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T.C. Memo. 2002-80

UNITED STATES TAX COURT

ESTATE OF WILLIAM G. ADAMS, JR. DECEASED, GEORGE W. SAENGER, EXECUTOR, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 14698-99. Filed March 28, 2002.

George W. Saenger, pro se.

James E. Gray and Steven Webster, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

COLVIN, Judge: Respondent determined a $635,018.85 deficiency in the estate tax of the Estate of William G. Adams, Jr. (decedent). After concessions, the sole issue for decision is whether the fair market value of decedent's 61.59-percent interest in Waddell Sluder Adams & Co., Inc. (WSA), on September

28, 1995, was $1,746,000, as respondent determined, or $920,800, as the estate contends. We hold that it was $1,161,705.

Unless otherwise specified, section references are to the Internal Revenue Code as amended and in effect on the date of decedent's death, and Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

A. Decedent and the Executor

Decedent, who lived in Asheville, North Carolina, died testate on September 28, 1995. When he died, he owned 178 shares of WSA voting common stock, which was 61.59 percent of its outstanding stock. Voting common stock was WSA's only outstanding stock when decedent died.

George W. Saenger, the executor of decedent's estate, lived in Asheville, North Carolina, when the petition was filed.

B. Waddell Sluder Adams & Co., Inc.

1. Insurance Business

WSA has been an S corporation since the early 1970s. It has two components, a retail insurance agency and a managing general insurance agency (MGA). In 1995, the retail agency generated 5 percent of WSA's revenue, and the MGA generated 95 percent. The retail agency sells insurance to the public.

When decedent died, and until the time of trial, WSA had a contract with the Maryland Casualty Co. (MCC) to be an MGA. The contract provides that MCC is the sole supplier of insurance to the MGA and that WSA has the exclusive right to sell personal and commercial lines of insurance for MCC in 17 counties in western North Carolina. In 1995, 68 to 72 percent of WSA's business came from personal lines. WSA was MCC's only MGA in 1995. MCC or WSA could terminate the contract at any time by giving 180 days' written notice to the other party.

WSA sells insurance for MCC through about 42 independent retail insurance agents. Independent agents may obtain insurance for their customers from any insurance company. WSA processes insurance applications from customers of the retail agents and makes underwriting decisions. If WSA accepts an application, it sets the premium, issues the policy to the retail agent, and pays the premium to MCC. MCC then pays part of the premium to WSA. WSA uses these funds to pay its expenses and the retail agents and keeps the excess as profit. The retail agents have contracts with WSA which establish the amounts of commissions they will receive for selling MCC products. WSA would not be a viable business without its relationship with MCC or if it could not sell personal lines of insurance.

2. Key Personnel

a. Decedent

Decedent began working for WSA in the mid-1940s. He became president of WSA around 1972, and he worked for WSA until April or May 1995. He worked fewer hours in his later years. His primary function in those later years was to set wage and bonus levels for WSA officers.

b. Robert B. Gelder, Jr.

Robert B. Gelder, Jr. (Gelder), was born in 1949 and has lived in Asheville, North Carolina, since 1953. He graduated from the University of North Carolina. He worked for 5 years for NCNB (now Bank of America). He began working for WSA in 1976.

Gelder spent his first year at WSA learning the insurance business. In 1976, WSA's insurance underwriting was divided between property and casualty lines of coverage. Gelder became the manager for personal and commercial lines of casualty insurance after 15 months at WSA. He began to perform underwriting services, i.e., to assess risk for applicants of property insurance policies, around 1982. He developed marketing skills and gained experience in all aspects of underwriting for WSA. He developed and maintained a close relationship with the independent agents who sold WSA products and with MCC personnel. He became the sole liaison between WSA and MCC beginning around 1982. He began managing WSA around 1987. He became the general

manager and president of WSA in 1994. In 1995, his duties included maintaining WSA's relationship with MCC and the retail agents in western North Carolina. He has performed all of the management functions for WSA since 1995.

Gelder has no written employment contract or noncompete agreement with WSA. WSA had no other employee who could replace Gelder in 1995. Gelder's compensation and dividends from WSA for 1991-95 were as follows:

	1991	1992	1993	1994	1995
Wages	$234,700	$258,100	$299,600	$381,200	$381,465
Dividends	76,614	83,581	84,247	108,889	167,239
Total	311,314	341,681	383,847	490,089	548,704

c. Julia Adams Slipher

Julia Adams Slipher (Slipher) is decedent's daughter. Slipher began working for WSA in 1977 as an assistant bookkeeper. She later began underwriting personal lines of insurance, and she was responsible for underwriting property insurance coverage for commercial middle markets (not otherwise described in the record) in 1995. Slipher could not have done Gelder's job in 1995.

3. Officers and Employees

On September 28, 1995, WSA's officers were Gelder (president), Slipher (vice president and secretary), and decedent (treasurer). On that date, WSA had 16 employees in addition to Gelder, Slipher, and decedent.

4. Stock Holdings on September 28, 1995

On September 28, 1995, decedent, Gelder, and Slipher owned WSA's stock as follows:

Shareholder	No. of shares	Percentage of total
William G. Adams, Jr.	178	61.59
Robert B. Gelder, Jr.	105	36.33
Julia Adams Slipher	6	2.08
Total	289	100.00

5. Zurich Insurance Group's Purchase of MCC

The Zurich Insurance Group (Zurich) purchased MCC in the late 1980s. Zurich considered implementing a "service center" concept for MCC, which would have caused WSA to lose underwriting authority, eliminated the need for WSA to serve as an MGA or as a retail agency, and eliminated the work done with WSA by the independent agents throughout western North Carolina. WSA opposed imposition of the service center concept in the 17 counties which it serviced, and Zurich eventually abandoned the concept. Through considerable effort, Gelder maintained and improved WSA's relationship with Zurich.

6. Pending Litigation

The North Carolina Rate Bureau represents insurance companies before the Insurance Commissioner of North Carolina. In 1994, the Rate Bureau commenced litigation with the Insurance Commissioner which potentially affected WSA. If the Rate Bureau had prevailed, WSA would have been required to pay about $407,000

to Zurich to be refunded to WSA's customers. That litigation was pending on September 28, 1995.

OPINION

A. Contentions of the Parties

The estate contends that the value of decedent's 178 shares of WSA stock (a 61.59-percent interest) on September 28, 1995, was $920,800. Respondent contends that the value was $1,746,000 on that date.[1]

A tax is imposed on the fair market value of the decedent's property on the date of death. Secs. 2001, 2031. The fair market value of property 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 to sell and both having reasonable knowledge of relevant facts." Sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512-1, Gift Tax Regs. The estate bears the burden of proof.[2] Rule 142(a)(1).

Both parties rely on the testimony of experts to establish the fair market value of decedent's WSA stock. We may accept or reject expert testimony according to our own judgment, and we may

[1] In objecting to the estate's proposed ultimate finding of fact, respondent contends that the fair market value was $1,757,911. However, respondent's proposed ultimate finding of fact is that the value of decedent's interest in WSA was $1,746,000, the value that respondent determined. Respondent does not explain this difference.

[2] The estate concedes that sec. 7491 does not apply because the examination began before July 22, 1998.

be selective in deciding what parts of an expert's opinion, if any, we accept. Helvering v. Natl. Grocery Co., 304 U.S. 282, 295 (1938).

Herbert T. Spiro (Spiro) testified for respondent. F. Foster Shriner (Shriner) testified for the estate.[3] Shriner and Spiro estimated, and computed the present value of, future returns an investor would receive from an investment in WSA. They did so by calculating the present value of the stream of estimated future cashflows to WSA. Spiro concluded that the fair market value of the shares at issue was $1,904,403 on September 28, 1995; Shriner concluded that it was $920,800.

B. Spiro's and Shriner's Expert Reports

We believe that Shriner's approach for estimating the value of WSA stock (before applying a discount for lack of marketability) was more thorough than Spiro's. Spiro did not speak with anyone from MCC or investigate the pending

[3] Kevin M. Stipe also testified for the estate. However, the estate does not rely on Stipe's estimate even though it was more favorable to the estate than Shriner's estimate. We do not consider Stipe's estimate of value.

litigation.[4] Shriner did those things, and reasonably concluded that it was unlikely that WSA would survive without Gelder.

C. Whether Shriner Properly Estimated Gelder's Future Compensation

Respondent contends that Shriner underestimated future net cashflows by overestimating future compensation to Gelder. On the basis of Spiro's testimony, respondent contends that Shriner should have used $125,000 per year as Gelder's future compensation. We disagree.

Gelder's salary in 1995 was $381,465 and his salary and dividends totaled $548,704. Spiro acknowledged that Gelder was a key employee, and that no one would buy WSA without Gelder. We do not believe that Gelder could have been replaced for $125,000 per year.

Respondent contends that WSA could have found a suitable replacement for Gelder in 1995 and that Gelder had no attractive employment alternative. We disagree. Slipher testified that it was unlikely that anyone could assume Gelder's responsibilities because few people understood as well as did Gelder the market, the industry, underwriting, and management as they affect WSA.

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[4] In his report, Spiro said:

> Not having interviewed persons in authority at The Maryland in 1995, it is impossible to determine conclusively whether or not The Maryland would have cancelled or materially modified WSA's personal lines underwriting authority upon the transfer of Mr. Adams' interest to another party.

Spiro projected Gelder's future salary based on the salary of the top 10 percent of underwriters, even though Gelder spent only 10 or 15 percent of his time underwriting. Spiro's methodology ignores the fact that Gelder did much more than underwriting.

Shriner used insurance industry data for officers and managers to estimate Gelder's future compensation. That data shows that officers of companies in the insurance industry with assets of $1 million received compensation of 14.6 percent of gross revenues. Shriner estimated that future compensation of WSA officers would be 14.7 percent of WSA's gross revenues. We believe that Shriner reasonably estimated Gelder's future compensation.

Respondent contends that Shriner should have assumed that WSA would make payouts to investors at the middle of the year (midyear convention) rather than at the end of the year (yearend convention). Respondent contends that Shriner's approach is incorrect because he "artificially treats net cashflows as not received until the end of each year." We disagree. There is support for use of the yearend convention on the grounds that payment at the end of the year is better than payment in the middle of the year because payment at the end of the year enables the managers to see how the year has turned out. Pratt, Cost of Capital, Estimations and Applications 30-31 (1998). We do not

apply the midyear convention here because respondent offered no evidence that WSA would pay its investors at the middle of the year rather than at the end of the year.

D. Estimating the Discount and Capitalization Rates

Shriner used the income capitalization method and Spiro used the discounted cashflow method to estimate the fair market value of WSA stock. In the discounted cashflow method, a discount rate is applied to a series of future cashflow periods (e.g., each year in the future that the asset will produce a return on investment) to estimate present value. In the income capitalization method, the future cashflow of a single period (e.g., the next year) is estimated. An estimated growth rate is applied to project the cashflow for that single period into the future. An estimated discount rate is applied to reduce the projected future cashflows to present value. A capitalization rate combines the estimated growth rate and the discount rate. It is applied to the estimated future cashflow of the single period. Neither party contends that the other's method is inappropriate here.

Both experts began their analyses by estimating a discount rate to apply to WSA's projected net cashflow using the "build-up method". They both used a rate of return on risk-free investments (risk-free rate) of 6.86 percent, which was the 30-year Treasury rate for August 1995.

1. Added Risk Premiums

Both experts increased the 6.86-percent rate to account for risks that an investor in WSA would assume; i.e., "added risk premiums".

Spiro and Shriner both added a 7.03-percent equity risk premium[5] to account for the fact that the rate of return on stock is less certain than on U.S. Treasury obligations. They obtained this value, which is based on investment returns of C corporations, from Stocks, Bonds, Bills, and Inflation: 1995 Yearbook by Ibbotson Associates, Inc.

Both experts added a 5.25-percent risk premium to account for the fact that WSA was a small company. Both experts based this added risk premium on data from Ibbotson Associates.

Spiro also added a 10-percent risk premium to account for potential loss of personal lines of underwriting authority and the fact that WSA is an S corporation. Shriner added a 9.03-percent risk premium (7.03 percent for WSA's tenuous relationship with Zurich and 2 percent for its thin management and the importance of Gelder). The sum of the risk-free rate and added risk premiums equaled a discount rate of 29.14 percent for Spiro and 28.17 percent for Shriner.

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[5] Adding the equity risk premium to the risk-free rate is a widely accepted method. Brealey & Myers, Principles of Corporate Finance 146-147 (5th ed. 1996); Pratt, Cost of Capital, Estimation and Applications 62 (1998).

2. Deriving a Capitalization Rate

Shriner derived a capitalization rate of 20.53 percent from his estimated discount rate and from his estimated future average annual growth rate of 6.34 percent for WSA.[6] Respondent does not dispute Shriner's estimated growth rate or capitalization rate. We accept Shriner's estimate of a capitalization rate of 20.53 percent. However, we do not accept an increase that Shriner made to that rate for reasons discussed next.

3. Whether Shriner Properly Converted the Capitalization Rate From an After Corporate Tax Rate to a Before Corporate Tax Rate

The net cashflow and the capitalization rate used to compute the fair market value of the WSA stock should have the same tax character; i.e., before corporate tax or after corporate tax. See Gross v. Commissioner, T.C. Memo. 1999-254 (both the discount rate and cashflow should be before shareholder tax or after shareholder tax), affd. 272 F.3d 333 (6th Cir. 2001). See generally Black & Issom Associates, Fundamentals, Techniques and Theory of Capitalization/Discount Rates, ch. 5, at 23 (1995); Ibbotson Associates, Stocks, Bonds, Bills and Inflation: Valuation Edition 1999 Yearbook; Pratt, supra at 151-152, 155.

[6] The capitalization rate is generally derived by reducing the discount rate by the expected long-term stable growth rate of net cashflows to the investment being valued. Pratt, supra at 21-23.

The estate contends that Shriner's estimates of WSA's prospective net cashflows are before corporate tax. The estate also contends that Shriner properly converted the capitalization rate from an after corporate tax rate to a before corporate tax rate to match estimated prospective net cashflows and that the conversion increased his capitalization rate from 20.53 percent to 31.88 percent. We disagree with the estate on both points.

We disagree that Shriner's estimates of WSA's prospective net cashflows are before corporate tax because it is appropriate to use a zero corporate tax rate to estimate net cashflow when the stock being valued is stock of an S corporation. Gross v. Commissioner, supra. WSA is an S corporation, and its cashflows are subject to a zero corporate tax rate. Thus, Shriner's estimates of WSA's prospective net cashflows are after corporate tax (zero corporate tax rate) and not before corporate tax as the estate contends.

We disagree that Shriner properly converted the capitalization rate because there was no need to do so. The parties agree that Shriner's estimated capitalization rate (before he converted it to before corporate tax) is an after corporate tax rate. Thus, as in Gross, the tax character of Shriner's estimate of WSA's prospective net cashflows matches that of the unconverted capitalization rate because both are after corporate tax. It follows that Shriner should not have

converted the capitalization rate from after corporate tax to before corporate tax because the tax character of both his estimated net cashflows for WSA and unconverted capitalization rates is after corporate tax.

We conclude that Shriner improperly increased the capitalization rate from 20.53 percent to 31.88 percent.[7]

4. Conclusion

The following shows the value of decedent's interest in WSA on September 28, 1995, before applying a discount for lack of marketability:

Normalized net cashflows	$595,746
Capitalization rate	÷ 20.53%
Capitalized net cashflows – total entity	[1]$2,901,831
Equity interest of 61.59 percent	x .6159
Value of decedent's interest	[2]$1,787,238

[1] $595,746/.2053 = $2,901,831.
[2] Before discount for lack of marketability.

E. Discount for Lack of Marketability

Both experts applied a discount for lack of marketability because there was no ready market for WSA stock on September 28, 1995. We agree that a discount for lack of marketability is appropriate.

[7] The result here of a zero corporate tax on estimated prospective cashflows and no conversion of the capitalization rate from after corporate tax to before corporate tax is identical to the result in Gross v. Commissioner, T.C. Memo. 1999-254, affd. 272 F.3d 333 (6th Cir. 2001), of zero corporate tax rate on estimated cashflows and a discount rate with no conversion from after corporate tax to before corporate tax.

Shriner applied a 20-percent discount for marketability. To calculate the marketability discount, he first derived a 32.89-percent discount by averaging the discounts found in various restricted stock studies. He reduced that amount to 20 percent to account for his belief that the insurance industry was more stable than the general market.

Like Shriner, Spiro found that the average marketability discount based on restricted stock studies was between 30 and 35 percent. Spiro also found that initial public offering studies show an average marketability discount of nearly 45 percent. Spiro considered the fact that WSA's very specialized operations would limit potential buyers and detract from the stock's marketability. He also considered the size of the block of stock and elements of control which could enhance marketability. After listening to testimony at trial, he stated that a discount for lack of marketability of 40 or 45 percent would be appropriate to account for the risk due to the pending Rate Bureau litigation. We conclude that a 35-percent discount for lack of marketability applies.

We disagree with Shriner's reduction from about 33 percent to 20 percent because we do not believe WSA was as stable as the insurance industry average. We disagree with Spiro's increase from 35 percent to 45 percent, not because the Rate Bureau litigation should not be considered, but because we believe a 35-

percent discount adequately takes into account WSA's vulnerabilities.

F. Conclusion

The fair market value of decedent's interest in WSA on September 28, 1995, is $1,161,705 ($1,787,238 x .65).

Because of concessions and the foregoing,

Decision will be entered under Rule 155.

Estate of Andrews v. Commissioner of Internal Revenue

Case name: Estate of Andrews v. Commissioner of Internal Revenue
Citation: 79 T.C. 938,1982 U.S. Tax Ct. LEXIS 12
Date of decision: November 29, 1982
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Whitaker
Experts: Sigurd Wendin and Orville Lefko (for petitioner) Edward Bard and James M. McKenzie (for respondent)
SIC: 6512 Operators of Nonresidential Buildings (except stadium and arena owners)
NAICS: 531120 Lessors of Nonresidential Buildings (except Miniwarehouses)

Keywords: Buy-sell agreement, Estate tax, Fair market value (FMV)

COUNSEL:

Franz P. Jevne III, Michael S. Frost, and George R. A. Johnson, for the petitioner.

Jeffrey D. Lerner, for the respondent.

JUDGES:

Whitaker, Judge.

OPINIONBY:

WHITAKER

OPINION:

OPINION

Respondent determined a deficiency of $ 160,981.67 in the Federal estate tax of petitioner. The sole issue for decision is the date-of-death fair market value of shares of stock held by decedent in four closely held corporations. Since this case is largely factual, we have combined our findings of fact with our opinion.

Some of the facts have been stipulated and are so found. The parties have stipulated that Woodbury G. Andrews (hereinafter referred to as the decedent) was a resident of Excelsior, Minn., when he died testate on May 16, 1975. It has been further stipulated that Woodbury H. Andrews, a son of decedent, was appointed executor of the estate of decedent and resided in Minneapolis, Minn., when the petition in this case was filed.

Among the assets listed in the estate tax return of decedent were his interests in the following four closely held corporations: (1) 54 shares of W.F. & H.H. Andrews Co. (W.F. & H.H.), (2) 100 shares of St. Anthony Holding Co. (St. Anthony), (3) 50 shares of Green Mountain Investment Co. (Green Mountain), and (4) 63 shares of Andrews, Inc. Decedent owned approximately 20 percent of the total outstanding shares of each of the four corporations at the time of his death, n1 with the remainder being owned by his four siblings in approximately equal proportions. The stock had been held by these five individuals since their father died in 1945. Decedent worked with these corporations from approximately 1927 until his death in 1975. His two brothers have been involved with the corporations since the early 1930's. Together, decedent and his two brothers constituted the entire management of all four corporations; the two sisters did not actively participate in management. There is no evidence of any significant internal management disputes or family discord.

n1 The exact percentages held by decedent were 20.4 percent of Andrews, Inc., 21.6 percent of W.F. & H.H., and 20 percent of the other two corporations.

As of the date of death, W.F. & H.H. had been in business 73 years; St. Anthony, 71 years; Green Mountain, 66 years; and Andrews, Inc., 53 years. All four corporations have been involved primarily in the ownership, operation, and management of commercial real estate properties, although they also held some liquid assets such as stocks, bonds, and cash. n2 The real estate holdings included warehouses, apartment buildings, factories, offices, and retail stores in the Minneapolis - St. Paul metropolitan area. Many of the properties were in rundown urban areas, and most of the buildings were quite old, having been acquired during the early years of the corporations' operations. Most of the properties were leased to small tenants under leases for periods of less than 5 years.

n2 Based on respondent's expert's appraisal of the assets of each corporation, W.F. & H.H. had 76.6 percent of its assets invested in real estate; Green Mountain had 80.9 percent; St. Anthony had 55.8 percent; and Andrews, Inc., had 66.4 percent as of the date of decedent's death. Additionally, most of the cash held by Andrews, Inc., was attributable to a condemnation award and fire insurance proceeds, which were to be invested in real property to avoid recognition under sec. 1033. These amounts, earmarked for the purchase of real estate, should be considered as invested in real estate for our purposes, and, after making this adjustment, Andrews, Inc., should be seen as having had 89.9 percent of its assets invested in real estate.

To handle their management and maintenance responsibilities, the corporations together employed approximately 22 persons in addition to the three Andrews brothers. Fourteen persons were listed as employed and paid by Andrews, Inc.; two by Green Mountain; and three, each, by St. Anthony and W.F. & H.H. However, the record discloses that many of the employees assigned to Andrews, Inc., performed services for all the corporations, which were billed on a monthly basis for their allocable shares of employee payroll and related charges. The types of employees included janitors, parking lot attendants, night watchmen, office personnel, and maintenance workers, who handled plumbing, carpentry, painting, heating, and other maintenance and repair work.

On its estate tax return, petitioner valued decedent's stock interest in Andrews, Inc., at $ 56,700; St. Anthony at $ 45,000; W.F. & H.H. at $ 12,690; and Green Mountain at $ 13,000. In his notice of deficiency, respondent determined that petitioner had significantly undervalued these stocks, and valued Andrews, Inc., at $ 517,608; St. Anthony at $ 287,400; W.F. & H.H. at $ 114,264; and Green Mountain at $ 93,650.

Fair market value has long been defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Sec. 20.2031-1(b), Estate Tax Regs.; United States v. Cartwright, 411 U.S. 546, 551 (1973). This is a question of fact, with the trier of fact having the duty to weigh all relevant evidence of value and to draw appropriate inferences. Hamm v. Commissioner, 325 F.2d 934, 938 (8th Cir. 1963), affg. a Memorandum Opinion of this Court.

In determining the value of unlisted stocks, actual arm's-length sales of such stock in the normal course of business within a reasonable time before or after the valuation date are the best criteria of market value. Duncan Industries, Inc. v. Commissioner, 73 T.C. 266, 276 (1979). However, the stock of these four corporations has never been publicly traded, and there is no evidence of any sales of stock in these corporations at any time near the date of decedent's death. In the absence of arm's-length sales, the value of closely held stock must be determined indirectly by weighing the corporation's net worth, prospective earning power, dividend-paying capacity, and other relevant factors. Estate of Leyman v. Commissioner, 40 T.C. 100, 119 (1963), remanded on other grounds 344 F.2d 763 (6th Cir. 1965); sec. 20.2031-2(f), Estate Tax Regs. n3 These factors cannot be applied with mathematical precision. Rather, the weight to be given to each factor must be tailored to account for the particular facts of each case. See Messing v. Commissioner, 48 T.C. 502, 512 (1967).

n3 Sec. 20.2031-2(f), Estate Tax Regs., provides:

(f) Where selling prices or bid and asked prices are unavailable. If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: the good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, * * *

Both parties relied upon experts' valuations derived from analyses of intrinsic factors. However, because of fundamental differences in approach between respondent's and petitioner's experts, particularly with respect to the weight to be placed upon net asset value as opposed to earnings or dividend-paying capacity, the amounts arrived at in the valuations were extremely far apart. The following chart, which was used on the estate tax return, lists the different values arrived at by petitioner's primary expert, Sigurd Wendin; petitioner's second expert, Orville Lefko; and respondent's expert, Edward Bard:

	Andrews, Inc.	St. Anthony	W.F. & H.H.	Green Mountain
Mr. Wendin	$ 56,700	$ 45,000	$ 12,690	$ 13,000
Mr. Lefko	55,755	46,500	12,204	12,250
Mr. Bard	570,843	260,000	113,832	97,800

Respondent's Valuations

Respondent's first witness, James M. McKenzie, performed an appraisal of the assets held by the corporations. He valued each real property using three commonly accepted approaches to valuation -- comparable sales, replacement costs, and income-producing capacity. After correlating the values found under each of these approaches, he arrived at the following total values for the assets held by the corporations:

	Andrews, Inc.	St. Anthony	W.F. & H.H.	Green Mountain
Real estate	$ 2,780,700	$ 1,239,800	$ 677,500	$ 645,500
Cash, stocks, and bonds	1,405,024	808,230	56,700	151,682
Miscellaneous assets	121,313	174,105		149,388
Total	4,307,037	2,222,135	883,588	797,182
Liabilities	116,493	2,667	696	515
Net asset value	4,190,544	2,219,468	882,892	796,667

Petitioner has not attacked Mr. McKenzie's valuations of the underlying assets. However, the executor has argued that in arriving at overall net asset value, adjustments should have been made to reflect costs that would have been incurred if the corporations had liquidated all their real estate properties and placed them on the market at one time. The adjustments sought by petitioner are for blockage, capital gains tax to the seller, real estate commissions, and real estate taxes and special assessments constituting a lien against the real estate. We disagree with this argument. Both parties have agreed here that there was no reasonable prospect of liquidation, and the evidence clearly supports this finding. When liquidation is only speculative, the valuation of assets should not take these costs into account because it is unlikely they will ever be incurred. See Estate of Piper v. Commissioner, 72 T.C. 1062, 1087 (1979); Estate of Cruikshank v. Commissioner, 9 T.C. 162, 165 (1947); Estate of Huntington v. Commissioner, 36 B.T.A. 698 (1937). n4

n4 See also Estate of Thalheimer v. Commissioner, T.C. Memo. 1974-203, affd. on this issue and remanded without published opinion 532 F.2d 751 (4th Cir. 1976); Gallun v. Commissioner, T.C. Memo. 1974-284.

Respondent's second expert, Edward Bard, a financial analyst employed by respondent, initially used three approaches to value the stock of each corporation: Earnings and dividend-paying capacity, linear regression analysis, and net asset valuation. The former two methods produced values far lower than

valuation based on net asset values. For instance, the values he computed for Andrews, Inc., based upon capitalization of earnings and dividends ranged from $ 1.1 million to $ 1.5 million, n5 the value based on linear regression analysis was $ 1.6 million but the value based on net asset value was $ 4.1 million. n6 He concluded that the former two values should be disregarded because they were unrealistically low, even though his computations did show that the corporations' yields on investment had consistently been exceptionally low. n7 Thus, his starting point for valuing each of these corporations was the net asset values derived from Mr. McKenzie's appraisals. Because he saw the corporations involved here as holding passive items, he believed they were comparable to closed end mutual funds, which are also corporate entities holding investment properties. He found that shares of mutual funds generally traded at a 25-percent discount from the value of the assets held by such funds, and accordingly, applied a 25-percent discount to the net asset values of the corporations. To this amount, he then applied a lack of marketability discount, varying from 11.9 percent to 20.74 percent to reflect each corporation's costs of flotation if the stock were to be publicly offered. n8

n5 To arrive at these figures, Mr. Bard computed the price-earnings ratios of publicly owned real estate enterprises, primarily real estate investment trusts, that he considered comparable to the corporations involved here. The corporations selected as comparables had price-earnings ratios on a 3-year average of approximately 11 percent, price cash flow earnings of approximately 6.4 percent, and dividend income that averaged 9.6 percent. He applied these percentages to the earnings of Andrews, Inc., to arrive at an income valuation of $ 1,393,990 based on the latest 3-year average earnings; $ 1,134,214 based on the latest 3-year average cash flow earnings; and $ 1,452,073 based on dividend-paying capacity.

n6 All these values were prior to any discount for lack of control or marketability.

n7 Dividing net assets by net income for each corporation showed yields on investment of 3.1 percent for St. Anthony, 3.6 percent for Andrews, Inc., 3.5 percent for W.F. & H.H., and 4.1 percent for Green Mountain.

n8 At trial and on brief, respondent, in light of Rev. Rul. 81-253, 1981-2 C.B. 187, has taken the position, which we discuss later in this opinion, that neither of these discounts should be allowed.

Respondent argues that Mr. Bard was correct in ignoring earnings and dividend-paying capacity because all four corporations should be classified as investment companies not involved in the active operation of a business. He believes that a willing buyer would recognize that the value of his investment would be in his right to share in the value of the corporations' underlying net assets, regardless of their low earnings and dividend-paying capacity. Petitioner attacks respondent's characterization of these corporations as investment companies, stressing that the corporations employed 25 employees and actively performed real estate management and maintenance functions. n9 Characterizing these corporations as operating companies, petitioner believes greater weight should be placed on earnings and dividend-paying capacity than on net asset values.

n9 As we found earlier, although employees other than the three Andrews brothers were assigned to only one corporation for bookkeeping purposes, many of them actively performed services for all the corporations.

We believe, however, the corporations here cannot be characterized for valuation purposes as solely investment companies or solely operating companies. The cases cited by respondent, n10 which involved corporations holding only cash, commercial paper, or marketable securities, are readily

distinguishable on the ground that the corporations involved here were actively engaged in the real estate management business. But cases dealing with corporations owning factories and other industrial or commercial operations are also not directly on point. n11 Unlike many industrial companies, where the value of the manufacturing equipment and plant is tied to the nature of the manufacturing operation, here, the value of the underlying real estate will retain most of its inherent value even if the corporation is not efficient in securing a stream of rental income. It seems reasonable to assume, as we did in Estate of Heckscher v. Commissioner, 63 T.C. 485, 493 (1975), that a --

potential buyer would have to forego some current return on his investment in exchange for an interest in a net worth much more valuable than the price he pays for the stock, and the seller would have to be willing to part with an equity interest in the company for much less than its indicated value in return for something that would produce a greater yield on his investment. * * *

n10 The following cases were cited by respondent: Estate of Cruikshank v. Commissioner, 9 T.C. 162 (1947); Gallun v. Commissioner, supra; Estate of Thalheimer v. Commissioner, supra; Estate of Cotchett v. Commissioner, T.C. Memo. 1974-31; and Richardson v. Commissioner, a Memorandum Opinion of this Court dated Nov. 30, 1943, affd. 151 F.2d 102 (2d Cir. 1945). Estate of Lee v. Commissioner, 69 T.C. 860 (1978), in which we used net asset values in arriving at the value of a close corporation that held primarily real estate is likewise distinguishable because the real estate was not rental property but rather undeveloped property that offered no immediate prospects for taxable income to the corporation.

n11 See Waterman v. Commissioner, T.C. Memo. 1961-225, in which we rejected both respondent's valuation based solely on net asset values and petitioner's valuation based solely on earning capacity as inappropriate for a corporation holding improved rental property; and Estate of Tompkins v. Commissioner, T.C. Memo. 1961-338, in which we rejected similar contentions with respect to a corporation holding unimproved real estate.

Furthermore, regardless of whether the corporation is seen as primarily an operating company, as opposed to an investment company, courts should not restrict consideration to only one approach to valuation, such as capitalization of earnings or net asset values. See Hamm v. Commissioner, 325 F.2d 934 (8th Cir. 1963), affg. a Memorandum Opinion of this Court; Portland Manufacturing Co. v. Commissioner, 56 T.C. 58, 80 (1971); Estate of Schroeder v. Commissioner, 13 T.C. 259 (1949); Hooper v. Commissioner, 41 B.T.A. 114 (1940). n12 Certainly, the degree to which the corporation is actively engaged in producing income rather than merely holding property for investment should influence the weight to be given to the values arrived at under the different approaches but it should not dictate the use of one approach to the exclusion of all others.

n12 See also Estate of Dooly v. Commissioner, T.C. Memo. 1972-164; Lippman v. Commissioner, T.C. Memo. 1965-73; and Wallace v. United States, an unpublished opinion (D. Mass. 1981, 49 AFTR 2d 82-1482, 82-1 USTC par. 13,442), in which the court stated:

"The 'willing buyer' and 'willing seller' * * * test the experts' advice, and the formulas the experts advance to bolster their advice, against common sense. The willing buyer and willing seller are not limited to choosing one formula or another among competing formulas advanced by experts. [49 AFTR 2d 82-1482.]"

The regulations n13 call for all relevant factors to be examined and, in a case such as this, we believe values arrived at under all the accepted valuation methods should be considered. We therefore believe respondent's expert was incorrect to simply reject earnings and dividend-paying capacity valuations because they produced too low a result. Certainly, a prospective buyer would not so reject one particular type of valuation. A buyer of stock in these corporations would necessarily look to the earning capacity for part of his return on his investment. Nevertheless, this would not be the only factor that he would consider. Undoubtedly, he would also give substantial weight to each corporation's underlying net asset value even though he would have no ability to directly realize this value by forcing liquidation.

n13 See sec. 20.2031-2(f), Estate Tax Regs.

Respondent argues that there is a particular reason why only net asset values should be used in this case. Mr. McKenzie's determination of the values of the real estate properties held by the corporations was arrived at through a computational method that considered, among other factors, the projected earning capacity of the properties. Respondent contends that in valuing each corporation it is therefore appropriate to use only the underlying net asset value, which is the sum of the appraised real estate values plus the values of other assets held by the corporation, such as stocks and bonds, minus all the corporation's liabilities. n14 However, to do so would ignore the corporate entities. If the properties had been held directly by decedent, respondent would undoubtedly be correct, but here we are not faced with the question of finding a value for the properties themselves; rather, we must find the value of shares of the corporations that held the properties. The corporations are businesses, engaged in the maintenance and management of these real estate properties. Thus, some of the value attached to the corporations must be based upon the operating nature of the businesses, with attention paid to their earnings and dividend history, management, and prospects for growth.

n14 Because the corporations followed a very conservative policy of avoiding substantial debt, St. Anthony, W.F. & H.H., and Green Mountain had virtually no liabilities, and the liabilities of Andrews, Inc., equaled only 2 percent of the value of its assets.

Petitioner's Valuations

We turn now to analyze petitioner's experts' valuations, which we also find to be markedly deficient, largely because of their adopting approaches that minimize the importance of the value of the underlying assets.

Petitioner's first expert, Sigurd Wendin, selected as comparables four large publicly traded real estate management corporations, although he recognized that there were differences in size, financing, number of employees, and types of activities carried on. Based on his analysis of these publicly traded corporations, he assigned price earnings multiples to the corporations involved here of five for future earnings, four for current earnings, five for the average of the last 3 years' earnings, and seven for the average earnings for the period 1970 through 1973. These multiples were somewhat lower than those obtained from the comparable companies because of the difficulty in marketing nonpublicly traded shares. He then applied these multiples to net operating income during the applicable periods, and applied a minority discount for lack of marketability of 40 percent based on his overall experience with the amount of such discounts commonly allowed.

For dividend capitalization purposes, Mr. Wendin assumed a 10-percent rate, based upon the fact that corporate bond yields were around 9 percent to 11 percent. He believed bond yields were better comparables than the yield rate on stocks because the assets involved here were frozen and stock yields had been quite variable during this time period. He applied this 10-percent rate to the last year dividend and to his estimate of the future dividend that could be expected. Again, he discounted these amounts by 40 percent for lack of marketability.

Mr. Wendin also looked at the corporate balance sheets showing net assets and liabilities of the corporations. He did not have Mr. McKenzie's or any other appraisal of underlying assets so he looked at book values instead of net asset values. He reduced the book values to 80 percent based on the market-to-book-value ratio here found in analyzing his four "comparables." n15 To this he applied a 40-percent discount for lack of marketability.

n15 Exactly how he arrived at this 80-percent figure is not clear since the ratios for three of the selected "comparables" were 51 percent, 79 percent, and 92 percent, and for the fourth "comparable" an astounding 3,007 percent.

In combining all of these factors to arrive at an overall valuation of each corporation, Mr. Wendin minimized the impact of the adjusted book value per share. He believed this approach was necessary because there were no plans to liquidate and because a minority stockholder would have had no ability to force liquidation. Listed below as an example are the weights given to each factor, the values per share, and the overall average value arrived at for Andrews, Inc., stock:

	Per share	Weight	Amount
Future dividend capitalization	900.00	5	$ 4,500.00
Last year dividend capitalization	770.76	4	3,083.04
Future earnings capitalization	1,167.00	3	3,501.00
Last year earnings capitalization	940.34	2	1,880.68
Three-year average earnings capitalization	963.57	1.5	1,445.36
1970-73 year average earnings capitalization	998.07	1.5	1,497.11
Book value	2,345.11	1	2,345.11
		18	18,252.30
		Average	1,014.02

To this $ 1,014.02 value per share he applied an additional discount to reflect specific negative factors such as deterioration of areas, strategic location, rising inflation, taxes, future maintenance costs, and the ability to quickly adjust rentals. He ended up with an estimated value for Andrews, Inc., of $ 900 per share. The values for the other three companies were determined in equivalent manners. In no case was book value given more than a one-ninth weight in determining the current value.

We find Mr. Wendin's valuations to be seriously flawed because they did not take into account each corporation's net asset value, i.e., the total value of its assets less liabilities. Although he attempted to approximate net asset values by using adjusted book values, n16 which were arrived at by reducing book values by a market-to-book ratio, the figures so computed bore no reasonable relation to actual net asset values. Mr. Wendin used a market-to-book ratio of 80 percent, but a comparison of book values to the appraised values determined by Mr. McKenzie shows the ratio was actually near 300 percent. Moreover, even if the adjusted book values had been close to actual net asset values, Mr. Wendin assured they would be of little importance in his overall computations by assigning insubstantial weights, varying from one-ninth to one-eighteenth, to them. As discussed earlier, a prospective buyer of stock in these corporations would undoubtedly give substantial weight to net asset values.

n16 Mr. Wendin apparently recognized that unadjusted book values are often unreliable for valuation purposes because they may have little relation to the assets' fair market values at the date of valuation. With an asset that appreciates in value (and thus has investment value), such as real estate, book value may be far below current fair market value. See Estate of Poley v. Commissioner, a Memorandum Opinion of this Court dated Mar. 7, 1947, affd. per curiam 166 F.2d 434 (3d Cir. 1948).

Another problem with the Wendin valuations was that he applied to his adjusted book values a 40-percent discount for lack of marketability and control. We believe this was improper because lack of control was also reflected (excessively) in the weighting of factors considered in computing an overall valuation.

Petitioner's second expert, Mr. Orville G. Lefko, was retained to prepare an analysis after the McKenzie appraisals had been made available to petitioner. Mr. Lefko employed an approach somewhat different than Mr. Wendin but still minimized the importance of net asset values and arrived at figures quite close to those computed by Mr. Wendin.

Mr. Lefko felt that both net asset value and earnings capability were not very important in comparison to dividend projections for purposes of valuing corporations such as the ones at issue here. Although the dividend history of each of the corporations had been irregular, Mr. Lefko came to the conclusion that each corporation had the ability to pay a regular dividend. To arrive at a rate of dividend capitalization, he looked at seven equity real estate investment trusts, which he selected as comparables. These "comparables" yielded a 12-percent dividend capitalization rate, which he increased to between 15 and 17 percent because he believed that real estate investment trusts involved lower risks due to factors such as professional management, geographical diversity, and size. After applying the dividend capitalization rate to projected dividends, he applied a 45-percent discount for lack of marketability.

Mr. Lefko did not entirely dismiss the net asset value of the corporations but attempted to factor into his overall value a liquidation probability value, to reflect the buyer's prospect of realizing on liquidation a share of the underlying asset values. First, he adjusted the appraised value of the corporation's assets. He decreased the values of real properties by anticipated liquidation costs of stocks and bonds by handling charges, and receivables by a bad debt allowance. This gave him a net realized value per share of each corporation. Next, he projected when a purchaser of shares that had been held by decedent might reasonably expect to obtain his share of the underlying assets through liquidation. Because of the corporation's long history of continuing operations and no prospect of imminent liquidation, Mr. Lefko believed there was no chance of liquidation within 5 years, a 5-percent chance in 10 years, a 10-percent chance in 15 years, a 35-percent chance in 20 years, and a 50-percent chance

in 25 years. He multiplied the net realized value per share by each of these percentages and then discounted the resulting amounts because of the lost time value of money prior to the assumed future liquidation. He thereafter added together all the discounted amounts and applied a 45-percent illiquidity discount. In this manner, he computed a liquidation probability value for each corporation, equal to approximately 3 percent to 5 percent of the fair market value of the underlying assets. This liquidation probability value was added to the previously determined dividend capitalization value of each of the corporations. n17

n17 We note that it is highly unusual in a valuation to add together the values derived through two independent estimates of valuation, here the liquidation probability approach and the dividend capitalization approach. Theoretically, each approach should result in computation of the entire value of the property and although averaging of the different computations might be necessary, it would not be appropriate to add together separate valuations.

We find the liquidation probability approach to be highly speculative at best. Moreover, we believe the computation improperly reduced asset values on account of lost use of money. This discounting for lost use of money is unrealistic because it fails to recognize that the underlying assets will themselves appreciate, most probably, at a rate similar to that applied as a discount. Another problem with Mr. Lefko's valuation was his use of real estate investment trusts (REITs) as comparables. These entities are not truly comparable to the corporations involved here because of the requirement that REITs must pass through 90 percent of earnings as dividends and because REITs are generally highly leveraged while the corporations here were virtually debt free.

Petitioner's third expert, Thomas C. O'Connell, based his valuation solely upon an approximation of cumulative future dividends of all the corporations. He started with the total average dividend for all the corporations over the 3-year period from 1972 through 1974. To this amount he applied a dividend capitalization rate of between 18.75 percent and 25 percent. He explained that this capitalization rate was arrived at based upon his belief that an investor would require a return of 150 to 200 percent of the prime rate because the companies had certain negative factors such as a low return on invested capital, a low rate of cash flow, very conservative management, fragmented management control, and a lack of consistent policy in prior years. He also stressed that there was no public market for the shares, a low return on net worth and a lack of any long-term plan or growth strategy. Applying the dividend capitalization rate to the prior 3-year total average dividend, he computed a value for the four corporations of between $ 605,000 and $ 807,000. For the 20 percent of the shares involved here, he estimated the value of $ 121,000 to $ 161,000 total.

We have accorded little weight to Mr. O'Connell's valuation for several reasons. Most importantly, he did not consider earnings and took no account whatsoever of the net asset values of the corporations. Furthermore, in selecting a dividend capitalization rate, he did not examine comparable companies but simply expressed his relatively unsubstantiated opinion that an 18.75- to 25-percent rate of dividend capitalization would be desired by a willing purchaser. In the absence of more facts showing why this specific rate was chosen, it is difficult for the Court to determine whether the rate was simply an educated guess or whether he really had a substantial basis for concluding that it was appropriate. Another problem with Mr. O'Connell's approach was that in applying the dividend capitalization rate to

the average dividends received for the prior 3-year period, he did not differentiate among the corporations but considered them as if they were only one single entity. Thus, there is no way in which his valuation can be used directly to arrive at the value of any particular corporation involved here.

Lack of Control and Marketability Discounts

In Mr. Bard's valuation report and in computing the amount of deficiency, the net asset values of the four corporations were each reduced first by a 25-percent discount based on a comparison with publicly traded closed end mutual fund shares, and then by discounts ranging from 11.9 percent to 20.74 percent based on Securities Exchange Commission flotation rates. These discounts were designed to reflect the shares' restricted marketability and lack of control.

Rev. Rul. 81-253, 1981-2 C.B. 187, was published by respondent after the statutory notice was issued, and it sets forth respondent's current position concerning the allowance of minority discounts in valuing stock of closely held family corporations. Based on Rev. Rul. 81-253, respondent now argues that no discounts for lack of control or restricted marketability should be applied, although he has not asserted a deficiency greater than that asserted in the statutory notice. Thus, respondent argues that discounts should not be applied to the extent they would result in reducing the values below those asserted in the notice of deficiency.

Petitioner has questioned whether it is proper for respondent to now argue against allowing a minority discount even though he allowed a discount in computing the deficiency in the statutory notice. However, this is not a case where petitioner was surprised at trial by respondent's introduction of a new issue. It is clear that petitioner was prepared for the minority discount question being raised at trial, and has devoted large portions of its briefs to rebutting respondent's position that no minority discount should be allowed. Therefore, we find no merit to petitioner's claim that the minority discount issue has been improperly raised by respondent. See Llorente v. Commissioner, 74 T.C. 260, 269 (1980), modified on other grounds 649 F.2d 152 (2d Cir. 1981).

Respondent argues that no discounts should be allowed because all the shareholders in the four corporations, including decedent, shared in control. According to respondent's argument, the hypothetical "willing seller" used in arriving at valuation of the stock must be presumed to be one of the five family members, including decedent, who held stock in the corporations and shared an element of control. Respondent reasons further that such a willing seller would not have sold his shares except as part of the controlling family interest, unless to another family member or the corporations, themselves. If the shares were sold in this way, respondent contends they would retain their control value, and no minority discount would be justified.

In their arguments, neither petitioner nor respondent clearly focuses on the fact that two conceptually distinct discounts are involved here, one for lack of marketability and the other for lack of control. n18 The minority shareholder discount is designed to reflect the decreased value of shares that do not convey control of a closely held corporation. The lack of marketability discount, on the other hand, is designed to reflect the fact that there is no ready market for shares in a closely held corporation. Although there may be some overlap between these two discounts in that lack of control may reduce marketability, it should be borne in mind that even controlling shares in a nonpublic corporation suffer from lack of marketability because of the absence of a ready private placement market and the fact that flotation costs would have to be incurred if the corporation were to publicly offer its stock. However, the

distinction between the two discounts is not crucial for purposes of this case. Because respondent's basis for opposing both discounts is the same -- that the hypothetical willing buyer must be seen as a family member -- our subsequent discussion, like the parties' briefs, will consider the two discounts together.

n18 See Fellows & Painter, "Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome," 30 Stan. L. Rev. 895, 920 (1978).

The leading case dealing with this question is Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981) (en banc), in which the court recognized that a minority interest in a corporation should not be seen as having any control value, even though the family unit had control of the corporation. The case involved whether a minority discount should be allowed in valuing a decedent's undivided one-half interest in the control block of 55 percent of the stock of a corporation, where the other one-half interest in the control block was owned by the husband of the decedent (who was also executor of the estate and subsequently trustee of the testamentary trust that received the stock in issue). Two major bases for its decision were explained by the court. First, it found that established case law did not support any type of "family attribution" in which the control of the corporation was attributed among family members. The Fifth Circuit noted that the Tax Court, since at least 1940, has uniformly valued a decedent's stock for estate tax purposes as a minority interest when the decedent, himself, owned less than 50 percent of the stock regardless of whether control of the corporation was in the decedent's family. n19 The court also cited two District Court opinions that took the same position, n20 and it stated that it had found no estate tax cases supporting respondent's position. The court found further that case authority in the analogous gift tax area also supported the taxpayer's position, although not unanimously. n21

n19 The following Tax Court cases were cited by the Fifth Circuit for this proposition: Estate of Zaiger v. Commissioner, 64 T.C. 927 (1975); Estate of Leyman v. Commissioner, 40 T.C. 100, 119 (1963); Estate of DeGuebriant v. Commissioner, 14 T.C. 611 (1950), revd. on other grounds 186 F.2d 307 (2d Cir. 1951); Hooper v. Commissioner, 41 B.T.A. 114 (1940); Estate of Kirkpatrick v. Commissioner, T.C. Memo. 1975-344; Estate of Stoddard v. Commissioner, T.C. Memo. 1975-207; Estate of Thalheimer v. Commissioner, supra; Estate of Maxcy v. Commissioner, T.C. Memo. 1969-158, revd. on other grounds 441 F.2d 192 (5th Cir. 1971); Estate of Katz v. Commissioner, T.C. Memo. 1968-171. We agree with the Fifth Circuit that these cases show our established view that a decedent's stock in a family controlled corporation should be seen as a minority interest whenever the decedent individually did not have control.

n20 The Two District Court opinions cited by the court were Obermer v. United States, 238 F. Supp. 29 (D. Hawaii 1964); and Sundquist v. United States, an unpublished opinion (E.D. Wash. 1974, 34 AFTR 2d 74-6337, 74-2 USTC par. 13,035).

n21 Cases cited by the court for the proposition that minority discounts were allowed for gifts of stock in family controlled corporations included Meijer v. Commissioner, T.C. Memo. 1979-344; Koffler v. Commissioner, T.C. Memo. 1978-159; Estate of Heppenstal v. Commissioner, a Memorandum Opinion of this Court dated Jan. 31, 1949; Whittemore v. Fitzpatrick, 127 F. Supp. 710 (D. Conn. 1954); Clark v. United States, an unpublished opinion (E.D. N.C. 1975, 36 AFTR 2d 75-6417, 75-1 USTC par. 13,076).

The second major reason cited in the Estate of Bright opinion for applying a minority discount was based upon the concept of the hypothetical willing-buyer, willing-seller rule. Section 20.2031-1(b), Estate Tax Regs., sets forth the following rule, which has been universally applied by the courts and respondent:

The fair market value 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 to sell and both having reasonable knowledge of relevant facts. * * *

The Fifth Circuit saw this language from the regulation as indicating that the "willing seller" is a hypothetical seller rather than the particular estate. Thus, the willing seller should not be identified with the decedent, and the decedent's stock should not be included as part of a family unit for valuation purposes. Nor was it proper, according to the Fifth Circuit, to place any weight upon the identity of the parties that actually received the stock after distribution from the estate. For purposes of valuation, one should construct a hypothetical sale from a hypothetical willing seller to a similarly hypothetical willing buyer.

In Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982), the Ninth Circuit followed Estate of Bright and discounted the value of an undivided one-half interest in real estate held by the decedent and his wife as community property at the time of death. The Ninth Circuit noted that Congress has explicitly directed that family attribution or unity of ownership principles be applied in other areas of Federal taxation, and felt that in the absence of any legislative directive, it should not judicially require such principles to be applied in the estate tax area. Furthermore, the court emphasized the advantage of using an objective hypothetical willing-buyer, willing-seller standard, instead of a subjective inquiry into the feelings, attitudes, and anticipated behavior of heirs and legatees, which might well be boundless.

Respondent argues that the Fifth Circuit misinterpreted the concept of the hypothetical willing seller and willing buyer. In his briefs, he relies primarily upon three cases to support his proposition that a minority discount should not be applied if family members control a corporation. Richardson v. Commissioner, a Memorandum Opinion of this Court dated November 30, 1943, affd. 151 F.2d 102 (2d Cir. 1945), involved a family holding company whose assets were readily marketable securities. On appeal, the Second Circuit upheld the value established by us but questioned whether we had used the correct standard of valuation. Our Richardson opinion must be read narrowly in view of the long series of subsequent cases in which we have allowed discounts in valuing shares of family corporations that held operating as well as investment assets. Blanchard v. United States, 291 F. Supp. 348 (S.D. Iowa 1968), contains language supportive of respondent's position. But the court stressed that it was dealing with a unique situation involving a planned sale of all the family's shares of stock in the corporation. At first blush, Rothgery v. United States, 201 Ct. Cl. 183, 475 F.2d 591 (1973), seems to support respondent. But even though its valuation was phrased in terms of seeing the willing buyer as a particular person (the family member who already held almost 50 percent of the shares of the corporation), the court also explicitly found that there would have been other potential buyers for the decedent's shares of the stock at the same price if the stock had been offered for sale to persons outside the Rothgery family. Thus, despite analyzing the hypothetical sale in terms of the sale to a particular person, the court evidently attributed no premium to the fact that the family member would assure himself of control by obtaining these shares.

Three cases provide at best weak support for respondent's position that no discounts should be applied here. Opposed to this meager case law in favor of respondent is the large number of cases allowing such discounts, which were discussed in the Estate of Bright opinion. We see no reason to depart from such established precedent but follow the Fifth Circuit's well-reasoned and thoroughly researched opinion. Respondent's approach would have us tailor "hypothetical" so that the willing seller and willing buyer were seen as the particular persons who would most likely undertake the transaction. However, the case law and regulations require a truly hypothetical willing seller and willing buyer. We must assume these hypothetical parties exist even though the reality of the situation may be that the stock will most probably be sold to a particular party or type of person. Certainly, the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect the value of the stock in the hands of decedent, but we do not see any actual facts in this case that require the stock to be valued as anything other than minority interests in each corporation.

Overall Valuation

We have pointed out above the defects of the approaches used by both parties' experts. Having taken diametrically opposed views as to the factors to be weighed in valuing the stock involved in this case, the parties "failed successfully to conclude settlement negotiations -- a process clearly more conducive to the proper disposition of disputes such as this." Messing v. Commissioner, 48 T.C. 502, 512 (1967). Because we have concluded that none of the experts gave appropriate weight to net assets as well as earning and dividend-paying capacity, we must necessarily make our own best judgments of value. While we have considered the valuation reports of Messrs. Wendin, Lefko, and Bard, we have also weighed all other relevant factors such as the extremely conservative business attitudes and practices of the management, the nature of the real estate holdings, the amount of cash and other liquid assets held by the corporations, and the business climate on the valuation date, both overall and for these corporations in particular. We have discounted the values because of the restricted marketability of the shares and the lack of control a hypothetical willing buyer of these minority shares would be able to exercise. Based on all these factors and on the entire record, we conclude and find as a fact the following date-of-death fair market values for the stock held by decedent:

Andrews, Inc	$ 302,400
St. Anthony	158,000
Green Mountain	56,000
W.F. & H.H	64,800

Decision will be entered under Rule 155.

24 T.C.M. (CCH) 1030 (1965)
T.C. Memo. 1965-200.

Bardahl Manufacturing Corporation
v.
Commissioner.

Docket No. 2917-63.

United States Tax Court.

Filed July 23, 1965.

Joseph H. Trethewey, White-Henry-Stuart Bldg., Seattle, Wash., for the petitioner. Richard H. M. Hickok and Wesley A. Dierberger, for the respondent.

Memorandum Findings of Fact and Opinion

WITHEY, Judge:

The respondent determined deficiencies in petitioner's income tax for the years and in the amounts as follows:

Year ended December 31	Deficiency
1956	$ 47,607.70
1957	77,997.79
1958	259,471.08
1959	263,771.03

The sole issue presented for our decision is whether petitioner was availed of during each of the years 1956 through 1959, inclusive, for the purpose of avoiding the imposition of individual income tax on its shareholders, by permitting its earnings and profits to accumulate instead of being divided or distributed.

Additional issues presented by the pleadings have been disposed of by concession or stipulation of the parties.

Findings of Fact

Petitioner **Bardahl Manufacturing Corporation** (sometimes hereinafter referred to as **Manufacturing** or the **corporation**) was organized under the laws of the State of Washington during September 1939. Petitioner filed its income tax returns for the years 1956, 1957, 1958, and 1959 with the director at Tacoma, Washington.

The **corporation's** principal place of business is located at Seattle, Washington.

Bardahl Manufacturing Corporation has been engaged in the business of **manufacturing** an oil additive known as "**Bardahl**" since the commencement of business in 1939. From 1939 to 1955 it was also engaged in the business of selling the **Bardahl** additive. The **corporation** was a pioneer in the oil additive business. During the years here pertinent it also has manufactured certain related products such as gasline antifreeze, engine cleaner, carburetor cleaner, a water pump lubricant, a lubricant for transmission and differentials, and an outboard motor oil.

During 1954 **Bardahl** International **Corporation** (sometimes hereinafter referred to as International) was organized under the laws of the State of Washington.

Pursuant to a contract executed by **Manufacturing** and International on January 1, 1955, **Manufacturing** agreed to sell its entire production to International which in turn undertook the responsibility of acting as the sole sales representative of **Manufacturing**.

At all times here material, Ole **Bardahl**, individually, was the principal stockholder of both **Bardahl Manufacturing Corporation** and **Bardahl** International **Corporation** and also served as president of each **corporation**. During the years 1956, 1957, 1958, and 1959 the outstanding common stock of **Bardahl Manufacturing** Company was held by the individuals and in the amounts as follows:

1031 *1031

	1956		1957		1958		1959	
	Number of shares	Percent of total shares	Number of shares	Percent of total shares	Number of shares	Percent of total shares	Number of shares	Pe of
Grace or Herbert Allen	15-5/8	--	18-3/4	--	21-7/8	--	25	
Bardahl, Inga	12-1/2	.1	15	.1	17-1/2	.1	20	
Bardahl, Ole	10,898-75/80	87.1	13,078-58/80	87.1	15,208-41/80	86.8	14,521-11/70	
Bartlett, Hugh	6-1/4	--	7-1/2	--	8-3/4	--	10	
Baurle, William	3-1/8	--	3-6/8	--	4-3/8	--	5	
Beck, H. C.	7-13/16	--	9-6/16	--	10-15/16	--	12-1/2	
Brown, Dean M.	23-7/16	--	28-2/16	--	32-13/16	--	37-1/2	
Chalaas, Clara M.	6-1/4	--	7-1/2	--	8-3/4	--	10	
Doll, George	7-13/16	--	9-6/16	--	10-15/16	--	12-1/2	
Gatt, Chin	31-1/4	--	--	--	--	--	--	
Halvarsen, H. J.	7-13/16	--	9-6/16	--	10-15/16	--	12-1/2	
Hard, Eve	156-1/4	--	187-1/2	--	218-3/4	--	250	
Ireland or White	12-1/2	--	15	--	17-1/2	--	20	
Jessen, J. or M.	46-7/8	--	56-2/8	--	65-5/8	--	75	
Langton, M. B. or A.	15-5/8	--	18-6/8	--	21-7/8	--	25	
Flood, Grace	7-13/16	--	9-6/16	--	10-15/16	--	--	
Merritt, B.	1-9/16	--	1-14/16	--	2-3/16	--	2-1/2	
Merritt, C. B. or C.	115-5/40	--	138-6/40	--	161-7/40	--	184-1/5	
Nicolaysen, E.	507-13/16	--	609-6/16	--	710-15/16	--	872-1/2	
Noritake, M.	78-1/8	--	93-6/8	--	109-3/8	--	125	
Peterson, G.	7-13/16	--	9-6/16	--	10-15/16	--	12-1/2	
Rice, H.	3-1/8	--	3-6/8	--	4-3/8	--	5	
Ridgeway, Dr. G. R.	15-5/8	--	18-6/8	--	21-7/8	--	25	

Simpson, Lillian	507-13/16	4.1	609-6/16	4.1	710-15/16	4.1	872-1/2	
Wiggs, G. B.	3-1/8	--	3-6/8	--	4-3/8	--	5	
Lee, Alice	--	--	37-1/2	--	43-3/4	--	50	
Seattle Trust — Pension Fund	--	--	--	--	25	.1	28-4/7	.1
Seattle Trust — Profit Sharing Fund	--	--	--	--	25	.1	28-4/7	.1
Burkey, Louis J.	--	--	--	--	--	--	12-1/2	
Seattle Trust — L. Simpson	--	--	--	--	--	--	1,250	6.3
Seattle Trust — E. Nicolaysen	--	--	--	--	--	--	1,250	6.3
Seattle Trust — Eric B. Nicolaysen	--	--	--	--	--	--	60	.3
Seattle Trust — Kurt B. Nicolaysen	--	--	--	--	--	--	60	.3
Seattle Trust — Wade B. Nicolaysen	--	--	--	--	--	--	60	.3
Seattle Trust — Nancy Nicolaysen	--	--	--	--	--	--	60	.3
	12,500	100%	15,000	100%	17,500	100%	20,000	

1032 *1032 Under the contract executed by **Manufacturing** and International on January 1, 1955, **Manufacturing** agreed to undertake the production of **Bardahl** concentrate which is the basic ingredient that is blended with oil to produce the **Bardahl** additive. **Manufacturing** also undertook responsibility for the quality control of its oil additive and for conducting research and development with a view to producing new products.

International at all times here material was exclusively a sales organization and undertook no **manufacturing** or production activities. It distributed **Bardahl** concentrate during the years in issue to various blenders and distributors located in the United States and in foreign countries with which it had executed franchise contracts. The blenders purchased the **Bardahl** concentrate and blended it with oil to produce a marketable product which, after canning, was distributed to retail outlets and sold to consumers. The franchise distributors, on the other hand, purchased the finished **Bardahl** additive and sold it themselves.

During the years in issue neither petitioner nor International had any capital investment in either the blenders or distributors of **Bardahl** additive (with the exception of **Bardahl** International Oil **Corporation**, S. P. A., an Italian **corporation** formed in 1959 on petitioner's behalf to manufacture concentrate in Europe). The blenders and distributors (except for **Bardahl** International Oil **Corporation**, S. P. A.) during the years here pertinent were wholly owned by individuals unrelated to either of the **Bardahl** corporations.

Petitioner maintained quality control over its additive by means of running chemical tests on raw materials throughout the **manufacturing** process and by testing samples of products marketed by the franchise blenders and distributors.

During 1959 and 1960 **Bardahl Manufacturing Corporation** organized wholly-owned subsidiaries located in foreign countries to manufacture its concentrate. Its foreign subsidiaries manufactured and blended the concentrate in accordance with formulae and procedures determined by **Manufacturing**. The foreign subsidiaries of petitioner which which manufactured its concentrate during 1960 and subsequent years were located in Montreal, Canada, and Milan, Italy. The concentrate plant located in Montreal was owned by **Bardahl** Lubricants (Canada), Ltd., and the **manufacturing** facilities located in Italy were controlled by **Bardahl** International Oil **Corporation**, S. P. A.

The accumulated earnings and profits of **Bardahl Manufacturing Corporation** as of December 31, 1955 through 1959, were as follows:

Year ended December 31	Amount
1955	$ 819,686.18
1956	965,039.74
1957	1,194,483.15
1958	1,540,049.28
1959	1,880,097.17

Petitioner's sales, net income before taxes, Federal taxes paid, net income after taxes, and cash dividends paid, both in dollar amounts and percentages, from 1939 through 1962 were as follows:

Year	Sales	Net income before taxes	Federal taxes paid	Net income after taxes	Cash dividends declared	Percent of net income distributed as cash dividends
1939	$ 188	.....	.....	.....	.....	....
1940	1,108	.....	.....	.....	.....	....
1941	2,956	.....	.....	.....	.....	....
1942	3,895	$ 317	$ 98	$ 219	.....	....
1943	14,550	959	239	720	.....	....
1944	19,228	3,948	987	2,961	.....	....
1945	39,318	7,237	1,854	5,383	.....	....
1946	68,211	13,259	2,949	10,310	.....	....
1947	64,583	2,352	494	1,858	.....	....
1948	155,321	26,454	6,520	19,934	.....	....
1949	266,786	71,192	27,053	44,139	$ 5,953	13.5
1950	404,714	107,133	40,246	66,887	9,305	13.9
1951	865,667	336,835	223,570	113,265	.....	....
1952	788,516	226,492	146,952	79,540	3,988	5.0
1953	1,172,931	282,228	192,341	89,887	9,985	11.1
1954	1,400,804	571,482	291,670	279,812	13,967	5.0
1955	1,236,093	456,206	231,474	224,732	30,000	13.3
1956	1,208,322	402,782	203,856	198,926	50,000	25.1

1033 *1033

Year	Sales	Net income before taxes	Federal taxes paid	Net income after taxes	Cash dividends declared	Percent of net income distributed as cash dividends
1957	$1,360,576	$524,836	$266,448	$258,388	$ 30,000	11.6
1958	2,123,333	758,613	388,858	369,755	17,500	4.7

1959	2,348,390	941,689	483,464	458,225	100,000	21.8
1960	1,375,435	126,449	60,195	66,254	67,500	101.9
1961	1,973,779	618,881	309,066	309,815	112,500	36.3
1962	1,788,242	431,161	206,783	224,378	112,500	50.1

The income and expenses of the **Bardahl Manufacturing** Company for the years ended December 31, 1956 through 1959, inclusive, were as follows:

	1956	1957	1958	1959
GROSS INCOME:				
Net sales	$1,208,321.85	$1,360,575.93	$2,123,332.92	$2,348,389.71
Less-Cost of sales	532,692.15	539,877.53	902,560.33	993,602.15
Gross profit from sales	675,629.70	820,698.40	1,220,772.59	1,354,787.56
Interest received	9,396.93	13,559.81	11,338.58	24,317.92
Rents	9,390.00	12,710.00	18,926.07	19,830.00
Gain on sale of capital assets	333.80	3,579.92	448.46	2,645.51
Other income	5,456.60	3,237.21	8,610.04	9,984.21
	700,207.03	853,785.34	1,260,095.74	1,411,565.20
EXPENSES:				
Salaries and wages, excluding factory payroll	99,877.50	105,334.60	105,050.67	108,910.50
Taxes	34,355.46	38,193.32	53,394.79	59,599.42
Contributions	511.00	546.00	566.00	540.50
Depreciation	28,517.41	30,646.33	32,546.00	68,915.09
Advertising	92,741.30	102,349.89	236,760.11	155,876.18
Contribution to pension and profit-sharing plans	15,647.80	21,397.41	24,172.84	25,286.95
Interest	451.12	36.06	.....	.....
Other expenses	25,323.49	30,445.94	48,992.66	50,747.57
	297,425.08	328,949.55	501,483.07	469,876.21
Income before Federal income tax	402,781.95	524,835.79	758,612.67	941,688.99
Federal income tax	203,856.49	266,448.03	388,857.51	483,463.99
Net income	198,925.46	258,387.76	369,755.16	458,225.00

The **Bardahl** oil additive is a highly promotional product and is subject to rapid fluctuations in the market place. It is a luxury type product and requires extensive national advertising in order to create a consumer demand. **Manufacturing** produced animated spot advertisements for its motor oil additive beginning about 1953. Such spot advertisements were carried over television stations in the United States and have proven successful in creating a nationwide advertising image of the **Bardahl** name and product.

The oil additive industry is a highly competitive field of business which includes numerous competing products. During the years 1956 through 1959 there were at least 45 different oil additives marketed which were competitive with petitioner's additive. Among the products competing with the **Bardahl** additive were those marketed by Shell Oil Company, Dupont, General Motors **Corporation**, Wynn Oil Company, Quaker State, and Chrysler **Corporation**.

It was the practice of the petitioner during the years here in issue to invest sizable amounts of its liquid funds in temporary securities such as Government notes, Treasury bills, municipal bonds, or readily convertible debentures, and occasionally in cash deposits in a savings and loan association, so as to enable its unused working capital to earn a small interest return and still be available when needed for the
1034 demands of its business operations or for financing capital improvements. At the end of each *1034 of the years in issue, petitioner held governmental obligations in the following amounts:

December 31	Amount
1956	$205,263.98
1957	204,857.73
1958	208,717.14
1959	556,889.80

On August 23, 1954, **Manufacturing** deposited $35,000 with the Ballard Savings & Loan Association. On December 31, 1959, petitioner's balance in this account, including accumulated interest, was $41,634.80.

During 1956 **Bardahl** International **Corporation** in the ordinary course of business incurred trade receivables due to **Manufacturing** in amounts between $60,000 and $90,000.

In 1958 International in the ordinary course of business incurred a trade receivable due petitioner in the amount of $81,787.17 which was paid in full during January 1959.

Throughout the years in question petitioner held 8 percent debentures of the Coast Mortgage Company in the total face amount of $40,000. By agreement with the issuer the debentures were cashable on demand by **Manufacturing**. The Coast Mortgage Company maintained a cash reserve for this purpose at all times during the years 1956 through 1959.

The current assets and current liabilities of **Bardahl Manufacturing Corporation** on December 31, 1956 through 1959, inclusive, were as follows:

Current Assets	1956	1957	1958	1959
Cash	$300,566.79	$ 390,993.39	$ 327,597.63	$ 372,262.49
Notes and accounts receivable	123,773.22	255,346.45	512,037.00	622,891.68
Inventories	105,419.27	126,214.08	97,176.43	79,070.23
Government securities	205,263.98	204,857.73	208,717.14	556,889.80
Coast Mortgage debentures	40,000.00	40,000.00	40,000.00	40,000.00

Total current assets	775,023.26	1,017,411.65	1,185,528.20	1,671,114.20
Current Liabilities				
Accounts payable	4,956.37	55,634.42	26,689.62	86,038.55
Mortgage payable within one year	3,357.58	.....	.....	.....
Accrued liabilities	42,095.15	54,034.53	50,899.80	52,629.42
Federal income tax payable	172,956.49	235,230.03	322,278.30	339,035.23
Dividends payable	51,594.50	32,688.25	20,871.25	102,682.21
Total current liabilities	274,960.09	377,587.23	420,738.97	580,385.41

Petitioner's net liquid assets (consisting of its total current assets less its total current liabilities) as of December 31, 1956 through 1959, inclusive, were (rounded to the nearest dollar) $500,063, $639,824, $764,789, and $1,090,729, respectively.

Operating Costs

Petitioner's annual operating costs (excluding depreciation and Federal income taxes), cost of goods sold, and the total of the two for 1955, 1956, 1957, 1958, and 1959 were as follows:

Year ended Dec. 31	Operating costs[1] (less depreciation and Federal income taxes)	Cost of goods sold	Total
1955	$242,474.07	$540,515.73	$ 782,989.80
1956	268.907.67	532,692.15	801,599.82
1957	298,303.22	539,877.53	838,180.75
1958	468,937.07	902,560.33	1,371,497.40
1959	400,961.12	993,602.15	1,394,563.27

1 Including advertising costs.

Manufacturing's operating cycle, consisting of the period of time required to convert cash into raw materials, raw materials into an inventory of marketable **Bardahl** products, the inventory into sales and accounts receivable, and the period required to collect the outstanding accounts, averaged approximately 4.2 months during the 4 years here in question.

Petitioner required working capital as of the end of each of the years in question at least in an amount sufficient to cover its reasonably anticipated costs of operation for a single operating cycle. Since its
1035 operating cycle during the period 1956 through 1959 averaged approximately 35 percent of a year, its working capital requirements for the continuation of its normal operations *1035 amounted to approximately 35 percent of its reasonably anticipated (and steadily increasing) total annual operating costs and cost of goods sold as of the end of each of the years in issue. Accordingly the amounts of working capital reasonably anticipated by **Manufacturing** as being necessary to finance its costs of normal operations as of December 31, 1956, 1957, 1958, and 1959 were $293,400, $480,000, $488,000, and $488,100, respectively.

Plant Expansion

During the years 1956 through 1959 **Bardahl Manufacturing Corporation** and **Bardahl** International **Corporation** occupied the same premises located in Seattle, Washington. **Manufacturing** owned all of the land, buildings, and other physical assets. International paid **Manufacturing** a rental in the amount of $725 per month prior to 1958 for the office space and warehouse facilities which it occupied.

The minutes of the meeting of the stockholders of **Bardahl Manufacturing Corporation** held March 12, 1956, stated in part as follows:

> There followed a general discussion on the financial progress of the company and to what extent the company would necessarily need to expand. It was brought to the attention of the stockholders that the company would need additional warehouse space and that also it would soon be necessary to add another floor to the office of the present building. It was estimated that it would require approximately $300,000 to accomplish this improvement. The discussion was closed by the president, with the understanding that the matter would be placed before the board of directors at their next annual meeting which would follow the present stockholders meeting.

The minutes of the meeting of the board of directors of **Bardahl Manufacturing Corporation** held March 12, 1956, contained the following statement:

> The President, in his comments on the outlook for the future, announced that very soon it would be necessary to provide additional warehouse space, and that considering the rapid growth of the business, it was imperative that the business office space be increased and improved by adding another floor of office space to the present office building.
>
> The President stated that, in his opinion, the sum of approximately $300,000.00 would be required to carry these proposals to completion, and that while it would not be possible to accomplish the completion of these projects during 1956, he deemed it quite important that plans be prepared for this undertaking so that the expansion program could be undertaken just as soon as the corporate finances would permit.
>
> After a general discussion of the suggested expansion program, it was duly moved, seconded and carried, that the President be authorized to employ a reliable architect to draw up plans for both the addition to the warehouse and for the addition of another floor to the present office building.

The minutes of the meeting of the stockholders of **Bardahl Manufacturing Corporation** held February 26, 1957, stated in pertinent part:

> The President announced that the expansion plans contemplated in 1956 were now taking shape and that new walk-in vaults would also be added to the present office building. Plans are presently being completed by one of the well-known Seattle architectural firms.

The minutes of the special meeting of the board of directors of **Manufacturing** held on August 14, 1957, contained the following statement:

> C. B. Merritt presented the current financial statement to the Board, outlining to the Board the financial condition of the business, and the progress being made in the new additions which would be dedicated in the very near future, stating also that the greater portion of the estimated $300,000.00 capital outlay has already been expended.

The minutes of the annual meeting of the stockholders of **Manufacturing** held February 28, 1958, stated in part as follows:

C. B. Merritt outlined the progress made in the estimated expansion program provided for in 1956, in connection with which there had been expended to date for new buildings, equipment	$300,000.00

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      and tank farm, approximately ..........     229,000.00
                                                 ___________
      leaving an unexpended estimate
      balance of ............................    $ 71,000.00
      to which should be added a further
      expansion estimate of .................      50,000.00
                                                 ___________
            Total ...........................    $121,000.00
    Of the total estimated expansion
      balance of ............................    $121,000.00
      it was estimated that expenditures
      in 1958-1959 for capital
      items would be in round figures
      as follows:

1036 *1036
      New equipment
        in plant ..............................  $47,500.00
      New office equipment ....................    8,500.00
      Building additions ......................    3,000.00
      Additions to tank farm ..................   62,000.00  $121,000.00
                                                 _________
```

> The Secretary stated that, in his opinion, it might be good financial policy to hold a minimum and [sic] dividend payment in 1958, in order to retain sufficient liquid capital to meet not only current working capital needs, but also to provide necessary funds to complete the above expansion proposals.

The minutes of the annual meeting of the board of directors of **Manufacturing** held February 28, 1958, contained a statement substantially identical to that last quoted above.

A number of architectural drawings relating to petitioner's proposed warehouse additions, tank farm, and office building additions were prepared and certified by a registered architect during 1957, 1958, and 1959. The first of such drawings was certified on May 3, 1957, and the last was certified on July 28, 1959.

After completion of the second floor addition to petitioner's office structure, some of the additional space was occupied by **Bardahl** International **Corporation** and its rent was increased in 1958 from $725 per month to $1,500 per month.

During the years 1956 through 1959, **Manufacturing** converted its production operation from a batch-type process to a continuous process. This change involved an expansion of petitioner's plant facilities which prior to 1956 were inadequate to accommodate a continuous operation. The cost savings to the **corporation** resulting from the change in **manufacturing** technique amounted to at least $30,000 a year during the years here involved.

The net expenditures (after salvage recoveries) made by **Bardahl Manufacturing Corporation** during 1956, 1957, 1958, 1959, and 1960 for the acquisition of additional equipment and plant, warehouse, and office facilities were $76,013.93, $112,947.41, $245,500.32, $123,571.12, and $106,553, respectively.

As of December 31, 1956, 1957, 1958, and 1959, petitioner's board of directors had formed specific and definite plans for the expenditure of $220,610, $245,500, $123,571, and $106,553, respectively, for the purpose of acquiring additional equipment, expanding its plant and warehouse facilities, and adding office space.

Raw Materials

Certain chemical compounds and raw materials are basic ingredients in the manufacture of **Bardahl** concentrate. One indispensable chemical component is a special type of lead naphthenate.

At all times here material it was necessary for petitioner to maintain a raw materials reserve of various chemicals in order to consistently maintain its level of production. Certain of these chemical ingredients which are indispensable to the production of the **corporation's Bardahl** additive occasionally have become quite difficult to obtain as a result of changes in world conditions.

Throughout the years 1956 through 1959, and over a span of approximately 20 years, petitioner purchased several of its essential raw materials from W. Ronald Benson, a chemical engineer, manufacturer's representative, and proprietor of a chemical supply business. As a manufacturer's representative Benson sold **Manufacturing** each year approximately $200,000 worth of raw materials during the years 1956 through 1959. In conjunction with the chemists and employees of **Bardahl Manufacturing Corporation** he formulated certain chemical components exclusively for petitioner's use.

During 1951, one of the ingredients essential to the production of a chemical compound used in the manufacture of **Bardahl** concentrate disappeared from the market and it became necessary for petitioner to spend approximately $75,000 in cash in order to stockpile the ingredient in sufficient quantity to enable it to remain in production.

During the years 1956 through 1959, W. Ronald Benson discussed with Ole **Bardahl**, president of **Manufacturing**, and also with its chief chemist and its secretary-treasurer, the possibility of emergency situations arising which would cut off the supply of raw materials needed for the production of chemical compounds used in the manufacture of **Bardahl** concentrate. Benson warned the officers of **Manufacturing** that shortages of such raw materials could force the **corporation** to stop production and he accordingly alerted them that it might become necessary to stockpile a surplus of raw materials on
1037 short notice. He advised petitioner's *1037 officers that in the event of an emergency it would be necessary to spend at least $100,000 in cash in order to acquire a stockpile of raw materials sufficient to enable it to remain in production through the emergency period.

As of December 31, 1956, 1957, 1958, and 1959, inclusive, petitioner reasonably anticipated the expenditure of at least $100,000 cash for the stockpiling of essential chemicals and raw materials in the event of emergencies which would cut off the supply of ingredients indispensable to the manufacture of **Bardahl** concentrate.

Foreign Subsidiaries

In May 1958, William G. Simpson, vice president of both **Manufacturing** and International, was sent to Europe by petitioner to assist several European distributors in marketing **Bardahl** products, and to investigate the general situation existing among the blenders and distributors there. Upon returning from his European trip, he reported to the board of directors of **Manufacturing** on September 30, 1958, as follows:

> When Mrs. Simpson and myself left for Europe, it had been rumored that Mr. Gheysens who was operating a sub-distributorship under Kjell Stray in Belgium, was marketing a fraudulent **Bardahl** product. We investigated this matter and found it necessary to cancel out Mr. Gheysens Belgium operation, as well as Mr. Stray in this territory.
>
> A new Belgium **Bardahl** firm was established under the name of **Bardahl** Lubricants Belgium, Ltd. During the negotiations which took place in Paris with Mr. Gheysen's attorney, Kjell Stray, Mr. Bagn, Mr. George L. Geddes and our **Bardahl** attorney representing us, and Mr. Vandenbusch from Antwerp were present.
>
> We met with Mr. Nathan Murat in Paris and had an opportunity to talk and discuss the **Bardahl** operation in France. Through these talks it was learned that Mr. Murat, our **Bardahl** distributor, and Mr. Geddes were having difficulties that might soon lead to litigation. As a result of the conversation in Paris, we proceeded to inspect the **Bardahl** operations in Portugal, Florence and London. We found many discrepancies in all of the operations that were under the control of Mr. Geddes.
>
> As a result of this trip Mr. Giorgio Geddes and his cousin Mr. Rudolfo Geddes agreed to come to the States and meet with their attorney, and our attorney, to straighten out the misunderstanding that was evident in Europe.

The European territory (except England and Scandanavia) for the marketing of **Bardahl** products, as well as the Far Eastern and South American territories, were under the control of Giorgio Geddes during 1956, 1957, 1958, and until May 1959. Geddes had originally obtained his franchise as a sub-distributor from Alex Henderson of Montreal, Canada, the first franchise distributor employed by the **Bardahl** interests.

In January 1959, Giorgio Geddes, Ole **Bardahl**, and William G. Simpson and their attorneys met in Seattle, Washington, for the purpose of discussing and settling their differences with regard to the operation of the European and South American **Bardahl** distributorships. The European distributorship accounted for approximately 15 percent of the total sales of **Bardahl** products. Approximately 70 percent of the **Bardahl** products sold in the European market were purchased by industrial users and about 30 percent were bought for use in automobiles, whereas in the United States approximately 80 percent of the total sales of **Bardahl** products were made for automotive use, with 20 percent sold to industrial purchasers.

On March 23, 1959, Ole **Bardahl** and William G. Simpson were authorized by petitioner's board of directors to make a trip to Europe to further investigate market conditions and the operation of the Geddes franchise. Upon their return from Europe they reported their findings to the board of **Manufacturing**. The minutes of the meeting of the board of directors of the **corporation** held on April 30, 1959, stated in part:

> The President then gave a brief outline of his recent European trip in which connection he stated that he was formulating plans for the establishment of the **corporation's** own blending plants in foreign territory, two in Europe and one in South America, the estimated cost of this expansion plan being somewhere in the neighborhood of $200,000.00.

During their European trip Simpson and **Bardahl** discussed with a Minister of Industry in France and with certain public officials in Italy the possibility of constructing a concentrate plant in either country. Ole **Bardahl** previously had expressed to W. Ronald Benson his intentions regarding the construction of a concentrate plant to be located in Europe and had requested Benson and the Witco Chemical Company,
1038 one of petitioner's suppliers of chemical components, to investigate the sources of chemical supply available in Europe. As a result, *1038 officers of Witco Chemical Company sought to confer with Ole **Bardahl** and William Simpson in Paris, France, for the purpose of discussing sources of raw materials and the feasibility of the construction of a chemical plant in Europe by Witco to serve as a supplier of chemical products for petitioner's contemplated European concentrate plant. The president of Witco was unable to contact **Bardahl** or Simpson in Europe and later wrote W. Ronald Benson on May 14, 1959, as follows:

> While Mr. Wishnick and I were in England, Mr. Clarke, of **Bardahl**, contacted our London Office to see if we were in a position to make raw materials for a plant to be located in the Common Market. I communicated with Mr. Clarke and he stated Mr. **Bardahl** and Mr. Simpson were in Europe and, from that, we tried very diligently to contact Mr. **Bardahl** but, apparently, we missed him by a few hours in Paris. However, we did get word to him of our willingness to cooperate on this matter.
>
> You will note by the attached copy of letter that I have written directly to Mr. **Bardahl** to inform him of our regrets at not meeting with him in Europe and offering our whole-hearted support and cooperation in this matter of furnishing him with the type of Lead Naphthenate they require. If they contact you concerning this matter, please get as much information as you can concerning the volume of their requirements and the proposed location of this plant. * * *

Max Minnig, president of Witco Chemical Company, also wrote to Ole **Bardahl** on May 14, 1959:

> Mr. R. I. Wishnick and I regretted very much that we were unable to make contact with you during our European trip. However, I do want to go on record that we wish to cooperate whole-heartedly with you in the furnishing of raw materials for your operations in the Common Market.
>
> We sincerely appreciate the cooperation of your Mr. Clarke, in England, and shall be delighted to hear from either you or Mr. Simpson concerning your requirements in the European area and the possible location of your European Plant. If you wish to transmit this information through Mr. Ronald Benson, this will be perfectly satisfactory.

On May 26, 1959, **Bardahl** International **Corporation** canceled the European franchise contract held by Giorgio Geddes. On July 15, 1959, International sent Geddes and Alex Henderson letters formally terminating the European franchise.

Following cancellation of Geddes' European franchise, William G. Simpson went to Europe to take steps to preserve the market for **Bardahl** products. On September 29, 1959, an Italian **corporation**, **Bardahl** International Oil **Corporation**, S. P. A., was incorporated by Lillian Simpson, William Simpson, and Amedeo Totaro. The stock of the **corporation** was held as follows:

```
Lillian Simpson ..................    550,000 Lire
William Simpson ..................     50,000 Lire
Amedeo Totaro ....................    400,000 Lire
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On May 20, 1960, petitioner purchased the stock of Amedeo Totaro in **Bardahl** International Oil **Corporation**, S. P. A., for $20,000. On May 22, 1960, **Manufacturing** acquired the stock of William and Lillian Simpson (totaling 600,000 lire) in the Italian **corporation** for $30,000. All of the stock certificates of **Bardahl** International Oil **Corporation**, S. P. A., were endorsed to **Bardahl Manufacturing Corporation** and deposited with a bank in Milan, Italy.

In the fall of 1959 **Manufacturing** purchased from Giorgio Geddes for $49,000 an inventory of concentrate bearing the **Bardahl** name which subsequently was destroyed. The reason for the purchase of the inventory was to prevent the overstocking of dealers and a saturation by Geddes of the European market for **Bardahl** products.

Bardahl International Oil **Corporation**, S. P. A., entered into an agreement with a refinery located in Genoa, Italy, pursuant to which the refinery agreed to furnish materials and blending facilities for a 1-year period. This arrangement was intended by **Manufacturing** as a temporary measure to keep the European distributors in business until a concentrate plant could be built in that territory. After shipment of the first batch of concentrate to Italy, **Manufacturing** assigned a man to the refinery in Genoa to supervise the blending and production process on behalf of **Bardahl** International Oil **Corporation**, S. P. A.

