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The Washington Report

Wealth Transfer Edition

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Houston, We Have a Problem – Valuations (Again)

MARKET TREND: The IRS continues its attack on valuations, and there's no end in sight.

SYNOPSIS: The U.S. Tax Court recently issued its decision in Estate of Cecil v. Commissioner. The decision is important because it contributes to the discussion whether tax affecting is necessary and/or appropriate when valuing an S corporation. Additionally, the decision reveals the zeal with which the IRS is pursuing wealthy taxpayers on valuation matters and highlights the importance of deep expertise needed for successful business succession planning and using reliable appraisals.

TAKE AWAYS: (1) Taxpayers with successful family-owned businesses who desire to retain ownership of the business within the family are well advised to engage advisors well versed in business succession planning. (2) Reliable appraisals matter.

MAJOR REFERENCES: Estate of Cecil v. Commissioner, T.C. Memo. 2023-24

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A. Background.

The Cecil case involves gifts of interests in the Biltmore Company, a profitable family -owned business organized as a Delaware corporation and taxed as an S corporation ("TBC"). At the time of the gifts, TBC owned the tourist destination in Asheville, North Carolina, known as the Biltmore estate, a property the Cecil family (a branch of the Vanderbilt family) considered integral to its identity.

In 2010, William A.V. Cecil ("Mr. Cecil") and his wife Mary Ryan Cecil ("Mrs. Cecil") gave TBC stock to their children and grandchildren. Specifically, Mrs. Cecil transferred non -controlling blocks of voting stock to the children, and Mr. Cecil transferred minority blocks of nonvoting stock to trusts for the grandchildren.

The Cecils timely filed U.S. gift tax returns. They elected to treat their gifts as "split gifts" under Internal Revenue Code § 2513 (i.e., as made one-half by each of them) and, as a result, they each reported making aggregate taxable gifts in 2010 of $10,438,766, which amount they supported with a formal appraisal using a hybrid income and asset-based valuation approach.

The IRS audited the returns and assessed a $13,022,552 deficiency against each of the Cecils. In determining the deficiencies, the IRS valued the transferred stock using an asset-based approach. Specifically, it valued the stock based on the liquidation value of TBC's assets and gave no weight to TBC's going concern value despite the fact that none of the transferred interests was in a position to cause TBC's liquidation and none of TBC's shareholders desired to liquidate TBC.

The Cecils petitioned the U.S. Tax Court for relief, and the Court consolidated their petitions.

B. Valuation Positions at Trial

The Cecils and IRS adopted new valuation positions at trial. The Cecils argued the Court should value the transferred stock using a hybrid market and income approach and the IRS argued the Court should value the stock using a hybrid income and asset-based approach. Experts on both sides, however, agreed that tax affecting was necessary to value the stock and further agreed as to the proper method of tax affecting to apply.

C. Issues for the Court

The issues for the Court were twofold: (1) whether tax affecting was necessary to value the transferred stock; and (2) the proper approach for valuing, and the value of, the transferred stock.

1. Tax Affecting?

The purpose of tax affecting is to compare "apples to apples" when valuing S corporation stock in reference to C corporation stock. Essentially, it requires the appraiser to apply a hypothetical entity-level tax to the S corporation's income to account for the fact that S corporation income is taxed once, at the shareholder level, whereas C corporation income is taxed twice, once at the entity level and once at the shareholder level when distributed

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as dividends.

Here, the Court held that tax affecting was necessary to value the transferred stock based on the experts' agreement. However, the Court cautioned that, "while we are applying tax affecting here, given the unique setting at hand, we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation."

2. Valuation Approaches

There are three possible valuation approaches: (1) the market approach, (2) income approach, and (3) asset-based approach. The Court summarized these approaches as follows:

- **Market.** "The market approach compares the subject property with similar property sold in an arm's-length transaction in the same timeframe. This approach values the subject property by taking into account the sale price of the comparable property and the differences between the comparable property and the subject property...."

- **Income. "**The income approach capitalizes income and discounts cashflow. This approach values property by computing the present value of the estimated future cashflow as to that property...."

- **Asset-based.** "The asset-based approach generally values property by determining the cost to reproduce it. One example of an asset-based approach in the setting of a nonpublicly traded corporation is to value the corporation on the basis of the fair market value of its net assets (i.e., the fair market value of its assets less its liabilities)."

