

Do BV Methods Apply to Determining Discount to Fractional Interest in Art?

In this case, the IRS tried to make the valuation all about art, while the taxpayer relied almost exclusively on appraisal science. The Court sought an appropriate balance, but it also revealed the limits to which it would entertain a wide dispute over the discounted value of fractional interests, especially where concrete, credible support from comparable market data was limited.

The Stone estate owned a 50% undivided interest in nineteen paintings, including Impressionist masterpieces. In filing its tax return, the estate applied a 44% discount to the fractional ownership, assessing its interest in the collection at \$1.42 million. An audit by the IRS assessed the fair market value of the 50% fractional interest in the entire collection at \$2.77 million; it also contested the valuation of two specific paintings.

IRS Retains Art Appraisers

In these cases, the IRS typically convenes a panel of independent art experts, including gallery owners, dealers, and museum curators. The panelists receive no reimbursement (except costs) and no information regarding the purpose of the valuation (whether for charitable contribution, estate tax, or gift tax). Nor do the panelists know the identity of the taxpayer.

To value the two contested paintings, the IRS panel examined comparable sales at or near the valuation date. The estate relied solely on a Sotheby's appraisal, which contained no information regarding the determinants of value. Not surprisingly, evidence from the art panel proved more persuasive, and the Court adopted the IRS values.

Valuing the estate's 50% undivided interest in the entire collection proved more difficult. The IRS argued that fractional discounts apply only to real property and not personal property—but the Court quickly rejected the contention, citing case law that permits discounts with sufficient evidentiary support.

The holder of an undivided interest in property would have to secure the consent of the owner or owners of the remaining interests before being able to sell as a

unit. This factor alone could affect valuation regardless of whether real or personal property is involved.

Interestingly, the estate's trustees comprised the other owners—and putative sellers—of the collection, and the IRS urged the Court to take this into consideration. But the applicable fair market value standard requires a willing but hypothetical seller, thus avoiding the uncertainties inherent in trying to assess the probability of related owners selling their fractional interests together. Based on the more objective standard, the Court's sole determination became the extent of an applicable discount to the fractional interest.

Taxpayer Enlists BV Expert

The estate retained a *credentialed* business valuation expert, who admitted finding no data regarding sales of fractional interests in art. Instead, he looked to transactional data involving undivided interests in real estate and real estate holding companies, which included discounts.

The Court found the real estate market not comparable. "Art is simply not fungible." Some collectors prefer to own a fractional interest in higher-valued works, despite lack of control and marketability, than a 100% interest in a lesser work. "More importantly,

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although there is evidence that partial interests in real estate have been sold at a discount, there is no evidence that similar sales have...occurred in the art market.”

The Court rejected those portions of the expert’s report that relied on undivided real estate and limited partnership transactions, concluding that a hypothetical, willing seller would likely sell the entire body of art and split the proceeds instead of selling his or her fractional interest at a discount. Since “one of the characteristics of an undivided interest is the right to partition,” the Court said, “some discount is appropriate to allow for the uncertainties involved in waiting to sell the collection until” a hypothetical partition action can be resolved.

Assumptions Must Be Credible

In calculating a cost-to-partition discount, the taxpayer’s expert talked to counsel as well as “representatives of fine art auctioneers” (whose names he could not recall at trial). Based on these conversations, he assumed the process would take three years, during which the art collection would appreciate 3%, approximating the rate of inflation; the volatility of the art market rendered any other rate too arbitrary. To calculate the sale proceeds, the expert deducted sales commissions of 2% (also based on conversations with art auctioneers), as well as \$50,000 in legal fees and \$5,000 in appraisal costs.

He then conducted a net present value (NPV) analysis, applying a 18% discount rate to future cash flows to the estate’s undivided half interest, based in part on micro-cap company comparisons. The expert concluded that a 51% cost-to-partition discount was appropriate—7% higher than on the original estate tax return.

Without any evidence to the contrary, the Court accepted the \$50,000 legal fees. It allowed the 2% commission rate, which the IRS experts agreed to. It disallowed any appraisal fees, relying on the same experts, who said that an auction house would likely waive fees in exchange for a higher buyer premium.