One of the principal reasons for petitioner's decision to establish a concentrate plant in Europe was the high rate of duty on imported **Bardahl** concentrate. The duty rate on shipments of concentrate to Italy or
1039 Spain during 1958 and 1959 was between 65 percent and 75 percent of the invoice price. In other countries the duty rate varied from 50 percent to nearly 100 percent of the invoice *1039 price. The officers of **Manufacturing** were informed that with a concentrate plant located in Europe its Italian subsidiary would be able to take advantage of certain benefits in marketing **Bardahl** products in the European Common Market.

Manufacturing's decision to create a subsidiary **corporation** in Italy also was influenced by the fact that otherwise it would be subject to corporate liability in Italy as a result of establishing a concentrate plant there. An additional incentive for the formation of **Bardahl** International Oil **Corporation**, S. P. A., was the fact that **Manufacturing** thereby would be able to avoid disclosing its financial statements to the Italian Government thus reducing its tax burden in Italy.

The minutes of the meeting of the board of directors of **Manufacturing** held December 16, 1959, stated:

> The members of the board expressed their concern with reference to the conditions found by Mr. Simpson in his travels to the various countries covered in his report. All members were now made to realize that some immediate action must be taken in order to recover the market that we so nearly lost. It was regularly moved and seconded and passed of the board that the sum of $257,000 be set aside and allocated to be used where needed and in the manner later to be determined in an effort to recover the market.

From November 28, 1959, through February 24, 1960, **Manufacturing** advanced supplies of chemicals and raw materials to its Italian subsidiary in the total amount of $61,153.41. Such advancements subsequently were repaid by **Bardahl** International Oil **Corporation**, S. P. A., during 1960, 1961, and 1962.

During the spring of 1960 petitioner's wholly-owned subsidiary **corporation** in Italy was able to achieve steady production and to deliver supplies of **Bardahl** products to its European distributors.

The distributorship held by Alex Henderson originally included the eastern portion of both the United States and Canada. During the years in issue Henderson's franchise territory was confined to eastern Canada which accounted for approximately 20 percent of the total sales of **Bardahl** products.

On January 15, 1960, a franchise contract was executed by Alex Henderson and **Bardahl** International **Corporation** with respect to the distribution of **Bardahl** products in eastern Canada.

On August 11, 1960, Henderson unexpectedly canceled the franchise agreement he had with International covering the entire eastern Canadian territory. The franchise termination was formally accepted by International on August 15, 1960.

On September 18, 1960, B. D. L. Lubricants, Ltd., was incorporated in Canada. The name of the **corporation** subsequently was changed to **Bardahl** Lubricants (Canada), Ltd.

The outstanding common stock of **Bardahl** Lubricants (Canada), Ltd., at all times here material was held as follows:

Shareholder	No. of shares
Bardahl Manufacturing Corporation	503
Stephen Swantz	1
Jacques Tetrault	1
Ole **Bardahl**	1
Inga **Bardahl**	1
W. G. Simpson	1
Evelyn Nicolaysen	1
R. E. Parsons	1
Total	510

On September 24, 1960, **Manufacturing** and Alex Henderson executed an agreement under which petitioner agreed to pay Henderson $25,000 for a covenant not to compete with it in the manufacture or sale of products similar to **Bardahl** in Canada.

On December 2, 1960, petitioner transferred $143,268.31 to **Bardahl** Lubricants (Canada), Ltd., which was used by it to purchase the inventory, supplies, materials, and the **Bardahl** trademark from the corporate blender and distributor controlled by Henderson.

Manufacturing advanced $46,480.50 to its Canadian subsidiary **corporation** on January 27, 1961, which was used by it for the construction of a concentrate plant located in Canada. During the years 1960 to 1962, **Bardahl** Lubricants (Canada), Ltd., purchased land for a plant site and commenced construction of a building.

As of December 31, 1962, **Manufacturing** had advanced as loans to **Bardahl** Lubricants (Canada), Ltd., a total of $498,742.71 (including the above-mentioned advances in the amounts of $143,268.31 and $46,480.50). A portion of the above-described advances was paid out of funds that had been designated by petitioner's board of directors on December 16, 1959, for the reestablishment of the market in Europe for **Bardahl** products. Part of these funds were diverted to the Canadian market during 1960 through 1962 because of the unexpected termination by Alex Henderson of his franchise agreement.

1040 *1040 Petitioner limited its equity investment in its Canadian subsidiary during 1960, 1961, and 1962 to $510 so as to be in a position to recover the funds advanced and to enable **Bardahl** Lubricants (Canada), Ltd., to deduct its interest expense in computing its Canadian tax liability.

On October 12, 1961, **Bardahl** Lubricants (Canada), Ltd., borrowed $100,000 from the Canadian Imperial Bank of Commerce. The loan was personally guaranteed by Ole **Bardahl**.

As of December 31, 1959, **Manufacturing's** officers and directors had formed specific and definite plans for the expenditure of $257,000 for the rehabilitation of the European market for **Bardahl** products.

Drawing Account

During the years here in question **Bardahl Manufacturing Corporation** maintained a drawing account for its president Ole **Bardahl**. The purpose of the drawing account was to make cash advances and to pay certain personal bills during his absence from the home office. Ole **Bardahl** traveled extensively in connection with the conduct of petitioner's business operations during 1956, 1957, 1958, and 1959. Petitioner paid Ole **Bardahl's** Federal income taxes during January of each of those years.

It was the consistent practice of Ole **Bardahl** to make substantial cash payments to **Manufacturing** in reduction of his temporary loan balance at various times during each of the years in issue and to make payment in full satisfaction of his account during December of each year.

During April 1958, Ole **Bardahl** sold a residence to International in exchange for the assumption by that **corporation** of a mortgage in the amount of $15,152.39 and a demand note in the amount of $84,847.61 bearing 4 percent interest. In December 1958, petitioner's president delivered to it the foregoing promissory note issued to him by International in the amount of $84,847.61, and a note executed by him in the amount of $45,000 bearing bank interest. The delivery to **Manufacturing** of the two above-described notes by Ole **Bardahl** constituted partial payment of his drawing account balance for that year. The note for $84,847.61 was paid in full with interest on September 10, 1959, and the $45,000 note bearing bank interest was paid in five installments made during the period March 1959 through September 1959.

Real Estate Investment

Prior to the formation of **Manufacturing** in 1939, Ole **Bardahl** had been engaged for 20 years in the business of land development and the construction of houses. He had constructed approximately 400 houses in Seattle, Washington, prior to 1940. David Harvey, a friend and former business associate of Ole **Bardahl**, approached him in 1955 concerning the possibility of investing in a land development venture. **Bardahl** caused petitioner to invest funds in the development of a subdivision known as **Bardahl** Parks as a joint venturer with David Harvey. Petitioner's investment in **Bardahl** Parks was in the following amounts at the end of each of the years 1955 through 1959:

Year	Amount
1955	$79,902.44
1956	86,332.58
1957	62,148.50
1958	52,794.61
1959	26,163.99

David Harvey and Ole **Bardahl** selected jointly the parcel of land to be developed. Petitioner did not participate in the management of **Bardahl** Parks. David Harvey supervised the addition of improvements to the undeveloped land and also conducted the sale of lots. He shared equally with **Manufacturing** any profits resulting from the sale of lots in **Bardahl** Parks. After petitioner and David Harvey began their joint undertaking in **Bardahl** Parks the cost of unimproved land rose so sharply that Ole **Bardahl** decided to terminate any further joint ventures in real estate.

In 1958 and 1959 **Manufacturing** invested $27,072.64 and $15,916.55, respectively, in another land development project known as Sunset Developers.

Petitioner's investments in the **Bardahl** Parks and Sunset Developers real estate projects during the years in issue were unrelated to its oil additive business and did not constitute a diversification of business activity.

A parcel of land situated adjacent to petitioner's plant was offered to **Manufacturing** in 1959 by its owners, Dickey and Clauson, for $80,000. The offer was refused because the officers of the **corporation** felt that the asking price was excessive.

1041 On April 13, 1960, **Manufacturing** purchased the abovementioned parcel from Dickey and Clauson for $75,000. On the same date petitioner leased the property to *1041 Dickey and Clauson for a period of 10 years with the understanding that the lessees could vacate the premises at any time.

As of December 31, 1959, petitioner had not formed a specific and definite plan for the expenditure of any of its funds for the acquisition of the property subsequently purchased from Dickey and Clauson.

Loans

During 1955 **Manufacturing** loaned Harvey $30,000 for the purpose of protecting its interest in the **Bardahl** Parks development. This loan in the amount of $30,000 was still outstanding at the close of 1956.

During 1957 petitioner accepted a mortgage from Albert Anderson in the amount of $21,750 in satisfaction of the Harvey loan. The amount of the outstanding mortgage from Albert Anderson was reduced to $21,444.62 as of December 31, 1957, and was further reduced to $20,808.94 as of December 31, 1958. This mortgage was replaced in 1959 by a mortgage from Melvin Heide in the amount of $20,754.32 which was reduced to $20,136.68 as of December 31, 1959.[1]

Manufacturing loaned W. A. Watts, an electrical contractor, $12,000 in exchange for his promissory note in that amount in 1955. The outstanding balance on petitioner's loan to W. A. Watts was increased to $20,000 as of December 31, 1956, and was decreased to $8,000, $6,000, and $4,000 as of the end of 1957, 1958, and 1959, respectively.

In 1957 petitioner accepted conveyance of a dwelling house from W. A. Watts in partial satisfaction of its outstanding loan to him.[2] In 1959 petitioner sold the house to E. R. Rollin for $31,500. Rollin executed and delivered to petitioner a mortgage in that amount. The amount of the outstanding mortgage from E. R. Rollin was reduced to $30,729.04 as of December 31, 1959.

None of the above-described loan transactions were related to **Manufacturing's** business.

Dividend Policy

The policy of petitioner consistently has been to finance its operations and capital investments with cash whenever possible. The officers of the **corporation**, since the commencement of its operations in 1939, have been opposed to the utilization of borrowed funds unless forced to do so. With the exception of the construction of a plant in 1951 which required petitioner to borrow $60,000, it has not financed its equipment acquisitions or capital improvements with borrowed funds.

Manufacturing's board of directors generally based its decisions as to dividend distributions at the close of each of the years here in question upon the recommendations of its secretary-treasurer, C. B. Merritt, or its president, Ole **Bardahl**.

Petitioner's net income after taxes, its outstanding capital stock, its net earnings per share after taxes, cash dividends declared per share, the percentage of its net income after taxes distributed as dividends, and the percentage of net earnings after taxes retained as of the end of 1956, 1957, 1958, and 1959 were as follows:

Year	Net income after taxes	Stock outstanding on dividend date	Per share net earnings after taxes	Cash dividends per share	Percent of net earnings after taxes distributed as cash dividend	Percent of net earnings after taxes retained
1956	$198,925.46	12,500	$15.91	$4	25.14	74.86
1957	258,387.76	15,000	17.23	2	11.61	88.39
1958	369,755.16	17,500	21.13	1	4.73	95.27
1959	458,225.00	20,000	22.91	5	21.82	78.18

Several of the above findings are summarized in the following table:

1042 *1042

Year ended Dec 31 —	(1) Accumulated earnings and profits	(2) Increase in earnings and profits over prior years	(3) Net liquid assets available to meet anticipated business needs	(4) Ordinary operating expenses for one business cycle	(5) Anticipated extraordinary expenses
1955.....	$ 819,686	.....	.....	.....	.....
1956.....	965,040	$145,354	$500,063	$293,400	$320,610
1957.....	1,194,483	229,443	639,824	480,000	345,500
1958.....	1,540,049	345,566	764,789	488,000	223,571
1959.....	1,880,097	340,048	1,090,729	488,100	463,553

Year ended Dec 31 —	(6) Total needs of business for liquid assets (Col. 4 plus Col.5)	(7) Excess or (shortage) of working capital	(8) Investment in unrelated properties	(9) Loans unrelated to business	(10) Amount accumulated beyond reasonable needs of business
1955.....	.....	.....	.....	.....	.....
1956.....	$614,010	($113,947)	$86,333	$50,000	$ 22,386
1957.....	825,500	(185,676)	62,148	29,445	--0--
1958.....	711,571	53,218	79,868	26,809	159,895
1959.....	951,653	139,076	42,081	54,866	236,023

Manufacturing's income tax returns and its books and records were examined by the **Commissioner's** agents during July 1961. On October 2, 1962, respondent mailed petitioner a notification that he proposed to issue a notice of deficiency for the years 1956, 1957, 1958, and 1959 determining a deficiency under section 531 of the Internal Revenue Code of 1954 relating to the accumulated earnings tax. In response thereto petitioner filed with the respondent a statement containing certain grounds and allegations on which it sought to rely in support of the retention of its undistributed current and accumulated earnings and profits.

On March 28, 1963, the respondent mailed petitioner a notice of deficiency determining that its earnings and profits were accumulated beyond the reasonable needs of its business and that it was availed of for the purpose of avoiding the income tax with respect to its shareholders by permitting its earnings and profits to accumulate instead of being distributed.

Ultimate Findings

During 1956, 1958, and 1959, petitioner permitted its earnings and profits to accumulate beyond the reasonable needs of its business to the extent of $22,386, $159,895, and $236,023, respectively. In each of the years 1956, 1958, and 1959 **Bardahl Manufacturing Corporation** was availed of for the purpose of avoiding the income tax with respect to its shareholders by permitting earnings and profits to accumulate

instead of being divided or distributed.

During 1957 petitioner did not permit its earnings and profits to accumulate beyond the reasonable needs of its business and in that year it was not availed of for the purpose of avoiding the income tax with respect to its shareholders by permitting its earnings and profits to accumulate instead of being divided or distributed.

Opinion

Sections 531 and 532 of the Code impose an accumulated earnings tax upon corporations availed of for the purpose of avoiding the income tax with respect to their shareholders by permitting earnings and profits to accumulate instead of being divided or distributed. Section 533(a) provides that the fact that the earnings and profits of a **corporation** are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders unless it shall prove to the contrary by a preponderance of the evidence. Under section 537 the "reasonable needs of the business" include the reasonably anticipated needs of the business.

Under section 534 the burden of proof in proceedings before this Court may be shifted to the respondent with respect to a determination that the earnings and profits of a **corporation** have been permitted to accumulate beyond its reasonable business needs if: *1043 (1) the **Commissioner** has mailed the taxpayer notification of his intention to impose the accumulated earnings tax and (2) the taxpayer has submitted a timely statement of the grounds (together with facts sufficient to show the basis thereof) on which it relies to establish that all or any part of its earnings have not been permitted to accumulate beyond its reasonable business needs.

In order to effectuate a partial shift of the burden of proof to the **Commissioner**, the statement submitted by a taxpayer pursuant to the provisions of section 534 must set forth facts supporting the grounds contained therein which are substantial, material, and definite. *American Metal Products **Corporation*** [Dec. 24,142], 34 T. C. 89, affd. [61-1 USTC ¶ 9332] 287 F. 2d 860; *I. A. Dress Co.* [Dec. 23,541], 32 T. C. 93, affd. [60-1 USTC ¶ 9204] 273 F. 2d 543, certiorari denied 362 U. S. 976.

The respondent mailed petitioner proper notification pursuant to section 534 and the **corporation** in turn filed a statement in response thereto. In view of the state of the record here presented we find it unnecessary to determine the adequacy or inadequacy of petitioner's statement to accomplish any shifting of the burden of proof to the respondent. See *I. A. Dress Co., supra.* Our conclusions herein rest upon the clear and convincing evidence presented and would remain the same regardless of which party bears the burden of proof with respect to any or all of the grounds contained in petitioner's section 534 statement.

We have commenced our analysis of the evidence presented by first ascertaining the amount of net liquid assets available to petitioner at the close of each of the years in question so as to determine whether it possessed sufficient liquid funds to enable it to meet its reasonably anticipated business needs and still permit the distribution of additional dividends to its stockholders. See *Gus Blass Co.* [Dec. 15,885], 9 T. C. 15; *Sauk Investment Co.* [Dec. 9436], 34 B. T. A. 732. We have determined from the record that petitioner had available liquid working capital as of December 31, 1956, 1957, 1958, and 1959 in the amounts of $500,063, $639,824, $764,789, and $1,090,729, respectively.

In our computation of **Manufacturing's** current assets as of the end of each of the years in issue we have included items representing the equivalent of cash, such as Treasury bills and Government securities. The record discloses that petitioner's 8 percent debentures in the total face amount of $40,000 issued by the Coast Mortgage Company were cashable on demand pursuant to an agreement between **Manufacturing** and the issuer thereof and that during the years in question the Coast Mortgage Company consistently maintained a cash reserve for bond redemptions. Accordingly, we also included the $40,000 Coast Mortgage Company debentures in determining petitioner's current assets at the end of each of the years before us. In our computation of the current liabilities of **Manufacturing** at the close of each year we have included its provision for Federal income taxes payable for the indicated year. See *Kerr-Cochran, Inc.* [Dec. 22,934], 30 T. C. 69, at 73, 74; *Sandy Estate Co.* [Dec. 27,195], 43 T. C. 361, 377.

Turning next to a consideration of the reasonably anticipated needs of petitioner's business at the close of each of the years here in question, we must first determine the amount of working capital which it reasonably anticipated as sufficient to finance its expected costs of normal operations. Earnings retained to provide for working capital requirements are accumulated for the reasonable needs of the business. Section 1.537-2(b)(4), Income Tax Regs.

On brief, the respondent contends that the amounts of working capital required by petitioner as of the end of 1956, 1957, 1958, and 1959 to cover its anticipated operating costs were $322,965, $348,180, $396,500, and $435,243, respectively. Petitioner claims that it required as of the close of each of the years before us a working capital reserve to finance its expected costs of operation in the amounts of $448,132, $499,182, $632,496, and $726,984, respectively. **Manufacturing** does not contend that its reasonably anticipated business needs as of the close of each of the years before us required a working capital reserve in an amount sufficient to cover the cost of its operations for an entire year. *Cf. J. L. Goodman Furniture Co.* [Dec. 16,614], 11 T. C. 530; *Sandy Estate Co., supra.*

In view of the nature of petitioner's business, the amounts of its inventories and the rate of inventory turnover, the amount of its accounts receivable, and the collection rate thereof, we would be unable to find on the record before us that a cash reserve sufficient to cover one year's operating costs would be justified. The parties appear to agree on brief that the most appropriate *1044 basis for determining petitioner's need for operating capital is to compute the amount of cash reasonably expected as being sufficient to cover its operating costs for a single operating cycle. See *Smoot Sand & Gravel **Corporation** v. **Commissioner*** [60-1 USTC ¶ 9241], 274 F. 2d 495, affirming a Memorandum Opinion of this Court [Dec. 21,668(M)]; *United States v. McNally Pittsburg **Manufacturing** Corp.* [63-1 USTC ¶ 9498], 342 F. 2d 198. The evidence discloses that the **corporation's** operating cycle, consisting of the period of time required to convert cash into raw materials, raw materials into an inventory of marketable **Bardahl** products, the inventory into sales and accounts receivable, and the period of time required to collect its outstanding accounts, averaged approximately 4.2 months during the 4 years here involved. Thus the length of **Manufacturing's** operating cycle during the period 1956 through 1959 averaged approximately 35 percent of a year. In our view, at the beginning of each year petitioner would need liquid assets to meet operating expenses for a maximum of only 4.2 months on the assumption that no operating revenue would be received until the expiration of its operating cycle. Additional expenditures for operating costs beyond the first 4.2 months of each year would not be incurred without the production of operating revenue.

We accordingly have computed the amounts of working capital needed to finance **Manufacturing's** reasonably anticipated costs of normal operations as being approximately 35 percent of its expected annual operating costs and cost of goods sold. Its total annual cost of goods sold and operating costs consistently increased throughout the years here in issue. We have determined that the amounts of liquid working capital which reasonably could have been anticipated by **Manufacturing** as being necessary to finance its costs of normal operations as of December 31, 1956, 1957, 1958, and 1959 were $293,400, $480,000, $488,000, and $488,100, respectively. In making the above computation of petitioner's working capital requirements, we have considered all of its expenses as shown in its profit and loss statements, including both direct and indirect expenses (except depreciation), and its cost of goods sold. We have eliminated from our computation of funds necessary for petitioner's operating costs for one operating cycle any consideration of its anticipated Federal income taxes for the following year since this is not the kind of operating expense for which cash is needed in advance. Federal income taxes would be incurred in the following year only if there arises sufficient earnings from profitable future operations to require their imposition.

The parties on brief devote considerable argument to the question whether petitioner needed funds for advertising expenses and whether the retention of cash to meet its anticipated advertising expenses was justifiable. It is not entirely clear from petitioner's brief whether it claims that during the years here involved it was entitled to maintain a separate cash reserve exclusively to meet its advertising costs or whether its argument as to this item is merely one aspect of its broader contention regarding its need for working capital to finance normal operating costs for one operating cycle.

In our computation of the amount of working capital which petitioner at the end of each of the years in question reasonably could have anticipated as being needed to finance its normal operating costs for a single operating cycle, we have taken into account its expected advertising expenses. In concluding that it was entitled to accumulate a sufficient cash reserve to meet its estimated operating expenses for 4.2 months, we have permitted it to accumulate sufficient cash to cover approximately 35 percent of its anticipated annual advertising costs. The record demonstrates to our satisfaction that petitioner's reasonable business needs did not require any additional accumulation of liquid assets to meet expected advertising expenses as of the close of any of the years before us.

Petitioner also contends that at the end of each of the years in question it had formed specific and definite plans for the expenditure of substantial amounts of cash for the expansion of its plant and office facilities and that it was entitled to accumulate liquid assets to the extent thereof. Section 1.537-2(b)(1), Income Tax Regs. The minutes of several meetings of the board of directors of **Bardahl Manufacturing Corporation** held during 1956, 1957, and 1958 clearly demonstrate that the **corporation** had specific and definite plans to construct additions to its warehouse, office building, and tank farm in the immediate future. Further, it engaged the services of a registered architect who prepared and certified a set of architectural drawings *1045 relating to these proposed additions to petitioner's plant and office facilities. The first of such drawings was completed and certified by the architect on May 3, 1957, and the last of the series was completed and certified on July 28, 1959.

The record discloses that one of **Manufacturing's** principal purposes in expanding its plant facilities was to enable it to convert its production from a batch-type process to a continuous process, a change which was completed during the years in question, and which resulted in an operating cost saving to the **corporation** of at least $30,000 a year due to the change in its **manufacturing** technique.

Petitioner actually completed most of its contemplated expansion projects during the years before us. Its net expenditures, after salvage recoveries, for the acquisition of additional equipment, plant, warehouse, and office facilities were $76,013.93, $112,947.41, $245,500.32, $123,571.12, and $106,553 during 1956, 1957, 1958, 1959, and 1960, respectively.

We have determined that as of December 31, 1956, 1957, 1958, and 1959 **Manufacturing** had formed specific and definite plans for the expenditure of $220,610, $245,500, $123,571, and $106,553,

respectively, for the expansion of its plant and office facilities.

An additional extraordinary expense which was reasonably anticipated by the **corporation** at the close of each of the years involved was an emergency fund in the amount of approximately $100,000 which was needed throughout the 4 years in issue to finance the stockpiling of chemicals and raw materials in the event of sudden changes in world conditions. It is apparent from the record that it was necessary at all times during the 4-year period in question for petitioners to maintain a raw materials reserve of various chemicals in order to maintain a consistent level of production. Certain of the chemical ingredients which are indispensable to the production of the **Bardahl** additive occasionally have become scarce as a result of changes in world conditions.

During 1951, one of the essential raw materials needed by petitioner in the production of its **Bardahl** concentrate disappeared from the market and the **corporation** found it necessary to spend approximately $75,000 in cash in order to stockpile the ingredient in a quantity sufficient to allow it to remain in production.

One of petitioner's suppliers of chemical products who was a chemical engineer and who had sold chemical products to **Manufacturing** over a period of approximately 20 years, testified that he had advised its officers during the years 1956 through 1959 that in the event of a sudden change in world conditions an emergency situation might well arise which would necessitate the expenditure of at least $100,000 in cash to enable the **corporation** to acquire a stockpile of raw materials sufficient to allow it to continue its normal level of production.

We are convinced from the record that a **corporation** engaged in the type of business operated by petitioner, being dependent upon a continuous supply of chemicals and raw materials drawn from different sources throughout the world, would require a cash reserve to enable it to obtain a sufficient quantity of materials to remain in business during emergency periods. It is therefore our conclusion that a business need actually existed for the accumulation of a reserve to meet such a contingency. See *L. R. Teeple Co.* [Dec. 12,582], 47 B. T. A. 270; *William C. Atwater & Co.* [Dec. 16,240], 10 T. C. 218. We are persuaded by the testimony herein that petitioner's officers reasonably anticipated the need for a reserve of at least $100,000 as of December 31, 1956, 1957, 1958, and 1959 for the stockpiling of essential chemicals and raw materials in the event of emergencies which would cut off the supply of ingredients indispensable to the manufacture of **Bardahl** concentrate and we have so found.

With respect to the reasonable needs of the **corporation** existing at the close of 1959 it claims that in addition to expected expenditures for normal operating costs, plant expansion and the emergency stockpiling of raw materials essential to its operations, it anticipated the expenditure of $257,000 as of December 31, 1959, for the rehabilitation of its European market, capital investments in an Italian subsidiary and the construction of a concentrate plant to be located in Europe. It accordingly contends that it was justified in accumulating liquid assets in that amount at the end of 1959 for such purposes.

During 1956, 1957, 1958, and until May 1959, the European territory for the sale of **Bardahl** products as well as the Far Eastern and South American territories was under the control of Giorgio Geddes. The
1046 European distributorship produced approximately *1046 15 percent of the total sales of **Bardahl** products.

Petitioner's officers made trips to Europe in 1958 and 1959 and discovered a number of irregularities in the operation of Giorgio Geddes' distributorship which seriously hampered the marketing of **Bardahl** products in the territory under his control. During 1959 **Bardahl** International **Corporation** terminated Geddes' European franchise. The officers of **Manufacturing** thereupon began to take steps to investigate the possibility of constructing a concentrate plant in Europe and forming an Italian **corporation** to serve as a subsidiary of petitioner for the production of **Bardahl** concentrate for the European market.

The minutes of the meeting of petitioner's board of directors held April 30, 1959, show that its officers had previously formulated plans for the construction of one or two concentrate plants in Europe as well as one in South America. The estimated costs of constructing the three plants was placed at $200,000. During 1959 the president and vice president of **Manufacturing** discussed with government officials in France and Italy the possibility of erecting such a plant in one country or the other. They also investigated the sources of raw materials available in Europe and approached at least one supplier of chemicals which expressed interest in constructing its own European chemical plant for the purpose of supplying petitioner's contemplated concentrate plant in that area.

One of the principal reasons for **Manufacturing's** decision to construct a concentrate plant in Europe was the opportunity to avoid the high rate of duty on imported **Bardahl** concentrate. During 1958 and 1959 the duty rate on shipments of concentrate to Italy or Spain was between 65 percent and 75 percent of the invoice price. Petitioner's officers were informed that with a concentrate plant located in Europe its contemplated Italian subsidiary would be able to take advantage of certain benefits in marketing **Bardahl** concentrate in the European Common Market.

On September 29, 1959, **Manufacturing's** vice president, William G. Simpson, caused an Italian **corporation** to be formed under the name of **Bardahl** International Oil **Corporation**, S. P. A., the stock of which was held temporarily by three individuals and later was acquired by **Bardahl Manufacturing Corporation** in May 1960 for $50,000. During 1959 **Bardahl** International Oil **Corporation**, S. P. A., entered into an agreement with a refinery located in Genoa, Italy, under which the refinery agreed to furnish petitioner's Italian subsidiary with materials and blending facilities for a 1-year period. **Manufacturing** later assigned a man to work with the refinery in Genoa to supervise the blending and production of **Bardahl** concentrate on behalf of **Bardahl** International Oil **Corporation**, S. P. A. One of the principal purposes for the formation by petitioner of a subsidiary **corporation** in Italy was the avoidance by **Manufacturing** of corporate liability in Italy upon establishing a concentrate plant there.

In the fall of 1959, **Manufacturing** purchased from Giorgio Geddes for $49,000 an inventory of concentrate bearing the **Bardahl** name in order to prevent his overstocking the dealers in Europe and thereby saturating the European market.

From November 28, 1959, through February 24, 1960, petitioner advanced supplies of raw materials in the amount of $61,153.41 to its Italian subsidiary. The minutes of the meeting of petitioner's board of directors on December 16, 1959, state that its directors formally resolved to set aside $257,000 of its funds for use in reestablishing the European market for **Bardahl** products.

During the spring of 1960 petitioner's Italian subsidiary achieved a steady level of production.

On August 11, 1960, Alex Henderson unexpectedly canceled his franchise agreement with International covering the eastern Canadian territory. As the result of the unanticipated emergency which disrupted the Canadian distributorship for **Bardahl** products, petitioner in September 1960 formed a Canadian subsidiary known as **Bardahl** Lubricants (Canada) Ltd. In order to capitalize its Canadian subsidiary with funds sufficient to enable it to purchase inventory, supplies, and land for use as a plant site and to enable it to commence construction of a concentrate plant in Canada, **Manufacturing** found it necessary to divert to the Canadian market in 1960, 1961, and 1962 a portion of the funds that had been designated by its board of directors on December 16, 1959, for the recovery of the European market.

1047 In view of the extensive groundwork that had been laid by petitioner's officers during 1959 for the construction of a concentrate plant in Europe, the formation of its Italian *1047 subsidiary in September 1959, the clear statements contained in the minutes of its directors' meetings held April 30, 1959, and December 16, 1959, allocating $257,000 of its funds for the reestablishment of its European market, and the actual expenditure in 1960 of roughly $110,000 in cash and raw materials for the capitalization of its Italian subsidiary and the rehabilitation of its European market, we are of the opinion that on December 31, 1959, petitioner had formed specific and definite plans for the expenditure of $257,000 for the purpose of reestablishing its market in Europe for **Bardahl** products.

In further support of its accumulation of liquid assets as of the close of 1959, **Manufacturing** advances the argument that it anticipated the expenditure of approximately $80,000 for the acquisition of a parcel of land located adjacent to its plant site in Seattle, Washington. This property was offered to petitioner in 1959 by its owners, Dickey and Clauson, for $80,000. Their offer was refused. Subsequently, however, in April 1960, **Manufacturing** purchased the parcel of land from Dickey and Clauson for $75,000. On the date of purchase petitioner leased the property back to the sellers for a period of 10 years. It appears from the record herein that petitioner has never made any use whatever of this parcel of land. It is apparent from the evidence before us that the Dickey-Clauson property was not needed by petitioner in its business and that on December 31, 1959, it had not formed any definite plan for the expenditure of any amount for the acquisition of such property. We therefore have not allowed petitioner to accumulate any amount of its liquid assets for this purpose in ascertaining its reasonably anticipated expenses as of December 31, 1959.

The respondent emphasizes on brief that petitioner has unjustifiably accumulated at least $469,561, $488,224, $748,426, and $579,336 at the end of 1956, 1957, 1958, and 1959, respectively, because it is claimed that **Manufacturing** held unrelated investments and made loans to its principal stockholder to the extent of those total amounts. A very substantial proportion of the foregoing totals represents amounts invested by petitioner in Government bonds, Coast Mortgage debentures, and cash on deposit with a savings and loan association. We conclude from the record that these amounts represent temporary investments by **Manufacturing** of its liquid assets which its officers believed it might need to withdraw at any time in order to finance the cost of operation or expansion. We are convinced that petitioner throughout its history has consistently followed a policy of financing its operations and expansion activities with cash insofar as possible. In our view the amounts represented by petitioner's savings and loan deposit, its investment in Government bonds and its Coast Mortgage debentures do not represent a diversion of the **corporation's** funds to unrelated activities. As noted above, we have included these amounts in our computation of **Manufacturing's** current assets in calculating its available working capital at the close of each of the years here involved.

The respondent's calculation of petitioner's unrelated investments for 1958 includes an outstanding trade receivable from **Bardahl** International **Corporation** in the amount of $81,787.17 which arose in the ordinary course of business operations and which was paid in full during January 1959. This item quite obviously does not represent a diversion of petitioner's funds or an investment in unrelated activities.

We thoroughly agree with the respondent, however, that the **corporation's** investments in the **Bardahl** Parks and Sunset Developers real estate projects during the years in issue were unrelated investments for which its funds were unjustifiably withdrawn. It is clear from the record that the investment of petitioner's funds in these real estate ventures was fundamentally the personal endeavor of its principal stockholder, Ole **Bardahl**. Neither the joint venture with David Harvey in **Bardahl** Parks nor the Sunset Developers project was conducted in a manner which would tend to indicate a corporate purpose on the part of **Manufacturing** to enter the real estate business, and we conclude from the record that these investments did not represent a genuine diversification of corporate activity but were in fact a diversion of corporate funds to a personal project of its principal stockholder which was wholly unrelated to its oil additive business.

In addition to its investments in certain real estate projects during the years here involved, **Manufacturing** loaned money to several individuals for purposes entirely unrelated to its business. The outstanding balances of such loans totaled $50,000, $29,445, $26,809, and $54,866 at the end of 1956, 1957, 1958, and 1959, respectively.

1048 *1048 The respondent also contends that **Manufacturing** made a permanent loan to its principal stockholder which was perpetuated throughout the entire 4-year period here involved and which it is argued represented an unjustifiable diversion of corporate funds for the purely personal purposes of its stockholder. The record discloses that the advances in question were made to Ole **Bardahl** pursuant to a drawing account which was set up primarily for the purpose of taking care of his personal expenses while he was away from Seattle on trips connected with the business of the **corporation**. He traveled extensively in connection with the conduct of petitioner's business operations during each of the 4 years before us. During January of each year **Manufacturing** paid Ole **Bardahl's** Federal income taxes. It was his practice to make substantial cash payments to **Manufacturing** in reduction of his drawing account balance during each of the years in question and to make payment in full satisfaction of his account during December of each year.

In December 1958, Ole **Bardahl** delivered to **Manufacturing** a promissory note previously issued to him by International as partial consideration for the purchase of a residence in the amount of $84,847.61 bearing 4 percent interest, and he also delivered to the **corporation** a note which he personally executed in the amount of $45,000 bearing bank interest. The delivery of these two notes to petitioner was made in partial payment of Ole **Bardahl's** drawing account balance for 1958. Both notes were paid in full with interest during 1959.

In view of the purpose of these drawing account advances and the facts that they were consistently repaid promptly either in the same year or in an immediately subsequent year and that in two instances the **corporation** was paid interest on loans made to Ole **Bardahl**, we find that the advances and loans made to him in connection with his drawing account during the years in issue constituted bona fide loans. We are unable to find from the record that the above-mentioned loans and advances were of indefinite duration and should be regarded as a substitute for the distribution of dividends to the **corporation's** principal stockholder. Since the amounts in question were consistently repaid and since the record indicates that Ole **Bardahl** intended at all times to repay the **corporation** the amounts advanced to him, we cannot conclude that the transactions did not represent bona fide loans or that such advances require us to conclude that the funds advanced were unreasonably diverted from the petitioner's business. *F. E. Watkins Motors Co.* [Dec. 23,233], 31 T. C. 288; *Corporate Investment Co.* [Dec. 10,928], 40 B. T. A. 1156.

To summarize the several conclusions set forth above, we shall first consider the total accumulations of earnings and profits available as of the close of 1956 and 1957. As indicated by the table appearing near the conclusion of our findings of fact herein, a comparison of petitioner's liquid assets available for the needs of its business with the amounts we have determined to be its reasonably anticipated need for cash at the close of each of the years in question discloses an apparent shortage of working capital at the end of 1956 and 1957. To the extent of **Manufacturing's** investment in unrelated properties at the end of those years and the outstanding balances of loans made by it for purposes unrelated to its business, any such working capital shortage was solely of its own making.

Had petitioner retained the funds which were represented by its net investment in unrelated properties and the loans unrelated to its business at the conclusion of 1956, it would have had available an actual *excess* of working capital in the amount of approximately $22,386. We accordingly hold that as of December 31, 1956, petitioner had permitted its earnings and profits to accumulate beyond the reasonable needs of its business to the extent of $22,386.

However, at the close of 1957, if petitioner had funds available equal to its net loans unrelated to its business and its net investment in unrelated properties, its liquid assets still would have fallen far short of the total needs for cash expenditures which the record has established were reasonably anticipated by its officers and directors at that time. Even with the funds available which the liquidation of such unrelated loans and real estate investments would have produced, **Manufacturing** nevertheless would have faced a very sizable shortage of working capital at the close of 1957. We are satisfied from the record that the amounts anticipated by the **corporation** for its expected business needs in the following year substantially exceeded *both* the available liquid assets and its investments in unrelated loans and real estate
1049 ventures. We therefore *1049 conclude that as of December 31, 1957, **Bardahl Manufacturing Corporation** did not accumulate its earnings and profits beyond the reasonable needs of its business.

With respect to 1958 and 1959, the total picture is considerably different. A comparison of **Manufacturing's** available liquid assets at the close of each of those years with its reasonably anticipated business needs discloses a substantial excess of available liquid funds at the end of each year. To such excessive amounts of liquid assets, we have added petitioner's net investments in unrelated real estate ventures and unrelated loans and have determined that it permitted its earnings and profits to accumulate beyond the reasonable needs of its business as of December 31, 1958 and 1959 to the extent of $159,895 and $236,023, respectively.

Under the statutory presumption created by section 533(a) of the Code our findings that petitioner allowed its earnings and profits to accumulate beyond the reasonable needs of its business as of the close of 1956, 1958, and 1959 are determinative of the ultimate issue that it was availed of for the purpose of avoiding taxes on its shareholders unless it has demonstrated to the contrary by a preponderance of the evidence. Although the evidence before us discloses that petitioner had followed a consistent policy of financing its operations and capital improvements exclusively with cash expenditures and despite the further fact that it has demonstrated a favorable dividend record which shows that throughout the 4-year period here involved it had distributed an average of approximately 18 percent of its net income (after taxes) as cash dividends to its shareholders, these factors are overridden by its substantial investment in unrelated real estate ventures and its loans made for purposes unrelated to its business throughout each of those years. Accordingly, in addition to the statutory presumption that **Bardahl Manufacturing Corporation** at the end of 1956, 1958, and 1959 was availed of for the purpose of avoiding taxes on its shareholders by reason of the fact that it allowed its earnings and profits to accumulate beyond its reasonable needs, we are of the opinion that the record in its entirety independently demonstrates that such accumulations were in fact due to the purpose of avoiding taxes on its shareholders and we so hold.

Decision will be entered under Rule 50.

[1] The terms of the arrangement under which petitioner accepted first the mortgage from Albert Anderson in 1957, and subsequently the mortgage from Melvin Heide in 1959 in satisfaction of the original $30,000 loan to David Harvey are not disclosed by the record.

[2] The terms of the arrangement under which petitioner accepted the house from W. A. Watts in partial reduction of his indebtedness to it are not disclosed by the record.

Beasley v. Beasley

Case name: Beasley v. Beasley
Citation: 359 Pa. Super. 20, 518 A.2d 545, 1986 Pa. Super. LEXIS 13031
Date of decision: November 20, 1986
Country: US
State or Federal: State
State/Jurisdiction: Pennsylvania
Court: Superior Court
Type of action: Marital Dissolution
Judge: Tamilia
SIC: 8111 Legal Services
NAICS: 541110 Offices of Lawyers

Keywords: Marital dissolution, Personal goodwill, Sole proprietorship

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COUNSEL:

Larry I. Haft, Philadelphia, for appellant Helen M. Beasley.

Richard Sprague, Philadelphia, for appellant James E. Beasley.

JUDGES:

Cirillo, President Judge, and Wickersham, Brosky, Wieand, Olszewski, Del Sole, Montemuro, Tamilia and Johnson, JJ. Wieand and Montemuro, JJ., concur in the result by Tamilia, J. Del Sole, J., files a dissenting opinion which is joined by Johnson, J.

OPINIONBY:

TAMILIA

OPINION:

This matter was appealed by Helen M. Beasley, plaintiff in the court below, and a cross-appeal was filed by the defendant, James E. Beasley.

In her complaint for divorce, the appellant/wife made a claim for equitable distribution and as part of that claim requested that the good will aspect of the husband's law practice be determined to be marital property and subject to equitable distribution. The court denied this request and held that good will is future earnings and that the Divorce Code of 1980 permitted distribution only of present property, the value of which could be ascertained. Thus, the issue raised by appellant/wife is whether or not, under the equitable distribution proceedings of the Divorce Code, good will is a component of the value of a professional practice and to be considered marital property.

In the alternative, appellant/wife asks, if the law practice, conducted as a sole proprietorship, is not marital property must it not nonetheless be appraised for purposes of equitable distribution and alimony as the separate estate of its owner and as an income-generating asset. The court responded affirmatively to this, but to the degree that the files of a professional practice are confidential, it was subject to a non-disclosure order, and only to the extent that it is necessary to ascertain present value of work in progress can there be an appraisal. In doing so, the court limited the extent of intrusion into the personal files of the cross-appellant, James Beasley.

In the cross-appeal, James Beasley alleged that the trial court was without jurisdictionto consider or decide the petition filed by appellant/wife to permit appraisal pursuant to Pa.R.A.P. 1701 because an appeal in the same action was pending in the Superior Court from an Order by Brody, J. granting appraisal fees. The lower court rejected this objection on the basis that the matter was ancillary and incidental to the main suit and found that the main suit could go forward.

Secondly, on cross-appeal, the husband contends good will of his sole proprietorship is not subject to equitable distribution under the Divorce Code of 1980, which position was sustained by the trial court. In counterstatement, cross-appellant/husband also alleged that good will, pertaining to sole proprietorship of a law practice, could not be appraised for the purpose of setting alimony under section 501 of the Pennsylvania Divorce Code. The alimony issue was not raised or addressed in the lower court but Mr. Beasley's position was actually sustained by the trial court when it held that appraisal was permitted for the purpose of determining present value only. It permitted appraisal of work in progress to ascertain the present value of the proprietorship, while rejecting appraisal of good will.

The next issue on cross-appeal is whether or not work in progress of a law practice could be appraised by requiring the examination of case files and financial information relating to cases which could lead to the disclosure of confidences and secrets of the attorney's clients. The lower court rejected the cross-appellant's position even though appellant's expert attributed no value to work in progress. For reasons discussed below, we believe the finding by the trial court is correct.

Lastly, cross-appellant alleges that it would be a denial of due process and an abuse of discretion to order appraisal fees when in fact there had been no determination on the record that the property to be appraised was in fact marital property. The court determined that simply setting an appraisal fee would not be an abuse of discretion and that there would be no prejudice or harm resulting from the appraisal of property even if it later should not be determined to be marital property.

The issues are clearly stated, but prior to analysis of the legal issues, a brief discussion of the facts is warranted.

James and Helen Beasley were married in 1958, at which time Mr. Beasley was employed as an associate of a Philadelphia law firm in which he had no proprietary interest. In January of 1959, he acquired a minority partnership interest in the law firm of Cohen, Ornsteen and Beasley. Later that year, in December 1959, that firm was dissolved and Mr. Beasley became an equal partner in the firm of Beasley and Ornsteen. Dissolution of Beasley and Ornsteen occurred at the end of 1963 and from early 1964 until the present time Mr. Beasley has continued his law practice as a sole proprietorship.

The record establishes that of the last twenty of the twenty-six years of Mr. Beasley's marriage to Mrs. Beasley, his practice has remained in the form of a sole proprietorship. As a sole proprietor, Mr. Beasley employs fourteen to fifteen attorneys, primarily, in the field of "negligence" or "tort" practice, focusing on

medical malpractice, product liability, defamation, a few automobile cases and some incidental matters. At the time of their marriage, Mr. Beasley's annual salary was approximately $ 6,000, whereas his annual earnings now exceed that amount substantially, as established by the parties' 1982 joint federal income tax returns. All of the physical assets of his practice are owned by him. Mr. Beasley alone determines the compensation of his employees and they have no control over the operation of the law practice. He pays them no compensation over and above their salaries for any revenue they generate for the firm or any cases they may attract to the firm. The practice is, however, conducted under the name of Beasley, Hewson, Casey, Colleran, Thistle and Erbstein.

Some of the attorneys associated with Mr. Beasley have dual professions. Hewson is a physician and Thistle is an engineer. Clients frequently come to the practice because of one of the other attorneys and not because of Mr. Beasley. Many of the cases in the office are handled entirely by attorneys other than Mr. Beasley, who may himself have no knowledge of the files and may never have discussed the client with the other attorney. Each of the attorneys associated with Mr. Beasley may leave at any time and each client would, in the event his attorney left, determine whether he wished to take his case and follow the departing attorney or remain with Mr. Beasley's office. The cases handled by the attorneys associated in the practice are conducted on a contingent fee basis. Among the cases are disciplinary cases, malpractice cases and defamation cases. Some, as with the disciplinary matters, are matters of sensitivity, which have received no public exposure and may not entail litigation. Even where litigation has started and the matters are of public record, the files contain extremely sensitive, confidential information regarding the parties, witnesses, the conduct of the cases or confidences and secrets of the clients.

The attorneys in this law practice keep no time records and Mr. Beasley does not know nor can he estimate the percentage of his time spent on the office operation as opposed to the practice of law. Each year, during the course of this marriage, the balance of monies generated by Mr. Beasley's practice of law, which were not returned to the proprietorship as business expenses, were drawn out and used jointly by Mr. and Mrs. Beasley.

Mrs. Beasley in no way contributed to Mr. Beasley's education, creation of the business or operation of the law practice, and aside from her employment as a secretary during the first year of marriage, she has not been employed outside of the home.

We will consider the issues as they developed in this case, but it appears necessary to first determine whether the issue raised on cross-appeal, that the lower court was prohibited from exercising jurisdiction in this matter by reason of Pa.R.A.P. 1701, stays any proceeding in the court below, during the pendency of that appeal. That appeal resulted from an Order by Judge Brody in the lower court granting $ 3,500 in appraisal fees when Mr. Beasley and his counsel of record were not present at a hearing. We need not go into the merits of that Order as it was decided by this Court by Opinion Per Curiam filed September 28, 1984, that the appeal must be quashed as there were no exceptions filed and final judgment was not entered on the docket. In that Opinion, it was, however, stated that this was an appealable issue citing Sutliff v. Sutliff, 326 Pa.Super. 496, 474 A.2d 599 (1984). However, Sutliff has been overruled by the Pennsylvania Supreme Court in Fried v. Fried, 509 Pa. 89, 501 A.2d 211 (1985), which holds that ancillary matters in a divorce proceeding must await a final decree of divorce before being appealed.

The present contention of lack of jurisdiction, based on the matter being on appeal, is that the Order of the Superior Court is presently subject to review by the Supreme Court which has before it a petition for allowance of appeal upon which it has not yet acted. In light of Fried and the findings of the Superior Court in quashing that appeal, we may not assume that Mr. Beasley will prevail. However, aside from that, we believe there is no question that this case can proceed to the merits despite an appeal on the issue of the appraisal fee.

In Beasley v. Beasley, 348 Pa.Super. 124, 501 A.2d 679 (1985), an earlier appeal in this case on the issue of whether or not bifurcation was an appealable matter, (as an Order which is separable from and collateral to a cause of action, appealable under certain circumstances), Judge Wieand, author of that Opinion, found as follows:

Those circumstances, all of which must be present [for appeal to lie], are as follows:

' [the order is] separable from, and collateral to, rights asserted in the action, too important to be denied review and too independent of the cause itself to require that appellate consideration be deferred until the whole case is adjudicated.' Cohen v. Beneficial Industrial Loan Corporation , 337 U.S. 541, 69 S.Ct. 1221, 93 L.Ed. 1528 [1949].

Id., 348 Pa.Superior Ct. at 127, 501 A.2d at 680. Also see Fried, supra; Pugar v. Greco, 483 Pa. 68, 394 A.2d 542 (1978). "A final order is one which usually ends the litigation or alternatively, disposes of the entire case."

The order of appraisal from which appeal was taken does not involve a right which is too important to be denied immediate review. The issue of the appraisal fee, aside from compliance by the court with due process, will turn upon the final determination of the matter sub judice. See Pa.R.A.P. 1701(c).

The record also shows that Mr. Beasley appealed the appraisal Order before appraisal was actually undertaken and before the lower court had the opportunity to certify the issue to this Court as a controlling question of law as to which there is a substantial ground for difference of opinion (Pa.R.A.P. 312, 1311 and 1312, interlocutory appeal may be taken by permission under 42 Pa.C.S.A. § 702(b)). The issue, not having been certified or accepted, was not an appeal which would result in a stay in the lower court.

That leads us to the subsequent certification of the matters sub judice, which are in proper form for our consideration.

Ancillary to the question of jurisdiction of the lower court to proceed in that case is consideration by this Court as to whether or not we should accept certification of the issues before us. (Pursuant to 42 Pa.C.S.A. § 702(b), interlocutory appeals by permission, governed by Pa.R.A.P. 312, 1311 and 1312). The temptation is great in this case, and might be justified under Fried, supra, to reject the certification and return the case to the trial court for a full determination of all issues as presented and ultimately to bring the matter back to the Court when a final judgment is entered. Except for one aspect of it, this case cries out for such a treatment. Already it has involved multitudes of proceedings and appeals and the parties have proceeded in a piecemeal fashion to have the rights of the parties adjudicated. This case was commenced in October of 1981 and, well into the year of 1986, it has still not progressed to

the merits in the court below, despite the extraordinary number of pleadings, filings, appeals and hearings which appear to carry the adversary nature of the proceedings to the ultimate degree.As Judge Wieand stated in the earlier appeal,

[t]he right of appeal is intended to confer upon an appellate court the power of review; it has never been intended to vest in an appellate court the power to intervene in matters pending before the trial court. So long as actions remain open, undetermined and unfinished, this Court will not intrude by deciding premature appeals. (citation omitted)

Beasley, 348 Pa.Superior Ct. at 128, 501 A.2d at 680.

The exceptional ingredient in this matter is the issue concerning the right of appraisal of a professional sole proprietorship and the possibility of irreversible harm by the intrusion into confidential records and relationships of clients, whose rights are superior to those of the parties in resolving their private litigation. If we await a final decision in this case, those rights, if inviolate, will be lost. See Cohen, supra. Also, the issue of value of goodwill in a sole proprietorship law practice as marital property is one of first impression in Pennsylvania and one of such commanding importance that it is believed, before the case moves forward in the lower court, this Court should rule on those considerations. For these reasons we proceed to consider the issues on their merits, first of which is the determination of whether good will of a sole proprietorship is marital property.

The trial court, by its Opinion and Order dated March 30, 1984, held "the law practiceconducted by defendant James E. Beasley, as a sole proprietorship, exclusive of good will factor, is marital property as defined by the Pennsylvania Divorce Code of 1980." Despite the lower court's refusal to include good will as a factor of the law practice as marital property, it did conclude that Mrs. Beasley was entitled to an appraisal of Mr. Beasley's interest in the law practice for the purpose of determination of the present value of that practice including work in progress if any. Appellant/wife contends that the court was in error in refusing to consider good will as a factor in marital property subject to distribution whereas the cross-appellant/husband alleges the court was in error in permitting an appraisal for the purpose of present value and particularly allowing any consideration of work in progress as present value. These issues will be considered separately and discussed below.

The rule, until recent times, was stated in Sale of "Good Will" of Law Practice, 79 A.L.R.3d 1243:

In the very few reported cases which have dealt specifically with the subject under annotation, the courts have agreed that despite the fact that the good will of a law practice has an ascertainable value for certain purposes, it is not an asset which may be sold or transferred for a consideration. Thus, it has been held that the good will or personal professional reputation of an attorney, does not survive him, and may not be sold or transferred upon his death. And in what is apparently the only case in which the court directs its full attention to the question of the validity of a contract for sale of good will of a law practice, under the restrictive guidelines set forth in the ABA Canons of Ethics, the court in Geffen v. Moss (1975) 53 Cal App 3d 215, 125 Cal Rptr 687, 79 A.L.R.3d 1232, infra § 4, refers specifically to pertinent regulations set forth in the California Business and Professions Code, the State Bar Act (of California), and the ABA Canons of Ethics as prohibiting the sale of a law practice as a going business.

As defined in Corpus Juris Secundum:

Goodwill 38 C.J.S. § 1. Definition

Good will is that element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business. It is distinguishable from the "going value" or "profits" of a business.

At Goodwill 38 C.J.S. § 3. Adherence to Place, Name, Property, or Business, it is stated:

Good will exists as property merely as an incident to other property rights and is not susceptible of separate ownership or disposition. It may attach to the place, name, property, or reputation of a business, but some decisions hold that it may not adhere to a business or profession dependent solely on the personal qualities of the owner.

The only reported Pennsylvania case on the sale of good will of a professional man is In re Baer's Estate, 38 D. & C. 409 (1940) which held there is no legally recognized property right in the nature of good will attached to the practice of a professional man, such as to continue after his death.

Good Will 38 Am Jur2d § 1. Definitions defines good will in its narrowest case "as the probability that old customers will resort to the old place", to the broadest,

the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital stock, funds, or property employed therein, in consequence of general public patronage and encouragement, which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.

J. Story, Commentaries on the Law of Partnerships, § 99, at 170 (6th ed. 1868).

The appellant/wife would have us rely on the very recent line of cases expanding good will to capitalization of personal reputation and relies primarily on the testimony of Seymour Rubin, C.P.A., to establish that good will is a factor in establishing the value of marital property and that it is essential to its measurement to look at the confidential files in the office of Mr. Beasley.

For purpose of our considerations, the extensive testimony of Mr. Rubin may be summarized as follows. Various computations are made which result in an "adjusted income" figure.Deduction is then made for overhead and for reasonable compensation, utilizing well known law firm economic surveys. A second deduction is then made for "fair rate of return of net tangible assets." The resulting figure is "excess earnings." To arrive at a calculation of good will, these excess earnings are capitalized using an appropriate multiple. The amount attributable to good will is then added to the cumulative value of the practice's tangible assets to achieve a final valuation of the law practice. In evaluating the tangible assets, competent trained people would consider the value of computers, word processors, typewriters, telephones, motor vehicles, the law library and other physical assets. The evaluation would also review tax returns, accounts receivable, actual original books and records of the entity, including accounts receivable records and work in progress records, bank statements, journal ledgers and independent accountant's year-end worksheets and other things of that nature. As to the good will of the proprietorship, this would be an intangible asset in the evaluation; the appraisal would be started with the tax returns, the reputation of the lawyer,reviewing records for the prior five years to see the type of practice Mr. Beasley had and to determine what he had done for five years.

The evaluation would include the past work and present work in progress on files that were opened as of the end of each of the years that he was examining for a determination of costs, advances, details of pension and profit sharing plans, insurance policies, employment contracts, or employee compensation arrangements to establish a determination of reasonable compensation so that the element of good will can be calculated from the excess over reasonable compensation that was obtained by the firm's activities.

Mr. Rubin testified that he would handle the confidentiality by not disclosing or identifying any of the files or names of persons contained in those files and do whatever was required by a non-disclosure Order issued by the court. In this way, Mr. Rubin testified he could ascertain the good will which he defined as "the valuation of the excess earnings that are derived from any business endeavor, whether it would be a professional practice or what have you, over and above a fair rate of return on net tangible assets -- and after making allowance for reasonable compensation for the owners of that particular endeavor."

Appellant/wife contends that the majority of jurisdictions which have considered the issue have held that professional good will is subject to equitable distribution in divorce. Appellant/wife relies on the definition of good will stated by Mr. Rubin and alleges that by deducting the average of actual earnings in the amount reflecting the sum of a reasonable return on the enterprise's capital and the reasonable value of the professional's services, the result in excess earnings which are then capitalized over a specific period of years in accordance with accepted accounting procedures, provides a present value that is ascertainable and capable of distribution. As authority for this position, cases from various jurisdictions, as well as law review and professional journal articles, are cited. Stern v. Stern, 66 N.J. 340, 331 A.2d 257 (1975); Levy v. Levy, 164 N.J.Super. 542, 397 A.2d 374 (1978); Mueller v. Mueller, 144 Cal.App.2d 245, 301 P.2d 90 (1956); also see In Re Marriage of Ronald Keith Hull, 712 P.2d 1317(Mont.1986); Raggio, Professional Goodwill and Professional Licenses as Property Subject to Distribution upon Dissolution of Marriage, 16 Fam.L.Q. 147, 154 (1982). This is known as the "capitalization formula" which holds that a future flow of income has a present value which can be reduced to a lump sum payment. Appellant would also find authority in the Divorce Code of 1980 in its mandate under 23 P.S. § 102(a)(6) to "[e]ffectuate economic justice between parties who are divorced or separated and . . . insure a fair and just determination and settlement of their property rights" and in subparagraph (b), "The objectives . . . shall be considered in construing provisions of this act and shall be regarded as expressing the legislative intent."

Further, reliance is placed on 23 P.S. § 401(f), that all property acquired by either party during the marriage is presumed to be marital property regardless of whether its title is held individually or by the parties in some form of co-ownership. Additionally, appellant points out that in Commonwealth ex rel. Gutzeit v. Gutzeit, 200 Pa.Super. 401, 189 A.2d 324 (1963) (allocatur denied), good will is a valuable asset. In that case, good will was evaluated in the context of a support order to determine the value of a one-man company with thirteen employees. Good will was also considered by this Court in Smith v. Munizza, 170 Pa.Super. 122, 84 A.2d 352 (1951) and Boni v. Boni, 302 Pa.Super. 102, 448 A.2d 547 (1982), and by the Supreme Court in Felt v. Hope, 416 Pa. 118, 206 A.2d 621 (1964). It would appear to be incontrovertible that good will is a valuable asset and in proper context must be considered in valuation of a property.

The context most cited is that of a corporation or business entity in which it can be clearly calculated that there is an excess value beyond the fair return of compensation for work performed. It is the contention of the cross-appellant/husband that a sole proprietorship of a law firm is unique in the sense that there is no value to be transferred upon the dissolution of a sole proprietorship. In effect, there cannot be a sale of a sole proprietorship, and since no sale is possible, the good will aspect of such a sole proprietorship in fact does not exist. This was the position accepted by the trial court and the one that seems to be most appropriate under the circumstances and facts of this case. See Goodwill 38 C.J.S. § 3, supra.

A sole proprietorship can be distinguished from a partnership, or a professional corporation, to which an ascertainable value can be ascribed for the purpose of buying into or withdrawing from the relationship; but it is the association, or some share of it, that is valued and not the individual partner upon which the value is placed. See Geesbright v. Geesbright, 570 S.W.2d 427 (Tex.Civ.App.1978). The productivity or work effort of the partner is often not the measure of the share possessed by various members of the association. That share is a measurable and marketable commodity and is generally defined by contract. When a sole proprietor terminates his activity, the lights go out, the value of the sole proprietorship is extinguished and is non-transferable; the clients in the law firm cannot be sold, they can only be transferred and they have the absolute right to select their own future representation; nothing remains in residue which could be determined of value aside from tangible physical property, or work performed on partially completed cases, which may entitle the lawyer or his heirs to a quantum meruit payment. Appellant argues that if Mr. Beasley, tomorrow, converted his sole proprietorship to a partnership he could obtain payment from the proposed partners for admission to the firm based on the value of good will of his law practice. While this might be so, the entity, the sole proprietorship, which is the whole, would be diminished in terms of Mr. Beasley's share of the income and profits to the degree of division in exchange for monies he received in capitalization of the firm, and the theoretical value would be unchanged.

The key issue as to good will of a sole proprietorship has to do with the value, if any, which can be attributed to it, causing it to be subject to distribution. Aside from a share arrangement in partnerships or professional corporations, the only commodity subject to good will considerations in a sole proprietorship is the professional reputation. A number of cases have considered this to be of ascertainable and divisible value and numerous articles have discussed this issue. n1 The testimony of appellant/wife's expert, Mr. Rubin, capsulates the underlying theory espoused by those cases (supra). The major cases to the contrary are Nail v. Nail, 486 S.W.2d 761 (Tex.1972) (since skill, experience and reputation -- good will are not distinguishable from the professional (doctor) and would be extinguished in the event of death, retirement or disablement or sale of the practice, it may not be characterized as an earned or vested right or one which fixes any benefit in any sum at any future time); Austin v. Austin, 619 S.W.2d 290, 291 (Tex.Civ.App.1981) (good will of an ongoing, noncorporate, professional practice is not the type of property that is divisible as property in a divorce proceeding); Stephens v. Stephens, 625 S.W.2d 428 (Tex.Civ.App.1981) (there is no separate good will where the earnings of a sole practitioner depend on his individual skill and experience); Holbrook v. Holbrook, 103 Wis.2d 327, 309 N.W.2d 343 (1981) (the reputation of a partner in a law firm was not property subject to division in a divorce action).

n1 See: Adams, Professional Goodwill As Community Property: How Should Idaho Rule?, 14 Idaho L.Rev. 473 (1978); Foster, Equitable Distribution of Professional Degrees, Licenses and Goodwill, 1 Fairshare 9 (Jan.1983); Kennedy & Thomas, Putting a Value on: Education and Professional Goodwill, 2 Fam.Advoc. 3 (1979); Krauskopf, Marital Property at Marriage Dissolution, 43 Mo.L.Rev. 157 (1978); Raggio, Professional Goodwill and Professional Licenses as Property Subject to Distribution upon Dissolution of Marriage, 16 Fam.L.Q. 147 (1982); Lurvey, Professional Goodwill on Marital Dissolution: Is it Property or Another Name for Alimony?, 52 Cal.St.B.J. 27 (1977); Note, Professional Corporation May Have Valuable Goodwill, Apart from Person of Individual Member, that Must Be Considered in Property Settlement on Divorce, 11 St. Mary's L.J. 222 (1979). See also: Annot., 52 A.L.R.3d 1344 (1973); 24 Am.Jur.2d Divorce and Separation § § 899, 945 (1983); 38 Am.Jur.2d Good Will § 8 (1968); 38 C.J.S. Goodwill § 3 (1943).

While the position of the Texas courts appears solid despite the numerous findings in other jurisdictions to the contrary (see footnote 1, supra), the inescapable logic of that position becomes evident upon consideration of the effect on an award of alimony after assessing value to good will based upon reputation, skill and experience. The good will of a sole proprietorship is related only to his future earnings, since an actual sale produces no value. To assess a value on future productivity and to award a proportionate amount to the spouse is akin to making a lump sum alimony payment since it is based on future earnings of the paying spouse. If, in addition to this payment, alimony is awarded, there is, in effect, a double charge on the future income of the paying spouse. Even without an alimony award, a fixed sum, not having the designation as alimony, carries none of the flexibility of an alimony award derived from its modifiability and, therefore, may penalize the payor if he suffers reverses, unemployment or dies. See Lurvey, Professional Goodwill on Marital Dissolution: Is It Property or Another Name for Alimony?, 52 Cal.State Bar J. 27 (1977).

In Holbrook, supra at 350, 309 N.W.2d at 354, the court said:

The concept of professional goodwill evanesces when one attempts to distinguish it from future earning capacity. Although a professional business's good reputation, which is essentially what its goodwill consists of, is certainly a thing of value, we do not believe that it bestows on those who have an ownership interest in the business, an actual, separate property interest. The reputation of a law firm or some other professional business is valuable to its individual owners to the extent that it assures continued substantial earnings in the future. It cannot be separately sold or pledged by the individual owners. The goodwill or reputation of such a business accrues to the benefit of the owners only through increased salary.

In an exhaustive article, Marital Property at Marriage Dissolution, 43 Mo.L.Rev. 157 (1978), Krauskopf states in her conclusion:

The second round of appellate decisions will reveal the depth and sophistication of the courts' acceptance of the partnership theory of marriage. If the fruits of all efforts of each spouse are, indeed, to benefit the family created by the marriage, then all interests of value, whether contingent (nonvested retirement benefits), nonassignable (personal injury cause of action), unmarketable (goodwill of a professional practice), or cloaked in separate title (increased value of prior owned close corporation or realty), developed by the efforts of either spouse during the marriage should be subject to the discretionary division of the trial court.

Id. at 198. The single exception to contingent value to be considered under the partnership concept of acquisition of marital property, which is both presently unascertainable and subject to double assessment through alimony, is professional good will. Thus no matter how ingenious the formulae are in establishing "value," assessing it as value and subjecting the same assessment to alimony is inequitable and prohibited by the Divorce Code, 23 P.S. § 102(a)(6), 23 P.S. § 401(d).

In cases where there is a contingent fee arrangement, the value of work completed, or work done and the costs advanced, is absorbed by the sole proprietor and cannot be recouped until the case is completed. This cannot be equated with those cases in which a fee is fixed based upon the work to be performed whereby an appraisal can be made establishing the value to the time of distribution as a recoverable asset. See Sundheim v. Beaver Co. Bldg. & Loan Assoc., 140 Pa.Super. 529, 14 A.2d 349 (1940); Tranberg v. Tranberg, 456 F.2d 173 (3d Cir.1972); In Re Normal Towel Service Inc., 18 B.R. 949 (Ill.1982); Detroit Bank & Trust Co. v. Coopes, 93 Mich.App. 459, 287 N.W.2d 266 (1979). However this process is construed by the I.R.S., (appellant contends value can be fixed as if at the time there was a sale) it cannot be a sale under standards controlling the practice of law as a profession. If there was a fee prorated upon work performed, then the amounts would have been collected and presumably absorbed in the performance of the work that was done. To the extent there was value received, this presumably would have been absorbed in the salaries and overhead and profits of the proprietorship. The amounts collected in the future would follow the performance of the work and would be payable to the person performing that work.

It is tenuous and risky to attempt to evaluate the likely return on contingent fees and as such, no value can be placed on them for purposes of equitable distribution. However, the Divorce Code is flexible and in this respect, the income producing capacity reflected by such cases can be estimated on the basis of compensation for completed cases and, therefore, that record should be sufficient to project the earning capacity of the attorney without speculating on the nebulous return that might be derived from examining active contingent fee cases. Permanent alimony, as support, is modifiable, and should the expectations vary either upward or downward, adjustments can be made by the court in an expeditious and reasonable manner. For support, and recently for alimony, earning capacity has been one of the considerations upon which an award may be based. In Hodge v. Hodge, 337 Pa.Super. 151, 486 A.2d 951 (1984), we held that increased earning capacity through acquisition of a professional degree during marriage was not marital property subject to distribution, but it would be a consideration in awarding alimony. Similarly, and perhaps more to the point, this Court said in Pacella v. Pacella, 342 Pa.Super. 178, 492 A.2d 707 (1985):

Nor did the trial court err in considering appellant's earning capacity rather than his salary, as a basis for calculating the appropriate amount of the award. The Divorce Code directs that a trial court "grant or withhold alimony according to the actual need and ability to pay of [] the parties . . . ." in order to "effectuate economic justice between [the] parties[.]" 23 Pa.C.S. § 102(a)(6). While ordinarily this means that alimony should be based upon actual earnings, that is true only because ordinarily actual earnings accurately measure "ability to pay." Moreover, in the context of support proceedings, we have held that earning capacity, rather than actual earnings, is the determinative factor in ascertaining a party's ability to pay support, Commonwealth ex rel. Raitt v. Raitt, 203 Pa.Super. 226, 199 A.2d 512 (1964), ... Where we have found, in support cases, that actual earnings did not reflect earning capacity, we have approved the use by trial courts of a variety of means to arrive at earnings figures that accurately reflect a party's real wealth. See e.g., Commonwealth ex rel. Maier v. Maier, 274 Pa.Super. 580, 418 A.2d 558

(1980) (where supporting spouse is sole stockholder of corporation and determines his own salary, court may pierce corporate veil and use corporate income as basis for determining earning capacity); Commonwealth v. Miller, 202 Pa.Super. 573, 198 A.2d 373 (1964) (where supporting spouse is self-employed, net income, as it appears on income tax forms, is not "infallible" measure of real wealth; court accordingly may add back portion of depreciation deduction in calculating amount of support owed); Commonwealth ex rel. Gutzeit v. Gutzeit, 200 Pa.Super. 401, 189 A.2d 324 (1963) (in determining supporting spouse's earning capacity, court should consider not only salary paid by wholly owned corporation, but all prerequisites [sic] provided by corporation.) As a matter of economic common sense, earning capacity is equally relevant whether the proceeding be for support, alimony pendente lite, or alimony after divorce.

Id., 342 Pa.Superior Ct. at 186-88, 492 A.2d at 712.

In this manner, the wife will not receive, as property or alimony, that which has no present value from which she may be unjustly enriched, whereas the husband will not have a windfall from income or property that has only a present potential but which will be realized in the future.

Contingent fees, while having a degree of similarity to pensions, do not have the same expectation of vesting which permits greater certainty in fixing value and for establishing present worth. Of course, in those cases wherein the professional is paid for service performed, a clear appraisal of the value of uncompensated work in progress can be made upon which a determination of marital property and division of that property can be based. This can be ascertained through bookkeeping records, which do not involve the evaluation of confidential files.

There is no question that the law firm itself has value which is ascertainable. For this purpose, the trial court permitted a controlled appraisal to look into the files of the firm, even though confidential, for the determination of that value.

The right of appraisal provides an extremely difficult issue to resolve because aside from the interests of the parties in whatever business the firm may pursue, there is the right of confidentiality and for the clients to have their personal affairs be absolutely privileged and private. On balance, it would appear that the trial judge approached this in a sensible manner. It is undeniable that he carefully considered the rights of the individual clients, the ethical standards of the bar association and the ability of the court to exercise control over such confidential information. (Code of Professional Responsibility, Canon 4, Disciplinary Rule 4-101(A), (B), (C), (D); Ethical Consideration 4-1, 4-4.) He permitted the appraisal pursuant to EC 4-2, DR 4-101(C)(2) and (4) which authorizes revelationof client case files where required by law or court Order. n2 Unquestionably, lawyers cannot be carved out as a special category of professionals who are immune from evaluation as to present value, but to permit inquiry into confidential files for the purpose of evaluating contingent fees as potential earnings is inappropriate. The review by an outsider of confidential files, which can contain information which would never be revealed except to the lawyer in a confidential relationship, would have a chilling effect on that relationship which far outweighs the need to appraise those files for these purposes. With these limitations, it is believed that adequate means are provided by Pa.R.C.P. 1920.22, for this purpose. n3

n2 DR 4-101.(C)(2)

DR

4-101. Preservation of Confidences and Secrets of a Client

(C) A lawyer may reveal:

(2) Confidences or secrets when permitted under Disciplinary Rules or required by law or court order.

EC

4-2. Details the considerations for preserving the confidences and secrets of a client and restates the provision of DR 4-101(C)(2).

n3 Pa.R.C.P. 1920.22 provides:

Rule 1920.22 Discovery

(a) Except as provided by subdivision (b), there shall be no discovery in an action of divorce or for annulment or a claim which has been joined as permitted under the Divorce Code unless authorized by special order of court.

(b) When a claim is made for alimony or the determination and distribution of property rights, any party may serve upon any other party as of course within such time as not to delay the trial interrogatories limited to those claims. The practice and procedure shall be governed by the rules of civil procedure governing depositions and discovery.

We, therefore, hold that good will of a sole proprietorship under these facts is not an element of present value; we also hold that the records of the firm may not be appraised to determine present value and to evaluate earning capacity. n4

n4 That is not to say that good will expressed as a share of a partnership or professional corporation, with an ascertainable value which can be purchased or transferred, is to be excluded. Such is not the case here.

The major contention of the cross-appellant/husband is that since this is an office that works entirely on a contingent fee basis, there cannot be an evaluation of present value by evaluating the work in progress. The expert for appellant/wife agreed that work in progress is not a basis for assessing present value. This would appear to be true.

We have previously held that property for purposes of marital distribution must be a liquidated amount in a tort claim. Hurley v. Hurley, 342 Pa.Super. 156, 492 A.2d 439 (1985). Just as we could not establish good will based on contingent fee earnings, as at best these are potential earnings, so must we limit consideration of contingent fees for purposes of present value. Under these circumstances, no significant distinction exists between good will and present value as to contingent fees. If the firm ceased to exist or the appellee/husband retired or withdrew from the firm, there would be no capitalization of contingent fees for the reasons discussed earlier as to good will.

While this appraisal aspect of the case has another overtone, which is alleged by the appellant/wife, it was neither considered by the lower court nor is it a factor in our finding against the appraisal of the law practice. That has to do with the appraisal of good will for purposes of alimony. As we have held that in this case good will is not a factor in terms of the value of the sole proprietorship for purposes of equitable distribution, neither can it be a factor for evaluating the amount to be awarded in alimony. Gutzeit, supra, does not apply in this case since there, the court considered a business corporation which had substantial assets and good will beyond the earnings and income of the firm which would generate substantial profits upon the sale of that business. No facts similar to that exist in this case. No sale can be made here from which a profit maybe derived. Therefore, to consider the value of the property to include good will for the purposes of establishing alimony would be to include a non-existent asset. That is not to say that the appraisal of the present value of the law firm (not including good will), Mr. Beasley's income, and potential earnings, and those related factors are not relevant considerations under the Divorce Code, 23 P.S. § 501, Alimony.

The final issue in this case has to do with whether an appraisal for the purposes of establishing value can be made without first determining what is marital property subject to distribution. This is a matter that would appear to be within the discretion of the trial court. Unquestionably, a determination of what is marital property in many cases can easily be made prior to any appraisal of the value of that property. Pursuant to 23 P.S. § 401(d), there is a presumption that all property, whether real or personal, acquired by either party during the marriage is marital property, subject to limited exceptions under section 401(e). Since this presumption has not been overcome and the issue relates to the transfer of airplanes by Mr. Beasley to a trust fund for his sons, with further action being stayed by the court, appraisal is proper.

In a case as involved and complex as this one, the court could properly find that the appraisal would establish a two-fold purpose; that it would divulge both the value of the assets and particularly in regard to the airplane, which appears to have been placed in trust under questionable circumstances, aid in determining whether that trust, in fact, is not an improper divestiture of marital property. Since appraisals normally would include the time of acquisition of an asset, its increase or decrease in value, and whether or not there was a sale or divestiture or whether there was some return or equivalency derived from a transfer, it would serve to aid the court in making a determination both as to value and as to marital property. It would serve the dual purpose of appraisal and accounting. There can be no prejudice to the defendant by this evaluation and it would forward the progress of this case.

In summation,we find: review of this case is not prevented or stayed by the pendency of the matter of an award of appraisal fees before the Supreme Court; the review is not prevented as being interlocutory as it presents substantial questions of fact and law which have been certified to us for consideration; good will is not an element of value for purposes of equitable distribution involving a sole proprietorship of a professional practice; good will is not an element for alimony considerations of a sole proprietorship of a professional practice; contingent fees may not be considered to establish present value or good will; contingent fees may not be considered for the purpose of establishing a basis for an alimony award since they are unascertainable earnings; appraisal of the law practice, not including confidential records, is permissible to ascertain present value and basis for alimony; and appraisal of property transferred into a trust is permitted without a prior determination that it is marital property.

We, therefore, modify the Order of the lower court by eliminating therefrom the direction that "client files" be delivered to Helen Beasley or her selected appraiser; as modified,the Order is affirmed.

DISSENTBY:

DEL SOLE

DISSENT:

DEL SOLE, Judge, dissenting:

I respectfully dissent based upon my belief that the permission to appeal was improvidently granted, and the appeal should be quashed.

The Majority citing Fried v. Fried, 509 Pa. 89, 501 A.2d 211 (1985) and Cohen v. Beneficial Industrial Loan Corporation, 337 U.S. 541, 69 S.Ct. 1221, 93 L.Ed. 1528 (1949) notes that rejection of certification "might be justified". Majority Opinion at 549. It finds, however, an "exceptional ingredient" in this case, the potentially lost rights of those clients who may be irreversibly harmed by intrusion into their attorney's confidential files. I believe this rationale is flawed for two reasons.

The test applied to a question of appealability in Fried v. Fried, was as follows:

(u)nder Cohen, an order is considered final and appealable if (1) it is separable from and collateral to the main cause of action; (2) the right involved is too important to be denied review; and (3) the question presented is such that if review is postponed until final judgment in the case, the claimed right will be irreparably lost. (Citations omitted).

Fried v. Fried, 509 Pa. at 94, 501 A.2d at 214, quoting Pugar v. Greco, 483 Pa. 68, 73, 394 A.2d 542, 545 (1978).

The Majority would find, under the third prong of the Cohen test, the client's rights to confidentiality will be "irreversibly harmed" by the failure of this Court to grant permission to appeal. However, prong three of the test speaks to lost rights which belong to the parties, not the parties' clients.

In addition, the Majority's conclusion that an appeal is proper here because the case contains an issue of "commanding importance", is not based on the appropriate standard. See: Toll v. Toll, 293 Pa.Super. 549, 439 A.2d 712 (1981).

This court does have discretionary power to hear an appeal of an interlocutory order that has been certified by the lower court as presenting a "controlling question of law as to which there is substantial ground for difference of opinion and (where) an immediate appeal from the order may materially advance the ultimate determination of the matter (.)

Toll v. Toll, 293 Pa.Super. at 554, 439 A.2d at 715 (emphasis added), citing 42 Pa.C.S.A. § 702(b).

While the certified issues in the present appeal have not been previously treated by the appellate courts of this Commonwealth, I am not convinced that immediate appellate review will materially advance the ultimate termination of the case. Rather, I perceive this appeal as premature and inappropriate since it serves to add yet another delay to disposition of this litigation.

Assuming this court were to rule that the interlocutory appeal in this case should be quashed, I believe it would expedite the case without serving to expose the confidential matters included in a client's file. For appraisal purposes, most of the information necessary to evaluate the potential worth of a claim is based upon information gleaned through discovery, and is therefore readily available without breaching any duties of confidentiality. Materials sought for appraisal which counsel deems are confidential and nondiscoverable are best handled by the trial judge supervising the evaluation on a case-by-case basis. If a situation were to develop where a decision is issued and a party fails to comply with a court order requiring information to be disclosed, a contempt citation would be issued and sanctions would be imposed.An appeal from this type of final order would then be appropriate. See: Hester v. Bagnato, 292 Pa.Super. 322, 437 A.2d 66 (1981).

Beerly v. Dept of Treasury

768 F.2d 942 (1985)

Gustav E. BEERLY, Trustee of the Gustav E. Beerly Trust, Plaintiff-Appellant, v. DEPARTMENT OF the TREASURY, et al., Defendants-Appellees.

No. 84-1763.

United States Court of Appeals, Seventh Circuit.

Argued April 12, 1985.
Decided July 29, 1985.
Rehearing Denied August 30, 1985.

James E. McParland, Morgan, Lanoff, Denniston & Madigan, Chicago, Ill., for plaintiff-appellant.

Frank C. Bonaventure, Jr., Washington, D.C., for defendants-appellees.

Before CUMMINGS, Chief Judge, POSNER, Circuit Judge, and PECK, Senior Circuit Judge.[1]

POSNER, Circuit Judge.

This appeal requires us to examine the meaning and constitutionality of the little-known statutory provisions for appraisal by the Comptroller of the Currency of shares owned by shareholders dissenting from (1) mergers, consolidations, or conversions of national banks into state banks, 12 U.S.C. § 214a; (2) consolidations of national or state banks under the charter of a national bank, 12 U.S.C. § 215; or (3) mergers of national or state banks into a national bank, 12 U.S.C. § 215a—all transactions that require the Comptroller's approval. The provisions for appraisal go back to 1918, yet, surprisingly in this litigious age, in only one reported case has an appraisal under any of them been challenged. See *Simonds v. Guaranty Bank & Trust Co.,* 492 F.Supp. 1079 (D.Mass.1979).

In the case of a type (3) transaction, the type involved in this case, a dissenting shareholder who gives the proper notice (as was done here) is entitled to receive the "value" of his shares. 12 U.S.C. § 215a(b). Value is determined by a committee of three appraisers of which the dissenters select one, the bank resulting from the merger another, and the two party-designated appraisers the third. 12 U.S.C. § 215a(c). If any dissenter is dissatisfied with the appraisers' valuation of his shares, or if for some reason one of the appraisers is not appointed, or if the appraisers fail to make an appraisal, then the Comptroller shall on request "cause an appraisal [or reappraisal, if the dissenter was dissatisfied with the appraisers' appraisal] to be made which shall be final and binding" on all parties. 12 U.S.C. §§ 215a(c), (d). Similar provisions are applicable to transactions of types (1) and (2). See 12 U.S.C. §§ 214a(b), 215(c), (d).

[1] Hon. John W. Peck of the Sixth Circuit, sitting by designation.

The Mid-City National Bank of Chicago was merged into Mid-City Bank, N.A., which immediately became a subsidiary of Mid-Citco, a newly formed bank holding company. All three entities are under common ownership, the purpose of the chain of transactions being simply to enable Mid-City National Bank to operate in the bank holding company form. However, the first step—the merger of Mid-City National Bank into Mid-City Bank, N.A., a so-called "interim bank," see 12 C.F.R. § 5.21(a)—required the Comptroller's approval under 12 U.S.C. § 215a. Beerly, trustee of 2,061 shares, dissented from the merger. When the party-designated appraisers were unable to agree on a neutral appraiser, Beerly, pursuant to 12 U.S.C. § 215a(d), requested the Comptroller to do the appraising, who after considering written submissions from the parties fixed a value of $282.39 per share for Beerly's stock. Beerly thought the appraisal too low, sued the Comptroller under 28 U.S.C. § 1331, lost in the district court, and appeals to us. The record is silent on the current price of Mid-City's stock.

Even though section 215a(d) states that the Comptroller's appraisal is "final and binding" on all parties, and no procedure for judicial review of an appraisal is specified, it has not been suggested that Congress wanted to insulate the Comptroller's appraisal from judicial review. We cannot rest on the parties' concession of subject-matter jurisdiction, but our independent analysis leads us to the same conclusion. The presumption that final administrative action substantially affecting personal and property rights is judicially reviewable is a powerful one, see, e.g., *Abbott Laboratories v. Gardner,* 387 U.S. 136, 140-41, 87 S.Ct. 1507, 1510-11, 18 L.Ed.2d 681 (1967), and we can find nothing in the history or setting of the appraisal provisions to overcome it. The valuation of dissenters' shares is a traditional judicial function, see *Simonds v. Guaranty Bank & Trust Co., supra,* 492 F.Supp. at 1081-82, and, when performed by an administrative agency rather than a court, invites judicial review. It is not a managerial or political judgment, the kind of judgment that a court cannot usefully review because it lacks the proper analytic tools. The statutory words "final and binding" have no necessary reference to judicial review; they may just mean that the Comptroller's appraisal is the last appraisal.

When no statute prescribes the procedure for judicial review of a particular administrative action, review is in the district court under 28 U.S.C. § 1331, the general federal-question jurisdictional statute, see Administrative Procedure Act, § 10(b), 5 U.S.C. § 703; *General Finance Corp. v. FTC,* 700 F.2d 366, 371 (7th Cir.1983), with a right of appeal to the court of appeals. That was the route followed here.

Our review of the district court's decision is plenary, *Stop H-3 Ass'n v. Dole,* 740 F.2d 1442, 1450 (9th Cir.1984), since that court and this court have the identical information on which to base review of the challenged administrative action, namely the written record compiled in the administrative proceedings. So it is as if we were reviewing the Comptroller directly; and the parties agree as they must that the scope of judicial review of the Comptroller's decision is for the usual reasons narrow, deferential. See *E.I. DuPont de Nemours & Co. v. Collins,* 432 U.S. 46, 56-57, 97 S.Ct. 2229, 2235, 53 L.Ed.2d 100 (1977); *City Federal Savings & Loan Ass'n v. Federal Home Loan Bank Bd.,* 600 F.2d 681, 688 (7th Cir.1979). Thus the issue for us is not whether the Comptroller's decision was correct but whether it was reasonable—not "arbitrary, capricious, [or] an abuse of discretion," 5 U.S.C. § 706(2)(A); cf. *Camp v. Pitts,* 411 U.S. 138, 141-42, 93 S.Ct. 1241, 1243-44, 36 L.Ed.2d 106 (1973).

There are many ways to value a share of stock. The Comptroller considered four: book value, adjusted book value, market value, and investment value.

1. Book value is the difference between the firm's assets and liabilities as valued on its books of account, divided by the number of shares. For Mid-City this comes out to $600.10. But the Comptroller gave book value zero weight in his appraisal.

2. Adjusted book value is book value multiplied by the ratio of the market prices of comparable institutions to their book values. The "peer group" used by the Comptroller to determine the adjusted book value of Mid-City stock consisted of other middle-sized Chicago banks. Their stock was selling at an average of 46 percent of book value. Multiplying this by Mid-City's book value per share produced the figure $294.05; this was the stock's adjusted book value.

