MERCER CAPITAL
Business Valuation & Financial Advisory Services

Estate of Powell v. Commissioner

Tax Court Decisions Highlight Need for Competent Appraisal Work

The Moral of the Story

What Not to Do When Valuing a Retail Company

The Importance of Investigating and Supporting All Major Valuation Assumptions

Value Matters™

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Estate of Powell v. Commissioner

Estate of Nancy H. Powell, Deceased, Jeffrey J. Powell, Executor, Petitioner v. Commissioner of Internal Revenue, Respondent. 148 T.C. No.18 (May 18, 2017)

CASE SUMMARY

- Nancy Powell died August 15, 2008
- On August 6, 2008, Jeffrey Powell (Nancy Powell's son) created a limited partnership, NHP Enterprises LP ("NHP") and named himself general partner.
- Jeffrey then transferred approximately $10 million in cash and securities from his mother's revocable trust to NHP in exchange for a 99% limited partnership interest.
- On August 7, Jeffrey obtained a doctor's note that allowed him to act as agent under his mother's durable power of attorney for property due to his mother's incapacity. He used the power of attorney to create a charitable lead annuity trust ("CLAT") and transferred the 99% limited partnership interest to the CLAT. The CLAT paid the annuity interest to the Nancy H. Powell Foundation for the remainder of his mother's life. The CLAT named Jeffrey and his brother as remainder beneficiaries upon his mother's death.
- The power of attorney Jeffrey used contained two significant provisions:
    - o Jeffrey had the power to "[t]o grant, convey, sell, transfer, mortgage deed in trust, pledge and otherwise deal in all property real and personal, which the principal may own."
    - o The POA also authorized Mr. Powell "[t]o make gifts on the principal's behalf, including, but not limited to, forgiveness of loans, to a class composed of the principal's children, any of such children's issue, or any or all to the full extent of the federal annual gift tax exclusion under Internal Revenue Code Section 2503(b) or any successor statute."
- Jeffrey later filed a gift tax return for the transfer to the CLAT. He determined the value of the 99% limited partnership interest to be $7.5 million after a 25% discount for lack of marketability and lack of control. This resulted in a gift to the reminder beneficiaries of just over $1.6 million. The IRS issued deficiency notices for the gift tax return and the estate tax return.

KEY ISSUE

- Misuse of Powers of Attorney
    - o Here the decedent's son used a power of attorney that granted him the power to make gifts of up to the $14,000 annual gift exclusion to the principal's family members to make a gift of $7.5 million to his family and his mother's private foundation. This misuse of the power of attorney caused the Tax Court to disallow the gift.
- Last-Minute Estate Planning
    - o Many of the more sophisticated estate planning techniques require time to implement. Compressed planning might implicate a step-transaction doctrine challenge. The step-transaction doctrine is intended to have the tax consequences reflect the economic substance of the transaction. If the step-transaction doctrine is applied, then a multiple-step process is treated as

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one transaction. In other words, transferring property to a FLP and then transferring FLP interests to younger generations may be collapsed into a single indirect gift of the underlying property, without the FLP wrapper, to the younger generations.

- While there are no hard-line rules for the time periods between different stages in a plan being effectuated, few practitioners find it surprising that the nine-day period in Powell helped to undermine the plan.
- The other issue in Powell involving last minute estate planning is that the plan did not account for the decedent's situation. The decedent's son knew of the decedent's imminent death. But when calculating the gift to the CLAT, Jeffrey Powell did not consider his mother's health.

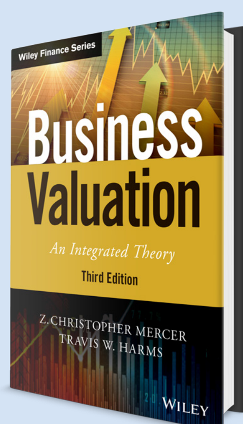
COURT FINDINGS

- According to notices of deficiency in both estate and gift tax, the 99% LP interest in NHP was worth $8,518,993 on August 8, 2008 and remainder interests in the CLAT were worth $8,363,095. The estate tax notice increased the value of the decedent's gross estate by $12,983,936. The Tax Court ruled in favor of the IRS.
  - Because the decedent retained the possession, enjoyment, or right to income from property transferred to NHP, the property transferred to NHP (valued at $10,022,570) is includible in the gross estate under IRC Sec. 2036(a)
  - Because the decedent retained the power to change enjoyment of a 99% LP interest in NHP, the fair market value of the 99% LP interest is includible under IRC sec. 2038(a)

KEY TAKEAWAY

If a durable power of attorney is used for tax planning after the principal is incapacitated, the gift power should be sufficiently broad to allow for the desired level of gifting. Standard provisions generally are limited to descendants and annual exclusion gifts.