Notably, the government did not provide any comparable cost-to-partition expert analysis. Nevertheless, the Court found the taxpayer’s 51% discount unpersuasive. First, it was “incongruous” to assume a 3% appreciation rate while also assuming an expected rate of return under the NPV analysis of 18%. Second, any comparison of art to micro-cap companies or stock offerings was not credible. These commodities differed too much from the art market, especially when the collection in this case included works by well-known and frequently sold artists.

Court Declines to Step in for Experts

At the same time, given the volatility of the art market, the Court rejected the IRS’ contention that

no discount applied. And though it could have determined a discount from the evidence, “if necessary,” the Court preferred to let the parties attempt settlement. It cautioned them to keep in mind that it had found most of the estate’s assumptions unpersuasive, and that the government had failed to adequately address the valuation of the estate’s undivided interest. Burden of proof (on the estate) was also an important factor.

The opinion ended with this advisory: If the parties could not reach a negotiated value, then the Court would decide an appropriate discount rate somewhere between the government’s 2% discount and the estate’s 51%. But rather than suggesting a midpoint or “split-the-difference” resolution, the overall tone suggests the Court would not accept a large discount for the fractional interest, especially in a market that does not provide direct sales data in support.

Disappointed Investors Can’t Recover for Collapsed Stock Value without Expert Evidence

It’s an unfortunate but familiar story from the burst telecomm bubble: In October 1999, a small wireless data services business, SmartServe Online, Inc. (SSOL), was worth \$1 per share. Within four months, SSOL had skyrocketed to \$170 per share, and by the summer of 2000, its value had settled to a range between \$70 and \$90 per share.

Countless retail investors purchased millions of dollars of SSOL stock between 2000 and 2002. These included over a hundred buyers who later claimed that institutional investors with Citicorp financial services (formerly Salomon Smith Barney, Inc.) fraudulently induced them to hold their SSOL stock, even though they knew that the company was having problems with its contracts. Even when the Dow Jones started to plunge—down from 11,723 in January 2000 to 8,341 in December 2002—the plaintiffs claimed that Citicorp told them SSOL was “still a good deal” and a “certain money winner.” In fact, they urged them to invest in more SSOL stock, to the exclusion of almost all other companies.

Poor Portfolio Design or Fraud?

There was the rub, according to the federal appeals court (7th Cir.), which reviewed the investors’ claims after they lost a motion to dismiss at trial. In 2000, when SSOL disclosed public filings that the company had yet to derive any significant revenues, its stock price began to fall, and over the next two years it slid from \$80 to \$1 per share, a bottom value from which

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it never recovered. But its competitors suffered the same fate, with one losing 98.9% of its value over the same time, and another losing 98.39% of its value.

The SSOL investors acknowledged these facts but urged that in their case, Citigroup's misrepresentations were the reason for the decline in SSOL's share price. This was because SSOL never had the contracts, revenues, or funding that Citicorp repeatedly claimed it did.

Causation was the key link to plaintiff's case—and they needed to show more than just “transaction causation”—i.e., that experienced investors would not have purchased SSOL stock had they known all its financial facts. The plaintiffs needed to prove “loss causation” by one of two approaches. In the first (“materialization of risk”), they had to show that but for the defendants' fraud—the very facts about which they lied—the stock wouldn't have lost its value. Alternatively, in the securities context, plaintiffs could show “fraud on the market”: that the defendants' false statements artificially inflated the stock price and, once the deception became public, the stock value declined.

Plaintiffs Fail to Provide Expert Evidence on Causation

The Court quickly dispensed with the first approach. “There is no evidence on the record from which a jury could conclude that the drop in the value of the SSOL shares was attributable somehow to [the defendants'] misrepresentations.”

In fact, the defendants submitted an expert study showing that market forces caused SSOL's drop in value—and the plaintiffs offered nothing to rebut that theory, “no expert evidence suggesting that the collapse was caused by the lack of the fraudulently promised contracts and financing, no evidence that companies similar to SSOL that had firm contracts survived.” Plaintiffs' only proffered expert considered the amount of damages but not the critical causal link.