3. The meaning of market value is self-evident; but because Mid-City's stock had been very thinly traded (only one-quarter of one percent of its stock had been traded in any recent year), the Comptroller decided to give zero weight to this valuation too. The stock's market value was about $160.

4. Finally, the Comptroller computed an "investment value" for Mid-City by multiplying its most recent annual earnings per share by the price-earnings multiple—which was 6—of Mid-City's peer group; and this produced a figure of $270.72. The Comptroller averaged the two figures he had calculated — the adjusted book value and the investment value—and this yielded his appraisal of $282.39 for each of Beerly's shares.

The methodology of appraisal used by the Comptroller resembles that used in appraising dissenting shareholders' rights under state corporation laws. See, e.g., Fischel, *The Appraisal Remedy in Corporate Law,* 1983 Am.Bar Foundation Research J. 875, 889-96; Note, *The Valuation of a Close Corporation: Glimpses of Objectivity in an Inflationary Period,* 13 Loyola U.L.J. 107, 114-25 (1981); Note, *Valuation of Dissenters' Stock Under Appraisal Statutes,* 79 Harv.L.Rev. 1453, 1456-71 (1966). Although this methodology has frequently been criticized (as in the articles just cited), the fact that the Comptroller was following a conventional approach goes far to shield his results from judicial invalidation. It is not for a reviewing court to tell an administrative agency to defy the conventional wisdom, to innovate, to be daring. And one of the principal criticisms of the conventional methodology of appraisal—that market value is a better index of value than any valuation formula—is, as we shall see, inapplicable to this case. The criticisms of the Comptroller's appraisal that Judge Keeton made in the *Simonds* case, *supra,* 492 F.Supp. at 1084, are also inapplicable.

The purpose of an appraisal is to give the owner of the property being appraised the cash equivalent of what he has given up by relinquishing his ownership. In the case of stock what he gives up is the opportunity to sell the stock or to keep it and obtain an income from it. Ordinarily the best estimate of what an opportunity to sell is worth is found in recent sales of the same thing, which would mean, recent sales of stock in Mid-City National Bank. See, e.g., *Metlyn Realty Corp. v. Esmark, Inc.,*763 F.2d 826, 835-36 (7th Cir.1985). If the Comptroller had used this method of estimation, it would have turned out very badly for

Beerly, because the market value of the stock in the relevant period was only about $160 a share.

It is true that when stock is traded infrequently, past sales may not be a reliable guide to current value, because they impound valuations by only a few buyers and sellers, and because circumstances may have changed since those sales took place. (The other side of the coin is that if a stock has a "thick" market, not only is market value the only rational measure of value, but appraisal rights are unnecessary since the dissenting shareholder can fully protect his interests by selling his shares. On this ground, Delaware does not recognize appraisal rights in such settings. See Del.Gen.Corp.Law § 262(b)(1) (1984).) But the fact remains that if Beerly had wanted to cash in his stock he would have had to take his chances in a market in which the demand was weak. Indeed, since he owned 4 percent of the stock of the company—16 times as much stock as had been sold in any recent year—he might not have been able to unload all of his stock at $160 a share.

And it is necessary to distinguish between a "squeeze-out" and a change merely in the form of the shareholder's rights. When a stock is thinly traded, so that its market value is not a reliable index of its true value, controlling shareholders may be tempted at a time when the market valuation is unreasonably low to force minority shareholders to give up their shares in exchange for the market value of the shares, which by hypothesis is less than their true value. But Beerly was not squeezed out; he was offered what appears to have been equivalent shares in the reorganized firm; he left voluntarily. The Comptroller was generous in giving no weight at all to the (low) market value of Beerly's stock.

Book value is a virtually meaningless index of what a share of stock is worth to the shareholder, and the Comptroller properly disregarded it. The main component of book value is the original cost of the firm's assets, as depreciated. Wholly apart from the well-known vagaries of depreciation, if a firm's assets are specialized to the firm's business they may have very little sale value. Their only value may be to generate the firm's earnings. But then it is clear that the value of the firm is some multiple of its earnings, and not some function of the original cost of its assets. Evidently the book value of middle-sized Chicago banks in the relevant period was greater than their market value, for the stock of Mid-City's "peer group" was trading in the market at an average of only 46 percent of book value per share. Such discounts are common, as any owner of railroad stock knows.

It is true that Beerly presented evidence that some middle-sized Chicago banks had been bought for more than their book value. But there is a big difference between the value of a minority shareholder's interest and the value of a controlling interest, which is what is at stake when the whole firm is acquired and not just some shares of its stock. Someone who thinks he can run a firm better than its present owners—that is, thinks he can get more value out of the firm's assets than they can—naturally will be willing to pay more (if he must!) for a controlling interest than the current market value of the firm's stock; that stock is worth more to him. But the qualification is vital; the stock is worth more to him only if he has control of the firm, so that he can run it; and for control he needs more than 4 percent. Of course the analysis would be more complicated if a buyer were not allowed to pay a premium for a controlling block of stock—if he had to pay all shareholders the same price for their shares. But federal law contains no such requirement, which would make transfers of corporate control more costly and therefore reduce the effectiveness of the market for

corporate control in disciplining managers and in moving corporate resources into the hands of those who can get the most value out of them. See Easterbrook & Fischel, *Corporate Control Transactions,* 91 Yale L.J. 698 (1982). All shareholders may be better off, ex ante, with a rule that facilitates takeovers, even though, ex post, some may get lower prices for their shares if a takeover occurs.

The two measures of value that the Comptroller used are more consonant with economic reality than book value is and more favorable to Beerly than market value. The Comptroller's "adjusted book value" was essentially a measure of the market value of a portfolio of comparable banks, and thus corrected for the thinness of the market in Mid-City's own stock. The Comptroller's "investment value" assumed quite sensibly that the value of bank stock is as an income-producing asset and is therefore a function of the bank's income. The precise form of that function depends on investors' estimates of the riskiness of the bank's stock and the prospects for the bank's future earnings; and while it is possible that Mid-City is less risky than its peers or has brighter prospects, the Comptroller was entitled to assume, in the absence of more direct evidence of Mid-City's prospects, that investors were unlikely to consider it a more valuable asset, per dollar of earnings, than a portfolio of stocks of similar banks.

The two measures the Comptroller used are closely related. In effect he made two adjustments to the average market value of the stock of the peer firms to derive the market value of Beerly's shares in Mid-City: He multiplied it first by the ratio of Mid-City's book value to the peer group's average book value and then by the ratio of Mid-City's earnings to the peer group's average earnings, and then he took the average of these two products. He assumed, in other words, that Mid-City's stock would be worth more, relative to the market value of comparable banks' stock, the more its book value exceeded the average book value of the comparable banks and the more its earnings exceeded their earnings. This is a defensible procedure (ratios of book values may be a little more meaningful than absolute book values), and on the whole one generous to Beerly.

The Comptroller gave no weight to the appraisal made by Beerly's own appraiser, in the aborted private appraisal that preceded the Comptroller's intervention: $743.77. But, contrary to Beerly's suggestion, the Comptroller was not required to average that appraisal with his own in coming up with a valuation for Beerly's shares. If the parties had agreed on a neutral appraiser, he would not have averaged his own estimate with those of the party-designated appraisers. People estimate value differently, and there is no difficulty in finding an expert from the upper tail of the distribution. *Metlyn Realty Corp. v. Esmark, Inc., supra,* 763 F.2d at 836. The search for extremes in valuation should not be encouraged by requiring that the highest appraisal be averaged in with the others.

The most questionable feature of the Comptroller's valuation (apart from his giving no weight to the bank's market value—an omission that favored Beerly, however) was the refusal to count any part of the bank's reserve for bad loans as an asset, rather than a liability. The reserve, $2 million, had remained unchanged for many years during which the bank wrote off an average of only $10,000 a year in bad loans. The recent and well-publicized difficulties of large Chicago banks, together with the uncertainties that have been created by the deregulation (though as yet partial) of banking, seem to confirm the prudence of the Comptroller's conservative approach to bank reserves—and in any event

we can think of few areas less suitable for judicial second-guessing than the Comptroller's determination of how large a reserve is suitable for a bank of Mid-City's size and condition. But the point is not whether the Comptroller acted reasonably in requiring a large reserve for bad loans; it is whether investors would have considered the reserve excessive, for if so they would have treated the excess as an asset rather than a liability in valuing the firm. However, an adjustment to take account of this possibility would not have altered the appraisal significantly. The reserve was equal to only 7 percent of the bank's book value. Suppose it was twice as large as investors would have thought proper. The effect on adjusted book value (equal to 46 percent of book value) would be to increase that value by only 1.6 percent (46 percent of 3.5 percent is 1.6 percent); and since adjusted book value was given a weight of one-half in valuing Beerly's stock, the result would be a less than 1 percent (0.8 percent, to be precise) increase in the value of his stock. If there was an error in the treatment of the reserve for bad loans—and that is uncertain—it was trifling.

We do not understand Beerly's complaint that the bank paid lower dividends than comparable banks. That would just go to increase the bank's capital, and hence book value, and hence the valuation of Beerly's shares.

Beerly argues that the statutory procedure for appraisal by the Comptroller violates the Fifth Amendment's due process clause because it does not provide for an evidentiary hearing. Although the due process clause comes into play only when there is a deprivation of life, liberty, or property, there was a deprivation of property here. Granted, the merger itself did not deprive Beerly of his stock. He was not squeezed out; he opted out; he could have exchanged his stock for shares in the interim bank. But the new shares would not have been the exact equivalent of the old; at common law he could have vetoed the transaction, *Chicago Corp. v. Munds,* 20 Del.Ch. 142, 149, 172 A. 452, 455 (1934); a forced exchange is still a deprivation. A less metaphysical point is that once Beerly chose appraisal, as the statute entitled him to do, he was stuck with the result of that appraisal; and if the Comptroller violated due process of law in conducting the appraisal, and as a consequence valued Beerly's stock at less than the minimum reasonable estimate of its true value, the Comptroller could be said to have deprived him of property without due process of law. It is true that we have found the valuation reasonable, but this conclusion is based on the record compiled by the Comptroller; if that record is tainted by his failure to accord Beerly a hearing, our conclusion is undermined. So we must determine whether the procedure denied Beerly due process.

The process that is due depends on the nature of the inquiry. Since time out of mind, appraisal by informal procedures not involving oral hearings has been used to value property, including property as valuable as Beerly thought his stock was. Generally, appraisers are not arbitrators; they do not weigh in a trial setting conflicting opinions of value that have been subjected to cross-examination; they make their own evaluation. See *Hayes v. Allstate Ins. Co.,* 722 F.2d 1332, 1340 (7th Cir.1983) (dissenting opinion) (citing cases). The procedure for valuing dissenting shareholders' rights under state law is various. See 12B Fletcher Cyclopedia of the Law of Private Corporations § 5906.8 (Van Swearingen rev. ed. 1984). In some states the court does the appraising; in others appraisers are appointed and use their own judgment in valuing the shares; in still others the appraisers take evidence before making their valuation. In none so far as we know is an oral evidentiary hearing with cross-examination either required or customary.

The procedure used by the Comptroller in this case was as formal as any used in cases of this general nature and more formal than many.

Thus if the appraisers designated by the parties had been able to agree on a neutral appraiser, and the committee of appraisers had then set about to appraise Beerly's stock, in all likelihood it would not have done so with an oral hearing or any of the other traditional accouterments of formal procedure. We need not decide, however, whether the Comptroller could, consistently with due process, have proceeded as informally as private appraisers. He weighed the written submissions by Beerly and the bank and having done so made his appraisal in a reasoned opinion that considered all of Beerly's evidence and argument. The only thing missing was oral testimony and the opportunity for cross-examination. Beerly has not shown how the use of these expensive and time-consuming procedures would have reduced an otherwise high probability of a serious error in the appraisal. The procedure was therefore constitutionally adequate. See, e.g., *Mathews v. Eldridge,* 424 U.S. 319, 335, 96 S.Ct. 893, 903, 47 L.Ed.2d 18 (1976); cf. *Richardson v. Perales,* 402 U.S. 389, 402, 91 S.Ct. 1420, 1427, 28 L.Ed.2d 842 (1971); *Chicago & North Western Transport Co. v. United States,* 678 F.2d 665, 671 (7th Cir.1982).

Beerly's final complaint is that the statute makes no provision for the payment of interest. The merger took place in February 1982, and that fixed the date for valuing Beerly's shares. The Comptroller made his valuation in June 1983, about 15 months later. Assuming purely for illustrative purposes that the market rate of interest on such an investment was 9 percent, Beerly lost $65,000 as a result of the delay between the merger and the valuation. The delay was not unreasonable, but the consequences for Beerly's wealth position were significant and, he argues, unreasonably deprived him of property. But we shall not consider the merits of the argument. It appeared for the first time in Beerly's reply brief. That was too late. *Christmas v. Sanders,* 759 F.2d 1284, 1291-92 (7th Cir.1985).

AFFIRMED.

54 T.C.M. 1123 (1987)
T.C. Memo. 1987-576

Estate of Norman L. Bell, Deceased, Shirley Bell, Independent Executrix
v.
Commissioner.

Docket No. 12692-85.

United States Tax Court.

Filed November 23, 1987.

1124 *1124 Donald D. DeGrasse, for the petitioner. Thomas G. **Norman** and David E. Whitcomb, for the respondent.

Memorandum Findings of Fact and Opinion

WILLIAMS, Judge:

The Commissioner determined a deficiency in petitioner's Federal **estate** tax in the amount of $1,194,949.31. The issue we must decide is the value for Federal **estate** tax purposes of shares of stock in a closely-held corporation. Our decision has turned on how poorly petitioner and respondent have carried their respective burdens of proof.

Respondent's determination of a deficiency in **estate** tax is presumptively correct. Thus, petitioner has the burden of proving that respondent's valuation of **Bell** Oil stock is erroneous. *Welch v. Helvering* [3 USTC ¶ 1164], 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure. Respondent, on the other hand, must prove the correctness of his increased deficiency claimed in his amended answer. Rule 142(a), Tax Court Rules of Practice and Procedure. Based on the record before us, we conclude that neither petitioner nor respondent has satisfied the burden of proof.

Some of the facts have been stipulated and are so found. **Norman L**. **Bell** died on July 12, 1981 a resident of Jefferson County, Texas. Shirley **Bell** McBride was appointed as executrix.

At the time of his death, decedent owned 16,825 shares of stock in **Bell** Oil of Texas, Inc. (hereinafter "**Bell**-Tex"), and 4,510 shares of stock in **Bell** Oil of Louisiana, Inc. (hereinafter "**Bell**-La"). No other shares of either company were outstanding. The decedent was survived by a wife and left a community **estate**. The shares of stock in the **Bell** Oil corporations were, however, decedent's separate property.

During 1981, the **Bell** Oil companies owned and operated 21 **Bell's** convenience stores, including several hardware stores, in eastern Texas and western Louisiana. Some of the stores operated "washaterias," and each of the stores retailed gasoline and oil.

Petitioner filed a Federal **estate** tax return on April 13, 1982. As reflected on Schedule B of the **estate** tax return, the 16,825 shares in **Bell**-Tex were valued at $452,592.50; the 4,510 shares in **Bell**-La were valued at $470,167.50. Petitioner's valuation was based on multiplying earnings by assuming a price/earnings ratio of 5:1. Petitioner did not offer evidence to support its use of this price-earnings multiple to value the stock or any discount for lack of marketability of the stock. While it is generally recognized that the value of stock in closely-held corporations is subject to a discount for lack of marketability, petitioner must establish (1) the value to be discounted and (2) the amount of the discount. See, e.g., *Ward v. Commissioner* [Dec. 43,178], 87 **T.C.** 78 (1986); ***Estate** of Andrews v. Commissioner* [Dec. 39,523], 79 **T.C.** 938, 953 (1982). Both points are a matter of proof.

The only evidence offered by petitioner to substantiate its valuation of **Bell**-Tex and **Bell**-La was the testimony of Shirley **Bell** Marshall, the daughter of decedent. While she was a credible witness, the scope of her testimony was limited. The principal subject of her testimony was the effect on operations of the death of **Norman L**. **Bell**, founder and key employee. The loss of

decedent's services decreased the value of the companies, and a knowledgeable individual who could assume supervisory responsibility over all operations had to be found and hired. Mrs. Marshall also testified that a significant number of improvements had to be made to the stores. While the improvements prevented deterioration of the stores, petitioner failed to prove that the stores were dilapidated or in serious need of restoration. Further, this testimony lacked a starting point for valuation. Although we accept this testimony, petitioner's valuation of **Bell**-Tex at $452,592.50 and of **Bell**-La at $470,167.50 was asserted summarily and was not supported by the detail necessary to carry the burden of proof.

Respondent valued the decedent's interest in **Bell**-Tex at $1,000,000.00 and in **Bell**-La at $900,000.00. Respondent amended his answer to claim the value of **Bell**-Tex was $2,100,000.00 and of **Bell**-La was $1,136,000.00, based on a seven volume appraisal report by James T. Johnson. Johnson was called as an expert witness to testify concerning his appraisal of the closely-held **Bell** Oil corporations.

In his seven volume appraisal of **Bell** Oil, Johnson utilized four methods of valuation: (1) the capitalization of the income stream method, (2) the excess earnings method, (3) the tangible net worth method, and (4) a ratio of "value of stock to sales," a ratio concocted by Johnson that was little more than speculation masquerading as empirical analysis.

A primary basis for Johnson's analysis was industry data appearing in an article by John F. Rosco, "The Annual Dollars Per Day Survey of the Small Food Store Industry." From this publication, the expert developed capitalization rates and industry ratios which he used in appraising petitioner's corporations.[1] No testimony or evidence supported the authority of the information in
1125 the Rosco article. Indeed, another article identified by petitioner reported *1125 different financial information for the same companies for the same periods. The subjects of the articles were all publicly traded companies, but no one compared this conflicting information with annual reports filed with the Securities and Exchange Commission. Moreover, no relationship was shown to exist between the performances of these companies and either **Bell**-Tex or **Bell**-La. The expert did not know the differences or similarities between these companies and the **Bell** Oil companies and thus did not analyze any differences or similarities in his valuation report. This lack of careful analysis undermines our confidence in Johnson's report and in the accuracy of the fundamental information supporting the expert's conclusions.

Johnson's method for choosing a capitalization rate in both the capitalization of income stream method and the excess earnings method was arbitrary. After listing the range and mean average of ratios found in the article of doubtful authority, Johnson chose his capitalization rate of 11 percent for the capitalization of the income stream method without any explanation. In determining the capitalization rate for the excess earnings method, Johnson applied different rates of return to income assumed to be earned by three categories of assets and long-term debt[2] on the balance sheet of each corporation: (1) 12 percent for working capital, (2) 12 percent for equipment and improvements, (3) 10 percent for land, and (4) 13 percent for long-term debt. He assumed, moreover, that an investor would desire a 26 percent rate of return on "good will." He chose these rates of return without explaining how he arrived at these rates or why the rates vary.

The mean average of U.S. Treasury bonds and notes at the time was 12.33 percent according to the expert. This represents the rate of return an investor would expect on risk-free, intermediate and long-term investments generating taxable income. The expert gave no explanation for why the rates applied in his excess earnings method were lower than the U.S. Treasury bond and note rates despite the comparatively higher risk that investment in **Bell** companies' stock presented. The expert's arbitrary choice of rates of return was neither accurate nor realistic.

The inherent flaws in Johnson's methodology are emphasized by the way in which the expert arrived at his bottom line valuation under the excess earnings method. For some unexplained reason the expert added the value of excess earnings, determined using unrealistic rates of return, to the value of the **Bell** Oil companies as determined under the expert's tangible net worth method. The expert gave no rationale for this adjustment. It would appear that this method, as employed by Johnson, results in determining a premium or penalty adjustment to tangible net worth and is not an independent valuation method. If so, no premium exists for either company and a significant penalty should be applied. It is apparent from the actual earnings of **Bell**-Tex and **Bell**-La that the corporations were earning a return on their assets that fell well below market yield. Consequently, we believe that there were no "excess" earnings.

Furthermore, the rates of return applied by Johnson in the excess earnings method bore no relationship to the capitalization

rate Johnson used in the capitalization of income stream method. We believe his choice of varying rates 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. Johnson made little effort to identify comparable investments.

In the tangible net worth method the appraiser valued each asset as if sold individually. While this valuation approach is of interest we do not find it persuasive of the value of the stock in an ongoing, closely held business.

In figuring the ratio of value to sales, Johnson, relying on the industry data found in "The Annual Dollars Per Day Survey of the Small Food Store Industry," divided the gross sales by total stock value of each convenience food store company listed in the article. This produced a list of ratios found on Table III and IV of the expert's summary report from which Johnson somehow derived a multiplier of .20 which he applied to the gross sales of each **Bell** Oil company. This produced a value of $2,100,000.00 for **Bell**-Tex and $760,000.00 for **Bell**-La.[3] Johnson admitted that he "eyeballed" a list of gross sales/stock ratios found in his report to arrive at his multiplier of 20 percent which he applied to the gross sales of each **Bell** Oil company. Not only was this unique method based on arbitrary choice (which Johnson could not articulately defend), the method itself was not reasoned.

Analyzing the results of the valuation methods used, Johnson concluded that the value of the Texas company was
1126 $2,100,000.00 and the *1126 value of the Louisiana company was $1,136,000.00.

Aside from arbitrary and result-oriented analysis, Johnson's report had many errors. During the trial the Court found that a whole column of numbers was misplaced in the report and wrongly used by the expert. The stores owned by **Bell** Oil companies had to be reconsidered during the trial to determine the correct number of them. The Court also had to refigure the breakdown of gas sales and food sales for the **Bell** Oil corporations because of the expert's inaccuracy. Much time was used to correct the mistakes in the report. Consequently, we have no confidence in Johnson's report. We conclude, therefore, respondent has failed to carry his burden of proving the increased deficiency in the amendment to his answer.

Accordingly and because of concessions, we hold that respondent's original determination of deficiency must stand. The appropriate value to be applied to the **Bell** Oil company stock is $1,000,000.00 for the Texas company and $900,000.00 for the Louisiana company.

Decision will be entered for the deficiency originally determined.

[1] There are some mathematical errors in the expert's report on the tables labeled "Data on Convenience Food Stores." The expert developed some of his figures based on these errors.

[2] Johnson never explained how long-term debt of the corporation could earn any return. We assume that he meant a return on the proceeds of the debt. Nevertheless, Johnson failed to identify how the proceeds were invested and failed to explain the difference between the return on the use of the debt proceeds and the return on the assets he chose to categorize into three groups.

[3] Noting the expert's apparent arbitrary methods and some of the errors made by him in calculating the ratio of value to sales, the Court, while not giving any credence to the ratio, recalculated the multiplier used during trial. Applying this new multiplier (.16) to the **Bell** Oil companies, Johnson concluded that **Bell**-Tex should be valued at $1,680,000.00 and **Bell**-La should be valued at $608,000.00.

COMMONWEALTH OF MASSACHUSETTS
THE TRIAL COURT
PROBATE AND FAMILY COURT DEPARTMENT

DUKES, ss. DOCKET NO.: 00D-0037-DV1

JUDITH E. BERNIER, Plaintiff,
Defendant in Counterclaim

v.

STEPHEN A. BERNIER, Defendant,
Plaintiff in Counterclaim

SUPPLEMENTAL JUDGMENT

This matter came before the Court (Kaplan J.) for trial and the issues having been duly heard, and a Judgment of Divorce Nisi having been entered on February 27, 2002, granting a divorce to the parties on the grounds of irretrievable breakdown of the marriage pursuant to G.L. c. 208, § 1B and bifurcating all remaining issues for trial. In consideration of the Findings of Fact and Conclusions of Law entered herewith, it is hereby ORDERED AND ADJUDGED as follows:

PROPERTY DIVISION

1. The Husband shall have the exclusive right of election ("option") to buy out Wife's fifty percent (50%) interest in Bernier's Market, Inc. and Bernier's Up Island Market, Inc. (hereinafter "the Markets") for the sum of $3,925,000, which represents one half of the total value of $7,850,000. The Husband shall have sixty (60) days to notify the Wife in writing, with copies to counsel, of his intent to buy out her interest under the terms of this Judgment.

2. In the event that the Husband elects to buy out the Wife's fifty percent (50%) interest, the Husband shall pay the Wife a lump sum down payment of $1,000,000 within six months from the date of his notice of election. Thereafter, the Husband shall pay the balance due to the Wife, of $2,925,000 in equal installments of $585,000 over a five year period, beginning on January 1, 2005 and on January 1st of each year thereafter until January 1, 2009. The Husband shall also pay interest to the Wife on the balance of $2,925,000, at six percent (6%) simple interest calculated annually. All

interest shall be due at the payment of the last installment.

3. The balance of funds due to the Wife shall be secured by a combination of mortgages on the underlying real estate of the Markets and by perfecting a security interest in the stock of the Markets. The Husband shall cause a legend to be created on the Markets' stock certificates reflecting said interest. The legends shall be deleted in pro rata proportion to the balance then due to the Wife after each annual payment over the five year period. The shares in which a security interest is perfected shall be held in escrow by the Husband's attorney, with copies sent to the Wife's attorney. Additionally the Husband shall grant to the Wife a blanket mortgage on all of the commercial real estate transferred to him pursuant to Paragraphs 4, 5, and 7, except that he shall be able to borrow against said real estate to pay the lump sum payment of $1,000,000 to the Wife. The amount of the mortgage shall be decreased in pro rata proportion to the balance then due to the Wife after each annual payment over the five year period.

4. Within 30 days of the Husband's exercise of his option to buy out the Wife's interest in the Markets, the Wife shall transfer to the Husband her fifty (50%) percent beneficial interest in and to the Bernier Realty Trust, which holds title to the real estate located at 357-369 State Road, Vineyard Haven, MA. The Husband shall be the sole beneficiary of said trust, and the Wife shall have no further rights to such trust property. The Husband shall be exclusively responsible for any and all costs associated with the aforementioned properties, including without limitation the mortgage (principal and interest), taxes, insurance, utilities and repairs. The Husband shall indemnify and hold the Wife harmless from any such expenses.

5. Within 30 days of the Husband's exercise of his option to buy out the Wife's interest in the Markets, the Wife shall forthwith transfer to the Husband all of her right, title and interest in the real estate located at 469 and 479 State Road, West Tisbury, MA. The Husband shall be exclusively responsible for any and all costs associated with his ownership of the aforementioned properties, including without limitation mortgage (principal and interest), taxes, insurance, utilities and repairs. The Husband shall indemnify and hold harmless the Wife from any such expenses.

6. Within 30 days of the Husband's exercise of his option to buy out the Wife's interest in the Markets the Wife shall forthwith transfer to the Husband all of the shares of stock standing in her name in Bernier's Market, Inc. (doing business as Cronig's State Road Market and known as the Down Island Market) and to Bernier's Up Island Market, Inc. (doing business as Cronig's Up Island Market, know as the Up Island Market). From and after the date of the transfer the Husband shall be the sole shareholder in each corporation, and the Wife shall have

no further rights of stock ownership.

7. Within 30 days of the Husband's exercise of his option to buy out the Wife's interest in the Markets the Wife shall forthwith transfer to the Husband all of the shares of stock standing in her name in the Colonial Drive Real Estate Corporation, and shall convey all of her right, title and interest in and to the real estate located at 31 Colonial Drive, Vineyard Haven, MA (title to which is held in the name of Colonial Drive Real Estate Corporation). The Husband shall be exclusively responsible for any and all costs associated with his ownership of the aforementioned properties, including without limitation mortgage (principal and interest), taxes, insurance, utilities and repairs. The Husband shall indemnify and hold harmless the Wife from any such expense.

8. The Husband shall be solely responsible for the preparation of all documents necessary to effectuate the transfers of stock and real estate, and for securing his monetary obligations under this judgment.

9. If the Husband elects not to exercise this option at the expiration of sixty (60) days from the date of this Judgment, then the Wife shall have the next right of election ("option") to buy the Husband's interest in the Markets under the same terms and conditions. She shall have sixty (60) days, from the date that the Husband has advised her in writing of his intention not to exercise his option to purchase, to notify the Husband in writing, with copies to counsel, of her intent to buy out his interest, for the sum set forth in Paragraph 1, above. Upon said notification the Husband shall turn over control of the Markets to the Wife within 60 days.

10. In the event that the Wife elects to buy out the Husband's fifty percent (50%) interest, the Wife shall pay the Husband a lump sum down payment of $1,000,000 within six months from the date of her notice of election. Thereafter, the Wife shall pay the balance due to the Husband, of $2,925,000 in equal installments of $585,000, over a five year period, beginning on January 1, 2005 and on January 1st of each year thereafter until January 1, 2009. The Wife shall also pay interest to the Husband on the balance of $2,925,000, at six percent (6%) simple interest calculated annually. All interest shall be made on or before the first of each month, beginning the month after the Wife makes her election to purchase the Markets.

(11) 10. The balance of funds due to the Husband shall be secured by a combination of mortgages on the underlying real estate of the Markets and by perfecting a security interest in the stock of the Markets. The Wife shall cause a legend to be created on the Market's stock certificates reflecting said interest. The legends shall be deleted in pro rata proportion to the balance then due to the Husband after each annual payment over the five year period. The shares in which a security interest

is perfected shall be held in escrow by the Wife's attorney, with copies sent to the Husband's attorney. Additionally the Wife shall grant to the Husband a blanket mortgage on all of the commercial real estate transferred to her pursuant to Paragraphs 11, 12, and 14, except that she shall be able to borrow up to $1,000,000 to make the lump sum payment to the Husband. The amount of the mortgage shall be decreased in pro rata proportion to the balance then due to the Husband after each annual payment over the five year period.

11. Within 30 days of the Wife's exercise of her option to buy out the Husband's interest in the Markets, the Husband shall transfer to the Wife his fifty (50%) percent beneficial interest in and to the Bernier Realty Trust, which holds title to the real estate located at 357-369 State Road, Vineyard Haven, MA. He shall also resign as trustee and the Wife shall be appointed as successor trustee. The Wife shall be the sole beneficiary of said trust, and the Husband shall have no further rights to such trust property. The Wife shall be exclusively responsible for any and all costs associated with the aforementioned properties, including without limitation the mortgage (principal and interest), taxes, insurance, utilities and repairs. The Wife shall indemnify and hold the Husband harmless from any such expenses.

12. Within 30 days of the Wife's exercise of her option to buy out Husband's interest in the Markets, the Husband shall forthwith transfer to the Wife all of his right, title and interest in the real estate located at 469 and 479 State Road, West Tisbury, MA. From and after the date of such transfer, the Wife shall be exclusively responsible for any and all costs associated with his ownership of the aforementioned properties, including without limitation mortgage (principal and interest), taxes, insurance and utilities and the like. The Wife shall indemnify and hold harmless the Husband from any such expenses.

13. Within 30 days of the Wife's exercise of her option to buy out the Husband's interest in the Markets, the Husband shall forthwith transfer to the Wife all of the shares of stock standing in his name in Bernier's Up Island Market, Inc. and Bernier's Market, Inc. From and after the date of the within Judgment the Wife shall be the sole shareholder in said corporation, and the Husband shall have no further rights of stock ownership.

14. Within 30 days of the Wife's exercise of her option to buy out the Husband's interest in the Markets the Husband shall forthwith transfer to the Wife all of the shares of stock standing in his name in the Colonial Drive Real Estate Corporation, and shall convey all of his right, title and interest in and to the real estate located at 31 Colonial Drive, Vineyard Haven, MA (title to which is held in the name of Colonial Drive Real Estate Corporation). The Wife shall be exclusively responsible for any and all costs associated with her ownership of the

aforementioned properties, including without limitation mortgage (principal and interest), taxes insurance, utilities and repairs. The Wife shall indemnify and hold harmless the Husband from any such expense.

15. The Wife shall be solely responsible for the preparation of all documents necessary to effectuate the transfers of stock and real estate, and for securing her monetary obligations under this judgment.

16. In the event that neither the Husband or Wife exercises their option to buy the other out of the Markets, then Attorney Malcolm Jones shall be appointed as a Special Master to sell the Markets, and the real estate located at 357-369 State Road, Vineyard Haven; 31 Colonial Drive, Vineyard Haven; 469 State Road, West Tisbury; and 479 State Road, West Tisbury. Immediately upon his appointment the Special Master shall place the Markets and the real estate on the open market for sale to a third party. The net proceeds shall be distributed equally, except for the adjustments set forth in Paragraph 25 (C) below. Each party shall be solely responsible for one half of the capital gains taxes attributed to the sale of both the Markets and the underlying real estate. Upon completion of the sale all related corporate entities and realty trusts shall be dissolved.

FURTHER PROPERTY DIVISION

17. The Wife shall forthwith transfer to the Husband all of her right, title and interest in the marital real estate located as follows:

a) 10 Hammett Road, Chilmark, Dukes County, MA;
b) 602 Royal Palm, St. Maarten, West Indies;
c) Unit B231 & B332, Pelican Resort, St. Maarten, West Indies;

From and after the date of such transfer, the Husband shall be exclusively responsible for any and all costs associated with his ownership of the aforementioned properties, including without limitation mortgage (principal and interest), taxes, insurance and utilities and the like. The Husband shall indemnify and hold harmless the Wife from any such expenses.

18. The Wife shall forthwith execute any deeds necessary to transfer to the Husband all of her right, title and interest in and to the properties awarded to the Husband in paragraph fourteen (¶14) above and shall waive and release any claim of right, title and interest in and to the properties that she may now have or may hereafter acquire as spouse under the present and future laws of any jurisdiction. All documents necessary to effectuate the transfers shall be prepared by the Husband.

19. The Husband shall forthwith transfer to the Wife all of his right, title and interest in the marital real estate located as follows:

    a) 147 Stoney Hill Road, West Tisbury, Dukes County, MA;
    b) 155 Stoney Hill Road (known as Rosewood Farm), West Tisbury, Dukes County, MA;
    c) 181 Stoney Hill Road, West Tisbury, Dukes County, MA;
    d) 141 Stoney Hill Road, West Tisbury, Dukes County, MA;
    e) 17 Dodger's Hole Road, Edgartown, Dukes County, MA;
    f) 7 Sparrow Lane, Edgartown, Dukes County, MA.

    From and after the date of such transfers, the Wife shall be exclusively responsible for any and all costs associated with her ownership of the aforementioned properties, including without limitation mortgage (principal and interest), taxes, insurance, utilities and the like. The Wife shall indemnify and hold harmless the Husband from any such expenses.

20. The Husband shall forthwith execute any deeds necessary to transfer to the Wife all of his right, title and interest in and to the properties awarded to the Wife in paragraph seventeen (¶17) above and shall waive and release any claim of right, title and interest in and to the properties that he may now have or may hereafter acquire as spouse under the present and future laws of any jurisdiction. All documents necessary to effectuate the transfers shall be prepared by the Wife.

21. The Wife shall retain any and all interest she may have in and to the following:

    a) Dukes County Savings Bank
    Checking Account No. 23057014

    b) Dukes County Savings Bank
    Savings Account No. 23089114

    c) Dukes County Savings Bank
    Savings Account No. 02-00-029822
    (Dodger's Hole Rental)

    d) Dukes County Savings Bank
    Savings Account No. 03-31551

    e) Salomon Smith Barney
    Account No. 136-002732

f) First Community Credit Union
Account No. 011-11101425

g) American Funds- IRA
Account No. 61245497-16

h) Salomon Smith Barney
Profit Sharing (Bernier's Market)
Account No. 136-01273-18

i) Motor vehicles standing in the name of the Wife, including without limitation: 1999 Chevrolet Suburban SUV, 1995 Sundowner Horse Trailer, 2000 Ford F350 Pick Up Truck, 2001 Sundowner Tagalong horse trailer.

k) Furniture, jewelry, art, antiques, furnishings, cash on hand, horses and personal property located in or about the Wife's residence and/or property.

20. The Husband shall retain any and all interest he may have in and to the following:

a) Martha's Vineyard Cooperative Bank
Checking Account No. 33365753

b) Salomon Smith Barney
Account No. 136-02731-12
[not subject to division]

c) Salomon Smith Barney- IRA
Account No. 136-60387-17-502

d) Salomon Smith Barney- IRA
Account No. 136-01307-18-502

e) Salomon Smith Barney
Profit Sharing (Bernier's Market)
Account No. 136-01273-18

f) Motor vehicles standing in the Husband's name, including without limitation: 1995 Land Rover, 1995 Chevrolet 1500 Pick Up Truck, 1996 Chevrolet Tahoe, 1997 Ford Box Truck, 2000 Chevrolet Malibu.

g) Furniture, jewelry, furnishings and personal property located in or about the Husband's residence and/or property.

21. The Husband shall forthwith transfer to the Wife his interest in the following joint accounts:

a) Dukes County Savings Bank
Account No. 01-35-577202;

b) Dukes County Savings Bank
Checking Account No. 23135205;

c) Dukes County Savings Bank
Savings Account No. 03-21301;

22. The Wife shall forthwith transfer to the Husband her interest in the following joint accounts:

a) 1784 Funds
Account No. 901-40000904472.

b) Salomon Smith Barney
Account No. 1360130817502

23. The Wife shall forthwith transfer to the Husband her ownership interest in the following life insurance policies: Jefferson Pilot Universal Life Policy Numbers 2122903 and 506047069. The Husband shall retain in his individual name the cash surrender value in the following life insurance policies: Jefferson Pilot Universal Life Policy Numbers 2122904, 2122903, and 506047069.

24. The parties shall take all steps necessary to transfer to one another from joint accounts those accounts assigned to each of them pursuant to the foregoing paragraphs.

25. In order to equalize the real estate asset division and non-real estate asset division, exclusive of the Markets, including credits and debits for legal and expert fees, excess operational expenditures for Rosewood Farm advanced by the Markets, capital improvements to the Wife's home and to the Farm, the following division of assets shall apply:

A. If the Husband exercises his option to buy out the Wife interest in the Markets, then he has received real estate assets valued at $5,412,052 and non real estate assets of $1,320,378.50, totaling $6,732,430.50. The Husband has

listed on his financial statement debts to Cronig's Limited Partnership of $865,233 which the Court finds is a debt of the Markets and not a personal obligation of the Husband. This debt shall be the responsibility of the person who retains ownership of the Markets. Under this scenario the Wife is receiving real estate assets valued at $2,994,568 and non-real estate assets of $1,018,661, totaling $4,013,229. The Wife has debts on her financial statement of $23,269, which the Court finds is marital debt. The Wife is therefore receiving net assets of $3,989,966. An equalization of these assets would result in each party receiving assets valued at $5,361,198, and the Husband would owe the Wife the sum of $1,371,232. From this amount the following credits needs to be taken: 1) the amount of legal and expert fees advanced to the Wife from the Markets during the pendency of this litigation; 2) advances made to the Wife for operational expenses for the Farm, as follows: ii. for 2001 any sums paid in excess of $375,000 and ii. for 2002 and 2003 any sums paid for operational expenses, except for the payments for the mortgage, homeowners insurance and real estate taxes; and 3) one half of improvements made to the Wife's home and the Farm, pursuant to the terms of the temporary order. Once this sum has been calculated if the Husband owes the Wife any monies then those shall be paid in 60 days. If the Wife would owe the Husband money then the amount owed shall be deducted from the $1,000,000 lump sum payment due to the Wife.

B. If the Wife exercises her option to buy out the Husband's interest in the Markets then she has received real estate assets valued at $6,905,650 and non real estate assets of $1,018,661, totaling $7,924,311. The Wife has debts of $23,269 which the Court finds is marital debt. The Wife is therefore receiving net assets of $7,901,042. Under this scenario the Husband is receiving real estate assets valued at $1,591,970 and non-real estate assets of $1,320,378.50, totaling $2,912,348.50. The debt to Cronig's, listed on Husband's financial statement shall become the responsibility of the Wife. An equalization of these assets would result in the Wife paying to the Husband the sum of $2,494,346.50. From this amount the total advanced to the Husband for his legal and expert fees should be deducted. Added to this amount are the following: 1) advances to the Wife for operational expenses for the Farm, as follows: ii. f or 2001 any sums paid in excess of $375,000 and ii. for 2002 and 2003 any sums paid for operational expenses, except for the payments for the mortgage, homeowners insurance and real estate taxes; and 3) one half of improvements made to the Wife's home and the Farm, pursuant to the terms of the temporary order. Once this sum has been calculated the Wife shall pay the Husband the amount owed within one year from the date of this Judgment.

C. If the Markets are sold then each party shall repay the company, within 60 days of their election to sell, all monies each has been advanced for legal and expert fees. From the final distribution of the proceeds from the sale of the Markets and commercial real estate, before the proceeds are equalized the following adjustments shall be made: 1) The Wife shall pay the Husband one half of the cost of the improvements paid for her home and the Farm; 2) The Wife shall pay the Husband for the amount of advances made to her for operational expenses for the Farm, as follows: ii. f or 2001 any sums paid in excess of $375,000 and ii. for 2002 and 2003 any sums paid for operational expenses, except for the payments for the mortgage, homeowners insurance and real estate taxes; and 3) the Wife shall pay to the Husband the sum of $538,808.70 which represents the amount necessary to equalize the property division that each will receive under this scenario (Wife receives assets valued at $3,989,966 and Husband receives assets valued at $2,912,348.50).

26. There shall be no further division of personal property between the parties.

HEALTH INSURANCE

27. The Husband shall continue to maintain health insurance for the Wife, or its reasonable equivalent, so long as she remains eligible at no additional cost to the Husband. If there is an additional cost for the Wife to remain on the Husband's plan, the Husband shall provide written notice to the Wife of the cost and effective date. The Wife may elect to continue such coverage and personally pay the cost for the additional coverage, and must notify the Husband in writing of her election within fourteen (14) days of receipt of notice from the Husband. If the Wife exercises her option to purchase the Markets, the provisions of this paragraph shall require the Wife to maintain health insurance for the Husband, under the same terms and conditions.

28. The Husband and Wife shall each be responsible for their own uninsured medical, dental, mental health and hospital expenses.

LIABILITIES AND TAXES

29. The Husband and the Wife shall each be responsible for his or her own liabilities as set forth on their respective Rule 401 Financial Statements filed on February 27, 2002, excluding legal and expert fees and the debt to Cronig's [*see supra.*]. Each party shall indemnify and hold harmless the other of and from any loss, cost or damage, including attorney's fees incurred by such other as a result of any breach of the obligations of the provisions of this Judgment.

30. The Husband shall be solely responsible for the payment of all corporate taxes for the Markets and the other business entities from the date of separation until the date of this Judgment. In the event that the Markets are sold to a third party then the Husband shall continue to be responsible for the payments of all corporate taxes until the sale. If the Wife exercises her option to purchase the Market s then from the date of her election she shall be solely responsible for the payment of all corporate taxes.

ALIMONY AND LIFE INSURANCE

31. Commencing on the first Friday after the date of the Judgment the Husband shall pay $5,288.46 per week in alimony to Wife, commencing on the first Friday after the date of the Judgment. The Husband's alimony obligation shall terminate at the remarriage of the Wife or the death of the Husband, or when he exercises his option not to purchase the Markets, or the Markets and business properties are sold to a third party. In addition, until the Husband has made his final payment to the Wife for her share of the Markets, he shall pay her an additional $3,160.11 per week as alimony. This payment shall commence on the first Friday after the date of the Judgment and continue until January 1, 2009, or sooner if the Husband has completed his payment s to the Wife for her share of the assets or exercised his option not to purchase the Markets, or the Markets are sold to a third party.

32. Providing that the Wife retains the Markets, she shall pay from the Markets, the mortgage and real estate taxes on 10 Hammett Road, the Husband's automobile expenses and provide him with a house account at the Markets to buy groceries. The Wife's obligation to pay these expenses for the Husband's benefit shall continue until January 1, 2009 or sooner if she has completed her payments to the Husband for his share of the assets.

33. If neither party elects to retain the Markets, either party may file a modification on the payment of alimony from the Husband to the Wife after the Markets are sold.

34. For so long as Husband is obligated to provide support under the terms of the Judgment, he shall maintain life insurance insuring his life with a death benefit value of $2,000,000.00, naming Wife as the sole beneficiary.

35. In the event that the Wife purchases the Markets then she shall maintain life insurance, insuring her life, with a death benefit value of $1,000,000.00, naming Husband as the sole beneficiary until she has no further financial obligations to the Husband.

Date: 6/18/03

Randy J. Kaplan, Justice
Probate and Family Court Department

Bernier v. Bernier (2007)

SJC-09836

JUDITH E. BERNIER vs. STEPHEN A. BERNIER (and a companion case[1]).

Dukes. May 7, 2007. - September 14, 2007.

Present: Marshall, C.J., Greaney, Ireland, Spina, Cowin, & Cordy, JJ.

Divorce and Separation, Division of property, Alimony. Corporation, Close corporation, Valuation. Estoppel. Collateral Estoppel.

Complaints for divorce filed in the Dukes Division of the Probate and Family Court Department on June 12, 2000.

The cases were heard by Randy J. Kaplan, J.

Civil action commenced in the Dukes Division of the Probate and Family Court Department on July 28, 2003.

A motion to dismiss was heard by Randy J. Kaplan, J.

After consolidation of the appeals in the Appeals Court, the Supreme Judicial Court on its own initiative transferred the case from the Appeals Court.

David L. Kelston (Theodore Tedeschi with him) for Judith E. Bernier.

Paul M. Kane for Stephen A. Bernier.

MARSHALL, C.J. This appeal by Judith E. Bernier (wife) from decisions of a judge in the Probate and Family Court incident to her divorce from Stephen A. Bernier (husband) presents us with the novel question whether it is proper to discount the value of an S corporation, see 26 U.S.C. §§ 1361-1379 (2000), by "tax affecting" income at the rate applicable for C corporations, where one spouse will receive ownership of all shares of the S corporation after the divorce and the other will be required to relinquish all ownership in the business. See 26 U.S.C. §§ 311, 312 (2000). Also presented by the wife's appeal are whether the judge erred in discounting the fair market value of the S corporations at issue here by applying "key man" and "marketability" discounts; whether the amount of alimony awarded to the wife was proper; and whether the judge improperly dismissed the wife's equity complaint against the husband alleging misuse of marital assets.

On the issue of tax affecting, we conclude that the judge erred in adopting the valuation of the husband's expert witness that tax affected the fair market value of the parties' S corporations at the "average corporate rate," in the words of the husband's expert, of a C corporation.**[2]** As a preliminary matter, where valuation of assets occurs in the context of divorce, and where one of the parties will maintain, and the other be entirely divested of, ownership of a marital asset after divorce, the judge must take particular care to treat the parties not as arm's-length hypothetical buyers and sellers in a theoretical open market but as fiduciaries entitled to equitable distribution of their marital assets. See G. L. c. 208, § 34.

Further, careful financial analysis tells us that applying the C corporation rate of taxation to an S corporation severely undervalues the fair market value of the S corporation by ignoring the tax benefits of the S corporation structure and failing to compensate the seller for the loss of those benefits. On the other hand, in the circumstances of this divorce action, we agree with a recent decision of the Delaware Court of Chancery that failure to tax affect an S corporation entirely artificially will inflate the value of the S corporation by overstating the rate of return that the retaining shareholder could hope to achieve. See Delaware Open MRI Radiology Assocs. v. Kessler, 898 A.2d 290, 327 (Del. Ct. Ch. 2006) (Kessler). Our review of the scant case law and the pertinent literature on the issue leads us to adopt generally the metric employed by the Kessler court, see id. at 328-330, described more fully infra, which most closely achieves the parties' stated intention in this case to divide the value of their S corporations equally, the outcome the judge also sought to achieve. We also conclude that, where the husband testified that he planned to retain control of the S corporations after the divorce, the judge erred in applying key man and marketability discounts, discounts that assume the possible sale of the asset.

On the issue of alimony, we hold that the judge did not err in awarding the wife an amount of alimony sufficient to meet her personal needs, as reflected in her financial statement, exclusive of losses she incurred in owning and operating a horse farm acquired by the parties during the marriage and given to the wife pursuant to the parties' stipulation and the judge's award in the divorce action. See Heins v. Ledis, 422 Mass. 477, 482 (1996) (purpose of alimony is support and maintenance). Finally, we determine that the wife's equity complaint against the husband was not barred by principles of issue preclusion and res judicata and therefore should not have been dismissed. We affirm the portion of the third amended supplemental judgment in the divorce matter concerning alimony, vacate the portion of the third amended supplemental judgment concerning valuation of the parties' S corporations, and remand for further proceedings not inconsistent with this opinion. We vacate the judgment of dismissal in the wife's equity action, which we also remand for further proceedings not inconsistent with this opinion.

1. Background. The parties were married in Massachusetts in 1967. On June 12, 2000, the husband, then fifty-two years old, and the wife, fifty-four years old, filed cross complaints for divorce in the Dukes Division of the Probate and Family Court Department.**[3]** The record indicates, and the judge found, that initially the parties were of modest means. However, in 1986, after they moved from Billerica to Martha's Vineyard, their circumstances improved markedly. The

engine of the parties' financial success was two supermarkets that were subsequently owned by two S corporations, of which the husband and wife each owned one-half.[4] During their marriage, the parties also acquired what the judge termed an "extensive" portfolio of residential, commercial, and undeveloped properties. Among these properties was a thirty-six acre plot of land in West Tisbury, which the parties purchased in 1996, and on which they constructed Rosewood Farm (horse farm), a horse breeding farm under the control and management of their company, Rosewood Farm, Inc.

After they filed for divorce but before trial, the parties voluntarily entered into numerous temporary stipulations governing their financial affairs during the pending proceedings. The stipulations gave the husband sole authority to operate and manage the supermarkets and similar authority for the wife to run the horse farm. Further, the stipulations provided that certain business and personal expenses, and the parties' attorney's fees and costs, be paid from specified joint assets. Additionally, before trial, the parties agreed that all of their assets would be divided equally, and stipulated to the value of most of their assets, approximately $11 million. The parties were unable to reach agreement on two issues: the value of the supermarkets and the amount of alimony due to the wife. On February 27, 2002, a judge in the Probate and Family Court entered a judgment of divorce nisi, bifurcating the trial on the two remaining issues.

Between February and May, 2002, the judge heard eight days of testimony, which centered principally on the value of the supermarkets.[5] During the trial, each party presented the testimony of an expert witness on valuation: Mark Leicester prepared the wife's valuation, and Joel Horvitz prepared that of the husband.[6] Leicester and Horvitz were in broad agreement on key points. Specifically, both agreed that the buyer of the supermarket shares would seek an investment that would yield the buyer's required rate of return. They also agreed that the most accurate estimate of the supermarkets' value would be achieved by employing what both parties refer to as the "income" approach, taking the supermarkets' average adjusted income after expenses for a set number of years, divided by the appropriate capitalization rate.[7]

Despite their areas of agreement, however, the two experts arrived at vastly different appraisals of the supermarkets' fair market value. Leicester testified that the fair market value of the supermarkets was $16,391,000. Horvitz set the fair market value at $7,850,000.

The discrepancy in the experts' valuations was due to several factors, primarily Horvitz's application of tax affecting, as well as certain discounts to his calculations of fair market value[8] and Leicester's omission of those considerations. Specifically, Horvitz tax affected as if the S corporation were a C corporation, at what he termed the "average corporate rate" of thirty-five per cent. But see note 19, infra. He testified that tax affecting the S corporations at the C corporation rate was proper because, among other things, a person contemplating the purchase of an S corporation would factor into his probable rate of return the tax consequences of the purchase. Leicester, on the other hand, did not tax affect the supermarkets' income in his valuation because, as he testified, an S corporation, unlike a C corporation, does not pay taxes at the entity level, and because no sale of the business was contemplated.[9] Horvitz additionally discounted the fair market value of the supermarkets by applying a ten per cent "key man" discount to the adjusted net income of the supermarkets to account for the undisputed fact that the husband was the most important figure in the operation and management of the supermarkets.[10] He then applied an additional ten per cent discount to account for the "lack of marketability" of the S corporation as a closely held business. Leicester maintained that, because the husband planned to maintain ownership and control of the supermarkets after the divorce, key man and marketability discounts should not apply.

On August 18, 2003, the judge entered a supplemental judgment, finding of facts, rationale, and conclusion of law on the valuation of the supermarkets. The judge rejected Leicester's valuation as "unreliable." Specifically, she faulted Leicester on the grounds that he improperly combined

pretax and posttax data in establishing a capitalization rate, improperly applied a rate of growth to his valuation, omitted a marketability discount, and lacked experience valuing S corporations. The judge adopted substantially without change Horvitz's method of applying tax affecting and key man and marketability discounts to the supermarkets, and adopted his conclusion that the fair market value of the supermarkets on the relevant date, see note 5, supra, was $7,850,000. In concluding that the income of the parties' S corporations should be tax affected for valuation purposes, the judge cited Gross v. Commissioner of Internal Revenue, 272 F.3d 333 (6th Cir. 2001), cert. denied, 537 U.S. 827 (2002) (Gross) (affirming United States Tax Court judgment that it was proper to tax affect using zero per cent corporate tax rate, in context of valuing gift of S corporation stock).

On January 22, 2004, nunc pro tunc to October 6, 2003, the judge entered a third amended supplemental judgment, awarding the husband the option to purchase the wife's fifty per cent ownership interest in the supermarkets for $3,925,000 -- one-half of the supermarkets' total value of $7,850,000 -- and providing other relief.[11]

After the close of trial, and while the divorce proceedings were pending, the wife, individually and, in a derivative action, on behalf of the parties' business entities, filed a separate verified complaint in equity against the husband and the business entities. The wife sought fifty per cent of the supermarkets' net income from January 1, 2001, the date of the last reconciliation of the supermarkets' accounts, to February 2, 2004, the date the husband exercised his option to purchase the wife's fifty per cent ownership interest in the supermarkets.[12] Among other things, the wife alleged that the husband had taken the position at a corporate meeting in July, 2003, that he was entitled to all of the income from the supermarkets after the last reconciliation (December 31, 2000), and that he had failed to provide the wife with accountings and distributions as required under the temporary orders. After a hearing, the judge dismissed the wife's equity complaint with prejudice, holding that because the wife's claims should and could have been brought in the divorce action and were resolved by the divorce action, her equity claims were barred by issue preclusion and res judicata.[13] The wife's appeals from the judge's decisions in the divorce action and from the dismissal of her equity complaint were consolidated in the Appeals Court, and we transferred the case from the Appeals Court on our own motion.

2. Tax affecting the valuation of S corporation shares. The parties agree, as the judge found, that the "major difference" in the valuations of Horvitz and Leicester is Horvitz's use of tax affecting. To assess the propriety of the judge's adoption of Horvitz's methodology of tax affecting, it is instructive to summarize the pertinent facts regarding corporate structure and taxation.

The husband and wife, as equal shareholders, elected that the supermarkets be taxed under the provisions of subchapter S of the Internal Revenue Code, 26 U.S.C. §§ 1361-1379. To elect S corporation status, the corporation and its shareholders must meet and maintain several requirements, including, as relevant here, that (1) the corporation may not have more than one hundred shareholders, and (2) only individuals, estates, or certain trusts may hold its shares. 26 U.S.C. § 1361(b). In other words, an S corporation may not have a traditional corporation (known as a "C corporation") as one of its shareholders. The primary advantage of an S corporation over a C corporation is that the S corporation is not Federally taxed at the corporate level,[14] but is "passed through" to the shareholders on a pro rata basis and taxed to the shareholders when earned by the corporation, whether or not the corporation pays dividends. Cf. 26 U.S.C. §§ 707-777 (2000) (taxation of partnerships); 26 U.S.C. § 1363 ("taxable income of an S corporation shall be computed in the same manner as in the case of an individual"). See note 2, supra. Net income from these entities is passed through to owners and taxed at the individual level in the year that it is earned. In contrast, the earnings from a C corporation are taxed twice: once at the corporate level, and then at the individual level as a tax on shareholder dividends, if any, paid by the C corporation. Thus, as we illustrate in the margin, S corporation shareholders enjoy the considerable benefit of avoiding the "double taxation" of corporate dividends that is the hallmark of the C corporation.[15]

To distinguish between S and C corporations, however, does little in itself to clarify the issue of valuation. To begin with, we must acknowledge that the valuation of an S corporation is an inexact science.[16] See, e.g., Gross, supra at 356 (Cohn, J., concurring in part and dissenting in part). Compounding the difficulty in the case of an S corporation is the question whether, and how, to account for tax consequences. The matter has bedeviled the professional appraisers' community for some time, and certainly was the source of some confusion at the time of the trial. See id. at 355 (Cohn, J., concurring in part and dissenting in part). See also Kessler, supra at 326 (valuation of S corporation by tax affecting has "elicited a fair amount of attention from judges, appraisers and academics"). While the Internal Revenue Service (IRS) appears to have endorsed the practice of tax affecting an S corporation in the manner that Horvitz followed, see Gross, supra at 353 (Cohn, J., concurring in part and dissenting in part), quoting IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers[17] (in valuing S corporations, one "need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made"), both case law and professional scholarship have cast serious doubt on the validity of this practice.[18]

In this case, the debate over tax affecting played out in the diametrically opposed positions taken by the parties' experts. Would the hypothetical purchaser of the supermarkets at fair market value, as the wife's expert maintained, not factor any tax consequences at all into his analysis of the achievable rate of return on his investment, because an S corporation, as an entity, pays no taxes? Or, as the husband's expert asserted, would that purchaser tax affect at the C corporation tax rate,[19] because, in the judge's words, "the value of an entity should not depend on whether the shareholders make the elections to be a C or S Corporation." Or would an alternative to these two extremes better account for the value of the supermarkets in the circumstances of this case?

Valuation of a business is a question of fact. See Demoulas v. Demoulas Super Mkts., Inc., 424 Mass. 501, 541 n.47 (1997). Thus, the standard is whether the judge's findings were clearly erroneous. See Mass R. Civ. P. 52 (a), as amended, 423 Mass. 1402 (1996). When the opinions of valuation experts differ, a judge may "accept one reasonable opinion and reject the other" (emphasis added). Fechtor v. Fechtor, 26 Mass. App. Ct. 859, 863 (1989). The judge may also "reject expert opinion altogether and arrive at a valuation on other evidence." Id. The judge may not, however, reach a valuation that is materially at odds with the totality of the circumstances or, in the case of divorcing spouses, at variance with the requirements of the equitable distribution statute. G. L. c. 208, § 34. See C.P. Kindregan, Jr., & M.L. Inker, Family Law and Practice § 45.8, at 334-335 (3d ed. 2002), citing Fechtor v. Fechtor, supra at 862-867.

In adopting Horvitz's approach over Leicester's in the matter of tax affecting, the judge invoked the Gross case to support her conclusions. That case does not, however, do the work to which the judge assigned it. At issue in Gross was the fair market value of certain gifts of restricted stock of an S corporation.[20] Declining to adopt the position set out in its own valuation guide, see note 17, supra, the IRS opposed the tax affecting of cash flows that the company had employed in estimating fair market value using the income approach. See Gross, supra at 354 (Cohn, J., concurring in part and dissenting in part). The United States Court of Appeals for the Sixth Circuit affirmed that the Tax Court had the discretion to adopt the testimony of the Commissioner of Internal Revenue's expert witness that tax affected the S corporation using a zero per cent corporate tax rate -- effectively meaning no tax affect at all. Id. at 355 (Cohn, J., concurring in part and dissenting in part). The court was unpersuaded by the position taken by the taxpayer's expert, who tax affected at the corporate rate to account for the possibility that the corporation might lose its S corporation status in the future, because, the court noted, the record did not contain sufficient evidence that this was likely to happen. Id. at 353 (Cohn, J., concurring in part and dissenting in part). The court likewise rejected the argument that tax affecting at the C corporation rate was necessary to offset the fact that an S corporation must distribute enough funds to shareholders to pay their tax liability on its earnings; the court noted that the S

corporation at issue had always distributed almost one hundred per cent of its net earnings and there was no evidence this practice would not continue. Id.

The judge in this case cited Gross for the proposition that "[t]ax affecting Subchapter S income for valuation purposes should be reflected in determining the 'cost of capital.'" However, the judge ignored the Gross court's application of a zero per cent corporate tax rate and instead adopted Horvitz's thirty-five per cent "average corporate tax rate."**[21]** See note 19, supra. We conclude there is no support in Gross for the judge's adoption of Horvitz's figure, and moreover, the judge failed to offer a cogent explanation of her choice. See note 21, supra. The husband has cited no cases, nor have we found any, that apply the presumed thirty-five per cent rate of taxation of a C corporation to estimating the fair market value of an S corporation using the income approach.**[22]** We agree with the husband that the judge is free to credit the reasonable opinion of one expert over that of another. See Kendall v. Selvaggio, 413 Mass. 619, 620 (1992) (in reviewing valuation, court should "accept the judge's findings of fact as true unless they are clearly erroneous"); Fechtor v. Fechtor, supra at 863. However, even though the consensus on tax affecting was not entirely clear at the time of trial, and still remains subject to debate, the judge erred in adopting in all material respects Horvitz's valuation that tax affected at thirty-five per cent**[23]** when doing so was not reasonable as it would clearly produce an arbitrary result: a significant undervaluation of the supermarkets. See Fechtor v. Fechtor, supra, citing Caldwell v. Caldwell, 17 Mass. App. Ct. 1032, 1033-1033 (1984).

The difficulty with the judge's position is framed cogently in the decision in Kessler, supra. Kessler concerned a closely held S corporation, where the dealings between the majority and minority shareholders were constrained by fiduciary considerations.**[24]** See Donahue v. Rodd Electrotype Co. of New England, Inc. 367 Mass. 578, 593 (1975), quoting Cardullo v. Landau, 329 Mass. 5, 8 (1952) ("we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another . . . [that standard of duty being defined as] the 'utmost good faith and loyalty'"). Here too, the property division between the husband and wife is constrained by fiduciary considerations. See G. L. c. 208, § 34. In Kessler, three of eight shareholders (Kessler group) of a radiology practice operating as an S corporation wanted the majority shareholders (Broder group), with whom business relations had ruptured, to buy out their shares. Predictably, the value each side attached to the shares differed markedly. The expert for the Broder group treated the S corporation as a C corporation in his valuation, applying forty per cent as the tax rate to the business's earnings. The Kessler group's expert did not tax affect earnings at all. The judge found neither expert's testimony concerning tax treatment to be fair. "The problem with [the] approach of treating [the entity] as a C corporation is obvious. [The entity] is a very small entity. The record reveals no set of circumstances in which it is likely that [the entity] will convert to C corporation status. It is a highly profitable entity that generates and distributes income well in excess of the stockholder level taxes its stockholders must pay. The S corporation tax status is a highly valuable attribute to the shareholders of [the entity], given its profitability and the affluent status of its physician stockholders, who face top marginal tax rates." Kessler, supra at 326. Treating the enterprise effectively as a C corporation, the court held, failed to account for the comparative tax benefits of S corporation ownership -- its signature feature -- and therefore depressed the estimate of the business's fair value. Id. at 327. On the other hand, the judge in Kessler reasoned, not tax affecting at all was also unfair, because it would lead to a windfall for the minority sellers. "[Denying] the reality that each shareholder owes taxes on his proportional interest in [the business] would result in the [Kessler group] receiving a higher per share value from the court than it could ever have realized as a continuing shareholder. . . . This is a simple premise -- no one should be willing to pay for more than the value of what will actually end up in her pocket." Id. at 328-329, citing Fisher, The Sale of the Washington Redskins: Discounted Cash Flow Valuation of

S Corporations, Treatment of Personal Taxes, and Implications for Litigation, 10 Stan. J. L. Bus. & Fin. 18 (2005).

Having rejected the rationale and conclusions of both experts, the Delaware court proposed an alternate approach. This approach attempted to capture the tax benefit to the buyer of S corporation shares (the Broder group) of receiving cash dividends that are not subject to dividend taxes. Id. at 330. The court observed that, as is the case here, the buyout was an "involuntary removal," id., and not an arm's-length purchase. To calculate the effect of taxes on the buyers and the sellers in these circumstances, the judge asked: if the S corporation at issue were a C corporation, at what hypothetical tax rate could it be taxed and still leave to shareholders the same amount in their pockets as they would have if they held shares in an S corporation? In other words, the judge asked what the effective corporate tax rate would be for the S corporation shareholder, although the entity itself paid no corporate tax. Assuming a dividend tax rate of fifteen per cent and a personal income tax rate of forty per cent (the shareholders were wealthy physicians who paid individual taxes at the highest rate),**[25]** the court imputed a "pre-dividend" corporate tax rate of 29.4 per cent to the S corporation. Id.**[26]** The result was to leave the shareholder of an S corporation with the same amount of money in his or her pocket as the shareholder of a C corporation being taxed at a (fictitious) 29.4 per cent corporate tax rate. Id. Applying this rate to the earnings of the entity measures "with the greatest practicable precision the fair value of the . . . interest in the going concern value of" the business. Id.

The Kessler court's trenchant analysis allows us to see that, in this case, applying the presumed thirty-five per cent tax rate applicable to a C corporation to the valuation of the supermarkets understated the value of the supermarkets, while failing adequately to account for the loss of S corporation benefits to the wife.**[27]** The result was particularly misplaced in this case in light of the uncontroverted evidence that the supermarkets would continue to operate as S corporations after the parties' divorce; that they would continue to be owned by one of the existing shareholders**[28]**; and that the supermarkets were profitable and would continue their historic practice of making cash distributions. We emphasize, moreover, that the valuation of the supermarkets was undertaken pursuant to G. L. c. 208, § 34, for purposes of equitable distribution in a divorce matter. Even though the judge did not have the benefit of the Kessler decision at the time she rendered her judgment, these circumstances alone should have prompted the judge to look past the all-or-nothing approach of the parties' experts and pay particular attention to the facts of this case over more abstract considerations.

We conclude that the metric employed by the Kessler court provides a fairer mechanism for accounting for the tax consequences of the transfer of ownership of the supermarkets from one spouse to the other in the circumstances of record. On remand on the issue of valuation, the judge is to employ the tax affecting approach adopted in Kessler.

3. Discounts. The parties' experts agreed that the husband's expertise was critical to the continued success of the supermarkets. On the assumption that after the divorce the supermarkets might be sold to a third party who would replace the husband at the helm of the supermarkets,**[29]** Horvitz (the husband's expert) discounted the value of the two supermarkets by ten per cent each for the "loss of [the husband]" as the "key man" and for the costs of sale (including broker's fees and advertising) of the supermarkets as closely held corporations. In evaluating the supermarkets, the judge adopted Horvitz's key man and marketability discounts. In the circumstances of this case, that was error.

It is appropriate to assess a key man discount when an individual's "continued services are critical to the financial success" of the business being valued and may be or will be lost. See Commonwealth v. Levin, 11 Mass. App. Ct. 482, 485 (1981) (defining term). See also Rev. Rul. 59-60, 1959-1 C.B. 237; Estate of Feldmar v. Commissioner, 56 Tax Ct. Mem. Dec. (CCH) 118, 130 (1988); Nelson v. Nelson, 411 N.W.2d 868, 871 (Minn. Ct. App. 1987). Here, however, given the husband's uncontradicted testimony that he would maintain total ownership and control of the supermarkets, it is beyond reason to conclude that the business's value should be reduced to account for loss of the man who is "the whole show." Indeed, the cases cited by the husband support rather than detract from our analysis. In Estate of Feldmar v. Commissioner, supra, the

court adopted a key man discount because the "key man" in the complex insurance holding company at issue had in fact died; without him, the court reasoned, the company might have no value at all. In Nelson v. Nelson, supra, the court found a key man discount applicable where the heart of the business was the sale of the employee's unique engineering services; the key man and the business were literally inseparable. The husband's role in the supermarkets, in contrast, is that of chief executive; his services are critical but not unique or irreplaceable, and in any event, as we have previously noted, the husband was not likely to be "lost" to the enterprise. In the circumstances of this case, the judge should not have adopted a key man discount in valuing the supermarkets.[30]

Similarly, a marketability discount "adjusts for a lack of liquidity in one's interest in [a closely-held corporation], on the theory that there is a limited supply of potential buyers for stock in a closely-held corporation." Tierney v. John Hancock Mut. Life Ins. Co., 58 Mass. App. Ct. 571, 577 n.8 (2003), cert. denied, 541 U.S. 903 (2004), quoting Lawson Mardon Wheaton, Inc. v. Smith, 160 N.J. 383, 398-399 (1999). See Balsamides v. Protameen Chems., Inc., 160 N.J. 352, 373 (1999). As Horvitz testified, and the judge found, a marketability discount is "the ability to convert the subject company to cash." This discount was not warranted in light of the husband's testimony negating any possibility of a sale. See note 28, supra. The subject companies will continue as going concerns and are not being converted to cash. "[N]either marketability nor a minority discount should be applied absent extraordinary circumstances . . . . Close corporations by their nature have less value to outsiders, but at the same time their value may be even greater to other shareholders who want to keep the business in the form of a close corporation." Brown v. Brown, 348 N.J. Super. 466, 474-476 (2002). Applying a marketability discount in light of the husband's intended, and presumed, acquisition of the supermarkets unfairly deflated their value.

One final issue raised by the wife is the matter of the rate of growth utilized in valuing the supermarkets. Horvitz used no growth rate in his valuation because he testified that doing so was a mere "guess" about the future. However, while he testified that the supermarkets "had a downward trend in sales over the last three years," he also admitted on cross-examination that the supermarkets' revenues were, in fact, growing, and that only the percentage of growth had been trending downward. Leicester testified that his valuation added a two and one-half per cent growth rate to account only for inflation. The judge "[did] not find that the application of a growth rate is appropriate in this matter." We disagree. We are persuaded that the judge abused her discretion by rejecting the two and one-half per cent growth rate advanced by Leicester where the uncontroverted record demonstrated that revenue growth had exceeded that amount in all relevant years, and there was no evidence that future growth would fall short of inflation.[31]

4. Award of alimony. The wife was awarded alimony in the pretax amount of $5,288.46 per week, or $275,000 per year (approximately $165,000 after taxes, assuming forty per cent total rate of taxation).[32] The judge also ordered the husband to pay to the wife as additional alimony the sum of $3,160.11 per week to cover the expenses of the horse farm, until he paid the wife in full for her interests in the supermarkets.[33] The wife claims that the alimony award must be vacated as inadequate to meet her demonstrated needs, because it fails to cover the costs associated with her postdivorce ownership and management of the horse farm, which had always been principally under her management and control, which had never made a profit, and which sustained yearly losses in excess of $600,000.[34] The wife also claims that the award leaves the parties "drastically unequal in terms of income" because the husband will have postdivorce income of almost $2 million yearly while she receives only $275,000 yearly. We decline to vacate the alimony award.

A judge has considerable discretion in fashioning an alimony award, on consideration of all the factors set forth in G. L. c. 208, § 34. See Heins v. Ledis, 422 Mass. 477, 480-481 (1996); Drapek v. Drapek, 399 Mass. 240, 243 (1987); Rice v. Rice, 372 Mass. 398, 400 (1977); Bianco v. Bianco, 371 Mass. 420, 422 (1976). Our review of an alimony award made pursuant to § 34 is essentially a two-step analysis. "First, we examine the judge's findings to determine whether all

relevant factors in § 34 were considered."[35] Bowring v. Reid, 399 Mass. 265, 267 (1987). The second part of our review is to determine whether the reasons for the judge's rulings are apparent in her findings and rulings. Id. If a judge has made findings consistent with her obligations under G. L. c. 208, § 34, indicating that she has fairly considered all factors relevant under § 34 and has not considered any irrelevant matter, her determinations as to alimony may not be reversed unless "plainly wrong or excessive." See Ross v. Ross, 385 Mass. 30, 37-38 (1982).

The judge's findings of fact show that she considered all of the factors under § 34 in reaching her conclusion.[36] Her determination that the alimony award should not be used as a postdivorce subsidy of the horse farm was also sound. "Alimony is an award for support and maintenance . . . ." Heins v. Ledis, supra at 482, quoting Inker, Alimony and Assignment of Property: The New Statutory Scheme in Massachusetts, 10 Suffolk U.L. Rev. 1, 11 (1975). See Keller v. O'Brien, 420 Mass. 820, 827 & n.13 (1995) (award of alimony is improper absent finding of financial need on part of recipient spouse); Gottsegen v. Gottsegen, 397 Mass. 617, 623 (1986) ("§ 34 does not alter the fundamental purpose of alimony: to provide economic support to the dependent spouse" [emphasis in original]). Alimony "has historically been based on the common law duty of the husband to support his wife. Property division, on the other hand, is based on the joint contribution of the spouses to the marital enterprise." Heins v. Ledis, supra, quoting Inker, supra. Neither the court nor the parties may "blur the distinction between alimony and property division." Heins v. Ledis, supra, quoting Inker, supra. "The standard of need is measured by the 'station' of the parties -- by what is required to maintain a standard of living comparable to the one enjoyed during the marriage." Grubert v. Grubert, 20 Mass. App. Ct. 811, 819 (1985). See Sampson v. Sampson, 62 Mass. App. Ct. 366, 369 (2004) (same). There was no evidence that the money-losing horse farm was necessary to maintain the wife's "station" in life. The wife's election to maintain the horse farm is a personal decision concerning the postdivorce use of former marital property; the husband cannot be forced to finance that decision.

The wife relies on Kelley v. Kelley, 64 Mass. App. Ct. 733, 741 (2005), for the proposition that it is error to reduce an alimony award so that a husband may avoid "subsidiz[ing]" for the foreseeable future the wife's "avocation." This case is readily distinguishable. First, the Kelley decision addressed only modification of a judgment for alimony (based on the husband's request to eliminate support), rather than an original alimony award. Therefore, the standard of review was whether there had been a change of circumstances since the entry of the earlier judgment, not whether the wife was entitled to alimony to support her position of underemployment. See id. at 738-739. Second, if we are to extrapolate from the Kelley decision to comment on the actual award of alimony provided to the wife by the Probate and Family Court judge in that case, that award was designed to support the wife's ability to care for three children while working as an artist. The wife here, in contrast, was awarded an amount sufficient to meet her personal expenses without being required to seek any additional employment. Moreover, the judge found that the wife had skills in the management of horse breeding that would permit her to acquire "future capital, assets and income." To require that the husband in this case subsidize a venture that loses on the order of $600,000 per year, regardless whether the horse farm is a vocation or "avocation" for the wife, is a matter different from ordering support of an individual who, for reasons inapplicable here, may not be able to earn up to her full potential. The wife has failed to present persuasive evidence that her desire to continue to run the horse farm at a loss is integral to maintaining an "elaborate life-style." That choice cannot, as the wife urges, be analogized to awards properly designed to maintain a similar standard of living to the marriage, such as allowing an individual to "socialize or entertain" or "purchase clothing" as in the past. See, e.g., Goldman v. Goldman, 28 Mass. App. Ct. 603, 608 (1990); Grubert v. Grubert, supra at 812. We cannot say that the judge's award was "plainly wrong or excessive."

5. Complaint in equity. The parties entered into stipulations for temporary orders during the divorce that provided, among other things, that both would continue to own the supermarkets and equally share their profits during the pendency of the divorce, as well as to account for certain monies from the supermarkets to be used for particular purposes, including their attorney's fees

and costs. The net income of the supermarkets was equalized through the end of 2000, thus leaving "unequalized" income of some $3.6 million yearly for the period of more than three years, from January 1, 2001, to February 2, 2004 (post-2000 period), during which the wife continued to be a fifty per cent shareholder of the supermarkets. The wife appeals from the judge's dismissal of her complaint in equity, filed after the close of evidence but while the case was still pending, seeking an accounting and equalization of income for the post-2000 period. We conclude that the judge's actions in this case effectively deprived the wife of a reasonable opportunity to bring the issue of income equalization during the post-2000 period before the court at an appropriate juncture, and that the equity complaint was therefore wrongly dismissed.

A brief chronology is in order. The wife sought to introduce the matter of income equalization on several occasions. The first was through a contempt claim filed in November, 2002.**[37]** Then, on July 28, 2003, before the divorce or contempt judgments entered, the wife filed an equity complaint against the husband. The impetus for this complaint was the husband's assertion at a corporate meeting of the supermarkets on July 10, 2003, that the income of the supermarkets was entirely his. When it issued, the divorce judgment on the property division did not address equalization of income for the post-2000 period. In September, 2003, the wife moved postjudgment for equalization, to which she appended the complaint in equity.**[38]** The contempt judgment issued in September, 2003, and did not address the issue of income equalization for the post-2000 period.**[39]** On September 30, 2003, during a hearing on the wife's postjudgment motion for equalization, the judge suggested that the wife was entitled to a share of the income ("I don't think there's any dispute that she owned those shares") but nevertheless precluded the claim because the "issue was never presented to me." She noted that the wife's equity complaint was "potentially a remedy for that issue." In July, 2004, the judge dismissed the wife's equity action on the husband's motion to dismiss, giving two reasons for so ruling: first, that the pretrial stipulations of the parties did not specify any entitlement of the wife to equalization of income; and second, that the issue should have been raised and resolved during the pendency of the divorce action, and was therefore barred under the doctrine of claim preclusion.

The judge's actions created a "Catch-22" for the wife, whose various attempts to have the court address the issue of equalization for the post-2000 period were denied as either premature or waived. Before a claim will be barred on the ground of claim preclusion, it must be established that the claim was actually and necessarily decided in a prior action or that there was a full and fair opportunity to have done so that was not taken. See Heacock v. Heacock, 402 Mass. 21, 24 (1988); Massachusetts Prop. Ins. Underwriting Ass'n v. Norrington, 395 Mass. 751, 753 (1985); Ratner v. Rockwood Sprinkler Co., 340 Mass. 773, 775 (1960). Here, the judge erred in concluding that the pretrial stipulations somehow canceled the need to consider equalization for the post-2000 period in her judgment. The stipulations were entered as temporary orders to govern spending (e.g., salary, attorney's fees, and expenses) only until the divorce judgment entered.**[40]** The parties agreed in the stipulations that payments debited to the parties' accounts would be considered loans repayable on "the final division of [the] marital assets." The stipulations were not intended to divest the wife of her fifty per cent share in the supermarkets. If the stipulations respond to the wife's entitlement to income in any way, they weigh in the wife's favor, providing that "[t]he parties agree that neither will draw any funds from any of the corporations for their personal benefit, other than the weekly paycheck to [the husband], except as provided herein in their agreement." The stipulations clearly do not entitle the husband to full ownership of the income distribution.**[41]**

Second, it is clear that the judge's rulings did not provide the wife with a full and fair opportunity to air her claims, which the wife brought in a timely manner. The equity complaint was filed less than two weeks after the husband declared at a corporation meeting that he would henceforward treat the income from the supermarkets as entirely his own. The wife could not have known in advance of the divorce judgment that that judgment would not address equalization for the post-2000 period, a matter that was clearly set before the judge months before the judgment issued. Principles of res judicata and claim preclusion were inapplicable to the wife's complaint in equity.

In regard to equalization, we are also constrained to note one final issue concerning the parties' attorney's fees and costs. In the novel and complex circumstances of this case, we conclude that valuation of the markets and equal distribution of property are not issues that are easily separable. The parties' original stipulations provided that the supermarkets would advance the parties' attorney's fees, with the payments "debited to the party's account who has incurred those expenses," and that such payments would be considered loans repayable by each party on the "final division of [the] marital assets." The parties agreed to an equal division of the marital assets and the supermarkets. Each party has expended a considerable sum for legal representation toward the joint goal of valuing the supermarkets and dividing these assets. A final equalization of the supermarkets should incorporate the fees paid to attorneys for each party, and be treated so that each party is effectively debited with half of the attorney's fees. To fail to do so would leave the wife to pay her entire legal expenses out of her own pocket while the husband effectively would receive a windfall by simply moving money from one source under his control to another. We therefore conclude that the valuation of the supermarkets should be adjusted to take into account advances of legal fees for both parties since the December 31, 2000, reconciliation.

6. Conclusion. The portion of the third amended supplemental judgment in the divorce matter concerning alimony is affirmed. We vacate the portion of the third amended supplemental judgment concerning valuation of the parties' S corporations, and remand for further proceedings not inconsistent with this opinion concerning tax affecting, key man and marketability discounts, the application of a two and one-half per cent growth rate to account for inflation, and the equalization of attorney's fees. We vacate the judgment of dismissal in the wife's equity action, and remand for further proceedings not inconsistent with this opinion.**[42]**

So ordered.

FOOTNOTES:

[1] Judith E. Bernier vs. Stephen A. Bernier; Bernier's Market, Inc., doing business as Cronig's State Road Market; Bernier's Up Island Market Inc., doing business as Cronig's Up Island Market; and Colonial Drive Real Estate Corporation, doing business as Islander.

[2] As we discuss infra, the income of a C corporation is subject to income tax at both the corporate (or entity) level and the shareholder level on dividends, if any, paid to shareholders. In contrast, the income of an S corporation is not subject to Federal tax at the entity level, see note 14, infra, but is passed through and taxed to the shareholder when earned by the corporation, whether or not the corporation pays dividends. In the context of valuation of the stock of an S corporation, "tax affecting" is employed in what the parties refer to as the income

approach to appraising the value of S corporation shares, by which the estimated future earnings of the corporation are discounted by imputed future tax burdens at the entity level, even though the S corporation pays no entity level earnings taxes. See Gross v. Commissioner of Internal Revenue, 272 F.3d 333, 344-347 (6th Cir. 2001), cert. denied, 537 U.S. 827 (2002) (Gross).

[3] Their two children were emancipated at the time the parties filed for divorce.

[4] The corporations were Bernier's Market, Inc., doing business as Cronig's State Road Market, and Bernier's Up Island Market, Inc., doing business as Cronig's Up Island Market. The supermarkets produced substantial yearly cash flow for their owners.

[5] The parties agreed to establish the valuation of the supermarkets as of December 31, 2000, the date of the last reconciliation of accounts prior to trial.

[6] At trial, neither party challenged the qualifications of the other's expert witness.

[7] We understand the term "income" approach to valuation, as used by the parties, to mean the same as the method also referred to as the "capitalization of income" approach, see Dallas v. Commissioner, 92 Tax. Ct. Mem Dec. (CCH) 313, 315 (2006), or the "capitalized economic income" method. For a discussion of these methods utilized for valuation, see generally S.P. Pratt, R.F. Reilly, & R.P. Schweihs, Valuing Small Businesses & Professional Practices (3d ed. 1998) at 236-237, 254-257.

[8] "Fair market value" is generally defined as 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 the relevant facts." Gross, supra at 344, quoting Treas. Reg. § 25.2512-1. See United States v. Cartwright, 411 U.S. 546, 551 (1973). See also C.P. Kindregan, Jr., & M.L. Inker, Family Law and Practice § 45:8, at 332-333 (3d ed. 2002) (discussing factors to consider in valuing closely held corporation). But see Dallas v. Commissioner, supra at 318 (distinguishing "fair value" -- fair merger price that stockholder would receive -- and "fair market value" -- price hypothetical willing buyer would pay hypothetical willing seller, both having reasonable knowledge of all relevant facts and neither being under compulsion to buy or sell).

[9] Leicester testified that, in his opinion, the highest and best use of the supermarkets was as an S corporation. He also testified that the application of tax affecting to S corporations depended on the facts of each case and could not be established categorically. Horvitz, the husband's expert, testified that he did not "speculate" on the characteristics of a potential buyer because in a divorce action he considered it appropriate to value the businesses as of a specific date only.

[10] Both experts agreed, and the judge found, that at the time of trial, the husband was the "whole show" for the supermarkets, the person "who makes it all happen." The judge accepted the parties' testimony that they contributed equally to the acquisition and maintenance of their marital estate from the date of their marriage in 1967 until the date of their separation in 2002.

[11] Previously, on August 26, 2003, nunc pro tunc to August 19, 2003, the judge had entered an amended supplemental judgment, and the wife had filed a number of postjudgment motions objecting to the division of assets and alimony award. On the parties' joint motion the judge issued the third amended supplemental judgment, in which the husband was also ordered to pay alimony in the amount of $8,448.57 per week from the date of the judgment until August 17, 2007, and $5,288.46 per week thereafter.

[12] Earlier, in November, 2002, the wife had filed a complaint for contempt against the husband, alleging that he had violated the temporary orders by failing to provide her with financial information concerning the supermarkets and by taking money from the supermarkets for purposes not sanctioned by the temporary orders. In September, 2003, the judge found the husband in contempt for (a) failing to provide monthly accounting of income generated from the rentals to Bernier Realty Trust from May 1, 2002, until November, 2002; (b) failing to deliver copies of weekly cash journals and accounts payable check registers and monthly reports generated by the supermarkets within forty-eight hours of the date the reports were generated; and (c) utilizing corporate assets and pledging the credit of the supermarkets to attempt to start a health food store. The husband was ordered to (a) provide an accounting to the wife for all monies taken for his personal benefit; (b) pay to the wife the sum of $7,500 for

her attorney's fees; and (c) cease making any investments or otherwise utilizing assets of the supermarkets until the wife was paid in full for her share of the supermarkets.