Rohan Bose
214.206.3796
boser@mercercapital.com



UPCOMING BOOK

Business Valuation: An Integrated Theory Third Edition

Whether you are an accountant, auditor, financial planner, or attorney, *Business Valuation: An Integrated Theory*, Third Edition enables you to understand and correctly apply fundamental valuation concepts.

This new edition is expanded to integrate the conceptual levels of value with total enterprise value and address the implications of the new tax law on the value of interests in S corporations.

Tax Court Decisions Highlight Need for Competent Appraisal Work

Clients sometimes ask how we derive fee estimates for gift and estate tax work. The answer is relatively simple since it is really just the product of two variables – our effective hourly billing rate and the number of hours we expect to work on a given project. The effective billing rate is determined by several factors (level of experience and expertise required, likelihood of testimony, etc.) but is generally competitive across most appraisal firms. This means the disparity in fee estimates is largely attributable to the number of hours that a business appraiser (and his or her team) intends to put into that assignment.

Like many professions, we are just selling our time, so a low fee quote from a valuation firm is likely indicative of the effort that its employees intend to exert on the analysis and report. Conversely, higher fees generally mean that the project will be a focal point for senior staff members and other analysts that have familiarity with similar types of businesses (i.e. industry experience). Basically, you get exactly what you pay for.

While we're not privy to the appraisers' initial fee quotes for their work in the cases discussed below, we suspect they were relatively low given the deficiencies pointed out by the Tax Court. Here's a list of appraiser miscues identified by the Tax Court over the years.

Lacking Explanation Needed to Replicate

No matter how "correct" your conclusion of value is, the court may not accept it if you do not provide sufficient details and explanations about how you arrived at that conclusion. Another valuator should be able to replicate your work after reviewing your report or work-papers. In *Winkler Estate v. Commissioner* (T.C. Memo 1989-231. See also *Former IBA Business Appraisal Standards* Sec. 1.8. See also *True Est. v. Comr.*, T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004), the Tax Court provided perhaps one of the best arguments for a free-standing, comprehensive appraisal report:

> Respondent's expert appears to be extremely well qualified but he favored us with too little of his thought processes in his report. In another area, for example, his report briefly referred to the projected earnings approach, but the discussion was too abbreviated to be helpful. His testimony on the computer models he used, while unfortunately never developed by counsel, suggested that a lot of work had been done but simply not spelled out in his report. That may also be the case in his price-to-earnings computations, but the Court cannot simply accept his conclusions without some guide as to how he reached [them].

Failure to Explain Weightings

It is essential that you include a significant discussion in the valuation report of how you weighted products of various multiples in your conclusion of value. This did not happen in *True Estate v. Commissioner* (T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004)), as the Tax Court pointed out:

> [The valuator's] report's guideline company analysis was even more questionable. It provided no data to support the calculations of … pretax earnings and book value for either the comparable companies or True Oil. Further, [he] did not explain the relative weight placed on each factor.…Without more data and explanations, we cannot rely on [his] report's valuation conclusions using the guideline company method.

Where different valuation methods yield differing indications of value, you must be very clear about how you use them to arrive at a conclusion of value.

It sometimes is tempting to simply weight the indications equally. What is more important, however, is to have an explanation for the weighting of the indications of value, whatever they might be. In *Hendrickson Estate v. Commissioner* (T.C. Memo 1999-278. See also Pratt with Niculita, *Valuing a Business, 5th Ed.,* McGraw-Hill, NY, 2008, pp. 477-482), the Tax Court criticized the work of a valuator who simply gave the indications of value equal weight without bothering to explain why.

Inadequate Guideline Company Data

You are usually required to include the names of guideline companies in the valuation report. This was not done in J*ann Estate v. Commissioner* (T.C. Memo 1990-333. See also *AICPA Statement on Standards for Business Valuation,* Paragraph 61), where the Tax Court pointed out:

> [The valuator's] report referred to comparable companies but did not identify them; did not state whether [he] used average earnings or a weighted average earnings in his analysis; referred to a standard industrial classification number but did not identify it; and did not explain how he arrived the price-earnings ratio of 9.8.

