



# WHEN RESULTS COUNT

## ESTATE AND GIFT E-FLASH

Volume 1-13

1999

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### Estate of Frank A. Branson v. Commissioner T.C. Memo 199-231, July 13, 1999

### Estate of Frank A. Branson v. Commissioner 113 T.C. No. 2, July 13, 1999

*The Tax Court has valued shares of two banks from a November 9, 1991, death. In the first bank, decedent owned 12,889 shares (12.89%) valued at \$181.50 by petitioner, \$300.00 by respondent, and \$276.00 by the Court. In the second bank, decedent owned 500 shares (6.25%) valued at \$485.00 by petitioner, \$850.00 by respondent, and \$626.00 by the Court. The Court largely disallowed the use of the restricted stock studies and pre-IPO studies widely used by appraisers.*

### Mendocini Savings Bank of Mendocino County

The Mendocino Savings Bank of Mendocino County (Savings) was founded in 1903 and was primarily family owned. Its stock was not traded on any established exchange or over the counter. Decedent owned 12.89% of the outstanding shares and two other family members owned 16.72% and 17.35% respectively. The remaining 53.04% was widely distributed with many of the shareholders owning less than 3%. The investment department of Savings maintained an informal list of people who were interested in buying shares of its stock. Usually, when a shareholder wanted to sell his or her shares, the shareholder contacted Savings, which informed the shareholder of the most recent sale price and the current book value of the stock. Savings then assisted the shareholder in finding a buyer. Historically, Savings shares traded at or near book value. Since 1980, there had been several sales of blocks of several hundred shares. In each of these sales, the shares traded hands on a single day and all the shares traded for the same price per share, although most of the buyers each purchased less than 100 shares. No blocks of Savings stock comparable to the size owned by petitioner had ever been sold; the only shareholders who had ever owned blocks of that size were family members, and none of them had ever tried to sell an entire interest.

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#### **Value measurement is used for many purposes, including:**

- Business Planning
- Succession Planning
- Purchase Price Allocations
- ESOP Values
- Economic Damages
- Corporate Dissolutions
- Shareholder/Partner Disputes
- Marital Dissolutions
- Estate and Gift

On October 9, 1991, decedent sold 1,111 shares for \$307 per share to approximately 20 buyers (the book value on October 31, 1991 was \$283.44 per share). On August 27, 1992, petitioner sold 2,800 shares for \$335 per share to approximately 45 buyers (the third-quarter book value was \$321.74 per share). Savings assisted petitioner in this sale, and petitioner did not attempt to sell these shares in any way other than through Savings.

The parties agreed that the best indication of the "market value" of Savings stock was the actual sale price of the shares. The petitioner argued that the actual sales price was "just the starting point for deciding fair market value - - that discounts should be applied to the sale price for minority interest, lack of marketability, and blockage." The respondent argued that the actual sale price was already reflective of the discounts for lack of control and marketability. The respondent also argued that since higher prices were paid in the post death market, no significant blockage discount was appropriate.

#### **Petitioner's Expert**

The petitioner's Big 5 accounting firm expert used the market and income methods to value Savings stock. In arriving at fair market value, the expert relied on the pre-IPO and restricted stock studies typically used by business appraisers. Based on the trading history in the Savings shares, the expert estimated it would take more than 8 years to dispose of all of the estate's shares.

The Court was not persuaded by the petitioner's expert and found his "reliance on the restricted stock studies for the size of the discount factor to be misplaced, since the studies analyzed only restricted stock that had a holding period of 2 years. The Savings shares were not restricted either by law or by agreement. The fact that Savings maintained a waiting list of willing buyers is evidence that the stock's history of low trading volume is due to the shareholder's preference to hold Savings shares for investment rather than for sale. As the investment time horizon of an investor in Savings stock evidently is long term, we do not believe that marketability concerns rise to the same level as a security with a short-term holding period like a restricted stock...Therefore, we find no persuasive

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evidence in the record to support reliance on the restricted stock studies in determining an appropriate marketability discount.”

The Court further rejected the pre-IPO studies, noting that the \$307 received by the decedent in the sale shortly before his death is more likely “40 to 45 percent less, rather than more, than the price at which the same shares would sell in an IPO.” In addition, since the expert’s calculated marketable minority value was nearly identical to the actual sales price of the shares, the Court believed that “the marketability of the Savings shares in the nonpublic market is essentially equal to that of a minority interest in the public market, in which case no discount for marketability is required for a minority interest in Savings.”

The expert’s blockage discount (although not called that by the expert - just the Court) was rejected. The Court rejected the analysis of sales prior to death and was critical that the expert did not consider petitioner’s actual sale less than 10 months after death.