[13] The judge reasoned that the wife's failure to raise her claims for equalization of the income of the supermarkets during the divorce proceedings barred her from raising the claims in a subsequent equity action, where the issue of equalization of income had been addressed in temporary orders pursuant to the parties' stipulations.

[14] Massachusetts has a nominal State tax on the income of S corporations at the entity level, about which there is no dispute. Both parties' experts included this State tax in their valuations.

[15] We demonstrate the cognizable tax benefit to S corporation shareholders by way of an example adapted from the opinion of the Delaware Court of Chancery in Delaware Open MRI Radiology Assocs. v. Kessler, 898 A.2d 290 (Del. Ct. Ch. 2006) (Kessler). Assume that a corporation generates one hundred dollars in net annual earnings. If it is organized as a C corporation, its earnings after tax would be sixty dollars, assuming, as is the usual custom, that the effective corporate tax rate is forty per cent. Then, assume that the entity distributes its posttax earnings to its shareholders in the form of a dividend. Applying the individual tax on dividends at the prevailing rate of fifteen per cent, the shareholder (assuming for the moment one single shareholder) would receive total posttax distributions of fifty-one dollars. Thus, the shareholder's effective tax rate after corporate income and dividend taxes would be forty-nine per cent. If the corporation were organized as an S corporation, its shareholder (again, assuming only one) would receive the entire one hundred dollars in earnings as distributions and be subject only to a shareholder-level tax. Thus, the shareholder would be responsible for paying taxes on the one hundred dollars at his or her individual tax rates, which will vary according to the shareholder's total net income. If we assume the individual tax rate to be forty per cent because the shareholder is in the highest marginal tax rate, the shareholder would pocket sixty dollars after tax if all earnings were distributed. The benefit is thus clear: the shareholder of the S corporation in this example ends up with sixty dollars, while the shareholder of the C corporation ends up with fifty-one dollars. See Kessler, supra at 329.

[16] As counsel for both parties agreed at oral argument, valuation of any closely held corporation is fraught with uncertainties, and thus difficult to accomplish with precision

and consistency. There are several unknown variables present in valuing shares of a company that is not publicly traded and not immediately marketable. See C.P. Kindregan, Jr., & M.L. Inker, Family Law and Practice § 45:8, at 332 (3d ed. 2002), citing B.H. Goldberg, Valuation of Divorce Assets 74 (Supp. 1987) ("Valuations of closely held businesses are 'not an exact science, . . . especially one dealing in services and largely dependent upon the personalities and abilities of its principals'").

[17] The judge in this case improperly relied on the IRS valuation guide as authority to justify the tax affecting advocated by Horvitz. See Gross, supra at 347, quoting IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers ("This material was designed specifically by the IRS for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position").

[18] See, e.g., Dallas v. Commissioner, 92 Tax Ct. Mem. Dec. (CCH) 313, 318 (2006) (tax affecting earnings is not appropriate in valuing gift of stock to determine fair market value; distinguishing Kessler application of "fair value" approach); Estate of Adams v. Commissioner, 83 Tax Ct. Mem. Dec. (CCH) 1421, 1425 (2002), citing Gross, supra ("it is appropriate to use a zero corporate tax rate to estimate net cashflow when the stock being valued is stock of an S corporation"); Estate of Heck v. Commissioner, 83 Tax Ct. Mem. Dec. (CCH) 1181, 1188 n.7

(2002); Wall v. Commissioner, 81 Tax Ct. Mem. Dec. (CCH) 1425, 1432 n.19 (2001) (discussing undervaluation resulting from tax affecting and overvaluation resulting from failure to tax affect, and concluding, "[b]ecause [one expert's] methodology attributes no value to [the entity's] S corporation status, we believe it is likely to result in an undervaluation of [the entity's] stock").

See also Finkel, Is There An S Corporation Premium?, 4 Valuation Strategies 14, 16-17 (2001) (S corporation should not be tax affected if likely buyers are eligible S corporation shareholders); Fisher, The Sale of the Washington Redskins: Discounted Cash Flow Valuation of S Corporations, Treatment of Personal Taxes, and Implications for Litigation, 10 Stan. J. L. Bus. & Fin. 18 (2005); Hawkins & Paschall, A Gross Result in the Gross Case: All Your Prior S Corporation Valuations Are Invalid, 21 Bus. Valuation Rev. 6 (Mar. 2002) (if S election will not be lost, then "tax-affecting may not be the more appropriate valuation method to employ"); Raby & Raby, Tax Affecting -- or Effecting -- S Corporation Stock Valuations, 93 Tax Notes 1315 (2001) (inappropriate to tax affect earnings of S corporation assumed to continue as such).

[19] Throughout his testimony, Horvitz was notably imprecise in explaining his use of a thirty-five per cent tax rate. On direct examination, he said that the figure "represents the after-tax weighted average adjusted earnings in the hands of a new owner," while agreeing that S corporations pay no Federal tax at the entity level. On cross-examination, Horvitz testified both that the thirty-five per cent tax rate represents "the average corporate rate" and that the thirty-five per cent rate was for "personal tax." This discrepancy alone diminished the integrity of Horvitz's analysis. The judge was similarly vague. She stated only that Horvitz "applied an effective tax rate of thirty-five (35%) per cent to arrive at the after-tax weighted average adjusted earnings" and that "the Court believes that a deduction for taxes that will be owed must be made to either earnings or cash flow before an appropriate valuation can be made."

[20] The subject of taxation in Gross was the valuation of a gift of stock. The adverse parties were the government and the gift recipients of S corporation shares. The issue of equitable distribution was not present, as it is here. See Gross, supra.

[21] The judge stated in her findings that Horvitz distinguished the outcome of Gross on the ground that the issue in that case "was the value of a fractional, minority interest in an S Corporation that was to be valued for gift tax purpose[s]." She does not explain how that supposed distinction affects the determination of value here.

The judge also cited the IRS valuation guide to justify tax affecting. However, the IRS valuation guide cannot be cited as authority. See note 17, supra.

The judge's written "Rationale" provides no clearer window on her thinking, perhaps reflecting a confusion about whether corporate or individual taxation rates were being applied. See note 19, supra. The judge stated, "A buyer [of] either entity

has to consider the tax consequences of the income generated. A shareholder of a C corporation only personally pays taxes on the dividend that [it] receive[s]. [It has] actually received the dividend and can utilize those monies to pay the resultant tax. . . . A shareholder of an S corporation pays taxes on [its] proportionate share of the company, whether or not [it] actually receive[s] the cash. If sufficient funds were not received by the shareholder then he would have to utilize personal funds to pay the taxes. When the S corporation distributes additional funds to the shareholders so that the tax can be paid [as was the testimony in this case] the working capital of the company is reduced, and the income available to distribute to the owners is also reduced. Therefore, the Court believes that a deduction for taxes that will be owed must be made to either earnings or cash flow before an appropriate valuation can be made."

[22] Subsequent to Gross, the United States Tax Court also decided in several cases that it was improper to tax affect an S corporation. See cases cited at note 18, supra.

[23] See note 19, supra.

[24] In Kessler, the Delaware court reached its determination noting the presence of both a Delaware "equitable entire fairness claim and a statutory appraisal claim." Kessler, supra at 310.

[25] The Delaware court emphasized, as do we, that a different analysis might apply if the profits of the S corporation were plowed back into the company instead of distributed, or if the shareholders were not individually taxed at the highest bracket. See Kessler, supra at 329 n.101.

[26] The Delaware court determined the 29.4 per cent figure by creating fictional percentages to represent Federal corporate tax at the entity level and dividend tax at the shareholder level, to arrive at the same figure that would be left in the pockets of shareholders of an S corporation after taxing one hundred dollars of earnings (i.e., sixty dollars resulting after taxing one hundred dollars of earnings at the rate of forty per cent as in our example, see note 15, supra). To derive this fictional figure, the court worked in reverse. To achieve a posttax income of sixty dollars (after corporate entity tax and dividend tax), the figure to tax would be $70.60 (fifteen per cent of $70.60 is $10.60, and subtracting the latter from the former arrives at sixty dollars). To arrive at $70.60 from the total one hundred dollars of earnings, the court subtracted 29.4 per cent, the appropriate fictional tax rate. Phrased differently, the court asked at what rate a C corporation would be taxed at the entity level to permit the shareholder to receive a distribution of sixty dollars (as he would from an S corporation) rather than the fifty-one dollars he would have received as a C corporation shareholder. That differential rate captures the benefit of ownership in the S corporation.

[27] The judge stated: "[The wife's expert's] position is that a Subchapter S corporation would be worth substantially more than a Subchapter C corporation to a buyer. This is premised on the notion that an S corporation has an ability to provide greater cash flow to the owner due to the single level of tax paid by the entity. The court does not agree with this argument. Owners of S corporations normally distribute funds to themselves, as additional compensation, in order to pay the taxes arising from the corporate profits." The judge apparently eschewed the common understanding that shareholders in S corporations benefit from not having to pay a tax at the entity level. The fact that the husband paid himself additional money to meet his tax burden only supports the proposition that he benefited from the entity's S corporation status.

[28] The husband testified that the supermarkets were not for sale at any price. The wife made clear that she was willing and able to purchase the husband's one-half share for $8 million. There was additional evidence at trial that two other supermarkets on Martha's Vineyard, each totaling 25,000 square feet of selling space (smaller than the supermarkets at issue), had recently sold for approximately $9 million each. There was evidence that a large supermarket chain had made an overture to the husband to purchase the supermarkets, and that the husband was not open to discussions.

[29] Horvitz testified that he applied the discounts because, "I don't have the luxury in a divorce case of knowing who the owner's going to be and what the person will be able to do" with the supermarkets.

[30] Even if the husband had full control of the supermarkets, of course, his services could be lost due to illness or other catastrophe, to the detriment of the supermarkets' financial

success. Leicester's valuation, as well as Horvitz's, took into account the risk that the businesses could potentially suffer in the event of the husband's incapacity or death. See C.P. Kindregan, Jr., & M.L. Inker, Family Law and Practice § 45:8, at 332-333 (3d ed. 2002).

[31] Leicester testified that revenues grew as follows: 10.3 per cent in 1997; 7.8 per cent in 1998; 7.1 per cent in 1999; and 3.2 per cent in 2000.

[32] Alimony was to terminate on the earliest of the wife's remarriage, the husband's death, or the wife's death.

[33] The husband was ordered to pay $8,448.57 per week in alimony to the wife until August, 2007, at which time alimony would be reduced to $5,288.46 per week, representing the amount necessary to meet the wife's needs exclusive of operating costs of the horse farm, which were factored into the initial, higher alimony award. Originally the court ordered that the husband be given the option to buy the wife's shares through five equal payments of $585,000 over five years, during which time he was to pay interest at the rate of six per cent. By order of the third supplemental judgment, the husband was permitted to buy the wife's ownership of the supermarkets with a single lump sum payment, while continuing to provide the wife with extra alimony until August, 2007.

[34] The judge found that the wife will receive assets from the property settlement that are adequate to provide her with sufficient income to meet the expenses of the horse farm if she continues to run it at a loss.

[35] General Laws c. 208, § 34, contains fourteen mandatory factors that the judge must consider, and four discretionary factors that the judge may consider.

[36] The parties did not submit in the record before us their statements of personal expenses. The wife testified that her personal expenses were $3,364.25 per week and that weekly expenses for the horse farm totaled $12,654.45. We credit the judge's findings on the matter of weekly expenses based on the representations the parties made at trial and the financial statements submitted during the trial.

[37] The contempt action claimed that the husband had failed to provide monthly reports of the supermarkets, as stipulated; had withdrawn funds for personal use; had violated the automatic restraining order; and had caused her to incur a potential tax liability for S corporation income for 2002.

[38] When the divorce judgment entered and the husband did not voluntarily agree to the final reconciliation, the wife filed her motion to amend the judgment to provide for equalization of the supermarkets' net income from January 1, 2001, until the transfer of the wife's ownership to the husband. The wife claimed that she was charged for her "withdrawals" from the supermarkets over the years, while she was not given "credit -- even against those charges -- for her fifty per cent ownership of distributable income during the applicable period." The motion additionally noted that it could be rendered moot if the judge decided to rule on the contempt action.

[39] The judge did, however, find the husband in contempt for failing to render an accounting to the wife and for certain expenditures not provided in the temporary orders.

[40] The stipulations controlled what money the parties could take from the supermarkets' income from January 1, 2001, until judgment entered (which occurred on August 18, 2003): the

horse farm's expenses, $2,100 per week for the wife's basic living expenses, $5,000 per week as a salary for the husband, and various other expenses.

[41] Furthermore, as the wife notes, Federal law requires that S corporation distributions be made strictly based on stock ownership. 26 U.S.C. § 1361(b)(1)(D).

[42] We appreciate that the valuation issues in this case were complex and that the judge did not have the benefit of the Kessler analysis in rendering her decision. We emphasize the judge's role in weighing the parties' necessarily adversary arguments to ensure that the final judgment reflects the statutory requirements of equitable distribution and, here, the parties' agreement to divide assets evenly between them. On remand, we leave to the judge's discretion whether to solicit additional briefs and testimony from the parties on the specific issues presented.

JUDITH E. BERNIER *vs*. STEPHEN A. BERNIER (and a companion case[1]).

No. 11-P-394.
Dukes. January 11, 2012. - June 29, 2012.

Present: GRASSO, FECTEAU, & SULLIVAN, JJ.

Divorce and Separation, Division of property, Attorney's fees. *Corporation,* Close corporation, Valuation. *Damages,* Interest. *Interest.*

The cases were heard by *Randy J. Kaplan*, J.

David L. Kelston (*Max D. Stern* with him) for Judith E. Bernier.
Paul M. Kane (*Joan E. Kolligian* with him) for Stephen A. Bernier.

SULLIVAN, J.

In *Bernier* v. *Bernier*, 449 Mass. 774, 799 (2007) (*Bernier I*), the Supreme Judicial Court vacated that portion of the third amended supplemental judgment of divorce of the Probate and Family Court valuing the parties' S corporations and remanded the matter for further proceedings concerning, among other things, the issue of "tax affecting." More specifically, the court directed the probate judge to employ "the tax affecting approach" adopted in *Delaware Open MRI Radiology Assocs*. v. *Kessler*, 898 A.2d 290, 328-330 (Del. Ct. Ch. 2006) (*Kessler*). *Bernier I*, 449 Mass. at 790. The court also vacated the judgment of dismissal in the wife's equity suit in which the wife had sought an accounting and equalization of income derived from the parties' S corporations during a specified period. *Id*. at 796-799.

On remand, and after separate trials in the divorce and equity proceedings, the probate judge revalued the S corporations and entered a fourth amended supplemental judgment of divorce dividing the assets. By a judgment on the complaint in equity, the judge ordered the husband to pay the wife a certain sum but stated that there shall be no payment of statutory interest on the money owed. The parties' appeals from the divorce and equity judgments have been consolidated in this court.

Notwithstanding the judge's thoughtful analysis of the *Kessler* approach, set out in her supplemental findings of fact and rationale in the divorce case, for the reasons discussed below we are constrained to vacate the fourth amended supplemental judgment of divorce as it pertains to the valuation of the S corporations and remand the matter again to the Probate and Family Court. We affirm the judgment on the complaint in equity.

A. *The divorce case*. 1. *Valuation of the S corporations/tax affecting*. a. *Background*. The general background of the divorce case is set out in *Bernier I* and need not be rehearsed in detail. We concentrate here on the issue of tax affecting of the S corporations and draw liberally, both in our background description and discussion of the law, from the Supreme Judicial Court's opinion. During the marriage the parties achieved financial success through the operation of two supermarkets that were owned by two S corporations, of which the husband and wife each owned one-half. *Bernier I*, 449 Mass. at 777.[2] Before the initial trial

[1] Judith E. Bernier *vs*. Stephen A. Bernier, a suit on an amended complaint in equity.

[2] The husband and wife, as equal shareholders, had elected that the supermarkets be taxed under the provisions of subchapter S of the Internal Revenue Code, 26 U.S.C. §§ 1361-1379 (2000). *Bernier I*,

in 2002, the parties agreed to an equal division of assets. At trial, the testimony centered principally on the value of the supermarkets, with the parties agreeing to establish the valuation of the markets as of December 31, 2000, the date of the last reconciliation of accounts prior to trial. *Id*. at 778 & n.5. Each party presented the testimony of an expert witness on valuation: Mark Leicester prepared the wife's valuation, and Joel Horvitz prepared the husband's valuation. *Id*. at 778. Although "Leicester and Horvitz were in broad agreement on key points," including that "the buyer of the supermarket shares would seek an investment that would yield the buyer's required rate of return," and that the most accurate estimate of the supermarkets' value would be achieved by employing the "income" approach to valuation, the experts arrived at markedly different appraisals of the supermarkets. *Ibid*. Leicester opined that the fair market value of the supermarkets was $16,391,000; Horvitz fixed the fair market value at $7,850,000. *Ibid*.

The discrepancy in the experts' valuations, the Supreme Judicial Court noted, was due primarily to Horvitz's application of "tax affecting,"[3] as well as certain other discounts to his calculations of fair market value,[4] and Leicester's omission of those considerations. *Bernier I*, 449 Mass. at 778-779. The positions of the parties' experts were described by the court as follows:

> "Horvitz tax affected as if the S corporation were a C corporation, at what he termed the 'average corporate rate' of thirty-five per cent.[5] . . . He testified that tax affecting the S corporations at the C corporation rate was proper because, among other things, a person contemplating the purchase of an S corporation would factor into his probable rate of return the tax consequences of the purchase. Leicester, on the other hand, did not tax affect the supermarkets' income in his valuation because, as he testified, an S corporation, unlike a C corporation, does not pay taxes at the entity level, and because no sale of the business was contemplated."

Id. at 779.

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449 Mass. at 782. Unlike a traditional C corporation, the income of which is "subject to income tax at both the corporate (or entity) level and the shareholder level on dividends, if any, paid to shareholders . . . , the income of an S corporation is not subject to Federal tax at the entity level . . . but is passed through and taxed to the shareholder when earned by the corporation, whether or not the corporation pays dividends." *Id*. at 775 n.2. See *J.S.* v. *C.C.*, 454 Mass. 652, 660 n.10 (2009). The shareholders of an S corporation thus "enjoy the considerable benefit of avoiding the 'double taxation' of corporate dividends that is the hallmark of the C corporation." *Bernier I*, 449 Mass. at 782. The Supreme Judicial Court demonstrated in *Bernier I* the cognizable tax benefit to S corporation shareholders by way of an example adapted from *Kessler*. 449 Mass. at 782 n.15. In Appendix A to this opinion, we have set out and illustrated by chart the court's example.

[3] The Supreme Judicial Court stated that "[i]n the context of valuation of the stock of an S corporation, 'tax affecting' is employed in what the parties refer to as the income approach to appraising the value of S corporation shares, by which the estimated future earnings of the corporation are discounted by imputed future tax burdens at the entity level, even though the S corporation pays no entity level earnings taxes." *Bernier I*, 449 Mass. at 775 n.2, citing *Gross* v. *Commissioner of Int. Rev*., 272 F.3d 333, 344-347 (6th Cir. 2001), cert. denied, 537 U.S. 827 (2002).

[4] Horvitz additionally discounted the fair market value of the supermarkets by applying "key [person]" and "lack of marketability" discounts. *Bernier I*, 449 Mass. at 779. The Supreme Judicial Court ultimately determined that these discounts were not appropriate in the present case. *Id*. at 790-792. On remand, neither of the parties' experts made adjustments for these particular discounts, and the discounts are not implicated in the present appeals.

[5] The Supreme Judicial Court later stated that "[t]hroughout his testimony, Horvitz was notably imprecise in explaining his use of a thirty-five per cent tax rate." *Bernier I*, 449 Mass. at 784 n.19.

The judge in the initial trial rejected Leicester's valuation as "unreliable" and "adopted substantially without change Horvitz's method of applying tax affecting and key [person] and marketability discounts to the supermarkets, and adopted his conclusion that the fair market value of the supermarkets on the relevant date . . . was $7,850,000." *Bernier I*, 449 Mass. at 780. Thereafter, the judge entered a supplemental judgment on August 18, 2003 (which was later the subject of further supplementation), awarding the husband the option to purchase the wife's fifty percent ownership interest in the supermarkets for $3,925,000,[6] and certain other relief. *Ibid*.

On the wife's appeal, the Supreme Judicial Court concluded that the judge erred in adopting Horvitz's valuation that tax affected the fair market value of the parties' S corporations at a presumed "average corporate rate" of a C corporation. *Bernier I*, 449 Mass. at 775.[7] Applying the C corporation rate of taxation to an S corporation, the court stated, "severely undervalues the fair market value of the S corporation by ignoring the tax benefits of the S corporation structure and failing to compensate the seller for the loss of those benefits."[8] *Id*. at 776. The court reasoned that such a result was particularly misplaced in this case in view of the uncontroverted evidence that the supermarkets would continue to operate as S corporations after the parties' divorce; that they would continue to be owned by one of the existing shareholders; and that the supermarkets were profitable and would continue their historic practice of making cash distributions. *Id*. at 790. On the other hand, the court continued, in the circumstances of this divorce case, "failure entirely to tax affect an S corporation artificially will inflate the value of the S corporation by overstating the rate of return that the retaining shareholder could hope to achieve." *Id*. at 776. After review of the scant case law and pertinent literature on the subject, the court decided on an alternative approach to these two extremes and "adopt[ed] generally the metric employed by the *Kessler* court." *Ibid*.

As explained in *Bernier I*, *Kessler* involved a radiology practice, operating as a closely held S corporation, where the dealings between the majority and minority shareholders were constrained by fiduciary considerations. *Bernier I*, 449 Mass. at 787. Three of the eight shareholders of the corporation (the Kessler group) wanted the majority shareholders (the Broder group) to buy out their shares. *Id*. at 787-788. The parties' experts differed markedly in their valuation of the shares -- the expert for the Broder group treated the S corporation as a C corporation in his valuation (applying forty per cent as the tax rate to the business's earnings); the Kessler group's expert did not tax affect earnings at all. The Delaware court found, for reasons similar to those set out by the Supreme Judicial Court, see *supra*,[9] that neither expert's testimony concerning tax treatment was fair. *Id*. at 788.

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[6] On February 2, 2004, the husband exercised his option to purchase the wife's fifty percent ownership interest in the supermarkets. *Bernier I*, 449 Mass. at 781. The parties agree that on February 4, 2004, the husband paid the wife the then-ordered value for her one-half ownership interest in the markets.

[7] The court emphasized, as a preliminary matter, that "where valuation of assets occurs in the context of divorce, and where one of the parties will maintain, and the other be entirely divested of, ownership of a marital asset after divorce, the judge must take particular care to treat the parties not as arm's-length hypothetical buyers and sellers in a theoretical open market, but as fiduciaries entitled to equitable distribution of their marital assets." *Bernier I*, 449 Mass. at 775-776, citing G. L. c. 208, § 34.

[8] On this point, the court stated, more particularly, that "the judge erred in adopting in all material respects Horvitz's valuation that tax affected at thirty-five per cent when doing so was not reasonable, as it would clearly produce an arbitrary result: a significant undervaluation of the supermarkets" (footnote omitted). *Bernier I*, 449 Mass. at 787.

[9] The Delaware court's rationale is further explicated in note 10, *infra*.

The Supreme Judicial Court then summarized the so-called *Kessler* metric or approach:

"Having rejected the rationale and conclusions of both experts, the Delaware court proposed an alternate approach. This approach attempted to capture the tax benefit to the buyer of S corporation shares (the Broder group) of receiving cash dividends that are not subject to dividend taxes. The court observed that, as is the case here, the buyout was an 'involuntary removal,' and not an arm's-length purchase. To calculate the effect of taxes on the buyers and the sellers in these circumstances, the judge asked: if the S corporation at issue were a C corporation, at what hypothetical tax rate could it be taxed and still leave to shareholders the same amount in their pockets as they would have if they held shares in an S corporation? In other words, the judge asked what the effective corporate tax rate would be for the S corporation shareholder, although the entity itself paid no corporate tax. Assuming a dividend tax rate of fifteen per cent and a personal income tax rate of forty per cent (the shareholders were wealthy physicians who paid individual taxes at the highest rate), the court imputed a 'pre-dividend' corporate tax rate of 29.4 per cent to the S corporation.[10] The result was to leave the shareholder of an S corporation with the same amount of money in his or her pocket as the shareholder of a C corporation being taxed at a (fictitious) 29.4 per cent corporate tax rate. Applying this rate to the earnings of the entity measures 'with the greatest practicable precision the fair value of the . . . interest in the going concern value of' the business." (Citations and footnote omitted.)

Bernier I, 449 Mass. at 788-789. For an illustration of this approach, see the chart in Appendix B to this opinion.

The Supreme Judicial Court stated that although the probate judge did not have the benefit of the *Kessler* decision at the time she rendered her judgment, the judge, in the circumstances, should have looked past the "all-or-nothing" approach of the parties' experts and paid particular attention to the facts of the case over more abstract considerations. *Bernier I*, 449 Mass. at 790. The court concluded that "the metric employed by the *Kessler* court provides a fairer mechanism for accounting for the tax consequences of the transfer of ownership of the supermarkets from one spouse to the other in the circumstances of record." *Ibid*. As we have indicated, the court directed the judge, on remand on the issue of valuation, "to employ the tax affecting approach adopted in *Kessler*." *Ibid*.

[10] In *Bernier I*, 449 Mass. at 789, the Supreme Judicial Court added here its footnote 26, which provides:

"The Delaware court determined the 29.4 per cent figure by creating fictional percentages to represent Federal corporate tax at the entity level and dividend tax at the shareholder level, to arrive at the same figure that would be left in the pockets of shareholders of an S corporation after taxing one hundred dollars of earnings (i.e., sixty dollars resulting after taxing one hundred dollars of earnings at the rate of forty per cent as in our example . . .). To derive this fictional figure, the court worked in reverse. To achieve a posttax income of sixty dollars (after corporate entity tax and dividend tax), the figure to tax would be $70.60 (fifteen per cent of $70.60 is $10.60, and subtracting the latter from the former arrives at sixty dollars). To arrive at $70.60 from the total one hundred dollars of earnings, the court subtracted 29.4 per cent, the appropriate fictional tax rate. Phrased differently, the court asked at what rate a C corporation would be taxed at the entity level to permit the shareholder to receive a distribution of sixty dollars (as he would from an S corporation) rather than the fifty-one dollars he would have received as a C corporation shareholder. That differential rate captures the benefit of ownership in the S corporation."

b. *The proceedings on remand*. The proceedings on remand were marked by some uncertainty, and disagreement between the parties, as to what the Supreme Judicial Court intended when it directed that the *Kessler* metric or the *Kessler* approach be applied. The uncertainty arose in large part from the fact that, as the judge explained and the parties agree, when the *Kessler* valuation was set in 2004 the applicable Federal dividend tax rate was fifteen percent. However, as the judge and the parties also concluded, the applicable dividend tax rate on December 31, 2000, the date the parties agreed was to remain the valuation date of the supermarkets, was forty percent.[11] The probate judge (the same judge who presided at the *Bernier I* proceedings) noted that the Supreme Judicial Court's decision in *Bernier I* did not address the change in the dividend rates.

The wife's business valuation expert, Howard Gordon, testified that he used the formula set forth in *Kessler* but applied the dividend tax rate that was in effect in 2000 (i.e., forty percent). This resulted, as the judge noted, in a zero percent tax affecting rate because the personal dividend tax rate at the time of the stipulated date of valuation was the same as the applicable personal income tax rate, forty percent. For illustration, see the chart contained in Appendix C to this opinion. Utilizing a tax affecting rate of zero percent, Gordon valued the supermarkets at a combined value of $14 million.

David Merfeld, the husband's tax expert,[12] took a different approach. In his report, which was an exhibit at trial, Merfeld stated that S corporation income flowing out to the shareholders of the two markets is subject to Federal and State tax as ordinary income. Merfeld, the judge found, thus applied a 5.85 percent Massachusetts State tax based upon the tax on income allocable to an individual residing in Massachusetts in 2000, and a 39.6 percent Federal tax rate as in effect for tax year 2000. The judge stated that, in total, Merfeld tax affected the value of the markets at approximately forty-six percent by combining the State and Federal individual tax rates.[13] Merfeld ultimately valued the markets at $9,349,193.

Finding that both parties "took unreasonable positions in regards to their interpretation of the [Supreme Judicial Court's] ruling" in *Bernier I*, the judge rejected both experts' new valuations for the markets. More specifically, the judge found that the Gordon valuation, which utilized a zero percent tax affecting rate, overlooked the Supreme Judicial Court's "clear mandate[]" that "not tax affecting the valuation was unfair."[14] The judge stated that

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[11] There was a change in the Federal taxation of dividends between 2000 and 2004. See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752. See generally Bank, Dividends & Tax Policy in the Long Run, 2007 U. Ill. L. Rev. 533, 533-534 & nn.1, 11; Internal Revenue Service Publication No. 553, at 2 (rev. Jan. 2004). See also Internal Revenue Service Publication No. 550, at 19 (2000); Internal Revenue Service Publication No. 550, at 19-21 (2004).

[12] Merfeld is a certified public accountant who does primarily tax planning and tax return preparation with some financial statement preparation and litigation support. He has no experience in business valuation or the valuation of S corporations. The judge qualified him as a tax expert.

[13] The exhibits reflect that Merfeld also applied a Massachusetts S corporation tax at the entity level (as in effect in the year 2000) of 4.50 percent.

[14] In support of her position, the probate judge pointed, among other things, to the following language in the Supreme Judicial Court's discussion of *Kessler* in *Bernier I*: "On the other hand, the judge in *Kessler* reasoned, not tax affecting at all was also unfair, because it would lead to a windfall for the minority sellers. '[Denying] the reality that each shareholder owes taxes on his proportional interest in [the business] would result in the [Kessler group] receiving a higher per share value from the court than it could ever have realized as a continuing shareholder.' " *Bernier I*, 449 Mass. at 788, quoting from *Kessler*, 898 A.2d at 328-329. This would be the result, the probate judge stated, were she to accept Gordon's valuation.

she did not agree that the intent of the Supreme Judicial Court "was to literally plug in the formula utilized in *Kessler* if in fact the tax rate was substantially different and would have resulted in a [zero percent] tax [affecting] rate." Similarly, the judge found that Merfeld's valuation ignored the import of the court's decision in *Bernier I* that (in the probate judge's view) any tax affecting rate above the rate of thirty-five per cent would undervalue the markets. The judge stated that to adopt a tax affecting rate of forty-six percent, which is higher than the husband's originally proposed "corporate tax rate" of thirty-five percent[15] (a percentage, the judge indicated, the Supreme Judicial Court determined to be "too high") "would lead to an even more significant undervaluation of the supermarkets."

Having rejected the opinions of valuation of the parties' experts, the judge arrived at a different valuation of the supermarkets. Stating that the Supreme Judicial Court, in adopting the metric of the *Kessler* court, found that the application of a tax affecting rate of 29.4 percent was appropriate, the judge determined that she would use that tax rate in order to calculate the value of the markets. Indeed, the judge stated that the tax affecting rate of 29.4 percent was the only rate that she could apply to the valuation of the markets in the light of the Supreme Judicial Court's reliance on *Kessler*. Using a tax affecting rate of 29.4 percent, the judge found that the supermarkets had a combined total value of $11,366,129.

By a fourth amended supplemental judgment of divorce dated September 1, 2009, the judge ordered that the husband purchase the wife's fifty percent interest in the markets for the sum of $5,683,065. The husband was provided sixty days in which to pay the wife the sum of $1,758,065, representing the difference between the fifty percent payment under the third amended supplemental judgment ($3,925,000)[16] and fifty percent of the value of the markets as found by the court on remand ($5,683,065).[17] The judge also ordered the husband to pay the wife the sum of $328,529, in order to equalize certain attorney's fees and costs paid by the markets.

c. *Analysis*. On appeal, each party claims error in the judge's valuation of the supermarkets. The wife takes the position that the judge, on remand, was required to follow strictly the mandate of the Supreme Judicial Court to apply, in valuing the supermarkets, the method defined by the *Kessler* court, and that the judge "essentially ignored *Kessler's* method and the formula it and the Supreme Judicial Court adopted, and instead . . . , and incorrectly, used the tax rate that the *Kessler* court applied in the case before it," a rate which was predicated on a valuation date of 2004, not 2000. The husband, while acknowledging that a strict application of the *Kessler* metric (applying tax rates for the year 2000) results in a zero percent tax affecting rate,[18] argues that *Bernier I* (and *Kessler*), and the Supreme Judicial Court's later decision in *Adams* v. *Adams*, 459 Mass. 361, 388-390 (2011) (involving partnership interests), stand for the proposition that subchapter S corporation earnings must be tax affected to avoid an inequitable result in the valuation process. In the husband's view, the "accident of timing" with respect to applicable tax rates should not control the outcome of this case. The husband argues that to avoid the "apparent inequities when the '*Kessler* metric' is applied strictly on the basis of pure mathematics," the "tax rate

[15] See note 5, *supra*, and accompanying text.
[16] See note 6, *supra*, and accompanying text.
[17] The parties agree that the husband paid the wife the sum of $1,758,065 on March 1, 2010, and appear to be in substantial agreement that the husband paid the wife interest on that sum (for the period from about October, 2009, to March 1, 2010), as calculated by the Probate and Family Court in a subsequent judgment of contempt dated May 17, 2010.
[18] The husband states in his brief that "this result would be technically accurate strictly on the basis of mathematics."

to be applied by the trial court in tax affecting the valuation" of the supermarkets should be the Federal and State tax rates that were in effect in 2000 (i.e., an entity level tax of 4.5 percent [see note 13, *supra*], the Massachusetts individual income tax of 5.85 percent, and the Federal individual income tax of 39.6 percent).

While resolution of the issue is not a foregone conclusion, in interpreting *Bernier I*, we think the wife presents the more cogent position. Consequently, we reject the approaches taken by the judge on remand and by the husband, both on remand and on the appeal.

As we have stated, the Supreme Judicial Court adopted generally the metric employed by the *Kessler* court and directed the judge, on remand on the issue of valuation, to apply the tax affecting approach adopted in *Kessler*. The wife's expert, Gordon, as both the judge and the husband appear to acknowledge, utilized the *Kessler* metric in valuing the markets. Strictly speaking, the valuation proffered by Gordon is consistent with the Supreme Judicial Court's mandate.[19] Furthermore, application of the *Kessler* metric, even if it results (as in the present case) in a zero percent tax affecting rate, does not necessarily lead to an inequitable result. There is a distinction to be drawn between failing to tax affect at all the earnings of the supermarkets because an S corporation does not pay Federal taxes at the entity level (a basis for the approach taken by the wife's expert, Leicester, in *Bernier I*), and utilizing a zero percent tax affecting rate arrived at through application of "all applicable rates, as [the Supreme Judicial Court] ordered in *Bernier [I]*." *Adams* v. *Adams*, 459 Mass. at 390. See note 21, *infra*. The *Kessler* metric, as we have stated, attempts to capture the tax benefit to the buyer of S corporation shares of receiving taxable cash dividends that were not already taxed at the corporate level. *Bernier I*, 449 Mass. at 788. It does so by "calculat[ing] the effect of taxes on the buyers and the sellers," to wit, the judge asks: "if the S corporation at issue were a C corporation, at what hypothetical tax rate could it be taxed and still leave to shareholders the same amount in their pockets as they would have if they held shares in an S corporation?" *Id*. at 789. In the instant matter, because the dividend tax rate in effect in 2000 was forty percent, a tax affecting rate of zero percent was necessary to achieve that result.[20]

At best, the husband's argument is that *Bernier I* requires generally a tax affecting *Kessler* "approach," not literal application of the *Kessler* metric. Putting to one side the fact that such an argument ignores much of the Supreme Judicial Court's tax affecting discussion in *Bernier I*, there was no evidence that the methodology proposed by the husband on remand, i.e., the combination of personal income tax rates, constituted an accepted form of tax affecting for purposes of valuing an S corporation. As we have stated, Merfeld, the husband's sole expert, was a tax expert who had never valued a business or S corporation. The husband on remand offered no expert testimony from a business valuation expert concerning tax affecting. To the extent the husband claims additional support for his

[19] The husband indicated in his brief, and he conceded specifically at oral argument, that his approach to valuation does not adhere to the *Kessler* metric.

[20] The parties agreed at the first trial in this matter, and in the proceedings on remand, that the valuation date of the supermarkets was to be December 31, 2000. *Bernier I*, 449 Mass. at 778 n.5. Data in the case were calculated as of that date. The flaw in the probate judge's use on remand of a 29.4 percent tax affecting rate (the precise figure adopted by the *Kessler* court and discussed in *Bernier I*) is that that figure assumes a dividend tax rate of fifteen percent, the rate that was in effect in 2004. *Id*. at 789. While the probate judge clearly sought to reach what she viewed as an equitable result in this difficult and complex case, her ultimate determination of the value of the supermarkets, which utilizes a 29.4 percent tax affecting rate, cannot stand, because the 29.4 percent tax rate bears no relationship to, and is contrary to, the parties' stipulated valuation date of December 31, 2000.

valuation/tax affecting position in *Adams* v. *Adams*, *supra*, we fail to discern anything in that case that would cause us to reach a different result.[21]

2. *Postjudgment interest on new valuation of markets*. The Supreme Judicial Court's orders for remand in *Bernier I* contain no direction with respect to the calculation of interest on the judgment.[22] In various papers filed at the proceedings on remand, the wife requested interest on the new valuation of the markets, citing at one point to G. L. c. 235, § 8 (providing, inter alia, "[e]very judgment for the payment of money shall bear interest from the day of its entry . . ."), as appearing in St. 1983, c. 652, § 2. See *Karellas* v. *Karellas*, 54 Mass. App. Ct. 469, 471 (2002) ("A judgment is the act of the trial court finally adjudicating the rights of the parties including a decision by the court that a party shall recover a sum certain"). Interest under the statute is paid as "compensation for delay." *Trinity Church in the City of Boston* v. *John Hancock Mut. Life Ins. Co*., 405 Mass. 682, 684 (1989). Although the fourth amended supplemental judgment of divorce is silent with respect to interest, the judge, as the wife points out, stated at the hearing on the husband's later motion to stay judgment, "[T]hat's why I did not award interest on this money, which normally I would have, I think, because of the uniqueness of the issue."[23] It would appear that the wife's request for interest was implicitly denied by the judge.

The wife, invoking both Massachusetts and Federal authority,[24] argues that the probate judge erred in failing to order postjudgment interest on the $1,758,065 award to her pursuant to the new valuation of the markets for the period from the initial supplemental judgment on August 18, 2003, to the entry of the fourth amended supplemental judgment

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[21] In *Adams*, 459 Mass. at 388, the special master tax affected (by deducting 20.3 percent to reflect the combined Federal and Massachusetts capital gains tax rates) the transfer of the wife's portion of the present value of the partnership interest in issue. The special master did not tax affect at the effective income tax rates suggested by the experts for the parties. While noting that it was not necessarily error that the special master tax affected at a rate different from the rates advanced by both experts, the court stated that it was not clear why the special master had "applied a combined capital gains tax rate in lieu of the effective income tax rates suggested by [the parties' experts], *or some amalgamation of all applicable rates, as this court ordered in [*Bernier I*, 449 Mass. at 787-790], in the context of the transfer of an interest in a close corporation*" (emphasis supplied). *Adams*, 459 Mass. at 390. The court remanded for further explication. It is implicit in the language of *Adams* that what was contemplated and ordered by the court in *Bernier I* was something different from a combination, or stacking, of personal tax rates.

[22] We note that Rule 37 of the Federal Rules of Appellate Procedure, as amended effective Dec. 1, 1998, provides: "(a) When the Court Affirms. Unless the law provides otherwise, if a money judgment in a civil case is affirmed, whatever interest is allowed by law is payable from the date when the district court's judgment was entered[;] (b) When the Court Reverses. If the court modifies or reverses a judgment with a direction that a money judgment be entered in the district court, the mandate must contain instructions about the allowance of interest." Rule 37(a) finds expression in our case law. See *Thomas O'Connor & Co*. v. *Medford*, 20 Mass. App. Ct. 761, 765 n.6 (1985), and cases cited. There is no Massachusetts analogue for rule 37(b). *Ibid*.

[23] The parties disagree as to the meaning of the judge's comment, in context, and what the judge was referring to when she explained that she did not award interest.

[24] See, e.g., *Thomas O'Connor & Co*. v. *Medford*, 20 Mass. App. Ct. 761, 765 n.6 (1985); *Cordero* v. *De Jesus-Mendez*, 922 F.2d 11, 16 (1st Cir. 1990) ("In general, where a first judgment lacks an evidentiary or legal basis, post-judgment interest accrues from the date of the second judgment; where the original judgment is basically sound but is modified on remand, post-judgment interest accrues from the date of the first judgment"). See also *Loughman* v. *Consol-Pennsylvania Coal Co*., 6 F.3d 88, 97 (3d Cir. 1993) ("The standard for determining whether post-judgment interest should run from the original judgment is well established. . . . [T]he decision turns on the degree to which the original judgment was upheld or invalidated on appeal").

on September 1, 2009[25] (see the discussion in part A.1.b, *supra*). The wife asserts that this court should reverse and remand the matter to the Probate and Family Court with an order that she is entitled to postjudgment interest on any payment "attributable to the valuation of the markets made pursuant to appellate and/or remand proceedings."

As we are vacating that portion of the fourth amended supplemental judgment concerning the valuation of the supermarkets (under which the figure of $1,758,065 was derived) and remanding the matter for additional adjustments, we also treat as vacated the implicit denial of postjudgment interest on the specific amount awarded. In the circumstances presented here, where (among other things) new orders concerning the valuation of the markets and the payments to be made by the husband have yet to enter, there are uncertainties with respect to the time frame in which the wife seeks interest (see note 25, *supra*), and there is no indication the probate judge was afforded the opportunity to consider the specific arguments (and authorities) now advanced by the parties, we think the question of postjudgment interest should be revisited by the probate judge at the proceedings on further remand.

B. *The equity case*. 1. *Background*. As explained in *Bernier I*, the parties entered into stipulations for temporary orders during the divorce that provided, among other things, that both "would continue to own the supermarkets and equally share their profits during the pendency of the divorce." *Bernier I*, 449 Mass. at 796. The net income of the supermarkets was equalized through the end of 2000, leaving unequalized income of about $3.6 million yearly for the period from January 1, 2001 (the day after the last reconciliation of the parties' accounts), to February 2, 2004 (the date the husband exercised his option to purchase the wife's ownership interest in the supermarkets), "during which the wife continued to be a fifty per cent shareholder of the supermarkets." *Ibid*. Following a corporate meeting of the supermarkets on July 10, 2003, at which the husband asserted that the income of the supermarkets was entirely his, the wife, on July 28, 2003, filed a complaint in equity (later amended) seeking, among other things, "an accounting and equalization of income for the post-2000 period."[26] *Ibid*. In July, 2004, the judge dismissed the wife's equity action, stating, inter alia, that the wife's claims were barred under the doctrine of claim preclusion. *Id*. at 797. On the wife's appeal, the Supreme Judicial Court vacated the judgment of dismissal and remanded for further proceedings. *Id*. at 799. More specifically, the court concluded that the judge's actions and rulings in the case "effectively deprived the wife of a reasonable opportunity to bring the issue of income equalization

[25] There is some uncertainty in the wife's brief as to the time frames in which she is asserting her entitlement to postjudgment interest. Notwithstanding her statement in the "argument" section of her brief that the judge erred by failing to order interest on the $1,758,065, from August 18, 2003, the wife indicates in the "conclusion" section of her brief that she is entitled to interest from February 4, 2004. Similarly, although the wife indicates at one point in her brief, as we have stated, that postjudgment interest should run to September 1, 2009, she states at another point that it should run to March 1, 2010.

[26] The amended complaint in equity contained four counts: (1) request for an accounting and an order for appropriate payment to the wife; (2) breach of fiduciary duty; (3) waste of corporate assets; and (4) constructive trust.

The Supreme Judicial Court noted that the wife had also sought, unsuccessfully, to introduce the matter of income equalization through a complaint for contempt and a motion to amend the divorce judgment on property division. See *Bernier I*, 449 Mass. at 796-797, for a full description of the chronology and actions taken by the wife.

during the post-2000 period before the court at an appropriate juncture, and that the equity complaint was therefore wrongfully dismissed." *Id*. at 796.

Following a trial on the amended complaint in equity, where the issue was the equalization of the net income of the markets during the period in question,[27] the probate judge, by a judgment dated September 1, 2009, ordered the husband to pay the wife the sum of $762,375.30 on her claim for an accounting, and stated that there shall be no payment of statutory interest on the money owed. The judge dismissed with prejudice the remaining counts of the amended complaint (see note 26, *supra*). Both parties have appealed.

2. *Tax liability*. In arriving at the amount to be paid to the wife, the judge considered "what deduction should be made from the market[s'] net distributable income for income taxes between 2002 [and] 2004."[28] The husband and wife filed individual tax returns in those years, and the husband paid the taxes on all of the income for all of the business entities, including the markets. It was the wife's position at trial that the judge should not deduct the actual taxes paid by the husband for 2002, 2003, and 2004. Rather, the wife argued that the deduction for taxes should be based on a hypothetical tax she would have paid if her share of the distributable income had been paid to her in each calendar year. The parties agreed that, if the judge were to utilize the wife's tax rate for her one-half of the income in the years at issue, her taxes would have been $245,279 less than the husband actually paid.[29] The wife claimed that this was a loss for which she should be compensated, a claim the judge rejected.

Contrary to the wife's assertion, we fail to discern error in the judge's failure to, essentially, credit her with the additional sum of $245,279. Among other things, the judge noted that the parties had entered into various stipulations that became orders of the court, which required the husband to make tax payments for the supermarkets. Those stipulations were in effect until August 18, 2003, when the supplemental judgment of divorce was entered. The judge found specifically that the husband relied on these stipulations, as well as various judgments of the court that did not change his obligation to pay all corporate taxes, in paying estimated and final taxes (the taxes accrued in 2002 and 2003).[30] That the husband's final tax returns for 2002 and 2003 were actually filed after the wife filed her complaint in equity on July 28, 2003, and after the divorce judgment entered on August 18, 2003, does not, in our view, require a different result.

3. *Prejudgment interest*. The wife argues that she was entitled to, and the judge erred in failing to order, statutory prejudgment interest pursuant to G. L. c. 231, § 6C (interest added to damages in contract actions), § 6H (interest on damages not otherwise provided

[27] At trial, the wife claimed that she was owed $1,082,785.80; the husband put the figure at $509,816.30.
[28] The parties filed joint tax returns in 2001.
[29] The $245,279 figure represents "excess taxes" purportedly paid by the husband in the amount of $50,848 for the tax year 2002, $190,142 for the tax year 2003, and $4,289 for the tax year 2004. The amount for the 2004 tax year borders on de minimis.
[30] The judge noted also that the wife did not seek an order for instructions as to how the taxes were to be paid.

by law), and § 6B (interest added to damages in specified tort actions),[31] on the equalization payment of $762,375.30, from July 28, 2003, to the date of the equity judgment, September 1, 2009. See *O'Malley* v. *O'Malley*, 419 Mass. 377, 381 (1995) (section 6C, concerning prejudgment interest in contract actions, commands a ministerial act in which interest attaches automatically). In the wife's view, the husband was found to have long owed her the sum of $762,375.30, and the accounting and payment could only be ordered as a result of breach of agreement (the parties' stipulations or the parties' S corporation agreements) or "breach of fiduciary duty/restitution." We fail to discern error, for the reasons set out below.

As the husband suggests in his brief, the complaint in equity in this case cannot be viewed in a vacuum; it arises from the marital relationship and the divorce proceedings, which called for a division of the marital assets. As we have indicated, the Supreme Judicial Court in *Bernier I* set out the chronology of the wife's attempts, through different procedural vehicles filed within a short period of time, to introduce the matter of income equalization. See note 26, *supra*. Among other things, the wife moved specifically to amend the divorce judgment on the property division after her complaint in equity had been filed (appending to her motion a copy of the equity complaint) to provide for equalization of the supermarkets' income.[32] *Bernier I*, 449 Mass. at 796-797. Such an approach would presumably call for the income equalization to be effectuated through a property division -- it would not constitute an award of damages. Had the wife been successful on her motion, it is difficult to perceive how she would have been entitled to prejudgment interest on the equalization amount. See *Karellas* v. *Karellas*, 54 Mass. App. Ct. at 474.

Through her alternate request for an accounting and an order for payment in her equity action (the dismissal of all other counts is not challenged on the appeal) the wife sought, similarly, to equalize the markets' income. However, the wife now appears to characterize the judge's income equalization award as damages under the prejudgment interest statutes. In the peculiar circumstances of the case, and the context in which the matter of income equalization arose, we are not persuaded that the judge's accounting and order for payment constitute an award of damages on which prejudgment interest is to be added.

C. *Equalization of attorney's fees and costs*. At the close of its discussion of the complaint in equity in *Bernier I*, the Supreme Judicial Court commented with respect to the equalization of attorney's fees:

"In the novel and complex circumstances of this case, we conclude that valuation of the markets and equal distribution of property are not issues that are easily separable. The parties' original stipulations provided that the supermarkets would advance the parties' attorney's fees, with the payments 'debited to the party's account who has incurred those expenses,' and that such payments would be considered loans repayable by each party on

[31] "Damages" has been defined as "the word which expresses in dollars and cents the injury sustained by a plaintiff." *Rood* v. *Newberg*, 48 Mass. App. Ct. 185, 195 (1999), quoting from *Turcotte* v. *DeWitt*, 333 Mass. 389, 392 (1955).

[32] In discussing why principles of res judicata and claim preclusion were not applicable to the wife's complaint in equity, the Supreme Judicial Court also suggested that the issue of income equalization might have been an appropriate subject in the divorce action: "The wife could not have known in advance of the divorce judgment that that judgment would not address equalization for the post-2000 period, a matter that was clearly set before the judge months before the judgment issued." *Bernier I*, 449 Mass. at 798.

the 'final division of [the] marital assets.' The parties agreed to an equal division of the marital assets and the supermarkets. Each party has expended a considerable sum for legal representation toward the joint goal of valuing the supermarkets and dividing these assets. A final equalization of the supermarkets should incorporate the fees paid to attorneys for each party, and be treated so that each party is effectively debited with half of the attorney's fees. To fail to do so would leave the wife to pay her entire legal expenses out of her own pocket while the husband effectively would receive a windfall by simply moving money from one source under his control to another."

Bernier I, 449 Mass. at 798-799.

The court concluded that "the valuation of the supermarkets should be adjusted to take into account advances of legal fees for both parties since the December 31, 2000, reconciliation." *Id*. at 799.

At the proceedings on remand, the parties disagreed as to the meaning and intent of the Supreme Judicial Court's directive with respect to the "time frame" over which the attorney's fees were to be equalized. The husband argued that the probate judge was to equalize the attorney's fees through the date of the entry of the supplemental divorce judgment dated August 18, 2003. The wife took the position that the end date for the equalization period, although not specified by the Supreme Judicial Court, must be the termination of the proceedings before the Probate and Family Court, including the appeal and remand proceedings. The wife also asserted that the equalization of attorney's fees should apply to the equity case as well as the divorce case.

The judge ultimately concluded that it was the intention of the Supreme Judicial Court that the equalization of attorney's fees occur as of August 18, 2003, and, in the fourth amended supplemental judgment of divorce, ordered the husband to pay the wife, as an additional payment for her share of the business, the sum of $328,529.[33] The judge stated in her findings in the divorce case that there was nothing in *Bernier I* that would entitle the wife to an equalization of postjudgment fees and fees for the equity action.

Seizing upon the language of the Supreme Judicial Court that the parties agreed to an equal division of the marital assets and the supermarkets and that "[a] final equalization of the supermarkets should incorporate the fees paid to attorneys for each party," *Bernier I*, 449 Mass. at 799, the wife argues that "where a critically important part of the equalization could only occur well after the initial judgment, it was error for the court to impose an August 18, 2003 cutoff date." Put another way, the wife asserts that the Supreme Judicial Court's rationale -- the parties' equal sharing of the cost of getting a right result in these cases -- logically extends the equalization through the present appeal. The wife also argues that the probate judge erred by failing to equalize the attorney's fees from the equity case, particularly where the Supreme Judicial Court ordered equalization specifically as part of its discussion in the equity case.

[33] The judge found that from the commencement of the divorce through August 18, 2003, the supermarket entities paid legal fees, costs, and expert and professional fees in the amount of $1,202,651 on behalf of the wife. No further fees were paid for her benefit after that date. During that same period the supermarket entities paid fees and costs on behalf of the husband in the amount of $545,594.36. Any legal fees incurred after August 18, 2003, and even through January 22, 2004, the date of the third supplemental judgment of divorce, were not paid by the corporations but by the parties individually. As the total legal and other fees amounted to $1,748,246, the judge determined that a payment by the husband to the wife of $328,529 "would have each party pay $874,123 of legal fees, costs and expert fees."

We agree with the probate judge that the probable intent of the Supreme Judicial Court was to equalize the attorney's (and other) fees as of August 18, 2003. At the outset, the Supreme Judicial Court made reference to the parties' original stipulation concerning the advancement to the parties of attorney's fees and the payment of those fees. That stipulation, as the probate judge noted, was dated January 10, 2001. The Supreme Judicial Court indicated that the stipulations of the parties "were entered as temporary orders to govern spending (e.g., salary, attorney's fees, and expenses) only until the divorce judgment entered."[34] *Bernier I*, 449 Mass. at 797-798. Furthermore, the court's specific concern that the husband might benefit unfairly (i.e., receive a "windfall") by simply moving "money from one source under his control to another," *id*. at 799, appears directed toward a period prior to a division of the parties' property. Finally, as the probate judge stated, the Supreme Judicial Court's directive, that the valuation of the supermarkets should be adjusted to take into account *advances* of legal fees for both parties, does not order the parties to equalize all attorney's fees and expenses incurred after monies were no longer advanced from the corporation. In the circumstances, we also agree with the judge that the wife was not entitled to an equalization of attorney's fees for the equity action.[35]

D. *Conclusion*. We vacate the portion of the fourth amended supplemental judgment of divorce concerning valuation of the parties' S corporations (as well as the implicit denial of the wife's request for postjudgment interest) and remand the matter to the Probate and Family Court for further proceedings and amendment to the judgment not inconsistent with this opinion. On remand, the judge may hold such hearings as she deems necessary. That judgment is otherwise affirmed. The judgment on the complaint in equity is affirmed.

So ordered.

[34] In a footnote in its discussion of the equity action, the court stated: "The stipulations controlled what monies the parties could take from the supermarkets' income from January 1, 2001, until judgment entered (which occurred on August 18, 2003): the horse farm's expenses, $2,100 per week for the wife's basic living expenses, $5,000 per week as a salary for the husband, and various other expenses." *Bernier I*, 449 Mass. at 798 n.40.

[35] The husband argues on appeal that the judge erred in calculating the adjustments to be made for payment of attorney's fees and costs. He claims that under the equalization methodology employed by the judge, the wife owes *him* the sum of $328,529. As the husband's notice of appeal was limited to the provision of the fourth amended supplemental judgment concerning the valuation and division of the supermarkets, we do not address his contention. See *Sturges* v. *Chilmark*, 380 Mass. 246, 262 (1980) ("Of course, that portion of the judgment from which no appeal was taken stands").

APPENDIX A.

General illustration of Federal income tax benefit to S Corporation shareholders, adapted from *Delaware Open MRI Radiology Assocs*. v. *Kessler*, 898 A.2d 290, 329 (Del. Ct. Ch. 2006) (*Kessler*), as discussed in *Bernier* v. *Bernier*, 449 Mass. 774, 782 n.15 (2007) (*Bernier I*). See *ante* at 83 n.2.

C Corp S Corp
Income Before Tax $100 $100
Corporate Tax Rate 40%#(3) (3-
)#0%
Available Earnings $60 $100
Dividend or Personal Income Tax Rate 15%#(3) (3-
)#40%
Available After Dividends1 $51 $60
1-3¢1The phrase "available after dividends" was employed in Kessler, and was characterized in Bernier I as meaning "total posttax distributions," assuming that all net earning were distributed. 449 Mass. at 782 n.15, 789 n.26.

APPENDIX B.1

Illustration of tax affecting approach of *Delaware Open MRI Radiology Assocs.* v. *Kessler*, 898 A.2d 290, 330 (Del. Ct. Ch. 2006) (*Kessler*) (using year 2004 tax rates), described and adopted in *Bernier* v. *Bernier*, 449 Mass. 774, 787- 790 (2007) (*Bernier I*).2 See *ante* at 87.

C Corp S Corp S Corp
Valuation
Income Before Tax $100 $100 $100
Corporate Tax Rate 40%#(3)(3- 29.4%
)#0% (tax
affec-
ting
rate)
Available Earnings $60 $100 $70.60
Dividend or Personal Income Tax Rate 15%#(3)(3- 15%
)#40%
Available After Dividends3 $51 $60 $100

1-4¢1This chart is consistent with the chart in Kessler and with chalk C at the trial on remand after Bernier I.

1-4¢2At least one commentator has put aspects of the Kessler metric to formulation. See McMorrow, Consider "Tax Affecting" When Setting the Value of an S Corporation, Bus. Entities, Nov./Dec. 2008, at 36, 45.

1-4¢3The phrase "available after dividends" was employed in Kessler and was characterized in Bernier I as meaning "total posttax distributions," assuming that all net earnings were distributed. 449 Mass. at 782 n.15, 789 n.26.

APPENDIX C.1

Illustration of tax affecting approach of *Delaware Open MRI Radiology Assocs*. v. *Kessler*, 898 A.2d 290, 330 (Del. Ct. Ch. 2006) (*Kessler*), using year 2000 tax rates. See *ante* at 88.

C Corp S Corp S Corp
Valuation
Income Before Tax $100 $100 $100
Corporate Tax Rate 40%#(3)(3- 0% (tax
)#0% affec-
ting
rate)
Available Earnings $60 $100 $70.60
Dividend or Personal Income Tax Rate 40% 40% 40%
Available After Dividends2 $36 $60 $60
1-4¢1 This chart is consistent with chalk D used at the trial on remand after Bernier v. Bernier, 449 Mass. 774 (2007) (Bernier I).
1-4¢2 The phrase "available after dividends" was employed in Kessler and was characterized in Bernier I as meaning "total posttax distributions," assuming that all net earnings were distributed. 449 Mass. at 782 n.15, 789 n.26.

Borruso v. Communications Telesystems International

Case name: Borruso v. Communications Telesystems International
Citation: 753 A.2d 451,1999 Del. Ch. LEXIS 197
Date of decision: September 24, 1999
Country: US
State or Federal: State
State/Jurisdiction: Delaware
Court: Court of Chancery
Type of action: Dissenting Shareholder
Judge: Lamb
Experts: Peter S. Huck (for Borruso)
Anthony P. Kern (for Communications Telesystems)
SIC: 4813 Telephone Communications, Except Radiotelephone (except resellers)
NAICS: 517911
1147, 1759

Keywords: Control premium, Discount for lack of marketability (DLOM), Fair value, Market multiples

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JUDGES:

Stephen P. Lamb, Vice Chancellor.

OPINIONBY:

Stephen P. Lamb

OPINION:

MEMORANDUM OPINION

LAMB, Vice Chancellor

I. PRELIMINARY STATEMENT

In this appraisal action, filed pursuant to Section 262 of the Delaware General Corporation Law ("DGCL"), I am called upon to determine the fair value of the shares of common stock of WXL International, Inc. ("WXL"), a Delaware corporation, as of December 16, 1997, the date on which WXL was merged with and into its parent corporation, Communications Telesystems International ("CTS") (the "Merger"). As of that date, petitioners were the holders of 500,000 shares (or five percent) of WXL common stock, CTS being the holder of the other 95 percent of the WXL shares. It is conceded that petitioners made a timely demand for appraisal in accordance with the requirements of Section 262.

Although the parties and their experts differ widely in their conclusions as to the appraised value of the shares, the issues in contention at this point of the proceeding are quite limited in scope. The parties' testifying experts both used the same method of analysis (the "comparable company method") and both testified that it was the only method properly relied upon for this case. The experts also agreed that using total revenues as the multiplicand was the only appropriate iteration of that method. Moreover, the two experts each identified eight companies as "comparable," five of which companies were used by both experts. As a result of examination at trial, there is now agreement to include a sixth company as a "comparable."

The experts' analyses differed materially in only a few respects: (i) whether, in deriving a multiplier for WXL from the data generated as to comparable companies, a premium should be added to reflect WXL's better than average rate of growth over the 12-month period leading up to the merger, (ii) at what point in the analysis the information derived should be adjusted to eliminate the minority discount inherent in the comparable company method, and (iii) whether the value derived from that analysis should, in this case, be reduced to account for any observed "private company" discount.

In summary, I conclude as follows: (a) no growth premium is warranted, (b) a control premium should be added to adjust the market value of the equity derived from the comparable company method, and (iii) on the record before me, no "private company discount" is appropriate. Based on these conclusions, and for the other reasons explained in this opinion, I find that the fair value of the shares of common stock of WXL, as of December 16, 1997, was $ 0.6253 per share, or a total of $ 312,650 for the 500,000 shares subject to appraisal. I will allow interest on this sum at the legal rate, compounded quarterly, through the date judgment is entered in accordance with these findings.

II. BACKGROUND

A. WXL's Creation

CTS is a facilities-based long-distance telephone company that operates throughout most of the United States and has been attempting to expand internationally. Founded in 1991, it offers to its customers direct dial long-distance services as well as prepaid calling card, Internet and other communications services.

In 1994, petitioner Carl Borruso ("Borruso") approached Roger Abbott, Chairman and CEO of CTS, and presented a business plan to begin long-distance telecommunications operations in the United Kingdom, France and Germany. At the time, CTS had no European operations. Thereafter, in November 1994, CTS and Borruso entered into a Formation Agreement and a Shareholders Agreement with respect to the to-be-formed WXL. The Shareholders Agreement attached the business plan proposed by Borruso, including financial projections. The business plan provided that CTS would fund WXL for two years, estimated to include $ 2 million in "seed money," with the expectation that at the end of that

period, WXL would be cash flow positive. Monthly pre-tax losses were expected until the spring of 1996. On the projected balance sheets, WXL was expected to have retained earnings of nearly $ 2 million by September, 1996.

At WXL's formation, Borruso received 400,000 shares, or 4%, of the company's stock; the other petitioner, William Lee received 100,000 shares, or 1%. CTS received the remaining 9,500,000 shares, or 95% of the common equity.

B. WXL's Operations

WXL began operations sometime in the first half of 1995. It had revenues of $ 0.6 million for the fiscal year ("FY") ended September 30, 1995. Revenues increased to $ 5.2 million in FY'96. These revenue figures were far lower than the $ 7 million and $ 39 million revenues projected in the business plan attached to the Shareholders Agreement for FY'95 and FY'96, respectively. Revenues grew to $ 10.7 million in FY '97, $ 11.9 for the 12 months ended December 31, 1997, and were $ 2.8 million in the first quarter of FY'98 (ended December 31, 1997).

Over this period, the mix of WXL's revenue streams changed rapidly. Commercial revenue amounted to 72.4% of revenues in FY'95 but only 14.7% in FY'97. Carrier revenue represented 17.4% of revenues in FY'96, 68.5% in FY'97 and only 17.9% in the first quarter of FY'98. Finally, intercompany revenue grew from 6.1% of total revenue in FY'96 to 48.0% of total revenue in the first quarter of FY'98. These radical changes in revenue sources reflected quickly changing competitive pressures and opportunities. For example, when WXL initially failed to attain the projected amount of revenues from residential or commercial end-users, it sought to enter the more "niche" calling card market. This foray was successful at first but revenues shrank when competitive pressures mounted. WXL then identified "call shops" as a potential source of revenues. n1 WXL was, at first, successful in generating substantial revenues in this business. But WXL was quickly forced to change its credit and collection procedures when bad debt charges rose to unacceptable levels. These procedural changes caused the call shop revenue flow to dry up.

n1 Call shops are store-front facilities with multiple telephone booths for placing international calls.

WXL's revenues were derived principally from operations in the United Kingdom. WXL had other, less substantial, operations in France and Germany. The United Kingdom had voluntarily deregulated its market for telecommunications services in the early 1990's, which led to greater opportunities for WXL in those markets. Deregulation of the markets in France and Germany did not occur until after the effective date of the merger. Even then, the actual process and timetable for deregulation in those and other European countries remained uncertain. The key element of deregulation is the ability of newly competing companies to interconnect with the dominant telephone company in each country. At the time of trial, WXL had still not achieved interconnection in Germany.

Operating income (loss) before interest, taxes, depreciation, and amortization ("operating EBITDA") was ($ 2.6) million in FY'95, ($ 2.9) million in FY'96 and ($ 4.5) million in FY'97. For the first quarter of FY'98 the operating EDITDA was ($ 0.4) million. By contrast, the projections attached to the Shareholders Agreement called for operating EBITDA of ($ 1.6 million) in FY'95 (on revenues of $ 7 million) and of $ 3.6 million in FY'96 (on revenues of $ 39 million).

By early 1997, CTS began to consider its options with regard to WXL, including the possibility of shutting it down. Ultimately, CTS decided not to shut WXL down, reflecting the concern that doing so would adversely affect CTS' operations in other countries in which CTS was having greater success. Also, CTS hoped that, with an infusion of needed additional capital, WXL's operations in the UK and Europe could prove to be profitable.

C. The Merger

On December 16, 1997, CTS, as the owner of 95% of WXL's common shares (the only class of shares outstanding), was able unilaterally to effect a short form merger with WXL, pursuant to Section 253 of the DGCL. In the Merger, CTS fixed the consideration to be paid to Borruso and Lee at $ .02 per share. The method by which that price was determined had none of the attributes that would justify giving it any consideration in this proceeding. n2 No outside financial analysis of WXL was obtained by CTS. Instead, the $ 0.02 per share price was developed informally by the principal officers or owners of CTS, who did not retain their original work papers. That proposed price was then approved by the CTS board. It would appear from the record that the directors of CTS concluded that there was no positive value to WXL.

n2 Indeed, CTS went out of its way to make clear that Anthony Kern, its valuation expert, performed his work independently of the methods followed by CTS in setting the Merger price.

Petitioners point out several flaws in the procedure followed by CTS in arriving at a fair price for the WXL shares. First, the valuation was done at the end of 1996 or the beginning of 1997--up to a year before the merger became effective (Tr. at 252, 256). According to Mr. Abbott, CTS' Chairman and CEO, the most recent financial numbers for WXL at his disposal were the first or second quarter of fiscal 1997 n3--when WXL was much smaller than on the Merger date. n4 Moreover, CTS used revenue multiples derived from the prices at which United States telecommunications companies were selling at the time. By using these multiples, of course, CTS' owners failed to take into account that WXL was a European - based telecommunications company, which CTS acknowledged would expect to enjoy higher revenue, margins and growth rates than its American counterparts. Additionally, the fair value analysis performed by CTS may have improperly included a minority discount, not appropriately applied under the law of this State. See Cavalier Oil Corp. v. Harnett, Del. Supr., 564 A.2d 1137, 1144-45 (1989).

n3 WXL's fiscal year began October 1 of each year. Accordingly, the first quarter of fiscal 1997 began October 1, 1996.

n4 For example, revenues for the first quarter of fiscal 1997 were $ 1,542,722, while revenues for the first quarter of fiscal 1998 (which ended only 15 days after the Merger) were $ 2,767,000. In addition, as of October 1, 1996, the bulk of WXL's business was in the United Kingdom, with France and Germany producing relatively little revenue at that time.

Petitioners also point out that CTS did not comply with the requirements of 8 Del. C. § 262, in that it delayed in mailing notice of the merger to petitioners until January 12, 1998--17 days beyond the statutorily permitted time. In addition, the notice violated § 262(d)(2) by not including a copy of the appraisal statute.

II. DISCUSSION

The parties' experts were in agreement about significant aspects of the method properly employed in this case to determine the fair value of Petitioners' shares. I find no reason to deviate from the process they jointly followed. Thus, I make the following findings, based on the record before me in this matter:

1. It is proper to rely on the comparable company method of analysis in determining the fair value of WXL.

2. No other method of valuation is appropriately relied upon here. n5

3. Because no single comparable company's profile and operations is more indicative of the value of WXL than any other's, the median multiple exhibited by the comparable companies is the best indication of value for WXL.

4. The median unadjusted multiple for the basket of the five common comparable companies is 2.6x. Including the sixth comparable, about which there is no dispute, the unadjusted median multiple is 2.5x.

5. The adjusted multiple (after it is derived) should be applied to WXL's latest pre-Merger 12-month revenues of $ 11,480,945 to derive the market value of invested capital ("MVIC").

n5 Because of the limited financial history of WXL available as of the Merger date, neither expert was comfortable using a discounted cash flow analysis to determine WXL's appraised value. Also, due to the limited number of comparable transactions available as of the Merger date, neither expert relied on that method of valuation.

Thus, I will turn to that analysis and the parties' points of disagreements.

A. The Comparable Companies

Petitioners' testifying expert was Peter S. Huck, P.E., ASA. Mr. Huck is Assistant Vice President and Principal for the Milwaukee Financial Valuation Group of American Appraisal Associates, Inc. ("AAA"). He is a Professional Engineer and and is certified as an Accredited Senior Appraiser by the American Society of Appraisers. Respondent CTS called Mr. Anthony P. Kern of Price Waterhouse Coopers, LLP to testify on its behalf. Mr. Kern is Partner-in-Charge of that firm's FAS Information, Communications and Entertainment Industry Group in Washington, D.C.

To perform their analyses, Huck and Kern both identified a set of eight companies judged by them to be sufficiently comparable to CTS. Five of the eight were common to both sets of comparables. The comparables used were as follows:

Five Common Comparables	Huck's Distinct Comparables	Kern's Distinct Comparables
Pacific Gateway Exchange, Inc. (PGEX)	IDT Corporation (IDTC)	ACC Corp. (ACC)
Primus Telecomm. Group, Inc. (PRTL)	Esprit Telecom Group plc (ESPRY)	Startec Global Comm. Corp.(STARTEC)
RSL Comm., Ltd. (RSLC)	Colt Telecom Group plc (COLTY)	Telegroup (TELEGROUP)
Viatel, Inc. (VYTL)		

Star Telecomm., Inc.

(STRX)

Respondent concedes that Esprit is appropriate to use as a comparable company, but continues to object to the inclusion of Colt and IDT. I agree that Colt and IDT are not useful comparables and should be eliminated from the analysis. Colt is a local exchange carrier in the UK. It is not a long-distance company, but rather the company that owns the wires that connect homes or offices to the local switch. Thus, it does not compete with WXL or the other comparable companies. Its lack of comparability is also apparent from the great variation of its derived revenue multiplier (10.5x) from those of the other guideline companies utilized by Huck (ranging from 1.2x to 4.5x). I also agree that IDT should be disregarded in the analysis due to the fact that a substantial portion of its revenues is derived from its operations of an Internet network. The growth of that segment of IDT's business is very strong and, as is commonly known, current valuations of all Internet related businesses are unusually high. While Petitioners are correct that IDT also competes in the European long-distance market and might otherwise be a good comparable, its participation in the Internet market offers too great a chance of distortion to allow its inclusion.

Petitioners continue to object to the inclusion of any of Kern's distinct comparables: ACC, Startec and Telegroup. I agree with Petitioners that the inclusion of any one of these three companies presents substantial issues. ACC was, at the relevant time, subject to an announced agreement for its acquisition by another company. Thus, reliable information about its stock trading activity during the pertinent period of time could not be directly observed. Because there is otherwise a sufficiently large group of other companies to use, this is a sufficient reason to reject ACC as a comparable. Startec derives most of its revenue from non-European markets and only 2.2% from Western Europe and, thus, was not significantly involved in the same market as WXL. Telegroup has a highly concentrated share ownership, with 85% of its stock held by founders or otherwise in private hands. On the record before me, I am not able to discern whether there is a sufficiently active market for its shares from which to derive reliable information for valuation purposes. For these reasons, I will exclude Startec and Telegroup from the basket of companies used for purposes of comparison.

For the foregoing reasons, I find that the group of comparables should consist of the five companies identified by both experts plus Esprit.

B. The Derived Multiple

As stated above, the unadjusted median multiple for the five common guideline companies plus Esprit is 2.5x. n6 The next issue to be addressed is the downward adjustments made by the experts to that multiple.

n6 I will use Huck's derived multiples, as the parties have both done in post-trial briefing, because they are derived from data that correlates to the WXL revenue figure to be used in calculating WXL's value.

Huck applied his adjustments directly to the median multiple (and not to individual comparable company multiples) to account for three factors: size, profitability and growth. He concluded that WXL's small size and lack of profitability relative to the guideline companies, together justified a downward adjustment of 25% to 35%. He also determined that WXL's superior latest-12-month growth rate justified a 15% to 20% upward adjustment to the median. On balance, he discounted the median multiple by 15% to adjust for differences between WXL and the guideline companies.

Kern compared WXL to each guideline company individually to assess the appropriate level of discounting. In doing so, he factored in revenue (size), profitability, and operating markets/product diversity. In my view, Kern's company-specific discount methodology more reliably correlates WXL to the guideline companies. Nevertheless, I conclude that Kern's decision to discount PGEX's multiple by 15% on account of profitability is excessive and will reduce that discount to 10%, which correlates better with his treatment of STRX.

Huck, but not Kern, adjusted the median multiple upward due to WXL's superior FY'97 revenue growth rate. For several reasons, I conclude that Kern properly rejected such adjustment. There is nothing in the record to show that WXL's rate of growth was sustainable. Even the FY'97 growth rate is in question, as it does not reflect the substantial bad debt booked in FY'97, since it appears on the income statement "below" the net revenue line. n7 Moreover, WXL's failure to meet its business plan, its heavy indebtedness, its lack of access to capital and its unstable mix of business leave me unable to conclude that anyone would pay a premium to acquire WXL on account of its higher than median growth rate in FY'97.

n7 If FY'97 revenues are reduced by the amount of bad debts booked in FY'97, WXL's rate of growth is reduced to the median of the comparable companies. It is also worth mentioning WXL's high level of intercompany revenue in the final quarter of 1997, which also has a distortive effect on revenue growth rates during that period.

The resulting analysis is summarized in the following chart:

Market Multiples

(Based on Earnings Streams and MVIC)

Multiple	ESPRY	PGEX	PRTL	RSLC	STRX	VYTL	Median
Inv. Cap./Net Rev.	2.4	2.6	1.7	4.5	1.2	3.3	2.5
Adjustments							
Revenue	(10%) *	(20%)	(20%)	(20%)	(20%)	(10%)	
Profitability	(0%) *	(10%)	(5%)	(0%)	(10%)	(0%)	
Operating Markets							
& Product Diversity	(10%) *	(10%)	(10%)	(10%)	(10%)	(10%)	
Adjusted Multiple	1.92	1.56	1.11	3.05	.72	2.64	1.74

* Kern did not include ESPRY in his analysis. Because ESPRY most

closely resembles VYTL, in terms of revenue and profitability,

I have applied for ESPRY the same adjustments as Kern applied for VYTL.

From this, I derive a median adjusted multiple for the six guideline companies of 1.74x.

C. Application of a Control Premium

The parties sharply disagree about the proper application of a control premium. There is no dispute between them that the comparable company method produces a minority valuation of the shares subject to appraisal, as has been recognized in decisions of this court. See, e.g., Kleinwort Benson Ltd. v. Silgan

Corp., 1995 Del. Ch. LEXIS 75, *9, Del. Ch., C.A. No. 11107, Chandler, V.C., (June 15, 1995). Rather, the dispute is over the point in the analysis at which to apply a control premium and, to a lesser degree, the amount of that premium.

Huck added a 30% equity control premium to the median multiple used to determine MVIC for WXL. He then subtracted the value of WXL's long term debt to derive the fair value of the equity. Kern also used a 30% equity control premium figure but applied that premium only after he had completed the steps of comparable company method and determined MVIC for WXL. Having determined WXL's MVIC, Kern (i) subtracted the fair market value of WXL's long term debt, and then (ii) increased the result by 30% to eliminate the minority share discount that inheres in the comparable company method. Respondent argues that Huck's method improperly applies a control premium to WXL's debt and, in doing so, inflates the value of the equity. I agree with Respondent on this point and will apply the control premium only to the equity market value derived from the comparable company method.

I first observe that the difference in methodology has a significant impact on the result in this case. Using an adjusted median multiple of 1.74, an equity premium of 30% and a value of $ 15.17 million for long term debt, Huck's approach yields a fair value of the appraised shares equal to $ 540,000, while Kern's approach yields a fair value of $ 312,650. n8 Huck's result is approximately 85% higher than Kern's. n9

n8 Huck would adjust the median multiple to 2.262 (1.74 plus 30%) then apply it to the latest 12 months revenues ($ 11.48 million) to derive MVIC of $ 25.97 million. Huck would derive a total equity value of $ 10.8 million ($ 25.97 million minus $ 15.17 million long term debt), or $ 540,000 for the Petitioners' shares ($ 10.78 million x 5%). Kern's method of analysis, by contrast, would derive MVIC of $ 19.98 million (1.74 x $ 11.48 million), a total market value of the equity of $ 4.81 million ($ 19.98 million minus $ 15.2 million long term debt), a total fair value of the equity of $ 6.253 million ($ 4.81 million plus 30%), and a value of $ 312,650 for Petitioners' shares ($ 6.253 million x 5%).

n9 In fact, Huck derives an even higher value because he employs a higher adjusted median multiple (2.47x) and a lower value ($ 13.7 million) for long-term debt.

The problem that both Huck and Kern sought to address is, as I have said, that the comparable company method of analysis produces an equity valuation that inherently reflects a minority discount, as the data used for purposes of comparison is all derived from minority trading values of the comparable companies. Because that value is not fully reflective of the intrinsic worth of the corporation on a going concern basis, this court has applied an explicit control premium in calculating the fair value of the equity in an appraisal proceeding. See id. at 6. It would seem to me to be particularly appropriate to do so where, as is true here, the comparable company method is the only method available to me to value the shares in question.

I am persuaded that Petitioners' approach to the control premium is wrong. The observation that the comparable company method of analysis produces a minority equity value does not require that I change the methodology of that analysis. Rather, it requires only that I adjust the result derived from it to eliminate the implicit minority discount. Instead of adjusting the result, Huck undertook to alter, in a significant way, the methodology itself. Doing so, in my view, introduced an analytical distortion that, in this case, significantly overstates the value of the WXL equity. Neither Petitioners nor Huck has supplied authority in the valuation literature justifying this change in the accepted methodology. Because Huck's

methodology is inconsistent with the methodology followed in Harris v. Rapid-American Corp., 1992 Del. Ch. LEXIS 75, *9, Del. Ch., C.A. No. 6462, Chandler, V.C., (April 1, 1992), and because it is otherwise hard to square with the comparable company method, n10 I will not adopt it.

n10 The comparable company method is based on a "debt-free" analysis that permits one to use publicly available data relating to companies with differing capital structures to derive the MVIC of the subject of the appraisal. Equity value is then determined by subtracting from MVIC the fair market value of the long term debt of the subject company. Adjusting the multiples used to derive MVIC to account for a control premium (at least as was done here) is inconsistent with this debt-free approach because such premiums are typically only observed in equity transactions and the multiples are used to derive a combined equity and debt value. Huck tried to compensate for this fact by adjusting his premium to reflect the average debt-to-equity ratio in the industry, but doing so can only dampen and never eliminate the distortional power of the adjustment he made. This distortion is particularly important in the case of a highly leveraged entity such as WXL, which deviates substantially from the observed industry average debt-to-equity ratio. Ironically, Petitioners criticize Kern by arguing that his approach produces a different value for MVIC depending on the debt-to-equity ratio of the company being valued, a result they claim is inconsistent with the debt-free approach underlying the comparable companies method. This argument is fallacious for the simple reason that, as this court has recognized in the past, the value of MVIC derived using the comparable companies approach does not reflect any element of value for control. Computing MVIC without adjusting for control, Huck and Kern employ the same methodology and, given a consistent set of assumptions, would reach the same result without regard to the structure of WXL's balance sheet. It is only when Petitioners try to adjust the method to reflect a control premium that the inconsistencies noted by Petitioners appear.

In Rapid-American, the court valued the three wholly-owned subsidiaries of Rapid-American Corporation by multiplying the equity values of the three (in each case, derived by the comparable company method) times the indicated control premiums for each. Unlike Huck, the court in that case did not calculate the equity value of the subsidiaries by adjusting the multiple used to derive MVIC. Rather, MVIC was derived from the comparable company analysis. That amount was reduced by the value of the debt to determine the value of the equity. Only then was the control premium calculation performed. That is the method Kern used and the one I find appropriate to apply in this case.

D. Appropriate Amount of a Control Premium

Kern identified and used 30% as the appropriate control premium. Huck identified a 40% premium from his review of available information, which he reduced (as a part of his rejected methodology) from 40% to 30% to reflect the average debt-to-equity ratio in the industry. n11 He also recognized that, under our law, I must exclude from that amount elements of value to be realized from the Merger and opined that a small portion of the total was reflective of such amounts. He then testified that, at most, his premium calculation should be reduced to 25% to eliminate impermissible elements of post-merger value. Because I reject Huck's method for applying the control premium, it is unnecessary to follow the first step of this process. Instead, I will reduce Huck's 40% premium to 30% to reflect the elimination of impermissible elements of post-merger value. See Hintmann v. Fred Weber, Inc., 1998 Del. Ch. LEXIS 26, *31, n.52, Del. Ch., C.A. No. 12839, Steele, V.C., (Feb. 17, 1998); Kleinwort Bensen Ltd. V. Silgan, Del. Ch., C.A. No. 11107, Chandler, V.C., mem. op. at 6-10 (June 15, 1995). Because Kern's testimony also supports my use of the 30% figure, I determine to employ that figure. n12

n11 Huck derived his information about the appropriate equity control premium from published data about change of control transaction involving telecommunications companies and total transactions in 1997. He calculated the equity premium paid for control in those transactions by comparing the "tender price in each transaction to the closing price three days prior to the announcement of each transaction."

n12 Respondent argues that there is a failure of proof as to the appropriate level of premium because neither expert was able to testify to the existence of studies analyzing the amount of impermissible post-merger synergies reflected in data on control premiums. Although Huck did express an opinion on this subject, I recognize that there remains some uncertainty about the actual amount of impermissible post-merger values reflected in the gross figures for control premiums. Nevertheless, I conclude that it is more appropriate to apply the 30% control premium used by the experts in order to eliminate the inherent minority discount than to make no adjustment at all. See Kleinwort Bensen at 9.

E. Private Company Discount

In his analysis, Kern applied a final 20% discount, which is described in his report as a "Discount for Lack of Liquidity". His report states that this discount is "based on market observations" and "reflects the fact that WXL International's common stock is not publicly traded." Respondent acknowledges that in Cavalier Oil Corp. v. Harnett, Del. Supr., 564 A.2d 1137, 1144 (1989), the Supreme Court held that it is wrong to apply a discount "at the shareholder level" for a lack of marketability of shares. Nevertheless, Respondent argues that a discount "for lack of marketability that affects all shares equally is an appropriate corporate level discount," and claims that Kern "applied his liquidity discount to all the equity of WXL because WXL was not a publicly traded company."

To the extent Respondent is arguing for the application of a "corporate level" discount to reflect the fact that all shares of WXL shares were worth less because there was no public market in which to sell them, I read Cavalier Oil as prohibiting such a discount. This is simply a liquidity discount applied at the "corporate level." Even if taken "at the corporate level" (in circumstances in which the effect on the fair value of the shares is the same as a "shareholder level" discount) such a discount is, nevertheless, based on trading characteristics of the shares themselves, not any factor intrinsic to the corporation or its assets. It is therefore prohibited.

Respondent argues, alternatively, that Kern's discount is justified on the basis of Kern's testimony about the existence of studies showing that privately held corporations sell at valuation multiples substantially lower than publicly held corporations. I agree with Respondent that, if the record supported this assertion, Cavalier Oil would not prevent taking such studies into account in determining the fair value of shares of a privately held corporation. Unquestionably, it would be appropriate to use a lower control premium than I have because the size of that premium is based substantially or entirely on data derived from sales of publicly traded companies.

