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Tax Valuation E-Flash

Estate of Bailey v. Commissioner, T.C. Memo 2002-152, June 17, 2002

The Tax Court allowed a 20% discount for lack of control and a 37.5% discount for lack of marketability for a 25% interest in a corporation owing two motels. The motels were appraised by real estate appraisers and the stock valuation was based solely on the asset approach, utilizing the real estate appraisals.

Lewis Bailey died in 1995 owning a 25% interest in C&L Bailey, Inc. (C&L), which owned and operated a motel in Arkansas and one in California. *[Editor's note - The case does not disclose if C&L was a "C" corporation or an "S" corporation.]* Mr. Bailey was also beneficiary of a QTIP trust owning 25% of C&L. Both the IRS and the taxpayer agreed that the values of these two interests can not be aggregated for valuation purposes. On the original estate tax return, the value of the C&L stock was based on the "liquidation value" of the two motels net of liabilities, reduced by 50% for "Key Man, Minority Ownership, Lack of Market Discount".

Real Estate Appraisals

When Mr. Bailey died, his estate engaged appraisers in Arkansas and California to determine the fair market values of the motels. The Arkansas motel was appraised at \$2,380,000 and the California

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motel at \$1,388,000. After the appraisals were completed and the estate return filed, the estate discovered that Mr. Bailey personally owned a 50% undivided interest in one of the two parcels of the land that was part of the California motel. The Tax Court ultimately determined to ignore the overstatement of the value of the corporate land and the commensurate understatement of Mr. Bailey's personal assets.

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At trial, the estate disavowed the appraisal of the California motel based on a “desk review” by the Arkansas appraiser. The Arkansas appraiser faulted the California appraiser for failure to consider a “quick sale value” which was appropriate because of the “need to settle the estate.” The Arkansas appraiser also concluded that the 9.846% capitalization rate should have been 15.5474% and that

The Court also noted that the “quick sale value” was not fair market value.

the expenses used in the capitalization calculation should have been 75% of revenue and not 60%. The Tax Court was “unconvinced” that the desk review of the California appraisal by the Arkansas appraiser was valid and did not rely on it. The Court also noted that the “quick sale value” was not fair market value.

Stock Appraisals

In his original appraisal, the IRS appraiser determined the net asset value of C&L was \$3,610,200 and subtracted only a 25% discount for lack of marketability from this to arrive at fair market value. In the notice of deficiency, the IRS increased the total discount to 50%, matching the discount taken on the original estate tax return. *[Editor's note - It is not apparent from the case how the net asset amount was determined in the original appraisal, but this amount was not used at trial.]*

For the trial, the IRS appraiser arrived at a net asset value of \$2,861,903. In arriving at this, the appraiser ignored a \$145,000 liability to shareholders, treating it as paid-in capital. The Tax Court ultimately decided to exclude this from liabilities because the record did not “reliably substantiate the \$145,000 liability.” From the net asset value, the IRS appraiser subtracted a 20% discount for lack of control and a 27.44% discount for lack of marketability. The discount for lack of marketability was based on a 21.44% discount for the tax on built-in gains and a 6% discount for “stock sale costs.”

The tax on built-in gains was calculated assuming the assets would be held for five years, appreciating at 2% per year. The appraiser assumed selling expenses of 7% and then calculated the present value of the built-in gains tax using an 8% discount rate. The Tax Court was critical of this calculation, noting the lack of “explanation or support for any of the many assumptions” and

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concluding, “An expert report that is based on estimates and assumptions not supported by independent evidence or verification is of little probative value or assistance to the Court.”

The taxpayer appraisal expert arrived at a net asset value of \$1,945,651. This differed from the IRS expert because of the revised value for the California motel as a result of the desk review by the Arkansas appraiser and the inclusion of the \$145,000 in shareholder debt. He also excluded \$202,252 of other assets, which included cash and accounts receivable, from the net asset value.

“An expert report that is based on estimates and assumptions not supported by independent evidence or verification is of little probative value or assistance to the Court.”

[Editor’s note – It is not clear if this amount was excluded from the appraisal or just excluded by mistake on brief.] From the net asset value, the taxpayer appraiser deducted a 20% discount for lack of control and a 40% discount for lack of marketability. *[Editor’s note – These were added to arrive at 60% instead of multiplied to arrive at 52%, but this could be a mistake in the taxpayer brief and not the appraisal report.]* The discount for lack of marketability was based on the pre-IPO studies. The Tax Court was “unpersuaded that [the taxpayer expert] appropriately relied on these restricted stock studies in deriving his recommended 40-percent marketability discount.” *[Editor’s note – There is no discussion in the case to allow us to determine if the taxpayer appraiser considered the built-in gains tax.]*

Tax Court Conclusion

The Tax Court agreed with the IRS expert’s \$2,861,903 net asset value and determined a 50% combined discount for lack of control and marketability was proper, as claimed in the original estate tax return.