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Tax Court Confirms Preference for the Net Asset Value Method in Valuing a Holding Company

In the Estate of Richmond v. Commissioner (T.C. Memo 2014-26), the Tax Court accepted the IRS's expert's position that relying on the Net Asset Value Method ("NAV") was the appropriate approach to valuing a personal holding company that owned primarily marketable securities. The Court rejected the Estate's expert's use of the capitalization-of-dividends valuation method, citing the sensitivity inherent in the method. In addition to the valuation method, this tax court opinion covers a number of other valuation issues.

Background

The decedent in Richmond owned 23.44 percent of Pearson Holding Co. ("PHC") on December 10, 2005 (the Date of Death - "Valuation Date"), representing the second largest ownership interest. PHC was incorporated in 1928 as a family-owned investment holding company. As of the Valuation Date, PHC continued to be a family-owned investment holding company, and was taxed as a C corporation. PHC's approach, as described by its current chairman and president, is "to preserve capital, to grow capital where possible, and to maximize dividend income for the family shareholders."

Through the Valuation Date, PHC followed its stated philosophy of maximizing dividend income, paying dividends reliably at a rate that grew slightly more than 5 percent per year from 1970 through 2005.

The turnover of PHC's securities has been slow – for the period from 2000 to 2005, 1.1 percent per year; and for the 10-year period ending December 31, 2005, 1.4 percent per year. At the 1.4 percent rate, a complete turnover of the securities would take 70 years.

This fact is important, given that as of the Valuation Date, 87.5 percent of the value of PHC's portfolio consisted of appreciation on which capital gain tax had not yet been paid ("BICG tax").

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From 1971 through 1993, there were nine transactions involving the sale or redemption of PHC stock by a shareholder. It appears that the value of the stock for those transactions was determined using the dividend model. In addition, when another shareholder died in 1999, the estate used the dividend model to value his interest in PHC.

As of the Valuation Date, the fair market value of PHC's total assets was $52,159,430, with outstanding liabilities of $45,389, for a net asset value of $52,114,041. The parties agree that the BICG tax was $18,113,083 on the same date.

As shown below, each side offered multiple fair market values prior to trial:

Source	Comment	Value of Decedent's Interest
Belfint, Lyons & Shuman, P.A.	Form 706	$3,149,767
IRS	Notice of Deficiency	$9,223,658
John A. Thomson	IRS's Trial Expert	$7,330,000
Robert Schweihs	Estate's Trial Expert	$5,046,500

Peter Winnington from Belfint, Lyons & Shuman, P.A. ("Belfint") prepared a draft report that used the capitalization-of-dividends method to value the decedent's interest in PHC.

The Estate's expert at trial, Robert Schweihs, relied primarily on the capitalization-of-dividend method, using the net asset value method as an alternative to propose corrections to Mr. Thomson's net asset valuation. Mr. Schweihs used a dividend growth model, with a discount rate of 10.25 percent, a long-term growth rate of 5 percent, and the decedent's share of PHC's dividends in 2005. In the net asset value method, he reduced PHC's net asset value by 100 percent of PHC's BICG tax, then applied an 8 percent lack of control discount and a 35.6 percent discount for lack of marketability.

The IRS's expert at trial, John A. Thomson, valued the interest by the cost approach, using a discounted net asset method. He applied a lack of control discount of 6 percent, and a 36 percent discount to adjust both for lack of marketability and the BICG tax. Of the 36 percent, 15 percent was a discount for the BICG tax.

Points of Contention

The experts disagreed over the following issues:

- Valuation method.
- BICG tax adjustment.
- Discount for lack of control.
- Discount for lack of marketability.

Valuation Method

The Court noted that the Estate's valuation method ignores the most concrete and reliable data that is available, the actual market prices of the publicly traded securities that constituted PHC's portfolio. In addition, the Court agreed with the Commissioner's criticism of the Estate's use of a 10.25 percent discount rate relying on

data from 1926-2004, a different period from the one used to calculate PHC's dividend growth rate (1970-2004). If the same time period was used, the discount rate dropped to 9.414 percent, resulting in a value for the decedent's interest of $6,005,000. This change in value was cited by the Court as an example of the sensitivity inherent in the capitalization-of-dividends method, making it less reliable.

The Court cited three cases to support the use of the NAV method for holding companies whose assets are marketable securities. The Estate also cited three cases to support its income capitalization valuation of holding companies, but the Court noted that in each of those cases the company to be valued held stock in a closely held operating company or was itself an operating company.

In summary, the Court noted that the market values of the marketable securities inherently reflect the market's judgment as to the projected income streams of each stock and therefore reflect the future income stream of PHC. Therefore, the Court followed the precedent of using the net asset value method for companies with holdings like PHC.

BICG Tax

The IRS's notice of deficiency seems to make no discount for the BICG tax, a position that the Commissioner does not defend in trial. In his net asset value method, Mr. Schweihs reduced the net asset value by 100 percent of the BICG tax. Mr. Thomson proposes a 15 percent discount from net asset value for the BICG tax, which equates to 43 percent of the liability of $18,113,083.

