

J.L. PIERSON & Co.

VALUE ADDEDTM

ROUTE TO:

J.L. PIERSON & Co.
BUSINESS VALUATIONS
September, 1998

<http://www.jlpierson.com>

Post Office Box 2392
Darien, Connecticut 06820-0392
Telephone/Fax: (203) 325-2703 • e-mail: jlp@jlpierson.com

Davis v. Commissioner

Tax Court Recognizes Discount for Imbedded Capital Gains

[Docket No. 9337-96, filed June 30, 1998]. In the recent Tax Court decision, *Davis v. Commissioner*, the Court considered the impact of imbedded capital gains on the valuation of the stock of closely held companies. The term "imbedded capital gains" refers to the difference between the market value and the cost basis of assets. Imbedded capital gains are also referred to as "built-in gains" or as "unrealized gains"

	(Taxpayer)		(IRS)	Tax Court
	Petitioner	Respondent		
Per Share Conclusion	\$ 276,195	\$ 481,879	\$	413,549
x No. of Shares	25	25		25
Value of Each Gift	\$6,904,875	\$12,046,975		\$10,338,725

Table 1

At issue in this case is the value of two separate blocks of 25 shares each of ADD Investment and Cattle Company ("ADDI&C") which were gifted on November 2, 1992. ADDI&C, a holding company which had certain cattle operations, owned 1.3% (1,020,666 shares) of Winn-Dixie Stores, Inc. ("Winn-Dixie") stock. Winn-Dixie is a large grocery store chain with operations primarily in the Southeast whose shares are traded on the New York Stock Exchange. As of the valuation date, ADDI&C was a closely held Florida corporation with all of its 97 issued and outstanding shares held by a trust ("Davis Trust") for the benefit of Artemus Davis. ADDI&C and the Davis Trust were deemed to be affiliates under Rule 144, making sale of the Winn-Dixie stock subject to certain restrictions. Table 1 indicates the various values attributed to the gifts after Petitioner modified the original gift tax return value and Respondent modified the original deficiency notice value.

For the fiscal year ended October 31, 1992, ADDI&C received \$1.27 million in dividends from its ownership of the Winn-Dixie stock. Table 2 indicates the historical cost basis and fair market value for the Company's assets and liabilities as of the valuation date. The parties agreed on this fair market value, before application of any valuation discounts. On November 2, 1992, Artemus Davis transferred 25 shares of ADDI&C to his son Robert Davis and 25 shares to his son Lee Davis. The gift tax return affixed a value of \$297,770 per share to the transfer. The IRS issued a deficiency notice.

The parties disputed four issues: 1) whether a blockage/restricted stock discount should be applied to the Winn-Dixie stock's value and if so, how much of a discount;

(Continued on Page 2)

Fundamentals of a Solid Business Appraisal

In the preparation of this newsletter, we usually look for topics of specialized appeal. However, it is frequently good to remember the basics which are crucial to the success of valuation assignments. Our purpose here is to highlight some of the fundamentals of a sound business appraisal.

Specify the Purpose. The purpose of any appraisal should be clearly stated at the outset because purpose can affect valuation conclusions. The purpose statement places an appraisal, and its conclusion(s), in an appropriate context.

Identify the Entity Being Valued. An appraisal must clearly identify the entity to be valued. It may be apparent which company or business interest is being valued; however, there have been cases where a subsidiary was valued instead of the parent company

(Continued on Page 4)

IN THIS ISSUE

Davis v. Commissioner 1

Fundamentals of a Solid Business Appraisal 1

Closing the FLP Loophole? 3

	Historical Cost Basis of Assets	Assets at Fair Market Values
Feeder Cattle	\$6,474,368	\$8,074,368
Breeding Herd	\$1,072,843	\$1,894,400
Winn-Dixie stock	\$338,283	\$70,043,204
DDI stock	\$120,263	\$535,162
Total Equipment	\$172,999	\$130,294
Other Assets	\$1,295,539	\$1,295,539
Total Assets	\$9,474,295	\$81,972,967
Total Liabilities	\$1,832,698	\$1,832,698
Net Asset Value	\$7,641,597	\$80,140,269

Table 2

2) whether a discount for imbedded capital gains should be applied and, if so, how much of a discount; 3) the appropriate minority interest discount; and 4) the appropriate marketability discount. The Court reviewed expert opinions submitted by Alex Howard and Shannon Pratt for the Petitioner, and by John Thomson for the Respondent. Table 3 delineates the positions of Petitioner's and Respondent's experts.

