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Estate of James Waldo Hendrickson v. Commissioner  
T.C. Memo.1999-278, August 23, 1999

*The Tax Court has valued a 49.97% interest in a closely held bank, treating it as a controlling interest. The Court rejected the IRS expert's guideline companies because of their lack of similarity in operations and size. Further, the Court rejected the IRS expert's use of the "Capital Asset Pricing Model" (CAPM) for determining the cost of capital of "a small, closely-held corporation with little possibility of going public." The Court opined that the greater risk of small stocks is not captured by CAPM and a "small stock premium" should be added.*

Decedent owned 1,499 of the 3,000 shares of Peoples Trust and Savings Bank of Boonville, Indiana (Peoples). Decedent's ex-wife owned 610 shares, his son held 85

	Value	
	Total	Per Share
Form 706	\$ 3,159,726	\$2,126.00
Taxpayer expert	\$ 4,497,000	\$3,000.00
IRS expert's value	\$ 8,938,912	\$5,963.25
Tax Court decision	\$ 5,757,296	\$3,840.76
Stockholder's equity	\$19,900,000	\$6,600.00

shares and the remaining 806 shares were held by 29 shareholders each of whom owned at least 3 shares. Judge Beghe determined that "although the estate shares were numerically a minority interest, they were a controlling interest in substance. The estate shares had effective control of Peoples, regardless of who owned them." In advancing this theory, the Judge noted, "Because every shareholder owned at least 3 shares, any existing shareholder who acquired the estate shares would automatically acquire a majority interest."

The original share value for the Form 706 filing was de-

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The Financial Valuation Group was established in 1990 to provide financial consulting services to closely held and publicly traded companies. Our **Consulting** and **Expert Witness** services are based on our professionals' unique knowledge about what creates value in a business entity and the various methods used to measure value.

**We Value:**

- Corporate Securities
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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

terminated by a local CPA firm on a minority basis using a weighted average under three methods: capitalized earnings, price/earnings multiple and price/book value multiple. This firm then applied a 30% lack of marketability discount to arrive at a fair market value of \$2,126 per share. This firm was not used as an expert in the proceedings.

The IRS expert determined the shares' fair market value using the weighted average under an income approach and a market approach, reduced by a marketability discount of 10%. The income approach was the discounted cash flow method (DCF) based on forecasted cash flows. The expert adjusted the forecast because the bank was over-capitalized due to a lack of dividends paid and he added back the excess capital as a non-operating asset in his calculation. For the cost of capital used in the DCF method, the expert used the weighted average cost of debt and equity capital (WACC) and calculated the cost of equity capital using the capital asset pricing model (CAPM) approach. In calculating the beta (a measure of systematic risk used in a CAPM calculation), the expert used only large multi-location publicly traded banks compared to the relatively small single-location Peoples. The expert determined a beta of 1 which is the same as the beta for the stock market as a whole.

The Court noted that the IRS expert had significant shortcomings in his application of CAPM, which highlighted the Court's doubts over the appropriateness of CAPM in the valuation of small, closely-held companies, especially those with little prospect of going public. The Court pointed out a number of the problems with applying CAPM, including the accuracy of beta. Further, the Court faulted the IRS expert for ignoring the small stock risk premium as a crucial part of determining cost of capital.

The IRS expert also improperly selected guideline companies according to the Court. The IRS expert's principal criterion for selecting guideline companies was geography rather than size, financial, or operating characteristics. Also, even though Peoples was a commercial bank, its operations more closely resembled that of a thrift institution, which should have been taken into account in selecting guideline companies.

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ESTATE AND GIFT E-FLASH



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The IRS expert took a 10% discount for lack of marketability. He concluded that little or no marketability discount was appropriate because the estate shares carried significant elements of control and might command a control premium. The Court was critical of the expert for failing to distinguish that the discount for lack of marketability and a premium for the benefits of control are conceptually different.

The taxpayer's expert valued the estate shares using the guideline companies approach. This expert's "methodology for selecting guideline companies was significantly more exacting..." according to the Court. His selection criteria were limited to thrifts comparable in size to Peoples. For this reason, the court relied on the data supplied by the taxpayer's expert. This expert, in the Court's view, however, failed to properly consider the excess assets (overcapitalization) in his analysis. In addition, this expert relied on market multiples that more closely resembled minority interests rather than the controlling interest imputed by the Court. After adjusting this expert's calculation for these changes, the Court applied a 30% marketability discount and noted, "While we recognize the elements of control may enhance marketability, we do not think that the estate shares were rendered marketable by virtue of their effective control. No matter who was in control, Peoples was still a small community bank with limited growth opportunities, capitalized with common stock that was not publicly traded and not easily sold privately."

This 60-page Tax Court Memorandum contains an extensive discussion of Peoples' 1960's style of operations and would make interesting reading for anyone involved in the valuation of a small community bank.

[\*Click Here for a Complete Copy of the Case\*](#)

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