In *True Estate v. Commissioner* (T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004)), the Tax Court criticized one of the taxpayer's valuators, stating:

> [He] provided no data showing: (1) How he computed the guideline company multiples or the Belle Fourche financial fundamentals, (2) which of three multiples he applied to Belle Fourche's fundamentals, or (3) how he weighed each resulting product. Without more information we cannot evaluate the reliability of [his] results.

Lack of Independence

The work of valuators and appraisers must be independent, which means having no personal interest in the company being valued or the outcome of litigation. In fact, appraisers usually must certify that they are independent. (See for example *2010-2011 USPAP Ethics Rule line 207, NACVA/IBA Professional Standards* Sec. II(J)*, Former NACVA Professional Standards* Sec. 1.2(k), *ASA BVS* Sec. III(A), *Former IBA Business Appraisal Standards* Section 1.3, and *AICPA Statement on Standards for Valuation Services* Paragraph 15.)

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In *McCormick Estate v. Commissioner* (T.C. Memo 1995-371), the Tax Court noted the following about a lack of independence:

> Petitioners' proffered 'expert' was John McCormick III, son of petitioner.

In *Cook Estate v. Commissioner* (86-2 USTC Par. 13.678 (D.C. W.D. Mo. 1986)), the Tax Court disregarded testimony of a person who was too close to the action:

> [The appraiser's] valuation of the stock at issue is not persuasive because of his self-interest. [He] is….president of Central Trust Bank…and the co-executor of Howard Winston Cook's estate.

Inconsistency

Contradicting your own assertions without adequate explanation can undermine your authoritativeness, whether it's done within a single valuation report, or from one report to another,

or between writings of various kinds. For example, assumptions used in more than one valuation approach, within a single report, must be consistent. That rule was violated in *Bell Estate v. Commissioner* (T.C. Memo 1987-576):

> Furthermore, the rates of return applied by [the valuator] in the excess earnings method bore no relationship to the capitalization rate [he] used in the capitalization of income stream method. We believe his choice of varying rate indicates a result-oriented analysis. An appropriate capitalization rate is determined by the comparable investment yield in the market not by the choice of a valuation method. [The valuator] made little effort to identify comparable investments.

Any significant discrepancy between your report and your testimony can compromise your credibility, as the Tax Court demonstrated in *Moore v. Commissioner* (T.C. Memo 1991-546):

> First, his report and trial testimony are inconsistent in that they indicate different methodologies for valuing the partnership interests. The report indicates that he valued the interests by discounting the fair market value of the business to reflect the lack of control and illiquidity associated with the minority interests. His trial testimony indicates that he valued the partnership interests under the procedure prescribed in *Rev. Rul. 59-60, 1959-1 C.B. 237.*

Any significant discrepancy between your report and your testimony can compromise your credibility

Valuators must use commercially available data consistently as well. In *Klauss Estate v. Commissioner* (T.C. Memo 2000-191), the Tax Court said that:

> [The valuator] testified that it is appropriate to use the Ibbotson Associates data from the 1978-92 period rather than from the 1926-92 period because small stocks did not consistently outperform large stocks during the 1980s and 1990s. We give little weight to [his] analysis. [He] appeared to selectively use data that favored his conclusion. He did not consistently use Ibbotson Associates data from the 1978-92 period; he relied on data from 1978-92 to support this theory that there is no small-stock premium but used an equity risk premium of 7.3 percent from the 1926-92 data (rather than the equity risk premium of 10.9 percent from the 1978-92 period.

In *Caracci v Commissioner* (118 T.C. 379 (2002), rev'd 456 F. 3d 444 (5th Cir. 2006)), the Tax Court used the valuator's past writings against him in the selection of a price-to-revenue multiple:

> Moreover, in an article published [in Intrinsic Value] in the spring of 1997, [the valuator wrote] that for the prior two years, a standard market benchmark for valuing traditional visiting nursing agencies, such as the Sta-Home tax-exempt entities, was a price-to-revenue multiple of .55. We fail to understand why the Sta-Home tax-exempt entities had a much lower multiple of 0.26.

There may be a legitimate basis for valuing the same interests using different methods in sequentially issued reports. But in *True Estate v. Commissioner* (T.C. Memo 2001-167), the Tax Court found that the valuator's inconsistent application of valuation methodology was a problem, commenting:

> [His report] calculated the equity value of Dave True's 68.47 percent interest in Belle Fourche on a fully marketable non-controlling basis without first valuing the company as a whole. This significantly departed from the initial…report's guideline company approach, which first valued the company on a marketable controlling basis, and then applied a 40 percent marketability discount. Even though both reports used the guideline company method, we believe the approaches were substantially different and find it remarkable that both reports arrived at the same ultimate value of roughly $4,100,000 for Dave True's interest. This suggests that the final…report was result-oriented.

