

## ***Kohler: Textbook Valuation of Large Closely-Held Leads to Total Victory for Taxpayer***

***Kohler et al. v. Commissioner of Internal Revenue, 2006 Tax Ct. Memo LEXIS 156 (July 25, 2006)***

The stars must have been aligned during the *Kohler* decision, because everything went right for the taxpayer. First, lawyers for the Kohler estate won key legal victories on the burden of proof and the valuation date; then the expert for the IRS made a critical miscalculation in his report (the kind you'd never wish on anyone, even the opposition). Finally, the Tax Court (Judge Kroupa) not only considered both Kohler experts to be "thoughtful and credible," giving significant weight to their reports—but also found that between them, the more advantageous valuation ruled the day.

Of course, the taxpayer could have wished that the IRS had never assessed deficiencies in the first place, but then the business valuation and legal community would be without this "textbook" case, brought to you by two of the leading authorities in the field, on how to value a large, closely-held business.

### **A household name**

Kohler is one of the leading manufacturers of kitchen and bath products; separate divisions also manufacture small industrial engines, household furnishings, and operate hospitality services. Despite public renown, Kohler has always been a privately-held family business since its founding in 1887. It has also paid annual dividends since 1900. In fact, Kohler's stated policy was to reinvest at least 90% of its annual earnings in the business, paying out 7% to 10% as dividends even during recessions (even if it had to cut back on retained earnings). Shareholders depended on dividends as the sole source of ROI—and often as their only source of income, without any active market for sale or appreciation of the shares.

Kohler also issued two business plans: A management plan, which was a realistic projection of achievable targets, given current economic realities; and an operations plan, which was a theoretical, "best case" projection of what could happen in a perfect world. Kohler regularly updated its management plan for lenders, insurance companies, etc.; its operations plan was for internal use only.

### **Reorganization in 1998**

To recapture the 4% of stock held by non-family members, Kohler effected a tax-free reorganization (under §368(a) IRC) in May of 1998. Under its terms, non-family shareholders could either accept a cash-out price of \$52,700 per share, or exercise dissenters' rights—which some did with varying success, settling for up to \$135,000 per share, including claims for breach of fiduciary duty.

During the reorganization, on March 4, 1988, Frederic Kohler died. Before reorganization, Kohler's estate owned 12.85% voting stock; afterwards, it owned 14.45%. To value the taxable interest, the estate hired Robert Schweihs ASA, CBA (Willamette Management Associates, Chicago), who had performed periodic valuations for the company and knew its operations well. Schweihs was (and still is) a household name in business valuation, having co-authored a leading text (*Valuing a Business*, Fourth Edition) with Shannon Pratt and Robert Reilly.

Schweihs appraised the fair market value of the estate's Kohler holdings as of September 4, 1998 at \$47.01 million. He also appraised the value of the estate at Frederic's death six months earlier at \$50.115 million. Pursuant to §2032 IRC, the estate elected the alternate date—six months after the decedent's death, to value its holdings, and filed its return with the \$47.01 million appraisal. After an extended audit, during which the estate withheld certain documents until the court denied its motion to quash, the IRS determined the fair market value of the Kohler holdings on the alternate date to be \$144.5 million, based on an appraisal by Richard May (founder of Valuemetrics Advisors, Inc., now with Duff & Phelps, Chicago). (The decision does not mention whether the IRS used May's appraisal during the subsequent litigation).

The valuations were, needless to say, nearly \$100 million apart.

### **A critical shift in taxpayer's favor**

In most cases, it's up to the taxpayer to prove that IRS deficiency notices are incorrect. This burden of proof shifts to the IRS if the taxpayer can show well-maintained, substantiated records and cooperation with the IRS. In this case, the Kohler estate had "legitimate" concerns about turning over sensitive corporate records—but after an unsuccessful motion to quash, the company complied with all IRS requests. The deluge of documents made the burden of proof "a meaningful issue, rather than simply an academic one." (A good lesson for lawyers and taxpayers: the more you turn over, the more likely you can show credible records and compliance.) Accordingly, the Tax Court placed the burden on the IRS to prove that the taxpayer was liable: an important shift, which became critical to the taxpayer victory.

The IRS also lost a bid to value the Kohler estate on the date of Frederic's death, because it missed a procedural deadline for amending its pleadings. The question still remained whether, on the alternate valuation date, the Kohler stock should be valued before or after the reorganization; the IRS tried to "backdoor" its argument by claiming the Court should either: (a) value the pre-organization stock on the alternate valuation date; or (b) ignore the transfer restrictions and purchase option in valuing the post-organization stock. The taxpayer won on this point, too, primarily because the Court recognized that pursuant to §2032(a) and the accompanying Estate Tax Regulations, a qualified, tax-free reorganization is not a "distribution, sale, or exchange" or other substantial change in form—or value.