The record in this matter is not adequate, however, to support the application of such a discount. The parties refer to Shannon P. Pratt, et al., Valuing a Business: The Analysis and Appraisal of Closely Held Companies, 355-56 (3d ed. 1996). There, Dr. Pratt discusses a study published in Mergerstat Review 1994 (Los Angeles: Houlihan Lokey Howard & Zukin, 1995) at 107, which shows that for certain years during the period 1985-1994, private companies were acquired at lower median price/earnings ratios than were public companies. I note, however, as does he, that during the last two years of the study, 1993 and 1994, the opposite effect is observed, i.e., private companies sold for higher median p/e ratios

than private companies. Discussing the general trend in earlier years, Dr. Pratt suggests that the relatively smaller size of the private companies may partly explain the observation. Here, of course, I have already discounted the median multiple derived from the comparable company method to account for WXL's small size. Dr. Pratt also refers to an article discussing the issue. Z. Christopher Mercer, Should "Marketability Discounts" Be Applied to Controlling Interests of Private Companies?, in Business Valuation Review, June 1994. Mr. Mercer argues against the application of such a discount based on the available data.

Considering this evidence as a whole, I am unable to conclude that there is presently a sufficient theoretical support for the private company discount for which Respondent contends.

F. The Fair Market Value of WXL's Long Term Debt

The parties do not agree on the correct way to account for WXL's debt. Although I conclude that the difference between them is immaterial to my decision, I conclude that Respondent's approach is more consistent with the valuation of WXL as a going concern. Kern used a figure of $ 15,169,057 (or $ 15.17 million) as the fair market value of WXL's long term debt. This figure is taken from WXL's 12/31/97 balance sheet, where it appears as "Intercompany Loan Payable." Huck reduced long term debt by the amount of an asset also reflected on that balance sheet appearing as "Intercompany Loan Receivable" in the amount of $ 1,468,080 (or $ 1.47 million). Because he concluded that the elimination of this asset resulted in a working capital deficit of approximately $ 2.0 million, Huck subtracted that amount from his final result to derive the ultimately fair value of the equity. As I understand it, this difference in methodology between the experts results in a negligible difference in outcome. Using the parameters I have established in this opinion, the outcome changes from $ 310,500 using Kern's approach to $ 308,200, using Huck's approach. n13 Because I believe it is more consistent with the valuation of WXL on a going concern basis, I will adopt Kern's approach.

n13 The size of the change is minimized by the fact that Kern then applies the control premium, which nearly eliminates the difference. Huck applied the control premium earlier in his analysis.

G. Interest

Section 262(i) provides, in pertinent part, that after appraising the shares:

The Court shall direct the payment of the fair value of the shares, together with interest, if any, by the surviving or resulting corporation to the stockholders entitled thereto. Interest may be simple or compound, as the Court may direct.

8 Del. C. § 262(i).

The statute gives the Court of Chancery "discretion to award simple or compound interest. Cede & Co. v. Technicolor, Inc., Del. Supr., 684 A.2d 289, 301 (1996); Grimes v. Vitalink Communications Corp., 1997 Del. Ch. LEXIS 124, *35, n.65, Del. Ch., C.A. No. 12334, Chandler, V.C., (Aug. 26, 1997).

The parties are in agreement that the legal rate of interest is the correct rate to apply in this matter. The issues are whether interest should be simple or compound and, if compound, the period of compounding. Respondent's opposition to compound interest is only half-hearted and, in any case, is inconsistent with the trial testimony of its own expert. Mr. Kern, on cross-examination, gave the following testimony:

Q. To your understanding, all financial investments carry compound as opposed to simple interest; correct?

A. As far as I know, yes. Well, all - I'd like to restate that. "All" is pretty inclusive. I don't know if that's the case all over the world.

Q. In the United States you're not aware of any financial investment that carries simple interest?

A. Generally, speaking, that's correct.

This verity was recently recognized by Chancellor Chandler in Onti, Inc. v. Integra Bank, 1999 Del. Ch. LEXIS 130, *63, Del. Ch., Consol. C.A. No.14514, Chandler, C., (May 26, 1999), wherein he said: "it is simply not credible in today's financial markets that a person sophisticated enough to perfect his or her appraisal rights would be unsophisticated enough to make an investment at simple interest." To the extent it is necessary to look beyond Mr. Kern's testimony, I also note that CTS did not make a good faith effort to value WXL in the merger, instead offering only $ 0.02 per share, or a nominal value of $ 10,000 for all of Petitioners' shares. I find the appraised value of those shares to be 32 times as much and judge that compound interest on that amount is required fairly to compensate Petitioners for having to wait to be paid fair value.

The only testimony in the record about the period of compounding is Huck's, who opined that quarterly compounding is most appropriate. Huck reached this conclusion because he thought the legal rate of interest (10%) most nearly resembles a return on a bond which, he stated, typically compounds quarterly. On cross-examination, Huck also stated that annual compounding is often used in certain methods of appraisal, such as the discounted cash flow analysis. He did not, however, abandon his view that quarterly compounding is appropriate here.

Giving weight to Huck's testimony, I will award interest at the legal rate, compounded quarterly from the date of the merger until the date of final judgment.

IV. CONCLUSION

For all the foregoing reasons, I determine that the fair value of each share of WXL common stock, as of the date of the Merger, was $ 0.6253 and, thus, will enter an order awarding Petitioners a total of $ 312,650 plus interest at the legal rate, compounded quarterly. The parties are directed to present an order of final judgment in conformity with this opinion.

Stephen P. Lamb

Brown v. Brown

Full Text of Court Cases

Brown v. Brown

Case name: Brown v. Brown
Citation: 348 N.J. Super. 466, 792 A.2d 463, 2002 N.J. Super. LEXIS 105
Date of decision: February 28, 2002
Country: US
State or Federal: State
State/Jurisdiction: New Jersey
Court: Court of Appeals
Type of action: Marital Dissolution
Judge: Wecker
Experts: Stephan C. Chait, CPA/ABV, DABFA (for wife)
Kalman A. Barson, CPA/ABV, CVA (for husband)
SIC: 5193 Flowers, Nursery Stock, and Florists' Supplies (merchant wholesalers except those selling nursery stock via retail method)
NAICS: 424930 Flower, Nursery Stock, and Florists' Supplies Merchant Wholesalers
1330

Keywords: Capitalization rate, Discount for lack of control (DLOC), Discount for lack of marketability (DLOM), Fair value, Income approach, Marital dissolution, Market approach

NOT FOR PUBLICATION WITHOUT THE
APPROVAL OF THE APPELLATE DIVISION

SUPERIOR COURT OF NEW JERSEY
APPELLATE DIVISION
A-985-00T5

ELLEN BROWN,

Plaintiff-Respondent,

v.

JAMES BROWN,

Defendant-Appellant.

Argued September 20, 2001 - Decided February 28, 2002

Before Judges Cuff, Wecker and Winkelstein.

On appeal from Superior Court of New

Jersey, Chancery Division, Family Part,

Essex County, FM-07-1163-98.

Sheldon A. Weiss and Richard Diamond

argued the cause for appellant

(Diamond & Diamond, attorneys;

Mr. Weiss, of counsel and on the brief;

Mr. Diamond, on the brief).

Howard B. Felcher argued the cause for

respondent.

The opinion of the court was delivered by

WECKER, J.A.D.

Defendant James Brown ("James") appeals from the financial terms of a divorce judgment, challenging the amounts awarded to plaintiff Ellen Brown ("Ellen") as permanent alimony, child support, equitable distribution, counsel fees, and expert witness fees. In this appeal, we hold that under the rationale of Balsamides v. Protameen Chemicals, Inc., 160 N.J. 352, 368 (1999), and Lawson Mardon Wheaton, Inc. v. Smith, 160 N.J. 383, 397 (1999), which adopt the position of the American Law Institute as set forth at 2 ALI Principles of Corporate Governance § 7.22(a) and comment e thereto, neither marketability nor minority discounts apply to the valuation of defendant's 47½% interest in a closely-held corporation for purposes of equitable distribution. For this and other reasons, we remand for reconsideration and further findings with respect to the equitable distribution of James's interest in his family's business, as well as the counsel fee and experts' fee awards to Ellen.

We briefly summarize the relevant background. The parties were married on August 21, 1975, when James was twenty-two years old and Ellen was twenty-three. After twenty-two years of marriage, the parties separated in October 1997. The divorce complaint was filed in November 1997. The trial took place on five days between June and November 1999, and the trial judge issued a thirty-two-page written decision on July 20, 2000. The judgment of divorce was entered on September 7, 2000.

When the parties married, James had recently graduated from college and immediately went to work in his family's wholesale florist business, Union County Florist Supplies, Inc. (Florist), eventually acquiring a 47½% interest in the firm and becoming an officer. He has continually been employed by Florist. Ellen worked full-time as a dental assistant during virtually all of the marriage and continues in the position she has held for many years. The parties' only child, Matthew, was born September 6, 1985 and adopted as an infant. The parties agreed to joint legal custody of Matthew, with Ellen as the primary residential custodial parent.

The parties owned their own home in Bloomfield, which they improved over the years. They sent Matthew to a private school, Montclair Kimberley Academy, as well as to summer camp; generally took vacations three times per year; and each drove a leased car supplied by Florist and replaced every three years. In 1998, James reported W-2 income of $75,000, 1099 income of $75,000, and interest income of $7,131, all from Florist, and "passive income" of $8,514 from both Florist and PRJ, a real estate partnership in which James, his brother Richard, and his mother Patricia each held a one-third interest. Thus James's income reported in 1998 was in excess of $165,645. Ellen reported W-2 income of $27,194.99 for 1998. Each party's reported income in 1997 and 1996 was similar to that reported for 1998.

With respect to equitable distribution, the trial judge adopted Ellen's expert's valuation of James's interest in Florist as $561,925, which excluded discounts for lack of marketability and lack of control that James's expert included, and which omitted any reduction for James's claim that he received his interest as a gift. The judge awarded Ellen 40% of James's interest, $225,000, in equitable distribution. The parties agreed on the appraised value of PRJ's real property and the partnership's equity therein. After rejecting James's claim that his one-third interest was a gift and therefore immune from equitable distribution, the judge awarded Ellen $67,000, 40% of James's share of the equity in the property.

The parties stipulated the fair market value of the marital residence at $182,500 and the mortgage balance at $94,000. The judge awarded James $35,500, approximately 40% of the equity in the house. Ellen received title to the house subject to the mortgage and responsibility for repairs to the roof and windows and for water damage, thus receiving net value of approximately $49,700.

In addition to the house and to James's holdings in Florist and PRJ, the parties' assets subject to equitable distribution and valued as of the date of the complaint, were:

James's Paine Weber Investment Account	$27,000.00
James's Paine Weber Retirement Account	$29,536.82
Ellen's IRA Account	$ 6,464.00
Ellen's Employer's Pension Account	$37,284.00
Household Furnishings	$15,000.00
Ellen's Jewelry	$15,320.00

These assets were ordered divided equally between the parties. In awarding Ellen 50% of the filing-date balances in James's Paine Weber accounts, plus "accumulated dividends, interest and growth . . . to the date of distribution . . . ," the trial judge found that although James had invaded those accounts during the course of the litigation with permission of the court, the orders allowing those withdrawals had reserved a final accounting to the conclusion of trial, and James "had the financial ability to pay the

attorney fees, reasonable Bar Mitzvah costs; camp and temple expenses from his income and/or from his mother who paid the camp and temple costs prior to the parties' marital problems." The judge applied the following legal principles:

> Marital liabilities as well as marital assets must be considered when awarding equitable distribution. Monte v. Monte, 212 N.J. Super. 557 (App. Div. 1986). "However, if the debt resulted because the husband intentionally dissipated marital assets such intentional dissipation is no more than a fraud on marital rights and the debt will not be charged to the wife." Monte, supra. If the defendant depleted marital assets to discharge his obligations, he would be charged with the amount of the depletion. Weiss v. Weiss, [226 N.J. Super. 281 (App. Div. 1988).] Moreover, a party may not use marital assets to defray support from current earnings and thereby defeat a spouse's interest in the asset at the time of equitable distribution. Lynn v. Lynn, 165 N.J. Super. 328 (App. Div. 1979).

The parties' only marital debts as of the filing date were found to be an $18,000 credit card debt and James's $1,500 dental bill. The trial judge rejected James's claim that he owed his brother $2,300 and his mother $21,850 as a result of loans he claimed he needed in order to comply with his support obligations. The total $19,500 debt subject to equitable distribution was allocated 24% to Ellen and 76% to James, thus rejecting James's contention that the credit card debt was not marital. As James summarizes the award of equitable distribution, his net cash obligation to Ellen under the divorce judgment is $261,500.

With respect to alimony, the judge properly considered the statutory factors, N.J.S.A. 2A:34-23b; the parties' marital standard of living, consistent with the subsequent decision of the Supreme Court in Crews v. Crews, 164 N.J. 11 (2000); the parties' projected budgets; and their respective earnings and earnings potential. After finding that Ellen had little likelihood of substantially increasing her earnings in the future, whereas James had the potential for increasing his income from Florist, the judge awarded Ellen "permanent alimony in the amount of $62,500 payable $1,200 weekly," consistent with our subsequent decision in Cox v. Cox, 335 N.J. Super. 465 (App. Div. 2000). James did not dispute the appropriateness of a permanent alimony award to Ellen, but only the amount. In setting the amount of alimony, the judge noted that although James's "household consists of another 'family' which [he] is substantially subsidizing from his current income," he did not provide any information respecting his contribution to his new partner's living expenses and those of her children.

The judge calculated James's child support obligation under the Child Support Guidelines at $194 per week. Matthew's private school expenses of $16,500 per year were allocated 25% to Ellen and 75% to James, with James to be responsible for 100% of Matthew's approximately $6,700 in annual hockey expenses and summer camp. James was to provide medical and dental coverage for Matthew, and unreimbursed expenses above $250 were to be allocated 44% to Ellen and 56% to James.

James was to provide security for alimony and child support by maintaining life insurance in the amount of $500,000 with plaintiff as the irrevocable beneficiary to secure his alimony obligation, and by maintaining $150,000 with plaintiff as trustee for Matthew to secure child support until his emancipation. The insurance obligation is not challenged on this appeal.

Finally, the judge cited R. 5:3-5(c), Williams v. Williams, 59 N.J. 229 (1971), and D'Onofrio v. D'Onofrio, 200 N.J. Super. 361 (App. Div. 1985), as the basis for a discretionary award of counsel fees to Ellen based upon "the plaintiff's needs, the defendant's financial ability to pay, and the parties' good faith in instituting or defending the action." In addition to the disparity in income between the parties, the judge emphasized as a rationale for the fee award that a sizeable portion of the legal work performed by the plaintiff's attorney was the result of the defendant's bad faith in raising or prolonging issues related to income, alimony, child support, and equitable distribution . . . . [and finding] that the defendant acted in bad faith in misrepresenting his income, his "immunized" family business assets (subject to equitable distribution); his claim of business discounts not permitted in equitable distribution evaluations without exceptional circumstances and his use of marital assets to pay "expenses" with the intent to deprive the plaintiff of her right to equitable distribution . . . .

The judge found Ellen's attorney's certification of services reasonable and necessary both in the hourly rates and time expended, and awarded plaintiff $40,250 (less $7,500 previously paid by defendant pendente lite) against the $65,987.50 claimed by her attorney for legal fees plus $1,894.90 costs. The judge also awarded Ellen $18,500 (less $3,500 previously paid pendente lite) against her accounting expert's total invoice of $25,050.90, plus $580.90 costs and noted the balance owed to defendant's accounting expert, $23,000, from which he "infer[red] that the plaintiff's expert's fees were both reasonable as to time and hourly charges."

I.

We do not interfere with the judge's determinations respecting alimony, child support, or the equitable distribution of assets other than defendant's interest in Florist. The judge's findings and allocation of marital assets and liabilities, other than Florist, are supported by substantial credible evidence, and we defer to those findings. See Pascale v. Pascale, 113 N.J. 20, 33 (1988); Rova Farms Resort, Inc. v. Investors Ins. Co. of Am., 65 N.J. 474, 484 (1974); Borodinsky v. Borodinsky, 162 N.J. Super. 437, 443-44 (App. Div. 1978). The trial judge's determinations of alimony and child support are likewise supported by credible evidence in the record, and we defer to those determinations. We recognize however, the interrelationship of equitable distribution, alimony, child support, and fee awards. See John D. Miller v. Margaret C. Miller, 160 N.J. 408, 420 (1999); Gladys Miller v. Jay Miller, 97 N.J. 154, 171 (1984); Stamberg v. Stamberg, 302 N.J. Super. 35, 42 (App. Div. 1997); Koelble v. Koelble, 261 N.J. Super. 190, 192 (App. Div. 1992); Slayton v. Slayton, 250 N.J. Super. 47, 50 (App. Div. 1991). We therefore leave it to the discretion of the Family Part Judge on remand to reconsider alimony and child support determinations in light of any significant changes in equitable distribution to Ellen arising from James's holdings in Florist. See Dotsko v. Dotsko, 244 N.J. Super. 668, 682 (App. Div. 1990); Borodinsky v. Borodinsky, 162 N.J. Super. at 448.

II.

We now address equitable distribution with respect to James's 47½% interest in Florist. In this appeal, James challenges the trial judge's refusal to credit evidence that his interest was a gift from his parents and to exclude from the marital estate that portion of James's interest in Florist, representing the value of his shares as of the various dates when they were received from his father or his mother. James concedes that as an active asset, the increase in the value of shares that he received as gifts would be subject to equitable distribution. Scherzer v. Scherzer, 136 N.J. Super. 397, 400 (App. Div. 1975), certif. denied, 69 N.J. 391 (1976). James also challenges the trial judge's adoption of Ellen's expert's valuation

and rejection of James's expert's valuation, particularly the judge's holding that neither marketability nor minority discounts were appropriate in evaluating James's interest in Florist. Finally, James challenges Ellen's entitlement to 40% of this marital asset because she did not play an active role in the business.

A.

Each party presented the testimony of a certified public accountant with expertise in business valuation. Ellen's expert was Stephan C. Chait, C.P.A., of the firm Morrison & Company. James's expert was Kalman A. Barson, C.P.A., of the firm Rosenberg Rich Baker Berman & Company. Each expert testified from his own written report, which was admitted into evidence.

Chait valued the entire business of Florist, as of the date of the complaint, at $1,183,000, and James's 47½% interest at $561,925, taking no discount for marketability or lack of control and assuming that the full value of James's interest was subject to equitable distribution. Barson valued James's 47½% interest in the business as of the date of the complaint at $339,000, after applying discounts of 25% for lack of marketability and 15% for lack of control. Using the same methodology and the same discounts, Barson also valued the shares James acquired from his parents as of the six separate dates of acquisition between 1980 and 1996. Barson then subtracted the $121,000 value he placed on James's shares when acquired, from the $339,000 value he had placed on James's shares at the date of the complaint, leaving $238,000 as the incremental value of James's shares to be included in the marital estate. Neither Chait nor Barson offered an opinion with respect to whether the shares were gifts; each adopted the assumption of the party who retained him.

As the Court recently observed in Balsamides v. Protameen Chemicals, Inc., 160 N.J. 352, 368 (1999) ("Balsamides"), and Lawson Mardon Wheaton, Inc. v. Smith, 160 N.J. 383, 397 (1999) ("Lawson"), valuation is not an exact science. See also Bowen v. Bowen, 96 N.J. 36, 44 (1984) (quoting Lavene v. Lavene, 162 N.J. Super. 187, 193 (Ch. Div. 1978) (on remand) (Lavene II)); John R. MacKay, II, 2 New Jersey Business Corporations § 14-6(d)(1) (2d ed. 1996) ("MacKay"). Careful analysis on a case by case basis is required, with sensitivity and adjustment for the particular circumstances and the flexibility to deal with extraordinary circumstances. In Lavene v. Lavene, 148 N.J. Super. 267 (App. Div.), certif. denied, 75 N.J. 28 (1977) (Lavene I), where we held that the husband's 43% interest in a closely-held corporation "constitute[d] a distributable asset" and remanded for valuation, Judge Pressler noted:

> There are probably few assets whose valuation imposes as difficult, intricate and sophisticated a task as interests in close corporations. They cannot be realistically evaluated by a simplistic approach which is based solely on book value, which fails to deal with the realities of the good will concept, which does not consider investment value of a business in terms of actual profit, and which does not deal with the question of discounting the value of a minority interest.

[Id. at 275.]

With the exception of brief mention in Bowen v. Bowen, 96 N.J. at 51-52, where the parties' experts disagreed respecting the application of a minority discount to the husband's minority interest in a closely-held corporation, and where the wife's expert testified to having "built in a discount" by lowering the multiple of earnings used to determine value; in Lavene I, quoted above; and in Lavene II, 162 N.J. Super. at 202 ("It would not be appropriate to discount defendant's interest in the corporation,

notwithstanding the fact that he has only a minority interest"), we find no reported case in New Jersey that addresses the applicability of either minority or marketability discounts in valuing shares in a closely-held corporation for purposes of equitable distribution.

A trial court is free to accept or reject the testimony of either side's expert, and need not adopt the opinion of either expert in its entirety. Carey v. Lovett, 132 N.J. 44, 64 (1993). In fact, the trial judge adopted the Chait valuation with the following explanation:

> The court finds that the conclusions of Stephan C. Chait [are] more credible than the conclusions of Kalman A. Barson based on the assumptions each made in arriving at their respective conclusions. After reviewing the testimony of Mr. Barson and the documentary evidence relied upon by him and evaluating his demeanor and credibility as to evaluation conclusion, the court finds his opinion of value not sufficiently reliable and too speculative as to his assumptions to be acceptable. While the court acknowledges the approaches used by both experts as methods of evaluation, the court accepts Mr. Chait's valuation conclusions as more credible as it related to the financial analysis of "Florist"; his adjustments; officer compensation; reasonable compensation; normalization earnings; tax rate; discount rate; discretionary expenses, disuse of discounts, and disuse of "gifting".

Both experts took similar approaches to valuing the business. Each used a weighted average of the results of two valuation methods, the market approach (comparable sales of similar companies) and the capitalization of income approach (placing a present value on the anticipated future income stream). Both gave the income approach substantially more weight than the market approach, Chait using relative weights of 80% for income and 20% for market (a four-to-one ratio), and Barson using 75% for income and 25% for market (a three-to-one ratio). The experts differed somewhat in the capitalization rates they adopted in their income approach valuations (20% for Chait and 25% for Barson). The inverse of the capitalization rate is the multiple applied to a projected future income stream to place a value on the business. Thus Chait's 20% capitalization rate translates to a multiple of five times annual income, whereas Barson's 25% capitalization rate translates to a multiple of four.

Chait and Barson also differed somewhat in the extent to which they added back to income excess business expenses of the company (largely for excess officer compensation and personal expenses paid for officers) to calculate true net income. It is plain, however, that the magnitude of the disparity between the values these two experts placed on James's interest in Florist arose largely out of their respective approaches to the two legal issues we have identified – (1) application of marketability and minority discounts and (2) gifting.

When we eliminate the marketability and minority discounts from Barson's valuation, we find the two experts' conclusions as to the value of James's interest as of the filing date substantially closer than originally appears. Whereas Chait valued James's interest at $561,925, Barson's value, if we add back the twenty-five percent marketability discount and the fifteen percent minority discount that he applied, would have been $500,000. The difference between Ellen's 40% share under Chait's valuation (rounded to $225,000) and under Barson's valuation (rounded to $200,000) is accounted for by the several

judgment calls involved in each expert's approach. We are hard-pressed to interfere with the trial judge's adoption of Chait's judgments, separate and apart from the gift issue – on which each expert merely adopted the assumption of his own client.

The trial judge's overall conclusion with respect to the weight and credibility to be given to the experts' respective opinions – that Chait's opinion should be adopted in its entirety and Barson's disregarded – actually reflects the judge's view of the discounting and gift issues, which we now address.

B.

James maintains that the credible evidence in the record does not support the trial judge's conclusion that James failed to prove that his interest in Florist was acquired by gift. We agree. The trial judge correctly placed upon James the burden of establishing that his interests in Florist and in PRJ were exempt in whole or in part as gifts. See Pascale v. Pascale, 140 N.J. at 609; Landwehr v. Landwehr, 111 N.J. 491, 504 (1988); Painter v. Painter, 65 N.J. 196, 214 (1974); Dotsko v. Dotsko, 244 N.J. Super. at 676; Weiss v. Weiss, 226 N.J. Super. 281, 291 (App. Div.), certif. denied, 114 N.J. 287 (1988). But the judge ignored significant evidence that supports the claimed gifts of 47½ shares in Florist, when he concluded that James "failed to produce any evidence of an unequivocal donative intent on the part of the donor, actual or symbolic delivery of the subject matter of the gift, and an absolute and irrevocable relinquishment of ownership by the donor," citing In re Dodge, 50 N.J. 192 (1967). The judge found that James's father "continued to exercise 'ownership' control" over both the business itself and the brothers' relationship as co-owners "long after he transferred his shares of stock." That analysis might apply to a dispute between the sons and their parents over ownership; it does not assist us in determining whether James acquired his 47½ shares as gifts from his parents or in exchange for past or future services.

James, his brother Richard, and his mother each testified that the elder Browns, as the original owners of all 100 shares of Florist, intended to give the business to their sons; gave their shares away without compensation as part of their own estate plan; and never intended anyone else, including their daughters-in-law, to own the business. In light of that testimony, which was not contradicted by Ellen, it is impossible to accept the trial judge's conclusion that James offered no evidence of a gift. On the contrary, we are satisfied that James met his burden of proving by a preponderance of the evidence that his shares were gifts, and that their values when received must be excluded from equitable distribution.

In reaching that conclusion, we note the absence of any substantial evidence to rebut James's evidence that his shares were received as gifts from his parents as part of their own estate planning. Ellen argues on appeal that modest salary payments to James's father and mother after the stock transfers, payments that were unrelated to their actual work in the business, contradict the claimed gifts. We fail to see the logic in that argument. Moreover, our conclusion is influenced by Ellen's acquiescence in the gifting plan. The record establishes that the elder Browns gradually divested themselves of their 100 shares in Florist by directly and indirectly giving an equal number of shares to James and to Richard on six separate dates, totaling 47½ to each. It is undisputed that their father, Albert Brown, first transferred twenty-two shares to each of them; that in 1990, 1991 and 1992, Patricia Brown, their mother, transferred three shares each to James, to Ellen, to Richard, and to Richard's wife, Gloria; that each of the wives then transferred the shares she received to her husband; that in 1993, Patricia Brown transferred one share each to James, Ellen, Richard and Gloria, and again Ellen transferred the share she received to James, and Gloria transferred her share to Richard; and finally, that in 1996, Patricia Brown transferred 3½ shares each to James and to Richard.

Barson admitted that there was no evidence that either James's father or his mother ever filed a gift tax return, which would have been required for any gift with a value in excess of $10,000. He also admitted that Patricia Brown's transfers to James's and Richard's wives were intended to keep the gifts under the maximum allowed free of gift tax. Whether James's parents breached any tax reporting or tax payment obligation arising from those transfers does not affect the character of the transfers as between parent and child, absent evidence that the shares were acquired as anything other than gifts.

The value of James's shares as of the dates they were received as gifts must be deducted from the complaint-date value to calculate that portion of James's interest in Florist that is subject to equitable distribution. We stress that the valuation of Florist, and thus of the shares when received by James, must be determined in accordance with our holding that neither marketability nor minority discounts are appropriate. In other words, the valuation approaches for each date must be consistent with the approaches taken for the complaint-date valuation.

In light of our conclusion respecting the gift issue, James's litigation posture on that issue does not support the finding of bad faith on his part nor a lack of credibility on the part of his expert.

C.

James contends that the trial judge erred in rejecting the applicability of marketability and minority discounts in valuing his interest in Florist. We disagree.

The Supreme Court recently addressed the applicability of marketability and minority discounts in valuing a less than controlling interest in a closely-held corporation. See Balsamides, 160 N.J. at 352, and Lawson, 160 N.J. at 383. "A minority discount adjusts for lack of control over the business entity on the theory that non-controlling shares of stock are not worth their proportionate share of the firm's value because they lack voting power to control corporate actions. . . . A marketability discount adjusts for a lack of liquidity in one's interest in an entity, on the theory that there is a limited supply of potential buyers for stock in a closely-held corporation." Lawson, 160 N.J. at 398-99. Whether marketability or minority discounts are appropriate to the valuation of a less than controlling interest in the entity are questions of law which we review de novo, giving no special deference to the trial judge's determination. Balsamides, 160 N.J. at 372-73; Lawson, 160 N.J. at 398.

The general rule we deduce from Lawson and Balsamides is that in a statutory appraisal for purposes of determining the fair value of shares owned by a dissenting shareholder, N.J.S.A. 14A:11-1 to -11 (as in Lawson), or for valuing shares in a court-ordered buy-out resulting from an oppressed shareholder situation, N.J.S.A. 14A:12-7(1)(c) (as in Balsamides), neither a marketability nor a minority discount should be applied absent extraordinary circumstances. See MacKay § 14-6(d)(2)(d) (Supp. 2001). The functional similarity of these two discounts has been recognized by the American Law Institute. 2 ALI Principles of Corporate Governance § 7.22(a) ("ALI Principles").

Although in Balsamides the Court found a 35% marketability discount appropriate, whereas in Lawson the Court disallowed any discount, the Court enunciated its application of "the same guiding principle" in both cases – "a marketability discount cannot be used unfairly by controlling or oppressing shareholders to benefit themselves to the detriment of the minority or oppressed shareholders." Lawson, 160 N.J. at 407-08; accord Balsamides, 160 N.J. at 378-79. The unfairness of using those discounts lies in the

potential for depriving minority shareholders of the full proportionate value of their shares and enriching majority shareholders by allowing a buy-out of minority interests at bargain prices. Lawson, 160 N.J. at 402.

In Balsamides, the extraordinary circumstance that warranted use of a marketability discount was that it was the oppressing 50% shareholder who was to acquire the shares of the oppressed 50% shareholder, and equity demanded that the oppressor not be rewarded for his conduct by allowing a buy-out at a discounted price. In Lawson, the Supreme Court found no comparably extraordinary circumstance and rejected use of the discounts where discounting would have allowed the oppressive majority shareholder to buy out minority owners at less than full value.

The ALI's rationale for the fair value, no-discount rule, a rationale adopted in Lawson and Balsamides, is that neither the dissenting (minority) shareholder, nor the oppressive (majority) shareholder, nor a veto-wielding (50%) shareholder, can be allowed to exploit the very situation that triggered the right to an appraisal, thereby capturing more than a proportionate share of the corporation's value and depriving other shareholders of their fair share.

In Lawson, the Court expressly adopted the approach of § 7.22(a) of the ALI Principles:

> "The fair value of shares [subject to statutory appraisal rights] should be the value of the eligible holder's . . . proportionate interest in the corporation, without any discount for minority status or, absent extraordinary circumstances, lack of marketability."
>
> [160 N.J. at 403.]

That position is elaborated in comment e to ALI Principles,

§ 7.22(a):

> Some decisions have upheld the subtraction of a minority discount from the value of shares held by small stockholders on the theory that non-controlling stock is worth less than its proportionate share of the corporation's fair value. Other decisions have accepted a functionally similar adjustment to reflect the non-marketability of minority shares. However, both Delaware and Maine have recently and properly rejected the use of any such discount. See Cavalier Oil Corp. v. Harnett, 564 A.2d 1137 (Del. 1989); In re Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997 (Me. 1989). See Reporter's Note 4. Section 7.22(a) follows these jurisdictions in requiring the appraisal court to value the firm as a whole, not specific shares, and to allocate that value proportionately, absent extraordinary circumstances. Any contrary rule would require the court to undertake a complicated and ultimately speculative inquiry, which could produce disparate awards depending on the number of shares held by otherwise similarly situated dissenting shareholders. Similarly, the status of shares as "restricted securities" for purposes of the federal securities laws should not affect their valuation under the proportionate interest standard of § 7.22(a).

It has been said that the very purpose of the appraisal remedy for dissenting shareholders would be undermined by application of a minority discount to the value of their shares. Robert B. Heglar, Rejecting the Minority Discount, 1989 Duke L.J. 258, 266-75 (1989). There is a recognized risk of double-counting

by an expert, that is, of duplicative reductions in the value of a minority interest in a closely-held business, as a result of increasing the capitalization rate (and decreasing the valuation multiple) to account for limited marketability, and then in addition applying a "marketability discount" to the value derived from capitalizing income. See Balsamides, 160 N.J. at 379-81; McKay, § 14-6(d)(2)(d) at 36 (Supp. 2001).

In his capitalization of income approach to valuation, Chait took into account an "equity risk" over a "safe," "risk-free" investment, such as a twenty-year United States Treasury bond; a "small company risk" (based upon a comparison of small and large company public stocks); and a "specific company risk," all of which he factored into his determination that a twenty percent capitalization rate was appropriate. Barson's income approach to valuation also took into account both small company risk and a "small company risk premium" when he determined to use a twenty-five percent capitalization rate. Thus the additional twenty-five percent discount Barson applied for lack of marketability appears to double-count the same risk, a factor that further justifies eliminating that discount.

Although the Court's holdings in Lawson and in Balsamides directly addressed the use of a marketability discount, in each case the Court also discussed the use of a minority discount. Lawson, 160 N.J. at 401-03; Balsamides, 160 N.J. at 373-75. We recently denied the application of both marketability and minority discounts where no extraordinary circumstances were proven. Casey v. Brennan, 344 N.J. Super. 83 (App. Div.), certif. granted, ___ N.J. ___ (2001), and certif. denied, ___ N.J. ___ (2001). We held in Casey that dissenting shareholders exercising their right to a statutory appraisal pursuant to N.J.S.A. 14A:11-7(1), as well as those dissenting shareholders whose rights on being cashed out arose under common law, all were entitled to their proportionate shares of the value of the whole corporation, and not merely a discounted price for their minority holdings. 344 N.J. Super. at 111-12.

In Casey, after discussing the holdings of Lawson and Balsamides with respect to the marketability discount, and relying in part upon the reasoning of the Delaware Supreme Court in Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144 (Del. 1989) (the object of the statutory appraisal is "to value the corporation itself, as distinguished from a specific fraction of its shares as they may exist in the hands of a particular shareholder"), we found "no reason to distinguish, for these purposes between marketability and minority discounts and . . . conclude[d] that minority discounts likewise are not to be applied in a valuation proceeding." 344 N.J Super. at 112.

Statutory appraisal rights accorded to dissenting shareholders in New Jersey (and in most states) include the right to a determination of the "fair value" (not "fair market value") of their shares. N.J.S.A. 14A:11-3; see Bobbie J. Hollis, II, The Unfairness of Applying Lack of Marketability Discounts to Determine Fair Value in Dissenter's Rights Cases, 25 J. Corp. L. 137, 139 (1999), explaining the distinction between "fair value" and "fair market value":

> "Fair value" is not the same as, or short-hand for, "fair market value." "Fair value" carries with it the statutory purpose that shareholders be fairly compensated, which may or may not equate with the market's judgment about the stock's value. This is particularly appropriate in the close corporation setting where there is no ready market for the shares and consequently no fair market value.
>
> A closely-held corporation is one that has few shareholders and little market for the stock, or one that has an integration of ownership and management. When appraising shares of a close corporation, fair value cannot be fairly equated with the company's fair market value. Close corporations by their nature have less value to outsiders, but at the same time their value may be even greater to other shareholders who want to keep the business in the form of a close corporation.
>
> [Footnotes omitted.]

The "fair value" concept is inherently inconsistent with discounting value to reflect limited marketability. That which has been labeled a "marketability discount" reflects the theoretically limited market for the sale of a privately-held, small business. That which has been labeled a "minority discount" reflects a theoretically more limited market for sale of a non-controlling interest in such a business. The significance of a limited market is that the asset is illiquid. Both discounts represent an attempt to account for the fact that unlike shares in a publicly-traded company, shares in a closely-held corporation have limited liquidity.

But liquidity is of little consequence here. As between James and his brothers, the only other shareholders, there is no evidence of a contemplated sale of all or part of the business, forced or otherwise. All of the evidence supports the likelihood that the business will continue under the present ownership for the foreseeable future, with James and Richard each continuing to be the active owners and officers, each holding 47½% of the outstanding shares, and Gilbert holding the remaining 5%. The distinction between fair value and fair market value appears to us equally applicable in the valuation of one spouse's interest in his family's closely-held corporation for purposes of equitable distribution.

Given the Court's adoption of the "proportionate share" approach to valuing the interest held by a dissenting or an oppressed shareholder, any dispute among the existing shareholders would presumably see James either buying out his brothers' interests or selling his own at a proportionate share of fair value, with no discount for lack of control. Indeed, the statutory protections for dissenting shareholders, as interpreted in Lawson, demonstrate that the value of James's minority interest in Florist, vis-à-vis his brothers (the only other shareholders), is protected by the fair value rule itself. That is, if he were to find himself at irreconcilable odds with his brothers, he could force a statutory appraisal in which each bloc would be valued at a proportionate share of the whole.

Unlike Balsamides, Lawson, and Casey, no actual transfer of shares is involved in this equitable distribution case. That distinction makes the marketability discount even less appropriate than in the statutory appraisal or deadlock contexts, since no sale of the business appears likely in the foreseeable future. We see no reason to reward the spouse who holds title to the shares by allowing him to retain the value of the entire bloc at a bargain "price," that is, crediting the non-owner spouse with less than the owner's proportionate share of full value when determining equitable distribution of the marital assets. Here, allowing the marketability or minority discounts would unfairly minimize the marital estate to

Ellen's detriment and is inconsistent with the concept of equitable distribution. While "there is no ready market for the shares and consequently no fair market value" of Florist, James's shares in the going concern have value to him and to his co-owners that does not depend upon a theoretical sale to an outsider and has not changed as a result of the divorce complaint or judgment.

The ALI cautions that valuation contexts other than dissenting shareholder appraisal rights, such as tax valuations, may warrant a different approach to discounting, ALI Principles § 7.22, comment e at 325-26. However, we see no reason for a different approach in equitable distribution. Even James's expert, Barson, admitted that the value of a minority bloc of stock is not to be discounted for lack of control under New Jersey's "fair value" statutes. He did not offer any explanation for adopting a different rule for purposes of equitable distribution. While Barson cited a controlling shareholder's "power to change the bottom line" as one rationale for applying a discount here, no single shareholder controlled Florist or its officers' bottom line.

The record before us reveals no extraordinary circumstances related to the operation or control of Florist to warrant a discount from the fair value of the company for lack of marketability, or a discount from the value of James's interest for his minority bloc. Under these circumstances, and consistent with the reasoning of our Supreme Court, we see no reason to reduce the proportionate value of James's 47½ shares (47½%) for lack of liquidity (marketability discount) or lack of control (minority discount).

Given the purpose of equitable distribution to fairly divide the accumulated wealth of a marital partnership, and that the purpose of valuing the shareholder spouse's interest is to determine the non-owner spouse's fair share of other marital assets; where the shareholder will retain his shares and the divorce will not trigger a sale of those shares, lack of liquidity does not affect the fair value of the minority interest. Neither discount is appropriate.

We therefore find no legal error in the judge's holding marketability and minority discounts inapplicable in this case, and we affirm the trial judge's determination that there are no "extraordinary circumstances" to warrant use of those discounts. However, because there has been little in the way of case law respecting that issue in the context of equitable distribution, we cannot agree with the judge's finding that Barson's use of those discounts or defendant's contentions respecting the discounts amount to "bad faith" as a factor in awarding Ellen professional fees.

D.

We find no merit in James's contention that Ellen is not entitled to 40% of Florist because she was not active in the business. See R. 2:11-3(e)(1)(E). The theory of equitable distribution is that marriage is a partnership whose assets should be fairly and equitably distributed when the partnership breaks up. E.g., Pascale v. Pascale, 140 N.J. at 609; Portner v. Portner, 93 N.J. 215, 219 (1983); Rothman v. Rothman, 65 N.J. 219, 229 (1974). There is ample support for the trial judge's finding that Ellen fulfilled that partnership role:

> Although the defendant was the primary wage earner, it is clear that the plaintiff made substantial contributions to both the defendant's earning power and to the acquisition and preservation of the marital property. . . . In light of both the plaintiff's financial and non-financial contributions, the court finds that she was not only a partner, but an equal force, in the marriage and made substantial contributions to the economic betterment of the parties' marriage.

Indeed, in his written summation, James proposed allocating to Ellen an amount equal to 45% of the $238,000 incremental value that Barson placed upon James's interest in Florist. Allowing Ellen 40% of that portion of James's interest in Florist that is determined to be part of the marital estate is well within a reasonable exercise of judicial discretion, and we will not interfere.

III.

We now address equitable distribution of James's one-third interest in the real estate partnership, PRJ, which owns the property in Linden that is now occupied by Florist. PRJ's three equal partners are James, his brother Richard, and Patricia Brown (James's and Richard's mother).

James contends that his interest in PRJ was received as a gift from his father and is therefore immune from equitable distribution. The trial judge rejected that contention. James argues that the Linden property owned by PRJ was purchased in PRJ's name with the proceeds of the sale of the Staten Island property formerly occupied by Florist and allegedly owned by James's father. We agree with the trial judge that the record does not support that argument.

The testimony and the documentary evidence are inconsistent, and neither supports the gift claim. The RESPA statement for the July 10, 1987 purchase of the PRJ property in Linden reflects a purchase price of $1,099,400, plus closing costs and related expenses that bring the total to $1,115,351. The purchase was financed by PRJ's assumption of an Economic Development Authority (EDA) loan of $602,996, a $300,000 mortgage loan from the seller, and the balance paid in cash. The source of the cash portion of the purchase price is not identified in the record.

The Staten Island property apparently consisted of three parcels, each of which was titled in the name of Florist when it was sold to a third party. Florist sold the first parcel, 87 Grove Avenue, on September 22, 1987, for $285,000 in an all cash sale, two-and-one-half months after PRJ took title to the Linden property. Florist sold the second parcel, 78 Faber Street, for $150,000 on September 1, 1988, receiving $30,000 as a cash deposit and taking back a mortgage to secure the remaining $120,000 due. Florist sold the third parcel, 97-99 Grove Avenue, on January 26, 1996, taking back a mortgage for the entire purchase price, $60,000. These two mortgages are carried as assets on Florist's books.

James himself testified that he considered Florist and PRJ as a single entity. If corporate funds or corporate credit was used to purchase the partnership property, then James's acquisition of a one-third interest in PRJ was not a gift, but a distribution from Florist. Apparently based upon these facts, the trial judge concluded that James "produced no credible evidence as to immunize his interest in PRJ Associates from equitable distribution." In other words, the trial judge found that James did not meet his burden of proving that the real estate purchased by PRJ in 1987 constituted a gift from his father. We defer to that finding, which is supported by the record, and we affirm the trial judge's conclusion that James failed to prove that his interest in PRJ was acquired by gift.

The parties agreed on the equity in the property, and thus on the value of James's one-third share. That share was properly included in the marital estate, and we are satisfied that distributing 40% ($67,000) to Ellen was a reasonable exercise of discretion.

IV.

The trial judge's award of counsel fees and expert witness fees was grounded largely upon a finding of bad faith on James's part in regard to equitable distribution of his interests in Florist and PRJ. Because we do not find support in the record for the judge's findings that James acted in bad faith respecting those two assets, the fee awards must be vacated and considered anew on remand. By vacating these awards, we do not suggest that no fee award to Ellen is appropriate, or that the Court may not have grounds for a substantially similar award. The court must, however, consider all of the Williams factors in light of the entire record and its final decision on all other financial issues.

V.

We reject defendant's request that we exercise our original jurisdiction to determine the disputed valuation issues other than the gift and discounting issues addressed in Parts II B, II C, and III of this opinion. We also reject defendant's request in the alternative that any issues remanded to the Family Part be assigned to a different judge. The mere fact that a judge has issued legal rulings or made factual findings in a case does not warrant reassignment in the event of reversal and remand. However, where findings of credibility respecting the testimony of key witnesses have been made, and where a significant portion of those findings have been found unsupported by the record, fairness dictates a fresh look. See Luedtke v. Shobert, 342 N.J. Super. 202, 219 (App. Div. 2001) ("[I]t would place the court in an untenable position to now have to reevaluate a case in which it had already expressed a preference for one of the experts over the other.")

As we have explained, we view the judge's adoption of Chait's valuation testimony as largely a result of his view of the two legal issues which we have now determined. On balance, we are satisfied that the trial judge will be guided by our decision and can fairly reconsider the valuation of the marital portion of James's interest in Florist, as well as counsel and expert fees. Alimony or child support may warrant modification in light of the final decision on equitable distribution. See Bowen v. Bowen, 96 N.J. at 52-53; Dotsko v. Dotsko, 244 N.J. at 682. The trial judge will be in the best position to consider any such modification.

Affirmed in part, reversed in part, and remanded for further proceedings consistent with this opinion.

Cede & Cinerama v. Technicolor

Full Text of Court Cases

Cede & Cinerama v. Technicolor

Case name: Cede and Cinerama v. Technicolor
Citation: 684 A.2d 289, 1996 Del. LEXIS 386
Date of decision: October 14, 1996
Country: US
State or Federal: State
State/Jurisdiction: Delaware
Court: Supreme Court
Type of action: Dissenting Shareholder
Judge: Holland
Experts: John Torkelsen (for plaintiff)
Alfred Rappaport (for defendant)
SIC: 7812 Motion Picture and Video Tape Production
NAICS: 512110 Motion Picture and Video Production
155

Counsel: Robert K. Payson, Esquire, and Arthur L. Dent, Esquire, of Potter, Anderson & Corroon, Wilmington, Delaware, and Gary J. Greenberg, Esquire (argued), New York, New York, for appellants.

Rodman Ward, Jr., Esquire, Thomas J. Allingham, II, Esquire (argued), and R. Michael Lindsey, Esquire, of Skadden, Arps, Slate, Meagher & Flom, Wilmington, Delaware, for appellee.

Judges: Walsh, Holland, and Horsey. n1

n1 Sitting by designation pursuant to Del. Const. art. IV, § § 12, 38.

Opinion by: Holland

This appeal is from a final judgment of the Court of Chancery in an appraisal action. The proceeding arises from a cash-out merger of the minority shareholders of Technicolor Incorporated ("Technicolor"), a Delaware corporation. With the approval from a majority of Technicolor's shareholders, MacAndrews & Forbes Group Incorporated ("MAF") merged its wholly-owned subsidiary, Macanfor Corporation ("Macanfor"), into Technicolor. The only defendant-appellee in this appraisal action is Technicolor, the surviving corporation of the merger. The plaintiffs-appellants are Cinerama, Incorporated, the beneficial owner of 201,200 shares of Technicolor common stock, and Cede & Company, the record owner of those shares (collectively "Cinerama.")

Cinerama contends, inter alia, that the Court of Chancery erred, as a matter of law, in appraising the fair value of its Technicolor shares. According to Cinerama, that legal error was a refusal to include in the valuation calculus "MAF's new business plans and strategies for Technicolor, which the Court [of Chancery] found were not speculative but had been developed, adopted and implemented" between the date of the merger agreement and the date of the merger. That contention is correct and dispositive of

this appeal. Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701 (1983). Accordingly, the appraisal action will be remanded for further proceedings in accordance with this opinion. Cinerama's other contentions are addressed only to the extent they are relevant to the remand.

Procedural History

This is the fourth appeal by Cinerama relating to the same companion litigation: a first-filed Delaware statutory appraisal proceeding (the "appraisal action"), and a later-filed shareholder rescissory damages lawsuit for "fraud" and unfair dealing (the "personal liability action"). Cinerama's first appeal was taken from an interlocutory judgment. In that appeal, this Court concluded the Court of Chancery had erred, as a matter of law, in requiring Cinerama to make an election of remedies before trial. Cede & Co. v. Technicolor, Inc., Del. Supr., 542 A.2d 1182 (1988) ("Technicolor I"). This Court held that Cinerama was entitled to pursue its appraisal action and its personal liability action concurrently, through trial. Id. at 1192. Both proceedings were remanded to the Court of Chancery. Id.

The consolidated trial of the personal liability and appraisal actions lasted forty-seven days. The Court of Chancery announced its decision in the appraisal action on October 19, 1990. In its "appraisal opinion," the Court of Chancery found the fair value of Cinerama's Technicolor stock to be $ 21.60 per share as of the date of the merger, January 24, 1983. Cede & Co. v. Technicolor, Inc., 1990 Del. Ch. LEXIS 259, Del. Ch., C.A. No. 7129 (Oct. 19, 1990).

The Court of Chancery issued its "personal liability opinion" in June 1991. Cinerama, Inc. v. Technicolor, Inc., 1991 Del. Ch. LEXIS 105, Del. Ch., C.A. No. 8358 (June 24, 1991), reprinted in 17 DEL. J. CORP. L. 551 (1992). The Court of Chancery held that, even if the defendant-directors had not exercised due care in approving the merger, Cinerama had not been damaged. It reached that conclusion on the basis that the $ 21.60 per share valuation in its appraisal opinion was less than the merger agreement price of $ 23 per share. The Court of Chancery entered judgment for the defendants in the personal liability action.

Cinerama's second appeal to this Court was from the final judgments entered in both the appraisal action and the personal liability action. Cede & Co. v. Technicolor, Inc., Del. Supr., 634 A.2d 345 (1993) ("Technicolor II"), modified on reargument, 636 A.2d 956 (1994). Technicolor cross-appealed from the judgment in the appraisal action. Id. This Court affirmed in part, reversed in part, and remanded the personal liability action to the Court of Chancery for an application of the entire fairness standard to the challenged transaction and to resolve certain additional issues relating to the duty of loyalty. Technicolor II, 634 A.2d at 373. This Court also concluded that the issues raised by the appeal and cross-appeal in the appraisal action were "moot" as a result of our decision in the liability action. Id. at 351.

Following this Court's decision in Technicolor II, the parties agreed to submit the remanded issues in the personal liability action to the Court of Chancery for a decision without presenting any additional evidence. After reconsideration, the Court of Chancery issued an opinion which initially resolved the loyalty issues identified by this Court in Technicolor II and then concluded that the defendants had met their burden of showing entire fairness. Cinerama, Inc. v. Technicolor, Inc., Del. Ch., 663 A.2d 1134, 1144 (1994). The Court of Chancery entered another judgment for the defendants in the personal liability action.

Cinerama filed its third appeal. This Court affirmed the Court of Chancery's final judgment in the personal liability action. Cinerama, Inc. v. Technicolor, Inc., Del. Supr., 663 A.2d 1156, 1180 (1995) ("Technicolor III"). Although the liability action had been concluded in favor of the defendants, Cinerama was still entitled to receive the fair value of its Technicolor shares. Technicolor I, 542 A.2d at 1191. Consequently, the appraisal action, which had remained in abeyance following this Court's remand in Technicolor II, was no longer moot.

The Court of Chancery entered a Restated Modified Order and Final Judgment in the appraisal action on October 27, 1995. That judgment set the fair value of a share of Technicolor stock at $ 21.60. The judgment awarded Cinerama: the principal amount of $ 4,345,920; pre-judgment interest on that amount at the rate of 10.32%, compounded annually from January 24, 1983 (the date of the merger) to August 2, 1991 (the date of the original appraisal action judgment); and post-judgment interest thereafter, at the rate of 10.5% simple interest, accruing only on the principal award of $ 4,345,920.

Cinerama filed a timely appeal with this Court. Technicolor did not cross-appeal. Cinerama's fourth appeal is the subject matter of this opinion.

Facts

The history of this litigation has been recounted at length. Technicolor II, 634 A.2d at 351-58; Technicolor I, 542 A.2d at 1185-86; Cinerama, Inc. v. Technicolor, Inc., Del. Ch., 663 A.2d 1134, 1135-37 (1994). We will rely upon those comprehensive recitations of the entire facts. Only the operative facts that are relevant to this appeal in the appraisal action will be recounted. Technicolor was a corporation with a long and prominent history in the film/audio-visual industries. By the early eighties, Technicolor's increase in market share had leveled off. The company's core business earnings had stagnated.

Technicolor engaged in a number of distinct businesses through separate operating units. Technicolor's Professional Services Group was its main source of revenue and profit. The Videocassette Duplicating Division operated one of the largest duplicating facilities in the world. The Consumer Services Group operated film processing laboratories ("Consumer Photo Processing Division" or "CPPD"), which provided film processing services to other photofinishers. CPPD also operated the Standard Manufacturing Company ("Standard"), which manufactured film splicers and associated equipment. The Government Services Group ("Government Services") provided photographic and non-photographic support and management services under contract to governmental agencies. Technicolor's Gold Key Entertainment Division ("Gold Key"), licensed motion pictures and other programs for television exhibition. The Audio Visual Division ("Audio Visual") distributed film and video equipment.

Morton Kamerman ("Kamerman"), Technicolor's Chief Executive Officer and Board Chairman, concluded that Technicolor's principal business, theatrical film processing, did not offer sufficient long-term growth for Technicolor. Kamerman proposed that Technicolor enter the field of rapid processing of consumer film by establishing a network of stores across the country offering one-hour development of film. The business, named One Hour Photo ("OHP"), would require Technicolor to open approximately 1,000 stores over five years and to invest about $ 150 million.

In May 1981, Technicolor's Board of Directors approved Kamerman's plan. The following month, Technicolor announced its ambitious venture with considerable fanfare. On the date of its OHP announcement, Technicolor's stock had risen to a high of $ 22.13.

In the months that followed, Technicolor fell behind on its schedule for OHP store openings. The few stores that did open reported operating losses. At the same time, Technicolor's other major divisions were experiencing mixed, if not disappointing, results.

As of August 1982, Technicolor had opened only twenty-one of a planned fifty OHP retail stores. Its Board was anticipating a $ 5.2 million operating loss for OHP in fiscal 1983. On August 25, 1982, the Technicolor Board "authorized the company's officers to seek a buyer for Gold Key." During 1982, Technicolor also decided to terminate the Audio Visual Division. Nevertheless, Kamerman remained committed to OHP. In Technicolor's Annual Report, issued September 7, 1982, Kamerman stated, "We remain optimistic that the One Hour Photo business represents a significant growth opportunity for the Company."

Technicolor's September 1982 financial statements, for the fiscal year ending June 1982, reported an eighty percent decline of consolidated net income - from $ 17.073 million in fiscal 1981 to $ 3.445 million in 1982. Profits had declined in Technicolor's core business, film processing. Technicolor's management also attributed the decline in profits to write-offs for losses in its Gold Key and Audio Visual divisions, which had already been targeted for sale. By September 1982, Technicolor's stock had reached a new low of $ 8.37 after falling by the end of June to $ 10.37 a share.

In the late summer of 1982, Ronald O. Perelman ("Perelman"), MAF's controlling stockholder, concluded that Technicolor would be an attractive candidate for a takeover or acquisition by MAF. Kamerman and Perelman met for the first time on October 4, 1982 at Technicolor's offices in Los Angeles. Perelman informed Kamerman that MAF would be willing to pay $ 20 per share to acquire Technicolor. Kamerman replied that he would not consider submitting the matter to Technicolor's Board at a price below $ 25 a share.

Perelman met with Kamerman in Los Angeles for a second time on October 12, 1982. MAF's Chief Financial Officer also attended the meeting. The meeting's principal purposes were: (1) to allow MAF's Chief Financial Officer to review Technicolor financial data; and (2) to give Perelman a tour of Technicolor's Los Angeles facilities.

On October 27, Kamerman and Perelman reached an agreement by telephone. Perelman initially offered $ 22.50 per share for Technicolor's stock. Kamerman countered with a figure of $ 23 per share. He also stated that he would recommend its acceptance to the Technicolor Board. Perelman agreed to the $ 23 per share price.

The Technicolor Board convened on October 29, 1982 to consider MAF's proposal. All nine directors of Technicolor attended the meeting. Kamerman outlined the history of his negotiations with Perelman. Kamerman explained the basic structure of the transaction: a tender offer by MAF at $ 23 per share for all the outstanding shares of common stock of Technicolor; and a second-step merger with the remaining outstanding shares converted into $ 23 per share, with Technicolor becoming a wholly owned subsidiary of MAF. Kamerman recommended that MAF's $ 23 per share offer be accepted in view of the present market value of Technicolor's shares. Kamerman stated that accepting $ 23 a share was "advisable rather than shooting dice" on the prospects of Technicolor's OHP venture.

On October 29, 1982, the Technicolor Board agreed to the acquisition proposal by MAF. The Technicolor Board: approved the Agreement and Plan of Merger with MAF; recommended to the stockholders of Technicolor the acceptance of the offer of $ 23 per share; and recommended the repeal of the

supermajority provision in Technicolor's Certificate of Incorporation. Technicolor filed forms 14D-9 and 13D with the Securities and Exchange Commission which reflected those Board actions and recommendations.

In November 1982, MAF commenced an all-cash tender offer of $ 23 per share to the shareholders of Technicolor. When the tender offer closed on November 30, 1982, MAF had gained control of Technicolor. n2 By December 3, 1982, MAF had acquired 3,754,181 shares, or 82.19%, of Technicolor's shares. Thereafter, MAF and Technicolor were consolidated for tax and financial reporting purposes.

n2 As stipulated by the parties, the Court of Chancery's opinion is mistaken when it states that MAF gained control "by December 31, 1982."

The Court of Chancery made a factual finding that, "upon acquiring control" of Technicolor, Perelman and his associates "began to dismember what they saw as a badly conceived melange of businesses." Perelman testified: "Presumably we made the evaluation of the business of Technicolor before we made the purchase, not after." That evaluation assumed the retention of the Professional and Government Services Groups and the disposition of OHP, CPPD, Gold Key and Audio Visual.

Consequently, immediately after becoming Technicolor's controlling shareholder, MAF "started looking for buyers for several of the [Technicolor] divisions." Bear Stearns & Co. was also retained by MAF in December 1982 to assist it in disposing of Technicolor assets. A target date of June 30, 1983 was set for liquidating all of Technicolor's excess assets. As of December 31, 1982, MAF was projecting that $ 54 million would be realized from asset sales.

In December 1982, the Board of Technicolor notified its stockholders of a special shareholders meeting on January 24, 1983. At the meeting, the Technicolor shareholders voted to repeal the supermajority amendment and in favor of the proposed merger. MAF and Technicolor completed the merger.

Valuation of Technicolor

Perelman Plan or Kamerman Plan

The merger was accomplished on January 24, 1983. The parties agree that the appraised value of Technicolor must be fixed as of that date. See Alabama By-Products Corp. v. Neal, Del. Supr., 588 A.2d 255, 256-57 (1991). There is a fundamental disagreement between the litigants, however, concerning the nature of the enterprise to be appraised.

Cinerama argues that the Court of Chancery should have valued Technicolor as it existed on the date of the merger and, in particular, with due regard for the strategies that had been conceived and implemented following the merger agreement by MAF's controlling shareholder, Ronald O. Perelman ("Perelman Plan"). Technicolor argues that the Court of Chancery properly considered Technicolor without regard to the Perelman Plan and only as it existed on or before October 29, 1982, with the then extant strategies that had been conceived and implemented by Technicolor's Chairman, Morton Kamerman ("Kamerman Plan"). According to Cinerama:

Reduced to its simplest form, the dispute was whether the trial court should value Perelman's Technicolor - a company whose business plans and strategies focused on the processing and duplication of film and videotape and the provision of services to the United States Government and which planned and expected to generate $ 50 million in cash during 1983 from the sale of unwanted and/or unsuccessful businesses, namely, OHP, CPPD, Gold Key and Audio Visual; or Kamerman's Technicolor - a company whose business plans and strategies assumed diversification away from a concentration on film processing and videotape duplication for the professional market toward consumer oriented businesses, especially OHP.

The economic experts for both parties used a form of discounted cash flow methodology to value Technicolor. Cinerama's expert was John Torkelsen ("Torkelsen"), a financial analyst with Princeton Venture Research, Inc. Technicolor's primary expert witness was Alfred Rappaport ("Rappaport"), a professor at Northwestern University Graduate Business School and a consultant with The Alcar Group ("Alcar"). The fundamental nature of the disagreement between the parties about the Perelman Plan and the Kamerman Plan, however, resulted in different factual assumptions by their respective experts.

Question of Law

Perelman Plan or Kamerman Plan

The Court of Chancery recognized that the parties' disagreement about valuing Technicolor based upon either the Perelman Plan or the Kamerman Plan presented a question of law with regard to the proper interpretation of the appraisal statute. See 8 Del. C. § 262(h). According to the Court of Chancery, that legal

issue is whether in valuing Technicolor as of January 24, 1983, the court should assume the business plan for Technicolor that MAF is said by [Cinerama] to have had in place at that time [Perelman Plan], or whether a proper valuation is premised upon ignoring such changes as Mr. Perelman had in mind because to the extent they create value they are "elements of value arising from the accomplishment or expectation of the merger. " 8 Del. C. § 262(h).

The Court of Chancery also recognized that legal issue was "particularly pertinent when considering One Hour Photo, Standard Manufacturing and [the Consumer Photo Processing Division]." Torkelsen's valuation assumed each of those businesses would be sold by MAP. Rappaport assumed that, but for the MAF acquisition, those businesses would have continued operating. Therefore, the Rappaport valuations included those businesses as going concerns. Predictably, the different assumptions factored into each expert's discounted cash flow model yielded disparate valuation results. n3

n3 Cinerama's expert opined that the statutory appraisal fair value of Technicolor on a per share basis as of January 24, 1983 was $ 62.75. Technicolor's expert opined that the statutory appraisal fair value of Technicolor at the time of the merger was $ 13.14 per share.

The Parties' Contentions

Perelman Plan or Kamerman Plan

In the Court of Chancery, Cinerama argued that the Perelman Plan - which contemplated the sale of several businesses, focusing the company on film processing, and the new videocassette duplication business - was governing the operation of Technicolor on January 24, 1983. Consequently, Cinerama argued Perelman's Plan had to govern any expert's projection of net cash flow. For example, according to Cinerama, Technicolor's previous projections of negative cash flow from OHP's operation would be irrelevant in the appraisal valuation. In support of its position, Cinerama presented evidence that, prior to the merger date, Perelman had not only formulated, but had also implemented, a plan for how OHP and certain other Technicolor assets would be sold.

Technicolor argued to the Court of Chancery that the Perelman Plan, which it admitted called for the liquidation of OHP and a number of its other businesses, was not sufficiently defined on the date of the merger to form the factual premise for the Cinerama expert's cash flow projections from asset sales. The Court of Chancery unequivocally rejected that assertion by Technicolor. The Court of Chancery made a specific factual finding that "the record supports the conclusion that MAF intended from the outset to realize by one technique or another the capital value of One Hour Photo and to terminate that division's drain on the company's cash flow. Insofar as sale of that enterprise is involved, the 'Perelman Plan' was fixed by the merger date." n4

n4 In Technicolor II, Technicolor filed a cross-appeal which contended that the Court of Chancery erred in "finding that MAF's strategic plan was sufficiently definite as of the Merger" to be valued. Technicolor did not file a cross-appeal on any issue in this appeal.

In view of that adverse factual determination, Technicolor's alternative contention was a legal argument. According to Technicolor, any value attributable to the Perelman Plan as of the merger date had to be excluded as arising from the expectation of the merger. See 8 Del. C. § 262(h). Thus, Technicolor argued that the net cash flows which followed from the Perelman Plan should be excluded from the statutory appraisal valuation, as a matter of law.

In response, Cinerama argued to the Court of Chancery that this Court had construed the statutory phrase "exclusive of any element of value arising from the accomplishment or expectation of the merger" to exclude "only the speculative elements of value that may arise from the 'accomplishment or expectation' of the merger. . . . But elements of future value . . . which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered." Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701, 713 (1983). Thus, Cinerama argued any nonspeculative element of future value that could be proven may be considered in a statutory appraisal proceeding, even if it is an "element of value arising from the accomplishment or expectation of the merger." See 8 Del. C. § 262(h).

Court of Chancery's Holding

Majority Acquiror Principle/Proximate Cause Exception

The Court of Chancery acknowledged that, based upon the quoted language from Weinberger, Cinerama's legal argument appeared to be persuasive. The Court of Chancery concluded, however, "that reading [of Weinberger] is too difficult to square with the plain words of the statute to permit the

conclusion that that is what was intended." The Court of Chancery then stated "in order to understand the quoted passage [from Weinberger] when read together with the statutory language, I assume an unexpressed phrase to the effect 'unless, but for the merger, such elements of future value would not exist.'" According to the Court of Chancery, the language in Weinberger would read: "But elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered [unless, but for the merger, such elements of future value would not exist]." Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701, 713 (1983).

In explaining the "but for" caveat that it had superimposed upon this Court's holding in Weinberger, the Court of Chancery reasoned that, as a matter of policy, the valuation process in a statutory appraisal proceeding should be the same irrespective of whether a merger is accomplished in one or two steps:

Delaware law traditionally and today accords to a dissenting shareholder "his proportionate interest in a going concern" and that going concern is the corporation in question, with its asset deployment, business plan and management unaffected by the plans or strategies of the acquiror. When value is created substituting new management or by redeploying assets "in connection with the accomplishment or expectation" of a merger, that value is not, in my opinion, a part of the "going concern" in which a dissenting shareholder has a legal (or equitable) right to participate.

If one accepts this principle, the question arises how is it to be applied in a two-step arms'-length acquisition transaction. In such a transaction there will be a period following close [to] the first-step tender offer in which the [majority] acquiror may, as a practical matter, be in a position to influence or change the nature of the corporate business, or to freeze controversial programs until they are reviewed following the second-step merger.

Accordingly, the Court of Chancery concluded that "future value that would not exist but for the merger . . . even if it is capable of being proven on the date of the merger," is irrelevant in a Delaware statutory appraisal proceeding. (Emphasis added.) Consequently, the Court of Chancery held "that value added to [Technicolor] by the implementation or the expectation of the implementation of Mr. Perelman's new business plan for [Technicolor] is not value to which, in an appraisal action, [Cinerama] is entitled to a pro rata share, but is value that is excluded from consideration by the statutory exclusion for value arising from the merger or its expectation."

Legal scholars have written extensively with regard to the economic desirability of including or excluding certain valuation elements in an appraisal proceeding, n5 especially with regard to cash-out two-step mergers. See, e.g., John C. Coffee, Jr., Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones? 21 DEL. J. CORP. L. 359 (1996); Robert B. Thompson Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law, 84 GEO. L.J. 1 (1993). n6 The Court of Chancery's construction of "fair value" followed logically from its concept of what was economically desirable and efficient. However, the majority acquiror principle and correlative proximate cause exception for two-step mergers, upon which the Court of Chancery premised its holding, are inconsistent with this Court's interpretation of the appraisal statute in Weinberger.

n5 See, e.g., FRANK H. EASTEREROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (Harvard Univ. Press 1991); Benjamin Hermalin & Alan Schwartz, Buyouts in Large Companies, 25 J. LEGAL STUD. 351 (1996); Lynn A. Stout, Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law, 99 YALE L.J. 1235 (1990); Angie Woo, Note, Appraisal Rights in Mergers of Publicly-Held Delaware Corporations: Something Old, Something New, Something Borrowed, and Something B.L.U.E., 68 S. CAL. L. REV. 719 (1995).

n6 See also Bate C. Toms, III, Compensating Shareholders Frozen Out in Two-Step Mergers, 78 COLUM. L. REV. 548 (1978).

All Relevant Factors

Only Speculation Excluded

An appraisal proceeding is a limited statutory remedy. Technicolor I, 342 A.2d at 1186. Its legislative purpose is to provide equitable relief for shareholders dissenting from a merger on grounds of inadequacy of the offering price. Id. The appraisal statute affords the dissenters the right to a judicial determination of the fair value of their shareholdings. Id. (citing Weinberger v. UOP, Inc. Del. Supr., 457 A.2d 701, 714 (1983)); accord Cavalier Oil Corp. v. Harnett, Del. Supr., 564 A.2d 1137, 1142 (1989). We summarized the nature of the proceeding in Technicolor I, as follows:

in a section 262 appraisal action the only litigable issue is the determination of the value of the appraisal petitioners' shares on the date of the merger, the only party defendant is the surviving corporation and the only relief available is a judgment against the surviving corporation for the fair value of the dissenters' shares.

Technicolor I, 542 A.2d at 1187.

The seminal decision by this Court regarding an appraisal proceeding is Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701 (1983). n7 In Weinberger, this Court broadened the process for determining the "fair value" of the company's outstanding shares by including all generally accepted techniques of valuation used in the financial community. Weinberger v. UOP, Inc., 457 A.2d at 712-13; see Technicolor I, 542 A.2d at 1186-87. The result of that expansion was the holding in Weinberger that "the standard 'Delaware block' or weighted average method of valuation, formerly employed in appraisal and other stock valuation cases, shall no longer exclusively control such proceedings." Weinberger v. UOP, Inc., 457 A.2d at 712-13.

n7 Although Weinberger did not involve an appraisal action per se, this Court has recognized Weinberger's interpretation of the appraisal statute as definitive in subsequent appeals from appraisal proceedings. See, e.g., Rapid-American v. Harris, Del. Supr., 603 A.2d 796 (1992); Cavalier Oil Corp. v. Harnett, Del. Supr., 564 A.2d 1137 (1989); see also Technicolor I, 542 A.2d at 1186-87.

The Delaware appraisal statute provides that the Court of Chancery:

shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors.

8 Del. C. § 262(h). In Weinberger, this Court construed the appraisal statute. That construction required this Court to reconcile the dual mandates of Section 262(h) which direct the Court of Chancery to: determine "fair" value based upon "all relevant factors;" but, to exclude "any element of value arising from the accomplishment or expectation of the merger." In making that reconciliation, the ratio decidendi of this Court was, as follows:

Only the speculative elements of value that may arise from the "accomplishment or expectation" of the merger are excluded. We take this to be a very narrow exception to the appraisal process, designed to eliminate use of pro forma data and projections of a speculative variety relating to the completion of a merger. But elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered. When the trial court deems it appropriate, fair value also includes any damages, resulting from the taking, which the stockholders sustain as a class. If that was not the case, then the obligation to consider "all relevant factors" in the valuation process would be eroded. We are supported in this view not only by [Tri-Continental Corp. v. Battye, Del. Supr., 31 Del. Ch. 523, 74 A.2d 71, 72 (1950)], but also by the evolutionary amendments to section 262.

Weinberger v. UOP, Inc., 457 A.2d at 713 (emphasis added).

After examining the evolution of the statutory text in Section 262(h), this Court concluded "there is a legislative intent to fully compensate shareholders for whatever their loss may be, subject only to the narrow limitation that one can not take speculative effects of the merger into account." Id. at 714 (emphasis added). Therefore, in Weinberger, this Court held that the more liberal methodology we had just authorized in appraisal and other stock valuation cases "must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court, subject only to our [narrow] interpretation of [the exclusionary language in] 8 Del. C. § 262(h)," i.e., requiring that only speculative elements of value, which may arise from the accomplishment or expectation of the merger, be disregarded. Weinberger v. UOP, Inc., 457 A.2d at 713 (emphasis added); see also Kahn v. Household Acquisition Corp., Del. Supr., 591 A.2d 166, 174 (1991); Rosenblatt v. Getty Oil Co., Del. Supr., 493 A.2d 929, 940 (1985).

This Court's final holding in Weinberger was to overrule the trilogy of cases that had adopted the business purpose test for mergers. Weinberger v. UOP, Inc., 457 A.2d at 715. We explained that the final holding followed logically from the entire fairness test, the expanded appraisal remedy being made available to dissenting shareholders, and the Court of Chancery's broad discretion to fashion equitable relief. Id. Consequently, we concluded that no "additional meaningful protection is afforded minority shareholders by the business purpose requirement." Id. Accordingly, the majority may now cash-out the minority by a merger without a business purpose, but must pay the dissenters fair value for "whatever their loss may be, subject only to the narrow limitation that one can not take speculative effects of the merger into account." Id. at 714 (emphasis added).

Perelman Plan

Susceptible of Proof/Non-Speculative

The underlying assumption in an appraisal valuation is that the dissenting shareholders would be willing to maintain their investment position had the merger not occurred. Cavalier Oil Corp. v. Harnett, Del. Supr., 564 A.2d 1137, 1145 (1989). Accordingly, the Court of Chancery's task in an appraisal proceeding is to value what has been taken from the shareholder, i.e., the proportionate interest in the going concern. Id. at 1144 (citing Tri-Continental Corp. v. Battye, Del. Supr., 31 Del. Ch. 523, 74 A.2d 71, 72 (1950)). To that end, this Court has held that the corporation must be valued as an operating entity. Id. We conclude that the Court of Chancery did not adhere to this principle.

The Court of Chancery determined that Perelman "had a fixed view of how [Technicolor's] assets would be sold before the merger and had begun to implement it" prior to January 24, 1983. Consequently, the Court of Chancery found that the Perelman Plan for Technicolor was the operative reality on the date of the merger. Nevertheless, the Court of Chancery held that Cinerama was not entitled to an appraisal of Technicolor as it was actually functioning on the date of the merger pursuant to the Perelman Plan.

The Court of Chancery reached that holding by applying its majority acquiror principle and correlative proximate cause exception. The Court of Chancery excluded any value that was admittedly part of Technicolor as a going concern on the date of the merger, if that value was created by substituting new management or redeploying assets during the transient period between the first and second steps of this two-step merger, i.e., Perelman's Plan. The Court of Chancery reasoned that valuing Technicolor as a going concern, under the Perelman Plan, on the date of the merger, would be tantamount to awarding Cinerama a proportionate share of a control premium, which the Court of Chancery deemed to be both economically undesirable and contrary to this Court's holding in Bell v. Kirby Lumber Corp., Del. Supr., 413 A.2d 137, 140-42 (1980). n8 See also Rapid-American Corp. v. Harris, Del. Supr., 603 A.2d 796, 805-07 (1992). Thus, the Court of Chancery concluded "that value [added by a majority acquiror] is not . . . a part of the 'going concern' in which a dissenting shareholder has a legal (or equitable) right to participate."

n8 Although the Court of Chancery's analysis preceded our decision explaining Kirby in Rapid-American Corp., it is also inconsistent with our explanation of the concept "proportionate interest in the going concern" vis-a-vis a minority's "lack of control" in Cavalier. See Rapid-American Corp. v. Harris, Del. Supr., 603 A.2d 796, 806 n.2 (1992); Cavalier Oil Corp. v. Harnett, Del. Supr., 564 A.2d 1137, 1145 (1989).

In Kirby and its progeny, including Technicolor I, this Court has explained that the dissenter in an appraisal action is entitled to receive a proportionate share of fair value in the going concern on the date of the merger, rather than value that is determined on a liquidated basis. Bell v. Kirby Lumber Corp., 413 A.2d at 142; see also In re Shell Oil Co., Del. Supr., 607 A.2d 1213, 1219 (1992); Technicolor I, 542 A.2d at 1186; Rosenblatt v. Getty Oil Co., Del. Supr., 493 A.2d 929, 942 (1985); Rothschild Int'l. Corp. v. Liggett Group Inc., Del. Supr., 474 A.2d 133, 137 (1984); accord Rapid-American Corp. v. Harris, 603 A.2d at 802-03. n9 Thus, the company must first be valued as an operating entity. Cavalier Oil Corp. v.

Harnett, 564 A.2d at 1144. In that regard, one of the most important factors to consider is the "nature of the enterprise" that is the subject of the appraisal proceeding. Rapid-American Corp. v. Harris, 603 A.2d at 805; see Weinberger v. UOP, Inc., 457 A.2d 701, 713 (1983).

n9 See DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 36.07 (1996).

In a two-step merger, to the extent that value has been added following a change in majority control before cash-out, it is still value attributable to the going concern, i.e., the extant "nature of the enterprise," on the date of the merger. See Rapid-American Corp. v. Harris, 603 A.2d at 805. The dissenting shareholder's proportionate interest is determined only after the company has been valued as an operating entity on the date of the merger. Cavalier Oil Corp. v. Harnett, 564 A.2d at 1144; cf. Walter W.B. v. Elizabeth P.B., Del. Supr., 462 A.2d 414, 415 (1983). Consequently, value added to the going concern by the "majority acquiror," during the transient period of a two-step merger, accrues to the benefit of all shareholders and must be included in the appraisal process on the date of the merger. See Rapid-American Corp. v. Harris, 603 A.2d 796; Cavalier Oil Corp. v. Harnett, 564 A.2d 1137; cf. Walter W.B. v. Elizabeth P.B., 462 A.2d at 415.

In this case, the question in the appraisal action was the fair value of Technicolor stock on the date of the merger, January 24, 1983, as Technicolor was operating pursuant to the Perelman Plan. The Court of Chancery erred, as a matter of law, by determining the fair value of Technicolor on the date of the merger 'but for" the Perelman Plan; or, in other words, by valuing Technicolor as it was operating on October 29, 1982, pursuant to the Kamerman Plan. By failing to accord Cinerama the full proportionate value of its shares in the going concern on the date of the merger, the Court of Chancery imposed a penalty upon Cinerama for lack of control. Cavalier Oil Corp. v. Harnett, 564 A.2d at 1145; accord Rapid-American Corp. v. Harris, 603 A.2d at 805-07 n10; Bell v. Kirby Lumber Corp., 413 A.2d at 140-42.

n10 The mandate to value the dissenters' proportionate share in the corporation as a "going concern" taking into account all other relevant factors affecting value precludes an adjustment of valuation "to reflect a shareholder's individual interest in the enterprise." Rapid-American Corp. v. Harris, 603 A.2d at 805.

The "accomplishment or expectation" of the merger exception in Section 262 is very narrow, "designed to eliminate use of pro forma data and projections of a speculative variety relating to the completion of a merger." Weinberger v. UOP, Inc., 457 A.2d at 713. That narrow exclusion does not encompass known elements of value, including those which exist on the date of the merger because of a majority acquiror's interim action in a two-step cash-out transaction. Cf. In re Shell Oil Co., 607 A.2d at 1218-19. "Only the speculative elements of value that may arise from the 'accomplishment or expectation' of the merger" should have been excluded from the Court of Chancery's calculation of fair value on the date of the merger. Weinberger v. UOP, Inc., 457 A.2d at 713 (emphasis added); cf. In re Shell Oil Co., 607 A.2d at 1219.

The Court of Chancery's determination not to value Technicolor as a going concern on the date of the merger under the Perelman Plan, resulted in an understatement of Technicolor's fair value in the appraisal action. That result was inevitable when the Court of Chancery valued Technicolor pursuant to a discounted cash flow model with the negative factual input and assumptions from the Kamerman Plan rather than the Perelman Plan. Consequently, the Court of Chancery permitted MAF to "reap a windfall from the appraisal process by cashing out a dissenting shareholder [Cinerama]," for less than the fair value of its interest in Technicolor as a going concern on the date of the merger. Cavalier Oil Corp. v. Harnett, 564 A.2d at 1145.

Cinerama has asked this Court to make an appraisal of the fair value of its Technicolor shares on the date of the merger, rather than remand this protracted litigation to the Court of Chancery. This Court will not make an independent determination of value on appeal. Rapid-American Corp. v. Harris, 603 A.2d at 799. This appraisal action will be remanded to the Court of Chancery for a recalculation of Technicolor's fair value on the date of the merger. See id.

Upon remand, it is within the Court of Chancery's discretion to select one of the parties' valuation models as its general framework, or fashion its own, to determine fair value in the appraisal proceeding. See Rapid-American Corp. v. Harris, 603 A.2d at 804. The Court of Chancery has properly recognized that its choice of a framework does not require it to adopt any one expert's model, methodology, or mathematical calculations in toto. See id. The undervaluation in this appraisal proceeding resulted from negative factual assumptions that originated from an erroneous legal theory, not from either the valuation framework selected or adaptions to it by the Court of Chancery. In that regard, however, we have concluded that the Court of Chancery's erroneous majority acquiror principle and proximate cause exception permeated its factual assumptions so pervasively, that the Court of Chancery's attribution of only a $ 4.43 per share value difference between the Perelman Plan and the Kamerman Plan should not be considered the law of this case upon remand.

Law of Case

Perelman Plan is Valuation Element

The Court of Chancery's majority acquiror principle and proximate cause exception for two-step mergers are also contrary to the law of this case, as set forth in Technicolor I. See Technicolor I, 542 A.2d at 1186-87 & n.7. In Technicolor I, this Court provided specific guidance regarding the application of Weinberger's holdings to the trial of Cinerama's consolidated appraisal and personal liability actions. Id. at 1186-88. We began by emphasizing that upon remand, the Weinberger "'liberalized approach' to appraisal shall be used to determine the value of a cashed-out minority's [Cinerama's] share interest on the day of the merger, reflecting all relevant information regarding the company [Technicolor] and its shares." Id. at 1187 (emphasis added).

In an effort to convey this Court's comprehensive interpretation of the statutory "all relevant information," we recognized in Technicolor I "that the majority [MAF] may have insight into their company's [Technicolor's] future based primarily on bits and pieces of nonmaterial information that have value as a totality." Id. at 1187 n.8. Consequently, in Technicolor I, we said "it is this information that, if available in a statutory appraisal proceeding, the Court of Chancery must evaluate to determine if future earnings will affect the fair value of shares on the day of the merger." Id." n11 (emphasis added) (citing 8 Del. C. § 262(h)). This Court reinforced the relevance of such information to the appraisal action, independent of

the personality liability action, stating "the issue we are addressing is not the manipulation of the transaction, nor the suppression or misstatement of material information by insiders defrauding the market." Id. n12 (citations omitted). Thus, the law of this case required the Court of Chancery to consider nonspeculative information about the Perelman Plan.

n11 In Technicolor I, recognizing the potential for investor harm in cash-out transactions, this Court held that Cinerama was entitled to discovery in the appraisal proceeding to obtain this information. Technicolor I, 542 A.2d at 1187 n.8; cf. Randall S. Thomas, Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information, 38 ARIZ. L. REV. 331 (1996).

n12 In Technicolor I, this Court noted that a "determination of fair value does not involve an inquiry into claims of wrong-doing in the merger." Technicolor I, 542 A.2d at 1189; accord Cavalier Oil Corp. v. Harnett, Del. Supr., 564 A.2d 1137, 1143 (1989).

The record is replete with information about Technicolor's future that was known on the date of the merger. Cf. Rosenblatt v. Getty Oil Co., Del. Supr., 493 A.2d 929, 941-42 (1985). MAF's October 18, 1982 financing package presented to the lending banks, Chase Manhattan Bank and Bank of America, contemplated that MAF would realize $ 50 million in net proceeds from the sale of assets by the end of 1983. Moreover, the loan agreement between MAF and the banks specifically identified OHP, CPPD, Gold Key and Audio Visual as assets which could be sold by MAF on behalf of Technicolor.

The Court of Chancery found that as of the date of the merger one "would not have projected" that Technicolor would retain OHP and the other businesses (CPPD, Gold Key and Audio Visual) that Perelman had designated for elimination. Following this remand, Technicolor must be viewed and valued "as an on-going enterprise, occupying a particular market position in the light of future prospects." In re Shell Oil Co., Del. Supr., 607 A.2d 1213, 1218 (1992). All "elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may [and should] be considered." Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701, 713 (1983); accord Rosenblatt v. Getty Oil Co., 493 A.2d at 940; cf. In re Shell Oil Co., 607 A.2d at 1219.

Evidentiary Issues

Cinerama has raised several evidentiary contentions which we will address briefly because this matter will be remanded for further proceedings. Cinerama argues that the Court of Chancery's reliance upon the stock market price of Technicolor's shares in September 1982 was improper for two reasons: first, that price reflected the market's negative opinion of the Kamerman Plan; and, second, the market never had an opportunity to price Technicolor stock in the context of the Perelman Plan. This Court has recognized that the "market price of shares may not be representative of true value." Paramount Communications, Inc. v. Time Inc., Del. Supr., 571 A.2d 1140, 1150 n.12 (1989). Moreover, in this case, we noted that "information and insight not communicated to the market may not be reflected in stock prices." Technicolor I, 542 A.2d at 1187 n.8. Nevertheless, Cinerama's objection goes to the weight, if any, to be given to the stock market price for Technicolor stock in September 1982, rather than its admissability. See In re Delaware Racing Ass'n, Del. Supr., 42 Del. Ch. 406, 213 A.2d 203, 211 (1965);

cf. Rapid-American Corp. v. Harris, Del. Supr., 603 A.2d 796, 806 (1992) (rejecting "exclusive reliance upon market value in an appraisal action"). Upon remand, Cinerama can renew its argument that the September 1982 stock market price was of little significance to the issue of fair value on the date of the merger in January 1983.

Cinerama also argues that the Court of Chancery "erroneously considered the decision of the Technicolor directors to accept MAF's offer and the fairness opinion solicited by Technicolor from its investment banking firm in response to that offer in determining Technicolor's fair value." We have concluded that, given the statutory mandate to consider "all relevant factors," these objections are also directed at the weight, rather than the admissibility, of this evidence. 8 Del. C. § 262(h); see Rosenblatt v. Getty Oil Co., 493 A.2d at 940. Upon remand, Cinerama can renew its argument that this evidence should be given little weight because of its temporal remoteness to the date of the merger.

