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Tax Valuation E-Flash

Peter S. Peracchio v. Commissioner, T.C. Memo 2003-280, September 25, 2003

The Tax Court was highly critical of appraisers' calculations of discounts for lack of control (minority discount) and marketability for a family limited partnership holding only cash and marketable securities. The Court ultimately determined a 6% discount for lack of control and a 25% discount for lack of marketability.

The taxpayer formed a family limited partnership in 1997 with \$2,008,370 of cash and marketable securities. Immediately after formation, the taxpayer sold and gifted limited partner interests to a family trust and his son.

When the taxpayer filed the 1997 gift tax return, he claimed a combined discount of 40% from net asset value for lack of control and marketability. The IRS initially challenged taking any discounts at all under four theories: lack of economic substance, §2703 (a) (2), §2704 (b), and

"...his methodology is comparatively both imprecise (his 5-percent discount is not statistically derived from observed discounts) and incomplete..."

the general valuation rule under §2512. Before trial, the IRS abandoned the first three challenges and changed its position to include a 4.4% discount for lack of control and 15% for lack of marketability based on its trial expert's valuation.

At trial, the taxpayer offered two experts. The first expert concluded a 7.7% minority interest discount and a 35% marketability discount. The second expert concluded a 5% minority interest discount and a 40% marketability discount.

Minority Discount

All of the experts used closed-end mutual funds to determine the minority discount. The minority discount analysis of the second taxpayer expert was dismissed by the Court because,

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"...his methodology is comparatively both imprecise (his 5-percent discount is not statistically derived from observed discounts) and incomplete..." The Court was clearly not pleased with the analyses of the other two experts either, but did use their calculations to some degree.

For the cash portion of the investments, the remaining taxpayer expert applied a 5% discount and the IRS expert used 2%. Both appraisers lacked any empirical data for their discount. The Tax Court found neither expert persuasive, but allowed a 2% discount since this amount was conceded by the IRS and the taxpayer did not meet the burden of proof for a higher amount.

For the marketable securities, the main dispute was the selection of closed-end funds to include in the discount calculation. The taxpayer expert eliminated what he believed were "outliers" from his analysis. To determine the discount from the selected funds, the taxpayer

"To the extent [the appraiser] believes that the benchmark range of discounts we used in Mandelbaum is controlling in this or any other case, he is mistaken."

expert used the median discount while the IRS expert used the mean (average) discount. The Court was puzzled why the median was appropriate since the outliers had already been removed. The taxpayer expert was also unable to articulate at trial why the median was superior and the Court elected to use the mean. The Court made its own calculation using 6.9% for U.S. Government bond funds, 3.5% for State and local bonds, 3.4% for national municipal bond funds, 9.6% for domestic equities, and 13.8% for foreign equities, arriving at a 6% weighted average minority discount for all of the cash and marketable securities.

Discount for Lack of Marketability

Both of the taxpayer experts started with a benchmark rate and used the Mandelbaum factors (Mandelbaum v. Commissioner, T.C. Memo 1995-255) to determine whether the subject's discount should be higher or lower than the benchmark. The Court said, "Because we are unpersuaded by either expert's determination of the appropriate benchmark (starting point), we give little weight to their respective analysis." One of the appraisers simply used the benchmark in Mandelbaum as a starting point, to which the Court said, "To the extent [the appraiser] believes that the benchmark range of discounts we used in Mandelbaum [citations omitted] is controlling in this or any other case, he is mistaken."

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The other taxpayer appraiser started with a 30% discount based on the private placement studies. The Court said,

While restricted stock studies certainly have some probative value in the context of marketability discount analysis, see, e.g., McCord v. Commissioner, 120 T.C. at 390-393, [the expert] makes no attempt whatsoever to analyze the data from those studies as they relate to the transferred interests. Rather, he simply lists the average discounts observed in several such studies, effectively asking us to accept on faith the premise that the approximate average of those results provides a reliable benchmark for the transferred interests. Absent any analytical support, we are unable to accept that premise, particularly in light of the fundamental differences between an investment company holding easily valued assets (such as the partnership) and the operating companies that are the subject of the restricted stock studies.

The IRS expert didn't fare much better in the Court's analysis. He started with a judgmentally determined benchmark range of 5% to 25% and offered a brief analysis of six factors that may

"...we are not persuaded by his opinion that the appropriate range of marketability discounts is 5 to 25 percent. We are even less impressed by his arbitrary selection of the midpoint of that range (15%) as his suggested discount."

influence the size of the marketability discount within that range. The Court said, "...we are not persuaded by his opinion that the appropriate range of marketability discounts is 5 to 25 percent. We are even less impressed by his arbitrary selection of the midpoint of that range (15%) as his suggested discount."

Ultimately, the Court selected a 25% discount for lack of marketability, treating the 25% upper end of the range determined by the IRS expert as a concession and concluding the taxpayer did not meet his burden of proof to arrive at a higher discount.