The IRS advocated a hybrid income and asset-based valuation approach at trial and the Cecils advocated a hybrid market and income valuation approach at trial.

a. The IRS' Valuation Approach

The Court rejected the IRS' valuation approach in its entirety on the basis that the IRS should have afforded no weight to the asset-based approach. Because TBC was a profitable operating company, the Court determined that TBC's earnings, rather than its assets, more accurately reflected its value. Additionally, the Court observed that, given the facts and circumstances, use of the asset-based approach appeared to be inconsistent with Rule 9.3 of the Uniform Standards of Professional Appraisal Practice, which provides in pertinent part:

> "In developing an appraisal of an equity interest in a business enterprise with the ability to cause liquidation, an appraiser must investigate the possibility that the business enterprise may have a higher value by liquidation of all or a part of the enterprise.... However, this typically applies only when the business equity being appraised is in a position to cause liquidation."

Here, the Court found that none of the non-controlling blocks of voting stock transferred to the children and the minority blocks of nonvoting stock transferred to the trusts for the grandchildren was in a position to cause TBC's liquidation. Moreover, the Court found that it was unlikely, if at all likely, that TBC's shareholders would agree to liquidate TBC.

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With respect to the latter finding, the Court emphasized the family's proactive, diligent, business succession planning including, without limitation, a Shareholder's Agreement in effect at the time of the gifts that significantly restricted transfers of stock to nonfamily members and a formal education program adopted by TBC to prepare the grandchildren to assume control of TBC and to teach them the importance of retained ownership of TBC.

b. The Cecils' Valuation Approach

The Court accepted the Cecils' valuation approach although it criticized aspects of the two appraisals the Cecils' tendered for trial. Among its criticisms were:

- In applying the market approach, both appraisers compared TBC to companies the Court found were incomparable, one appraiser compared TBC to only one other company, and the other appraiser considered sales consummated in 2008, when sales prices were likely depressed as a result of the Great Recession.

- In applying the income approach, one appraiser considered TBC's poor financial performance in 2008, which the Court again determined was likely an aberration due to the Great Recession.

- In determining an appropriate discount for lack of marketability, one appraiser relied on data (primarily from the 1970s and 1980s) which the court determined was too old.

Despite these criticisms, the Court accepted one of the Cecil's appraisals more or less in its entirety.

3. Value of the Transferred Stock

Based on the appraisal it accepted, the Court found that the Cecils had actually **overreported** the value of the transferred stock on their 2010 gift tax returns and **ordered the IRS to issue a $1,383,544 refund to each of Mr. and Mrs. Cecil**.

D. Observations

1. Aggression by the IRS

To appreciate how aggressively the IRS pursued the Cecils, it's necessary to read their post-trial opening brief, which is signed by their attorneys and which, with respect to the verifiable statements below, we take as true.

- The IRS audited not only the Cecil's 2010 returns reporting transfers of TBC stock but also, previously, their 1999 and 2005/2006 returns reporting transfers of TBC stock. In other words, the IRS audited the Cecils three times, in connection with four sets of returns, in less than 12 years.

- The Cecils and the IRS settled the audit of the 1999 returns by agreeing to a hybrid income and asset-based formula for valuing TBC's stock. Although the Cecils used that formula in connection with their 2005/2006 returns, the IRS initially disavowed the formula before agreeing to follow it. When the Cecils used the same formula in connection with their 2010 returns, the IRS again disavowed it.

- According to the valuation tendered by the IRS for trial, the notices of deficiency overstated the total tax due by at least $22,989,798.

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- Although the IRS timely filed its valuation, it did so only 30 days prior to trial, meaning the IRS continued to pursue the inflated tax until the very last minute.

The IRS' zealous pursuit of the Cecils should serve as a warning to wealthy taxpayers that the IRS is taking a gloves-off approach to valuation battles.

2. Lessons for Advisors

a. Business Succession Planning

The Cecils prevailed (and even received refunds) in this case in large part due to their extensive and well-documented business succession planning. The Court was able to reject the IRS' valuation of the transferred stock because it incorporated a liquidation assumption despite ample evidence that the family intended to retain ownership of TBC for the foreseeable future.

b. Reliable Appraisals

The Court's careful review and criticism of the appraisals in this case should serve as a reminder that reliable appraisals matter. Appraisers applying the market approach should be discriminating in identifying comparable property and sales, and if limited comparables are available, should weight that portion of their analysis accordingly. Further, appraisers should be aware of and account for market aberrations in the data and use current data only.

Take Aways: (1) Taxpayers with successful family-owned businesses who desire to retain ownership of the business within the family are well advised to engage advisors well versed in business succession planning. (2) Reliable appraisals matter.

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