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Tax Valuation E-Flash

Clarissa W. Lappo v. Commissioner, T.C. Memo 2003-258, September 3, 2003

The Tax Court revalued gifts of limited partnership interests in a family limited partnership that held real estate and marketable securities. The Court relied on raw data in Dr. Bajaj's study, although not necessarily its conclusions, in arriving at the discounts for lack of control and marketability.

Clarissa Lappo and her daughter, Clarajane, formed a family limited partnership in 1996, funding it with real estate and marketable securities consisting mostly of municipal bonds. Clarissa made taxable gifts of limited partnership interests on two dates 1996 and the IRS challenged the valuation of these gifts.

The IRS and taxpayer appraisal experts agreed that the fair market value of the partnership should be determined by the net asset value of the Partnership assets reduced by discounts for

Both experts agreed that publicly traded real estate investment trusts (REITs) were the appropriate starting point for the minority interest discount.

lack of control and marketability. The taxpayer expert concluded that a 7.5% minority discount should be applied to the marketable securities and a 35% minority discount should be applied to the real estate. He also applied a 35% marketability discount to the first gift and a 30% marketability discount to the second gift. The IRS expert applied an 8.5% minority discount and an 8.3% marketability discount to both gifts.

The parties engaged in a little horse trading and a slight increase in asset values by the IRS was offset by applying the higher IRS 8.5% minority discount to the marketable securities. The marketability discount and the minority discount for the real estate were not so easily resolved.

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Minority Interest Discount

Both experts agreed that publicly traded real estate investment trusts (REITs) were the appropriate starting point for the minority interest discount. The taxpayer expert used a sample of only 7 comparable companies out of population of over 400 REITs. The Court believed the small number of companies in the sample was insufficient to negate comparability issues between the 7 companies and the Partnership. The IRS expert had a sample of 52 companies and the Court concluded that, "...[the] sample was sufficiently large to make tolerable any dissimilarities between the partnership and the REITs in his guideline group."

Both experts made adjustments to their REIT sample averages to arrive at an appropriate discount for the Partnership. The Court was troubled by the taxpayer expert's "terse" explanation for his adjustments and concluded that his, "...upward adjustments are, to some extent, plug numbers used to justify his ultimate, very round minority interest discount figures..." The IRS expert adjusted his REIT data based on the study by Dr. Bajaj, concluding that a 7.5% liquidity adjustment should be made to the REIT discount.

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The Tax Court was hesitant to rely on a single academic study, particularly one that the IRS expert did not participate in preparing and could not elaborate upon first hand. The Tax Court did find that there were similarities between the Bajaj study and the Wruck study and Hertzl & Smith study cited by Bajaj. The Tax Court ultimately averaged the "average discount observed in unregistered private placements" in each of the three studies, arriving at an illiquidity premium of 17.6%. The Court added this to the REIT discount and rounded to a 19% discount for the real estate.

Marketability Discount

The taxpayer expert relied on restricted stock data assembled by his firm. The Tax Court found that 13 of the 39 companies relied upon were high tech companies and not comparable to the Partnership. Removing these companies from the average resulted in a 19.45% discount before further adjustments.

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The IRS expert relied on the Bajaj study that showed the portion of private placement discounts attributable solely to impaired marketability was 7.2%. The Tax Court noted that it preferred this private placement approach to the taxpayer expert's restricted stock approach, but concluded, "*Absent further explication of the Bajaj study by [IRS expert], however, and without the benefit of other empirical studies that would tend to validate the conclusions of the Bajaj study, we are unpersuaded that a 7.2-percent discount is an appropriate quantitative starting point...*"

The Tax Court looked to the raw data in the Bajaj study that had an average discount of 22.21%

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and the Herztel & Smith study cited by Bajaj that had a 20.14% average discount. The Court averaged these two and arrived at 21% as the discount prior to adjustments specific to the Partnership.

Both experts made adjustments to the data from the studies to reflect the particular circumstances of the Partnership. The Tax Court reviewed the various considerations raised by the two appraisers and concluded a 3% upward revision was appropriate, arriving at a final marketability discount of 24%.