

'Friends and Family' Gifts of Private Stock Support 50% DLOM

Huber v. Commissioner, 2006 Tax Ct. Memo LEXIS 97 (May 9, 2006)

To support the taxpayers' claims that gifts of closely-held stock among family members were "arms length" transactions, sufficient to support a 50% discount for lack of marketability (DLOM), it helps that nearly 250 shareholders of the closely-held company, all of them related to some degree, also accepted the same discounted value. When you've got a pool of friends and family that large—executing about 90 transactions during the relevant time period—you've nearly created your own fair market for comparables.

When a private company acts public

The taxpayers were shareholders of JM Huber Corporation—one of the largest family-held businesses in the country, then reporting over \$500 million in annual sales. According to the Tax Court, Huber "emulated public companies" by maintaining high levels of communication with its 250 shareholders, who were generally family members (and also family-owned trusts). Pursuant to its by-laws, Huber could redeem stock from its shareholders, but there was no public market for the shares. To measure the financial performance of the company, set Board compensation (including CEO stock options), authorize redemptions, etc., Huber had employed Ernst and Young (E&Y, New York) since 1993 to provide an annual valuation.

To value Huber shares, E&Y had consistently used a publicly-traded market comparable methodology; and had consistently applied a 50% marketability discount. During the years in question (1994-2000), about 90 sales or exchanges of Huber stock had taken place between shareholders, including immediate family members, distant cousins, and trustees. All of these sales had taken place at the E&Y discounted value.

Those 90 transactions included Petitioners' gifts of Huber stock to family, which they valued according to E&Y reports. The IRS agreed with E&Y's assessment of the freely-traded value of the shares, but challenged the 50% marketability discount. According to its expert, Appraisal Economics, Inc. (Paramus, NJ), a 25%-40% DLOM was more appropriate, rejecting the E&Y discount because the sales at those values were not "arms-length" transactions.

IRS 'ignored' the evidence

Relying on such key cases as *McCord v. Commissioner* (2003) and *Estate of Bongard v. Commissioner* (2005), the IRS urged the court to closely scrutinize the family transactions for failure to maintain "arms-length." The Service also argued that the E&Y reports were not reliable because they were aged eight months to a year by the time the transactions took place.

But the Tax Court criticized the IRS for "focusing on isolated sales that took place between closely-related family members as if they were the only sales." The Service had ignored the 90-plus transactions involving an "amalgam of relationships," in which the parties were fully informed regarding Huber's finances, with sufficient independent knowledge to assess the E&Y valuations.

As examples, the taxpayers offered two sales: One took place when a Huber family executor had to raise money to pay estate tax (he was also a Stanford MBA, ran a private equity firm, and served as a nonvoting Huber director). In the second, a Huber family trustee needed to satisfy trust expenses, and sold to one of its beneficiaries, the sister of the Huber CEO and also a nonvoting board member.

These parties were under no compulsion to make/receive the gifts of stock (as in *McCord*); any family relationships between them were effectively "neutralized" by the distance of these relationships as well as their

fiduciary obligations to obtain the best price. The variety of these relationships was, according to the Court, “a positive indicator of the existence of arm’s length sales.”

In other words, “we reject [the IRS’] suggestion that almost 250 shareholders would harmoniously accept an artificially low valuation of the Huber stock so that a few people who may or may not be related to them can pay less estate tax.”

The Court also rejected the “hypothetical” notion that offering the stock for public sale would have garnered a higher price. “Courts have long recognized the rights of shareholders in closely held companies to remain private.” As there was “no basis to suggest” an available market where a potential buyer would purchase Huber shares at higher than the E&Y values, these values—including the discounts—were the “best reference” available, and confirmed the estate’s valuation.

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