The Financial Valuation Group

WHEN RESULTS COUNT

Estate and Gift E-Flash

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Estate of Sam Homer Marmaduke v. Commissioner T.C. Memo. 1999-342, October 14, 1999

The Tax Court effectively "split the baby" and allowed a 30% lack of marketability discount in Hastings Books, Music & Video, Inc. (Hastings). The taxpayer's two estate valuation experts claimed discounts of 60% and 40% respectively, while the IRS expert claimed a 15% discount. A separate appraiser determined a 20% marketability discount for an ESOP that owned 3% of the outstanding shares. There had been a number of small transactions proximate to the date of death, primarily with the ESOP and with other insiders, at a 20% marketability discount. The Tax Court did not believe heavy reliance could be placed on these transactions in the company stock because they comprised only approximately 1% of the outstanding shares compared to the decedent's 22% ownership, but neither could they be ignored.

Decedent, Sam Homer Marmaduke, died September 7, 1993, owning 22% of the outstanding shares of Hastings Books, Music & Video, Inc. (Hastings). Other members of the Marmaduke family owned an additional 57% with unrelated shareholders and the Hastings ESOP plan owning the remainder. In January of 1993, the ESOP appraiser determined a fair market value for the ESOP shares, which comprised some 3% of the company's total outstanding shares. The ESOP appraiser used a 40% marketability discount for Hastings stock, but reduced this to 20% for the ESOP shares because of the "put" option for these shares. The fair market value for the ESOP shares was $47.00 each.

During 1993, there were 18 Hastings stock transactions between employees, officers, and other affiliates, with these transactions aggregating less than 1% of the outstanding shares. All but two of these transactions were at $47.00 per share. One of these sales was by the decedent to a financial officer who possessed full knowledge of the Hastings financial affairs and who later testified at the Tax Court trial.

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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
- •Closely Held Businesses
- •Partnership Interests
- •Business Operations-subsidiaries, divisions, profit centers
- •Intangible Assets-covenants not to compete, customer lists, contract rights and core deposits
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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

When the estate return was filed, the estate claimed a value of $36.53 per share, although the estate abandoned this value and used different values at trial. The estate's first expert, using a 60% marketability discount, determined a fair market value of $25.15 per share. This expert relied on the guideline company method of valuation, the guideline "merged-and-acquired company" method, and the discounted cash flow method. No reliance was placed on the $47.00 transaction price due to "lack of independent bargaining and negotiations."

The estate's second expert used a 40% marketability discount and arrived at a price of $34.55 per share. This expert relied solely on the guideline company and discounted cash flow methods. The appraiser rejected the "transaction and other valuation methods as inappropriate indicators of value."

The IRS expert used a 15% marketability discount and relied on the guideline company, discounted cash flow, and transaction valuation methods.

[Editors' Note - The taxpayer and IRS experts used valuation methods that directly calculate a minority interest value, hence the lack of a minority discount.]

Judge Swift took particular note that the financial officer who purchased 2,000 shares at $47.00 testified that this was an accurate value and he was under no compulsion to make the purchase. The Court concluded that the $47.00 transactions could not be completely ignored as the taxpayer's experts had done. At the same time, the Court was critical of the IRS expert for placing such heavy reliance on transactions that cumulatively represented less than 1% of the outstanding stock.

In the discussion of marketability, the Court noted that the studies in evidence confirmed that marketability discounts in closely held corporations often exceed 30%. The Court noted the following as factors supporting a significant marketability discount: lack of a ready market for a block of stock the size of the estate's, the dependence of Hastings on a related company for management services, and the general credibility of the ESOP appraiser's report.

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The Court believed that the marketability should be "considerably less than the 40 and 60 percent discounts suggested by the [taxpayer's] experts" because these experts in no way factored the $47.00 sales into their appraisals, and Hastings was in excellent financial condition as of the valuation date.

The Court concluded a 30% marketability discount was appropriate, resulting in a value of $41.51 per share.

Click Here for a Complete Copy of the Case

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