



### **Business Valuation Case Update - July 2011**

In this *Business Valuation Case Update* we have three cases:

1. Divorce Court Prefers BV Appraiser Over Broker, but No DLOM for Prof. Practice *Nuveen v. Nuveen*, 2011 WL 988826 (N.D. - March 22, 2011). Another case where certified appraisers following USPAP are given credence in their testimony over non-accredited appraisers.
2. Tax Court Confirms Its Position on Subsequent Events re: Contingent Claims *Estate of Foster v. Commissioner*, 2011 WL 1598633 (U.S. Tax Ct. - April 28, 2011). Interesting case concerning after the fact evidence in regards to a legal judgment.
3. NY Statutory FV Includes DLOM, BIG Discounts *Gaiimo v. Vitale*, 2011 WL 1549064 (N.Y. Superior Court - April 25, 2011, unpublished). New York case concerning Fair Value and Built In Gains tax discounts.

#### **Divorce Court Prefers BV Appraiser Over Broker, but No DLOM for Prof. Practice *Nuveen v. Nuveen*, 2011 WL 988826 (N.D. - March 22, 2011)**

Both parties presented experts to testify regarding the value of the husband's successful orthodontic practice at their divorce trial. The husband presented a certified appraiser, who conducted his valuation in conformity with the Uniform Standards of Appraisal Practice (USPAP) as well as Revenue Ruling 59-60. The wife presented lawyer-broker, who typically prepared appraisals of dental practices for sale.

**Value of intangible assets is key.** The husband's expert used only the income approach to provide a fair market value of the orthodontic practice (a subchapter S corporation), and considered the tangible and intangible assets, its earnings, and also its debt. Notably, he also relied on the husband's purchase of intangible assets three years prior to divorce, finding the transaction was a "truly comparable sale" because it was arm's length between a willing buyer and seller in the same market.

The wife's expert used three valuation methods to arrive at a weighted average value for the practice. He also valued the intangible assets at more than double the amount that the husband had paid for them three years before, based on the practice's continued high earnings.

The trial court agreed that it made sense to consider the prior sale, but rejected the conclusion that the intangible assets would have increased more than twofold in a flat economic market. It also found that regardless of the difference between the two experts' valuation methods, they reached similar results, except for their value of the intangibles. (Note: The appellate court opinion does not provide the ultimate value conclusions of either expert or any greater detail regarding their approaches.)



Ultimately, the trial court found the appraisal by the husband's expert was more reliable, not only because he was a certified appraiser and his report complied with USPAP and other commonly accepted BV standards, but also because his method of determining the intangible value of the practice was more accurate given the current economic climate. At the same time, since both experts agreed that the practice was "stable and highly profitable," the court accepted the maximum values for the intangibles as well as the stock from the husband's expert, and made certain adjustments. First, it subtracted the cash assets because they had already been included in the parties' stipulated property division. Second, the court declined to adopt the expert's 12% discount for lack of marketability (the appellate opinion does not provide any further discussion on the lower court's reasoning).

The wife appealed the decision, but the appellate court affirmed, finding the valuation of the husband's orthodontia practice was within the range of evidence provided by the parties.



## **Tax Court Confirms Its Position on Subsequent Events re: Contingent Claims *Estate of Foster v. Commissioner*, 2011 WL 1598633 (U.S. Tax Ct. - April 28, 2011)**

In an opinion decided on the same day and by the same Judge (Cohen) as *Estate of Saunders v. Commissioner*, the U.S. Tax Court also considered whether a contingent claim could be reduced to a reasonably certain value on the date of death, but this time in the context of claims asserted by as well as *against* the estate.

**Litigation involved the decedent's husband.** When Thomas Foster died in 1996 he left a profitable mail-order horticulture business, worth approximately \$33 million, in three marital trusts for his wife. When his wife died in 2004 the business had gone bankrupt and had been sued by its ESOP beneficiaries. Her estate reported the value of the potential liabilities at a negative \$14.7 million at the time of death, based on appraisal filed in conjunction with its return which claimed a 29% "marital trust discount" due to the hazards of this litigation. Just about one year later, however, all claims against the estate were dismissed.

