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Tax Valuation E-Flash

Estate of William G. Adams Jr. v. Commissioner, T.C. Memo 2002-80, March 28, 2002

The Tax Court calculated the fair market value of a 61.59% interest in a closely held insurance agency. The Tax Court did not allow adjustment of the capitalization rate to account for imputed income taxes on the S corporation's income.

Decedent died in 1995 owing 61.59% of the common stock of Waddell Sluder Adams & Co. (WSA), an insurance agency organized as an S corporation. Experts for both the IRS and the taxpayer used the income approach to determine fair market value. The two experts agreed on a 20.53% capitalization rate before the tax adjustment discussed below.

The first area of disagreement between the experts was the anticipated future salary for a key employee of WSA. The experts agreed that nobody would purchase the agency without this employee in place. The Tax Court found the taxpayer expert's analysis more persuasive and accepted his conclusion.

The next disagreement was whether to use the mid-year or the end-of-year discounting convention. Because the IRS offered no evidence that WSA would pay its investors in the

The taxpayer expert "grossed up" the 20.53% after tax discount rate to 31.88% to match the pre-tax S corporation cash flow stream to which it was applied.

middle of the year, as is assumed under the mid-year convention, rather than at the end of the year, the Tax Court accepted the end-of-year calculation method used by the taxpayer.

The most important disagreement in the case was the treatment of imputed income taxes in S corporations. The taxpayer expert "grossed up" the 20.53% after tax discount rate to 31.88% to match the pre-tax S corporation cash flow stream to which it was applied. The Tax Court said, "We disagree that [the taxpayer expert's] estimates of WSA's prospective net cashflows are

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before corporate tax because it is appropriate to use a zero corporate tax rate to estimate net cashflow when the stock being valued is stock of an S corporation. WSA is an S corporation and its cashflows are subject to a zero corporate tax rate. Thus [the taxpayer expert's] estimates of WSA's prospective net cashflows are after corporate tax (zero corporate tax rate) and not

The Tax Court, therefore, did not allow imputed income taxes to be used in the calculation of fair market value.

before corporate tax as the estate contends." The Tax Court, therefore, did not allow imputed income taxes to be used in the calculation of fair market value.

The final area of disagreement was the discount for lack of marketability. The taxpayer expert claimed a discount of 20%. The IRS expert claimed a 35% discount, but changed this to between 40% and 45% at trial to account for litigation he did not know about before trial. The Tax Court applied a 35% discount.