Blockage Discount. The first issue the Court addressed was whether a blockage/restricted stock discount for the Rule 144 restrictions on ADDI&C's Winn-Dixie stock is appropriate. All parties agreed that the Winn-Dixie stock was subject to Rule 144 volume restrictions. As a result, disposal of the stock would have to be through a private placement (whereby the investor would be subject to a 2 year holding period and a 1 year volume limitation) or sale of the stock subject to that volume limitation (dribble-out method).

Alex Howard chose a 4.9% blockage discount based on an analysis using the Black-Scholes option pricing model. Mr. Howard explained that the model reflects the cost to lock in the value of a stock price to protect against market risk. He indicated the model was an appropriate estimate of blockage discount because the stock most likely would have been sold using the dribble-out method and that it would have taken 5 to 6 months for ADDI&C to sell its Winn-Dixie stock ... "without moving the market, [thereby] exposing

that stock to market risks which always results in a decreased value . . ."

Shannon Pratt indicated that a 10% discount was appropriate. However, the Court noted that it was not going to rely on his opinion because of his limited explanation as to how he arrived at his conclusion. Respondent's expert, John Thomson argued that a discount to reflect Rule 144 restrictions was not appropriate because Winn-Dixie's stock price "was on a rising trend line" from January 3, 1992 through November 2, 1992, increasing 72% during that period. Petitioner argued that this trend was not expected to continue. Petitioner cited the *Value Line Investment Survey* which indicated the "long-term total return prospects have been diminished" to support the argument that despite the increasing price, a discount was warranted.

The Court rejected the Petitioner's arguments and indicated that the *Value Line Investment Survey* did not reflect the short-term prospects for Winn-Dixie stock. The Court declined to follow Mr. Howard's analysis and determined that no discount was appropriate. Although the Court indicated that ADDI&C would have disposed of its Winn-Dixie stock using the dribble-out method, the Petitioner did not satisfy its burden of proving that a discount was appropriate. Interestingly, the Court did not go into detail regarding why Mr. Howard's opinion was not persuasive regarding the blockage discount.

Imbedded Gains & Discounts. All three experts agreed that the net asset value of ADDI&C should be reduced by the amount of the imbedded capital gains tax. Table 3 indicates the differences among the experts in their opinions of the amount and application of this reduction.

Mr. Howard deducted the full amount of the tax on the gain before applying any marketability or minority discount. Dr. Pratt and Mr. Thomson increased their marketability discounts to reflect the difficulty in marketing stock with such a substantial built-in gain.

The Court concurred that it was appropriate to discount the value of the stock to reflect these built-in gains. The Court stated "we reject respondent's position that, as a matter of law, no discount or adjustment attributable to ADDI&C's built-in capital gains tax is allowable in the instant case." Previous Tax Court decisions had indicated that, unless there was a clear plan of liquidation, means existed to avoid capital gains taxes; therefore, no discount was appropriate. The Court rejected precedent and stated:

"we are convinced ... that even though no liquidation of ADDI&C or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed ... on a price ... that took no account of ADDI&C's built-in capital gains tax. We are also persuaded on that

	Petitioner		Respondent
	Alex Howard	Shannon Pratt	John Thomson
Net Asset Value	\$ 80,140,269	\$ 80,140,269	\$ 80,140,269
Fair Market Value of Winn-Dixie Stock	\$ 70,043,204	\$70,043,204	\$70,043,204
Blockage Discount	-4.9% \$ (3,432,117)	-10.0% \$ (7,004,320)	0.0% \$ -
Adjusted Net Asset Value	\$ 76,708,152	\$ 73,135,949	\$ 80,140,269
Tax on Imbedded Gain of \$70,918,453	-35.8% \$ (25,395,109)	0.0% \$ -	0.0% \$ -
Net Asset Value	\$ 51,313,043	\$ 73,135,949	\$ 80,140,269
Minority Interest Discount	-15.0% \$ (7,696,956)	-20.0% \$ (14,627,190)	-12.0% \$ (9,616,832)
	\$ 43,616,087	\$ 58,508,759	\$ 70,523,437
Marketability Discount	-35.0% \$ (15,265,630)	-35.0% \$ (20,478,066)	-23.0% \$ (16,220,390)
	\$ 28,350,456	\$ 38,030,693	\$ 54,303,046
Capital Gains "Marketability" Discount	0.0% \$ -	-15.0% \$ (8,776,314)	-15.0% \$ (10,578,516)
Nonmarketable Minority Interest Value	\$ 28,350,456	\$ 29,254,379	\$ 43,724,531
Implied Total Discounts to Net Asset Value	64.6%	63.5%	45.4%
Value Per Share (97 shares outstanding)	\$ 292,273	\$ 301,592	\$ 450,768

