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Tax Valuation E-Flash

Estate of Thompson, T.C. Memo 2004-174, July 26, 2004

Citing the incompetence of the valuation experts for both the taxpayer and the IRS, the Tax Court made its own calculation of fair market value.

Decedent died in 1998 owing a 20.57% interest in Thompson Publishing Co., Inc. (TPC), a New York corporation and publisher of the Thomas Register. The estate claimed a fair market value of $1,750,000 for the subject interest, while the IRS claimed the value should be $35,273,000.

The taxpayer expert was an Alaska attorney who had little formal training and experience in business valuation. He was assisted by a CPA who likewise had little training or experience.

The taxpayer expert was an Alaska attorney who had little formal training and experience in business valuation. He was assisted by a CPA who likewise had little training or experience. The estate admitted that they hired the Alaska attorney because he represented to them that he would be able to secure a better valuation result for them in Alaska than they would be able to obtain in the New York IRS office.

The estate's experts relied solely on a capitalization of income method. In applying this method, the Tax Court said the experts " …*misstated certain financial data and they opined that TPC's business would be heavily and adversely impacted by the Internet and by other advances in technology, even though the estate's experts demonstrated no experience with the Internet and technology-related companies.*" The experts arrived at a 30.5% capitalization rate, including an "Internet and Management" risk of 12%, and a 0% growth rate.

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The taxpayer experts applied a 40% minority interest discount and a 45% lack of marketability discount. The 40% minority discount was "*based primarily on their reading of general valuation texts.*" They relied on several factors to determine the lack of marketability discount, but did not provide a "*credible explanation*" of why they used 40% as opposed to some other percent.

The Tax Court found both the taxpayer's and IRS' valuations to be "deficient and unpersuasive."

The IRS expert used both the guideline public companies and discounted cash flow methods in his appraisal. This expert issued a revised report and "*…in the process of making corrections to errors in his original report, respondent's expert made significant questionable adjustments in his discounted cashflow method that are inconsistent with the methodology utilized in his original report.*" The Tax Court noted, "*In calculating the residual value for TPC to be added to his net cashflow projections for 1998-2002, respondent expert's switch in his revised report from a terminal value to a liquidation value calculation appears to us to be an effort on the part of the respondent's expert to keep the valuation for TPC relatively high.*" The Tax Court was also critical that this expert used total working capital instead of the change in working capital in arriving at cash flow.

The IRS expert did not apply a minority discount since the cash flow he used was a minority cash flow. He applied a 30% discount for lack of marketability.

The Tax Court found both the taxpayer's and IRS' valuations to be "*deficient and unpersuasive.*" The Court cited the lack of experience and training of the Alaska lawyer and accountant and their lack of membership in any professional appraisal organizations. The Court was also troubled that the Alaska attorney was appointed to act as administrator for the estate to handle the anticipated audit. The reports and testimony of the taxpayer experts were termed "marginally credible" by the Court, which also noted they were "*barely qualified*" to value the company.

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According to the Court, the IRS expert, "…*appeared to be concerned with numbers only and did not appear to make an effort to base his valuation of TPC on a real company*…" The Court totally rejected the 11 guideline companies used by taxpayer in his market approach. The Court similarly rejected the IRS expert's discounted cash flow approach because of significant errors and lack of a minority discount.

In its calculation, the Tax Court used the capitalization of income method with an 18.5% capitalization rate (still without any adjustment for growth), a 15% minority discount and a 30% lack of marketability discount (albeit reluctantly), arriving at a value of $13,525,240 for the subject interest.

The IRS tried to assert a 40% penalty under I.R.C. 6662. The Court noted that, even based on its own appraisal, there was still a more than 25% understatement, thus qualifying under I.R.C. 6662. The Court decided that since there were some difficult judgment calls in the appraisal and even the IRS expert made errors, the penalty should not be assessed.