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Estate of Beatrice Ellen Jones Dunn v. Commissioner T.C.M. 2000-12

Decedent owned 62.96% of Dunn Equipment, a Texas "C" corporation that rented heavy equipment. The estate claimed a value of \$1,635,465 on Form 706. In the notice of deficiency, the IRS claimed a value of \$2,229,043, but amended this to \$4,430,238 by the time of trial. Judge Gale determined a value of \$2,738,558.

The Tax Court allowed the estate to average the income and asset valuation approaches, but weighed the income approach at 35%, not the 50% used by the estate. The Judge weighed the prospects for liquidation of the underlying assets (whose value was far greater than the capitalized cash flow or earnings value) in determining the weights to be applied to each of the two approaches. In addition, the Judge used this same liquidation probability in allowing only 5% of the built-in gain tax instead of the 100% claimed by the estate. A 15% lack of marketability discount and a 7.5% lack of supermajority discount

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were allowed. The supermajority discount was appropriate because even though the decedent owned a majority interest, the interest was less than the 66-2/3% required to approve a corporate liquidation.

When Decedent died on June 8, 1991, she was the controlling shareholder in a "C" corporation (Dunn Equipment) that rented heavy equipment to the oil industry.

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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.

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The corporation had paid no dividends from 1987 to 1991 and the officers were paid less than those in similarly situated companies.

The estate's first expert argued for a 50-50 weighting of the income and asset approaches as had been done for the estate tax return. The IRS expert, on the other hand, argued that the value should be based solely on the net asset value (reduced for lack of marketability and super-majority). The IRS expert was not a business appraiser, but rather worked in the "dispute analysis and corporate recovery division" of a "Big 5" CPA firm. She did not prepare an appraisal report, but rather critiqued the estate's first expert appraisal. The estate also engaged a second trial expert who did not prepare an appraisal report, but rather reviewed the first expert's report and critiqued the IRS expert's report.

The Court noted, "In light of the significant operational aspects of Dunn Equipment, the size of the block of stock in issue, the identity and attitudes of the remaining shareholders and directors, and the costs associated with liquidation, we conclude that the hypothetical investor would give earnings value substantial weight. It is well established that as a general rule, earnings are a better criterion of value for operating companies and net assets a better criterion for holding or investment companies Thus because Dunn Equipment was an operating company, the better question is not whether or not we should disregard

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the earnings-based value, but whether we should disregard the asset-based value."

The Court went on to criticize the taxpayer expert's assessment that the company had a 50% prospect for liquidation, concluding the likelihood for this was lower. However, the court considered "low profitability, volatility of earnings, high debt, limited customer base, and dependence upon one industry to give net asset value the greater

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significance” and assigned only a 35% weight to the income approach.

One of the criticisms leveled at the taxpayer expert's report was his use of net income rather than cash flow as the benefit stream to capitalize. The expert used a 21.67% capitalization rate (unchallenged by the other experts), and the Court accepted this rate. Since, however, this was based on total returns, the Court believed this must be based on cash flow, not earnings, and adjusted accordingly. Since this was a cyclical industry, the Court used a simple average and not a weighted average of historical cash flow.

Another criticism by the IRS of the taxpayer expert's earnings value was his failure to use the investment tax carryover and alternative minimum tax carryover in arriving at an earnings base. The Court concluded that a potential buyer would assign no value to these tax credits and, therefore, they should be ignored.

In arriving at asset value, the taxpayer expert used liquidation value, assigning no value to prepaid expenses. The Court disagreed with this and included the prepaid expenses in the value of the net assets. The taxpayer ex-

The Court noted that the taxpayer expert “failed to consider that the hypothetical buyer who did not wish to continue operating the company, and who was able to convince additional shareholders to form a super-majority, had other options besides liquidation.”

pert, in his calculation of net asset value, also deducted 100% of the C corporation built-in gain tax (calculated as 34% of the excess of market values of assets over their tax bases). The Court noted that the taxpayer expert “failed to consider that the hypothetical buyer who did not wish to continue operating the company, and who was able to convince additional shareholders to form a super-majority, had other options besides liquidation. A new owner who wished to change the business of the company into, for example, construction rather than equipment rental, would not have a need to buy new equipment ev-

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ery few years, and could use the equipment the company owned for its entire useful life, eliminating the realization of built-in gain." The Court believed the probability of a hypothetical buyer purchasing with intent to liquidate, while low, did exist. For this reason, the Judge allowed only 5% of the built-in gains tax.

After averaging the two approaches, the Court allowed application of the 15% marketability discount, which was undisputed by the experts. The Court then allowed a discount of 7.5% for lack of super-majority control, as claimed in the original tax return's appraisal, despite the taxpayer's argument on brief that the discount should be 10%.

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

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