After the wife died, the estate also began investigating possible claims against the husband's business lawyer and his lender for malpractice and breach of fiduciary duty with regard to the ESOP litigation. The executors did not however, list any value to these claims on wife's 2005 estate tax return, despite initiating a lawsuit just one month later. It was not until the IRS selected the return for examination in 2007 that the estate revealed these additional claims against the husband's lawyer and his lender as potential assets. An appraiser for the estate said the claims were worth no more than \$44,000 before application of a 25% discount for lack of marketability, reducing the claims' value to approximately \$33,000 as of the date of (2004).

The IRS disagreed, however, asserting a deficiency of nearly \$4.8 million related to the various litigation claims. After the estate received \$17.85 million to settle the case against the lawyer and lender, in 2008, the IRS increased its deficiency assessment to just over \$14.6 million.

At trial, the parties asserted widely disparate positions on the likely resolution of the various lawsuits and their respective values at the date of death. The U.S. Tax Court considered their arguments in three parts:

1. *Discount for hazards of litigation.* The parties agreed on the value of the assets in the marital trusts, but disputed the application of a discount due to the pending ESOP litigation. For purposes of trial the estates appraiser said the marital trusts had an "impaired" value of \$34.2 million based on: (i) a 12.9% to 17.2% discount for the litigation; plus (ii) discounts of 4% for lack of control and 15% to 20% for lack of marketability (due to a freeze on trust assets), for a total discount of 32.4%. In support, the estate cited case law in which litigation (or the threat of litigation) against an asset in the estate justified a discounted value.

The court distinguished the precedent, however by finding that in this case, the pending litigation would not have affected a potential buyer of the trust assets. In fact, given the particular circumstance of the litigation at the date of death, the estate could have transferred the assets free and clear of the ESOP plaintiff's claims.

Alternatively, the estate argued that it could claim a SEC. 2053 deduction for the contingent liability. The IRS reasserted the same arguments that it did in *Estate of Saunders*; that is, under applicable 9<sup>th</sup> Circuit precedent, post-death events (such as subsequent settlement or dismissal of a case) are relevant when the contingent claims are not certain and



enforceable at the time of death. Accordingly, because the litigation in this case was uncertain at the time of death, the court could take account of the subsequent dismissal of the ESOP litigation.

Once again, however, the Tax Court avoided the potential “minefield” of subsequent events precedent by citing its rationale in *Saunders*. There, “we declined to attempt to reconcile these cases and did not consider the effect of a post death settlement of a claim against the taxpayer estate,” the court said, “because we instead found that the value of the claim was not ascertainable with reasonable certainty on the valuation date.”

Likewise, in this case, the IRS assessed alternative deficiencies against the estate at various times, and estate's appraisers asserted combined discounts ranging from 29% at the filing of its return to over 32% at trial, representing an \$8.1 million difference in potential value. Moreover, only the estate's trial appraiser asserted discounts for lack of control and marketability purportedly related to the freeze of trust assets caused by the litigation; the estate's original appraiser “altogether failed to evaluate” these elements, the court said, and “the sharp discrepancy in their figures evidences a lack of reasonable certainty in the values they suggested.” Moreover, like the taxpayer's experts in *Saunders*, neither of the estate's experts could “reasonably opine” that the estate would have to pay amounts they suggested, the court said, finding the estate failed to establish the value of the marital trust discount with reasonable certainty, as required by Sec. 2053 and related Treasury regulations.

2. *Discounts due to frozen assets.* The court also found no basis for discounts on the marital trust assets, because the freeze restricted only the wife's (decedent's) access to the trusts and did not affect the underlying assets. Thus, the freeze would not affect a willing buyer in a hypothetical sale of the assets, and in fact, that same buyer would be able to market the assets in a subsequent sale free and clear of any discount.

3. *Claims held by the estate.* The estate admitted that it failed to report the pending claims against the lawyer/lender on the decedent's 2005 tax return. At the same time, after discussing the claims and various damages theories with the estate's attorneys, its appraiser concluded that only one claim had any value (\$33,000, after application of a 25% discount for lack of market ability) at the time of the wife's death.

