



WHEN RESULTS COUNT

TAX VALUATION E-FLASH

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Estate of James J. Renier v. Commissioner, T.C. Memo. 2000-208, September 25, 2000

This case concerns a valuation as of April 10, 1994, for an 88.4% ownership in a family electronics store in Dubuque, Iowa. The IRS valued Decedent's ownership at \$1,633,000 (\$73.89 per share), more than double the estate tax return's reported value of \$729,742 (\$33.02 per share). At trial, taxpayer experts valued the shares at \$815,158 (\$36.89 per share) and \$852,000 (\$38.55 per share). Judge Gale concluded a value of \$952,000 or \$43.08 per share. The primary items of contention were normalizing adjustments (primarily excess compensation and excess working capital) and determining the capitalization rate. The Court dismissed the use of the Weighted Average Cost of Capital (WACC) by the IRS expert. The Court rejected a summary report prepared by one of the taxpayer's experts who used only the Institute of Business Appraisers' database and rules of thumb.

Decedent passed away on April 10, 1994, owning 22,100 of the 25,000 outstanding shares of Renier Company, a retail electronics store in Dubuque Iowa.

The taxpayer utilized three experts. The first expert prepared the valuation used for filing the estate tax return. This expert was not used at trial. The next expert was apparently engaged to prepare a summary re-

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port. He limited his analysis to using the Institute of Business Appraisers database and applying rules of thumb. He also claimed a key-man discount, arriving at a value of \$852,000. Because of the lack of explanation and analytical support in this expert's summary report, Judge Gale gave the report no weight.

The single remaining taxpayer expert and the sole IRS expert both rejected the asset approach. The IRS expert considered the market approach, but ultimately

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rejected it. The taxpayer expert concluded that a market approach that compared Renier to publicly traded companies was inappropriate due to lack of sufficiently comparable public companies. This expert utilized what he called the "business broker" method under the market approach. Under this method, a multiple is applied to the seller's discretionary cash flow. These multiples generally range between 1 and 2 and the expert decided the appropriate multiple was 1.5, apparently with no justification provided. The Court rejected the method and concluded, "In the absence of any underlying data supporting [the appraiser's] selection of a multiple, we are unable to assess its appropriateness. See Rule 143(f)(1). Thus on this record the reliability of the business broker method has not been established."

Income Approach

Major differences existed between the two experts' methods of applying the income approach.

Reasonable Compensation

In determining excess compensation paid to related-party employees, the IRS expert determined that all of the employed family members, except for two, were unnecessary. The expert believed only one management/sales employee and one bookkeeper/office manager were required. To determine reasonable compensation for these positions, the expert used a wage survey from the Dubuque area and then adjusted that survey to the valuation date with a CPI adjustment. He assumed a normal 40-hour workweek. Fringe benefits at 20% of base wages were added, resulting in \$61,925 per year excess compensation.

The taxpayer expert determined that the excess compensation was \$15,000 per year. He did this by concluding that 15% of the time spent by the related parties on management duties represented duplicated effort and thus excess compensation.

The Tax Court accepted neither expert's opinion. The Court believed the taxpayer expert's method was "unsupported by any objective criteria" and represented a "conclusory guess". The Court approved of the IRS

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expert's methodology, but believed it understated the value of the services being provided. The Court made its own calculation by increasing the hours worked for the management/sales employee and adding 6.76% to the increase for fringe benefits. This resulted in excess compensation of \$39,540 per year.

Excess Working Capital

Both experts agreed that Renier had excess working capital to be added as a non-operating asset, but they disagreed on the amount of the excess. The IRS appraiser concluded the business required only 7 days of

The Tax Court believed the IRS expert's approach understated the working capital need and adopted the taxpayer expert's approach.

annual sales in working capital. The taxpayer appraiser concluded that an appropriate level of working capital was two months of average operating expenses plus 1.5 times average monthly inventory purchases. The Tax Court believed the IRS expert's approach understated the working capital need and adopted the taxpayer expert's approach.

Cost of Goods Sold Adjustment

The appraisers agreed that for a number of years Renier had used an accounting system that overstated cost of goods sold. The IRS expert spread the correction for this over 69.33 months. The taxpayer expert spread this adjustment over 10 years. The Court agreed with the IRS expert's approach.

Partial Year Adjustment

To arrive at the average income to capitalize, the taxpayer expert used the previous five years plus the 9.33 months from the latest fiscal year end to the date of death. The IRS expert converted the partial year to a full year using a simple average. The Tax Court agreed that the IRS expert ignored the seasonal nature of Renier's business in this calculation and adopted the taxpayer expert's approach.

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Income Taxes

In arriving at average net income after taxes, the IRS expert averaged pre-tax income and then applied a 38% Federal and State tax rate to the average. The taxpayer expert used the after tax income in his averaging. The Tax Court adopted the taxpayer expert's method.

Capitalization Rate

The primary difference in the two experts' capitalization rates was that the IRS expert used the weighted average cost of capital (WACC), while the taxpayer expert valued equity alone. Judge Gale reiterated the Tax Court's historical dislike for WACC, citing Tax Court cases as well as writings by Jack Bogdanski and Shannon Pratt. Another difference in the two calculations was the risk-free rate of return used in building up the capitalization rate. The taxpayer expert used a 20-year U.S Treasury Bond rate, while the IRS expert used a 30-year rate. Citing Pratt and Ibbotson Associates, the Tax Court determined the 20-year rate was the theoretically correct rate.

The two experts also disagreed on the long-term sustainable growth rate to be subtracted in the capitalization rate formula. The historical growth rate had been skewed as a result of a major flood that caused a one-time sales jump in 1993. The Tax Court did not agree with either expert, and adopted a 4.15% sustainable growth rate. The Court did accept the approach of the taxpayer expert who added 5% to the historical average income to arrive at the income to be capitalized.

It is interesting to note that the expert whose value was the closest to that of the Tax Court was the expert whose summary report was rejected. This is a clear indication of the importance of a well-documented business valuation report that considers all of the approaches to valuing a business.

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

Edited by John R. Gilbert, CPA/ABV, CVA
The Financial Valuation Group
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