Cinerama's last two evidentiary contentions both relate to the "inputs" relied upon by the Court of Chancery in its valuation framework. We are unable to determine from the record how much of the "input" accepted by the Court of Chancery was predicated upon its erroneous legal theory and how much was properly attributable to its assessment of credibility or a weighing of the evidence. See Cavalier Oil Corp. v. Harnett, Del. Supr., 564 A.2d 1137, 1146 (1989); cf. Rapid-American Corp. v. Harris, 603 A.2d at 802; Alabama By-Products Corp. v. Neal, Del. Supr., 588 A.2d 255, 259 (1991). Therefore, upon remand, Cinerama should be afforded an opportunity to renew all of its formulaic and factual arguments regarding valuation before the recalculation of fair value is made by the Court of Chancery.

Interest Rate and Costs

Cinerama argues that it should have been awarded compound interest from the date of the merger until the date of payment. The Court of Chancery is vested with discretion to award simple or compound interest. 8 Del. C. § 262(i). The record reflects no abuse of discretion in the Court of Chancery's decision to award simple interest. See Rapid-American Corp. v. Harris, Del. Supr., 603 A.2d 796, 808 (1992). Like any other discretionary act, that matter may be reconsidered upon remand.

Cinerama also argues that the Court of Chancery erred by denying full reimbursement of its expert witness costs. Section 262(j) provides that "the costs of the [appraisal] proceeding may be determined by the Court [of Chancery] and taxed upon the parties as the Court deems equitable in the circumstances." 8 Del. C. § 262(j). In the absence of an equitable exception, the plaintiff in an appraisal proceeding should bear the burden of paying its own expert witnesses and attorneys. In re Radiology Assocs., Inc. Litig., Del. Ch., 611 A.2d 485, 501 (1991); see also Goodrich v. E.F. Hutton Group, Inc., Del. Supr., 681 A.2d 1039 (1996); S. Samuel Arsht & Lewis S. Black, Analysis of the 1976 Amendments to the Delaware General Corporation Law, 3 Corporation 387, 393 (Prentice-Hall 1976). The record supports the Court of Chancery's decision not to invoke its equitable authority to award expert witness fees to Cinerama.

Conclusion

The judgment of the Court of Chancery in the appraisal action is reversed. This matter is remanded for further proceedings in accordance with this opinion.

Upon Motion for Reargument

Cinerama filed a Motion for Limited Reargument. In that motion, Cinerama urges this Court to supplement its opinion by holding that there is no legal bar to an award of post-judgment compound interest in an appraisal. Technicolor filed a response, at the Court's request. In its response, Technicolor acknowledges that it construes this Court's opinion to hold that the Court of Chancery is vested with discretion to award either simple or compound post-judgment interest.

Technicolor's construction of this Court's holding is correct. An award of compound post-judgment interest is the exception rather than the rule. Nevertheless, the Court of Chancery may, in the exercise of its discretion, award compound post-judgment interest in an appraisal proceeding, See Rapid-American Corp. v. Harris, Del. Supr., 603 A.2d 796, 808 (1992); Summa Corp. v. Trans World Airlines, Inc., Del. Supr., 540 A.2d 403 (1988). This restatement of the law will constitute the Court's action on the Motion for Limited Reargument and will be added to the original opinion.

Full Text of Court Cases

Central Trust Co. v. United States

Case name: Central Trust Co. v. United States
Citation: 158 Ct. Cl. 504, 305 F.2d 393, 1962 U.S. Ct. Cl. LEXIS 16
Date of decision: July 18, 1962
Country: US
State or Federal: Federal
State/Jurisdiction: Federal Circuit
Court: United States Court of Federal Claims
Type of action: Estate and Gift Taxation
Judge: Gamer
SIC: 3411 Metal Cans
NAICS: 332431 Metal Can Manufacturing

Keywords: Book value, Gift tax

COUNSEL:

Thomas L. Conlan, for the plaintiffs in No. 196-58. Kyte, Conlan, Wulsin & Vogeler, were on the briefs.

John W. Warrington, for the plaintiffs in No. 199-58 and No. 200-58. Graydon, Head & Ritchey, were on the briefs.

Earl L. Huntington, with whom was Assistant Attorney General Louis F. Oberdorfer, for the defendant.

OPINION:

These cases were referred by the court, pursuant to Rule 45, to Saul Richard Gamer, a trial commissioner of the court, with directions to make findings of fact and recommendations for conclusions of law. The commissioner has done so in a report filed April 17, 1962. Plaintiffs in case No. 196-58 filed their notice of intention to except to the commissioner's findings and recommendations on May 2, 1962, and on June 18, 1962, moved to withdraw this notice. Plaintiffs in case No. 199-58 and case No. 200-58 filed their notices to except to the commissioner's findings and recommendations on May 1, 1962, and on June 13, 1962, moved to withdraw these notices. On June 15, 1962, the defendant filed its reply advising the court that it had no objection to the withdrawal of the notices and on June 22, 1962, the court allowed plaintiffs' motions to withdraw the notices of intention to except in all three cases.

Plaintiffs in their motions to withdraw their notices of intention to except also moved, pursuant to Rule 46(a), that the court adopt the commissioner's report as the basis for its judgment in the cases. Defendant's reply filed June 15, 1962, concurred in these motions. Since the court agrees with the recommendations and findings of the commissioner, as hereinafter set forth, it hereby adopts the same as the basis for its judgment in these cases. Plaintiffs are therefore entitled to recover and judgment is entered to that effect. The amounts of recovery will be determined pursuant to Rule 38(c).

It is so ordered.

OPINION OF THE COMMISSIONER

These suits are for the refund of federal gift taxes. They involve the common question of the value of shares of stock of the same company. A joint trial was therefore conducted.

On August 3, 1954, Albert E. Heekin made gifts totaling 30,000 shares of stock of The Heekin Can Company. The donor had formerly, for 20 years, been president of the Company and at the time of the gifts was a member of its board of directors. The gifts were composed of 5,000 shares to each of six trusts created for the benefit of his three sons, each son being the beneficiary under two trusts. Following his death on March 10, 1955, the executors of his estate filed a gift tax return in which the value of the stock was fixed at $ 10 a share. On October 28, 1957, however, they filed an amended gift tax return and a claim for refund, contending that the correct value of the Heekin Company stock on August 3, 1954 was $ 7.50 a share.

On October 25, 1954, James J. Heekin made gifts totaling 40,002 shares of Heekin Can Company stock. This donor, a brother of Albert E., had also formerly been, for 23 years, the president of the Company and at the time of the gifts was chairman of the board. The gifts were composed of 13,334 shares to each of three trusts created for the benefit of his three children and their families. Separate gift tax returns with respect to these (and other) gifts were filed by both James J. Heekin and his wife, Alma (who joined in the stock gifts), in which the value of the stock was similarly declared to be $ 10 a share. However, on January 21, 1958, James filed an amended gift tax return and a claim for refund, also contending that the correct value of the stock on October 25, 1954, was $ 7.50 a share, and on the same day, the executor of Alma's estate (she having died on November 9, 1955) filed a similar amended return and claim for refund.

On February 5, 1958, the District Director of Internal Revenue sent to James J. Heekin and the executors of the estates of Alma and Albert E. Heekin notices of deficiency of the 1954 gift taxes. Each of the three deficiencies was based on a determination by the Commissioner of Internal Revenue that the value of the Heekin Company stock on the gift dates was $ 24 a share.

Consistent with his deficiency notices, the District Director, on May 15, 1958, disallowed the three refund claims that had been filed, and in July 1958 payment was made of the amounts assessed pursuant to the deficiency notices. After the filing in August and September 1958 of claims for refund concerning these payments, the claims again being based on a valuation of $ 7.50, and the rejection thereof by the District Director, these three refund suits were instituted in the amounts of $ 169,876.19, $ 95,927.08, and $ 94,753.70 with respect to the Albert E. Heekin, James J. Heekin and Alma Heekin gifts, respectively, plus interest.

The Heekin Can Company is a well-established metal container manufacturer in Cincinnati, Ohio. In 1954, the year involved in these proceedings, its principal business consisted of manufacturing two kinds of containers, its total production being equally divided between them. One is known as packer's cans, which are generally the type seen on the shelves of food markets in which canned food products are contained. The other is referred to as general line cans, which consist of large institutional size frozen fruit cans, lard pails, dairy cans, chemical cans, and drums. This line also includes such

housewares as canisters, bread boxes, lunch boxes, waste baskets, and a type of picnic container familiarly known by the trade names of Skotch Kooler and Skotch Grill. On the gift dates its annual sales, the production of five plants, were approximately $ 17,000,000.

The Company was founded in 1901 in Cincinnati by James Heekin, the father of the donors Albert and James. In 1908, it built a six-story 250,000 square foot factory in Cincinnati, which is still its headquarters and one of its main operating plants, producing general line cans. In 1917 it acquired a plant in Norwood, a suburb of Cincinnati, which has since become entirely surrounded by the city, and entered the packer's can business. By 1954, it was a multistory plant with about 275,000 square feet, having grown irregularly throughout the years, one section having four floors, another three, and another only one.

In 1946, the Company branched out from Cincinnati and established a packer's can plant at Chestnut Hill, Tennessee, on property leased from and contiguous to the plant of its largest customer, which used the entire output of the Heekin plant. The cans were run by conveyor directly into the customer's packing plant.

In 1949, the Company built a 100,000 square foot plant in Springdale, Arkansas, to supply its customers in the Ozark area on a more competitive basis concerning freight costs, a large part of which, under the industry's freight-equalization practice, it had therefore absorbed.

In 1952, the Company established its fifth plant, constituting an operation at Blytheville, Arkansas, similar to the one at Chestnut Hill, Tennessee. The plant was on leased property adjacent to the customer's plant, with the cans running directly into such plant. By 1954 this concept of installing can-making lines immediately adjacent to customer's packing plants was a recognized practice in the industry. Thus, the Company was progressively adapting itself to the modern practices of its industry.

From the beginning, the Heekin family has dominated the enterprise. James, the founder, was its president from 1901 to 1905. He was succeeded by his son, James J., one of the donors herein, who served as president for 23 years. In 1928, another son, Albert E., another donor herein, then became president, serving for 20 years. He was succeeded in 1948 by still another son, Daniel M., who served for 6 years. In March 1954, Albert E. Heekin, Jr., the son of donor Albert E. and the grandson of the founder, succeeded to the presidency. A lawyer, he had served the Company up to 1950 as its legal counsel, joining the Company in that year as assistant to the president. On August 3, 1954, of the ten-member board of directors, eight were members of the Heekin family, five of whom were sons of the founder, and three his grandsons. Both donors were members of the board, James J. being chairman. On October 25, 1954, the board was similarly constituted, except for the death of one son in August. Despite this family domination, there was no indication on the gift dates that the enterprise was not capably managed or that salaries were in any way excessive.

On the gift dates, the Company had 254,125 shares of common stock outstanding, there being no restrictions on their transferability or sale. There was no other class of stock. Including the 70,002 shares involved in these cases, a total of 180,510 shares were owned by 79 persons who were related to James Heekin, the founder. Thus, the Heekin family owned approximately 71 percent of all of the outstanding stock. The remaining 73,615 shares were owned by 54 unrelated persons, most of whom were employees of the Company and friends of the family.

Six major customers accounted for almost one-half of Heekin's 1954 business. Relations with these important customers were long-standing and excellent. One of these customers, the Hamilton Metal Products Company, which placed over $ 2,000,000 worth of business with Heekin in 1954, and for whom Heekin manufactured the Skotch Kooler and Grill, had, prior to the gift dates, advised Heekin of its need for certain new products, and on August 3, 1954 (one of the gift dates), Heekin's board of directors authorized the expenditure of approximately $ 90,000 for new tooling and equipment at its Cincinnati plant for the manufacture of such products. Another major customer was the Reynolds Tobacco Company, which placed almost $ 1,500,000 of business with Heekin in 1954 and with whom Heekin had dealt since 1908.

As indicated, freight costs play an important part in Heekin's business. These costs are significant in two aspects. One is the cost of transporting raw material to Heekin's plants. In this respect Heekin was quite favorably located. It has a dock on the Ohio River in Cincinnati, permitting it to take advantage of inexpensive water transportation of steel shipped from Pittsburgh, with a consequent advantage over some of its competitors in the same area who receive their raw materials by rail. The other important freight aspect is, as above noted, the cost of shipping the final product to the customer, and which factor motivated the establishment of its Springdale, Arkansas, plant. The Hamilton Metal Products Company was located only 25 miles from Cincinnati, giving Heekin an important freight advantage. And also, on August 3, 1954, Heekin's board of directors authorized the expenditure of about $ 650,000 for new tooling, machinery and equipment for its Norwood plant so that Heekin could enter the new field of manufacturing beer cans. At that time no other company in the Cincinnati area was engaged in the production of such cans, and Heekin concluded that, with the freight advantage it would have over its competitors in serving the brewers of the Cincinnati area, a profitable new source of business would be developed.

In 1954, favorable economic conditions generally prevailed in the can-manufacturing industry, and demand was at a record level. Indeed, this was the condition throughout the container and packaging industry, and optimism generally prevailed about the continuation of the then current high demand.

But Heekin had its problems too. It is a relatively tiny factor in a highly competitive industry dominated by two giants, the American Can Company and the Continental Can Company. In 1954, these two companies, each with over $ 600,000,000 of annual sales produced from 76 and 40 plants respectively, together accounted for about 75 percent of the country's total can sales. Three other can manufacturing companies, the National Can Corporation, the Pacific Can Company, and Crown Cork & Seal Co., Inc., together made about 8 percent of the sales. Heekin, with its five plants, did a little less than 1 percent of the total business. Prices in the can-making industry are for practical purposes established by American and Continental. When they announce prices, Heekin goes up or down with them. Unable to compete on a price basis, Heekin strives to give its customers better personal service, which, because it is smaller and closer knit, it can frequently do.

Probably Heekin's major problem is the age, and the resulting relative inefficiency, of a large part of its plant and equipment, and its inability to finance a large-scale program of modernization. This again is in part a problem of its small size. The relatively small amounts it can use for this purpose are generated by retained earnings, and it has consequently fallen behind the giants of the industry in erecting efficient plants and installing modern, high-speed, automatic can-making lines. During the war, Heekin was unable to buy new equipment. However, such competitors as American, Continental, and Pacific

manufactured their own can-making equipment and were able to forge ahead, and such equipment as Heekin was able to buy after the war from other companies could not match American and Continental's modern automatic packer's can equipment, which produced 500 cans a minute. Heekin's older packer's can equipment could turn out only about 300 cans a minute, and even the new equipment it was able to buy after the war could attain, with difficulty, speeds of only 400 cans a minute. In 1954, about 90 percent of Heekin's equipment had been acquired in the middle 1930's or prior thereto. In all its plants, the Company had 37 can-making lines, 11 of which were very old and still hand operated.

Similarly, Heekin's Cincinnati and Norwood multistory plants, which accounted for about 75 percent of Heekin's total 1954 production, were less efficient than modern, single-story buildings. The can-making business is primarily a material-handling one, requiring a rapid and efficient flow of large amounts of material through the plant, from the receipt of the raw materials to the shipment of finished products. In a single-story building, materials can freely be moved horizontally with fork-lift trucks and conveyors, whereas in its six-story Cincinnati and four-story Norwood plants, elevators are used for the vertical movement of materials, resulting in excessive labor and handling costs and more difficult production controls. The proceeds of a $ 3,000,000 long-term loan which Heekin secured in 1950 were for the most part not available for such a plant and equipment modernization program.

However, the competitive disadvantage of lack of modern equipment was reflected more on the packer's can phase of its business than on the general line cans, which are produced both by Heekin and its competitors on only semiautomatic equipment. Such equipment does not lend itself as readily to the speed and automation required with respect to packer's cans. Heekin's semiautomatic lines were capable of producing around 300 cans a minute.

The Heekin stock was not listed on any stock exchange, and trading in it was infrequent. There was some such activity in 1951 and 1952 resulting from the desire of certain minority stockholders (the descendants of a partner of James Heekin, the founder) to liquidate their holdings, consisting of 13,359 shares. One individual alone had 10,709 shares. Arrangements were privately made in early 1951 by these stockholders with Albert E. Heekin and his son, Albert E. Heekin, Jr., to sell these holdings at the prearranged price of $ 7.50 a share. These shares were all sold, commencing March 22, 1951, and ending April 16, 1952, in 44 separate transactions, 35 of which took place in 1951 and 9 in 1952. No attempt was made to sell the shares to the general public on the open market. All sales were made to Heekin employees and friends of the Heekin family at such $ 7.50 price. Other than these 1951 and 1952 sales, the only sales of stock made prior to the gift dates consisted of one sale of 100 shares in 1953 by one Heekin employee to another, and one sale in 1954 of 200 shares, again by one Heekin employee to another, both sales also being made for $ 7.50 a share.

Against these background facts, the valuation question in dispute may be approached. Section 1000 of the Internal Revenue Code of 1939 (26 U.S.C. 1952 Ed., § 1000, 53 Stat. 144), the applicable statute, imposed a tax upon transfers of property by gift, whether in trust or otherwise. Section 1005 provided that "If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift."

Section 86.19(a) of the Regulations issued with respect thereto (Treasury Regulations 108, 8 Fed. Reg. 10858) defines such property value as 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 to sell. * * * Such value is to be determined by ascertaining as a basis the fair market value at the time of the gift of each unit of

the property. For example, in the case of shares of stock * * *, such unit of property is a share * * *. All relevant facts and elements of value as of the time of the gift should be considered." With respect to determining the fair market value per share at the date of the gift, subsection (c)(6) stated that, if actual sales or bona fide bid and asked prices are not available, the value should be arrived at "on the basis of the company's net worth, earning power, dividend-paying capacity, and all other relevant factors having a bearing upon the value of the stock."

Further, a lengthy Revenue Ruling (54-77, 1954-1 Cum. Bull. 187), entitled "Valuation of stock of closely held corporations in estate tax and gift tax returns," was in effect at the time of these gifts which outlined "the approach, methods and factors to be considered in valuing shares of the capital stock of closely held corporations for estate tax and gift tax purposes." After warning in section 3 that fair market value, "being a question of fact," depends on the "circumstances in each case," and that "No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases," and that there is ordinarily "wide differences of opinion as to the fair market value of a particular" closely held stock, section 4 goes on to enumerate the following factors which "are fundamental and require careful analysis in each case": (1) the nature of the business and its history, (2) the general economic outlook of business in general and the specific industry in particular, (3) the book value of the stock and the company's financial condition, (4) the company's earning capacity, (5) its dividend-paying capacity, (6) its goodwill, (7) such sales of the stock as have been made as well as the size of the block to be valued and (8) "the market price of stocks of corporations engaged in the same or similar line of business which are listed on an exchange." After discussing each factor in detail, the Ruling goes on to consider such matters as (a) the weight to be accorded the various factors, concluding that, in a product selling company, primary consideration should normally be given to the earnings factor, and (b) the necessity of capitalizing the earnings and dividends at appropriate rates.

There appears to be no dispute between the parties concerning the validity, or the propriety of applying the principles, of the Regulations and the Ruling to these cases. The dispute arises from the differences of opinion which are inherent in the Ruling's statement that "A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."

Where, as in the present cases, the problem is the difficult one of ascertaining the fair market value of the stock of an unlisted closely held corporation, it is not surprising that, in assisting the court to arrive at an "informed judgment," the parties offer the testimony of experts. In such a situation, the opinions of experts are peculiarly appropriate. Bader v. United States, 172 F. Supp. 833 (D.C.S.D.Ill.). At the trial, the taxpayers produced three experts, and the Government one.

One of plaintiffs' experts was the senior partner of a firm of investment bankers and brokers. He felt that the limited prior sales of the stock at $ 7.50 warranted the consideration of the other factors listed in the Revenue Ruling applicable to closely held corporations. There were four major factors which he considered in arriving at his conclusion. The first was book value. Utilizing the Company's balance sheet as of December 31, 1954 (a date subsequent to the gift dates), the book value came to about $ 33 a share. In this connection he noted that the Company's financial position at that time was sound, with a ratio of current assets to current liabilities of about 4.3 to 1. However, principally because of the age and multistoried inefficiency of the Company's two main plants at Cincinnati and Norwood, he reduced the book value factor by 50 percent. The second factor was earnings. The Company's audited annual

statements for 1952, 1953 and 1954, which he accepted without adjustment, showed that the average of its earnings for these 3 years was $ 1.77 a share. He felt that, in the case of this Company, a price earnings ratio of 6 to 1 would be appropriate, but, recognizing that this was the most important factor, he weighted it to give it double value. The third factor was dividend yield. In said 3 years, the Company paid an annual dividend of 50 cents. Accepting this figure as the dividend the Company would be likely to pay in the future, he concluded that an investor would look for a 7 percent yield on this stock, and capitalized it on that basis. The fourth factor was the prior sales at $ 7.50. Adding and weighting these figures, he derived a value of $ 10.50 a share. However, because the stock was not listed on any exchange, and was closely held, with sales being infrequent, he discounted that value by 25 percent to reflect the stock's lack of marketability, and came out with an ultimate valuation of $ 7.88 a share. n1 This is the value plaintiffs now rely on in these cases. This value was applied to the entire block of 70,002 shares and to both dates, a block which, he noted, would give a purchaser only a minority position. Considering the Revenue Ruling's suggestion to investigate "the market price of stocks of corporations engaged in the same or similar line of business which are listed on an exchange," this witness felt that there were no listed companies that could properly be compared with Heekin.

n1

Book value =	$ 33.20, less 50%	$ 16.60
Earnings =	Average 3 years = 1.77; price to earnings	
	ratio = 6:1 = $ 10.62. Weighted to two factors	21.24
Dividends =	To give yield of 7% at rate of 50 cents per	
	annum, would have to sell at	7.14
Prior Sales		7.50
	Total all factors	52.48
	Divided by 5 to obtain weighted average	52.48/5 = $ 10.50
	Less 25% for lack of marketability	2.62
		7.88

Plaintiffs' second expert, a certified public accountant who had experience in and was familiar with the principles involved in valuing stocks of closely held corporations, arrived at the somewhat higher valuations of $ 9.50 per share for the 30,000 shares given on August 3, 1954, and $ 9.65 for the 40,002 given on October 25, 1954. He recognized that the previous sales of the stock in 1951, 1952, 1953 and 1954 at $ 7.50 could not be determinative because, being all at the same selling price, they could not have reflected the month-to-month or year-to-year fluctuations of actual value, which was the problem herein involved. He concluded that that price was predicated primarily to give a yield of 6 2/3 percent based on an annual dividend rate of 50 cents, which the Company had paid each year from 1946 through 1954, except for a 1 1/2-year period in 1950 and 1951. In 1950, the Company suffered

extraordinary losses and dividends were suspended, and in 1951, only 25 cents was paid. Accordingly, he considered the situation appropriate for the application of the principles enunciated in the Revenue Ruling.

In so doing, he too concluded that the four major factors to be considered were earnings, dividend yield, book value, and the price of the prior sales. As to earnings, he computed, from the Company's audited statements for the years 1950-54, without adjustment, average annual earnings of $ 1.68. Using the comparative method of calculating price-earnings ratios of listed companies in the same or similar business and then correlating such results to Heekin, he selected 11 leading corporations in the container industry (only two of which, American Can and Continental Can, were can companies), and computed their average price-earnings ratio over the similar 5-year period at 10 to 1, with 1954 alone producing a ratio of 11.6 to 1 because of the rise in prices of container industry stocks in that year. n2 However, he capitalized Heekin's 5-year average earnings of $ 1.68 at an earnings multiple of only eight times which he considered appropriate for a "marginal" company like Heekin. Since this produced a value of $ 13.44 based only on earnings, as of December 31, 1954, due to his using the figures for the full year 1954, he adjusted the figure to August 3, 1954, the first gift date, by reducing the figure by 14.1 percent, a figure derived by calculating the general rise in a relatively large group of certain other industry stocks between August 3 and December 31. Thus, on the basis of earnings alone, he calculated a value of $ 11.55 as of August 3.

n2 He noted that this 10-to-1 ratio was higher than the Dow-Jones average of 9.9 for 30 industrials, the Standard & Poor average of 9.3 for 50 industrials, and the Moody average of 9.7 for 125 industrials for the same 5-year period.

As to dividends, this witness then calculated Heekin's average for the 5 years ended December 31, 1954, at 35 cents per share and capitalized that figure at 6 percent, which he considered to be appropriate in Heekin's case in view of the 5-year average dividend yield of 5.1 percent for the 11 leading companies in the container industry which he used as comparatives, and the even higher returns, on a 5-year average basis, afforded by general groups of leading industrials during that period. Thus, on the basis of a 6 percent dividend yield alone, he calculated a value of $ 5.83.

Using as factors the value figures derived as described on the bases of price earnings ($ 11.55) and dividend yield ($ 5.83) ratios, together with a book value figure of $ 33.23 as of December 31, 1954, and a $ 7.50 figure as the price of the prior sales, the witness then weighted these four factor figures, giving the earnings and dividend factors 40 percent each (i.e. each figure multiplied by 4), and the book value and prior sales figure 10 percent each (i.e. each figure multiplied by 1). This total figure was then reduced by 15 percent to reflect the stock's lack of marketability (which was equated to the underwriting cost of floating 30,000 shares) which, after dividing by the weight factor (10), gave the market price as of August 3 as $ 9.37, n3 which he rounded out to $ 9.50.

n3

	Weight	Total

Price earnings ratio	$ 11.55	4	$ 46.20
Dividend -- 35 cents capitalized at 6%	5.83	4	23.32
Stock sales	7.50	1	7.50
Book value	33.23	1	33.23
			110.25
Less 15% -- amount for nonmarketability (flotation cost			16.51
Divided by factor 10			9.37

Using the same criteria and method, the witness valued the 40,002 shares given on October 25, 1954, at the slightly higher price of $ 9.65, the price of listed stocks having generally risen between the two dates.

The taxpayers' third expert, a senior officer in a firm specializing in valuing the stocks of closely held corporations, came out with the still higher valuation of $ 11.41 per share on August 3, in blocks of 10,000 ($ 11.76 in a block of 30,000 shares). For the shares given on October 25, however, his value was only $ 9.40 per share in blocks of 13,334 shares ($ 9.47 in a block of 40,002 shares).

This witness also used the technique of selecting comparable companies traded on a national exchange, ascertaining, by a very comprehensive study, the relationship between their market prices and their earnings, "earnings paid out," and return on invested capital (to which he added long-term debt), and then correlating the data to Heekin. Unlike the other two experts, he did not accept the exact figures of the audited statements of annual earnings, but studied them with a view to detecting and eliminating abnormal and nonrecurring items of loss or profit in order to obtain a better picture of the Company's normal operation and of what an investor, therefore, might reasonably conclude the Company's future performance would be. With such adjustments and eliminations, he thus recasted the Company's earnings for the years 1949-1953. He selected eight companies in both the can and glass container fields to use as comparatives.

In calculating Heekin's earnings, the witness used a 5-year average, as adjusted. One of the adjustments was to the Company's abnormal profits in 1951 as a result of the Korean war, which he eliminated and reduced to more normal levels. Another was to eliminate, as abnormal and nonrecurring, rather large losses the Company suffered in 1950, 1951 and 1952 as a result of the operations of a subsidiary which was liquidated. By applying a price-earnings ratio of 11.82, as derived from the comparative companies, he determined a value of the Heekin stock on August 3, based only on earnings, of $ 13.78 per share; a value based on earnings paid out (in which he included not only dividends but also interest on long-term debt) on the capital invested in the business of $ 9.59 per share; and a value based on invested capital of $ 31.34 per share. To these three determinants of value, he added the fourth factor of $ 7.50 derived from the prior sales price. He too then weighted these figures, assigning a weight of 33 1/3 percent each to the values based on earnings and earnings-paid-out, and 16 2/3 percent each to the values based on invested capital and the prior stock sales. This gave a total

weighted value of $ 14.26. He then too applied a 20-percent reduction for lack of marketability, which he also equated with flotation costs for blocks of 10,000 shares, resulting in the net figure of $ 11.41 as of August 3. n4

n4

Value based on earnings -- 13.78 at 33 1/3%	$ 4.59
Value based on earnings paid out -- 9.59 at 33 1/3%	3.20
Value based on invested capital -- 31.34 at 16 2/3%	5.22
Value based on stock sales -- 7.50 at 16 2/3%	1.25
100%	14.26
Less 20% for lack of marketability (flotation cost in blocks of 10,000 shares)	2 85
Net value	11.41
Less 17.5% reduction if in a block of 30,000 shares	11.76

The same technique produced a figure of $ 9.40 per share as of October 25, 1954, in blocks of 13,334 shares. n5 This lower valuation is attributable to the drop in the market prices of the comparative companies between August 3 and October 25, 1954. One of the comparatives (Pacific Can Company) which had been used for the August 3 valuation was dropped since it enjoyed a rather atypical sharp rise after such date due to a proposed merger.

n5 $ 9.47 per share in a block of 40,002 shares.

Various major criticisms can fairly be made of these three appraisals offered by plaintiffs. First, they all give undue weight as a factor to the $ 7.50 price of the prior stock sales. Almost all of these sales occurred in the relatively remote period of 1951 and early 1952. Only one small transaction occurred in each of the more recent years of 1953 and 1954. Such isolated sales of closely held corporations in a restricted market offer little guide to true value. Wood, Adm. v. United States, 89 Ct. Cl. 442, 29 F. Supp. 853; First Trust Co. v. United States, 5901 U.S. Tax Cas. (CCH) 11843, 3 A.F.T.R.2d (P-H) 1726 (D.C.W.D.Mo.); Drayton Cochran v. Commissioner, T.C.Mem.(P-H) 48094, 7 T.C.M. (CCH) 325; Schnorbach v. Kavanagh, 102 F. Supp. 828 (D.C.W.D.Mich.). In an evaluation issue, this court recently even gave little weight to the sale of shares on a stock exchange when the amount sold was "relatively insignificant." American Steel Foundries v. United States, 153 Ct. Cl. 234, 237. To the same effect is Heiner v. Crosby, 24 F.2d 191 (C.C.A. 3d) in which the court rejected stock exchange sales as being determinative and upheld the resort to "evidence of intrinsic value" (p. 194). Furthermore, the $ 7.50 price of the 1951 and 1952 sales evolved in early 1951 during a period when the Company was experiencing rather severe financial difficulties due to an unfortunate experience with a subsidiary which

caused a loss of around $ 1,000,000, and when, consequently, the Company found itself in a depleted working capital position and was paying no dividends. Further, there is no indication that the $ 7.50 sales price evolved as a result of the usual factors taken into consideration by informed sellers and buyers dealing at arm's length. Fair market value presupposes not only hypothetical willing buyers and sellers, but buyers and sellers who are informed and have "adequate knowledge of the material facts affecting the value." Robertson v. Routzahn, 75 F.2d 537, 539 (C.C.A. 6th); Paul, Studies in Federal Taxation (1937), pp. 193-4. The sales were all made at a prearranged price to Heekin employees and family friends. The artificiality of the price is indicated by its being the same in 1951, 1952, 1953 and 1954, despite the varying fortunes of the Company during these years and with the price failing to reflect, as would normally be expected, such differences in any way.

Secondly, in using the Company's full 1954 financial data, and then working back from December 31, 1954, to the respective gift dates, data were being used which would not have been available to a prospective purchaser as of the gift dates. "The valuation of the stock must be made as of the relevant dates without regard to events occurring subsequent to the crucial dates." Bader v. United States, supra, at p. 840. Furthermore, in the working-back procedure, general market data were used although it is evident that the stocks of a particular industry may at times run counter to the general trend. This was actually the situation here. Although the market generally advanced after August 3, 1954, container industry stocks did not.

Thirdly, the converse situation applies with respect to the data used by the third expert. His financial data only went to December 31, 1953, since the Company's last annual report prior to the gift dates was issued for the year 1953. But the Company also issued quarterly interim financial statements, and by the second gift date, the results of three-quarters of 1954 operations were available. In evaluating a stock, it is essential to obtain as recent data as is possible, as section 4 of the Revenue Ruling makes plain. Naturally, an investor would be more interested in how a corporation is currently performing than what it did last year or in even more remote periods. Although the use of interim reports reflecting only a part of a year's performance may not be satisfactory in a seasonal operation such as canning, it is possible here to obtain a full year's operation ending on either June 30 or September 30, 1954, which would bring the financial data up closer to the valuation dates.

Fourth, it is accepted valuation practice, in ascertaining a company's past earnings, to attempt to detect abnormal or nonrecurring items and to make appropriate eliminations or adjustments. As shown, only the plaintiffs' expert who came out with the highest August 3 valuation attempted to do this by adjusting the excessive Korean war earnings and by eliminating the unusual losses suffered in 1950, 1951 and 1952 arising from the operations of a financing subsidiary (Canners Exchange, Inc.) that had been liquidated in 1952. The reason this is important is that past earnings are significant only insofar as they reasonably forecast future earnings. The only sound basis upon which to ground such a forecast is the company's normal operation, which requires the elimination or adjustment of abnormal items which will not recur. Plaut v. Smith, 82 F. Supp. 42 (D.C. Conn.), aff'd., sub. nom. Plaut v. Munford, 188 F.2d 543 (Ct.App.2d Cir.). In American Steel Foundries v. United States, supra, the court similarly viewed the "earning prospects" of the company whose stock was being evaluated in light of its past earnings "as constructed by the accountants, eliminating or adjusting losses due to strikes or other nonrecurring events." And the court in White & Wells Co. v. Commissioner, 50 F.2d 120 (C.C.A. 2d), also held that: "*

* * past earnings * * * should be such as fairly reflect the probable future earnings" and that to this end "abnormal years" may even be entirely disregarded. The Revenue Ruling (sec. 4.02(d)) specifically points out the necessity of separating "recurrent from nonrecurrent items of income and expense."

Fifth, in deriving a past earnings figure which could be used as a reasonable basis of forecasting future earnings, none of plaintiffs' experts gave any consideration to the trend of such past earnings. They simply used the earnings of prior years and averaged them. But such averages may be deceiving. Two corporations with 5-year earnings going from the past to the present represented by the figures in one case of 5, 4, 3, 2, and 1, and in the other by the same figures of 1, 2, 3, 4, and 5, will have the same 5-year averages, but investors will quite naturally prefer the stock of the latter whose earnings are consistently moving upward. The Revenue Ruling specifically recognizes this in providing (sec. 4.02(d)) that: "Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power."

And further, since the most recent years' earnings are to be accorded the greatest weight, care must be taken to make certain that the earnings figures for such years are realistically set forth. For instance, in Heekin's case, profits for 1952-54 were understated because a noncontributory retirement plan for hourly employees was established in 1951 for which the costs attributable to 1950 and 1951 were borne in the later years of 1952-54. Similarly, 1954 profits were further understated because they reflected (1) a renegotiation refund arising out of excess profits made in 1951, and (2) they were subjected to a charge of $ 174,203.54 ($ 83,617.70 after taxes) as a result of a deduction from 1954 profits only of certain expenses attributable to both 1954 and 1955. This abnormal doubling up of 2 years' expenses in one year was permitted by a change in the tax laws which became effective in 1954 (and which was later revoked retroactively) which allowed taxpayers such as Heekin to change their methods of accounting so as to effect the accrual in 1954 of these 1955 expenses. If proper adjustments are made in Heekin's 1954 statements for these items, the earnings for the 1954 period prior to the gift dates would be realistically increased and given due weight insofar as earning trends are concerned.

None of plaintiffs' experts made any of these adjustments in connection with a trend study or otherwise.

Sixth, it is generally conceded that, as stated by the Revenue Ruling, in evaluating stocks of manufacturing corporations such as Heekin, earnings are the most important factor to be considered. Bader v. United States, supra. Yet only one of plaintiffs' experts, who assigned double value to this factor, gave it such weight. As shown, the other two assigned the dividend factor equal weight. Some investors may indeed depend upon dividends. In their own investment programs, they may therefore stress yield and even compare common stocks with bonds or other forms of investment to obtain the greatest yields. However others, for various reasons, may care little about dividends and may invest in common stocks for the primary purpose of seeking capital appreciation. All investors, however, are primarily concerned with earnings, which are normally a prerequisite to dividends. In addition, the declaration of dividends is sometimes simply a matter of the policy of a particular company. It may bear no relationship to dividend-paying capacity. Many investors actually prefer companies paying little or no dividends and which reinvest their earnings, for that may be the key to future growth and capital appreciation.

And further, in capitalizing the dividend at 6 and 7 percent, as did two of the experts, rates of return were used which well exceeded those being paid at the time by comparable container company stocks. And still further, one of the experts used a 35-cent dividend rate as the basis for his capitalization because that was the average paid for the 5 years ended December 31, 1954. However, it seems clear that an annual dividend rate of 50 cents a share would be the proper rate to capitalize since that was the dividend paid by Heekin every year since 1945 except for the year 1950 and the first half of 1951 when, as shown, dividends were temporarily suspended. By the end of 1951 the Company had recovered from the situation causing the suspension and the normal dividend (quarterly payments of 12 1/2 cents per share) was then resumed. By August and October 1954, Heekin's demonstrated earning capability and financial position were such that there was little doubt it would at least continue its 50-cent annual dividend, which represented only about 25 percent of its current earnings per share. To dip back into this 1950-51 a typical period to compute an "average" of dividends paid for the past 5 years is unrealistic.

Finally, the record indicates that all three experts took too great a discount for lack of marketability. Defendant disputes the propriety of taking this factor into consideration at all. It seems clear, however, that an unlisted closely held stock of a corporation such as Heekin, in which trading is infrequent and which therefore lacks marketability, is less attractive than a similar stock which is listed on an exchange and has ready access to the investing public. This factor would naturally affect the market value of the stock. This is not to say that the market value of any unlisted stock in which trading is infrequent would automatically be reduced by a lack of marketability factor. The stock of a well-known leader in its field with a preeminent reputation might not be at all affected by such a consideration, as was the situation with Ford Motor Company stock before it was listed. Couzens v. Commissioner, 11 B.T.A. 1040. But the stock of a less well-known company like Heekin which is a comparatively small factor in its industry is obviously in a different position. In such a situation, a consideration of this factor is appropriate, especially where, as here, only a minority interest is involved. Bader v. United States, supra; Baltimore National Bank v. United States 136 F. Supp. 642 (D.C. Md.); Schnorbach v. Kavanagh, supra; Cochran v. Commissioner, supra; First Trust Co. v. United States, supra. But see Couzens v. Commissioner, supra; Estate of Katharine H. Daily v. Commissioner, T.C.Mem.(P-H) 47025, 6 T.C.M. (CCH) 114.

Defendant concedes that if such a factor is appropriate in these cases, a reasonable method of determining the diminution in value attributable to lack of marketability is to determine how much it would cost to create marketability for the block of stock in question. This was the method used by the court in First Trust Co. v. United States, supra. The record shows that for a company of Heekin's size, and for blocks of 30,000 and 40,000 shares, which would appear to be the appropriate considerations, flotation costs would amount to about 12.17 percent of the gross sales prices. However, as shown, the discounts taken by plaintiffs' experts for this factor ranged from 15 to 25 percent.

For all the above reasons, the opinions of plaintiffs' experts are not wholly acceptable.

Defendant produced one expert, an employee of a recognized appraisal company. His primary work over many years was the valuation of intangibles, including closely held stock. His opinion was that the value of the Heekin stock in question on August 3 and October 25, 1954, was $ 16 and $ 15.25 per share, respectively. This witness also used the comparative appraisal method, considering a group of stocks in the can and glass container industries. As part of a very comprehensive study, he selected eight container companies, six engaged in can production and two in glass container production, glass container enterprises being similar to those engaged in can production. He considered net assets as a

key factor in the determination of a stock price, and one which keeps a stock price from declining to zero when earnings become zero or even when losses are suffered and when a price-to-earnings ratio would therefore become meaningless. He therefore developed for the comparative companies percentage ratios of profits and dividends to net worth as well as market value to net worth. In developing figures for the profits and dividends of the comparative companies for the past 5 years, he gave weight to the trends thereof. He then developed Heekin's profits over the period 1950 through September 1954, making adjustments for the retirement plan costs, the losses from subsidiaries, the renegotiation refund, and the abnormal 1951 profits, in order to reflect the more nearly normal operations over the period. Adjusted profits were developed for the 12-month periods ending June 30 and September 30, 1954. Before correlating the percentages developed for the comparative companies to Heekin, however, he concluded that only two of such companies, United Can and Glass Company and Crown Cork & Seal Company, Inc., could be considered conformable to Heekin. The others, including the giants of their industries, such as American Can, Continental Can, and Owens Illinois Glass Company which, because of acquisitions, diversification, premium investment quality position, and mere size, were not considered fairly comparable, were eliminated. Correlating the data developed with respect to such two companies, he concluded that, as of August 3, Heekin would be worth 59.5 percent of net worth, or $ 19.72 per share, a stock exchange equivalent of 19 3/4 per share. The similar method produced $ 18.78 per share as the value as of October 25, 1954, or a trading equivalent of 18 3/4.

This witness too felt that the correlation process resulted in comparing Heekin with seasoned listed stocks enjoying marketability, and that an adjustment should be made for the closely held nature of the Heekin stock with its resultant lack of marketability, especially where only a minority interest was involved. Similarly equating this adjustment to deductions a seller would experience through floating the shares through an underwriter, which he calculated to be almost 20 percent, resulted in net valuations of 16 and 15 1/4 as of August 3 and October 25, 1954, respectively. Since these values approximate Heekin's current assets (including inventories) less all of its liabilities, without giving any value at all to any of its plants, equipment, or other noncurrent assets, he concluded they were extremely conservative. Employing the common tests of price-to-earnings ratio and yield on the basis of the current 50-cent dividend, these values would result in a price-to-earnings ratio of 7.24:1 as of August 3, based on $ 2.21 adjusted net profit per share for the 12 months ending June 30, as well as a 3.13 percent dividend yield, and a ratio of 8.29:1 as of October 25, based on $ 1.84 adjusted net profit per share for the 12 months ending September 30, as well as a 3.28 percent dividend yield.

This witness' study has certain meritorious features. It is based on justifiable adjustments in Heekin's earnings records to eliminate abnormal and nonrecurring items (although he made no adjustment for the 1954 doubling up of certain expenses). It considers earnings trend. It disregards the prior $ 7.50 sales prices as a major factor. And in employing the Company's financial data going up to June 30 and September 30, 1954, it is based on its most recent performance. However, it has certain weaknesses too, the principal one being the limitation of the comparative companies to two, one of which, Crown Cork & Seal, leaves much to be desired as a comparative because its principal business is the manufacture of bottle caps and bottling machinery, an entirely different business. Only 40 percent of its business is in can production. On the basis of size too there are great differences. At that time, Crown, including its foreign subsidiaries, was doing about $ 115,000,000 worth of business as against Heekin's $ 17,000,000. And the other comparative, United Can and Glass, presents the complication that it declared periodic stock dividends to which the witness gave no consideration, although it seems that

some element of value should fairly be attributed to them. n6 Although no two companies are ever exactly alike, it being rare to have such almost ideal comparatives as were present in Cochran v. Commissioner, supra, so that absolute comparative perfection can seldom be achieved, nevertheless the comparative appraisal method is a sound and well-accepted technique. In employing it, however, every effort should be made to select as broad a base of comparative companies as is reasonably possible, as well as to give full consideration to every possible factor in order to make the comparison more meaningful.

n6 "In theory, of course, the additional stock certificate gives him [the stockholder] nothing that he would not own without it * * *. But in actuality the payment of periodic stock dividends produces important advantages. Among them are the following: * * * 4. Issues paying periodic stock dividends enjoy a higher market value than similar common stocks not paying such dividends." Graham & Dodd, Security Analysis, Principles and Technique (3d ed. 1951) pp. 444-5.

Further, in compiling Heekin's financial data for correlation purposes, this witness used Heekin's average dividends for the 4 1/2 years preceding the valuation dates, thus including the atypical period when no dividends were paid.

Defendant, considering its own expert's valuations to be unduly conservative, and disagreeing as a matter of law with any deduction for lack of marketability (and in any event with the amount deducted by its expert for such factor), now offers valuations on what it claims to be a more realistic basis. It also adjusts and redistributes Heekin's profits, including the "doubling up" expenses in 1954, the renegotiation refund, and the retirement plan. As comparatives, it uses for the purpose of developing a price-earnings ratio 11 can and glass container manufacturing companies, including American Can and Continental Can (although it concedes that with respect to the stock of such companies in this field, the investing public affords "some extra value coincident with size"), as well as Crown Cork & Seal and United Can. The dividend yield of seven comparative companies, based on their 1954 dividend payments, was 3.77 percent. Defendant too gives no cognizance to United Can's stock dividends, although it concedes that "stock dividends have some effect on market value." On Heekin's 50-cent dividend, the market price of Heekin stock would be $ 13.33, based solely on a 3.75 (the figure used by defendant) percent dividend yield.

Defendant then computes representative earnings for Heekin as $ 1.89 per share, based on 1953 and 1954 adjusted earnings. The average price to current earnings ratio of the 11 comparative companies in 1954 was 13 to 1. On this formula, Heekin's stock would sell for $ 24.57 per share if earnings were the sole factor. However, defendant reduces this figure to $ 22.50 for the purpose in question.

On the basis of the book value of Heekin stock being $ 33.15 as of June 30, 1954, and comparing the market prices of various alleged comparable companies to their book value (i.e., the stocks of 11 unidentified comparatives used by the Commissioner of Internal Revenue in making his valuation sold for 1.4 times book value), defendant concludes that Heekin stock would not sell for less than $ 33 per share.

The three factors of earnings, dividend yield, and book value are then weighted, earnings, considering their recognized importance for valuation purposes and the upward trend thereof, being assigned 50 percent weight, and dividend yield and book value receiving 30 percent and 20 percent respectively. On this basis, defendant arrives at a fair market value figure of $ 21.85 as of August 3, 1954. n7

n7

Earnings	$ 22.50 X .5 = $ 11.25
Dividend yield	13.33 X .3 = 4.00
Book value	33.00 X .2 = 6.6
	21.85

Since there was a slight drop in the market price of can manufacturing stocks between August 3 and October 25, 1954, defendant concludes the fair market value on the latter date would be about 50 cents less per share, or $ 21.35.

Thus, defendant now seeks a fair market value determination as of the gift dates of $ 21.85 and $ 21.35 respectively, in lieu of the $ 24 value fixed by the Commissioner of Internal Revenue. n8

n8 This $ 24 value resulted from a study by the Commissioner of 11 comparatives. Their price to book value ratio was 1.4; price to average earnings, 14.3; price to current earnings, 13; and price to current dividends, 31.1.

Applying these ratios to Heekin, 1.4 times book value of $ 33.23 as of December 31, 1954, equals $ 46.52 per share. Average earnings for a 5-year period of $ 1.68 per share times 14.3 equals $ 24.02 per share. Current earnings times 13 equals $ 17.16 a share. Price to current dividend equals $ 15.55 per share.

In addition, in 1954 National Can purchased Pacific Can and the Commissioner analyzed the sale price for comparative purposes. The sales price came to 12.5 times Pacific's earnings. Application of that ratio to Heekin's 1953 earnings would price Heekin's stock at $ 24.38 per share. Pacific's price also represented 17 times its average 1949-1953 earnings. Application of such ratio to Heekin would price its stock at $ 28.39 per share. Further, Pacific's price bore a ratio of 1.6 to book value. Application of such ratio to Heekin's stock would price it at $ 53.17 per share.

In its selection of the three basic factors to be considered in determining fair market value, the weights to be assigned to these factors, the earnings adjustments, and the use of 50 cents per annum as the proper dividend basis, this estimate has merit. However, the selection of such companies as American Can and Continental Can as comparatives -- companies held in esteem in the investment world -- will obviously give an unduly high result. It simply is not fair to compare Heekin with such companies and to adopt their market ratios for application to Heekin's stock. Furthermore, defendant's use of the comparatives is confusing. The employment of different comparatives for different purposes is

unorthodox. When the comparative appraisal method is employed the comparatives should be clearly identified and consistently used for all purposes. And the refusal to make any allowance for lack of marketability contributes further to the unrealistic nature of defendant's fair market value estimate.

To summarize, Heekin's stock has been valued as of August 3 and October 25, 1954, in blocks of 30,000 and 40,002 shares respectively, as follows: $ 10, originally, by two donors and the executor of the third; $ 7.50, in amended returns; $ 7.88 by one expert of plaintiffs (upon which valuation plaintiffs now stand); $ 9.50 and $ 9.65 respectively by plaintiffs' second expert; $ 11.76 and $ 9.47 respectively by plaintiffs' third expert; $ 16 and $ 15.25 respectively by defendant's expert; $ 21.85 and $ 21.35 respectively by defendant in these proceedings; and $ 24 by the Commissioner of Internal Revenue.

The proper use of the comparative appraisal method, applying the principles already indicated, should provide a reasonably satisfactory valuation guide in these cases. n9 In its application, it would under all the circumstances herein involved appear appropriate to select the three factors of (1) earnings, (2) dividends and dividend-paying capacity, and (3) book value, as being the important and significant ones to apply. First Trust Co. v. United States, supra; Cochran v. Commissioner, supra; Bader v. United States, supra.

n9 In the related estate tax area, § 2031(b) of the Internal Revenue Code of 1954 specifically provides that: "In the case of stock and securities of a corporation the value of which, by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange." 26 U.S.C. (1958 Ed.) § 2031(b).

As to earnings, an examination of them for the periods from 1950 to June 30 and September 30, 1954, which are the most recent periods in relation to the gift dates, would be most representative. For this purpose, the annual profit and loss statements, plus the Company's interim balance sheets, from which can be derived with reasonable accuracy the Company's earnings for the 12-month periods ending June 30 and September 30, 1954 (thus eliminating distortions due to seasonal factors), are the starting points. As stated, it would then be proper to make such adjustments therein as would be necessary to eliminate abnormal and nonrecurring items and to redistribute items of expense to their proper periods. In these cases, this normalizing process would require (a) the elimination from the years 1950 to 1952 of the abnormal, nonrecurring losses incident to its financing subsidiary, which had been completely liquidated by 1952; (b) the elimination of the abnormally large 1951 profits due to the Korean war; (c) the redistribution of the expenses attributable to the establishment subsequent to 1951 of a retirement plan, which expenses, although borne in later years, were also applicable to 1950 and 1951, thereby overstating 1950 and 1951 profits and similarly depressing 1953 and 1954 profits; (d) the shift from 1954 to 1951 of a renegotiation refund paid with respect to excessive 1951 profits; (e) the elimination from 1954 of the abnormally large charge relating to the accrual in 1954 of certain expenses actually attributable to 1955, as hereinabove explained, and which resulted in the doubling up of 2 years of such expenses in 1954, as permitted by a then recent change in the tax laws. The method adopted in making these adjustments, and the adjusted profit figures resulting therefrom, are set forth in detail in finding 47.

As indicated, it would then be appropriate to give due consideration and weight to the trend of such earnings. Greater weight should fairly be given to the most recent years and periods. The method adopted in finding 48 of assigning greater weight to the later periods is a reasonably accurate one, and indicates that as of June 30 and September 30, 1954, Heekin's reasonably expected annual earnings per share would be $ 1.93 and $ 1.79, based on average annual earnings of $ 491,460.86 and $ 454,492.82, respectively.

As to dividends and dividend-paying capacity, it has already been indicated that as of the gift dates, it could reasonably be expected that Heekin would continue to pay in the foreseeable future its usual 50-cent annual dividend. Indeed, on its aforesaid earnings basis, this would appear to be a conservative distribution. However, while the declaration by the board of directors of a small increase might have been considered a possibility -- a 10-cent increase would, for instance, result in a corporate outlay of only $ 25,412 on the 254,125 shares outstanding -- it seems clear, nevertheless, that no substantially larger payment, at least for some time to come, could reasonably have been anticipated. Heekin's equipment was, as shown, not modern and the Company was in need of relatively large sums for equipment and plant modernization if it hoped to continue to be a competitive factor in the industry. For such a program, the Company would have to depend almost entirely on retained earnings. A further limitation on the Company's dividend-paying capacity was its repayment obligations on its long-term debt. Annual installments on principal of $ 150,000 had to be made through 1965, plus 20 percent of the net income (less $ 150,000) for the preceding year.

As to book value, the Company's balance sheets showed the book value per share to be, conservatively, $ 33.15 and $ 33.54 as of June 30 and September 30, 1954, respectively (findings 51-53). These statements also showed the Company to be in a current sound financial condition. As of June 30, 1954, current assets alone, amounting to almost $ 8,700,000, far exceeded its total liabilities of approximately $ 4,700,000, including its long-term debt. Its ratio of current assets to current liabilities was 3.17 to 1.

With the above basic data applicable to Heekin, it is then appropriate to select as closely comparable companies as is possible whose stocks are actively traded on an exchange, and to ascertain what ratios their market prices bear to their earnings, dividends, and book values. The application of such ratios to Heekin would then give a reasonable approximation of what Heekin's stock would sell for if it too were actively traded on an exchange.

A study of all the numerous companies considered by the experts as proper comparatives indicates that five of them, i.e., Pacific Can Company, United Can and Glass Company, National Can Corporation, Brockway Glass Co., Inc., and Thatcher Glass Manufacturing Co., Inc., are, while by no means perfect comparables, certainly at least reasonably satisfactory for the purpose in question. The detailed reasons for their selection are set forth in finding 57. In size they all fall generally into Heekin's class, and the nature of their operations is also comparable. In addition, five companies give a sufficiently broad base. Such companies as American Can, Continental Can, and Crown Cork & Seal, for the reasons already indicated, are eliminated (finding 56).

After similarly computing the earnings, as adjusted, of the comparatives for the same periods as for Heekin (finding 58), and similarly weighting them to give effect to the trend factor (finding 59), the average ratio of their market prices to their adjusted earnings as of August 3 and October 25, 1954 (the

"price-earnings" ratio), was 9.45 and 9.84 to 1, respectively (finding 62). Thus, on the basis only of earnings, Heekin's stock would similarly sell for $ 18.24 and $ 17.61 per share on such dates.

Similarly, the comparatives' dividend payments for the 12 months ending June 30 and September 30, 1954, after making some allowance for United's stock dividend, show an average percent yield of 3.50 and 3.56 respectively (finding 64). Thus, on the basis only of dividend yield, Heekin's stock would similarly sell for $ 14.29 and $ 14.05 per share on August 3 and October 25, 1954, respectively (finding 65).

As to book value, the average market prices of the comparatives were 83.96 and 86.39 percent, respectively, of the book values of their common stocks on said dates (finding 66). Thus, on the sole basis of the average relationship between such book values and market prices, Heekin's comparable market prices on said dates would be $ 27.83 and $ 28.98 (finding 67).

However, since the three factors of earnings, dividends, and book value are not entitled to equal weight, it becomes necessary to consider their relative importance in the case of a company such as Heekin. In this connection, plaintiffs' contention that in these cases no factor is to be considered of greater importance than dividend yield and that no investor would reasonably be expected to buy Heekin stock at a price which would afford a yield of less than 7 percent, cannot be accepted, not only for the reasons set forth above concerning the general relative importance of this factor but also because it is not supported by the specific data relating to the container industry as shown by the comparatives' yields. Investors were purchasing the stocks of comparable container companies which were yielding much less return than 7 percent. As shown, the average dividend yield of the five comparative companies was only around 3 1/2 percent. Investors were purchasing Pacific Can at a price which afforded a yield of less than 3 percent. Indeed, they were purchasing National Can at more than $ 13 a share although it was paying no dividend at all.

Considering all the circumstances, it would appear appropriate to accept defendant's proposals in this respect and to consider earnings as entitled to 50 percent of the contribution to total value, and to give dividend yield (which in this case would appear to be substantially equivalent to dividend-paying capacity) 30 percent, and book value 20 percent, thereof. Cf. Bader v. United States, supra, in which the court gave 50 percent weight to earnings, and dividend the remaining 50 percent equally between the dividend yield and book value factors. Book value indicates how much of a company's net assets valued as a going concern stands behind each share of its stock and is therefore an important factor in valuing the shares. As defendant's expert pointed out, this is the factor that plays such a large part in giving a stock value during periods when earnings may vanish and dividends may be suspended. However, principally because book value is based upon valuing the assets as a going concern, which would not be realistic in the event of a liquidation of the corporation, a situation which a minority stockholder would be powerless to bring about in any event, and for the additional reasons set forth in finding 50, this factor is, in the case of a manufacturing company with a consistent earnings and dividend record, normally not given greater weight than the other two factors.

On the above percentage bases, the fair market value of Heekin's stock on August 3 and October 25, 1954, would be $ 18.98 and $ 18.83 respectively (finding 69).

These prices, however, assume active trading for Heekin's stock on an exchange, as was the situation with the comparatives. As shown, the closely held nature of, and the infrequent trading in, Heekin's stock resulted in a lack of market-ability which would affect its market value. Equating the proper discount to be taken for this factor with the costs that would be involved in creating a market for the stock, a method which defendant concedes is reasonable, results in a deduction of approximately 12.17 percent for a company of Heekin's size and for blocks of 30,000 and 40,000 shares. On this basis, the fair market values of the Heekin stock as of August 3 and October 25, 1954, would be $ 16.67 and $ 16.54 respectively.

These are the values resulting largely from strictly formula and statistical applications. While such use of figures and formulas produces, of course, results which are of important significance, and may in certain instances be given conclusive weight, it is nevertheless recognized that determinations of fair market value can not be reduced to formula alone, but depend "upon all the relevant facts," including "the elements of common sense, informed judgment and reasonableness." Revenue Ruling, sec. 3.01. The question of fair market value of a stock "is ever one of fact and not of formula" and evidence which gives "life to [the] figures" is essential. Estate of James Smith v. Commissioner, 46 B.T.A. 337, 341-2. The selection of comparatives has been a particularly troublesome problem in these cases. National Can's erratic earnings record, even though adjustments are attempted to normalize its situation (findings 57-58), and its nonpayment of dividends (finding 64), certainly weaken its position as a comparative, and suggest the desirability of an adjustment in the final market value figures set forth above. Pacific Can's sharp rise in price after August 3, 1954, justifies a similar adjustment for the October 25, 1954, valuation. While the inclusion of the glass container manufacturers with their higher dividend yields tends to neutralize somewhat the National Can situation, an adjustment downward would, in fairness to plaintiffs, nevertheless guard against their being prejudiced by the aforementioned selections of comparatives. Furthermore, while the sales of Heekin stock at $ 7.50 warrant, as hereinabove pointed out, only minimal consideration, the figures derived from the above formula give them no cognizance whatsoever.

Giving important weight to the figure of $ 16.67 produced by the application of the comparative appraisal method as applied herein, but viewing it in light of all the facts and circumstances involved in these cases, it is concluded that the fair market value of the 30,000 shares given on August 3, 1954, was $ 15,50 per share.

The market for stocks of the can and glass container manufacturing companies fell somewhat between August 3 and October 25, 1954, so that ordinarily on that basis as well as on the basis of Heekin's own financial and operating positions on October 25 as compared with August 3, a slightly lower value would be justified as of October 25 (although one of plaintiffs' experts felt that, insofar as Heekin stock is concerned, the same value should be applied to both dates, and another came out with a higher value for the second date). It seems clear, however, that the brightened prospects for increased business and profits resulting from the Company's decision in August 1954 to embark upon the beer can business and to satisfy further the demands of its largest customer for new products would, in Heekin's instance, tend to neutralize the market decline and to make its stock at least as valuable on October 25 as it had been on August 3. Accordingly, it is concluded that the fair market value of the 40,002 shares given on October 25, 1954, was also $ 15.50 per share.

A $ 15.50 valuation represents a price to adjusted earnings ration on the gift dates of between 8 and 9 percent (somewhat less than the 9-10 percent average of the comparatives (finding 62)), a dividend yield of 3.23 percent (slightly less than the 3.5 percent average of the comparatives (finding 64)), and only 46 percent of book value (considerably less than the approximately 85 percent of the comparatives (finding 66)). On these bases, it is a figure that is fair to both sides.

Plaintiffs should consider that such a valuation prices the stock only at an amount representing the difference between current assets and total liabilities, including its long-term debt, as shown by its June 30, 1954, balance sheet. Thus, at such price, the value of the stock would be represented in whole by current assets, with no consideration whatsoever given to plant, equipment, or any other assets. As such, it would appear to be a conservative price indeed. Despite the difficulties under which it is laboring in a highly competitive industry, Heekin was, as of the valuation dates, a profitable, dividend-paying company, in sound financial condition, in an industry in which demand was at record levels, and in which it was forging ahead with relatively large investments in new fields holding bright prospects. Only a disregard of these favorable factors would warrant any lower valuation.

On the other hand, defendant should consider that such a valuation would give an investor a dividend yield of less than 3.5 percent on his investment, with little prospect of any significant increase in the foreseeable future. The fact that the Company was, on the gift dates, a relatively small one competing, with a comparatively old plant, against the giants of the industry operating at high efficiency with the most modern equipment, makes unwarranted a valuation of this closely held stock representing only a minority interest on any significantly higher basis. For these reasons also the $ 15.50 valuation is considered to be fair and just to both plaintiffs and defendant.

On this valuation basis, plaintiffs are entitled to recover, the amount of the recovery to be determined in accordance with Rule 38(c).

FINDINGS OF FACT

1. Plaintiffs sue to recover alleged overpayments of gift taxes on gifts of stock of The Heekin Can Company, an Ohio corporation. These gifts consisted of 30,000 shares given by Albert E. Heekin on August 3, 1954, and 40,002 shares given by James J. Heekin on October 25, 1954. Gift taxes paid were based on an Internal Revenue Service valuation of $ 24 a share. On the gift tax returns, as amended, a value on such dates of $ 7.50 a share was placed.

2. On August 3, 1954, Albert E. Heekin of Cincinnati, Ohio, created six trusts for the benefit of his three sons, George E., Charles L., and Albert E., Jr., each son being the beneficiary of two trusts. On the same date, he transferred by gift 5,000 shares of the common stock of The Heekin Can Company to each of the six trusts, resulting in total gifts of 30,000 shares, 10,000 shares to each son. The Central Trust Company, an Ohio banking corporation, was designated as cotrustee under all six trusts, with the two sons other than the particular beneficiary of the trusts being designated as the other cotrustees in each instance.

3. On October 25, 1954, James J. Heekin of Cincinnati, Ohio (the brother of Albert E. Heekin hereinabove mentioned), created three trusts for the benefit of his three children, James R., Katharine Heekin Herrlinger, and Donald J., and their families, each child and family being the beneficiary of one of the trusts. On the same date, he transferred by gift 13,334 shares of the common stock of The Heekin

Can Company to each of the three trusts, resulting in total gifts of 40,002 shares. The Central Trust Company was designated as cotrustee under all three trusts, with the two children other than the particular beneficiary of the trusts being designated as the other cotrustees in each instance.

4. Albert E. Heekin died on March 10, 1955. On or before March 15, 1955, there was filed in the office of the District Director of Internal Revenue, Cincinnati, Ohio, the 1954 gift tax return of the Estate of Albert E. Heekin. This return listed thereon the six gifts of shares of The Heekin Can Company stock referred to above. The gift tax liability shown on the return, in the amount of $ 81,695.10, was paid to the District Director of Internal Revenue, Cincinnati, Ohio, on March 18, 1955. In reporting the amount of total gifts and computing net gifts for the year 1954 as shown on such return, The Central Trust Company, as Coexecutor of the Estate of Albert E. Heekin, used a value of $ 50,000 for each of the six gifts, constituting a value of $ 10 a share.

On or before March 15, 1955, James J. Heekin filed in the office of said District Director a 1954 gift tax return showing a gift tax liability of $ 33.75, which amount was paid on March 8, 1955. Similarly, on or before March 15, 1955, Alma R. Heekin, the wife of James J. Heekin, filed in the office of the District Director a 1954 gift tax return reflecting a gift of $ 7,000 to one of her children and showing that no tax was due.

6. On March 16, 1955, James J. Heekin filed in the office of the District Director an amended 1954 gift tax return listing thereon the gifts of the shares of The Heekin Can Company stock above described and further listing an additional gift to one of his children of cash in the amount of $ 4,500. Similarly, on March 16, 1955, Alma R. Heekin filed in the office of the District Director an amended 1954 gift tax return and, in accordance with the applicable provisions of the Internal Revenue Code, reported one-half of the gifts of her husband, and deducted one-half of the value of her gifts. In reporting the amount of total gifts and computing their gift tax liability, James J. Heekin and his wife, Alma, used a value of $ 10 per share for the stock of The Heekin Can Company, or $ 133,340 for each of the three gifts. In computing his gift tax liability, James J. Heekin deducted one-half of his gifts which were reported by his wife and included one-half of the value of the gifts made in 1954 by his wife. The gift tax liability of James J. Heekin shown on this amended return in the amount of $ 41,482.57, less the sum of $ 33.75 previously paid, was paid to the said District Director on March 18, 1955. The gift tax liability shown on Alma R. Heekin's amended return in the amount of $ 32,796 was paid to the said District Director on March 18, 1955.

7. On October 28, 1957, The Central Trust Company and Albert E. Heekin, Jr., as Coexecutors of the Estate of Albert E. Heekin, deceased, filed in the office of said District Director an amended gift tax return and a claim for refund in which the claimants alleged that the value of the shares of The Heekin Can Company stock given by Albert E. Heekin on August 3, 1954, was $ 7.50 per share and that his 1954 gift tax was overstated by the sum of $ 19,875.55. The claim requested refund of that amount.

8. On January 21, 1958, James J. Heekin filed in the office of said District Director a claim for refund of the 1954 gift tax in the amount of $ 11,216.82, alleging that the value of The Heekin Can Company stock given by him on October 25, 1954, was $ 7.50 per share, rather than $ 10 per share as set forth on the amended return he had previously filed. On the same day, The Central Trust Company, Successor Executor and Trustee of the Estate of Alma R. Heekin, who had died on November 9, 1955, filed a similar claim for refund with said District Director in the amount of $ 11,250.56.

9. On May 15, 1958, the District Director gave notice by registered mail of the disallowance of each of the three aforementioned claims for refund. More than 6 months had elapsed since the filing on October 28, 1957, by the Coexecutors of the Estate of Albert E. Heekin for refund prior to the decision rendered by the District Director on May 15, 1958.

10. On February 5, 1958, the District Director sent The Central Trust Company and Albert E. Heekin, Jr., Coexecutors of the Estate of Albert E. Heekin, deceased, by registered mail a notice of deficiency in gift tax for the year 1954 in the amount of $ 119,288.04. He assessed such tax on May 15, 1958. On July 30, 1958, the Estate of Albert E. Heekin paid such deficiency to the Internal Revenue Service, together with interest thereon in the amount of $ 30,712.60, a total of $ 150,000.64.

11. On February 5, 1958, the District Director sent James J. Heekin, by registered mail, a notice of deficiency in gift tax for the year 1954 in the amount of $ 68,484.22. He assessed such tax on May 5, 1958. On July 23, 1958, James J. Heekin paid such deficiency with interest thereon in the amount of $ 16,778.63. On August 11, 1958, James J. Heekin paid an additional $ 763.66 in interest. All such payments, totaling $ 86,026.51, were made to the Internal Revenue Service.

12. On February 5, 1958, the District Director sent The Central Trust Company, Successor Executor of the Estate of Alma R. Heekin, deceased, by registered mail, a notice of deficiency in gift tax for the year 1954 in the amount of $ 67,544.76. On July 23, 1958, such deficiency, with interest thereon of $ 16,548.47, was paid. On August 11, 1958, an additional amount of $ 753.16 in interest was paid. All such payments, totaling $ 84,846.39, were made to the Internal Revenue Service.

13. Each of the three aforementioned deficiencies in 1954 gift taxes was based on a determination by the Commissioner of Internal Revenue that the value of the stock of The Heekin Can Company, on the dates of the aforementioned gifts, was $ 24 per share.

14. On August 1, 1958, the Estate of Albert E. Heekin filed in the office of said District Director a claim for refund of 1954 gift tax in the amount of $ 150,000.64. On September 23, 1958, James J. Heekin and the Estate of Alma R. Heekin filed in the office of said District Director claims for refund of 1954 gift tax in the amount of $ 95,927.08 and $ 94,753.70, respectively. Each of such claims for refund alleged that the value of the stock of The Heekin Can Company, the subject of the aforementioned gifts, had a value of $ 7.50 per share on the date of the gifts. On October 15, 1958, the District Director notified the Estate of Albert E. Heekin, by registered mail, of the disallowance in full of its claim for refund. On March 2, 1959, the District Director notified James J. Heekin and the Estate of Alma R. Heekin, respectively, by registered mail, of the disallowance in full of their claims for refund.

15. James J. Heekin died September 7, 1959, and Katharine Heekin Herrlinger, James R. Heekin, Jr., and The Central Trust Company were duly appointed executors under the will of James J. Heekin and are now so acting.

16. Since Alma R. Heekin's death on November 9, 1955, her original executors have died, and The Central Trust Company has qualified as successor executor and trustee under the will of Alma R. Heekin and is now so acting.

17. The claims asserted by the plaintiffs have not been assigned and are still owned by them.

18. The Heekin Can Company (hereinafter sometimes referred to as the "Company" or "Heekin") was incorporated on August 1, 1901. Its founder was James Heekin who was the father of several children, including Albert E. Heekin (whose estate is plaintiff in case No. 196-58), James J. Heekin (whose estate and that of his wife are plaintiffs in cases Nos. 199-58 and 200-58), Daniel M. Heekin, Robert E. Heekin and Walter V. Heekin (now also deceased).

19. The founder of the Company, James Heekin, was its president from 1901 to about 1905. His son, James J. Heekin, was president of the Company from 1905 to 1928; another son, Albert E. Heekin, was president from 1928 to 1948; and Daniel M. Heekin, another son, was president from 1948 to March 1954. In that month, Albert E. Heekin, Jr., the son of Albert E. Heekin, became president of the Company. Prior to 1950 he had been a practicing attorney in Cincinnati, Ohio, and from 1946 to 1950 served as counsel to the Company. In January 1950, he came to the Company as assistant to the president (Daniel M. Heekin, his uncle), and in 1952, he became executive vice president.

20. On August 3, 1954, the board of directors of the Company was composed of the following ten members: Albert E. Heekin, James J. Heekin (chairman of the board), Daniel M. Heekin, Robert E. Heekin and Walter V. Heekin, all of whom were brothers and the sons of the founder, James Heekin; Albert E. Heekin, Jr. and Charles L. Heekin, both of whom were sons of Albert E. Heekin; Donald J. Heekin, the son of James J. Heekin; and Clarence A. Rolfes and Thomas L. Conlan, neither of whom was related to the Heekin family. On October 25, 1954, the membership of the board remained the same, except for Walter V. Heekin, who died in August 1954.

21. In 1954, the following salaries were paid to the following officers who were members of the Heekin family: James J. Heekin, chairman of the board, $ 5,000; Albert E. Heekin, Jr., president, $ 35,000; Charles L. Heekin, vice president, $ 15,000; and Donald J. Heekin, vice president, $ 11,100. Another Heekin employed by the Company was John G. Heekin (a son of Walter V. Heekin), who earned $ 4,980 as a salesman. No officer received any bonus or other type of compensation. The salaries paid in prior years did not exceed those set forth for 1954, except that in 1953, Daniel M. Heekin, the then president, received $ 40,000. There is no showing or any contention that any of these salaries were excessive. None of the other descendants of James Heekin, the Company's founder, numbering over 300, was employed by the Company. As of the gift dates, the Company was well managed.

22. On August 3 and October 25, 1954, the total number of common shares of the Company outstanding was 254,125. There was no other class of stock outstanding. The shares were not listed on any stock exchange. There were no restrictions on the transferability and sale of Company stock. Including the 70,002 shares involved in these cases, a total of 180,510 shares were owned by 79 persons who in some fashion were related to James Heekin, the founder of the Company. Thus, the Heekin family owned approximately 71 percent of all of the outstanding stock. The remaining amount, a total of 73,615 shares, was owned by 54 persons who were not related to James Heekin. Some of these non-related persons were employees of the Company. At the time of Walter V. Heekin's death in August 1954, he owned 9,145 shares.

23. Prior to 1901 James Heekin, the founder of the Company, was engaged in the business of selling coffee, tea and spices. In that year he decided to form his own can-making company. The original can-making factory, located at Third and Eggleston Avenue, Cincinnati, Ohio, was operated by water power from the canal that ran through the area at that time. In 1908 the Company built a six-story factory at the corner of Sixth and Culvert Streets, Cincinnati, which it has occupied to the present time. This plant has

approximately 250,000 square feet of floor area and is still one of the main operating plants of the Company. It is referred to as a general line plant, producing so-called "general line" cans, as distinguished from cans referred to as packer's cans, which are the type seen on the shelves of a grocery store. The general line cans manufactured by Heekin include such products of institutional size as 4-50-pound lard pails, 10-30-pound frozen fruit cans, dairy cans in gallon sizes, chemical cans and drums, as well as such housewares as canisters, bread boxes, lunch boxes, waste baskets, and picnic containers familiarly known as Skotch Koolers and Skotch Grills. Both plain and lithographed metal containers are manufactured in this plant. Lithography on metal is accomplished by offset presses. The lithographic work is sometimes performed on uncut flat sheets of tin plate, the fabrication of the can being done by others, as for instance, the lithography performed for the Prince Albert tobacco cans, the fabrication of which is performed by the Reynolds Tobacco Company itself.

24. In 1917 the Company acquired a plant in Norwood, a suburb of Cincinnati, which is wholly surrounded by the city, and commenced manufacturing packer's cans. In 1954 this plant had an overall footage of about 275,000 square feet. It was multistory, having grown irregularly through the years, so that one section had four floors, another three floors, and another one floor.

25. In 1949 the Company built a plant at Springdale, Arkansas. By 1954, this plant comprised about 100,000 square feet. It was built because of the freight-equalization practice in the can-making industry, which required a manufacturer to absorb the freight costs to his customer to the extent they exceeded the cost of freight to the nearest can-making plant. The American Can Company had built a plant at Fort Smith, Arkansas, about 60 miles from Springdale. Had Heekin continued to supply its customers in the Ozark area from its Norwood plant, it would have had to absorb the freight from Norwood to Fort Smith, and could charge the customer the freight only from the American Can plant at Fort Smith to the customer's place of business.

26. In 1946, the Company established a plant at Chestnut Hill, Tennessee, on property leased from and contiguous to the plant of Bush Brothers & Company, a dog food manufacturer, which is Heekin's largest customer. Bush used the entire output of Heekin's adjacent plant. The lease had a term of 10 years. Heekin installed its own equipment in the plant. The cans were run by conveyor directly into the Bush plant. The Heekin plant originally had only one line of can-making equipment but by 1954 the plant had two can-making production lines.

27. An operation similar to that at Chestnut Hill, Tennessee, was located at a plant in Blytheville, Arkansas, in a 5,000 square foot area under a 10-year lease and with the intent to eliminate material-handling by running the cans directly into the customer's plant. This Heekin plant, which was a one-line operation, was established in 1952. By August 1954, the concept of installing can-making lines immediately adjacent to customers' packing plants was a recognized practice in the industry. n1

n1 In 1956, another operation similar to that at Chestnut Hill was located at a plant in Clinton, Tennessee. Defendant's exhibit 12, p. 9. Plaintiffs' exhibit 8, p. 12, also refers to the operation of only five plants by Heekin in 1954.

28. Heekin manufactures only its general line of cans and its packer's cans, as hereinabove described. It does not manufacture any glass, plastic, wood, paper or fiber containers.

29. Prior to World War II, can-making equipment was made by two companies, Max Am's and the E. W. Bliss Company. However, these two companies ceased making such equipment at the beginning of the war. During the war Heekin was, consequently, unable to buy new equipment. After the war Bliss returned to the business, and another company, the Baldwin-Lima-Hamilton Company, also entered the field. During this entire period, the American Can Company, the Continental Can Company and the Pacific Can Company, which companies also manufacture cans, made their own can-making equipment, but neither American nor Continental, the two largest companies in the industry, nor Pacific, sell such equipment to others. The modern equipment of American and Continental used for making packer's cans has a speed of 500 cans a minute. In 1954, about 90 percent of Heekin's equipment had been acquired or built in the middle 1930's or prior thereto. In all its plants, the Company had 37 can-making lines, 11 of which were very old and still hand operated. The new packer's can equipment Heekin was able to purchase after the war from Bliss and Baldwin-Lima-Hamilton was able to attain a speed of but 400 cans a minute, and could attain such speed only with difficulty. The remainder of Heekin's packer's can equipment could generate speeds only up to 300 cans per minute. Heekin is in direct competition with American, Continental and Pacific.

30. About 50 percent of Heekin's total production consisted of packer's cans, the type wherein Heekin's largest competitors had the advantage of more efficient equipment, as hereinabove set forth. The remainder consisted of general line cans, a type of can which is produced, both by Heekin as well as its competitors, on semiautomatic lines. Although Heekin's semiautomatic equipment was also not modern, its disadvantage with respect thereto was not as great as with the packer's cans, since the semiautomatic equipment does not lend itself as readily to the speed and automation required with respect to packer's cans. Heekin's semiautomatic lines were capable of producing approximately 300 cans a minute.

31. The can-making business is primarily a material-handling one. It involves a rapid and efficient flow of a large amount of materials through a plant, from the receipt of raw materials to the shipment of finished products. Accordingly, multistory buildings are less efficient than single-story buildings, where material can be freely moved with such equipment as fork-lift trucks and conveyors. Heekin's Cincinnati and Norwood plants, its two largest, are multistory buildings, while its Springdale, Blytheville and Chestnut Hill plants are single story. The Cincinnati plant (which also serves as the Company's headquarters) with six stories, and the Norwood plant, with four, use elevators for the vertical movement of materials, which necessitates excessive labor and handling costs and tends to make production control more difficult. These two plants accounted for approximately 75 percent of the Company's total sales volume in 1954, the Cincinnati plant accounting for approximately 45 percent. The Springdale plant accounted for approximately 17 percent of such total volume, and the Chestnut Hill and Blytheville plants together accounted for approximately 8 percent of the Company's 1954 sales.

32. Heekin has a dock on the Ohio River in Cincinnati, permitting it to take advantage of inexpensive water transportation of steel shipped down the river from Pittsburgh, Pennsylvania. Thus, Heekin has an advantage on freight costs for its raw material over some of its competitors in the same area who receive their raw materials by rail. However, some can manufacturers are located adjacent to or in the vicinity of the steel mills from which they obtain their raw materials, and, consequently, pay little or no freight at all.

33. As of the 1954 valuation dates herein involved, there was no indication that the Company would not continue in business for the foreseeable future. During the year 1954, the Company acquired not less than $ 309,650 in new assets, of which $ 280,610 was in machinery, fixtures and dies, and $ 23,447 in seamer machinery and equipment. The indications were that its performance would continue to be at least equal to that of the past 2-3 years, during which operations were on a substantially normal basis. Prior to August 3, 1954, the Hamilton Metal Products Company, one of the Company's important customers, and for whom Heekin manufactured the Skotch Kooler and Grill, had advised the Company of Hamilton's need for certain new products, and on that date the Company, by unanimous vote of its board of directors, authorized the expenditure of approximately $ 90,000 for new tooling and equipment at its Cincinnati plant for the manufacture of said products. Also prior to that date, the Company had investigated the desirability of entering into the manufacture of beer cans, and, again by the unanimous vote of its board of directors at said meeting, there was authorized the expenditure of approximately $ 650,000 for new tooling, machinery and equipment at the Norwood plant for the manufacture of such cans. The Company was fully cognizant of the need of modernizing its Norwood and Cincinnati plants and equipment. In 1953, it engaged an engineering firm to make a survey and develop costs for an efficient one-story plant to replace these two multistoried plants. However, this firm's report to the Company had not been completed prior to October 25, 1954.

34. In 1954 no other company in the Cincinnati area was engaged in the production of beer cans. Heekin decided to enter this field because it would have a freight advantage over American and Continental plants outside the Cincinnati area. Thus, the brewers of the Cincinnati area could be served more economically by Heekin. Heekin thus anticipated that the venture would be a profitable one. Accordingly, in August 1954, Heekin hired a man from Continental and, as set forth above, appropriated money for this program. No beer cans were, however, manufactured in 1954.

35. In 1954 the domination of the industry by American and Continental was such that they made about 75 percent of the total can sales in the country. Three other can manufacturing companies, the National Can Corporation, the Pacific Can Company, and Crown Cork & Seal Co., Inc., together made about 8 percent of the sales. Heekin did a little less than 1 percent of the total business. In that year American's sales were about $ 652,000,000, Continental's about $ 616,000,000, and Heekin's about $ 16,300,000. American had 76 plants in operation, Continental had 40, and Heekin had 5. The prices in the can-making industry are in effect established by American and Continental. When they announce prices, Heekin goes up or down with them. Heekin competes with American and Continental in its trade area. In addition, National has a plant in Hamilton, Ohio, and Crown a plant in Chicago.

36. On June 22, 1950, the United States District Court for the Northern District of California, Southern Division, in a civil action entitled United States of America vs. American Can Company, entered an order adopting its opinion of November 10, 1949, which found and adjudged the American Can Company to have violated the Sherman Antitrust Act and the Clayton Act. By such order, American was enjoined from continuing certain practices, including the practice of requiring that lessees of certain American machines could not purchase for use in connection with such machines cans made or sold by anyone other than American, as well as from continuing certain quantity discount practices. Thereafter, new areas of business with larger packers were to some extent opened up for Heekin, benefiting Heekin's business to some degree. Although Heekin cannot compete with the industry's giants on a price basis, Heekin often can, because it is smaller and closer knit, offer customers better personal service than its larger competitors.

37. During 1953 and 1954, conditions generally in the container and packaging industry, including the production of metal cans, were good, and demand was at a record level. The general business outlook in the industry was favorable, and can manufacturers were optimistic about the continuation of the high demand. These favorable conditions prevailed also in the Middle Atlantic States, which comprise Heekin's trade area.

38. Heekin's Norwood plant was first unionized in 1941. As of 1954, Heekin had fairly good relations with the Norwood plant employees. In 1950 the Cincinnati plant was unionized. Both plants were unionized throughout 1954. Heekin's other plants were not unionized.

39. Heekin encountered some labor trouble at the Cincinnati plant between 1950 and 1954. One of the factors contributing to such trouble was the higher wages paid by American Can. In 1952 Heekin was struck for 8 weeks. In 1953 there was a work stoppage of about a week, and in May 1954 of about 4 weeks. Heekin's union contracts were on a different time basis from most of the industry. Heekin's strikes, therefore, were usually at different times than its competitors. The industry as a whole, other than Heekin, was struck during the latter part of 1953, helping Heekin's 1953 earnings. However, 1954 earnings were somewhat depressed because of the 4-week strike in May of that year.

40. In 1954 Heekin's sales totaled approximately $ 16,355,000, of which six customers represented about $ 7,636,000. Relations with these major customers were excellent and in 1954 there was every reason to believe they would continue to deal with Heekin. These customers included Bush Brothers & Company ($ 2,494,000), hereinabove mentioned; Hamilton Metal Products Company ($ 2,288,000), also mentioned above, and which was located only 25 miles from Cincinnati, with a consequent freight advantage to Heekin; and the Reynolds Tobacco Company ($ 1,403,000), with whom Heekin had been dealing since 1908.

41. In 1950 Heekin secured a $ 3,000,000 3 3/4 percent loan from New York Life Insurance Company, payable in annual installments through 1965 of $ 150,000 on principal, plus interest on the unpaid balance. In addition, there was required to be paid each year 20 percent of the net income of the Company (less $ 150,000) for the preceding year. Part of this loan was used to refinance a $ 1,000,000 loan from The Mutual Benefit Life Insurance Company of New York. $ 1,500,000 of the proceeds of the loan were paid to Weirton Steel Company to retire certain debts. The $ 500,000 balance was added to working capital. As of June 30, 1954, the net amount due on this long-term debt was $ 1,924,000, and as of September 30, 1954, such amount was $ 1,891,000. The Company has bank lines of credit for current borrowing. It did not have to rely on factoring its receivables. The Company has never engaged in public financing.