Finally we have an example of inconsistent use of pre- and post-tax figures. In *Dockery v. Commissioner* (T.C. Memo 1998-114. See also ASA BV Sec. IV(JV)(D)), the valuator:

> [M]isapplied the price/earnings capitalization rate of 5 used in Estate of Feldmar to convert Crossroads' weighted average earnings, in that the Court in *Estate of Feldmar* applied the capitalization rate to post-tax earnings and [the valuator] applied it to pre-tax earnings.

Cherry-Picking Valuation Multiples

In *Wall v. Commissioner* (T.C. Memo 2001-75), the Tax Court had this to say about the valuator's narrow selection of multiples:

> It did not use all the guideline company multiples but instead picked and chose among the lowest...[The valuator's] use of the two or three lower multiple companies is inconsistent with the conclusion expressed elsewhere in her report that, even after the decline in Demco's earnings had been taken in account, Demco's profitability and risk levels were close to or at the industry norm. It also may be inconsistent with her conclusion that the seven companies she identified as comparable were in fact comparable to Demco.

In *Gallo Estate v. Commissioner* (T.C. Memo 1985-363), the Tax Court was even more pointed in its cherry-picking criticism:

> In valuing Gallo under each of the five methods based on comparables that he used, [the valuator] assigned to Gallo ratios that would result in the highest possible valuations. [His] method was pervasive and absolute: he made no real attempt to compare Gallo with any of the individual comparables. Even if Gallo were an above-average company, which is was not when ranked among the comparables, it would be unreasonable to expect Gallo to be most attractive with respect to each and every ratio. None of the 16 comparables was so positioned.

Conclusion

While the taxpayer may have saved some money on the initial fee quote in these cases, the total cost to defend the appraisal and pay the IRS penalty were likely far greater than the price of a well-reasoned opinion from a competent appraiser in the first place. These mistakes (and subsequent decisions from Tax Court) could have easily been avoided if the appraiser had devoted the appropriate time and care in their initial report. We hope that you will keep this in mind as you vet appraisers for gift and estate tax work. A cheap appraisal could ultimately be very expensive.

Note: Portions of this article originally appeared in the July/August 2013 issue of ***The Value Examiner.*** It was adapted from Chapters 17-18 of ***A Reviewer's Handbook to Business Valuation*** by L. Paul Hood, Jr., and Timothy R. Lee, (John Wiley & Sons, New Jersey, 2011) and a subsequent posting at **https://mer.cr/2m363ZK** For book details, see **www.mercercapital.com** or **https://mer.cr/2mU6zcB.**

The Moral of the Story

What Not to Do When Valuing a Retail Company

We were involved in the valuation of a retail company with over 200 retail outlets in multiple states. About half the retail outlets were in the original "home" territory of the company and half were in other states. In the "home" territory (about three states) the subject company was the market leader with more than twice as many retail outlets as the leading national competitor.

In the non-home territory, the national market leader had approximately four times the number of retail stores as our subject. The company was being valued for a dissident stockholder lawsuit to determine the "fair value" under Delaware law.

The opposing expert did not do a store-by-store analysis. He grouped all the stores in a single 5-year forecast and did no underlying local or regional analysis. This was a significant shortcoming that undermined the credibility of his report.

We analyzed the historical performance of individual stores and in regional groupings. The management of the company, as part of the proxy process for approval of the acquisition of the company, had prepared a 5-year forecast where the number of stores was projected to grow from about 200 to 400.

Our store-by-store analysis proved to our satisfaction that this growth forecast was very speculative at best. Our regional analysis showed that all the profits (103%) were generated by the stores in the "home" territory and the other stores were losing money. Also, the CEO testified that the "home" territory was saturated. As a result, the likelihood of achieving the projected growth was remote.

The Moral of the Story

The credibility of valuation analysis for multi-location retailers may hinge on the quality of store-level performance analysis.

The Importance of Investigating and Supporting All Major Valuation Assumptions

We were valuing a real estate holding company with prime real estate in North Texas. Both our analysis and that of the opposing expert reached similar conclusions as to the fair market value of the underlying real estate. The key difference was the estimated time to liquidate and convert to cash, and the effect of that process on fair market value.

