, we make no determination as to whether the gift is the EMG stock or the UVL Policy. We will analyze the applicable law under both. Additionally, for reasons discussed below, the timing issue is immaterial.

III. *Statute of Limitations for Gift Tax Assessment*

Subject to various exceptions, the Commissioner generally has three years after a gift tax return is filed to assess any gift tax. I.R.C. § 6501(a), (c); Estate of Brown v. Commissioner, T.C. Memo. 2013-50, at *8-9. Section 6501(c)(9) provides an exception for certain gifts not shown on returns. It provides that the Commissioner may assess gift tax at any time for any gift of property, the value of which is required to be shown on a gift tax return and is not shown on such a return. I.R.C. § 6501(c)(9). This exception applies unless the gift has otherwise been "disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item." *Id.*; Treas. Reg. § 301.6501(c)-1(f)(1). If a gift has been adequately disclosed on the gift tax return, **[**16]** or a statement attached to the return, that was filed for the year the transfer occurred, then the ordinary three-year period for assessment commences upon filing. I.R.C. § 6501(c)(9); Treas. Reg. § 301.6501(c)-1(f)(1) and (2).

This is true even if the gift disclosed is ultimately determined to be an incomplete transfer under Treasury Regulation § 25.2511-2 so long as there was adequate disclosure. Treasury Regulation § 301.6501(c)-1(f)(5) provides that

> [a]dequate disclosure of *a transfer that is reported as a completed gift on the gift tax return will commence the running of the period of limitations for assessment of gift tax on the transfer, even if the transfer is ultimately determined to be an incomplete gift* for

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[6] Treasury Regulation § 25.2511-2(b) provides that the transfer of property is not a complete gift unless the donor parts with dominion and control over the property with no power to change its disposition.

> purposes of § 25.2511-2 . . . . For example, if an incomplete gift is reported as a completed gift on the gift tax return and is **[*11]** adequately disclosed, the period for assessment of the gift tax will begin to run when the return is filed . . . .

(Emphasis added.) Hence, under this Treasury regulation, for purposes of commencing the period of limitations, the focus is on when the transfer was reported, not when the transfer was completed.

Here we will focus on whether Mr. Schlapfer adequately disclosed the gift transfer reported on his 2006 gift tax return. The Commissioner determined that the gift transfer was **[**17]** completed in 2007, and his notice is predicated on that determination. However, when the transfer was completed is immaterial. Even if we were to decide that the gift was completed in 2007, Mr. Schlapfer's adequate disclosure of the gift on his 2006 return would suffice to commence the three-year period of limitations upon the filing of that return. *See* Treas. Reg. § 301.6501(c)-1(f)(5).

IV. *Adequate Disclosure*

"A disclosure is 'adequate' if it is 'sufficiently detailed to alert the Commissioner and his agents as to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one.'" *Thiessen v. Comm'r*, 146 T.C. 100, 114 (2016) (quoting *Estate of Fry v. Commissioner*, 88 T.C. 1020, 1023 (1987)). The Commissioner directs us to the reporting requirements for strict compliance. *See, e.g.*, Treas. Reg. § 25.6019-4. But Treasury Regulation § 301.6501(c)-1(f)(2) provides that transfers reported on a gift tax return will be considered adequately disclosed if the return (or a statement attached to the return) provides the following information:

> (i) A description of the transferred property and any consideration received by the transferor;
>
> (ii) The identity of, and relationship between, the transferor and each transferee;
>
> (iii) If the property is transferred in trust, the trust's tax identification number and a brief description **[**18]** of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;
>
> (iv) Except as provided in § 301.6501(c)-1(f)(3), a detailed description of the method used to determine the fair market value of property transferred, including any financial data (for **[*12]** example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property. . . . ; and

(vi) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer . . . .

