The Financial Valuation Group

When Results Count

Consulting • Valuations • Expert Testimony

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Tax Valuation E-Flash

Herbert Kohler, Jr. et al. v. Commissioner, T.C. Memo 2006-152, July 25, 2006

The Tax Court upheld the taxpayers' estate and gift valuations. The IRS expert's valuation was accorded no weight, in part because he did not include a Uniform Standards of Professional Practice (USPAP) certification.

Decedent died on March 4, 1998, owning a minority interest in Kohler Co. The fair market value of his shares was $47,009,625 utilizing the alternate valuation date. In its deficiency notice, the IRS asserted a $144,500,000 fair market value. The parties stipulated that the fair market value determined for estate purposes would be used for gifts that were also being challenged in this consolidated proceeding

Kohler is a private company, founded in 1887, that was predominately family owned. The company has four lines of business, including kitchen and bath products and power equipment. Kohler has paid dividends annually since approximately 1900. The Company's stated policy is to pay 7% to 10% of its earnings in dividends and reinvest the remainder.

In 1996, in order to redeem the approximately 4% of the stock held by non-family members, Kohler

> "After carefully reviewing and considering all of the evidence, we continue to find (the IRS expert's) conclusions to be incredible. We therefore give no weight to respondent's expert's conclusions. Respondent has therefore not met his burden of proof."

began taking steps for a tax-free reorganization under section 368(a). This reorganization was completed on May 11, 1998, and resulted in restrictions on stock transfers to non-family members. Because the estate chose to use the alternate valuation date, it was post-reorganization shares that

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became the subject of the valuation.

The first argument was over the burden of proof. The Court granted the Estate's motion to shift the burden to the IRS because the Estate introduced credible evidence, substantiated items, maintained records, and cooperated with reasonable IRS requests.

The second argument was whether pre-reorganization or post-reorganization stock should be valued. The Court determined that post-reorganization stock was appropriate as of the alternate valuation date.

Lastly, the Court turned to the valuation dispute. Because the IRS held the burden of proof, the Court looked first to the IRS valuation expert. This expert (who is not the same one that determined the fair market value for the notice of deficiency) calculated a $156 million fair market value. The expert used both the income and market approaches, but ignored the dividend method of the income approach. The expert also made a last minute correction to his income approach at trial, which resulted in an $11 million dollar overvaluation in his report. He determined a 25% discount for lack of marketability should be applied.

The expert did not apply the dividend-based method under the income approach despite the history of dividends and the understanding by management that dividends were the primary means for shareholders to obtain an investment return on this closely held stock.

The Court first discussed this appraiser's background and certifications. The Court was troubled that this expert's report was not submitted in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP), including the customary USPAP certification. *[Editor's note - valuation reports prepared by the Financial Valuation Group include this certification.]*

The Court noted that the IRS expert only spent 2-1/2 hours meeting with Kohler management, yet "*He decided the expense structure in the company's projections was wrong and decided to invent his own for the income approach analysis. He did not discuss his fabricated expense structure with management to test whether it was realistic.*"

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The Court concluded, "*After carefully reviewing and considering all of the evidence, we continue to find [the IRS expert's] conclusions to be incredible. We therefore give no weight to respondent's expert's conclusions. Respondent has therefore not met his burden of proof.*"

Testifying for the taxpayer were both the expert who prepared the original valuation report for the estate tax return as well as an expert added for trial. Court found both taxpayer experts to be "*thoughtful and credible*." Both experts were published authors and held valuation credentials. Both experts spent significant time with management in order to understand the Kohler business. The experts did not fabricate their own projections, but relied on those prepared by management. They also used the dividend method that the Court clearly liked.

The court found their appraisals to be "*more thorough and consistent with traditional appraisal methodologies for closely held companies.*" The valuation on the estate tax return was accepted as filed.

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