Table 3

record, and we find, that such a willing seller and such a willing buyer . . . would have agreed on a price on the valuation date at which each such block would have changed hands that was less than the price that they would have agreed upon if there had been no ADDI&C's built-in capital gains tax as of that date."

The Court indicated that the full amount of the built-in capital gains tax may only be deducted if there is record of a planned liquidation on the valuation date. Since there was no liquidation planned on the valuation date, a portion of the built-in capital gains tax amount could be reflected as a discount in determining the fair market value. The Court agreed with Dr. Pratt and Mr. Thomson that the discount could be part of the marketability discount.

Both Dr. Pratt and Mr. Thomson indicated that a discount of about 15% was appropriate to reflect the effect of built-in capital gains taxes. The dollar value of this incremental adjustment ranged from \$8.8 million to \$10.6 million. The Court determined that a \$9.0 million adjustment (implying an additional marketability discount of 13.2%) was appropriate. This is equivalent to saying that the Court allowed the use of a 12.7% tax rate on imbedded capital gains (\$9.0 million tax divided by \$70.9 million gain).

Minority Interest Discount. There was little discussion of the minority interest discount in the opinion. The appraisers used minority interest discounts of 15% (Howard), 20% (Pratt) and 12% (Thomson). The Court's conclusion was within the evidence at 15% for the minority interest discount.

Marketability Discount. The final issue the Court faced was the determination of the appropriate marketability discount. Mr. Howard applied a 35% discount and supported his conclusion with evidence from restricted stock studies and initial public offering studies. Dr. Pratt indicated that a 35% discount (in addition to the 15% for built-in gains) was appropriate based upon the same studies and ADDI&C's

history of not paying dividends. Dr. Pratt also analyzed the discount at which publicly traded limited partnership units were priced. Mr. Thomson did not consider the IPO studies, which suggest a higher range of marketability discounts. Mr. Thomson did consider the size of the block of ADDI&C stock, its swing potential, public awareness of ADDI&C, the type of business in which ADDI&C was engaged, financial strength of the company, dividend paying potential, methods of determining ADDI&C's asset value, and other relevant factors in determining an additional 23% marketability discount (on top of the 15% for built-in gains).

The Court indicated that Mr. Thomson made erroneous assumptions regarding the swing potential of the blocks of ADDI&C stock and its dividend paying capacity. The Court determined that a hypothetical buyer and seller would have no reason to believe dividend payment would be likely, given the history of no dividends. The Court stated "we are satisfied that the respective amounts of the lack of marketability discounts determined by the experts without regard to ADDI&C's built-in capital gains tax (\$15.2 million by Mr. Howard, \$16.2 million by Mr. Thomson and \$20.5 million by Dr. Pratt) set the appropriate range . . ." The Court determined that a discount of \$19.0 million (27.9%) was appropriate to reflect additional factors related to ADDI&C's lack of marketability. The Court's conclusion was based on the record of the case, restricted stock studies, and IPO studies highlighted by Mr. Howard's and Dr. Pratt's reports. Table 4 indicates the Court's calculation of the value of ADDI&C's stock.