These requirements can be satisfied by filing Form 709 with the required information, or if needed, an amended Form 709 with the required information. *Rev. Proc. 2000-34*, §§ 3 and 4, *2000-2 C.B. 186, 186*. However, if an amended return is the one that satisfies adequate disclosure, then the period of limitations commences with the filing of the amended return, **[**19]** not the original return. *Id.*

Whether a statement attached to a gift tax return adequately discloses a gift is a question of fact. *Estate of Hicks Sanders v. Commissioner, T.C. Memo. 2014-100, at *7*. Mr. Schlapfer argues that the period to assess gift tax has expired because he adequately disclosed the gift on his 2006 gift tax return. He points to four documents to support this claim: (1) the gift tax return; (2) a protective filing attachment; (3) Schedule F of Form 5471 for his 2006 tax return; and (4) the Offshore Entity Statement. The Commissioner argues that the period to assess gift tax did not expire because Mr. Schlapfer did not adequately disclose the gift. Specifically, he asserts that (1) the Offshore Entity Statement is not part of the 2006 gift tax return and it should not be considered to determine whether Mr. Schlapfer made an adequate disclosure of the gift; and (2) even if the Offshore Entity Statement is considered, Mr. Schlapfer still failed to adequately disclose the gift because he failed to satisfy all applicable requirements of *Treasury Regulation § 301.6501(c)-1(f)(2)*.

A. *Disclosure Contents We Can Consider*

The Commissioner argues that the Offshore Entity Statement is not among the documents we should **[**20]** consider in determining whether the gift was adequately disclosed. We disagree. **[*13]** We have addressed the question of what documents to consider for adequate disclosure in cases interpreting *section 6501(e)(1)* (regarding substantial income omissions), and we find that the rationale used in those cases applies with equal force here. Under *section 6501(c)(9)*, the Commissioner may assess a gift tax at any time if a gift is not shown on a return unless the gift is "*disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item.*" (Emphasis added.) *Section 6501(e)(1)(B)(iii)* has similar wording, providing that the period of limitations for the Commissioner to determine the amount omitted from gross income will extend to six years unless "*such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.*" (Emphasis added.) "Where the same word or phrase appears multiple times within a statutory text, it is generally presumed to have the same meaning each place it appears." *Whistleblower 22716-13W v. Commissioner, 146 T.C. 84, 92-93 (2016)* (citing *Atl. Cleaners & Dyers, Inc. v. United States, 286 U.S. 427, 433, 52 S. Ct. 607, 76 L. Ed. 1204 (1932)* ("Undoubtedly, there is a natural

presumption that identical words used in different parts of the **[**21]** same act are intended to have the same meaning.")). A review of applicable IRS guidance and a plain reading of the statute do not warrant a conclusion that Congress intended the similar phrases in *section 6501(c)(9)* and *(e)(1)* to be interpreted differently. Therefore, we look to adequate disclosure caselaw decided under *section 6501(e)(1)* for guidance in determining what documents can be used to prove adequate disclosure under *section 6501(c)(9)*.

This Court has frequently looked beyond a taxpayer's return for purposes of determining adequate disclosure, especially where the return references a separate document. *See* *Reuter v. Commissioner, T.C. Memo. 1985-607, T.C. Memo 1985-607, 51 T.C.M. (CCH) 99, 102* (discussing *Benderoff v. United States, 398 F.2d 132 (8th Cir. 1968)*, *Walker v. Commissioner, 46 T.C. 630 (1966)*, *Roschuni v. Commissioner, 44 T.C. 80 (1965)*, and *Rose v. Commissioner, 24 T.C. 755 (1955)*). For example, when the taxpayer's individual return references an information return (such as a partnership or S corporation return), we may look to those information returns to determine whether items were adequately disclosed. *See* *Reuter, 51 T.C.M. (CCH) at 102*. When deciding whether an item has been adequately disclosed, we may consider not only a return, but also documents attached to the return plus informational documents referenced in the return.

[*14] The Offshore Entity Statement provided with the gift tax return must be considered in determining adequate disclosure. It was submitted to the OVDP in a disclosure packet that included **[**22]** the gift tax return. Furthermore, the protective filing attached to the gift tax return referenced controlled foreign company (CFC) stock, which alerted the IRS to look to the Offshore Entity Statement for information on the gift referred to in the gift tax return. We will consider the return and all documents accompanying the return. Therefore, the documents we will consider in determining whether Mr. Schlapfer adequately disclosed the gift are the gift tax return, the protective filing, all relevant Forms 5471, and the Offshore Entity Statement.

B. *Strict vs. Substantial Compliance*

The Commissioner argues that Mr. Schlapfer did not adequately disclose the gift because he failed to strictly satisfy all applicable requirements of *Treasury Regulation § 301.6501(c)-1(f)(2)*. Mr. Schlapfer disagrees, arguing that he strictly, or at least substantially, complied with all applicable requirements of the Treasury regulation.

