ESTATE OF HELEN P. RICHMOND, DECEASED, AMANDA ZERBEY, EXECUTRIX, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

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CITATION
ESTATE OF HELEN P. RICHMOND, DECEASED, AMANDA ZERBEY, EXECUTRIX, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent, T.C. Memo. 2014-26

Docket No. 21448-09, Judge: Hon. David Gustafson, Filed: February 11, 2014

OVERVIEW
In order to determine the value of the decedent's 23.44% interest in Pearson Holding Co. ("PHC") at the time of death, the court resolved the following disputes:

- whether the capitalization-of-dividends approach or net asset value ("NAV") approach is appropriate to determine PHC's value, and
- the appropriate discounts applicable to the NAV method.

***E-flash* TAKEAWAY**

The 20% accuracy-related penalty under section 6662(a), (b)(5), and (g) could have been avoided if the estate demonstrated that it acted with reasonable cause and in good faith with respect to the underpayment portion. However, using an unsigned draft report prepared by its accountant as its basis for the value of the decedent's interest fails meet the burden of proof for exclusion from the penalty. In addition, the accountant does not have any appraisal certifications, was not used as an expert in the case and did not demonstrate that he was qualified as an expert in valuation.

THE FACTS
PHC is a family-owned investment holding company that was incorporated in Delaware in January 1928. The company's philosophy is to maximize its dividend income. As a holding company subject to tax on undistributed income, PHC has a strong incentive to pay out most of the dividend income, with the objective to provided a steady stream of income to the descendants of Frederick Pearson while minimizing taxes and preserving capital. As a result, PHC's dividends have grown slightly more than 5% per year from 1970 through 2005.

As of December 2005, Helen P. Richmond owned 548 shares in PHC, which is a 23.44% interest. In addition to having a minority interest, the decedent had no rights to "put" her stock to the company, and the company could not "call" her stock.

Historically, the capitalization of dividends approach was used for nine transactions involving the sale or redemption of PHC stock by a shareholder between 1971 through 1993 and once more in 1999 when a shareholder died. Therefore, the Federal estate tax return filed used the capitalization of dividends method, too.

Ultimately, the IRS issued a statutory notice of deficiency to the estate with an upward adjustment from $3,149,767 to $9,223,658, which increased the state tax liability by $2,854,729.

Additionally, a 40% gross valuation misstatement penalty of $1,141,892 was determined pursuant to section 6662(h). No other adjustments were made to the gross estate.

DISCUSSION

While there were discrepancies about the valuation method used to calculate the value of the decedent's interest, the parties agreed that the NAV of PHC's portfolio was $52,159,430 and its built in capital gains tax ("BICG") was $18,113,083. However, the parties also disagreed about the amounts of the applicable discounts using the NAV method.

Peter Winnington, who provided the original value in the estate tax return used the capitalization of dividends method to calculate value of the decedent's interest. Although Mr. Winnington has appraisal experience, he does not have any appraiser certifications and was not used as an expert for the estate. However, Robert Schweihs was used as an expert for the estate. Mr. Schweihs valued the decedent's interest using the capitalization of dividends method but came up with a value of $5,046,500. However, Mr. Shweihs considered the NAV method unlike Mr. Winnington.

In the deficiency note, the valuation method used by IRS auditor is not specified and no explanation is given to what extent, if any, his method allowed discounts. In his notice of deficiency, the Commissioner valued the decedent's interest at $9,223,658, but at trial he relied on John A. Thomson's expert testimony to argue the value of $7,330,000.

Using the courts consistent precedent for valuing holding companies like PHC, the court chose the NAV as the best method for valuing the estate.

Although Mr. Winnington considered the NAV method, his valuation differed from Mr. Thomas by the discounts he used in association with the BIG tax, discount for lack of control and discount for lack of marketability. The following table depicts the values that each expert used for discounts associated with the NAV as well as the values determined by the court.

	Mr. Schweih (estate's expert)	Mr. Thomson (commissioner expert)	Court Ruling
BICG tax discount	100%	15%	15%
Discount for lack of control	8%	6%	7.75%
Discount for lack of marketability	35.6%	21%	32.1%3
Value of decedent's interest	$4,721,962	$7,330,000	$6,503,804

CONCLUSION

The court decided that the most reasonable discount for the BICG tax liability is the present value of the cost of paying off that liability in the future. Since the Commissioners discount fell with the range of values, it was considered to be reasonable.

To determine the discount for lack of marketability the court used Mr. Thomson's data set of 59 funds and removed the outliers to determine a mean discount of 7.75%.

Using the range of marketability discounts that the parties agreed was between 26.4% and 35.6% an average discount of 32.1% was selected by the court.

Concluding that the value of the decedent's interest was $6,503,804 compared to the $3,149,767 reported on the estate tax return, a deficiency summary was upheld. In addition, the court ruled that estate did not demonstrate that it acted with reasonable cause. Therefore, the court upheld the accuracy related penalty under section 6662(a), (b)(5), and (g), as well.