Conclusion. This case is noteworthy because of the Court's departure on discounts for imbedded capital gains and in its careful treatment of each valuation issue. First, the Court indicated that even if there is no plan of liquidation, it is appropriate to take a

The Tax Court	
Net Asset Value	\$ 80,140,269
Fair Market Value of Winn-Dixie Stock	\$ 70,043,204
Blockage Discount	0.0% \$ -
Adjusted Net Asset Value	\$ 80,140,269
Tax on Imbedded Gain	
of \$70,918,453	0.0% \$ -
Net Asset Value	\$ 80,140,269
Minority Interest Discount	-15.0% \$ (12,021,040)
	\$ 68,119,229
Marketability Discount	-27.9% \$ (19,000,000)
	\$ 49,119,229
Capital Gains "Marketability" Discount	-13.2% \$ (9,000,000)
Nonmarketable Minority Interest Value	\$ 40,119,229
Implied Total Discounts to Net Asset Value	49.9%
Value Per Share (97 shares outstanding)	\$ 413,600

Table 4

discount for imbedded capital gains. This is the first time a court has recognized the "real-world" logic of an investor and indicated that a discount is appropriate to reflect the fact that a hypothetical willing buyer will pay less for stock due to built-in capital gains taxes for which he may be responsible. Second, the Court's conclusion favored the Respondent's position. Two-thirds of the disputed difference was found in favor of the IRS. Unlike many decisions, however, readers of *Davis* get the benefit of the Court's valuation logic at each key decision point. Appraisers are increasingly being called to task by the Court to provide the detailed explanations that make it possible for the Court to render reasonable opinions. ♦

Closing the FLP Loophole?

*1999 Revenue Proposals Eliminating
Non-Business Valuation Discounts
Rejected by Congress*

In the last issue of this newsletter, we alerted you to the possible elimination of non-business valuation discounts (especially as they apply to FLPs and LLCs) as outlined in the *General Explanations of the Administration's Revenue Proposals* for fiscal year 1999 released on February 2, 1998 by the U.S. Treasury Dept. These estate planning tax law revisions were introduced as amendments to the IRS Restructuring bill.

The amendments were rejected in committee and the bill was signed into law on July 23, 1998 without the amendments.

Fundamentals of a Solid Business Appraisal

(Continued from Page 1)

as intended. A related circumstance occurs when the underlying assets are mistakenly valued instead of the entity which owns them.

Specify the Valuation Date. The valuation date is known in valuation terms as the “as of” date. The valuation must relate to a point in time, because valuation changes over time. Information should be current through the valuation date, and subsequent events should be considered only as appropriate.

Determine the Standard of Value. Value is described or defined in a variety of ways. Some of the more frequently used terms are fair market value, market value, fair value, investment value, intrinsic value, going-concern value, liquidation value, and book value.

Fair market value, fair value, and market value are terms which typically establish legal standards for valuations.

They do not always prescribe the process to be employed. The others are attempts to define value from the financial analyst’s perspective. Each may incorporate one or more analytical exercises in deriving the answer. In other words, the valuation conclusions of fair market value or fair value are derived from approaches incorporating appropriate analytical techniques as well as judgment.

Choose the Appropriate Methodology.

This is a fundamental business appraisal tenet. The valuation methodology or methodologies should match the purpose for which it is intended. No single valuation approach is suitable for every valuation assignment.

Valuation guidelines and considerations may be very customized, subject to general guidelines, or strictly mandated. The appraiser often has considerable latitude in selecting the methodology. It is incumbent upon the reader to be aware of the propriety of the method employed.

Documentation. A good appraisal will have an appropriate degree of documentation. Documentation should be consistent with the nature and scope of the appraisal requirement. Most appraisals are presented as “stand-

alone” documents which support and validate their conclusions. However, even less well documented reports must be supported by analysis and file documentation.

Ability to Replicate. The careful reader of an appraisal should, with a reasonable amount of effort, be able to replicate the valuation result. Appraisers who do not provide sufficient documentation to enable a replication of their answer are practicing “black magic” or some other arcane art rather than business appraisal.

The Independence of the Appraiser. Appraisal reports should specify who is being retained by whom. Further, any previous or existing business relationships between the entity and the appraiser should be disclosed. An appraiser should state whether or not there are any factors which could call his or her independence into question.

The Final Test—Understandability. Simply put, an appraisal should be understandable by the lay reader as well as by the professional appraiser. In short, valuations must be built upon a solid foundation to avoid problems. ♦

* * * * *

This publication is intended to provide accurate and authoritative information on the subject matter covered. It is distributed with the understanding that the publisher and distributors are not rendering legal, accounting or other professional services and assume no liability whatsoever in connection with its use.

J.L. PIERSON & CO. BUSINESS VALUATIONS

Post Office Box 2392
Darien, CT 06820-0392

<http://www.jlpierson.com>