The Commissioner may insist that taxpayers strictly comply with regulatory requirements, but in certain circumstances we have held that regulatory requirements can be satisfied by substantial compliance. *See, e.g.,* *Am. Air Filter Co. v. Commissioner, 81 T.C. 709, 719 (1983)*. The question the Court must ask in determining whether to apply substantial or

strict compliance **[**23]** to regulatory requirements is whether the requirements relate "to the substance or essence of the statute." *Bond v. Commissioner, 100 T.C. 32, 41 (1993)* (quoting *Taylor v. Commissioner, 67 T.C. 1071, 1077 (1977)*). If the requirement is essential, then strict adherence to all regulatory requirements is a precondition to satisfying the statute. *Id.* However, if the requirement is "procedural or directory in that [it is] not of the essence of the thing to be done . . . [it] may be fulfilled by substantial . . . compliance." *Id.* (quoting *Taylor, 67 T.C. at 1077-78*). This test requires us to examine *section 6501(c)(9)* to determine whether the adequate disclosure requirements of *Treasury Regulation § 301.6501(c)-1(f)(2)* go to the essence of the statute or are merely procedural or directory.

Section 6501(c)(9) provides that the Commissioner may assess a gift tax at any time if a taxpayer fails to report a gift on a gift tax return, unless the gift is otherwise adequately disclosed on the return or a statement attached to it. Its essence is to provide the Commissioner with a viable way to identify gift tax returns that should be examined with **[*15]** minimum expenditure of resources. *T.D. 8845, 1999-2 C.B. 683, 684*. The purpose of the adequate disclosure requirements in the regulation is to provide taxpayers with guidance on what constitutes adequate disclosure for purposes of *section 6501(c)(9)*.

The Department of the Treasury has acknowledged **[**24]** that substantial compliance can satisfy the adequate disclosure requirements. In Treasury Decision 8845, which promulgated *Treasury Regulation § 301.6501(c)-1(f)*, Treasury specifically addressed substantial compliance. It rejected a recommendation that the regulation should expressly allow substantial compliance because of "the difficulty in defining and illustrating what would constitute substantial compliance." *T.D. 8845, 1999-2 C.B at 685*. It went on to note, however, that its rejection of the suggestion did not mean "that the absence of any particular item or items would necessarily preclude satisfaction of the regulatory requirements, depending on the nature of the item omitted and the overall adequacy of the information provided." *Id.* That statement describes, and accepts, the very essence of substantial compliance. Therefore, we conclude that the adequate disclosure requirements can be satisfied by substantial compliance.[7]

C. *Whether Mr. Schlapfer Strictly or Substantially Complied With the Adequate Disclosure Requirements*

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[7] Generally, "[s]tatutes of limitation sought to be applied to bar rights of the Government, must receive a strict construction in favor of the Government." *Badaracco v. Commissioner, 464 U.S. 386, 391, 104 S. Ct. 756, 78 L. Ed. 2d 549 (1984)* (quoting *E.I. Dupont de Nemours & Co. v. Davis, 264 U.S. 456, 462, 44 S. Ct. 364, 68 L. Ed. 788 (1924)*). However, we have applied the substantial compliance doctrine to situations where we are tasked in determining whether a return was sufficient to commence the running of the statute of limitations. *See, e.g., Gen. Mfg. Corp. v. Commissioner, 44 T.C. 513, 523-24 (1965)*.

Under *Treasury Regulation § 301.6501(c)-1(f)(2)*, a transfer will be considered adequately disclosed if the taxpayer provides the following information on a gift tax return or statement attached to it: (i) a description of the gift and consideration received **[**25]** for the gift; (ii) the identities of and relationship between the transferor and transferee; (iii) if the gift is transferred in trust, the trust tax identification number and a description of the terms of the trust; (iv) a detailed description of the method used to determine the fair market value of the gift; and (v) a statement describing any position taken that is contrary to Treasury regulations or revenue rulings published at the time of the transfer. Here, we need to decide only whether Mr. Schlapfer strictly or substantially satisfied requirements (i), (ii), and (iv). A taxpayer will be **[*16]** deemed to have substantially complied with a requirement if it is procedural and the taxpayer fulfilled all other essential purposes of the requirement. *See Am. Air Filter Co., 81 T.C. at 719*. Therefore, if Mr. Schlapfer fails to strictly comply with a requirement, we will find that he substantially complied with it if he has fulfilled all essential purposes of the requirement. We will look to the gift tax return, the protective filing, all relevant Forms 5471, and the Offshore Entity Statement to determine compliance.

