

VALUE ADDED 2001 SPECIAL EDITION

A popular feature of our newsletter has been recent court cases involving valuation issues. This special edition reviews six cases that involve estate and gift tax matters. Also included in this issue is VMI Highlights, an informative section keeping you up-to-date of the latest developments at Value Management Inc.

Court Case Updates

Estate of H.A. True & Jean D. v. Commissioner, July 6, 2001, T.C. Memo. 2001-167, October 3, 2001 at <http://www.ustaxcourt.gov/InOpHistoric/TRUE.TCM.WPD.pdf>

Buy-sell agreement considered testamentary device; Court holds taxpayer liable for valuation understatement penalties.

Numerous factors, including the lack of negotiation of the buy-sell agreements' terms, lack of independent legal representation for the parties and the failure to seek professional advice or appraisals in selecting the formula price were cited in determining that the agreements did not meet the non-testamentary device test.

True consulted only with his accountant to set the formula price. The Court said "We reject any notion that the accountant was qualified to opine on the reasonableness of using the tax book value in the True family buy-sell agreements....he had no technical training or practical experience in valuing closely held businesses". In addition to failing to obtain or rely on appraisals in selecting the price, True excluded significant assets from formula price (the value of oil & gas reserves) and had no periodic review of the price. The Court concluded that the buy-sell agreements are substitutes for testamentary dispositions and as a result do not control estate or gift tax values.

The Court stated that the True family was aware of the issues in controversy and the dollars at stake and that they took aggressive positions on the estate and gift tax returns. They did not rely on professional appraisers or obtain professional advice. The Court decided that the True's were liable for the penalties and that the reasonable cause exception did not apply to this case.

Estate of Elma M. Dailey, et al. v. Commissioner, T.C. Memo. 2001-263, October 3, 2001 at <http://ustaxcourt.gov/InOpHistoric/dailey4.TCM.WPD.pdf>

Court determines a 40 percent discount for a limited partnership interest in an FLP holding only marketable securities

The taxpayer's expert opined to a 40 percent discount for lack of: marketability, control and liquidity. His determination was based on closed end mutual fund data and the significant amount of unrealized capital gains relating to one of the securities in the portfolio. The Court found that the IRS expert's testimony was contradictory, unsupported by data and inapplicable to the facts. The Court concluded that the 40 percent discount was appropriate.

Estate of Helen Bolton Jameson, Deceased, Northern Trust Bank of Texas, N.A., Independent Executor v. Commissioner of Internal Revenue, U.S. Court of Appeals for the Fifth Circuit, No. 00-60489, September 18, 2001 at <http://www.valuemanagementinc.com/jameson.html>

Court of Appeals determines that the Tax Court erred in its approach to the discount of capital gains taxes

In the original Tax Court decision, the issue involved the value of appreciated timber property owned by

Johnco, Inc. The taxpayer claimed that the value should be reduced for the full amount of the built-in capital gains tax. The IRS argued no reduction was appropriate. The Tax Court rejected both arguments and calculated its own reduction based on the present value of the tax assuming that the timber was sold over nine years.

The Court of Appeals stated that the Tax Court erred by assuming that the buyer was a strategic buyer rather than a hypothetical buyer. This led to the Tax Court's peremptory denial of a full discount for the accrued capital gains liability.

The judgement of the Tax Court was vacated and remanded.

Estate of John L. & Sarah W. Baird v. Commissioner, T.C. Memo. 2001-258, September 28, 2001 at <http://www.ustaxcourt.gov/InOpHistoric/BAIRD.TCM.WPD.pdf>

A 60 percent discount is determined as appropriate for an undivided interest in real estate

The taxpayer and the IRS agreed on the total value of the real estate but disagreed on the proper fractional interest discount. The estate tax return for John claimed a 25 percent fractional interest discount. It was amended to a 50 percent discount and at trial a 60 percent discount was claimed. Sarah's estate tax return claimed a 50 percent discount, but was amended to 60 percent.

At trial, the taxpayers presented three real estate experts. The first two taxpayer experts based their discounts on comparable sales. The third expert, favored by the Tax Court, actively participated in buying and selling fractional interests. At trial he opined that the subject interests should be discounted by 90 percent.

The court found the IRS expert unqualified to opine on the value of fractional interests in timberland.

The Tax Court concluded a 60 percent discount was appropriate, relying on the third expert's expertise and practical knowledge.

Co-Executors of the Estate of Alice Friedlander Kaufman, Deceased, v. Commissioner of Internal Revenue Service, U.S. Court of Appeals for the Ninth Circuit, No. 99-71013, March 15, 2001 at <http://www.valuemanagementinc.com/kaufman.html>

Tax Court decision that the sale of minority stock two months after the valuation date should be disregarded is reversed by Court of Appeals

This case dealt with valuing a 19.86 percent common stock ownership in a closely-held, primarily family-owned corporation. The Estate determined the fair market value of the stock based on two sales of stock (3.25% and 4.67%) two months after the date of death.