To reach his $7.8 million BICG tax discount, Mr. Thomson analyzed the correlation between unrealized appreciation and NAV discounts for closed-end funds as of December 31, 2004. After compiling data from closed-end funds with unrealized appreciation accounting for 11 to 46 percent of the total net asset value, he was unable to find any statistical correlation. He therefore concluded that buyers are indifferent to PHC's BICG tax for the unrealized appreciation that is equal to 50 percent of the NAV. Applying a 39.74 percent effective tax rate to the unrealized appreciation above 50 percent of NAV equates to a discount of $7,757,111, equal to 14.9 percent of NAV, which he rounded up to 15 percent.

The Court noted that the BICG tax liability is a liability of the entity, affecting its net asset value, thus it should be determined at the entity level. Citing *Estate of Jensen v. Commissioner* and *Estate of Litchfield v. Commissioner*, the Court reasoned that the most reasonable discount is the present value of the cost of paying off that liability in the future. Although PHC's historic rate for turning over its securities indicated a 70-year complete turnover, the Court assumed that a hypothetical willing buyer and seller would expect PHC's portfolio to turnover faster, citing continued advice from PHC's financial adviser to diversify its portfolio. In testimony, Mr. Thomson indicated that a potential investor would expect that a portfolio like PHC's would turnover within a period of 20 to 30 years, which the Court found reasonable.

The Court then applied discount rates ranging from 7.00 percent to 10.27 percent over 20 and 30 year turnover periods, resulting in a range of discounts of $5.6 to $9.6 million. Although the Court did not endorse Mr. Thomson's methodology for calculating the BICG tax discount, since his $7.8 million concession falls in the range, his number was deemed reasonable and was used by the Court.

Discount for Lack of Control

Mr. Thomson used a data set of 59 closed-end funds for the week of December 9, 2005, finding a mean discount from net asset value of 6.7 percent. However, because of the size of the decedent's block, and low dispersion of the remaining ownership interest and ease of management, he reduced the discount to 6.0 percent. The Court noted that he did not explain how he chose 0.7 percent as the amount of the reduction, and therefore did not see the justification for the reduction.

Mr. Schweihs used the same data but selected the median of 8.0 percent as the appropriate discount.

The Court removed two high values and one low value from the original 59 funds, considering those three outliers that skew the mean. Removing those outliers results in a mean minority discount of 7.75 percent, which the Court concludes is reasonable.

Discount for Lack of Marketability

Mr. Thomson examined seven studies of restricted stock sales, which resulted in a range of 26.4 percent to 35.6 percent, with an average discount of 32.1 percent. He chose to use the very bottom of the range of 26.4 percent as his starting point, reasoning that most of the studies dealt with stock in operating companies, which are inherently more risky than stock in a company that holds publicly traded shares. Mr. Thomson then further reduced the discount to 21 percent due to PHC's consistent track record of paying dividends, small amount of debt, and management by professional investors.

Mr. Schweihs chose the very top of the range of 35.6 percent, arguing that the stocks in the seven studies used to derive the discount would relatively soon be freely marketable. He contended that stock whose public trading is restricted for only a defined period may be less discounted in value than stock whose non-public status is of indefinite duration.

The Court was unconvinced by either party's rationale for deviating from the average of the range of 32.1 percent. Therefore a lack of marketability discount of 32.1 percent was deemed reasonable.

Conclusion

After making the above adjustments, the Court ultimately determined a fair market value for the decedent's interest of $6,503,804. A 20 percent accuracy-related penalty was assessed, with the Court noting that Mr. Winnington of Belfint did not demonstrate that he is qualified as an expert in valuation. In addition, the Court noted that the Estate relied on an unsigned draft report for reporting the value of the decedent's interest in PHC. Therefore, it concluded that the Estate did not act with reasonable cause and in good faith in reporting the value of the decedent's interest in PHC.

We make the following general observations about this case.

While the Court discusses in great length its rationale for why 0 percent discount and 100 percent discount assumptions for the BICG tax are incorrect, the case summary does not explain why the discount rates selected are appropriate, including the 7.00 percent "generally accepted rate of return". A potential willing buyer would likely assume that the certainty of paying the BICG tax is greater than the certainty of achieving the market rate of return from the Ibbotson data, which argues for a lower discount rate. Quantifying this difference in certainty is difficult, which is likely the reason for the use of the 7.00 percent rate. An alternative calculation of the discount rate would be the use of the yield on long-term U.S. Treasury bonds as of the Valuation Date.

The Court selects the mean discount, not the median, of the closed-end fund dataset, after removing two premiums significantly above the next highest premium and one discount significantly above the next lowest discount.

The Court clearly wants the experts to quantify the reasons for reducing the marketability discount range or selecting the high-end of the range. While the business valuation industry continues to produce various alternatives to the historical restricted stock study "range", this range remains at the center of any discount for lack of marketability discussion for non-marketable minority interests.

About the Author

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Brant has more than 15 years of financial advisory and analysis experience. Since joining ComStock Advisors in 1999, he has performed more than 400 business appraisals in a wide variety of industries for various purposes, including ESOPs, estate and gift tax situations, shareholder disputes, family law matters, mergers and acquisitions, goodwill and other asset impairment tests, financial reporting, and fairness opinions.

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