1. *Description of the Property and Consideration Received*

Assuming the gift is the EMG stock, Mr. Schlapfer has **[**26]** strictly satisfied this requirement. *Treasury Regulation § 301.6501(c)-1(f)(2)(i)* requires that Mr. Schlapfer's gift tax return, or a statement attached to it, provide a description of the transferred property and any consideration he received.[8] The 2006 Instructions for Form 709 instructed taxpayers to "[d]escribe each gift in enough detail so that the property can be easily identified." 2006 Instructions for Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, at 8. For stock, the instructions specify that the taxpayer should disclose the number of shares and identify whether they are common or preferred. *Id.* Mr. Schlapfer provided the required information via three attachments: the protective filing, the Offshore Entity Statement, and the 2006 Form 5471. On the protective filing attached to the return, Mr. Schlapfer stated that he made a gift of CFC stock valued at $6,056,686. On the Offshore Entity Statement, he stated that "EMG was established by the Taxpayer in 2003, and was beneficially owned by the Taxpayer until July 6, 2006, at which time the Taxpayer gifted his entire interest in EMG to his mother." Lastly, on the 2006 Form 5471, he disclosed the number of and type of EMG shares. Together, these **[**27]** statements provided the IRS with a description of the property.

However, if the gift is the UVL Policy, Mr. Schlapfer did not strictly satisfy this requirement. He did not provide any information on his gift tax return, or on documents attached to it, that directly referenced or described a transfer of a

[8] Mr. Schlapfer transferred his shares of EMG stock for no consideration.

life insurance policy. But this failure does not preclude him from satisfying adequate disclosure. As previously mentioned, disclosure is adequate if it is sufficiently detailed to alert the Commissioner to the nature of the transaction so that the decision to select a return for audit is reasonably informed. *Thiessen,* ***[*17]*** *146 T.C. at 114*. And when finalizing the adequate disclosure regulations, Treasury provided "that the absence of any particular item or items would [not] necessarily preclude satisfaction of the regulatory requirements, depending on the nature of the item omitted and the overall adequacy of the information provided." *T.D. 8845, 1999-2 C.B at 685*. Thus, these "regulatory requirements" are not actually required. A requirement does not have to be satisfied depending on the importance of the requirement and what information is provided by the taxpayer. Furthermore, the Treasury Regulations provide that "[a] transfer will be **[**28]** adequately disclosed . . . *only if* it is reported in a manner adequate to apprise the [IRS] of the nature of the gift . . . . Transfers reported on the gift tax return as transfers of property by gift *will be* considered adequately disclosed . . . if the return . . . provides the following information." *Treas. Reg. § 301.6501(c)-1(f)(2)* (emphasis added). The difference between the wording used in these two sentences informs us that the requirements are not mandatory, but act as guidance to taxpayers to inform them on a way to satisfy adequate disclosure. Thus, we must determine whether Mr. Schlapfer's description of the property transferred was sufficient to alert the Commissioner to the nature of the gift.

Mr. Schlapfer provided enough information to satisfy this requirement through substantial compliance. While he may have failed to describe the gift in the correct way (assuming the gift is the UVL Policy), he did provide information to describe the underlying property that was transferred. Mr. Schlapfer asserts that he chose to disclose the assets held in the insurance policy instead of the actual policy because the OVDP required him to disregard entities holding foreign assets. The UVL Policy's value comes primarily **[**29]** from EMG stock, so Mr. Schlapfer's describing the transferred property as EMG stock goes to the nature of the gift. Because this description was sufficient to alert the Commissioner to the nature of the gift, Mr. Schlapfer substantially complied with this requirement.

