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Federal Editorial Materials

Federal Taxes Weekly Alert Newsletter

2011

07/07/2011 - Volume 57, No. 27

Articles

Tax Court finds estate tax value of interest in publishing company was less than reported (07/07/2011)

Federal Taxes Weekly Alert,

Tax Court finds estate tax value of interest in publishing company was less than reported

Estate of Louise Paxton Gallagher, TC Memo 2011-148

An estate challenging an almost \$7 million estate tax deficiency stemming from IRS's claim that the decedent's interest in a publishing company was undervalued has prevailed in Tax Court. Using the discounted cashflow method and applying minority and lack of marketability discounts, the Tax Court has found that the interest was worth about \$2 million less than the reported value.

Background. A decedent's gross estate includes the fair market value (FMV) of all of the decedent's property at the time of his death. (Code Sec. 2031) FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. (Reg. § 20.2031-1(b))

Under Tax Court precedent, if the property to be valued is stock of a closely held corporation, its FMV is best determined through arm's-length sales near the valuation date of reasonable amounts of that stock. If it is not possible to so value the stock, however, FMV is calculated by analyzing the value of publicly traded stock in comparable corporations engaged in the same or a similar line of business, as well as by considering certain factors that an informed buyer and seller would consider.

A generally accepted method for valuing stock of a closely held company is the guideline company method. It is a market-based valuation approach that estimates the value of the subject company by comparing it to similar public companies.

Facts. Louise Paxton Gallagher died on July 5, 2004 (the valuation date). Among the assets includable in her gross estate were 3,970 membership interests (units) in Paxton Media Group, LLC (PMG), a Kentucky limited liability company (LLC). Based on an appraisal, the units were reported on the estate tax return at a value of \$34,936,000 or \$8,800 per unit.

IRS issued a notice of deficiency asserting that the units were worth \$49,500,000 on the valuation date.

Appraisals done on behalf of the estate after IRS began its examination and before trial found values of \$26,606,940 and \$28,200,000. An appraisal done by IRS before trial showed a value of \$40,863,000.

W.F. Paxton formed PMG in 1896 in Paducah, Kentucky. The privately held and family-owned newspaper publishing company initially operated one newspaper. PMG grew by acquiring underperforming companies and improving their financial performance. Due, in part, to that strategy, by July 2004, PMG published 28 daily newspapers, 13 paid weekly publications, and a few specialty publications, and owned and operated a television station. PMG was carrying out that acquisition strategy as of the valuation date.

PMG served primarily small and mid-sized communities in the southeastern and midwestern U.S. It dominated the print media in those communities by reporting mostly local news, unlike its competitors. That dominance generated higher and more consistent revenue streams for PMG than were received by other companies in the industry.

Parties' valuations. IRS's expert valued the units using both a market approach and an income approach. He applied a 17% minority discount to the result under the income approach, and then applied a 31% marketability discount to the results under both approaches. After according both approaches equal weight, he derived a unit value for PMG of \$10,293, concluding that the decedent's units had an FMV of \$40,863,000.

The estate's expert relied primarily on the income approach in valuing the decedent's units, using the market approach only to establish a reasonable estimate of FMV. After certain adjustments and applying a 30% lack of marketability discount to his result, he concluded that the FMV value of the decedent's units was \$28,200,000, or \$7,100 per unit.

Among other items, the experts disagreed over the propriety of relying on a market-based valuation approach (specifically the guideline company method) in valuing the units, the application of the income approach (specifically the discounted cashflow valuation method), and the proper type and size of applicable discounts.

Tax Court's findings. The Tax Court found that IRS's expert improperly relied on the guideline company method because the four guideline companies he used alone were not similar enough to PMG to warrant application of that method.

Given the lack of public companies comparable to PMG, the Tax Court agreed that the discounted cashflow (DCF) method was the most appropriate method under which to value the units. The DCF method is an income-based approach whereby a company's value is measured by the present value of future economic income it expects to realize for the benefit of its owners. Both experts used it in their appraisals but disagreed as to various adjustments and other factors in applying it. The Tax Court resolved these disputes in some cases agreeing with IRS's expert and in others agreeing with the estate's expert.

The Court then went on to resolve disputes over discounts. Specifically, the Court determined a 23% minority discount to the equity value of PMG computed on a 30% controlling interest basis under the DCF method. It also found a 31% lack of marketability discount to be appropriate.

Accordingly, applying the foregoing methodology and discounts, the Tax Court determined that the value of the units as of the valuation date was \$32,601,640.

References: For the valuation of property generally, see FTC 2d/FIN ¶ P-6000 et seq.; TaxDesk ¶ 481,000 et seq.

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