42. Prior to 1950, Heekin organized a wholly owned subsidiary, Canners Exchange, Inc., to finance small packers in the Ozark area, whose accounts were supposedly secured by sufficient collateral. In 1950 Heekin experienced substantial difficulties as a result of the activities of this subsidiary. After Albert E. Heekin, Jr., entered the management, company officials determined that much of the collateral taken by the subsidiary was of little value. Consequently, Heekin suffered a loss of more than $ 1,000,000. The discovery of this situation in the affairs of its subsidiary and the incurrence of this large loss was made shortly after the aforementioned loan from New York Life Insurance Company had been negotiated. This situation strained Heekin's relations with this lender. New York Life required both Daniel M. Heekin, then the president, and Heekin's treasurer, to put up $ 35,000 and $ 10,000, respectively, from their personal funds to supplement Heekin's working capital. By 1954, however, this situation had been overcome. All

losses arising from this activity had been written off through 1952. The personal funds advanced to supplement working capital had, with New York Life's consent, been withdrawn and the subsidiary had been liquidated.

43. (a) James Heekin, the founder of the Company, had a partner whose descendants hold minority interests in Heekin stock. In 1951, certain of these minority stockholders made arrangements through Albert E. Heekin, Albert E. Heekin, Jr., and the aforementioned Rolfes (finding 20), who was also Heekin's sales vice president, to sell certain of their holdings. Sales of this stock were made to Heekin employees and friends of the Heekin family. No attempt was made to sell the stock to the public on the open market. A total of 13,359 shares was sold in this manner during 1951 and early 1952 in 44 separate transactions, 35 of which took place in 1951, commencing March 22, and 9 in 1952, ending on April 16. The smallest amount sold in these transactions was 50 shares and the largest 1,400. About three-quarters of these transactions resulted from the liquidation of a block of 10,709 shares by one individual. All sales were for $ 7.50 per share, which by previous agreement was satisfactory to the sellers. This price was arranged during the time when Heekin was experiencing its difficulties with Canners Exchange, Inc., and during a period when the payment of dividends had been suspended by the Company. When the price was arranged, the Company's last annual financial report was for the year 1950. In 1950 Heekin had paid no dividends, the payment of its usual quarterly dividends at the annual rate of 50 cents per share having been omitted. Dividends were not resumed until August 1, 1951, with the payment of a quarterly dividend of 12 1/2 cents a share.

In 1953, there was only one sale of Heekin stock, consisting of 100 shares by an employee of the Company who had purchased them in 1951, to another Heekin employee. In 1954, there was similarly only one sale of Heekin stock, consisting of 200 shares sold on August 6 to a Heekin employee by another employee who had also previously purchased this stock in 1951. These 1953 and 1954 sales were also on the basis of $ 7.50 a share.

(b) An analyst or investor attempting, as of the valuation dates herein involved, to determine the fair market value of Heekin stock would reasonably give only minimal weight to the above-mentioned sales. As shown, the predetermined price for the bulk of the sales occurred in 1951 during the difficult Canners Exchange episode and when the payment of dividends had been suspended. These sales were in point of time relatively remote from said 1954 valuation dates. Only one sale was made in 1953 and one in 1954. These isolated transactions would not be considered sufficient to establish a market price. Further, there is no indication that the $ 7.50 sales price of all these transactions evolved as a result of the usual factors taken into consideration by informed sellers and buyers dealing at arm's length.

44. The prospective earnings of a manufacturer type of corporation such as Heekin is normally the most important factor to be considered in determining the fair market value of its stock. One important element to consider in attempting to forecast such future earnings is the corporation's past earning during a representative period which is brought up to a date as close to the valuation date as is possible. Further, the later earnings during such period are the more important in that they reflect trend, and are therefore more likely to indicate future prospects than a simple average of past earnings throughout such period. In calculating such past earnings for the purpose in question, it is also important to consider and make appropriate adjustments for any abnormalities or nonrecurring items. In this manner, a picture

of the past normal operations of the corporation is, insofar as is reasonably possible, reconstructed and then used as a more accurate basis for a forecast of the earnings that future operations of the corporation will generate on a presumed normal basis.

45. The Company's operations were audited and analyzed annually by a competent firm of certified public accountants which furnished financial statements, including balance sheets and profit and loss statements. Without adjustment, these financial statements indicated net profits after taxes as follows:

Year	Amount
1950	$ 34,806.71
1951	852,427.30
1952	422,414.11
1953	495,978.83
1954	335,929.17

Analysis of these profits indicate there were certain abnormalities therein, as follows:

(a) As indicated, the Company suffered abnormal, nonrecurring losses of over $ 1,000,000 on the Canners Exchange venture. These losses were completely liquidated by the end of 1952. Thus, the 1950-52 profits inclusive were charged with these losses. Over $ 570,000 of these losses were charged against 1950 profits alone.

(b) Despite a loss of almost $ 360,000 charged against 1951 profits because of the Canners Exchange venture, the Company's 1951 profits were abnormally large due to the effects of the Korean war. Because of the shortages during that period, created in part by can users building up their inventories, competitive conditions in the can manufacturing industry temporarily eased, resulting in a seller's market and permitting an increase in the Company's normal profit margin.

(c) Profits for 1950 and 1951 were overstated because of a noncontributory retirement plan instituted subsequent to 1951 for hourly employees, for which the costs attributable to 1950 and 1951 were borne in later years. In like manner, profits for 1952 through 1954 were abnormally depressed because a portion of the payments during these years was applicable to previous years. That portion of the 1952-54 cost of the plan applicable to earlier years was as follows:

Year	Total payment	Applicable to other years
1952	$ 101,240	$ 45,9
1953	114,357	61,573
1954	160,106	61,540

40

On the basis of these 1952-54 payments, a reasonable estimate of the expense of this plan attributable to 1951 and 1950 would be approximately $ 50,000 and $ 40,000, respectively. n2

n2 In June 1953 Heekin also instituted a contributory plan for salaried employees. However, the portion of the payments thereafter made for this plan which are attributable to earlier years cannot be determined. Payments for this plan in 1953 were $ 46,293, and in 1954, $ 45,367.73. The amount of decrease in 1950-52 profits and increase in 1953 and 1954 profits as a result of this situation are thus unavailable, nor can they be reasonably estimated. They would, however, be insignificant in the overall picture.

(d) Profits shown for 1954 were abnormally depressed additionally because (1) they reflected payment to the Government in 1954 of a renegotiation refund of $ 35,437.50 arising out of excess profits made in 1951 (the 1951 profits being therefore similarly overstated by such amount), and (2) they are subjected to a charge of $ 174,203.54, which amounted to $ 83,617.70 after taxes, as a result of a deduction from 1954 profits only of both 1954 and 1955 expenses of such items as vacation pay, sales allowances and cash discounts. This abnormally large charge was permitted by a change in the tax laws which became effective in 1954 (Section 462 of the 1954 Internal Revenue Code) and which allowed a taxpayer such as Heekin to change this method of accounting so as to effect the accrual in 1954 of these 1955 expenses, thereby doubling up these types of expenses in 1954. The accrual of these 1955 expenses in the 1954 tax year was effected by a year-end book entry made after the valuation dates herein involved and was not reflected in Heekin's 1954 interim financial statements prepared prior to such dates.

46. The Company's interim financial statements which were available on August 3 and October 25, 1954, reflected net profits after taxes as follows:

6 months ended June 30, 1954	$ 218,606.47
9 months ended September 30, 1954	382,967.20

However, because the canning industry is a seasonal one, an entire year's operation as reflected by the Company's interim and annual statements, as hereinafter set forth, would give a more complete picture of profits than the results of 6 and 9 months operations.

47. (a) In accordance with the considerations set forth above concerning adjusting the past earnings records so as to eliminate or properly reflect the abnormalities and nonrecurring items hereinabove referred to, there are set forth below the adjusted profits of the Company for the years 1950 through June 30 and September 30, 1954, in accordance with such financial data as were available at the valuation dates herein involved. The reasonably accurate method adopted for the purpose of recomputing what the earnings would have been without such abnormalities and nonrecurring items is to calculate, on the basis of the Company's sales and other income, less its costs and operating expenses, what its pretax profits were and then to make the adjustments. Because the interim statements hereinabove referred to for the 6 and 9 months periods in 1954 may not allow for seasonal changes in the canning industry, the latest 12-month periods based on interim and annual statements are used.

(b) For the Calendar Year 1950

Sales	$ 12,099,267.25
Pretax Profit n3	706,989.10
Applicable Retirement Fund Expense	40,000.00

Adjusted Pretax Profit	666,989.10
Federal Income Tax -- Recomputed n4	341,334.33
Adjusted Net Profit	325,654.77

n3 This figure and the comparable ones for the subsequent years is taken from the Company's profit and loss statement. In this instance, the statement reflects this figure prior to a subsequent "Provision for Loss on Investments in and Receivables from Subsidiary Companies" in said amount of $ 573,880.74.

n4 This is estimated at $ 5,500 less than 52 percent of pretax profit.

For this year, the loss of $ 573,880.74 charged by the Company on account of the Canners Exchange operation has been eliminated, and the retirement expense hereinabove referred to properly applicable to this year's operations has been charged against profits.

(c) For the Calendar Year 1951

Sales	$ 15,040,705.83
Pretax Profit	1,714,131.44
Applicable Retirement Fund Expense	50,000.00
Adjusted Pretax Profit	1,664,131.44
Federal Income Tax -- Recomputed	859,848.34
	804,283.10
Renegotiation Refund	35,437.50
	768,845.60
Adjustment to eliminate abnormally high profits due to Korean war	347,254.62
Adjusted Net Profit	421,590.98

As for the previous year, the loss of $ 358,272.72 charged by the Company to this year's operations on account of the Canners Exchange operation has been eliminated, and the retirement fund expense properly applicable to the year's operations has been charged against profits. In addition, since 1951 net income was, as hereinabove noted, abnormally high due to the Korean conflict, it becomes necessary to adjust the profit to a more normal level if a reasonable comparison with other years' operations is to be

obtained. A reasonable method of properly adjusting 1951 profits so as to be in line with the Company's normal operations would be to compute the Company's average profit (as adjusted) as a percent of sales for 1950, 1952, 1953, and the portions of 1954 herein involved (6 and 9 months) and to apply the same percentage to 1951 sales. The average profit as a percent of sales for the other 3 1/2 and 3 3/4 years was 2.803. The application of such percentage figure to 1951 sales gives an adjusted net profit of $ 421,590.98, thus causing the elimination from the aforementioned $ 768,845.60 adjusted net profit figure the sum of $ 347,254.62 as excessive profits due to the Korean war.

(d) For the Calendar Year 1952

Sales	$ 14,571,742.65
Pretax Profit	583,714.65
Retirement Expense Overcharge	45,973.00
Adjusted Pretax Profit	629,687.65
Federal Income Tax -- Recomputed	321,937.58
Adjusted Net Profit	307,750.07

For this year, the loss of $ 46,788.19 charged by the Company on account of the Canners Exchange operation has been eliminated and the retirement expense charged to 1952 operations but which was applicable to prior years, as hereinabove explained, has been added to 1952 profits.

(e) For the Calendar Year 1953

Sales	$ 17,018,346.54
Pretax Profit	1,066,668.40
Retirement Expense Overcharge	61,540.00
Adjusted Pretax Profit	1,128,208.40
Federal Income Tax -- Recomputed	581,168.37
Adjusted Net Profit	547,040.03

The only adjustment for this year is the retirement expense charged to 1953 operations but which was applicable to prior years, as hereinabove explained. This overcharge has been added to 1953 profits.

(f) For the 12 months ended June 30, 1954

Sales	$ 17,939,205.05
Pretax Profit	1,179,195.74
Retirement Expense Overcharge	61,540.00
Renegotiation Charge Applicable to 1951	n5 36,000.00

Adjusted Pretax Profits	1,276,735.74
Federal Income Tax -- Recomputed	658,402.57
Adjusted Net Profit	618,333.17

n5 The Company's Financial Statement for the 6 months ended June 30, 1954, carried this amount as a "Provision for Renegotiation Refund for 1951." The amount actually paid prior to September 30, 1954, was, as previously mentioned, $ 35,437.50.

(g) For the 12 months ended September 30, 1954

Sales	$ 17,267,183.68
Pretax Profit	948,708.04
Retirement Expense Overcharge	61,540.00
Renegotiation Charge Applicable to 1951	35,437.50
Adjusted Pretax Profit	1,045,685.54
Federal Income Tax -- Recomputed	538,256.48
Adjusted Net Profit	507,429.06

(h) On the above bases, the following is a summary of the adjusted net profit of the Company for the periods indicated:

Year	Adjusted net profit
1950	$ 325,654.77
1951	421,590.98
1952	307,750.07
1953	547,040.03
12 months ending June 30, 1954	618,333.17
12 months ending Sept. 30, 1954	507,429,06

Thus, the Company's adjusted earnings over the 4 1/2 and 4 3/4 periods prior to the valuation dates herein involved were generally in a favorable upward trend.

48. (a) Since past earnings are analyzed only as a guide to forecasting future earnings, the later earnings in the past period examined are the more important. The future prospects of a company whose earnings have been growing consistently for 5 years would be better than the prospects of a company whose earnings have been diminishing for those 5 years, even though the average earnings for each company over this 5-year period may be the same. This growth trend in earnings would favor a higher valuation for the company showing such growth. A reasonable method of forecasting, as of the valuation

dates herein involved, Heekin's prospective yearly earnings, giving increased weight to these later earnings, and yet giving appropriate consideration to all earnings (as adjusted) during the last 4 1/2 and 4 3/4 years for the Company would be as follows:

Unit of weight	Year	Adjusted earnings
1	1950	$ 325,654.77
2	1951	421,590.98
3	1952	307,750.07
4	1953	547,040.03
5	12 months ending June 30, 1954	618,333.17
5	12 months ending September 30, 1954	507,429.06
Total		

Unit of weight	Year	Weighted value as of June 30, 1954	Weighted value as of Sept. 30, 1954
1	1950	$ 325,654.77	$ 325,654.77
2	1951	843,181.96	843,181.96
3	1952	923,250.21	923,250.21
4	1953	2,188,160.12	2,188,160.12
5	12 months ending June 30, 1954		3,091,665.85
5	12 months ending September 30, 1954		2,537,145.30
Total		7,371,912.91	6,817,392.36

Upon dividing these weighted totals by the total units of weight (15), a value of representative average annual earnings is obtained of $ 491,460.86 as of June 30, 1954, and $ 454,492.82 as of September 30, 1954. As of such dates, it could be reasonably expected that such amounts would be the approximate annual earnings that would result from the Company's normal operations for a reasonable period in the future.

(b) On the above basis, Heekin's reasonably expected annual earnings per share would, as of June 30, 1954, be $ 1.93 and, as of September 30, 1954, $ 1.79.

49. (a) Although some investors may care little about the receipt of dividends, while others may depend upon them and therefore give them greater significance, the amount of dividends which a stock is likely to yield, as a result of its dividend-paying capacity or corporate policy, is normally considered to be an important factor in determining its fair market value. As with earnings, the forecast of future dividends is generally based to a large extent upon the past dividend record of the stock.

(b) On August 3 and October 25, 1954, Heekin's annual dividend yield was 50 cents a share. Heekin paid such annual dividends each year since 1945 except for the 1 1/2-year period of 1950 and the first half of 1951 when, as previously shown, dividends were suspended. This was the period during which Heekin experienced substantial losses in connection with the operations of Canners Exchange. In view of this abnormal loss and the terms of its loan agreement with the New York Life Insurance Company, Heekin's surplus was restricted so that as of December 31, 1950, only $ 30,386.81 was available for dividend distribution. In August 1951, however, the Company, as a result of the large profits it was making due to the effects of the Korean war, felt it could resume its 50-cent annual dividend payments in the form of 12 1/2 cents quarterly distributions.

As of December 31, 1953, the restriction imposed by the loan agreement (finding 41) left $ 840,444.78 available for dividends, which was equivalent to more than $ 3 a share. As of August 3 and October 25, 1954, therefore, this restriction placed no real burden on the normal 50-cent annual dividend. Consequently, Heekin's demonstrated earning capability and financial position were such that in August and October 1954 it could reasonably be anticipated that Heekin would continue its 50-cent annual dividend. On this basis, Heekin's expected dividend payments would amount to approximately 25 percent of its reasonably expected earnings as of those dates. The general tendency is for publicly held companies to pay out a greater percentage of their earnings in dividends than privately held companies.

(c) Although, considering only its prospective earnings, the prospective dividend rate would appear to be a conservative one, no significant increase in such rate for some time to come could have reasonably been anticipated on the valuation dates. As shown, the bulk of Heekin's equipment was not modern, and the Company was in need of relatively large sums for modernization of equipment and plant if it hoped to continue to be a competitive factor in the industry. The Company would have to depend primarily on retained earnings for such a program. A further limitation on the Company's dividend-paying capacity was the requirement of its loan agreement covering its long-term indebtedness, which called for annual payments of $ 150,000 upon principal plus such amount as was owing as a result of applying the 20 percent formula. Such payments were not tax deductible and could be made only out of earnings after payment of income taxes, if paid out of earnings at all. Thus, these demands upon earnings would restrict the Company's dividend-paying capacity to such an extent that it could not reasonably be anticipated that the 50-cent annual rate would be increased to any substantial extent.

50. In the evaluation of the worth of a stock, it is recognized that the so-called "book value" of the stock is an important consideration, although there are considerable differences of opinion concerning the weight to be given this factor in the overall analysis. Book value is determined by ascertaining the corporation's net worth (assets less liabilities) and then dividing such worth by the number of shares outstanding. It indicates how much of the Company's net assets valued as a going concern is applicable to each share. The corporation's net worth is normally ascertained from its balance sheet. Some of the differences in opinion as to the relative weight to be given the factor of book value arise from the recognized fact that, absent a sale of the corporation or a merger or consolidation, "book value" could not be translated into realization except in the event of liquidation, and that in such event many of the assets reflected in the balance sheet, such as equipment and inventory, could not be sold at their stated values, which are based upon their going concern and not their liquidation value. In this connection, therefore, the factor of "current assets," such as cash and accounts receivable, is given special attention because in the event of a liquidation, their stated value would not normally be materially affected. However, in the event of a sale, merger, or consolidation (although there was no prospect of such on the

valuation dates with respect to Heekin), an ascertainment of the Company's net worth and the resulting book value of the outstanding stock is often of primary importance in the determination of the price to be paid for, or the value to be placed upon, such stock. Further in this connection there is normally considered the soundness of the company's financial condition as reflected by its current asset and current liability position.

51. On the pertinent gift dates, Heekin was in a current sound financial condition. Its balance sheet as of June 30, 1954, showed the following:

ASSETS	
Current Assets	
Cash	$ 1,942,469.64
Notes and Accounts Receivable	$ 2,176,025.13
Less: reserve for doubtful accounts	131,043.19
Net notes and accounts receivable	2,044,981.94
Mortgage notes receivable -- current portion	46,000.00
Inventories at lower of cost or market:	
Raw Materials and Supplies	2,271,681.81
Goods in process and finished products	2,391,172.72
Total inventories	4,662,854.53
Total current assets	$ 8,696,306.11
Other Assets	
Notes receivable -- portion not current	127,008.97
Investments -- at cost:	
Stocks and bonds	335,829.11
Less reserve for losses	25,000.00
Investments -- net	310,829.11
Property, plant and equipment -- at cost	8,948,515.48
Less reserve for depreciation	5,040,107.53
Property, plant and equipment -- net	3,908,407.95
Deferred charges	113,041.21
Total assets	$ 13,155,593.35

LIABILITIES	
Current Liabilities	
Notes payable -- current portion of long-term debt	$ 163,000.00
Trade acceptances and accounts payable	1,826,021.67
Accrued accounts	749,625.39
Total current liabilities	$ 2,738,647.06
Other Liabilities	
Long-term debt, less current portion	1,924,000.00
Deferred rental income	33,494.97
Reserve for workmen's compensation insurance	35,825.45
	1,993,320.42
Total liabilities	4,731,967.48
Capital stock, 254,125 shares issued -- stated value	1,569,596.00
Earned surplus	6,854,029.87
Total net worth	8,423,625.87
Total liabilities and net worth	$ 13,155,593.35

Thus, its current assets alone, amounting to almost $ 8,700,000, far exceeded its total liabilities of approximately $ 4,732,000, including its long-term debt to New York Life. Its ratio of current assets to current liabilities was 3.17 to 1.

There was no significant change in the Company's financial condition reflected in its September 30, 1954, balance sheet.

52. The values used in the foregoing balance sheet reflect inventory at the lower of cost or market. No provision was made for reserve for obsolescence in inventory because it was not considered that there was any such obsolescence. The plant, property and equipment were carried on the balance sheet at acquisition cost less depreciation despite the acquisition of the Cincinnati and Norwood plants as long ago as 1908 and 1917, respectively, and the subsequent rise in real estate values throughout the years. The reserve for doubtful accounts was increased substantially at the end of 1953 after a detailed analysis of the notes and accounts receivable outstanding as of December 31, 1953. Despite the

possibility that certain bonds included in the "Investments" entry may have been somewhat overvalued, the balance sheet as above set forth generally represents a conservative approach and fairly presents the Company's financial condition. Without making any adjustments either upward or downward in the assets or liabilities shown therein, it reasonably reflects the net worth of the Company as of June 30, 1954.

53. On the basis of the balance sheet figures set forth above, the book value for each share of the Company's 254,125 shares of common stock outstanding was $ 33.15 on June 30, 1954. On the similar basis of the Company's balance sheet figures for September 30, 1954, the book value of each share of its stock on September 30, 1954, was $ 33.54.

54. In ascertaining the fair market value of the stock of a closely held corporation, a reasonable guide, frequently employed by analysts and investors, is to consider the relationship that the market prices of actively traded stocks of companies in the same or closely similar lines of business bear to their earnings, dividends, and book values. In this manner, some indication may be obtained concerning the relative weights accorded by the investing public to these factors in the fixing of a fair market value. Such similar enterprises are normally affected by the same general economic factors as the stock being valued.

55. As of the valuation dates, can manufacturing companies in all respects comparable to Heekin did not exist. Such giants in the industry as American Can and Continental Can are so much larger, and had diversified into so many other products and other types of containers, such as fiber and plastic, as to disqualify them as reasonable comparables. Since eliminations based on such considerations would leave so few can manufacturing companies to compare with Heekin, some manufacturers of glass containers may reasonably be considered as appropriate comparatives. The long-term sales trends of can and glass container manufacturers are fairly parallel. The glass container companies are in competition with the can companies and are affected by similar economic factors. However, other companies in the packaging area, such as manufacturers of corrugated containers, are less desirable for comparative purposes because they are not as closely competitive with can companies and their pattern of long-term growth has been dissimilar to that of the can companies.

56. In both the can and glass container manufacturing fields, the large and highly diversified companies are considered of greater value by investors, and the stocks of such companies sell higher on the basis of such factors as earnings, dividends, and book value than those of the smaller, less diversified competitors. For this reason, American Can and Continental Can, the two largest can manufacturers, are, as noted, not fairly comparable with Heekin. For the same reason, Owens Illinois Glass Company, the largest glass container manufacturer, is also not reasonably comparable. Similarly, Hazel Atlas Glass Company, the industry's second largest glass container manufacturer, which is also well diversified in other lines, and the Crown Cork & Seal Company, which manufactures cans (40 percent of total production) but is also well diversified, with its principal business being the manufacture of bottle caps and bottling machinery, are to a large extent not comparable.

57. The following companies, despite certain differences and factors which make them less than ideal comparatives, may reasonably be considered as bearing such sufficient fundamental similarities to Heekin as to warrant their use as comparables for the purpose herein involved:

(1) Pacific Can Company manufactured plain, lithographed and lacquered cans, as well as other metal containers. Like Heekin, it made general line cans although its packer's cans were more important. This company designed, built and serviced its own can-making equipment. Its annual sales for the 4 1/2-year period prior to June 30, 1954, averaged approximately $ 23,500,000.

(2) United Can and Glass Company manufactured cans and glass containers. It was a large supplier of the requirements of Hunt Foods, Inc., which owned a controlling interest in it. General line cans represented a small portion of its total can output, packer's cans being its primary can production. Its glass containers were largely for food and dairy products, for which products Heekin also manufactured metal containers. This company too manufactured its own can-making equipment and also manufactured peach-pitting machinery. Its annual sales for the 4-year period prior to June 30, 1954, averaged approximately $ 15,000,000.

(3) National Can Corporation was primarily a manufacturer of cans, metal containers, and housewares. From the standpoint of the nature of its business, it is thus an excellent comparable. Its annual sales for the 4 1/2-year period prior to June 30, 1954, averaged approximately $ 32,500,000. However, other factors make this company less desirable as a comparative. During the pertinent period its earnings fluctuated more erratically than those of other can or glass container companies. In 1952 it suffered a large loss which could reasonably be considered to be of a nonrecurring nature. In addition, it experienced changes in management in early 1953 and at the same time acquired another can company. n6 Nevertheless, considering the closely similar nature of its business, and because of the paucity in the number of comparables available, National's use as a comparable is justified if certain adjustments are made in its erratic earnings record in order to arrive at figures which could be considered as being more normal. Such adjustments are hereinafter made. As noted, Heekin too suffered a large nonrecurring loss, for which appropriate adjustments, as set forth above, are made in computing its more normal earnings, and Heekin also had a change in management affecting operations in the years immediately preceding 1954.

n6 Because of its earnings' irregularities and the special condition described, the only plaintiffs' expert who made a detailed analysis of his selection of comparable companies and the consideration he gave them, as well as the defendant's expert, both excluded this company as a comparable.

(4) Brockway Glass Co., Inc. made a general line of glass containers, including food and Mason jars. Its annual sales for the 5-year period 1949-1953 averaged approximately $ 13,300,000. However, each year's sales during this period increased, with sales in 1953 totaling approximately $ 21,000,000.

(5) Thatcher Glass Manufacturing Co., Inc. was one of the principal manufacturers of glass containers. Its products included bottles and containers of all types for food, beverages and chemicals. Its annual sales for the 4-year period prior to June 30, 1954, averaged approximately $ 23,500,000.

58. The adjusted earnings on the common stock of the above five companies for the years 1950 through 1953 and for the 12-month periods ending June 30 and September 30, 1954, are as follows:

Year	Brockway	Pacific	Thatcher	United	National

	Glass	Can	Glass	Can	Can
1950	$ 602,000	$ 562,000	$ 446,500	$ 715,000	$ 303,000
1951	603,000	850,000	1,179,000	954,000	618,000
1952	520,000	743,000	630,000	737,000	475,000
1953	623,000	965,000	974,000	511,000	1,205,000
12 months ending					
June 30, 1954	* 912,500	* 1,076,000	1,035,000	* 693,000	1,039,000
12 months ending					
Sept. 30, 1954	* 1,057,250	* 1,131,500	941,000	* 784,000	891,000

* Interim profit unavailable. Profit at June 30, 1954 computed as one-half of 1953 earnings and one-half of 1954 earnings. Profit at September 30, 1954 computed as one-fourth of 1953 earnings and three-fourths of 1954 earnings.

These earnings reflect the following adjustments:

(1) Thatcher's reported profits for 1950-52 included large nonrecurring items, primarily for gain or loss on sale of equipment. These items have been eliminated in order to reflect the company's more normal earnings.

(2) United's 1950 and 1951 profits have been adjusted to exclude a $ 130,000 nonrecurring gain in 1950 and a $ 218,000 nonrecurring loss in 1951.

(3) National suffered unusual losses in 1952 and incurred a deficit of approximately $ 1,475,000. The major reasons for the deficit (a strike and costly litigation) were at least largely of nonrecurring character. The profits of container manufacturers were somewhat depressed in 1952. This followed the generally unusually good results of 1951 for can manufacturers due to the Korean conflict, as hereinabove set forth. Orders in 1951 were high due to customers' building up inventory. The effects of the 1951 inventory build-up was, however, felt in 1952, when orders decreased. Had National's situation been more normal in 1952 and had it not suffered the nonrecurring types of losses referred to, it would be reasonably assumed, based on the earnings of other container manufacturers during that year and the relationship that such year's earnings bore to 1951 earnings, that National's profit for 1952 would have been approximately $ 475,000.

59. Using the same technique as was adopted with respect to Heekin, and giving greater weight to the earnings of the later periods of time, in order to give proper consideration to the factor of trend, the reasonably anticipated annual earnings of the above-mentioned five companies selected as comparables, would, as of June 30 and September 30, 1954, be as follows:

12 months ending --	Brockway Glass	Pacific Can	Thatcher Glass	United Can	National Can

			1954		
June 30	$ 694,833	$ 915,400	$ 917,700	$ 689,533	$ 865,267
Sept. 30	743,083	933,900	886,367	719,867	815,933

60. The market prices of the common stock of the five comparable companies on the applicable dates were as follows:

	Price Aug. 3, 1954	Price Oct. 25, 1954
Brockway Glass	$ 50	$ 49
Pacific Can	21 5/8	n7 25 7/8
Thatcher Glass	18	15 3/8
United Can and Glass	13	13 1/2
National Can	13 3/4	13 7/8

n7 The sharp rise in price in this stock resulted from the then pending negotiations for the merger of Pacific Can with National Can. This special circumstance weakens its use as a comparable on this date and warrants consideration of this factor in the ultimate determination of a fair market price of the Heekin stock.

61. Earnings per share of the common stock of the five comparable companies, based on representative annual earnings as similarly computed for Heekin, were as follows:

	Number of shares common stock outstanding	Earnings per share Aug. 3, 1954	Earnings per share Oct. 25, 1954
Brockway Glass	65,219	$ 10.65	$ 11.39
Pacific Can	463,050	1.98	2.02
Thatcher Glass	495,303		1.85
	535,303		1.66
United Can and Glass	438,543	1.57	1.64
National Can	859,584	1.01	.95

62. The market prices of the five comparable companies bear the following ratios to the above computed annual earnings per share of common stock:

	Price-earnings ratio Aug. 3, 1954	Price-earnings ratio Oct. 25, 1954
Brockway Glass	4.69:1	4.30:1

Pacific Can	10.92:1	12.81:1
Thatcher Glass	9.73:1	9.26:1
United Can and Glass	8.28:1	8.23:1
National Can	13.61:1	14.61:1

Such ratio is commonly referred to as the "price-earnings ratio." The average price-earnings ratio for the above companies was 9.45 to 1 on August 3, 1954, and 9.84 to 1 on October 25, 1954.

63. On the basis of the earnings alone, as hereinabove computed, Heekin's stock would, as compared with the above five companies, and assuming Heekin's stock was similarly listed on a national stock exchange and was actively traded, be priced at $ 18.24 a share on August 3, 1954, and at $ 17.61 a share on October 25, 1954.

64. (a) Dividend payments for the 12 months ending June 30, 1954, and September 30, 1954, n8 reflect the following rates of yield on the common stock of the five comparable companies based on their market prices on such dates:

	Percent yield June 30, 1954	Percent yield Sept. 30, 1954
Brockway Glass	5.61	5.93
Pacific Can	2.78	2.32
Thatcher Glass	5.66	6.19
United Can and Glass	3.43	3.37
National Can	0	n9 0

The average percent yield for these companies was 3.50 as of June 30, 1954, and 3.56 as of September 30, 1954.

n8 Dividends for the 12 months ending June 30, 1954, computed as one-half of 1953 and one-half of 1954 dividends. For the 12-month period ending September 30, 1954, the dividends are computed as one-fourth of 1953 and three-fourths of 1954 dividends.

n9 National Can paid no dividends after its large 1952 deficit. Its use as a comparable for this purpose is thus weakened, and warrants consideration of this factor in the ultimate determination of a fair market price of the Heekin stock.

(b) For the years 1951 through 1954, United Can and Glass paid a 5 percent stock dividend in addition to a cash dividend. While stock dividends do not result in any increase by a stockholder in his percent of ownership in the corporation, and do not afford any actual cash yield, investors do commonly consider them to be of some value, a consideration which frequently is reflected in the market price of the stock. However, stock dividends are normally not considered as valuable as cash dividends. The appraisal of the value of a stock dividend would differ depending upon the company concerned. A reasonable approximation for the purpose herein involved would be to consider the 5 percent stock dividend for this

particular company as being worth approximately 25 percent as much as a cash dividend. On this basis, United's 5 percent stock dividend would be considered equivalent to a 1 1/4 percent cash dividend, and has been so treated in the above computation.

65. On the sole basis of the average of the latest 12 months dividends of the above five companies (as hereinabove computed) as compared with Heekin (and again assuming Heekin's stock would have equally wide access to the investing public), the market price of Heekin's stock on August 3, 1954, would, on the basis of Heekin's 50-cent annual dividend payment, be $ 14.29 a share, and on October 25, 1954, $ 14.05 a share. These prices would produce the dividend percentage yields of 3.50 and 3.56 above referred to.

66. The book value of the common stock of the above five companies as of June 30 and September 30, 1954, and its relation to market price on August 3 and October 25, 1954, were as follows:

As of June 30, 1954

	Book value June 30, 1954	Price Aug. 3, 1954	Price as a percentage of book value
Brockway Glass *	$ 93.99	$ 50	$ 53.20
Pacific Can *	18.05	21 5/8	119.81
Thatcher Glass	18.66	18	96.46
United Can and Glass	16.55	13	78.55
National Can	19.16	13 3/4	71.76

* Interim book value for Brockway Glass and Pacific Can was not available. Therefore, book value on June 30, 1954, was computed as one-half of 1953 year-end book value, and one-half of 1954 year-end book value. Book value on September 30, 1954, was computed as one-fourth of 1953 year-end book value and three-fourths of 1954 year-end book value.

Thus, on August 3, 1954, the average market price was 83.96 percent of book value.

As of September 30, 1954

	Book value Sept. 30, 1954	Price Oct. 25, 1954	Price as a percentage of book value
Brockway Glass *	$ 97.85	$ 49	$ 50.01
Pacific Can *	18.44	25 7/8	140.32
Thatcher Glass	17.39	15 3/8	88.41
United Can and Glass	16.98	13 1/2	79.51
National Can	18.83	13 7/8	73.69

Thus, on October 25, 1954, the average market price was 86.39 percent of book value.

67. On the sole basis of the average relationship that the book value of the common stock of the above five companies bore to their market prices, Heekin's comparable market price would be $ 27.83 on August 3, 1954, and $ 28.98 on October 25, 1954 (again assuming active trading in Heekin's stock).

68. As hereinabove set forth, earnings are normally the most important factor in the determination of the fair market price of a stock, and this is particularly true when they indicate trends and, therefore, future prospects. Dividend yield and book value are also important factors in such determination. In evaluating the Heekin stock, it would be reasonable, insofar as strictly statistical considerations are concerned, to confine the determinants to these three factors. In valuations of this kind, it is, after the selection of the value determinants, common practice to consider the relative importance or weight to be given each one. Although analysts and investors differ in such appraisal, a reasonable conclusion of their relative importance in Heekin's situation would be to consider earnings as contributing approximately 50 percent to the total determination, dividend yield, as the second most important factor, as contributing approximately 30 percent, and book value, as the least important of the three, as contributing approximately 20 percent.

69. On the bases set forth in finding 68, the fair market value of Heekin stock on the pertinent gift dates, would, were it an actively traded stock, be as follows:

	Aug. 3, 1954	Oct. 25, 1954
Earnings (finding 63):		
($ 18.24 X 50%		$ 9.12
($ 17.61 X 50%)		$ 8.81
Dividend yield (finding 65):		
($ 14.29 X 30%)		4.29
($ 14.05 X 30%)		4.22
Book value (finding 67):		
($ 27.83 X 20%)		5.57
($ 28.98 X 20%)		5.80
Fair market value	18.98	18.83

70. (a) As hereinabove noted, Heekin stock was for the most part closely held. It was not listed on any stock exchange and trading in it was infrequent. As shown by finding 43, there was only one transaction involving 100 shares in the entire year 1953, and only one involving 200 shares in the entire year 1954. Consequently, the stock lacked marketability. A closely held stock of such a corporation as Heekin which lacks marketability is less attractive to investors than a similar stock which has ready access to the general public, a consideration which affects the market value of Heekin stock. This is especially true when, as here, each block of stock involved in the gifts made on each valuation date represented only a minority interest, as distinguished from the situation where a block of stock large enough to give a purchaser control of the corporation is offered. Such control of a profitable, going, concern represents an added element of value to a block of stock.

(b) One reasonable method sometimes employed to determine the diminution in value attributable to a stock's lack of marketability is to determine how much it would cost to create marketability for the stock. Had Albert E. Heekin sold the 30,000 shares which were the subject of his gifts on August 3, 1954 through a public underwriting at the gross sales price of $ 18.98 a share, referred to in finding 69, the underwriter's compensation and other expenses would have amounted to approximately $ 2.31 a share. Similarly, had James J. Heekin sold the 40,002 shares which were the subject of his gifts on October 25, 1954 through such a public underwriting at the gross sales price of $ 18.83 a share also referred to in said finding, the underwriter's compensation and expenses would have amounted to approximately $ 2.29 a share. The reduction from the gross sales prices in both cases would amount to 12.17 percent. The net proceeds would thus have been $ 16.67 a share on the 30,000 shares given by Albert E. Heekin on August 3, 1954 and $ 16.54 a share on the 40,002 shares given by James J. Heekin on October 25, 1954.

71. (a) Considering all the facts and circumstances as herein set forth, the fair market value of the 30,000 and 40,002 shares which were the subject of the gifts on August 3 and October 25, 1954 was $ 15.50 a share.

(b) Although the market for stocks of the can and glass container manufacturing companies fell somewhat between August 3 and October 25, 1954, so that ordinarily a slightly lower value would be justified as of the latter date, the brightened prospects for increased business and profits resulting from the Company's decision in August 1954 to embark upon the beer can business and to satisfy further the demands of its largest customer for new products, would, in the instance of this particular Company, tend to neutralize the general market decline and make the stock at least as valuable on October 25 as it had been on August 3.

(c) The value of $ 15.50 would represent a price to adjusted earnings ratio of 8.03:1 on August 3 and 8.66:1 on October 25, 1954, a dividend yield (based upon a 50-cent annual dividend rate) of 3.23 percent, and 46.76 and 46.21 percent of book value on such dates respectively.

CONCLUSION OF LAW

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that the plaintiffs are entitled to recover, the amount of recovery to be determined in accordance with Rule 38(c).

In accordance with the opinion of the court and on a memorandum report of the commissioner as to the amounts due thereunder, it was ordered on August 17, 1962, that judgment for plaintiffs in case No. 196-58 be entered for $ 94,942.74, together with interest thereon as provided by law from July 30, 1958; that judgment for plaintiffs in case No. 199-58 be entered for $ 53,046.17, together with interest as provided by law to be computed on $ 763.66 from August 11, 1958, and on $ 52,282.51 from July 23, 1958; that judgment be entered for plaintiff in case No. 200-58 for $ 52,719.96, together with interest as provided by law to be computed on $ 753.16 from August 11, 1958, and on $ 51,966.80 from July 23, 1958.

Full Text of Court Cases

Christians v. Christians

Case name: Christians v. Christians
Citation: 732 So. 2d 47,1999 Fla. App. LEXIS 6687
Date of decision: May 19, 1999
Country: US
State or Federal: State
State/Jurisdiction: Florida
Court: Court of Appeals
Type of action: Marital Dissolution
Judge: Stevenson
SIC: 7999 Amusement and Recreation Services, NEC (scenic transport operations, land)
NAICS: 713990 All Other Amusement and Recreation Industries
1667

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JUDGES:

STEVENSON, J., DELL and POLEN, JJ., concur.

OPINIONBY:

STEVENSON

OPINION:

STEVENSON, J.

Grace Christians appeals the final judgment dissolving her nine-year marriage to her former husband, Robert Christians, and challenges the equitable distribution of the couple's marital assets and the court's failure to award her attorney's fees. We reverse in part because the trial court failed to include the value of a corporate bank account in its valuation of the husband's business, Flying Trapeze, Inc., but affirm on all other issues raised in the wife's appeal.

The valuation of a business is calculated by determining the fair market value of the business,

which is the amount a willing buyer and a willing seller would exchange assets absent duress. See Makowski v. Makowski, 613 So. 2d 924, 926 (Fla. 3d DCA 1993). Typically, fair market value measures the value of the assets of the business plus the value of goodwill. See id.

Flying Trapeze is a business whereby the husband primarily constructs and services trapeze equipment for lease or sale exclusively to Club Med. The husband acquired five trapeze units prior to the marriage and thirteen additional units during the marriage. Based upon evidence presented at trial by the couple's experts, the trial court found that the fair market value of Flying Trapeze included only its tangible assets and inventory and that the business had no goodwill value for the purposes of marital distribution. The court valued the marital portion of the business at $ 137,450 by assigning a value of $ 10,000 to each trapeze unit acquired during the marriage, adding the value of other inventory, and then subtracting the debt. The trial court, however, failed to include a corporate bank account worth $ 15,924 in the valuation of the husband's business. Because the trial court used a net asset method to value the business, we find that the court erred in failing to tally the corporate bank account in the valuation.

Additionally, we find that the trial court's failure to assign a goodwill value to Flying Trapeze was not error. Goodwill may be a marital asset subject to division in a dissolution proceeding if it developed during the marriage and it exists separate and apart from the reputation or continued presence of the marital litigant or the tangible asset. See Williams v. Williams, 667 So. 2d 915, 916 (Fla. 2d DCA 1996); Young v. Young, 600 So. 2d 1140, 1141 (Fla. 5th DCA 1992). The record contains competent evidence to support the trial court's conclusion that any goodwill of Flying Trapeze "rests solely on the Husband's well-known reputation and abilities and his continued existence and involvement [in the business]."

Accordingly, we reverse in part and remand to allow the trial court to readjust the equitable distribution consistent with the holding in this opinion.

Affirmed in part, reversed in part and remanded.

DELL and POLEN, JJ., concur.

Full Text of Court Cases

Church v. United States (I)

Case name: Church v. United States (I)
Citation: 2000 U.S. Dist. LEXIS 714
Date of decision: January 18, 2000
Country: US
State or Federal: Federal
State/Jurisdiction: Texas
Court: United States District Court
Type of action: Estate and Gift Taxation
Judge: Garcia
Experts: Bruce Johnson (for plaintiff)
SIC: 0291 General Farms, Primarily Livestock and Animal Specialties
NAICS: 112990 All Other Animal Production
8644

Keywords: Discount for lack of control (DLOC), Discount for lack of marketability (DLOM), Income approach, Market approach, Partnership formation

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For UNITED STATES OF AMERICA, defendant: Andrew L. Sobotka, Department of Justice, Dallas, TX.

Judge: Garcia

FINDINGS OF FACT AND CONCLUSIONS OF LAW

Following trial on the merits and submission of post-trial briefs (docket nos. 60, 63, 64, and 67), and pursuant to the February 17, 1999 agreement of the parties to withdraw this case from the jury and submit it to the Court for decision, the Court enters its findings of fact and conclusions of law. FED. R. CIV. P. 52. To the extent any finding of fact is made in the Conclusions of Law section, or vice versa, the section headings will be disregarded.

Jurisdiction and Venue

1. This court has jurisdiction over this matter pursuant to 28 U.S.C. § 1346(a)(1) because this suit arose under the Internal Revenue laws of the United States for a refund of estate taxes that were allegedly erroneously assessed and collected.

2. Venue for this action properly lies in the Western District of Texas pursuant to 28 U.S.C. § 1391(e).

Findings of Fact

1. Elsie S. Church ("Mrs. Church") died on October 24, 1993, at the age of about 72. (Tr. 166, 223).

2. Mrs. Church was the mother of plaintiffs Marshall B. Miller, Jr. and Mazy Elsie Newton. (Tr. 110).

3. On October 22, 1993, Mrs. Church, Marshall B. Miller, Jr., and Mary Elsie Newton signed an agreement entitled, "Agreement of Stumberg Ranch Partners, Ltd." ("Partnership Agreement"). (Tr. 131, 409, PX 1). The execution of this document resulted in the formation of a Texas limited partnership ("the Partnership"), subject only to substantial compliance with the Texas Revised Limited Partnership Act then in effect, TEX. REV. CIV. STAT. ANN. art. 6132a-1, and the Texas Uniform Partnership Act. TEX. REV. CIV. STAT. ANN. art. 6132b.

4. The purpose of the Partnership was twofold. Most importantly, the partners wished to consolidate their undivided interests in a family ranch known as the W.R. Stumberg Ranch ("the Ranch") to provide for centralized management of their interests and preserve the Ranch as an on-going enterprise for future generations. (Tr. 121-22, 126-27, 141, 148, 225-27). In addition, as she aged, Mrs. Church became concerned about protection of her substantial assets from judgment creditors in the event of a catastrophic tort claim against her. (Tr. 128-29).

5. The Ranch, located in West Texas, consists of approximately 23,000 acres. (Tr. 114). The ranch supports grazing of cattle, sheep, and goats. (Tr. 112. 115-17). Since about 1979, the Ranch has been leased for grazing and hunting. (Tr. 115-17, 126). There is currently an oil and gas lease on the Ranch. (Tr. 121).

6. Mrs. Church was a limited partner in the Partnership. (PX 1). While she had actively managed the Ranch on behalf of all of the owners in years past under an informal agreement, she had largely relinquished this role to her two children after her remarriage to William Church in 1984. (Tr. 118, 121, 124-25). The other undivided interest owners in the Drake family had never been active in the management of the Ranch. (Tr 118, 137).

7. Miller and Newton were also limited partners in the Partnership. Stumberg Ranch, L.C. was designated as the general partner, and was to be owned 50-50 by Miller and Newton to reflect their active roles in managing the Ranch. (Tr. 136, PX 1). This corporation, however, had not yet been formed when Marshall Miller signed the Partnership Agreement on its behalf on October 22, 1993. (PX 1 at 17, PX 5, PX 6).

8. The capital contributions to the Partnership consisted of each limited partner's undivided interest in the Ranch. In addition, Mrs. Church contributed approximately $ 1 million in securities inherited from her mother and from her husband Bill Church that were held in street name in an account at Paine Webber. (Tr. 131-32, 139, 192, PX 1 at 2, Ex. A, PX 11). At this time, the limited partners owned 57% of the Ranch while members of the Drake family owned the remaining 43%. Of the 57% interest owned by the Partnership, Mrs. Church owned 62% in her individual capacity, and Miller and Newton each owned 18%. Mrs. Church owned the remaining 2% as a trustee. (Tr. 123, 136. PX 1 at 3). The undisputed market value of the interest in the Ranch contributed by Mrs. Church was $ 380,038, while the value of her children's interests was $ 232,927. (Tr. 131-32, 154, PX 1, PX 9 at Ex. B).

9. The Agreement allocated profit or loss from Ranch operations in proportion to the interests contributed by the limited partners. Ninety-nine percent of the taxable income from the securities contributed by Mrs. Church was specially allocated to her after expenses. (Tr. 133, 136, 187, PX 1 at 2-3). Mrs. Church also received 62% of the income attributable to the operation of the Ranch. (Tr. 136). The result was that the Partnership was a pro rata partnership in the sense that profits, losses; and income were allocated in proportion to each partner's capital contribution, and no partner experienced an economic benefit from the contribution of another.

10. The limited partners conveyed their interest in the Ranch to the Partnership in a Special Warranty Deed signed on October 22, 1993. (PX 4). On the same day, Miller signed an Assignment Separate from Certificate conveying Mrs. Church's securities to the Partnership. (PX 3). He did so under a power of attorney Mrs. Church had given him in July of 1992. (PX 7).

11. Two days after these transactions, on October 24, 1993. Mrs. Church died suddenly and unexpectedly of cardiopulmonary collapse. (PX 8).

12. At the time she died, Mrs. Church had breast cancer. She had first been treated for this condition by Dr. Stephen Cohen in July of 1990. (Tr. 165). Dr. Cohen is an eminently qualified oncologist. (Tr. 163-65). Although the Court finds the cause and timing of Mrs. Church's death is largely irrelevant to this case, the Court accepts as true the testimony of Dr. Cohen that Mrs. Church's death was unexpected and unrelated to her cancer. (Tr. 169-70). After diagnosis and initial treatment, Dr. Cohen initially treated Mrs. Church with chemotherapy that was very debilitating but successful in destroying signs of the disease. (Tr. 165-66). After 1 1/2 years, the cancer recurred and Mrs. Church was again treated with chemotherapy that had to be stopped because of the side effects. (Tr. 166). This course of treatment nevertheless was successful in the sense that Mrs. Church went into clinical remission for the last six months of her life. (Tr. 171-72).

13. Notwithstanding her cancer, Mrs. Church was living a normal life at the time of her death. She had her own apartment where she lived without assistance, drove a car, visited family and friends, and did not exhibit any signs of a belief that she would die soon. Indeed, she had purchased new clothing shortly before her death, which is not the act of one on her deathbed. (Tr. 146-47, 167, 223-24). I thus accept as true the conclusion of Dr. Cohen that Mrs. Church had no reason to believe that she would soon die. Moreover, there were many available treatments for Mrs. Church's breast cancer that she had not yet undergone because she did not need them. Any estimate of how long she could or would have lived with her cancer would be a guess, with no factual support or probative value. (Tr. 173).

14. While the Partnership was formed on October 22, 1993, the organization of its affairs was not completed prior to Mrs. Church's death, The Certificate of Limited Partnership was not filed in the Office of the Texas Secretary of State until October 26, 1993. (PX 2). This Certificate states it was signed and executed on July 1, 1993 by Marshall B. Miller, Jr. Miller indicated at trial that this was incorrect, and that he probably signed it on October 22 with the other Partnership documents. He attributed this mistake to the fact that the Partnership Agreement, while not signed until October 22, has an effective date of July 1, 1993. Since the date on the Certificate was typed, I find that this was a clerical error that Miller did not notice when he signed the Certificate. Miller made no effort to conceal this mistake, and it is immaterial when the Certificate was signed.

15. The corporate general partner of the Partnership was not actually organized until March of 1994. (PX 5, 6). The Paine Webber account in the name of Elsie Church was not changed to a Partnership account until the same month. To the limited extent that a determination of relevance involves findings of fact, common experience tells us that it is not unusual that all of the paperwork associated with the formation of a business entity was not completed in a single day, or in the short interval of two days between execution of the Partnership Agreement and Mrs. Church's death. Indeed, the failure to complete the paperwork on Friday, October 22, 1993 lends credence to the testimony that the state of Mrs. Church's health arid her possible death were not motivating factors in the decision to form the Partnership. After Mrs. Church's death, it was obviously immaterial whether paperwork was completed in a day or a month. The legal consequences, if any, arising from the failure to complete the paperwork prior to death were fixed.

16. I find that the Primary purpose of the partners in forming the Partnership was a desire to preserve the family ranching enterprise for themselves and their descendants. Both Miller arid Newton testified to, and I accept as true, their feelings that their and their mother's association with a working ranch was an important and beneficial influence on their otherwise urban lives that would also benefit their descendants. Bringing organization to the Ranch would remove it from the control of one or more fractional, undivided-interest owners who could use the property at will, interfere with operations, and ultimately force a partition or sale of the Ranch. (Tr. 120-122, 126-27, 141-45, 148, 225-27).

17. The evidence of this motivation is concrete and persuasive. [10] In the first instance, Mrs. Church and her children had already experienced the consequences of undivided ownership in a real-estate-based business enterprise. Prior to formation of the Partnership, Mrs. Church's nephew, Rod Drake, had exercised his rights as an undivided owner by moving onto the Ranch, interfering with operations, threatening legal action, and almost driving off the grazing lessee who was the major source of the Ranch's income. (Tr. 122). Mrs. Church, her two children, and their cousin had to solve this threat by borrowing money to purchase the nephew's interest. (Tr. 122, 225), Moreover, they knew this nephew would likely inherit additional interest in the Ranch through his father and would likely have to be bought out again. (Tr. 123). This in fact occurred after formation of the Partnership. The securities contributed to the Partnership by Mrs. Church provided the $ 200,000 in capital necessary for this second buy-out that increased the Partnership's interest in the Ranch from 57% to its present 75%. It also was, and is, the intention of the Partnership to purchase the outstanding 25% undivided interest of Whit Drake when, and if, the Partnership has accumulated [11] sufficient capital to do so. (Tr. 144-45).

18. The Partnership was also formed with an eye towards the possibility of actively engaging in raising cattle. The Ranch was in the midst of a prolonged and continuing drought. The grazing lease expired in 1994, and there was a question whether it would be renewed. The Partnership was prepared, if necessary, to replace this lost income through active operations. (Tr. 184-85). Working capital over and above income from the Ranch would have been necessary to engage in this activity.

19. The Government contends that while the formation of the Partnership took the form of a bona fide business transaction, the transaction had no substance and was entered into for no purpose other than to reduce the taxation of Mrs. Church's estate. I do not find this to be the case. The character of the interests owning a majority of the Ranch changed dramatically as a result of the Partnership. Prior to its formation, Plaintiffs and their descendants would have owned undivided interests in the Ranch, with each interest carrying the right to use and enjoy the property, or force a partition or possible sale. The Partnership eliminated these individual [12] rights and placed ownership of a majority of the Ranch in a Partnership that was not controlled by any single person.

20. I find as a matter of fact that the Partnership had bona fide business purposes and was not a sham as that term is used in estate taxation.

21. I also find that the Partnership was not formed solely to reduce estate taxes.

22. Mrs. Church intended to, and did, convey her interest in the securities held by Paine Webber on October 22, 1993. This intent to relinquish her interest is explicitly expressed in the Partnership Agreement she signed on that date.

23. There is no ambiguity in the Partnership Agreement with respect to the power to amend it, and no claim of ambiguity has been brought to the attention of the Court. Even if such a claim had been made, no extrinsic evidence was offered to explain any claimed ambiguity.

24. Mrs. Church did not have the unilateral right to alter, amend, revoke, or terminate the Partnership Agreement. Section 29 of the Partnership Agreement provides that it may be amended "only upon the written agreement of the Partners then entitled to eighty percent (80%) or more of the Partnership interests in profits [13] from operations." The reference to "profits from operations" can logically refer only to Ranch operations, and therefore Mrs. Church was entitled to only 62% of those profits. Nor could Mrs. Church dissolve the Partnership through the use of her amendment power, even if she could cast more than 80% of the vote to do so. As Texas partnership law provides, no act in contravention of the agreement (such as dissolution) may be done without the consent of all the partners. TEX. REV. CIV. STAT. ANN. art. 6132b, § 18(h). Such a unilateral act would also contravene sections 15(a) and 22 of the Partnership Agreement.

25. There was no expressed or implied agreement between the partners in the Partnership that Mrs. Church could continue to use, possess, or enjoy partnership property, or retain the right to income from Partnership property, within the meaning of I.R.C. § 2036.

26. To the extent that the safe harbor exceptions to application of I.R.C. § 2703 involve issues of fact, I find that the Partnership was a bona fide business arrangement, and not a device to transfer property to members of Mrs. Church's family for less than full and adequate consideration in money or money's [14] worth. I also accept as true the uncontradicted testimony of Charles Hornberger that the terms and restrictions in the Partnership Agreement were comparable to similar arrangements entered into by persons in arms-length transactions. With respect to the issue of consideration, I reject the Government's contention that the difference in value between the Partnership interest Mrs. Church received on formation and the value of the assignee interest transferred upon her death is the appropriate measure of the consideration she received for her contribution of assets to the Partnership. These are two different interests that are not comparable. My finding that she received full and adequate consideration is premised upon the fact that whatever the value of her Partnership interest on the date of formation, it was directly proportionate to the contributions and Partnership interests of the other partners to a Partnership that had a bona fide business purpose.

27. The fair market value of the assets contributed by Mrs. Church to the Partnership, as of the date of her death or the alternate valuation date of April 24, 1994, was $ 1,467,748 (Tr. 410). Of this figure, the value of the Ranch [15] accounted for $ 380,038, and the value of the cash and securities contributed by Mrs. Church was $ 1,087,710.

28. The fair market value of Mrs. Church's limited partnership interest in the Partnership, as of the date of her death or the alternate valuation date of April 24, 1994, was $ 617,591. (PX 13 at i). While this is precisely the estimate of Plaintiffs' valuation expert, Mr. Bruce Johnson, and presumably could have been challenged given that the valuation of such interests are ultimately a matter of opinion, the Government chose not to present any valuation evidence of its own. Since the Court must find facts based on the record before it, it accepts Mr. Johnson's uncontradicted estimate.

29. On July 25, 1994, the Estate of Elsie Church timely filed a Form 706, United States Estate Tax Return. (Tr. 410).

30. On February 16, 1996, the Internal Revenue Service served a Notice of Deficiency proposing to assess against the estate a deficiency of $ 212,503 plus interest. (Tr. 410).

31. After adjustments, the estate made full payment of the deficiency on April 8, 1996 in the amount of $ 230,100, representing the principal sum of $ 197,221 and statutory interest [16] of $ 32,879. (Tr. 410).

32. On October 9, 1996, Plaintiffs filed a claim for refund that the IRS denied. (Tr. 411).

33. On March 3, 1997, the IRS refunded $ 14,631.65 to the estate. This refund was attributable to additional deductible attorney's fees of $ 43,769 and appraisal fees of $ 5,594 incurred in connection with this matter and necessary in the administration of the estate. (Tr. 411).

34. This lawsuit was filed on June 26, 1997. (Tr. 411).

35. Since March 3, 1997, Plaintiffs have actually and necessarily incurred the sum of $ 101,442.71 in additional attorney's fees and expenses in seeking a refund through this suit. I find that these attorney's fees and expenses were necessary in the administration of the estate because they were actually incurred in the collection of assets within the meaning of Treas. Reg. 20.2053-3. This sum is accordingly an additional deduction from the federal estate tax heretofore paid.

36. Plaintiffs are entitled to a refund based on the proper valuation of Mrs. Church's Partnership in the amount of $ 617,591. In accordance with the parties' stipulation, the Government shall calculate the refund and submit its calculation [17] to Plaintiffs for approval within thirty (30) days of this decision. Any dispute thereafter as to the amount of the refund shall be submitted to the Court, which shall include the dollar amount of the refund in its final judgment

Conclusions of Law

1. For the reasons stated in its order on the Government's motion in limine (docket no. 44), the Court concludes that the formation of Stumberg Ranch Partners, Ltd. was in substantial compliance in good faith with the Texas Revised Limited Partnership Act, and TEX. REV. CIV. STAT. ANN. art. 6132a-1, and the Texas Uniform Partnership Act. TEX. REV. CIV. STAT. ANN. art. 6132b.

2. Accordingly, the Partnership was a valid Texas limited partnership as of October 22, 1993, and Mrs. Church's limited partnership interest must be taxed as such under I.R.C. § § 2033 and 7701(a)(2).

3. The Government contends that prior to her death, Mrs. Church did not effectively convey to the partnership legal title to the securities in her Paine Webber account. Based on the undisputed facts, the Court concludes this contention is without merit. Mrs. Church did not hold legal title to these securities; hers was an equitable beneficial interest [18] and legal title was held by Paine Webber. It would make no difference even if this were not the case because neither Texas law nor the federal law of estate taxation concern themselves with legal title in determining ownership of partnership property Under well-established principles of Texas law, ownership of property intended to be a partnership property is not determined by legal title, but rather by the intention of the parties. Logan v. Logan, 138 Tex. 40, 156 S.W.2d 507, 512 (Tex. 1941); Foust v. Old Am. County Mut. Fire Ins. Co., 977 S.W.2d 783, 786 (Tex App.-- Fort Worth 1998, no writ). Mrs. Church's intention to relinquish her beneficial interest in the securities held by Paine Webber was clearly expressed by her executions of the Partnership Agreement in which these securities are specifically described. This intention governs without regard to legal title to the securities and the securities were the property and assets of the Partnership.

4. If Mrs. Church effectively conveyed the securities in her Paine Webber account to the Partnership, as the Court has concluded, the Government next contends that there was a taxable gift on formation [19] of the Partnership. The taxable value of this gift is represented to be the difference between the $ 1,467.748 in assets contributed by Mrs. Church to the Partnership, and what the Government claims was the value of the Partnership interest she received in return. This latter sum is the $ 617,591 estimated market value of Mrs. Church's interest in the Partnership at death.

5. Initially, the Government's contention confuses the market value of the assignee interest passing at death with the value of the Partnership interest Mrs. Church received in return for her contribution. The two interests are not comparable. More importantly, the Government ignores the fact that this was a pro rata partnership that did not confer a financial benefit on, or increase the wealth of, any partner. Implicit in the Government's argument is the notion that since the value of Mrs. Church's Partnership interest was less than the assets she contributed, someone must have received a gratuitous transfer of the difference. This was not the case, and never could be in the formation of a business entity in which each investor's interest is proportional to the capital contributed.

6. A gift can be made [20] in many guises, and it is the intention of I.R.C. § 2501, et. seq. to tax them whatever their form. Nevertheless, a taxable gift must involve a gratuitous transfer, which by definition requires a donee. Dickman v. Commissioner, 465 U.S. 330, 334, 104 S. Ct. 1086, 79 L. Ed. 2d 343 (1984). There was none in this case. Kincaid v. United States, 682 F.2d 1220 (5th Cir. 1982) and the other cases cited by the Government reinforce this point rather than contradict it. Each involved an attempt to donatively pass property to others through the formation of business entities in which the donor did not receive an interest proportionate to his or her capital contribution.

7. I.R.C. § § 2036 and 2038 likewise require a "transfer" as a predicate to their application. Shafer v. Commissioner, 749 F.2d 1216, 1221 (6th Cir. 1984); Estate of Harrison v. Commissioner, 1987 T.C. Memo 8, 52 T.C.M. (CCH) 1306, 1309 (1987). Since the gift and estate taxes are considered in pari materia, Wheeler v. United States, 116 F.3d 749, 761 (5th Cir. 1997), the term

"transfer" must be given the same meaning in construing [21] sections 2036 and 2038 as it is in the taxation of gifts. Having previously concluded that there was no gratuitous donative transfer in the formation of Stumberg Ranch Partners, Ltd. in connection with the Government's contention of a gift on formation, I likewise conclude that sections 2036 and 2038 do not apply to the transaction in issue. Estate of Harrison v. Commissioner, 1987 T.C. Memo 8, 52 T.C.M. (CCH) 1306, 1309 (1987); Estate of Michelson v. Commissioner, 1978 T.C. Memo 371, 37 T.C.M. (CCH) 1534, 1538 (1978).

8. The Government makes two contentions with respect to the application of I.R.C. § 2703 to this case. It first suggests that the term "property" refers to the assets Mrs. Church contributed to the Partnership prior to death, rather than her Partnership interest. There is no statutory basis for this contention. Mrs. Church did not own the assets she contributed to the Partnership on the date of her death; she owned a Partnership interest. The estate tax is imposed on that which a decedent transfers at death without regard to the nature of the property interest before or after death. I.R.C. § 2033; Estate of Bright v. United States, 658 F.2d 999, 1001 (5th Cir. 1981) [22] (en banc). I.R.C. § 2033 provides that the gross estate shall include any partnership interest owned by a decedent as defined by I.R.C. § 7701 (a)(2). Lusthaus v. Commissioner, 327 U.S. 293, 66 S. Ct. 539, 90 L. Ed. 679 (1946); Estate of Winkler v. Commissioner,73 T.C.M. (CCH) 1657, 1997 T.C. Memo 4 (1997), I.R.C. § 2703 does not define the term "property" in any matter inconsistent with these provisions, or indeed at all, and cannot have a meaning attributed to it without Congressional authorization that would make it unique in the estate tax provisions of the Code.

9. The Government alternatively contends that if I.R.C. § 2703 does require taxation of Mrs. Church's Partnership interest, it may nonetheless disregard the term restriction, and restrictions on sale in the Partnership Agreement that serve to reduce its market value. No case supports the Government's position, and nothing in the legislative history, or the regulations adopted by the IRS itself, convince this Court to read into Section 2703 something that is not there. By its very nature, a partnership is voluntary association of those who wish [23] to engage in business together, and upon whom the law imposes fiduciary duties. Term restrictions, or those on the sale or assignment of a partnership interest that preclude partnership status for a buyer, are part and parcel of the property interest created by state law. These are not the agreements or restrictions Congress intended to reach in passing I.R.C. § 2703. Reviewing the legislative history, and construing I.R.C. § 2703 with its companion statute, I.R.C. § 2704, it is clear that the former was intended to deal with below-market buy-sell agreements and options that artificially depress the fair market value of property subject to tax, and are not inherent components of the property interest itself.

10. The Court concludes that Plaintiffs have carried their burden of proof and are entitled to the refund prayed for in the amount set out in the findings of fact.

11. Interest on the Court's judgment shall run in accordance with the provisions of 28 U.S.C. § 2411.

SIGNED and ENTERED this 18th day of January, 2000.

ORLANDO L. GARCIA

UNITED STATES DISTRICT JUDGE

Full Text of Court Cases

Estate of Dailey v. Commissioner

Case name: Estate of Dailey v Commissioner (I)
Citation: T.C. Memo 2001-263
Date of decision: October 3, 2001
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Foley
SIC: 6733 Trusts, Except Educational, Religious, and Charitable (managers)
NAICS: 525920 Trusts, Estates, and Agency Accounts
1286

Keywords: Burden of proof, Control, Estate tax, Gift tax

T.C. Memo. 2001-263

UNITED STATES TAX COURT

ESTATE OF ELMA MIDDLETON DAILEY, DECEASED, DONOR,

K. ROBERT DAILEY, II, EXECUTOR, Petitioner v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

ESTATE OF ELMA MIDDLETON DAILEY, DECEASED,

K. ROBERT DAILEY, II, EXECUTOR, Petitioner v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 6251-00, 6262-00. Filed October 3, 2001.

Harold A. Chamberlain and Michael C. Riddle, for

petitioners.

Richard T. Cummings, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FOLEY, Judge: By notices dated March 15, 2000, respondent

determined a 1992 Federal gift tax deficiency of $53,808 and

section 6651(a) addition to tax of $13,452 relating to docket No..- 2 -6251-

00, and a Federal estate tax deficiency of $143,932 relating

to docket No. 6262-00. Unless otherwise indicated, all section references are to the Internal Revenue Code as amended, and all Rule references are to the Tax Court Rules of Practice and Procedure. The issues are the valuation of certain retained and gift interests in a Family Limited Partnership (FLP) and liability for the section 6651(a) addition to tax.

FINDINGS OF FACT

When the petitions were filed, K. Robert Dailey II was a resident of Harris County, Texas, where, in 1997, his mother, Elma Middleton Dailey, had died, and Mr. Dailey had received an appointment to be her executor. On December 2, 1982, Mrs. Dailey's husband died, leaving to her, among other things, the following:

Company	Number of Shares	Value per Share	Total Value
Exxon Corp.	11,108	$33.63	$373,562
American Telephone & Telegraph Co. (AT&T)	400	65.75	26,300

On October 20, 1992, Mrs. Dailey executed a will, a Revocable Living Trust (Trust), and an Agreement of Limited Partnership (Agreement) of Elma Middleton Dailey FLP. The will provided that Mrs. Dailey's residuary estate would pass to the Trust, from which her son would receive the corpus outright. Upon execution of the Agreement, Mrs. Dailey took a 1-percent general and a 98-percent limited partnership interest,.- 3 -and Mr. Dailey received a 1-percent limited partnership interest.

On November 13, 1992, Mrs. Dailey contributed, to the FLP, 400 AT&T, 20,000 Exxon, and 895 Bell South Corp. shares. Mr. Dailey did not contribute any assets to the FLP. On December 4, 1992, the Texas Secretary of State filed the FLP's Certificate of

Limited Partnership.

On December 8, 1992, Mrs. Dailey signed a letter which stated that by "the terms of the Elma Middleton Dailey Family Limited Partnership, this letter shall be sufficient evidence of my transfer and conveyance to you of the following limited partnership interest", giving 45-, 15-, and 38-percent interests to Mr. Dailey, his wife, and the Trust, respectively. On that date, the FLP had $1,267,619, consisting of:

Company	Number of Shares	Value per Share	Total Value
Exxon Corp.	20,000	$60.19	$1,203,750
AT&T	400	47.94	19,175
Bell South	895	49.94	44,694

On March 16, 1995, Mrs. Dailey appointed Mr. Dailey as the FLP managing partner. On July 26, 1995, he replaced her as the trustee of the Trust and FLP general partner, and her 1-percent general partnership interest became a limited one.

On January 10, 1997, Mrs. Dailey died, when the FLP had $1,047,603, consisting of:.- 4 -

Company	Number of Shares	Value per Share	Total Value
Exxon Corp.	10,000	$102.88	$1,028,750
American Veterinary Corp.	1,000	10.88	10,875
Olde Money Market Fund	7,978	1.00	7,978

The FLP had substantial unrealized capital gains due to the increase in the value of the Exxon stock. On April 17, 1997, Mrs. Dailey's attorney filed, and respondent received, a gift tax return reflecting the gifts of the 45- and 15-percent limited

partnership interests to Mr. Dailey and his wife. On the gift tax return, Mrs. Dailey reported a 40-percent discount from the net asset value (NAV) of the partnership's assets.

OPINION

The FLP was validly formed pursuant to Texas law, and we do not disregard it for tax purposes. See Estate of Strangi v. Commissioner, 115 T.C. 478, 487 (2000); Knight v. Commissioner, 115 T.C. 506, 513-515 (2000).

The parties agree that, pursuant to section 7491(a), petitioners have introduced credible evidence, and respondent shall have the burden of proof, relating to the valuation issue. Fair market value is the price at which 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. Sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512-1, Gift Tax Regs. On brief, the.- 5 -estate further contends that a "hypothetical, willing buyer may only become an assignee under this Partnership Agreement and Texas law", and Mrs. Dailey "actually transferred" assignee interests, but there is "no evidence in the record before this Court regarding the fair market value of any assignee * * * interests". Article IX of the Agreement provides for "Sale of a Partner's Interest", and the Texas Revised Limited Partnership Act, Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (Vernon 1993), provides for assignments but does not prohibit sales. The plain language of Mrs. Dailey's December 8, 1992, letter states that she was transferring partnership interests pursuant to the Agreement. See Kerr v. Commissioner, 113 T.C. 449, 463-465 (1999) (rejecting donors' contention that Texas partnership transfers were mere assignments). In addition, the lack of

evidence of the value of any purported assignment supports our rejection of the estate's contention.

Mrs. Dailey gave Mr. Dailey a 1-percent limited partnership interest on formation, but the FLP had no assets on that date. Mrs. Dailey made gifts of 45- and 15-percent limited partnership interests to her son and daughter-in-law, respectively, and thus retained 39 percent in the trust at death. The parties stipulated, however, that Mrs. Dailey retained 40 percent. Respondent inexplicably does not contend that the initial 1-.- 6 -percent limited partnership interest transferred to Mr. Dailey had gift tax consequences at formation or funding.

Both parties agree that the given and retained interests were, on December 8, 1992, and January 10, 1997, worth their proportionate share of the NAV of $1,267,619 and $1,047,603 for gift and estate tax purposes, respectively. They disagree, however, about the size of the minority and marketability discounts. Both parties' experts compared the FLP to closed-end mutual funds, which trade at a discount to NAV, but disagreed on the amounts of the discounts. Petitioners' expert, citing published data, opined that the aggregate discount is 40 percent for lack of marketability, control, and liquidity and testified that he considered the significant amount of unrealized capital gains relating to the Exxon stock.

Respondent's expert, on the other hand, relied in part on an unpublished study that he coauthored and, in a revised report submitted at trial, increased the marketability discount purportedly substantiated by his unpublished study from 12.5 percent to 14.1 percent. Respondent's expert opined that an aggregate discount of 15.72 percent on December 8, 1992, and 13.51 percent on January 10, 1997, should be applied. At trial,

respondent's expert testified that he could not recall reviewing the Agreement and, although he believed that unrealized capital gains are "an important source of discounts", he did not review.- 7 -the documents to determine if the FLP had any such gains.

Respondent's expert's testimony was contradictory, unsupported by the data, and inapplicable to the facts.

We are "not bound by the opinion of any expert witness when that opinion is contrary to our own judgment." Estate of Gilford v. Commissioner, 88 T.C. 38, 56 (1987). Although neither expert was extraordinary, petitioners' expert provided a more convincing and thorough analysis than respondent's expert. We conclude that an aggregate marketability and minority discount of 40 percent is warranted and is applicable to the aforementioned interests.

Section 6651(a)(1) imposes an addition to tax for failure to file a required return on the date prescribed. This addition to tax is imposed on the amount of tax required to be shown on the return. Although decedent's gift tax return was filed after the prescribed due date, the property valuation on the return was correct and, after application of decedent's unified credit, no gift tax was due. Accordingly, the estate is not liable for the section 6651(a)(1) addition to tax.

Contentions we have not addressed are moot, irrelevant, or meritless.

To reflect the foregoing,

Decisions will be entered for petitioners.

T.C. Memo. 2006-212

UNITED STATES TAX COURT

ROBERT DALLAS, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 7493-04. Filed September 28, 2006.

John M. Elias, Peter J. Ulrich, Rita M. Danylchuk, and Laura Lavie, for petitioner.*

Wendy D. Gardner and Brian E. Derdowski, Jr., for respondent.

* Kenneth N. Laptook was substituted as counsel for John M. Elias after trial, and all briefs except respondent's response to petitioner's supplement to reply brief were filed.

MEMORANDUM FINDINGS OF FACT AND OPINION

COLVIN, Chief Judge: Respondent determined deficiencies in petitioner's gift tax of $1,715,526 for 1999 and $823,160 for 2000.[1]

Petitioner transferred about 55 percent of the nonvoting stock of the Dallas Group of America, Inc. (DGA), an S corporation the stock of which is not publicly traded, to trusts established for the benefit of his sons (the trusts) in exchange for cash and promissory notes signed by his sons. The transfers occurred on November 29, 1999 and 2000. Petitioner and his sons agreed to be bound by a value for DGA stock as estimated in a third-party appraisal. Each promissory note used to pay for the stock at issue in 1999 provides it is deemed paid if petitioner dies before it is paid. Respondent determined that the transactions were bargain sales and thus were gifts. The issues for decision are:

1. Whether the value of the DGA stock at issue on November 29, 1999, was $907 as respondent determined or $620 as petitioner contends; and whether the value of the DGA stock at issue on November 29, 2000, was $906 as respondent determined or $650 as petitioner contends. We hold that the fair market value of the

[1] Amounts are rounded to the nearest dollar.

DGA stock was $751 per share on November 29, 1999, and $801 per share on November 29, 2000.

2. Whether the value of each 1999 note was $2,232,000, as petitioner contends, or $1,687,704 as respondent determined. We hold that it was $1,687,704.

Unless otherwise specified, section references are to the Internal Revenue Code as in effect for 1999 and 2000, and Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

A. Petitioner

Petitioner resided in Whitehouse, New Jersey, when he filed the petition in this case. He was 84 years old at the time of trial.

B. Dallas Group of America

1. Reagent Chemical & Research., Inc.

In 1959, petitioner and Thomas Skeuse (Skeuse) formed Reagent Chemical & Research, Inc. (Reagent), in Texas. Reagent initially processed elemental sulfur and later distributed hydrochloric acid. In the 1970s, Reagent expanded into the ammonium chloride and magnesium silicate businesses.

2. Formation of Dallas Group of America, Inc.

In February 1989, petitioner and Skeuse decided to split their interests in Reagent. Reagent spun off its ammonium

chloride and magnesium silicate divisions to form Dallas Group of America, Inc. (DGA), the stock of which petitioner received in exchange for his interest in Reagent. DGA manufactures and distributes ammonium chloride and synthetic magnesium silicate. Its headquarters is in Whitehouse, New Jersey. It is an S corporation for Federal income tax purposes.

DGA had nonoperating assets including 79 percent of Trenton Liberty Insurance Co.,[2] Unity Bankcorp, Inc. stock, land in New Jersey, and split-dollar insurance receivables in 1999 and 2000.

3. Ammonium Chloride and Magnesium Silicate Production

In the mid-1990s, DGA sold ammonium chloride to about 130 different distributors in volumes of at least one truckload. Ammonium chloride is used as an ingredient in fertilizer, cattle feed, cough medicine, and intravenous solutions, and in personal products such as cosmetics and shampoo. It is also used in galvanizing metal, producing dry cell batteries, growing baker's yeast, and servicing oil wells. As of September 1999, DGA supplied about 90 percent of the ammonium chloride used in the United States and Canada, or 18,000 tons per year, and exported about 5,000 tons per year. About 29 percent of DGA's gross revenue from 1998 to 2000 was from sales of ammonium chloride.

[2] Trenton Liberty Insurance Co. was formed to provide product liability insurance for DGA.

DGA also manufactures synthetic magnesium silicate. DGA is the only manufacturer of synthetic magnesium silicate in the Western Hemisphere. It markets this product under the trade name Magnesol.

About 50 percent of DGA's sales of Magnesol are to fast food chains such as McDonald's (DGA's largest customer), which use Magnesol to filter frying oil from other compounds to extend the life of the frying oil. About 40 percent of DGA's sales of Magnesol are for use in the manufacture of polymers. Ten to twenty percent of DGA's sales of Magnasol are to international food services and industries. About 70 percent of DGA's gross revenue in 1999-2000 was from sales of Magnasol.

4. Financial Status and Senior Management

Petitioner chairs DGA's board. His son, Robert Dallas II (Robert), is president, his son, David Dallas (David), is chief executive officer, and John Felowitz (Felowitz) is chief financial officer and executive vice president. David has worked for Reagent or DGA since 1974, and Robert has worked for either Reagent or DGA since 1972. DGA paid petitioner and his two sons salaries and bonuses in the following amounts in 1998, 1999, and 2000:

	1998	1999	2000
Petitioner			
Salary	$873,224	$983,164	$733,229
Robert			
Salary	833,851	785,709	821,253
Bonus	250,000	--	--
David			
Salary	831,238	785,275	820,931
Bonus	250,000	--	--
Total	3,038,313	2,554,148	2,375,413

Petitioner originally owned all of DGA's series A voting stock and series B nonvoting stock. Paul Rosenberg (Rosenberg) and Steven Holt (Holt) were petitioner's estate planning counsel. They recommended that petitioner use grantor retained annuity trusts (GRATs) and an estate freeze as part of his estate plan.

In 1992, petitioner and his wife, Fay Dallas (Fay), formed two GRATs and contributed 4,100 shares of DGA's series B stock to each trust. Petitioner transferred another 7,000 shares to Fay in 1998. Fay died on January 24, 1999. At that time she owned the 7,000 shares.

Rosenberg recommended that Fay's estate retain Empire Valuation Consultants, Inc. (Empire), a business appraiser, to appraise the stock as of the date Fay died. Empire appraised the stock in a report dated October 28, 1999.

Empire used a capitalization of income approach to estimate the value of DGA stock. In doing so, Empire opined that a

reasonable buyer would assume that DGA's net income would be reduced by 40 percent due to tax-affecting.[3]

Empire also assumed that executive compensation for petitioner and his sons would be set at about $1.4 million per year, causing DGA's future annual earnings to increase. Empire applied a 15-percent discount for lack of control and a 35-percent discount for lack of marketability. Empire concluded that the fair market value of a minority interest of DGA stock was $610 per share as of January 24, 1999.

The GRATs terminated in 1999, and 4,100 shares of DGA stock were transferred to Robert and David. Also in 1999, petitioner acquired 78 additional shares of series B stock.

DGA used retained earnings to expand. DGA paid enough dividends to its shareholders (petitioner, his sons, and the trusts established for his sons) to pay income tax that resulted from dividend distributions.

[3] Generally speaking, in the context of valuation of stock of an S corporation, "tax-affecting" is the discounting of estimated future corporate earnings on the basis of assumed future tax burdens imposed on those earnings, such as from the loss of S corporation status and imposition of corporate-level tax. See Gross v. Commissioner, T.C. Memo. 1999-254, affd. 272 F.3d 333 (6th Cir. 2001); Bogdanski, Federal Tax Valuation, par. 6.03[6][e][i], at S-36-38 (2006 & Supp. 2006).

C. Stock Transfers to Petitioner's Children

1. 1999 Stock Transfers From Petitioner to His Sons

On a date not stated in the record, Rosenberg advised petitioner to transfer stock of DGA to trusts established for the benefit of his sons in exchange for cash and notes signed by his sons as trustees of the trusts for their benefit promising to pay for the stock. Petitioner wanted the notes to be deemed paid in full if he died before all payments were made.[4]

Rosenberg and Holt chose Empire to appraise DGA's series B stock to determine the price for a sale of the stock by petitioner to the trusts. Petitioner and his sons agreed that the trusts would buy the stock at the price set by Empire.

Empire prepared a report dated November 15, 1999, and sent it to Felowitz. Empire concluded that the fair market value of the series B shares was $620 as of September 30, 1999. Empire used the same methodology that it had used to appraise the DGA shares held by Fay's estate. See par. B-4, above.

On November 29, 1999, petitioner transferred 4,000 shares of series B stock to the trust established for the benefit of Robert and 4,000 shares to the trust established for the benefit of David. In return, each trust transferred to petitioner $248,000 in cash and a promissory note for $2,232,000 (collectively the

[4] If the notes were deemed prepaid when petitioner died, the value of the notes would not be included in his estate.

1999 notes), on the basis of Empire's estimate of the value of the DGA stock at issue in 1999 ($620).

Petitioner and his sons signed the sale agreements and promissory notes. The sale agreements included the following share adjustment clause:

> In the event that the value of the Shares is finally determined in any IRS proceeding to be greater than $620 per share, the number of shares purchased and sold hereunder shall be reduced to the number which is the quotient of $2,480,000 divided by the value per share determined in such proceeding. In such event, Buyer shall transfer to Seller, for no additional consideration, the number of Shares which is equal to the difference between 4,000 minus the quotient determined under this Section 1.2.

The 1999 notes[5] include the following self-canceling clause:

> In the event that Holder shall die before the Maturity Date, this note shall be deemed to have been paid, satisfied and discharged on the day before the date of the Holder's death.

In 1999, Fay's estate distributed 544 shares of series B stock to Robert and 544 shares to David.

2. 2000 Stock Transfers From Petitioner to His Sons

On November 29, 2000, Fay's estate and the trusts signed an agreement under which the estate transferred 2,956 shares of series B stock to each of the trusts, and each trust transferred to the estate $192,140 in cash and a promissory note for $1,729,260 (collectively the 2000 notes), on the basis of

[5] The maturity date of the 1999 notes is Nov. 29, 2004.

Felowitz's estimate that the stock was worth $650 per share.[6] Felowitz assumed that Empire had correctly valued DGA stock at $620 per share as of November 29, 1999, and estimated that the value had increased to $650 per share as of November 29, 2000.

The 2000 sale agreements between Fay's estate and the trusts had the following share adjustment clause:

> In the event that the value of the Shares is finally determined in any IRS proceeding to be greater than $650 per share, the number of shares purchased and sold hereunder shall be reduced to the number which is the quotient of $1,921,400 divided by the value per share determined in such proceeding. In such event, Buyer shall transfer to Seller, for no additional consideration, the number of Shares which is equal to the difference between 2,956 minus the quotient determined under this Section 1.3.

The 2000 notes did not have a self-canceling clause.

Respondent audited petitioner's 1999 gift tax return in 2001. During the audit, respondent's tax examiner told Rosenberg that the 1999 notes were self-canceling and thus were worth less than face value because the notes were canceled if the holder of the notes died before payment.

On June 21, 2001, after respondent's tax examiner told Rosenberg about the self-canceling 1999 notes, petitioner and the trustees of the trusts executed new promissory notes that were

[6] The parties do not dispute that the transfers on Nov. 29, 2000, are treated as made by petitioner because the shares of DGA transferred in the 2000 transaction would have passed to him if Fay's estate had not transferred them to the trusts.

substantially identical to the original notes except that they did not contain the self-canceling clauses.

After all of the above transactions, the 25,078 shares of series B stock were owned as follows:

Individual	Number of shares
Petitioner	1,878
Robert	4,644
David	4,644
Robert's trust	6,956
David's trust	6,956

D. Respondent's Determinations

Respondent determined: (1) The DGA stock at issue had a fair market value of $907 per share on November 29, 1999, and $906 per share on November 29, 2000; (2) each of the 1999 notes, which had a face value of $2,232,000, had a fair market value of $1,687,704; and (3) petitioner is liable for gift tax as a result of these transfers because he received consideration worth less than the fair market value of the transferred stock.

OPINION

A. Contentions of the Parties

Petitioner contends that the fact that the price paid for the DGA stock at issue in November 29, 1999, was set by Empire, an unrelated third-party appraiser, means the price was the fair market value. Petitioner also contends that testimony of his expert witnesses supports Empire's estimate of the value. Respondent disagrees with petitioner's contentions.

B. Whether the Price for the DGA Stock at Issue Was an Arm's-Length Price

Petitioner points out that the 1999 price paid for the DGA stock at issue was set by Empire and contends that the parties properly structured and documented the sales of stock at issue as arm's-length transactions, thus establishing the fair market value of the DGA stock at issue. We disagree.