The Tax Court (Judge Laro) criticized and rejected the Estate's expert's report stating he relied on faulty assumptions, failed to analyze key indicia of value and assumed erroneously that the two subsequent sales were "arm's length". In addition, the judge concluded that it was not unreasonable to assume that a hypothetical buyer would expect a family member to be willing to pay a higher price for the stock, that the family had incentive to purchase shares to avoid outside shareholders. Thus, the shares did not lack marketability. The Court concluded that the fair market value of the Estate's stock was \$56.50 per share.

The Court of Appeals concluded that the willing buyer and seller are not seen as particular people, but are considered objectively and impersonally. It found that there was no good reason to reject the two sales occurring subsequent to the valuation date. The judgement of the Tax Court was reversed and the case was remanded to the Tax Court for entry of judgement for the Estate.

Patricia M. Adams, et al., Plaintiffs, vs. United States of America, Defendant. Civil Action No 3:96-CV-3181-D

US District Court for the Northern District of Texas, Dallas Division, 2001 US Dist. LEXIS 13092 Decided August 24, 2001, Entered August 27, 2001 at <http://www.valuemanagementinc.com/adams.html>

The court originally declined to discount the value of a 25 percent partner's assignee interest in a dissolved Texas partnership. Following the Fifth Circuit's remand of the case, the court determined that the appropriate overall discount was 53.2 percent.

Texas law states the estate of a deceased partner is treated as an assignee who is entitled to its pro rata share of the partnership's liquidation value. The Court originally declined to discount the value except to reflect liquidation costs, rejecting discounts for lack of marketability, lack of control, uncertain rights and ownership of an undesirable mix of assets. The district court concluded that the assignees could receive the partner's share of the dissolved partnership's surplus, thus rendering the discounts irrelevant.

The Fifth Circuit disagreed stating that the rights of an assignee are not clearly established and should be discounted. It remanded this case back to the district court with directions for the court to consider evidence from both sides, determine the applicability of the various claimed discounts and the correct percentage of the discounts.

The taxpayer's expert applied a 20 percent minority interest discount, citing the lack of control is defined not only by the 25 percent interest but also by the fact that it is an assignee interest not a partner. The court accepted the taxpayer's expert's discount. The taxpayer's expert applied a 10 percent portfolio discount. The court accepted that discount. The court also accepted a 35 percent discount for lack of marketability based on the SEC and IPO studies. The court determined that the effective overall discount was 53.2 percent.

VMI Highlights

VMI has a New Address. Our main office is now located at 758 Durham Rd. in Newtown, PA. Our zip code (18940), phone number (215) 598-9310 and fax number (215) 598-0589 remain the same. Our center city Philadelphia office (2009 Chestnut Street) also remains unchanged.

VMI's new website, www.valuemanagementinc.com, is up and running! In addition to presenting our experience and background information, it also has our recent newsletters along with the internet addresses and links to all court cases mentioned in the newsletters. The new E-mail addresses of our analysts (and their area of specialty) are as follows:

Analyst

E-mail address

Specialty

Ed Wilusz	eaw@valuemanagementinc.com	General valuation
Andrew Wilusz	amw@valuemanagementinc.com	Mergers & Acquisitions
Joe Egler	jme@valuemanagementinc.com	Divorce
Patricia McMullen	tmm@valuemanagementinc.com	FLPs, LLCs
Russ Scotti	rgs@valuemanagementinc.com	
Tim Rose	tdr@valuemanagementinc.com	

VMI is pleased to announce that Kathy Eby has joined our firm as Executive Administrative Assistant. Kathy brings with her a wide variety of administrative skills honed over her 18-year tenure at Bristol-Meyers Squibb. Welcome Kathy!

Value Management Inc. continued its support of the Philadelphia Estate Planning Council (the largest in the nation) by sponsoring its first meeting of the season on September 15, 2001. Seymour Goldberg, Esq. spoke on "Recent Changes in Retirement Plan Distributions". VMI encourages professionals in the estate planning field to participate and benefit from membership in local and regional estate planning councils. For information

on the Philadelphia, Bucks County and Montgomery County estate planning councils, feel free to contact Andrew Wilusz at (215) 598-9310.

Ed Wilusz, ASA, CFA, and President of VMI, gave a presentation to the Valuation Engineering Group of the Pennsylvania IRS. The topic was "The Use of an Economic Income Method in the Valuation of a Business or Business Interest". The presentation was given on October 17, 2001 in the Harrisburg area.

Value Management Inc. is pleased to co-sponsor "Strategies for Your Business In a Challenging Economy". This workshop will take place on Wednesday, November 28, 2001, from 8:00 – 10:30 a.m. at The Ritz-Carlton Philadelphia. Some of the topics to be discussed are: Valuing Your Business, Business Succession & Transition Planning and Business Financing Alternatives. For more information please call us at 215-598-9310.

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