By contrast, two appraisers for the IRS assessed the same claims at \$5.1 million. “These values, however, rise or fall on [the experts'] position that a hypothetical purchaser of the claims would have knowledge of all relevant facts that [were] reasonably known” at the wife's death, the court explained. These facts included all those that were present in the defendant bank's files, but took two years of “time consuming,” highly contested discovery by the estate's lawyers to bring to light. In essence, the IRS appraisers claimed that a hypothetical purchaser of the claims would be “omniscient of all relevant material” on the date of death, the court said, but they ignored the two years and the cost required to reach that level of knowledge.

**All appraisers were 'overzealous.'** As a result, the court had little confidence that either side's appraisers were “objective and reliable.” Each had engaged in “an overzealous effort... to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise,” the court held (citing a 1967 Tax Court opinion).

For example, the estate's appraiser assumed that, after an investigation of the claims, the estate would have concluded a 1% to 20% probability of success as of 2005. This was “not reasonable,” the court said, because the estate simply would not have proceeded past the investigation stage if the chance of a favorable outcome was less than 50/50. In fact, by the



time the estate amended its complaint in 2006, the lender refused to pay any settlement and asserted its attorneys' fees and costs. At this point, the estate's appraiser said the case had a 75% probability of success.

Based on this methodology as well as the evidence from the IRS appraiser, the Tax Court ultimately found that the estate's investigation of the case would have led it to conclude 10% to 50% probability of success (instead of 1% to 20%). It applied a 39.5% marketability discount (as determined by an IRS appraiser) and zero litigation costs (because the estate deducted these as an administrative expense), concluding that the fair market value of the estate's claims as of the date of death was \$930,000.



## **NY Statutory FV Includes DLOM, BIG Discounts *Gaiimo v. Vitale*, 2011 WL 1549064 (N.Y. Superior Court - April 25, 2011, unpublished)**

A brother and sister held equal shares in a family business that owned and operated 19 Manhattan apartment buildings. When the siblings could no longer agree on how to manage the properties, the brother elected to buy out the sister's shares. It took 17 days for a special referee to determine the statutory fair value of the 50% interest, to which he declined to apply a discount for lack of marketability (DLOM), but did apply a present value discount for built-in capital gains (BIG) tax liability. After the trial court adopted the special referee's findings, both parties appealed various issues to the New York Supreme Court (appellate division), in particular the application of discounts to statutory fair value.

**Decision doesn't even mention amounts at issue.** In valuing the real estate business, both parties' experts used the net asset value (NAV) approach. Notably, neither party challenged the referee's ultimate determination of NAV, which the appellate court opinion doesn't discuss—largely because it is well-settled in New York (and other jurisdictions) that the NAV approach is generally applicable to value real estate and investment holding companies.

Rather, the parties sharply disputed the unsettled law regarding the appropriate methodologies to use in assessing the two discounts. In particular, New York has not adopted the amendments to the Model Business Corporation Act, which preclude marketability and minority discounts in statutory fair value determinations. Instead, New York courts determine fair value of a dissenting shareholder's interest based on a going concern standard of value, that is, what a "willing purchaser in an arm's length transaction would offer for the corporation as an operating business," the court explained, with emphasis. After commending the special referee for a "thoughtful and exhaustive report on these complex issues," the court examined his findings regarding the discounts.

1. *DLOM*. Although N.Y. courts should consider the illiquidity of the shares at issue, the application of a percentage discount is not the only way to account for this risk, the appellate court observed. Prior cases have accepted an expert's factoring in a lack of marketability into his selection of the capitalization rate, for instance, while a leading case, *Friedman v. Beway Realty*, 87 N.Y.2d 161 (N.Y. Sup. 1995) upheld the application of a marketability discount to a closely held real estate company. At the same time, a more recent lower court case declined to apply DLOM to a real estate partnership; see *Vick v. Albert*, 47 AD3d 482 (NY 1st dept. 2008), reasoning that DLOM is more applicable to the goodwill portion of a corporation's value.

