WHEN RESULTS COUNT

Estate and Gift E-Flash

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Estate of Emily F. Klauss v. Commissioner T.C. Memo 2000-191, June 27, 2000

The Tax Court has affirmed that a small stock premium is an appropriate component of the discount rate, despite arguments to the contrary by an IRS expert. Further, the Tax Court has again concluded that the Capital Asset Pricing Model (CAPM), which relies on "beta", is not a proper way to determine the discount rate for non-public companies, particularly when the company has little prospect of going public. The Court concluded that the taxpayer expert had not properly calculated a guideline company growth rate in determining multiples for the guideline public companies approach. The Court allowed a discount for environmental liabilities, using the amount calculated by the taxpayer expert.

Decedent died on February 1, 1993, owning 184 shares (40%) of Green Light Chemical Co., Inc. The parties determined values as shown in the table.

Taxpayer's Tax Return and Petition	$1,810,000
Taxpayer's Expert Witness at Trial	$1,800,000
IRS Deficiency Notice and Answer	$4,080,200
IRS Expert at Trial	$2,713,000
Tax Court Decision	$2,150,000

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The Financial Valuation Group

WHEN RESULTS COUNT

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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

Small Stock Premium

The taxpayer expert used a 5.2% small-stock premium in determining the discount rate, based on the rate of return for the smallest quintile of the public market, using data from Ibbotson Associates. The IRS expert relied on an article by Bajaj and Hakala, "Valuation for Smaller Capitalization Companies" published in **Financial Valuation: Business and Business Interests**. The Court found the taxpayer expert's analysis more persuasive than this article.

The IRS expert testified that it was appropriate to use the Ibbotson data for 1978 through 1992 rather than for 1926 through 1992 because small stocks did not consistently outperform large stocks during the 1980's and 1990's. The Court noted, however, that the expert relied on Ibbotson data from 1978-92 to support his theory that there is no small stock premium, while using the Ibbotson data from 1926-92 to calculate his equity risk premium. The Court concluded that the IRS expert "appeared to selectively use data that favored his conclusion," and gave little weight to this analysis.

The Court concluded that the IRS expert "appeared to selectively use data that favored his conclusion."

Guideline Companies Price Earnings Multiples

Both experts used price/earnings multiples derived from public companies to determine a value for Green Light Chemical. The IRS criticized the taxpayer expert's calculation of the growth rate for the most similar guideline company. The Court believed the expert overstated the growth rate of the guideline company compared to Green Light, thus understating the valuation multiple. The Court increased the multiple for this perceived error, but did agree with the rest of the taxpayer expert's analysis.

The Court was quite critical of the IRS expert's calculation of multiples, concluding that the expert failed to consider such important differences from the closest guideline company as, "Green Light does not manufacture products; its product lines are far less diverse than those of the guide-

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line companies; its five largest customers accounted for more than 70% of its sales; it sells products regionally, not nationally; its primary market in 1993 was limited to the home and garden market and did not include agribusinesses or golf courses; and it had minimal insurance coverage for products liability and environmental claims." The IRS expert did not adjust multiples for "customer concentration, product mix, geographic diversification, or market segment factors, " according to the Court.

Capital Asset Pricing Model (CAPM)

The IRS expert used CAPM to determine the discount rate, while the taxpayer expert used the build-up method. In applying the CAPM method, the IRS expert chose a beta of .7 to estimate Green Light's systematic risk. In other words, an investment in Green Light would only have 70% of the risk of an investment in the Standard & Poor's 500 Stock Composite Index (S&P 500). The Court disagreed, noting, "Green Light was a small, regional company, had customer concentrations, faced litigation and environmental claims, had inadequate insurance, was not publicly traded, and had never paid a dividend. A beta cannot be correctly calculated for the stock in a closely held corporation; it can only be correctly estimated on the basis of the betas of comparable publicly traded companies." The Court also concluded that the CAPM method is not appropriate because Green Light has little possibility of going public.

> ***"A beta cannot be correctly calculated for the stock in a closely held corporation; it can only be correctly estimated on the basis of the betas of comparable publicly traded companies."***

Environmental Liabilities

Green Light was faced with a claim by a Texas government agency that the soil at its plant was contaminated. The Company disputed this claim, but the matter had not been resolved by the time of the Tax Court trial. The taxpayer expert reduced the value of the Green Light stock by $921,000 based on the cost to increase its products liability insurance, and management's estimates of fines, remediation

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costs, and attorneys fees. The IRS expert reduced value by $1,130,000 "in part because counsel for Green Light stated its maximum liability for litigation claims would be 10 percent." The Tax Court preferred the taxpayer expert's approach.

Discount for Lack of Marketability

The Court did not dispute the 30% discount for lack of marketability claimed by both experts.

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The Financial Valuation Group
Mountain States Managing Director

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