As to a fraud-on-the-market theory, the record failed to support the claim that SSOL's stock declined just when the misrepresentations became known. The plaintiffs discovered the alleged lies in June 2002, but by that time—and even earlier--SSOL's shares had already collapsed. Without any expert analysis to counter this market evidence, the Court said, “summary judgment for defendants...was inevitable.”

If you would like to receive a copy of any of the aforementioned court cases or to discuss a particular business valuation issue, please feel free to contact Susan Wilusz, ASA, at (215) 598-9310 or smw@valuemanagementinc.com.

Must State Agencies Defer to Internal Revenue Determination of Discounts?

In 1998, the Berry family limited partnership (FLP) was formed through a mother's contribution of over \$6.78 million in marketable securities and cash in return for a 1% general partnership interest and a 97% limited partnership interest. The mother later gifted a 15% limited partner interest to each of her two children and made substantial withdrawals of cash for additional gifts and expenses. When she died in 2003, her estate filed federal and state tax returns; the IRS accepted the estate's calculation of a 33% combined discount on the FLP for lack of control and marketability.

But the Pennsylvania Department of Revenue disallowed the discounts, asserting that—given the nature of the partnership and assuming no compulsion to sell—a partner would not have disposed of his or her interest at a discount.

Federal Regulations Typically Fill Gap in State Rules

After losing both an agency appeal and a lower court appeal, the taxpayer reached the state Commonwealth Court, which examined both the business purpose of the FLP and whether the IRS' allowance of the discounts was dispositive. The Court did not explain why the IRS had permitted the discounts, but it did acknowledge there were no state regulations pertaining to FLPs. Typically, the state Department of Revenue would defer to “criteria that mirror those of the Internal Revenue Service.” A local estate tax statute, for example, specifically provided that where the state had no rules pertaining to the value of a life interest, “the regulations in effect for Federal Estate tax purposes shall apply.”

Although all parties agreed that IRS regulations applied to the case, the Pennsylvania court found that the Service's conclusions regarding taxable value did not. There was no statutory or legal authority requiring the state Department of Revenue to be bound by the federal agency when making an assessment of local inheritance tax.

At the same time, the Court looked to the language of Internal Revenue Code § 2036 and established federal law to decide the FLP's purpose. It also reviewed testimony by the family accountant, who listed the standard estate planning objectives: to shield assets from liability, to preserve the estate, and to save taxes. (The partnership agreement reflected these as well.) The FLP's only activity consisted of selling stock to distribute funds to the decedent, who retained unfettered access to the assets throughout her lifetime.

Under these facts, the Court found the FLP served no legitimate business purpose and affirmed the state's denial of estate tax discounts.

VMI HIGHLIGHTS

- VMI sponsored the Philadelphia Estate Planning Council luncheon on September 18 at the Union League. The speaker was David Handler of Kirkland & Ellis. His topic was "The Power of Grantor Trusts and Improving the Sale to Grantor Trust Technique." Please contact us if you would like a copy of David's presentation.
- VMI was a conference sponsor at a 12th Annual Multi-State ESOP Conference Program on September 19-20, 2007 at the Hilton Scranton & Conference Center. Ed Wilusz led a session on Business Valuations for ESOPs. In attendance were participants from New Jersey, New York, Pennsylvania and Delaware.
- VMI will sponsor the Pennsylvania Bar Institute's 14th Annual Estate Law Institute held at the Philadelphia Convention Center to be November 28-29. Andrew Wilusz will be speaking on November 29. His topic will be "Selling the Business as part of the Estate Planning Process: What Clients Can Expect."
- On September 25, Andrew Wilusz and Patricia McMullen led a roundtable discussion for the Philadelphia Estate Planning Council. The topic was "Valuation of FLPs and other Asset Holding Entities-What Every Planner Should Know."
- Joseph Egler spoke at the Lehigh Valley Bar Association on September 26 and the Bucks County Bar Association on August 23. His topic was "What to Look for in a Small Business Valuation Report."

If you are interested in having one of our analysts speak to your firm or give a presentation at a conference, please contact Susan Wilusz at smw@valuemanagementinc.com or (215) 598-9310.

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