The New York Supreme appellate court did not find a relevant distinction between the applications of DLOM to a real estate partnership as opposed to a close corporation that holds real estate. It also noted that the "rationale for limiting DLOM to goodwill is unclear." At the same time, it acknowledged the inconsistency of precedent, finding that the special referee followed *Vick* (no discounts) and tried to distinguish *Beway* (DLOM) on the basis of the entities at issue, which were merely holding companies as opposed to real estate financing companies. Further, the special referee accepted the reasoning by the petitioner's expert, a noted business appraiser, who testified that the appropriate "level of value" in a fair value appraisal is "control value of a business," which was the implicit standard of value in *Beway*.

Nevertheless—and despite the expert's substantial credentials, the appellate court found his "control level of value" inconsistent with *Beway's* "going concern" standard. "While a discount for minority lack of control is impermissible, the illiquidity of the shares must be taken into account and, under *Beway*, a DLOM or other means of considering illiquidity is



not considered inconsistent with valuation on a going concern basis," the court held, and rejected the special referee's articulated rationale for precluding DLOM in this case.

At the same time, the court upheld the referee's conclusion, based on the particular facts of the case and the discretion inherent in the statutory fair value determination. Specifically, the special referee found "ample" evidence that similar properties were not widely available on the market and that a prospective buyer would have to buy through the parties' corporation. "This finding ... is as relevant to the determination as to whether to apply a [DLOM] as it is to whether to reduce the value of the corporations by embedded taxes," the court held, turning to the second issue.

2. *BIG*. Based on the formula in *Murphy v. U.S. Dredging Corp.*, 74 AD3d 815 (2008) (available at *BVLaw*), aff'd, 74 AD3d 815 (2d Dept. 2010), the referee reduced the value of the corporation's assets by the present value of the built-in capital gains taxes, using a 3% growth rate over a 10-year holding period, discounted back at a 10% rate. To calculate BIG, he declined to use a blended federal/tax rate, preferring a 45.8% rate for the virtually basis-free assets. Both parties contested the BIG finding. The petitioner argued that the court should reject the BIG deduction; or, alternatively, adjust it to accommodate the costs of selling the properties at the end of 10 years. The respondent claimed that instead of a present-value calculation, the BIG discount should be dollar-for-dollar, as applied in the matrimonial case, *Wechsler v. Wechsler*, 58 AD3d 62(2008); or, if it followed the present value approach, then it should account for additional taxes that the C corporation entities at issue would incur.

The court first noted that *Wechsler* did not address a present value formula for calculating BIG; it only considered whether it should reduce the value of the corporation by a dollar-for-dollar discount or the historical rate of taxes. Further, the *Murphy* court distinguished *Wechsler* on the basis of the entities at stake, mere investment companies (*Wechsler*) versus financing companies (*Murphy*).

The court noted (without endorsing) that the dollar-for-dollar approach avoided the uncertainties of a present value calculation, but in the end—as it did for its DLOM finding—the court held that there was a "sound legal and factual basis for the referee's decision to reduce the BIG to present value." His use of a 10-year holding period was supported by evidence that the entities had never sold any of their properties and did not have any financial reason to sell in the near future. Moreover, both party appraisers used a 10-year holding period in their NAV calculations. Finally, the availability of similar properties was "tight," the court noted, concluding once again that a prospective buyer could not avoid the BIG by purchasing on the open market.

Importantly, the court rejected the petitioner's contention that no deduction should be made for the BIG. Support for this argument rested largely on cases outside the jurisdiction that declined to consider the tax consequences of an asset sale in a going concern valuation without evidence of imminent liquidation. Although their reasoning had "much to recommend it," the court said, "New York follows the contrary view that it is irrelevant whether the corporation will actually liquidate its assets, and that the court, in valuing a close corporation, should assume that a liquidation will occur."

Accordingly, the appellate court endorsed the findings of the special referee in all respects, including the application of a BIG discount but no marketability discount.