### **Respondent’s Expert**

Respondent’s expert who had “performed many valuations for respondent in the past” also used the market and income approaches in his valuation. In determining his “liquidity discount” the expert relied on restricted stock and pre-IPO studies and 19 opinions of the Tax Court decided after 1983 where there was a discount separately and specifically identified for either lack of marketability or restrictions on transfer. The discounts in the studies and the cases ranged from 10% to 45%. The appraiser concluded that a 20% discount was appropriate. In order to use the actual sales price and blockage in his analysis, the expert assumed the estate would pledge the stock on a loan with payments over 8 years and 3 months, with loan payments made by selling stock. He then calculated the present value of the net cash flow from the stock sales and dividends, arriving at an “implied price per share” on a non-marketable minority basis. This was referred to as the piecemeal sales method.

Judge Parr rejected part of the expert’s opinion and accepted part. In his report, the expert noted a correlation between the price earnings ratio and earnings growth. The

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Judge could find no such correlation in the data presented and noted that using the average of the guideline companies' growth trends to determine a price earnings multiple for Savings "is akin to a navigator averaging compass points chosen at random to plot a course." The judge also rejected the expert's reliance on the restricted stock studies and pre-IPO studies for the same reasons she rejected the petitioner expert's use of those studies. The Judge also rejected the expert's assumptions under his piecemeal sales method.

Judge Parr concluded that the \$307 actual sales price of the 1,111 shares sold one month before death reduced by a 10% blockage discount was the proper valuation, resulting in a fair market value of \$276 per share.

### Bank of Willits

This bank was founded in 1904. At the date of death, there were 48 Willits shareholders, with decedent owning 6.25 % of the outstanding shares. Two other family members owned 30.51% and 17.68% respectively. Historically, very few Willits shares traded each year and from February 1980 until the valuation date, only 1,062 shares changed hands in 22 transactions. Most of the sales were by Willits board members either to Willits employees, board members, or directors, or to induce qualified persons to become board members or officers. Consequently, in these 22 transactions there were only six sellers and three buyers who were not Willits employees, board members, or directors. Most of the sellers, with the exception of decedent, sold few shares; decedent sold 674 shares. Historically, Willits shares have traded at or near book value. Petitioner sold 500 shares on August 12, 1992, for \$425,000 (\$850 per share). The book value of the shares on July 31, 1992 was \$875 per share. Petitioner did not independently value the shares before the sale nor did he contact or engage any brokers or agents for this sale.

Respondent had determined the value of petitioner's shares was \$850, but at trial reduced this to \$774 based on petitioner's sale of all if its shares some nine months after

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decedent's death. Petitioner asserted a \$485 share value, but conceded on brief to a range between \$485 and \$662 per share. Petitioner sold its 500 shares of Willits stock for \$850 per share, with 365 of these purchased by a family member who already owned more than 30% of the outstanding shares. The Court considered the relationship of the parties and petitioner's need for funds to pay the estate taxes and found the buyer "was an accommodating buyer, not a willing buyer," and did not rely on this sale. The Court did rely on the sale of the remaining 135 shares.

#### **Petitioner's Expert**

Petitioner used a different expert from Savings for this valuation. The Court noted that this expert's testimony at trial was "cryptic and unhelpful" so the Court relied solely on his written report. This expert used the guideline companies approach and arrived at a value of \$882 per share on a marketable minority basis. He then applied a 45% discount for lack of marketability based on the "usual restricted stock and IPO studies." As in Savings, the judge rejected the use of these studies and gave little weight to that portion of the expert's opinion

#### **Respondent's Expert**

The respondent used the same expert as Savings. The expert used the market and income approaches and considered actual sales to value the shares. He also used the same "piecemeal method" he used in the Savings valuation. The expert used a 20% "liquidity discount" based on the restricted stock and pre-IPO studies, averaged the various results, and concluded a \$774 per share value.

Again, the Judge found no persuasive evidence to rely on the restricted stock and pre-IPO studies. The expert had concluded that there was an established market for Willits' stock, but the judge disagreed and accorded that part of the expert's conclusion little weight. The Court rejected the value from the "piecemeal sales method" because that method results in the value to a particular borrower, not the fair market value.

Judge Parr concluded the best evidence of fair market value was the sale of 135 shares of petitioners stock at arm's

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length. Since petitioner's sale was 2.9% less than book value, the Court discounted the \$806 book value on the date of death to arrive at \$783 per share. The Court then applied a 20% discount for blockage, resulting in a value of \$626 per share.

### **Deduction of Estate Expenses**

Petitioner asserted that certain expenses incurred in supporting its position on fair market value should be deductible from the value of the gross estate. Respondent did not address this issue at trial or in brief. The deduction was allowed.

### **Equitable Recoupment**

In a separate but related case (113 T.C. No. 2) a divided Tax Court issued a 70 page Opinion dealing with the issue of equitable recoupment. The subsequent sales of Savings and Willits stock were reported by a residual legatee. The legatee paid individual income based on the values reported in the original estate tax return, which were lower than the values accepted by the Tax Court. Petitioner argued and the Tax Court agreed that, under the doctrine of equitable recoupment, petitioner is entitled to a credit for the income tax overpaid by the legatee on the gain recognized on the sales of shares due to the lower values reported on the estate tax return.

[\*Click Here for a Complete Copy of T.C. Memo 199-231, July 13, 1999\*](#)

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