The narrow question then became the fair market value of the post-reorganization Kohler stock on the alternate valuation date, including the transfer restrictions and purchase option. Given its decision on burden of proof, the Court first considered the IRS expert report by Scott Hakala, Ph.D., CFA (CBIZ Valuation Group, LLC).

### **How important is a USPAP certification?**

The Court considered the expert's credentials before his substantive appraisal, noting that although he had a doctorate and a CFA, he was neither a member of the ASA nor the Appraisal Foundation. The Court also noted that his report had omitted "the customary USPAP certification" regarding the appraiser's compliance with standards and independence. (An interesting observation, as not all appraisers regularly include the USPAP language, even though their reports qualify.)

In its more detailed discussion of the expert's income approach, the Court indicated that Hakala had declined to use a dividend based method, preferring a discounted cash flow (DCF) instead—but then he'd opted not to use Kohler-provided projections, making his own expense assumptions "without first discussing them [with] anyone at Kohler." He created two DCF models, one using revenues from the company's management and the other from its operations plan, giving the former a 20% weight versus 80% for the latter, because he believed the "aspirational" plan was the more likely scenario. The Court disagreed, saying he weighted the results "inconsistent with reality of the business."

The IRS expert had also made a last-minute correction to his income approach values, which had overvalued the Kohler stock by \$11 million—"not a minor mistake" according to the Court, and which—no matter how it was made—seemed to be one from which the Service couldn't recover. The Court noted for the record its market approach, using the guideline company method (80% weight) as well as the transaction method (20%), averaging the two and applying a 25% discount for lack of marketability. But in the final analysis, it found that: (1) the IRS had declined to use a dividend approach for a private company with a long and consistent dividend policy; (2) it had weighted a theoretical operations plan over a realistic management plan; and (3) it had failed to use management projections. These facts were sufficient to hold that the IRS had failed in its burden of proof. "Accordingly, we find the value of the estate's stock to be [as] reported on its return, \$47,009,625."

### **Discussion of taxpayer's appraisal academic**

The Court completed its record with high praise for the taxpayer's valuation reports by Schweih's and also Roger Grabowski, ASA (Duff & Phelps). It noted their respective credentials and professional experience, including extensive teaching experience and publications. Their reports provided "thoughtful, credible valuations strongly supporting the value the estate reported on its tax return."

The Court's discussion of their income and market approaches reads like a textbook case study on how to value a closely-held business, and is worthwhile reading for all business appraisers (and their attorneys). Highlights include:

*Schweihs report*

- Schweihs was "very familiar" with company management and operations, having performed periodic valuations before.
- His income approach used a discounted dividend method and also a dividend capitalization method, "important indicators of value where dividends represent the best, if not the only opportunity for minority shareholders to receive a cash return on...investment."
- His market approach used only the guideline company method, because he was unable to find sufficient comparables for the transaction method.
- He did not use prior sales of Kohler stock, because they included a premium for being a stockholder in a prominent, privately-held company, which could not be quantified.
- He applied a 45% discount for lack of marketability under the DCF and capital market methods, and a 10% DLOM to the dividend methods because they more directly reflected the value of shares.
- He applied a 26% lack of control discount in his DCF.
- He assigned a 20% weight to the DCF and capital market methods, 30% to dividend methods.
- He concluded a value for Kohler stock of \$47.01 million at the alternate valuation date (\$50.115 million at the date of death).

*Grabowski report*

- Grabowski spent 3 ½ days at the company interviewing 12 employees, including considerable time with the president and the general counsel/executor of the estate.
- He used the management plan, including its projections, in his DCF and discounted dividend analysis.
- For his guideline public company analysis, he identified publicly-traded companies in each market segment in which Kohler operated, and applied valuation multiples to these entities, weighting the valuation conclusion of each segment based on the relative portion of Kohler's business that each comprised.
- Each of his methods resulted in fairly close values; after assessing the strengths and weaknesses of each, he decided the adjusted discounted dividend method was the most appropriate, "because it reflected the actual cash flows a shareholder would expect to receive," and also the remote possibility that Kohler could be sold or go public.

- He applied a 35% DLOM, a 25% discount for lack of control, for a bottom line fair market value of Kohler stock on the alternate valuation date of \$63.385 million.