Tax Court Rules on Built-In Gains Discount and Appraiser Qualification

03.03.2014

BY: DANIEL J. DURST

On February 11, 2014, the United States Tax Court issued a memorandum opinion (i) determining the proper method for valuing a holding company (i.e., an S or C corporation holding marketable securities or appreciated investment assets), (ii) affirming its position with respect to the appropriate discount for built-in capital gains, and (iii) upholding an underpayment penalty due partly to an appraiser?s lack of expert qualification.

Background

In *Estate of Richmond v. Commissioner*, T.C. Memo 2014-26, the estate challenged the IRS?s valuation of the decedent?s interest in a family-owned personal holding company and the assessment of an underpayment penalty relating to that valuation.

At the time of her death on December 10, 2005, Helen Richmond owned a 23.44% interest in a family-owned holding company (in this instance, a C corporation). The company had paid a regular dividend to its shareholders from 1970 through 2005. From 1971 through 1999, shares were sold, redeemed, or issued in ten separate transactions that valued the stock using a dividends-capitalization method.

The estate retained a CPA to value Ms. Richmond?s interest in the company for purposes of the estate tax return. The CPA had been licensed in Delaware since 1975 but did not have any appraiser certifications. He had written 10-20 valuation reports and testified regarding valuation matters previously in court. The CPA valued the interest using a dividends-capitalization method and provided an unsigned draft of his valuation report to the estate, but was never asked to finalize his report. The estate reported the value of the decedent?s interest consistent with the value determined by the CPA (i.e., $3,149,767).

IRS Challenge and Tax Court Ruling

The IRS issued a notice of deficiency to the estate adjusting the value of the decedent?s interest upwards to $9,223,658, resulting in an increase in the estate tax liability of nearly $3 million. The IRS also assessed an underpayment penalty.

At trial, the IRS argued that the decedent?s interest should be valued using a discounted net asset value (NAV) method, and the Tax Court agreed. The court found that the dividends-capitalization approach was appropriate for entities with difficult to value assets, but that the NAV method was most appropriate for holding companies whose assets are marketable securities. Thus, the court found that the valuation of the subject interest should begin with the company?s NAV of $52,159,430.

The estate argued that, if the NAV method were accepted as the best approach for valuing the decedent?s interest, the tax liability on the company?s significant built-in capital gains (BICG) should reduce the company?s NAV on a dollar-for-dollar basis. On the facts presented, the IRS instead applied a BICG tax discount of 43% of the BICG tax liability. The court found that a 100% BICG tax discount was not appropriate; rather, the most reasonable discount was the present value of the projected cost of paying capital gains taxes in the future. This ruling was consistent with the Tax Court?s position with respect to BICG tax discounts in cases where there is no contrary, binding appeals court precedent (as there is in the 5th and 11th Circuit Courts of Appeals). In addition to the BICG tax discount, the Tax Court allowed minority interest and lack of marketability discounts of 7.75% and 32.1%, respectively.

The estate sought to avoid the underpayment penalty associated with the adjustment of the value of the decedent?s interest by claiming that the estate had reasonable cause for the undervaluation because the estate relied on the expert opinion of the CPA. The court found that the estate did not have reasonable cause, because (i) the CPA was not a ?certified appraiser,? (ii) the estate relied on an unsigned draft valuation report, and (iii) prior to trial, the estate hired another appraiser who offered a higher value, but the estate did not explain the defects in the CPA?s original valuation.

Implications

Estate of Richmond v. Commissioner indicates that, for transfer tax purposes, a NAV valuation approach is the most appropriate method for valuing an interest in a marketable securities holding company, even where the company has a lengthy history of consistent dividends and prior valuations using other approaches. Given the consistency of dividends and prior valuations, it is difficult to imagine a situation where the dividends-capitalization approach would be more appropriate for valuing an interest in a family holding company than it was in *Estate of Richmond*.

Estate of Richmond also affirms that, where the Tax Court is not bound to appeals court authority indicating a 100% BICG tax discount, the Tax Court will allow a BICG tax discount only to account for the predicted cost of paying capital gains taxes in the future. This approach seems to be at odds with the theory behind the NAV valuation method, as recognized by the 5th and 11th Circuits: that the company could be created from scratch by someone else, who would have no BICG tax liability.

Finally, *Estate of Richmond* underscores the importance of hiring well-qualified valuation experts who carry professional certifications and are familiar with Tax Court rulings regarding valuation methods and discounts to value interests in closely-held entities. In *Estate of Richmond*, a CPA license and some valuation experience was found to be insufficient to protect the taxpayer from underpayment penalties.

Related People

- Farhad Aghdami ? 804.420.6440 ? aghdami@williamsmullen.com
- Daniel J. Durst ? 804.420.6465 ? ddurst@williamsmullen.com
- Christine Nguyen Piersall ? 757.629.0703 ? cpiersall@williamsmullen.com

Related Services

- Private Client & Fiduciary Services
- Tax Law