2. *Identity of the Parties*[9]

Mr. Schlapfer did not strictly satisfy this requirement. *Treasury Regulation § 301.6501(c)-1(f)(2)(ii)* requires that Mr. Schlapfer provide the identity of, and his relationship to, each transferee. Mr. Schlapfer has stated various times that he transferred property by gift to his **[*18]** mother, aunt, and uncle. However, the Offshore Entity Statement states that he "gifted his entire interest in EMG to his mother;" there was no mention of his aunt or uncle. Because his return and

[9] For this requirement, it is immaterial whether the gift is the stock or the life insurance policy; therefore we do not analyze it separately for each gift.

documents attached thereto failed to identify his aunt and uncle as transferees, he did not strictly comply with this requirement.

But Mr. Schlapfer substantially complied with this requirement. This requirement was procedural, and a failure to list the identity and relationship of each transferee was not essential to the overall purpose of the requirement, which was to provide the IRS with enough information to understand the nature of the transfer. Mr. Schlapfer's statement **[**30]** on the Offshore Entity Statement listing his mother as the transferee provided the IRS with enough to understand the relationship between Mr. Schlapfer and the transferee, a member of his family. His failure to provide the names of his aunt and uncle does not make a meaningful difference in understanding the nature of the transfer. Therefore, we find that he substantially complied with the requirement when he identified his mother as the transferee.

3. *Description of Method Used to Determine FMV of Gift*

Mr. Schlapfer did not strictly satisfy this requirement. *Treasury Regulation § 301.6501(c)-1(f)(2)(iv)* requires that Mr. Schlapfer provide a detailed description of the method used to determine the fair market value of property transferred, including any financial data (balance sheets, etc. with explanations of any adjustments). Mr. Schlapfer did not provide any statement describing how he determined the fair market value of the gift, regardless of whether it is the EMG stock or the UVL Policy. Therefore, he failed to strictly satisfy this requirement.

However, Mr. Schlapfer substantially complied with this requirement. Assuming the gift is the EMG stock, Mr. Schlapfer provided enough financial information to apprise the Commissioner **[**31]** of the method used to determine its fair market value. The 2006 instructions for Form 709 explained that the purpose of this requirement is to provide the IRS with information on how the taxpayer determined the gift's fair market value. *See* 2006 Instructions for Form 709, at 8. The instructions also identified documents that could be submitted to satisfy this requirement. *Id.* ("For stock of close corporations or inactive stock, attach balance sheets, particularly the one nearest the date of the gift, and statements of net earnings or operating results and dividends paid for each of the 5 preceding years.").

[*19] Mr. Schlapfer provided all the documents identified in the instructions. His Forms 5471 for 2004, 2005, and 2006 enclosed balance sheets, statements of net earnings, dividends paid, and operating results. Furthermore, his Offshore Entity Statement stated that "[t]axpayer is taking into account all of the income earned by the accounts underlying EMG in the enclosed Amended U.S. Individual Tax Returns during the years he controlled and beneficially owned EMG." Although Mr. Schlapfer did not provide all the financial documentation listed in the regulation, he

provided the information **[**32]** identified in the 2006 Form 709 instructions, which was enough to show the IRS how he determined the fair market value of the EMG stock. Therefore, he substantially complied with this requirement.

Furthermore, Mr. Schlapfer substantially complied even if the gift is the UVL Policy. The UVL Policy's principal asset is the EMG stock, and the documents we considered above were enough to apprise the Commissioner of the method used to determine the fair market value of the EMG stock. Because the UVL Policy's value stems primarily from the EMG stock, those same documents can be used to illustrate the method used to determine the fair market value of the UVL Policy. Accordingly, we find that Mr. Schlapfer substantially complied with this requirement.

V. *Conclusion*

Mr. Schlapfer strictly or substantially complied with *Treasury Regulation § 301.6501(c)-1(f)(2)(i)*, *(ii)*, and *(iv)* by way of his gift tax return, protective filing, Offshore Entity Statement, and Forms 5471. As a result, he adequately disclosed the gift on his 2006 gift tax return, causing the three-year assessment period to commence on November 20, 2013, when he submitted his disclosure package to the OVDP, and end on November 30, 2017 (three years after that date including extensions). **[**33]** Therefore, we conclude that the period of limitations to assess the gift tax expired before the Commissioner issued the notice of deficiency. Accordingly, we will deny the Commissioner's Motion for Summary Judgment and grant Mr. Schlapfer's Cross-Motion for Summary Judgment.

To reflect the foregoing,

An appropriate order and decision will be entered.

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