One expert investigated the nature of the assets and the marketplace conditions and estimated a ratable liquidation over three years. The other expert assumed a liquidation over 15 years but assumed a limited amount of appreciation in the assets over this long period even though they were located in a prime North Texas location with an excellent long-term outlook.

The impact of this long liquidation period was that the conclusion of fair market value was approximately 50% lower than that of the other expert.

When challenged on the reasonableness of a 15-year discount period, the appraiser said he assumed it. The lawyer then asked the key follow up question, "Mr. Smith, what was the basis for that assumption?" The respondent had simply assumed it. He had no basis for the assumption and thereby artificially cut the value in half.

The Moral of the Story

Always make sure your valuation expert has support for all key assumptions. Never assume that such support exists.

Donald A. Erickson

Donald Erickson, ASA
(214) 468-8400
ericksond@mercercapital.com

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Mercer Capital in the News

Dallas and Nashville Offices Have Moved

Nashville Office:104 Woodmont Blvd. Suite 200 Nashville, Tennessee 37205
Dallas Office:12221 Merit Drive, Suite 975 Dallas, TX 75251

Seven Mercer Capital Analysts Successfully Complete Level III of CFA Exam

Mercer Capital analysts excelled in this year's Chartered Financial Analyst (CFA) exam, achieving a 100% pass rate for Level III of the professional designation exam, which is sponsored by the CFA Institute. This designation is recognized around the world as the premier designation in the finance profession. **Brian Adams, Mary Grace Arehart**, **Taryn Burgess**, **Heath Hamby, David Harkins, Daniel McLeod, and Zachary Milam** were successful in their completion of the exam.

Four Recent Additions to Mercer Capital's Staff

Mercer Capital welcomes **R. Andrew Fox**, **Mary Jane McCaghren,** and **Jake M. Stacy** to our professional staff as Financial Analysts. In their capacity as Financial Analysts Mary Jane, Jake and Andrew will provide business valuation and financial consulting services to public and private companies and financial institutions across the nation. Also joining the team is **Nikki Frierson** as the firm's Graphic Designer / Content Marketing Manager.

Z. Christopher Mercer, FASA, CFA, ABAR will present "Unlocking Private Company Wealth & Buy-Sell Agreements" at the NAVIX Company Seminar in Atlanta, Georgia.

Z. Christopher Mercer, FASA, CFA, ABAR will participate in a panel discussion on the topic of "The Value in Discounting Discounts - Partial Interest Valuations and Discounts" at the **2019 IRS Valuation Summit** sponsored by The Appraisal Institute.

Z. Christopher Mercer, FASA, CFA, ABAR will present "Will Kress v. US Change Your Life? Or Will It Change Your Valuation Practice?" at the **TSCPA Forensic & Valuation Services Conference** in Nashville,TN.

Travis Harms, Karolina Calhoun, and Z. Christopher Mercer will each present two sessions at the **AICPA Forensic & Valuation Services Conference** in Las Vegas.

Mercer Capital

Mercer Capital's ability to understand and determine the value of a company has been the cornerstone of the firm's services and its core expertise since its founding.

Mercer Capital is a national business valuation and financial advisory firm founded in 1982. We offer a broad range of valuation services, including corporate valuation, gift, estate, and income tax valuation, buy-sell agreement valuation, financial reporting valuation, ESOP and ERISA valuation services, and litigation and expert testimony consulting. In addition, Mercer Capital assists with transaction-related needs, including M&A advisory, fairness opinions, solvency opinions, and strategic alternatives assessment.

We have provided thousands of valuation opinions for corporations of all sizes across virtually every industry vertical. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement. Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation on behalf of their clients.

Contact Us

Travis W. Harms, CFA, CPA/ABV
901.322.9760
harmst@mercercapital.com

Nicholas J. Heinz, ASA
901.685.2120
heinzn@mercercapital.com

Z. Christopher Mercer, FASA, CFA, ABAR
901.685.2120
mercerc@mercercapital.com

J. David Smith, ASA, CFA
713.239.1005
smithd@mercercapital.com

Scott A. Womack, ASA, MAFF
615.345.0234
womacks@mercercapital.com

Timothy R. Lee, ASA
901.322.9740
leet@mercercapital.com

Bryce Erickson, ASA, MRICS
214.468.8400
ericksonb@mercercapital.com

Matthew R. Crow, ASA, CFA
901.685.2120
crowm@mercercapital.com

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