Intrafamily transfers are presumed to be gifts. Frazee v. Commissioner, 98 T.C. 554, 561 (1992); Harwood v. Commissioner, 82 T.C. 239, 258 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986). While the presumption may be overcome with evidence, see, e.g., Estate of Stone v. Commissioner, T.C. Memo. 2003-309, we conclude that petitioner has not done so.

The transactions were designed by petitioner's counsel to serve petitioner's estate planning goals. The facts that payment of the 1999 notes need not have been made if petitioner had not survived until they were due[7] and that the 1999 and 2000 notes contain a share adjustment clause show that the transactions were for estate planning purposes.

Petitioner's sons were not represented by their own counsel in the transactions. Petitioner's sons did not negotiate the terms of the agreements, and while that is not dispositive, see Estate of Thompson v. Commissioner, 382 F.3d 367, 382 (3d Cir.

[7] See discussion of the self-canceling clauses below at par. D.

2004), affg. T.C. Memo. 2002-246, it is a factor suggesting the lack of arm's-length transactions in these circumstances. See Harwood v. Commissioner, supra at 259 (family transaction structured by the family accountant with no arm's-length bargaining did not overcome the family transaction presumption); cf. Estate of Stone v. Commissioner, supra (arm's-length transaction where each member of the Stone family negotiated the transaction through his or her own independent counsel).

We conclude that the prices petitioner's sons agreed to pay for the DGA stock at issue were not arm's-length prices.

C. Expert Testimony

1. Introduction

We next consider the matters disputed by the expert witnesses who testified as to the value of the DGA stock at issue. Empire and Management Planning, Inc. (MPI), each submitted an expert report for petitioner. Scott A. Nammacher (Nammacher) testified for Empire, and Robert P. Oliver (Oliver) and Joseph C. Hassan (Hassan) testified for MPI. Appraisal Economics, Inc. (AE), submitted an expert report for respondent. T. Scott Vandervliet (Vandervliet) and Joseph G. Kettell (Kettell) testified for AE.

The primary points of disagreement among the expert witnesses were: (1) Whether to decrease the assumed income stream from DGA because of tax burdens imposed on DGA or its

shareholders after the hypothetical sale (i.e., tax-affecting); (2) whether to increase DGA's assumed income stream on the assumption that DGA's executive compensation will decrease after the hypothetical sale; and (3) whether, and if so, to what extent, to apply discounts for lack of control, lack of voting power, and lack of marketability.

The following chart summarizes the positions taken in the expert reports:

	Empire (Nammacher)	MPI (Oliver, Hassan)	AE (Vandervliet, Kettell)
Valuation methods	Capitalization of income	Discounted cash flow; guideline company	Capitalization of income; guideline company; guideline transactions
Capitalization rates	15.57% for 1999	16.5% for 1999; 15.5% for 2000	16% for 1999; 15% for 2000
Tax-affecting	Reduced net earnings by 40%	Reduced net earnings by 35%	None
Executive compensation adjustment	Reduced expenses by $1.4 million for 1998; compensation adjusted 8% per year for 1994-98	None	Reduced expenses by $1.3 million for 1999, compensation adjusted 5% per year for 1994-2000
Discounts	15% minority interest and lack of control for nonoperating assets; 35% lack of marketability	40% lack of marketability; 5% lack of voting power	20% minority interest and lack of control for operating assets; 15% minority interest and lack of control for nonoperating assets; 20% lack of marketability
1999 per-share value	$620	$528	$1,004
2000 per-share value	None given	$584	$1,026

We may accept or reject expert testimony according to our own judgment, and we may be selective in deciding what parts of an expert's opinion, if any, we accept. Helvering v. Natl. Grocery Co., 304 U.S. 282, 295 (1938). In general, we found AE's report and the testimony of Vandervliet and Kettell to be more

convincing than Empire's and MPI's reports and the testimony in support of those reports. AE's report and the testimony of Vandervliet and Kettell were cogent and thorough. Vandervliet and Kettell wrote the AE report and explained it clearly. Empire's letter report was, by its terms, limited. Nammacher's testimony in support of Empire's report was unconvincing for reasons stated at paragraph C-2-b-ii, below. MPI copied portions of its report verbatim from the Empire report.

2. Tax-Affecting

a. Background

Petitioner's expert witnesses reduced DGA's projected income by 40 percent (Empire) and 35 percent (MPI) based on "tax-affecting". Empire reduced DGA's projected profits by 40 percent on the assumption that, after a sale, the corporation will lose its S corporation status.[8] See, e.g., Gross v. Commissioner, T.C. Memo. 1999-254, affd. 272 F.3d 333 (6th Cir. 2001). MPI reduced DGA's projected profits by 35 percent because a shareholder is

[8] The income of a C corporation is subject to income tax at the corporate level, and shareholders are taxed on dividends paid by a C corporation. Secs. 11, 61. In contrast, the income of an S corporation generally is not taxed at the corporate level, but is passed through to the shareholder and taxed to the shareholder when earned, whether or not the corporation pays dividends. Sec. 1366.

Nammacher's testimony suggests that Empire tax-affected DGA's earnings on the assumption that DGA would lose its S corporation status after or as a result of the hypothetical sale of its stock. Oliver testified that this is why MPI tax-affected DGA's earnings.

liable for income tax on S corporation profits even if those profits are not distributed to the shareholder.

b. Whether To Assume DGA Would Cease Being an S Corporation

Petitioner points out that DGA's S corporation election could be ended at any time. Petitioner also points out that some potential buyers (e.g., C corporations) of DGA stock are not qualified to be S corporation shareholders. See secs. 1361(b)(1), 1362(d)(2).

There is no evidence in the record that DGA expects to cease to qualify as an S corporation. DGA has a history of distributing enough earnings for shareholders to pay their individual income tax liabilities on DGA's earnings. There is no evidence that DGA intends to change its practice of distributing enough to cover individual income tax liability.[9] See Davis v.

[9] Petitioner contends that DGA's practice of distributing only enough to cover individual income tax liability distinguishes this case from Gross v. Commissioner, T.C. Memo. 1999-254, in which the corporation distributed substantially all of its income, and thus tax-affecting is appropriate here. Whether tax-affecting applies turns on valuation principles including consideration of the hypothetical willing seller and buyer, the experts, and specific facts of the case, Gross v. Commissioner, 272 F.3d at 351-352, and not necessarily on formulas and opinions proffered by an expert witness, see Anderson v. Commissioner, 250 F.2d 242, 249 (5th Cir. 1957), affg. in part and remanding in part on another ground T.C. Memo. 1956-178; Estate of Newhouse v. Commissioner, 94 T.C. 193, 217 (1990); Estate of Hall v. Commissioner, 92 T.C. 312, 338 (1989). In addition, petitioner misunderstands our analysis of the effect of a shareholder-level tax in Gross v. Commissioner, supra. Our analysis did not depend on the proportion of corporate income

(continued...)

Commissioner, 110 T.C. 530, 559 (1998). The assumptions of petitioner's witnesses that a hypothetical buyer and seller would assume without any supporting evidence that those events would occur detracts from the credibility of their opinions. See Gross v. Commissioner, 272 F.3d at 351-355.

Petitioner contends that the testimony of Oliver and Nammacher establishes that a hypothetical willing buyer would tax-affect earnings in valuing DGA stock. We disagree.

i. Oliver's Testimony

Oliver initially testified that MPI tax-affected DGA's earnings to apply C corporation tax rates and later testified that MPI reduced DGA's earnings to reflect individual income tax rates. Oliver was substantially unfamiliar with the MPI report.[10] The MPI report contained passages lifted verbatim from the Empire report. We give Oliver's testimony little weight.

[9](...continued)
distributed. We said that, in determining the present value of an expected stream of earnings, any tax-affecting to reflect the shareholder-level tax burden should be done equally (or not at all) to both the discount rate and the expected cashflows, with the result that, in either case, the present value determined would be the same. That analysis is independent of the proportion of earnings distributed.

[10] Petitioner also called Hassan, another MPI employee, as a witness. However, Hassan did not testify about tax-affecting, executive compensation, or discounts.

ii. Nammacher's Testimony

Nammacher testified that: (1) He has always tax-affected S corporation income for the past 20 years;[11] (2) an informal poll at a recent conference showed 90 to 95 percent of responding appraisers tax-affect S corporation income; (3) the American Society of Appraisers (ASA) Board of Review rejects any application for certification if the candidate submits test answers or reports for review that do not tax-affect S corporation income; (4) his experience is that all bankers, investment bankers, and business brokers use tax-affecting in estimating the value of S corporation stock; and (5) Empire uses tax-affecting in valuing S corporation stock held by employee stock ownership plans (ESOP) that it submits to the Department of Labor.

We give little weight to Nammacher's testimony about an informal poll at an unidentified conference held on a date not stated in the record. Nammacher admitted that ASA has never issued an official directive or recommendation on tax-affecting S corporations' earnings.

Nammacher's claim that ASA's Board of Review rejects test answers or reports by a candidate applying for ASA certification

[11] Nammacher's testimony about whether the tax-affecting adjustment was based on individual or corporate income tax rates was vague and suggests that Empire applied tax-affecting based on C corporation income tax rates.

which do not apply tax-affecting is unpersuasive because Kettell testified that ASA's Board of Examiners approved Kettell for ASA certification even though he submitted a report to the board that did not tax-affect S corporation income. Respondent's expert witnesses do not automatically tax-affect all S corporation earnings.

Nammacher's testimony about valuing ESOP stock for the Department of Labor is not convincing because there is no evidence that the Department of Labor's definition of value is similar to the definition of fair market value in this case.

c. Del. Open MRI Radiology Associates, P.A. v. Kessler

Petitioner contends that the reasoning in Del. Open MRI Radiology Associates, P.A. v. Kessler, 898 A.2d 290 (Del. Ch. 2006), supports application of tax-affecting in this case. We disagree. The issue in Del. Open MRI was whether the minority stockholders of Delaware Open MRI Radiology Associates, P.A., received fair value of the going concern in a merger (fair merger price). Id. at 299, 310. The court of chancery said the fair merger price had to take into account the loss of the favorable tax treatment for the S corporation shareholders. Id. at 326. The fair merger price reflected equitable considerations including the possibility that in a merger minority shareholders might be squeezed out. Id. at 311-312.

"Fair value" in minority stock appraisal cases is not equivalent to "fair market value". Swope v. Siegel-Robert, Inc., 243 F.3d 486, 492-493 (8th Cir. 2001); Union Ill. 1995 Inv. L.P. v. Union Fin. Group, Ltd., 847 A.2d 340, 355 (Del. Ch. 2003); see Cavalier Oil Corp. v. Harnett, 564 A.2d 1137 (Del. 1989); see also JPMorgan Chase & Co. v. Commissioner, 458 F.3d 564, 569 (7th Cir. 2006), affg. in part, vacating in part and remanding Bank One Corp. v. Commissioner, 120 T.C. 174 (2003). In Del. Open MRI the court of chancery used a method to estimate the fair merger price that considered the difference between the value that a stockholder of Delaware Radiology would receive in Delaware Radiology as a C corporation and the value that a stockholder would receive in Delaware Radiology as an S corporation and applied a type of tax-affecting. Id. at 327. However, the court of chancery did not decide the price that a hypothetical willing buyer would pay a hypothetical willing seller, both having reasonable knowledge of all the relevant facts and neither being under compulsion to buy or to sell that we use in this case.

d. Conclusion

We conclude that there is insufficient evidence to establish that a hypothetical buyer and seller would tax-affect DGA's earnings and that tax-affecting DGA's earnings is not appropriate.

3. Whether To Assume DGA Would Reduce Executive Compensation

Respondent contends that DGA's projected net income should be increased on the assumption that the Dallas family officers are receiving unreasonable compensation and that those amounts would be reduced voluntarily or as a result of litigation brought by a minority shareholder if a minority block of DGA shares were sold to an unrelated investor. Respondent relies on AE's report to support this position. Petitioner contends that AE is incorrect and that DGA's compensation to petitioner and his sons would not decrease after the hypothetical sale, leading to higher income for DGA.

The record does not contain the quality of factual analysis customarily used by courts in deciding whether compensation is reasonable. Further, there is nothing in the record to suggest that DGA is planning to change how it pays petitioner and his sons. See Davis v. Commissioner, 110 T.C. 530 (1998). Thus, we have no more reason to assume changes in DGA's executive compensation policies than we have to assume changes in dividend paying policies or a change in its S corporation status.[12] On this record we, unlike AE and Empire,[13] do not assume DGA's

[12] We disagree with petitioner's expert Empire on all of these points.

[13] Empire's position on executive compensation is more (continued...)

projected profits will increase as a result of reduced compensation to petitioner and his sons after the hypothetical sale of DGA stock.[14]

4. Discount for Lack of Control or Minority Interest

a. Discount for Lack of Voting Power

MPI did not apply a discount for lack of control or minority interest because it estimated the value of a minority interest of the DGA stock at issue. However, MPI applied a 5-percent discount for lack of voting power. Petitioner contends that this discount for lack of voting power is warranted because the stock at issue is nonvoting stock. Petitioner contends that nonvoting stock is worth less than a minority interest because minority shareholders could pool their votes to influence the S corporation. Any anticipation of minority shareholders' pooling

[13](...continued)
favorable to respondent than MPI's position and fairly similar to AE's position. One may ask whether respondent viewed Empire's analysis as a concession of the matter. The record makes clear that respondent did not. At the start of the trial, petitioner's counsel listed valuation matters in dispute, including the executive compensation issue. Respondent's counsel concurred that it remained in dispute. Thus, it is clear that both parties understood that the executive compensation issue remained in dispute and thus were on notice of the need to present evidence relating to that issue.

[14] We do not consider AE's guideline company and transaction methods because the application of those methods is based on an incorrect assumption that adjustments must be made for executive compensation. Thus, AE's guideline companies and transaction methods are not comparable to DGA and its methods.

their votes is speculative. We conclude that no additional discount is warranted for lack of voting power.

b. Minority Interest Discount for Nonoperating Assets

AE and Empire estimated minority interest discounts of 15 percent for nonoperating assets.[15] Petitioner does not dispute the appropriateness of a minority interest discount of 15 percent for nonoperating assets.

c. Minority Interest Discount for Operating Assets

AE applied a 20-percent minority interest discount for operating assets.[16] Petitioner contends that amount is too low because AE computed it using a formula based on a control premium, and, in estimating the control premium, AE adjusted for excessive executive compensation. We disagree. There is no indication that AE based its selection of the control premium on excessive executive compensation.

5. Discount for Lack of Marketability

Each expert concludes that some discount for lack of marketability is appropriate because there was no ready market for DGA stock on the valuation dates.

[15] MPI did not use a separate minority interest discount for nonoperating assets because MPI used a net asset value approach to value a minority interest and because MPI's method assumed that the DGA stock at issue was for a minority interest.

[16] MPI did not use a minority interest discount for operating assets because MPI's method assumed that the DGA stock at issue was for a minority interest.

Respondent defends AE's conclusion that a lack of marketability discount of 20 percent is correct. Petitioner agrees with MPI that a lack of marketability discount of 40 percent is correct. We disagree with petitioner.

MPI compiled information from Private Equity Week, a weekly newsletter, on comparable private placements in recent years and found that the mean discount for lack of marketability for restricted stock like DGA's before 1990 was 34.2 percent, from 1990 to 1997 was 20.7 percent, and from 1997 to the present has been 13 percent. MPI used the 34.2-percent discount and adjusted it to 40 percent because DGA stock had no prospect of becoming public in more than 2 years. We believe MPI should have used the discount studies from the period that includes the transactions at issue. The valuation dates are in 1999 and 2000 when, according to MPI, the median lack of marketability discount rate was 13 percent. We conclude that a 20-percent discount for lack of marketability is appropriate.

6. Conclusion as to Fair Market Value of DGA Stock

We calculated the fair market value of DGA stock as follows:[17]

[17] This computation is based on AE's capitalization of income approach adjusted for executive compensation. Earnings before interest and tax (EBIT) are adjusted by $1,300 for 1999 and $1,100 for 2000 to correct the adjustment for executive compensation. Each amount (other than percentages and number of shares) in this calculation is multiplied by one thousand.

Total Equity

	1999	2000
Net sales	$30,867	$33,225
Adjusted EBIT:		
$4,600 less $1,300 for 1999	3,300	
and $1,100 for 2000		3,500
Long-term growth rate	3%	3%
EBIT (next 12 months)	3,399	3,605
Less incremental operating working capital	(148)	(159)
Net operating cashflow for capitalization	3,251	3,446
Capitalization rate (16%-3%; 15%-3%)	13%	12%
Indicated enterprise value (excl. nonoperating assets)	25,008	28,717
Indicated enterprise value (rounded)	25,000	28,700
Plus excess working capital	1,108	623
Fair market value of business enterprise	26,108	29,323
Nonoperating assets	3,253	3,199
Total equity value	29,361	32,522
Total equity value (rounded)	29,400	32,500

Discounted Equity

Total equity value	29,400	32,500
Discounts for lack of control:		
Operating assets (20%)	(5,222)	(5,865)
Nonoperating assets (15%)	(488)	(480)
As-if freely traded value	23,690	26,155
Discount for lack of marketability (20%)	(4,738)	(5,231)
Fair market value of equity	18,952	20,924

Fair Market Value Per Share

Number of shares	25,250	25,328
Fair market value per share	751	801

The fair market value of the DGA stock at issue was $751 per share on November 29, 1999, and $801 per share on November 29, 2000.

D. Fair Market Value of the 1999 Notes

Respondent determined that the fair market value of each of the 1999 notes was $1,687,704, which is less than face value because they were self-canceling. Petitioner contends that the

value of each 1999 note was its face value of $2,232,000[18] and the self-canceling clauses should be given no effect.

Petitioner contends generally that the promissory notes used to pay for the stock were not self-canceling because they were ambiguous on that point. We disagree. The notes unambiguously provided that they were self-canceling.

Petitioner contends that we should reform the 1999 notes because inclusion of the self-canceling clauses was a drafting mistake. We disagree. Rosenberg testified that he drafted the 1999 notes and that he meant for the self-canceling clauses to require the 1999 notes to be deemed paid if petitioner died before they were paid. Holt testified that the intent of the clauses was to treat the unpaid portion of the notes as a gift from petitioner to his sons in the event of petitioner's death. Holt's testimony is corroborated by a memorandum to his file dated September 28, 1999.

Petitioner cites cases which involve typographical errors. See, e.g., Woods v. Commissioner, 92 T.C. 776 (1989); Buchine v. Commissioner, T.C. Memo. 1992-36, affd. 20 F.3d 173 (5th Cir. 1994); Atkinson v. Commissioner, T.C. Memo. 1990-37. Those cases have no bearing here because this case involves no typographical errors. Petitioner may not disavow the self-canceling clauses.

[18] Petitioner offered no evidence about the value of the 1999 notes.

They are not the result of mistake, undue influence, fraud, or duress.

We conclude on the basis of the foregoing that the self-canceling clauses must be given effect, and that the value of each of the 1999 notes is $1,687,704 as determined by respondent.[19] To reflect the foregoing,

Decision will be entered under Rule 155.

[19] In the opening brief, respondent contended that the share adjustment clauses are void because they are against public policy. Petitioner did not respond to respondent's argument. We deem this issue conceded because petitioner made no argument about it on brief. See Chevron Corp. v. Commissioner, 104 T.C. 719, 758 (1995); Remuzzi v. Commissioner, T.C. Memo. 1988-8, affd. without published opinion 867 F.2d 609 (4th Cir. 1989).

Syllabus

DAUBERT ET UX., INDIVIDUALLY AND AS GUARDIANS AD LITEM FOR DAUBERT, ET AL. *v.* MERRELL DOW PHARMACEUTICALS, INC.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 92–102. Argued March 30, 1993—Decided June 28, 1993

Petitioners, two minor children and their parents, alleged in their suit against respondent that the children's serious birth defects had been caused by the mothers' prenatal ingestion of Bendectin, a prescription drug marketed by respondent. The District Court granted respondent summary judgment based on a well-credentialed expert's affidavit concluding, upon reviewing the extensive published scientific literature on the subject, that maternal use of Bendectin has not been shown to be a risk factor for human birth defects. Although petitioners had responded with the testimony of eight other well-credentialed experts, who based their conclusion that Bendectin can cause birth defects on animal studies, chemical structure analyses, and the unpublished "reanalysis" of previously published human statistical studies, the court determined that this evidence did not meet the applicable "general acceptance" standard for the admission of expert testimony. The Court of Appeals agreed and affirmed, citing *Frye* v. *United States*, 54 App. D. C. 46, 47, 293 F. 1013, 1014, for the rule that expert opinion based on a scientific technique is inadmissible unless the technique is "generally accepted" as reliable in the relevant scientific community.

Held: The Federal Rules of Evidence, not *Frye*, provide the standard for admitting expert scientific testimony in a federal trial. Pp. 585–597.

(a) *Frye*'s "general acceptance" test was superseded by the Rules' adoption. The Rules occupy the field, *United States* v. *Abel*, 469 U. S. 45, 49, and, although the common law of evidence may serve as an aid to their application, *id.*, at 51–52, respondent's assertion that they somehow assimilated *Frye* is unconvincing. Nothing in the Rules as a whole or in the text and drafting history of Rule 702, which specifically governs expert testimony, gives any indication that "general acceptance" is a necessary precondition to the admissibility of scientific evidence. Moreover, such a rigid standard would be at odds with the Rules' liberal thrust and their general approach of relaxing the traditional barriers to "opinion" testimony. Pp. 585–589.

(b) The Rules—especially Rule 702—place appropriate limits on the admissibility of purportedly scientific evidence by assigning to the trial

Syllabus

judge the task of ensuring that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand. The reliability standard is established by Rule 702's requirement that an expert's testimony pertain to "scientific . . . knowledge," since the adjective "scientific" implies a grounding in science's methods and procedures, while the word "knowledge" connotes a body of known facts or of ideas inferred from such facts or accepted as true on good grounds. The Rule's requirement that the testimony "assist the trier of fact to understand the evidence or to determine a fact in issue" goes primarily to relevance by demanding a valid scientific connection to the pertinent inquiry as a precondition to admissibility. Pp. 589–592.

(c) Faced with a proffer of expert scientific testimony under Rule 702, the trial judge, pursuant to Rule 104(a), must make a preliminary assessment of whether the testimony's underlying reasoning or methodology is scientifically valid and properly can be applied to the facts at issue. Many considerations will bear on the inquiry, including whether the theory or technique in question can be (and has been) tested, whether it has been subjected to peer review and publication, its known or potential error rate and the existence and maintenance of standards controlling its operation, and whether it has attracted widespread acceptance within a relevant scientific community. The inquiry is a flexible one, and its focus must be solely on principles and methodology, not on the conclusions that they generate. Throughout, the judge should also be mindful of other applicable Rules. Pp. 592–595.

(d) Cross-examination, presentation of contrary evidence, and careful instruction on the burden of proof, rather than wholesale exclusion under an uncompromising "general acceptance" standard, is the appropriate means by which evidence based on valid principles may be challenged. That even limited screening by the trial judge, on occasion, will prevent the jury from hearing of authentic scientific breakthroughs is simply a consequence of the fact that the Rules are not designed to seek cosmic understanding but, rather, to resolve legal disputes. Pp. 595–597.

951 F. 2d 1128, vacated and remanded.

BLACKMUN, J., delivered the opinion for a unanimous Court with respect to Parts I and II–A, and the opinion of the Court with respect to Parts II–B, II–C, III, and IV, in which WHITE, O'CONNOR, SCALIA, KENNEDY, SOUTER, and THOMAS, JJ., joined. REHNQUIST, C. J., filed an opinion concurring in part and dissenting in part, in which STEVENS, J., joined, *post*, p. 598.

Counsel

Michael H. Gottesman argued the cause for petitioners. With him on the briefs were *Kenneth J. Chesebro*, *Barry J. Nace*, *David L. Shapiro*, and *Mary G. Gillick*.

Charles Fried argued the cause for respondent. With him on the brief were *Charles R. Nesson*, *Joel I. Klein*, *Richard G. Taranto*, *Hall R. Marston*, *George E. Berry*, *Edward H. Stratemeier*, and *W. Glenn Forrester*.*

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*Briefs of *amici curiae* urging reversal were filed for the State of Texas et al. by *Dan Morales*, Attorney General of Texas, *Mark Barnett*, Attorney General of South Dakota, *Marc Racicot*, Attorney General of Montana, *Larry EchoHawk*, Attorney General of Idaho, and *Brian Stuart Koukoutchos;* for the American Society of Law, Medicine and Ethics et al. by *Joan E. Bertin*, *Marsha S. Berzon*, and *Albert H. Meyerhoff;* for the Association of Trial Lawyers of America by *Jeffrey Robert White* and *Roxanne Barton Conlin;* for Ronald Bayer et al. by *Brian Stuart Koukoutchos*, *Priscilla Budeiri*, *Arthur Bryant*, and *George W. Conk;* and for Daryl E. Chubin et al. by *Ron Simon* and *Nicole Schultheis*.

Briefs of *amici curiae* urging affirmance were filed for the United States by *Acting Solicitor General Wallace*, *Assistant Attorney General Gerson*, *Miguel A. Estrada*, *Michael Jay Singer*, and *John P. Schnitker;* for the American Insurance Association by *William J. Kilberg*, *Paul Blankenstein*, *Bradford R. Clark*, and *Craig A. Berrington;* for the American Medical Association et al. by *Carter G. Phillips*, *Mark D. Hopson*, and *Jack R. Bierig;* for the American Tort Reform Association by *John G. Kester* and *John W. Vardaman, Jr.;* for the Chamber of Commerce of the United States by *Timothy B. Dyk*, *Stephen A. Bokat*, and *Robin S. Conrad;* for the Pharmaceutical Manufacturers Association by *Louis R. Cohen* and *Daniel Marcus;* for the Product Liability Advisory Council, Inc., et al. by *Victor E. Schwartz*, *Robert P. Charrow*, and *Paul F. Rothstein;* for the Washington Legal Foundation by *Scott G. Campbell*, *Daniel J. Popeo*, and *Richard A. Samp;* and for Nicolaas Bloembergen et al. by *Martin S. Kaufman*.

Briefs of *amici curiae* were filed for the American Association for the Advancement of Science et al. by *Richard A. Meserve* and *Bert Black;* for the American College of Legal Medicine by *Miles J. Zaremski;* for the Carnegie Commission on Science, Technology, and Government by *Steven G. Gallagher*, *Elizabeth H. Esty*, and *Margaret A. Berger;* for the Defense Research Institute, Inc., by *Joseph A. Sherman*, *E. Wayne Taff*, and *Harvey L. Kaplan;* for the New England Journal of Medicine et al. by *Michael Malina* and *Jeffrey I. D. Lewis;* for A Group of American Law Professors

JUSTICE BLACKMUN delivered the opinion of the Court.

In this case we are called upon to determine the standard for admitting expert scientific testimony in a federal trial.

I

Petitioners Jason Daubert and Eric Schuller are minor children born with serious birth defects. They and their parents sued respondent in California state court, alleging that the birth defects had been caused by the mothers' ingestion of Bendectin, a prescription antinausea drug marketed by respondent. Respondent removed the suits to federal court on diversity grounds.

After extensive discovery, respondent moved for summary judgment, contending that Bendectin does not cause birth defects in humans and that petitioners would be unable to come forward with any admissible evidence that it does. In support of its motion, respondent submitted an affidavit of Steven H. Lamm, physician and epidemiologist, who is a well-credentialed expert on the risks from exposure to various chemical substances.[1] Doctor Lamm stated that he had reviewed all the literature on Bendectin and human birth defects—more than 30 published studies involving over 130,000 patients. No study had found Bendectin to be a human teratogen (*i. e.*, a substance capable of causing malformations in fetuses). On the basis of this review, Doctor Lamm concluded that maternal use of Bendectin during the first trimester of pregnancy has not been shown to be a risk factor for human birth defects.

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by *Donald N. Bersoff;* for Alvan R. Feinstein by *Don M. Kennedy, Loretta M. Smith,* and *Richard A. Oetheimer;* and for Kenneth Rothman et al. by *Neil B. Cohen.*

[1] Doctor Lamm received his master's and doctor of medicine degrees from the University of Southern California. He has served as a consultant in birth-defect epidemiology for the National Center for Health Statistics and has published numerous articles on the magnitude of risk from exposure to various chemical and biological substances. App. 34–44.

Petitioners did not (and do not) contest this characterization of the published record regarding Bendectin. Instead, they responded to respondent's motion with the testimony of eight experts of their own, each of whom also possessed impressive credentials.[2] These experts had concluded that Bendectin can cause birth defects. Their conclusions were based upon "in vitro" (test tube) and "in vivo" (live) animal studies that found a link between Bendectin and malformations; pharmacological studies of the chemical structure of Bendectin that purported to show similarities between the structure of the drug and that of other substances known to cause birth defects; and the "reanalysis" of previously published epidemiological (human statistical) studies.

The District Court granted respondent's motion for summary judgment. The court stated that scientific evidence is admissible only if the principle upon which it is based is "'sufficiently established to have general acceptance in the field to which it belongs.'" 727 F. Supp. 570, 572 (SD Cal. 1989), quoting *United States* v. *Kilgus*, 571 F. 2d 508, 510 (CA9 1978). The court concluded that petitioners' evidence did not meet this standard. Given the vast body of epidemiological data concerning Bendectin, the court held, expert opinion which is not based on epidemiological evidence

[2] For example, Shanna Helen Swan, who received a master's degree in biostatistics from Columbia University and a doctorate in statistics from the University of California at Berkeley, is chief of the section of the California Department of Health and Services that determines causes of birth defects and has served as a consultant to the World Health Organization, the Food and Drug Administration, and the National Institutes of Health. *Id.*, at 113–114, 131–132. Stuart A. Newman, who received his bachelor's degree in chemistry from Columbia University and his master's and doctorate in chemistry from the University of Chicago, is a professor at New York Medical College and has spent over a decade studying the effect of chemicals on limb development. *Id.*, at 54–56. The credentials of the others are similarly impressive. See *id.*, at 61–66, 73–80, 148–153, 187–192, and Attachments 12, 20, 21, 26, 31, and 32 to Petitioners' Opposition to Summary Judgment in No. 84–2013–G(I) (SD Cal.).

is not admissible to establish causation. 727 F. Supp., at 575. Thus, the animal-cell studies, live-animal studies, and chemical-structure analyses on which petitioners had relied could not raise by themselves a reasonably disputable jury issue regarding causation. *Ibid.* Petitioners' epidemiological analyses, based as they were on recalculations of data in previously published studies that had found no causal link between the drug and birth defects, were ruled to be inadmissible because they had not been published or subjected to peer review. *Ibid.*

The United States Court of Appeals for the Ninth Circuit affirmed. 951 F. 2d 1128 (1991). Citing *Frye* v. *United States*, 54 App. D. C. 46, 47, 293 F. 1013, 1014 (1923), the court stated that expert opinion based on a scientific technique is inadmissible unless the technique is "generally accepted" as reliable in the relevant scientific community. 951 F. 2d, at 1129–1130. The court declared that expert opinion based on a methodology that diverges "significantly from the procedures accepted by recognized authorities in the field . . . cannot be shown to be 'generally accepted as a reliable technique.'" *Id.*, at 1130, quoting *United States* v. *Solomon*, 753 F. 2d 1522, 1526 (CA9 1985).

The court emphasized that other Courts of Appeals considering the risks of Bendectin had refused to admit reanalyses of epidemiological studies that had been neither published nor subjected to peer review. 951 F. 2d, at 1130–1131. Those courts had found unpublished reanalyses "particularly problematic in light of the massive weight of the original published studies supporting [respondent's] position, all of which had undergone full scrutiny from the scientific community." *Id.*, at 1130. Contending that reanalysis is generally accepted by the scientific community only when it is subjected to verification and scrutiny by others in the field, the Court of Appeals rejected petitioners' reanalyses as "unpublished, not subjected to the normal peer review process and generated solely for use in litigation." *Id.*, at 1131. The

court concluded that petitioners' evidence provided an insufficient foundation to allow admission of expert testimony that Bendectin caused their injuries and, accordingly, that petitioners could not satisfy their burden of proving causation at trial.

We granted certiorari, 506 U. S. 914 (1992), in light of sharp divisions among the courts regarding the proper standard for the admission of expert testimony. Compare, *e. g., United States* v. *Shorter*, 257 U. S. App. D. C. 358, 363–364, 809 F. 2d 54, 59–60 (applying the "general acceptance" standard), cert. denied, 484 U. S. 817 (1987), with *DeLuca* v. *Merrell Dow Pharmaceuticals, Inc.*, 911 F. 2d 941, 955 (CA3 1990) (rejecting the "general acceptance" standard).

II

A

In the 70 years since its formulation in the *Frye* case, the "general acceptance" test has been the dominant standard for determining the admissibility of novel scientific evidence at trial. See E. Green & C. Nesson, Problems, Cases, and Materials on Evidence 649 (1983). Although under increasing attack of late, the rule continues to be followed by a majority of courts, including the Ninth Circuit.[3]

The *Frye* test has its origin in a short and citation-free 1923 decision concerning the admissibility of evidence derived from a systolic blood pressure deception test, a crude precursor to the polygraph machine. In what has become a famous (perhaps infamous) passage, the then Court of Appeals for the District of Columbia described the device and its operation and declared:

> "Just when a scientific principle or discovery crosses the line between the experimental and demonstrable stages

[3] For a catalog of the many cases on either side of this controversy, see P. Giannelli & E. Imwinkelried, Scientific Evidence § 1–5, pp. 10–14 (1986 and Supp. 1991).

> is difficult to define. Somewhere in this twilight zone the evidential force of the principle must be recognized, and while courts will go a long way in admitting expert testimony deduced from a well-recognized scientific principle or discovery, *the thing from which the deduction is made must be sufficiently established to have gained general acceptance in the particular field in which it belongs.*" 54 App. D. C., at 47, 293 F., at 1014 (emphasis added).

Because the deception test had "not yet gained such standing and scientific recognition among physiological and psychological authorities as would justify the courts in admitting expert testimony deduced from the discovery, development, and experiments thus far made," evidence of its results was ruled inadmissible. *Ibid.*

The merits of the *Frye* test have been much debated, and scholarship on its proper scope and application is legion.[4]

[4] See, *e. g.*, Green, Expert Witnesses and Sufficiency of Evidence in Toxic Substances Litigation: The Legacy of *Agent Orange* and Bendectin Litigation, 86 Nw. U. L. Rev. 643 (1992) (hereinafter Green); Becker & Orenstein, The Federal Rules of Evidence After Sixteen Years—The Effect of "Plain Meaning" Jurisprudence, the Need for an Advisory Committee on the Rules of Evidence, and Suggestions for Selective Revision of the Rules, 60 Geo. Wash. L. Rev. 857, 876–885 (1992); Hanson, James Alphonzo Frye is Sixty-Five Years Old; Should He Retire?, 16 West. St. U. L. Rev. 357 (1989); Black, A Unified Theory of Scientific Evidence, 56 Ford. L. Rev. 595 (1988); Imwinkelried, The "Bases" of Expert Testimony: The Syllogistic Structure of Scientific Testimony, 67 N. C. L. Rev. 1 (1988); Proposals for a Model Rule on the Admissibility of Scientific Evidence, 26 Jurimetrics J. 235 (1986); Giannelli, The Admissibility of Novel Scientific Evidence: *Frye* v. *United States*, a Half-Century Later, 80 Colum. L. Rev. 1197 (1980); The Supreme Court, 1986 Term, 101 Harv. L. Rev. 7, 119, 125–127 (1987).

Indeed, the debates over *Frye* are such a well-established part of the academic landscape that a distinct term—"*Frye*-ologist"—has been advanced to describe those who take part. See Behringer, Introduction, Proposals for a Model Rule on the Admissibility of Scientific Evidence, 26 Jurimetrics J. 237, 239 (1986), quoting Lacey, Scientific Evidence, 24 Jurimetrics J. 254, 264 (1984).

Petitioners' primary attack, however, is not on the content but on the continuing authority of the rule. They contend that the *Frye* test was superseded by the adoption of the Federal Rules of Evidence.[5] We agree.

We interpret the legislatively enacted Federal Rules of Evidence as we would any statute. *Beech Aircraft Corp.* v. *Rainey*, 488 U. S. 153, 163 (1988). Rule 402 provides the baseline:

> "All relevant evidence is admissible, except as otherwise provided by the Constitution of the United States, by Act of Congress, by these rules, or by other rules prescribed by the Supreme Court pursuant to statutory authority. Evidence which is not relevant is not admissible."

"Relevant evidence" is defined as that which has "any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Rule 401. The Rules' basic standard of relevance thus is a liberal one.

Frye, of course, predated the Rules by half a century. In *United States* v. *Abel*, 469 U. S. 45 (1984), we considered the pertinence of background common law in interpreting the Rules of Evidence. We noted that the Rules occupy the field, *id.*, at 49, but, quoting Professor Cleary, the Reporter,

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[5] Like the question of *Frye*'s merit, the dispute over its survival has divided courts and commentators. Compare, *e. g.*, *United States* v. *Williams*, 583 F. 2d 1194 (CA2 1978) (*Frye* is superseded by the Rules of Evidence), cert. denied, 439 U. S. 1117 (1979), with *Christophersen* v. *Allied-Signal Corp.*, 939 F. 2d 1106, 1111, 1115–1116 (CA5 1991) (en banc) (*Frye* and the Rules coexist), cert. denied, 503 U. S. 912 (1992), 3 J. Weinstein & M. Berger, Weinstein's Evidence ¶ 702[03], pp. 702–36 to 702–37 (1988) (hereinafter Weinstein & Berger) (*Frye* is dead), and M. Graham, Handbook of Federal Evidence § 703.2 (3d ed. 1991) (*Frye* lives). See generally P. Giannelli & E. Imwinkelried, Scientific Evidence § 1–5, at 28–29 (citing authorities).

explained that the common law nevertheless could serve as an aid to their application:

> "'In principle, under the Federal Rules no common law of evidence remains. "All relevant evidence is admissible, except as otherwise provided . . . ." In reality, of course, the body of common law knowledge continues to exist, though in the somewhat altered form of a source of guidance in the exercise of delegated powers.'" *Id.*, at 51–52.

We found the common-law precept at issue in the *Abel* case entirely consistent with Rule 402's general requirement of admissibility, and considered it unlikely that the drafters had intended to change the rule. *Id.*, at 50–51. In *Bourjaily* v. *United States*, 483 U. S. 171 (1987), on the other hand, the Court was unable to find a particular common-law doctrine in the Rules, and so held it superseded.

Here there is a specific Rule that speaks to the contested issue. Rule 702, governing expert testimony, provides:

> "If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise."

Nothing in the text of this Rule establishes "general acceptance" as an absolute prerequisite to admissibility. Nor does respondent present any clear indication that Rule 702 or the Rules as a whole were intended to incorporate a "general acceptance" standard. The drafting history makes no mention of *Frye*, and a rigid "general acceptance" requirement would be at odds with the "liberal thrust" of the Federal Rules and their "general approach of relaxing the traditional barriers to 'opinion' testimony." *Beech Aircraft Corp.* v. *Rainey*, 488 U. S., at 169 (citing Rules 701 to 705). See also Weinstein, Rule 702 of the Federal Rules of Evidence is

Sound; It Should Not Be Amended, 138 F. R. D. 631 (1991) ("The Rules were designed to depend primarily upon lawyer-adversaries and sensible triers of fact to evaluate conflicts"). Given the Rules' permissive backdrop and their inclusion of a specific rule on expert testimony that does not mention "general acceptance," the assertion that the Rules somehow assimilated *Frye* is unconvincing. *Frye* made "general acceptance" the exclusive test for admitting expert scientific testimony. That austere standard, absent from, and incompatible with, the Federal Rules of Evidence, should not be applied in federal trials.[6]

B

That the *Frye* test was displaced by the Rules of Evidence does not mean, however, that the Rules themselves place no limits on the admissibility of purportedly scientific evidence.[7] Nor is the trial judge disabled from screening such evidence. To the contrary, under the Rules the trial judge must ensure that any and all scientific testimony or evidence admitted is not only relevant, but reliable.

The primary locus of this obligation is Rule 702, which clearly contemplates some degree of regulation of the subjects and theories about which an expert may testify. "*If scientific*, technical, or other specialized *knowledge will assist the trier of fact* to understand the evidence or to determine a fact in issue" an expert "may testify *thereto*." (Emphasis added.) The subject of an expert's testimony must

[6] Because we hold that *Frye* has been superseded and base the discussion that follows on the content of the congressionally enacted Federal Rules of Evidence, we do not address petitioners' argument that application of the *Frye* rule in this diversity case, as the application of a judge-made rule affecting substantive rights, would violate the doctrine of *Erie R. Co.* v. *Tompkins*, 304 U. S. 64 (1938).

[7] THE CHIEF JUSTICE "do[es] not doubt that Rule 702 confides to the judge some gatekeeping responsibility," *post*, at 600, but would neither say how it does so nor explain what that role entails. We believe the better course is to note the nature and source of the duty.

be "scientific . . . knowledge."[8] The adjective "scientific" implies a grounding in the methods and procedures of science. Similarly, the word "knowledge" connotes more than subjective belief or unsupported speculation. The term "applies to any body of known facts or to any body of ideas inferred from such facts or accepted as truths on good grounds." Webster's Third New International Dictionary 1252 (1986). Of course, it would be unreasonable to conclude that the subject of scientific testimony must be "known" to a certainty; arguably, there are no certainties in science. See, *e. g.*, Brief for Nicolaas Bloembergen et al. as *Amici Curiae* 9 ("Indeed, scientists do not assert that they know what is immutably 'true'—they are committed to searching for new, temporary, theories to explain, as best they can, phenomena"); Brief for American Association for the Advancement of Science et al. as *Amici Curiae* 7–8 ("Science is not an encyclopedic body of knowledge about the universe. Instead, it represents a *process* for proposing and refining theoretical explanations about the world that are subject to further testing and refinement" (emphasis in original)). But, in order to qualify as "scientific knowledge," an inference or assertion must be derived by the scientific method. Proposed testimony must be supported by appropriate validation—*i. e.*, "good grounds," based on what is known. In short, the requirement that an expert's testimony pertain to "scientific knowledge" establishes a standard of evidentiary reliability.[9]

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[8] Rule 702 also applies to "technical, or other specialized knowledge." Our discussion is limited to the scientific context because that is the nature of the expertise offered here.

[9] We note that scientists typically distinguish between "validity" (does the principle support what it purports to show?) and "reliability" (does application of the principle produce consistent results?). See Black, 56 Ford. L. Rev., at 599. Although "the difference between accuracy, validity, and reliability may be such that each is distinct from the other by no more than a hen's kick," Starrs, *Frye v. United States* Restructured and Revitalized: A Proposal to Amend Federal Evidence Rule 702, 26 Jurimet-

Rule 702 further requires that the evidence or testimony "assist the trier of fact to understand the evidence or to determine a fact in issue." This condition goes primarily to relevance. "Expert testimony which does not relate to any issue in the case is not relevant and, ergo, non-helpful." 3 Weinstein & Berger ¶ 702[02], p. 702–18. See also *United States* v. *Downing*, 753 F. 2d 1224, 1242 (CA3 1985) ("An additional consideration under Rule 702—and another aspect of relevancy—is whether expert testimony proffered in the case is sufficiently tied to the facts of the case that it will aid the jury in resolving a factual dispute"). The consideration has been aptly described by Judge Becker as one of "fit." *Ibid.* "Fit" is not always obvious, and scientific validity for one purpose is not necessarily scientific validity for other, unrelated purposes. See Starrs, *Frye v. United States* Restructured and Revitalized: A Proposal to Amend Federal Evidence Rule 702, 26 Jurimetrics J. 249, 258 (1986). The study of the phases of the moon, for example, may provide valid scientific "knowledge" about whether a certain night was dark, and if darkness is a fact in issue, the knowledge will assist the trier of fact. However (absent creditable grounds supporting such a link), evidence that the moon was full on a certain night will not assist the trier of fact in determining whether an individual was unusually likely to have behaved irrationally on that night. Rule 702's "helpfulness"

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rics J. 249, 256 (1986), our reference here is to *evidentiary* reliability—that is, trustworthiness. Cf., *e. g.,* Advisory Committee's Notes on Fed. Rule Evid. 602, 28 U. S. C. App., p. 755 (" '[T]he rule requiring that a witness who testifies to a fact which can be perceived by the senses must have had an opportunity to observe, and must have actually observed the fact' is a 'most pervasive manifestation' of the common law insistence upon 'the most reliable sources of information' " (citation omitted)); Advisory Committee's Notes on Art. VIII of Rules of Evidence, 28 U. S. C. App., p. 770 (hearsay exceptions will be recognized only "under circumstances supposed to furnish guarantees of trustworthiness"). In a case involving scientific evidence, *evidentiary reliability* will be based upon *scientific validity.*

standard requires a valid scientific connection to the pertinent inquiry as a precondition to admissibility.

That these requirements are embodied in Rule 702 is not surprising. Unlike an ordinary witness, see Rule 701, an expert is permitted wide latitude to offer opinions, including those that are not based on firsthand knowledge or observation. See Rules 702 and 703. Presumably, this relaxation of the usual requirement of firsthand knowledge—a rule which represents "a 'most pervasive manifestation' of the common law insistence upon 'the most reliable sources of information,'" Advisory Committee's Notes on Fed. Rule Evid. 602, 28 U. S. C. App., p. 755 (citation omitted)—is premised on an assumption that the expert's opinion will have a reliable basis in the knowledge and experience of his discipline.

C

Faced with a proffer of expert scientific testimony, then, the trial judge must determine at the outset, pursuant to Rule 104(a),[10] whether the expert is proposing to testify to (1) scientific knowledge that (2) will assist the trier of fact to understand or determine a fact in issue.[11] This entails a preliminary assessment of whether the reasoning or method-

[10] Rule 104(a) provides:

"Preliminary questions concerning the qualification of a person to be a witness, the existence of a privilege, or the admissibility of evidence shall be determined by the court, subject to the provisions of subdivision (b) [pertaining to conditional admissions]. In making its determination it is not bound by the rules of evidence except those with respect to privileges." These matters should be established by a preponderance of proof. See *Bourjaily* v. *United States*, 483 U. S. 171, 175–176 (1987).

[11] Although the *Frye* decision itself focused exclusively on "novel" scientific techniques, we do not read the requirements of Rule 702 to apply specially or exclusively to unconventional evidence. Of course, well-established propositions are less likely to be challenged than those that are novel, and they are more handily defended. Indeed, theories that are so firmly established as to have attained the status of scientific law, such as the laws of thermodynamics, properly are subject to judicial notice under Federal Rule of Evidence 201.

ology underlying the testimony is scientifically valid and of whether that reasoning or methodology properly can be applied to the facts in issue. We are confident that federal judges possess the capacity to undertake this review. Many factors will bear on the inquiry, and we do not presume to set out a definitive checklist or test. But some general observations are appropriate.

Ordinarily, a key question to be answered in determining whether a theory or technique is scientific knowledge that will assist the trier of fact will be whether it can be (and has been) tested. "Scientific methodology today is based on generating hypotheses and testing them to see if they can be falsified; indeed, this methodology is what distinguishes science from other fields of human inquiry." Green 645. See also C. Hempel, Philosophy of Natural Science 49 (1966) ("[T]he statements constituting a scientific explanation must be capable of empirical test"); K. Popper, Conjectures and Refutations: The Growth of Scientific Knowledge 37 (5th ed. 1989) ("[T]he criterion of the scientific status of a theory is its falsifiability, or refutability, or testability") (emphasis deleted).

Another pertinent consideration is whether the theory or technique has been subjected to peer review and publication. Publication (which is but one element of peer review) is not a *sine qua non* of admissibility; it does not necessarily correlate with reliability, see S. Jasanoff, The Fifth Branch: Science Advisors as Policymakers 61–76 (1990), and in some instances well-grounded but innovative theories will not have been published, see Horrobin, The Philosophical Basis of Peer Review and the Suppression of Innovation, 263 JAMA 1438 (1990). Some propositions, moreover, are too particular, too new, or of too limited interest to be published. But submission to the scrutiny of the scientific community is a component of "good science," in part because it increases the likelihood that substantive flaws in methodology will be detected. See J. Ziman, Reliable Knowledge: An Exploration

of the Grounds for Belief in Science 130–133 (1978); Relman & Angell, How Good Is Peer Review?, 321 New Eng. J. Med. 827 (1989). The fact of publication (or lack thereof) in a peer reviewed journal thus will be a relevant, though not dispositive, consideration in assessing the scientific validity of a particular technique or methodology on which an opinion is premised.

Additionally, in the case of a particular scientific technique, the court ordinarily should consider the known or potential rate of error, see, *e. g.*, *United States* v. *Smith*, 869 F. 2d 348, 353–354 (CA7 1989) (surveying studies of the error rate of spectrographic voice identification technique), and the existence and maintenance of standards controlling the technique's operation, see *United States* v. *Williams*, 583 F. 2d 1194, 1198 (CA2 1978) (noting professional organization's standard governing spectrographic analysis), cert. denied, 439 U. S. 1117 (1979).

Finally, "general acceptance" can yet have a bearing on the inquiry. A "reliability assessment does not require, although it does permit, explicit identification of a relevant scientific community and an express determination of a particular degree of acceptance within that community." *United States* v. *Downing*, 753 F. 2d, at 1238. See also 3 Weinstein & Berger ¶ 702[03], pp. 702–41 to 702–42. Widespread acceptance can be an important factor in ruling particular evidence admissible, and "a known technique which has been able to attract only minimal support within the community," *Downing*, 753 F. 2d, at 1238, may properly be viewed with skepticism.

The inquiry envisioned by Rule 702 is, we emphasize, a flexible one.[12] Its overarching subject is the scientific valid-

[12] A number of authorities have presented variations on the reliability approach, each with its own slightly different set of factors. See, *e. g.*, *Downing*, 753 F. 2d, at 1238–1239 (on which our discussion draws in part); 3 Weinstein & Berger ¶ 702[03], pp. 702–41 to 702–42 (on which the *Downing* court in turn partially relied); McCormick, Scientific Evidence: Defin-

ity—and thus the evidentiary relevance and reliability—of the principles that underlie a proposed submission. The focus, of course, must be solely on principles and methodology, not on the conclusions that they generate.

Throughout, a judge assessing a proffer of expert scientific testimony under Rule 702 should also be mindful of other applicable rules. Rule 703 provides that expert opinions based on otherwise inadmissible hearsay are to be admitted only if the facts or data are "of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject." Rule 706 allows the court at its discretion to procure the assistance of an expert of its own choosing. Finally, Rule 403 permits the exclusion of relevant evidence "if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury . . . ." Judge Weinstein has explained: "Expert evidence can be both powerful and quite misleading because of the difficulty in evaluating it. Because of this risk, the judge in weighing possible prejudice against probative force under Rule 403 of the present rules exercises more control over experts than over lay witnesses." Weinstein, 138 F. R. D., at 632.

III

We conclude by briefly addressing what appear to be two underlying concerns of the parties and *amici* in this case. Respondent expresses apprehension that abandonment of "general acceptance" as the exclusive requirement for admission will result in a "free-for-all" in which befuddled juries are confounded by absurd and irrational pseudoscientific as-

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ing a New Approach to Admissibility, 67 Iowa L. Rev. 879, 911–912 (1982); and Symposium on Science and the Rules of Evidence, 99 F. R. D. 187, 231 (1983) (statement by Margaret Berger). To the extent that they focus on the reliability of evidence as ensured by the scientific validity of its underlying principles, all these versions may well have merit, although we express no opinion regarding any of their particular details.

sertions. In this regard respondent seems to us to be overly pessimistic about the capabilities of the jury and of the adversary system generally. Vigorous cross-examination, presentation of contrary evidence, and careful instruction on the burden of proof are the traditional and appropriate means of attacking shaky but admissible evidence. See *Rock* v. *Arkansas*, 483 U. S. 44, 61 (1987). Additionally, in the event the trial court concludes that the scintilla of evidence presented supporting a position is insufficient to allow a reasonable juror to conclude that the position more likely than not is true, the court remains free to direct a judgment, Fed. Rule Civ. Proc. 50(a), and likewise to grant summary judgment, Fed. Rule Civ. Proc. 56. Cf., *e. g.*, *Turpin* v. *Merrell Dow Pharmaceuticals, Inc.*, 959 F. 2d 1349 (CA6) (holding that scientific evidence that provided foundation for expert testimony, viewed in the light most favorable to plaintiffs, was not sufficient to allow a jury to find it more probable than not that defendant caused plaintiff's injury), cert. denied, 506 U. S. 826 (1992); *Brock* v. *Merrell Dow Pharmaceuticals, Inc.*, 874 F. 2d 307 (CA5 1989) (reversing judgment entered on jury verdict for plaintiffs because evidence regarding causation was insufficient), modified, 884 F. 2d 166 (CA5 1989), cert. denied, 494 U. S. 1046 (1990); Green 680–681. These conventional devices, rather than wholesale exclusion under an uncompromising "general acceptance" test, are the appropriate safeguards where the basis of scientific testimony meets the standards of Rule 702.

Petitioners and, to a greater extent, their *amici* exhibit a different concern. They suggest that recognition of a screening role for the judge that allows for the exclusion of "invalid" evidence will sanction a stifling and repressive scientific orthodoxy and will be inimical to the search for truth. See, *e. g.*, Brief for Ronald Bayer et al. as *Amici Curiae*. It is true that open debate is an essential part of both legal and scientific analyses. Yet there are important differences between the quest for truth in the courtroom and the quest

for truth in the laboratory. Scientific conclusions are subject to perpetual revision. Law, on the other hand, must resolve disputes finally and quickly. The scientific project is advanced by broad and wide-ranging consideration of a multitude of hypotheses, for those that are incorrect will eventually be shown to be so, and that in itself is an advance. Conjectures that are probably wrong are of little use, however, in the project of reaching a quick, final, and binding legal judgment—often of great consequence—about a particular set of events in the past. We recognize that, in practice, a gatekeeping role for the judge, no matter how flexible, inevitably on occasion will prevent the jury from learning of authentic insights and innovations. That, nevertheless, is the balance that is struck by Rules of Evidence designed not for the exhaustive search for cosmic understanding but for the particularized resolution of legal disputes.[13]

IV

To summarize: "General acceptance" is not a necessary precondition to the admissibility of scientific evidence under the Federal Rules of Evidence, but the Rules of Evidence—especially Rule 702—do assign to the trial judge the task of ensuring that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand. Pertinent evidence based on scientifically valid principles will satisfy those demands.

The inquiries of the District Court and the Court of Appeals focused almost exclusively on "general acceptance," as gauged by publication and the decisions of other courts. Ac-

[13] This is not to say that judicial interpretation, as opposed to adjudicative factfinding, does not share basic characteristics of the scientific endeavor: "The work of a judge is in one sense enduring and in another ephemeral. . . . In the endless process of testing and retesting, there is a constant rejection of the dross and a constant retention of whatever is pure and sound and fine." B. Cardozo, The Nature of the Judicial Process 178–179 (1921).

cordingly, the judgment of the Court of Appeals is vacated, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

CHIEF JUSTICE REHNQUIST, with whom JUSTICE STEVENS joins, concurring in part and dissenting in part.

The petition for certiorari in this case presents two questions: first, whether the rule of *Frye* v. *United States*, 54 App. D. C. 46, 293 F. 1013 (1923), remains good law after the enactment of the Federal Rules of Evidence; and second, if *Frye* remains valid, whether it requires expert scientific testimony to have been subjected to a peer review process in order to be admissible. The Court concludes, correctly in my view, that the *Frye* rule did not survive the enactment of the Federal Rules of Evidence, and I therefore join Parts I and II–A of its opinion. The second question presented in the petition for certiorari necessarily is mooted by this holding, but the Court nonetheless proceeds to construe Rules 702 and 703 very much in the abstract, and then offers some "general observations." *Ante*, at 593.

"General observations" by this Court customarily carry great weight with lower federal courts, but the ones offered here suffer from the flaw common to most such observations—they are not applied to deciding whether particular testimony was or was not admissible, and therefore they tend to be not only general, but vague and abstract. This is particularly unfortunate in a case such as this, where the ultimate legal question depends on an appreciation of one or more bodies of knowledge not judicially noticeable, and subject to different interpretations in the briefs of the parties and their *amici*. Twenty-two *amicus* briefs have been filed in the case, and indeed the Court's opinion contains no fewer than 37 citations to *amicus* briefs and other secondary sources.

The various briefs filed in this case are markedly different from typical briefs, in that large parts of them do not deal with decided cases or statutory language—the sort of material we customarily interpret. Instead, they deal with definitions of scientific knowledge, scientific method, scientific validity, and peer review—in short, matters far afield from the expertise of judges. This is not to say that such materials are not useful or even necessary in deciding how Rule 702 should be applied; but it is to say that the unusual subject matter should cause us to proceed with great caution in deciding more than we have to, because our reach can so easily exceed our grasp.

But even if it were desirable to make "general observations" not necessary to decide the questions presented, I cannot subscribe to some of the observations made by the Court. In Part II–B, the Court concludes that reliability and relevancy are the touchstones of the admissibility of expert testimony. *Ante,* at 590–592. Federal Rule of Evidence 402 provides, as the Court points out, that "[e]vidence which is not relevant is not admissible." But there is no similar reference in the Rule to "reliability." The Court constructs its argument by parsing the language "[i]f scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, . . . an expert . . . may testify thereto . . . ." Fed. Rule Evid. 702. It stresses that the subject of the expert's testimony must be "scientific . . . knowledge," and points out that "scientific" "implies a grounding in the methods and procedures of science" and that the word "knowledge" "connotes more than subjective belief or unsupported speculation." *Ante,* at 590. From this it concludes that "scientific knowledge" must be "derived by the scientific method." *Ibid.* Proposed testimony, we are told, must be supported by "appropriate validation." *Ibid.* Indeed, in footnote 9, the Court decides that "[i]n a case involving scientific evidence, *eviden-*

tiary reliability will be based upon *scientific validity.*" *Ante*, at 591, n. 9 (emphasis in original).

Questions arise simply from reading this part of the Court's opinion, and countless more questions will surely arise when hundreds of district judges try to apply its teaching to particular offers of expert testimony. Does all of this *dicta* apply to an expert seeking to testify on the basis of "technical or other specialized knowledge"—the other types of expert knowledge to which Rule 702 applies—or are the "general observations" limited only to "scientific knowledge"? What is the difference between scientific knowledge and technical knowledge; does Rule 702 actually contemplate that the phrase "scientific, technical, or other specialized knowledge" be broken down into numerous subspecies of expertise, or did its authors simply pick general descriptive language covering the sort of expert testimony which courts have customarily received? The Court speaks of its confidence that federal judges can make a "preliminary assessment of whether the reasoning or methodology underlying the testimony is scientifically valid and of whether that reasoning or methodology properly can be applied to the facts in issue." *Ante*, at 592–593. The Court then states that a "key question" to be answered in deciding whether something is "scientific knowledge" "will be whether it can be (and has been) tested." *Ante*, at 593. Following this sentence are three quotations from treatises, which not only speak of empirical testing, but one of which states that the "'criterion of the scientific status of a theory is its falsifiability, or refutability, or testability.'" *Ibid.*

I defer to no one in my confidence in federal judges; but I am at a loss to know what is meant when it is said that the scientific status of a theory depends on its "falsifiability," and I suspect some of them will be, too.

I do not doubt that Rule 702 confides to the judge some gatekeeping responsibility in deciding questions of the admissibility of proffered expert testimony. But I do not think

it imposes on them either the obligation or the authority to become amateur scientists in order to perform that role. I think the Court would be far better advised in this case to decide only the questions presented, and to leave the further development of this important area of the law to future cases.

110 T.C. No. 35

UNITED STATES TAX COURT

ESTATE OF ARTEMUS D. DAVIS, DECEASED, ROBERT D. DAVIS, PERSONAL REPRESENTATIVE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9337-96. Filed June 30, 1998.

Held: In determining the fair market value on a valuation date after the repeal of the doctrine established in General Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935), of each of two minority blocks of common stock of company A, the Court is not precluded on the record presented from giving consideration to A's built-in capital gains tax as of that date of about $26.7 million. Held, further, the fair market value on the valuation date of each block of stock at issue is $10,338,725, determined by first ascertaining A's net asset value on that date without regard to any discount or adjustment attributable to blockage and/or 17 C.F.R. sec. 230.144 (1992) or A's built-in capital gains tax, reducing that value by a 15-percent minority discount to which the parties agree, and reducing the resulting value by a lack-of-marketability discount of $28 million which the Court arrived at by giving consideration to, inter alia, A's built-in capital gains tax and including as part of that discount $9 million attributable to such tax.

Gregory V. Nelson, John W. Porter, and Richard A. Husseini, for petitioner.

Victoria J. Sherlock, Norman N. Pickett, and Harve M. Lewis, for respondent.

CHIECHI, Judge: Respondent determined a deficiency of $5,283,894 in the Federal gift tax of Artemus D. Davis (decedent) who died on June 11, 1995, after he made the two gifts to which that deficiency pertains. The sole issue for decision is the fair market value on November 2, 1992, of each of two blocks of 25 shares of common stock of A.D.D. Investment and Cattle Company (ADDI&C), one of which decedent gave to his son Robert D. Davis (Robert Davis) and the other of which decedent gave to his son Lee W. Davis (Lee Davis).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

Decedent, who was one of the founders of Winn-Dixie Stores, Inc. (Winn-Dixie), died testate on June 11, 1995, while he was a legal resident of Florida. Robert Davis, the personal representative of decedent's estate, resided in Jacksonville, Florida, at the time the petition was filed.

On or about November 2, 1992 (the valuation date), ADDI&C, a closely held Florida corporation that was incorporated on December 22, 1947, had a total of 97 shares of common stock issued and outstanding, all of which were owned by a trust (Davis

trust) for the benefit of decedent and none of which was subject to any restrictive sale provisions or buy-sell agreements. On the valuation date, decedent transferred 25 shares of such stock to his son Robert Davis and 25 shares of such stock to his son Lee Davis. On that date, each of those two blocks of ADDI&C common stock constituted 25.77 percent of the issued and outstanding common stock of ADDI&C.

As of the valuation date, ADDI&C was primarily a holding company for various assets of decedent, although ADDI&C also had certain cattle operations (both feeder and breeding cattle) as of that date. Specifically, on the valuation date, ADDI&C owned 1,020,666 shares, or 1.328 percent, of the issued and outstanding common stock of Winn-Dixie, which was at all relevant times traded on the New York Stock Exchange (NYSE); 3,456 shares, or .0737 percent, of the issued and outstanding common stock of D.D.I., Inc. (DDI), which was a holding company for various assets of decedent and his family and the stock of which was at all relevant times not publicly traded; various feeder and breeding cattle; certain equipment; and certain other unidentified assets.

As of the valuation date, ADDI&C's management group consisted of the following individuals who were serving in the positions indicated: Artemus D. Davis, chairman of the board of directors, president, and director; James E. Davis, executive

vice president and director; Robert Davis, vice president, assistant secretary, and director; H. J. Skelton, vice president, treasurer, and director; Harry D. Francis, vice president and assistant secretary; and G. P. Bishop, Jr., secretary and assistant treasurer.

On or before the valuation date, decedent, James E. Davis, and Robert Davis were directors of Winn-Dixie. For the 12-month period prior to the valuation date, the average daily trading volume of Winn-Dixie stock was 47,400 shares. For the 4-week period prior to the valuation date, the average weekly trading volume of Winn-Dixie stock was 310,675 shares.

As of the valuation date, decedent, ADDI&C, and the Davis trust were affiliates within the meaning and for purposes of 17 C.F.R. sec. 230.144 (1992)[1] with respect to the sale of Winn-Dixie stock. Pursuant to SEC rule 144, shares of Winn-Dixie stock held by affiliates were subject to certain restrictions, including restrictions on the sale of such shares prescribed by SEC rule 144(e)(1).

ADDI&C received the following dividends during its fiscal years ended October 31, 1988, 1989, 1990, 1991, and 1992:

[1] We shall refer to 17 C.F.R. sec. 230.144 (1992), which was promulgated by the Securities and Exchange Commission (SEC), as SEC rule 144. All references to SEC rule 144 are to the Code of Federal Regulations in effect on the valuation date.

Fiscal Year Ended October 31	Dividends Received
1988	$888,330
1989	996,584
1990	1,044,926
1991	1,145,370
1992	1,272,699

Over $1.2 million of the dividends that ADDI&C received during its fiscal year ended October 31, 1992, were dividends received on the Winn-Dixie stock that it owned.

DDI declared and paid dividends with respect to all of its issued and outstanding stock, including the shares of such stock owned by ADDI&C, in the following aggregate amounts during its fiscal years ended November 30, 1989, 1990, 1991, 1992:

Fiscal Year Ended November 30	Aggregate Dividends Paid
1989	$21,093,694
1990	21,796,815
1991	23,437,435
1992	23,906,184

Subject to the caveats stated below, the following table shows as of the valuation date ADDI&C's assets and liabilities, the historical cost basis and the fair market value of each such asset, and ADDI&C's net asset value:

Asset	Historical Cost Basis	Fair Market Value
Feeder cattle, cost	$6,474,368	$8,074,368
Breeding herd, net	1,072,843	1,894,400
Winn-Dixie stock	338,283	70,043,204
DDI stock	120,263	535,162
Total equipment, net	172,999	130,294
Other assets	1,295,539	1,295,539
Total assets	9,474,295	81,972,967
Total liabilities	1,832,698	1,832,698
Net asset value	7,641,597	80,140,269

The fair market value of ADDI&C's Winn-Dixie stock and its net asset value that are shown in the foregoing table do not reflect any type of discount or adjustment with respect to that stock which is attributable to blockage and/or SEC rule 144 (blockage and/or SEC rule 144 discount). Nor do the fair market value of each of ADDI&C's assets and its net asset value that are shown in the foregoing table reflect any type of discount or adjustment which is attributable to, inter alia, lack of a controlling interest, lack of marketability, or the Federal and State income tax (ADDI&C's built-in capital gains tax) that ADDI&C would have incurred at a combined tax rate of 37.63 percent on the gains as of the valuation date on ADDI&C's assets (i.e., the difference between the historical cost basis and the fair market value of each of its assets, hereinafter referred to as ADDI&C's built-in-

capital gains) if on that date each such asset had been sold or otherwise disposed of or ADDI&C had liquidated.

During 1990, ADDI&C paid $252,602 to an affiliated company as reimbursement for the use of an airplane by one of its shareholders. For Federal income tax purposes, ADDI&C reported that payment as a shareholder dividend. With the exception of that dividend, ADDI&C has not declared or paid any dividends to its shareholders.

On the valuation date, ADDI&C had not adopted a formal plan of liquidation, nor was there any intention by that corporation or decedent to liquidate ADDI&C or to dispose of its Winn-Dixie stock.

On October 31, 1992, ADDI&C's net operating loss carry-forwards totaled $1,580,217.

On or about April 15, 1993, decedent timely filed for 1992 Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return (gift tax return). In that return, decedent reported that the value on the valuation date of each of the two 25-share blocks of ADDI&C stock that he transferred to his sons was $7,444,250, or $297,770 a share. The value reported by decedent in the gift tax return was based on an appraisal by Alex W. Howard (Mr. Howard) of Howard Frazier Barker Elliott, Inc. (Mr. Howard's appraisal).

Respondent determined in the notice of deficiency (notice) that on the valuation date the fair market value of each of the

two 25-share blocks of ADDI&C stock that decedent transferred to his sons was $12,046,975, or $481,879 a share.

OPINION

Petitioner modified the position reflected in decedent's gift tax return as to the value on the valuation date of each of the two blocks of stock in question and now claims that the fair market value of each of those blocks on that date was $6,904,886, or $276,195 per share. Respondent modified the determination in the notice as to that value and now contends that the fair market value on the valuation date of each of the two blocks of ADDI&C stock in question was $13,518,500, or $540,740 per share.[2]

If a gift is made in property, its value at the date of the gift is considered the amount of the gift. Sec. 2512(a);[3] sec. 25.2512-1, Gift Tax Regs. The value of the property for Federal gift tax purposes is

> the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. * * * All relevant facts and elements of value as of the time of the gift shall be considered. * * * [Sec. 25.2512-1, Gift Tax Regs.]

The willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the individual

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[2] Respondent is not, however, claiming an increased gift tax deficiency.

[3] All section references are to the Internal Revenue Code in effect on the valuation date. Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure.

characteristics of these hypothetical persons are not necessarily the same as the individual characteristics of the actual seller or the actual buyer. Estate of Curry v. United States, 706 F.2d 1424, 1428, 1431 (7th Cir. 1983); Estate of Bright v. United States, 658 F.2d 999, 1005-1006 (5th Cir. 1981). The hypothetical willing buyer and the hypothetical willing seller are presumed to be dedicated to achieving the maximum economic advantage. Estate of Curry v. United States, supra at 1428; Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990).

In the case of unlisted stock, like the ADDI&C stock in question, the price at which sales of stock are made in arm's-length transactions in an open market is the best evidence of its value. Champion v. Commissioner, 303 F.2d 887, 893 (5th Cir. 1962), revg. and remanding T.C. Memo. 1960-51. In the instant case, the record does not disclose any such sales of ADDI&C stock.

Where the value of unlisted stock cannot be determined from actual sale prices, its value generally is to be determined by taking into consideration the company's net worth, prospective earning power, and dividend-paying capacity, as well as other relevant factors, including the company's good will, its position in the industry, its management, the degree of control of the business represented by the block of stock to be valued, and the values of securities of corporations engaged in the same or similar lines of business that are listed on a stock exchange. Sec. 25.2512-2(f)(2), Gift Tax Regs. Section 4 of Rev. Rul. 59-

60, 1959-1 C.B. 237, 238-242, sets forth criteria that are virtually identical to those listed in section 25.2512-2(f)(2), Gift Tax Regs., and "has been widely accepted as setting forth the appropriate criteria to consider in determining fair market value". Estate of Newhouse v. Commissioner, supra at 217. Section 5 of Rev. Rul. 59-60, 1959-1 C.B. at 242-243, which addresses the determination of the fair market value of the stock of a closely held investment company, provides in pertinent part:

> (b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

There is no fixed formula for applying the factors that are to be considered in determining the fair market value of unlisted stock. See Estate of Goodall v. Commissioner, 391 F.2d 775, 786 (8th Cir. 1968), vacating and remanding T.C. Memo. 1965-154. The weight to be given to the various factors in arriving at fair market value depends upon the facts of each case. Sec. 25.2512-

2(f), Gift Tax Regs. As the trier of fact, we have broad discretion in assigning the weight to accord to the various factors and in selecting the method of valuation. Estate of O'Connell v. Commissioner, 640 F.2d 249, 251-252 (9th Cir. 1981), affg. on this issue and revg. in part T.C. Memo. 1978-191; sec. 25.2512-2(f), Gift Tax Regs.

The determination of the value of closely held stock, like each of the two 25-share blocks of ADDI&C stock at issue, is a matter of judgment, rather than of mathematics. Hamm v. Commissioner, 325 F.2d 934, 940 (8th Cir. 1963), affg. T.C. Memo. 1961-347. Moreover, since valuation is necessarily an approximation, it is not required that the value that we determine be one as to which there is specific testimony, provided that it is within the range of figures that properly may be deduced from the evidence. Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo. 1974-285; Anderson v. Commissioner, 250 F.2d 242, 249 (5th Cir. 1957), affg. in part and remanding in part T.C. Memo. 1956-178.

As is customary in valuation cases, the parties rely extensively on the opinions of their respective experts to support their differing views about the fair market value on the valuation date of each of the two 25-share blocks of ADDI&C stock in question. The estate relies on (1) Mr. Howard, who is an accredited senior appraiser of the American Society of Appraisers and a principal in the business valuation firm of Howard Frazier

Barker Elliott, Inc., and (2) Shannon Pratt (Mr. Pratt), who is an accredited senior appraiser and fellow of the American Society of Appraisers and a founder and managing director of the business valuation firm of Willamette Management Associates. Respondent relies on John A. Thomson (Mr. Thomson), who is an accredited senior appraiser of the American Society of Appraisers and a vice president and the managing director of the Long Beach, California, office of the business valuation firm of Klaris, Thomson & Schroeder, Inc. Each of the experts prepared an initial expert report (expert report)[4] and a rebuttal expert report (rebuttal report).[5]

We evaluate the opinions of experts in light of the demonstrated qualifications of each expert and all other evidence in the record. Anderson v. Commissioner, supra at 249; Parker v. Commissioner, 86 T.C. 547, 561 (1986). We have broad discretion to evaluate "'the overall cogency of each expert's analysis.'" Sammons v. Commissioner, 838 F.2d 330, 334 (9th Cir. 1988)(quoting Ebben v. Commissioner, 783 F.2d 906, 909 (9th Cir. 1986), affg. in part and revg. in part T.C. Memo. 1983-200), affg. in part and

[4] The expert report of petitioner's expert Mr. Howard is identical to Mr. Howard's appraisal on which the value reported in the gift tax return for each of the two gifts in question was based. Hereinafter, we shall refer to Mr. Howard's appraisal as his expert report.

[5] Each of petitioner's experts prepared a rebuttal report with respect to the expert report of respondent's expert, and respondent's expert prepared separate rebuttal reports with respect to the expert reports of petitioner's two experts.

revg. in part T.C. Memo. 1986-318. We are not bound by the formulae and opinions proffered by expert witnesses, especially when they are contrary to our judgment. Silverman v. Commissioner, supra; IT&S of Iowa, Inc. v. Commissioner, 97 T.C. 496, 508 (1991). Instead, we may reach a determination of value based on our own examination of the evidence in the record. Lukens v. Commissioner, 945 F.2d 92, 96 (5th Cir. 1991)(citing Silverman v. Commissioner, supra at 933), affg. Ames v. Commissioner, T.C. Memo. 1990-87. The persuasiveness of an expert's opinion depends largely upon the disclosed facts on which it is based. See Tripp v. Commissioner, 337 F.2d 432, 434 (7th Cir. 1964), affg. T.C. Memo. 1963-244. Where experts offer divergent estimates of fair market value, we shall decide what weight to give those estimates by examining the factors used by those experts to arrive at their conclusions. Casey v. Commissioner, 38 T.C. 357, 381 (1962). While we may accept the opinion of an expert in its entirety, Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 452 (1980), we may be selective in the use of any part of such an opinion, Parker v. Commissioner, supra at 562. We also may reject the opinion of an expert witness in its entirety. Palmer v. Commissioner, 523 F.2d 1308, 1310 (8th Cir. 1975), affg. 62 T.C. 684 (1974); Parker v. Commissioner, supra at 562.

For convenience, the following chart (chart) shows the respective positions of the experts[6] and the parties on brief with respect to the net asset value of ADDI&C on the valuation date and the discounts or adjustments that each believes should be applied to such value in order to arrive at the fair market value on that date of each of the two 25-share blocks of ADDI&C stock in question:[7]

[6] The respective positions of the experts that are shown in the chart reflect the agreement of the parties as to the fair market value of each of ADDI&C's assets and the aggregate amount of its liabilities as of the valuation date without taking into account any type of discount or adjustment attributable to blockage and/or SEC rule 144, lack of a controlling interest, lack of marketability, or ADDI&C's built-in capital gains tax. However, those positions do not reflect the agreement of the parties at trial that the applicable minority discount should be 15 percent. Despite that agreement, the respective dollar amounts of a 15-percent minority discount urged on brief by petitioner and by respondent differ. That is because of the differences between them as to whether a blockage and/or SEC rule 144 discount and a discount or adjustment attributable to ADDI&C's built-in capital gains tax should be taken into account in arriving at ADDI&C's net asset value on the valuation date.

[7] All dollar amounts in the chart are rounded to the nearest dollar.

	Petitioner's Expert Mr. Howard	Petitioner's Expert Mr. Pratt	Respondent's Expert Mr. Thomson	Petitioner[1]	Respondent
Blockage and/or SEC rule 144 discount	4.9 percent or $3,432,117	10 percent or $7,004,320	-$0-	10 percent or $7,004,320	-$0-
Discount or adjustment attributable to ADDI&C's built-in capital gains tax	25,395,109	Factored in as part of lack-of-marketability discount	Factored in as part of lack-of-marketability discount	24,645,525	-0-
Net asset value of ADDI&C	51,313,043	73,135,976	80,140,269	49,490,424	80,140,269
Minority discount	15 percent or 7,696,956	20 percent or 14,627,195	12 percent or 9,616,832	15 percent or 7,273,564	15 percent or 12,021,040
Lack-of-marketability discount	35 percent or 15,265,630	50 percent or 29,254,391	38 percent or 26,798,906	35 percent or 14,425,901	23 percent or 15,667,423
Portion of lack-of-marketability discount attributable to ADDI&C's built-in capital gains tax	-0-	15 percent or 8,776,317	15 percent or 10,578,516	-0-	-0-
Total dollar amount of discounts or adjustments	51,789,812	50,885,906	36,415,738	53,349,310	27,688,463
Fair market value of each 25-share block of ADDI&C common stock	7,306,825	7,539,800	11,250,000	6,904,886	13,518,500
Fair market value of each share of each 25-share block of ADDI&C common stock	292,273	301,592	450,000	276,195	540,740

[1] This column reflects petitioner's position on brief regarding all of the items reflected in the chart except for ADDI&C's net asset value. The Court had to calculate petitioner's position with respect to the amount of ADDI&C's net asset value because nowhere on brief does petitioner state what that figure should be. The Court calculated petitioner's position as to that amount, which is shown in the chart, based on petitioner's contentions that a 10-percent blockage and/or SEC rule 144 discount on the NYSE price of ADDI&C's Winn-Dixie stock (viz., $7,004,320) and a discount or adjustment equal to the full amount of ADDI&C's built-in capital gains tax, which petitioner calculates to be $24,645,525, should be applied in determining ADDI&C's net asset value on the valuation date. Even assuming arguendo that petitioner's contentions regarding a blockage and/or SEC rule 144 discount and a discount or adjustment for the full amount of ADDI&C's built-in capital gains tax were correct, we believe that petitioner erroneously calculated the amount of that tax to be $24,645,525. It appears that in calculating that amount petitioner improperly failed to take into account the $1,580,217 of net operating loss carryforwards that ADDI&C had as of Oct. 31, 1992. That error had a domino effect; as a result, the dollar amounts of the minority and the lack-of-marketability discounts that petitioner advocates are slightly less than they would have been if petitioner had not made that error.

The parties and all of the experts agree that the initial step in ascertaining the fair market value on the valuation date of each of the two 25-share blocks in question is to determine as of that date the fair market value of each of ADDI&C's assets and the aggregate amount of its liabilities in order to calculate its net asset value on that date. All of them also are in agreement that, without taking into account any discounts or adjustments (including but not limited to a blockage and/or SEC rule 144 discount, a minority discount for lack of a controlling interest, a lack-of-marketability discount, and a discount or adjustment attributable to ADDI&C's built-in capital gains tax), on the valuation date the aggregate fair market value of ADDI&C's assets was $81,972,967, its liabilities totaled $1,832,698, and its net asset value was $80,140,269.

Petitioner and petitioner's experts agree that, in determining the fair market value of ADDI&C's Winn-Dixie stock and its net asset value on the valuation date, it is necessary to reduce the fair market value of that stock and ADDI&C's net asset value to which the parties in this case have stipulated by applying a blockage and/or SEC rule 144 discount to that stock. Petitioner and petitioner's expert Mr. Pratt believe that a blockage and/or SEC rule 144 discount of 10 percent is proper, and petitioner's expert Mr. Howard concludes that such a discount of

4.9 percent is appropriate.[8] Respondent and respondent's expert maintain that no blockage and/or SEC rule 144 discount is warranted.

The parties and their experts agree that the Winn-Dixie stock held by ADDI&C on the valuation date was subject to the volume limitation on the sale of that stock prescribed by SEC rule 144(e)(1) (SEC rule 144(e)(1) volume limitation). That rule limited the amount of restricted or other securities that could have been sold by an affiliate during a given 3-month period generally to the greater of (a) one percent of the shares of the outstanding class of stock or (b) the average weekly reported trading volume during the 4-week period preceding the filing of a notice of proposed sale which was required under SEC rule 144(h).

The parties and their respective experts also are in agreement that as of the valuation date there were two ways in which ADDI&C could have disposed of its Winn-Dixie stock. One such method was for ADDI&C to have sold its entire block of that stock in a private placement to a nonaffiliated investor. Unless that block of stock were registered, that investor would have been subject to a 2-year holding period for that stock under SEC rule 144(d)(1) and thereafter would have been subject for 1 year to the volume

[8] In his rebuttal report, Mr. Howard modified the amount of the blockage and/or SEC rule 144 discount that he believed should be applied in determining as of the valuation date the fair market value of ADDI&C's Winn-Dixie stock and its net asset value. Mr. Howard made that change because of matters brought to his attention after he had prepared his expert report. See infra note 10.

limitation on the sale of that stock prescribed by SEC rule 144(e)(2).[9] See SEC rule 144(k). The other method by which ADDI&C could have sold its Winn-Dixie stock was through the sale of that stock over a period of time consistent with the SEC rule 144(e)(1) volume limitation (dribble-out method).

The parties and their respective experts further agree that (1) because of the size of the block of Winn-Dixie stock owned by ADDI&C on the valuation date, ADDI&C could not have disposed of all of its Winn-Dixie stock at the same time without depressing the market value of such stock; and (2)(a) in order to dispose of its Winn-Dixie stock without depressing its market value and at the same time selling that stock in compliance with the restrictions in SEC rule 144, it would have taken ADDI&C 5 to 6 months after the valuation date to dispose of its Winn-Dixie stock under the dribble-out method, and (b) a purchaser of that stock would not have been subject to the 2-year holding period under SEC rule 144(d)(1) or the volume limitation in SEC rule 144(e)(2), see SEC rule 144.

Petitioner's expert Mr. Howard and respondent's expert Mr. Thomson agree that ADDI&C probably would have sold its Winn-Dixie stock pursuant to the dribble-out method.[10] Mr. Pratt opined that

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[9] The volume limitation in SEC rule 144(e)(2) is identical to the SEC rule 144(e)(1) volume limitation.

[10] Mr. Howard opined in his expert report that a sale by private placement would have been a "more efficient" way for ADDI&C to have disposed of its Winn-Dixie stock than the dribble-out

(continued...)

it was likely that ADDI&C would have disposed of its Winn-Dixie stock through a private placement. On the record before us, we find that ADDI&C probably would have used the dribble-out method to sell its Winn-Dixie stock, since it was likely that such a sale would have resulted in a higher value for ADDI&C's Winn-Dixie stock than would have been yielded if that stock had been sold in a private placement. That is because a nonaffiliated investor who purchased that stock in a private placement would have been subject to a 2-year holding period under SEC rule 144(d)(1) and thereafter would have been subject for one year to the volume limitation in SEC rule 144(e)(2). See SEC rule 144(k).

Although respondent's expert Mr. Thomson acknowledges that ADDI&C's Winn-Dixie stock was subject to the SEC rule 144(e)(1) volume limitation and that, as we have found, ADDI&C probably

[10](...continued)
method. However, after Mr. Howard prepared that report, he learned that a purchaser of ADDI&C's Winn-Dixie stock in a private placement would have been required to hold that stock for 2 years under SEC rule 144(d)(1) and thereafter would have been subject for 1 year to the volume limitation in SEC rule 144(e)(2). Consequently, Mr. Howard changed the view reflected in his expert report regarding ADDI&C's sale of its Winn-Dixie stock by private placement and took the position in his rebuttal report and at trial that it was more likely that ADDI&C would have disposed of its Winn-Dixie stock through the dribble-out method because that method would have yielded a greater value for that stock than would have been obtained through its sale by private placement. We reject any contention by respondent that Mr. Howard should not be permitted to change in his rebuttal report and at trial the position that he had taken in his expert report with respect to ADDI&C's Winn-Dixie stock. See Rule 143(f). The Court is interested in reaching the proper result, aided by witnesses who will recognize and correct an error. We are not interested in attempts to force a party to maintain an erroneous or unreasonable position for strategic advantage.

would have used the dribble-out method to sell its Winn-Dixie stock over a 5-to-6 month period, he did not discount or adjust the NYSE price of that stock on the valuation date in order to arrive at its fair market value and ADDI&C's net asset value on that date. That is because, inter alia, Winn-Dixie's NYSE price "was on a rising trend line" from January 3, 1992, through November 2, 1992, the valuation date, and, in fact, "increased 72 percent during that period."[11]

To counter Mr. Thomson's view that no blockage and/or SEC rule 144 discount is warranted because, inter alia, the NYSE price of Winn-Dixie stock "was on a rising trend line" during the 10-month period preceding the valuation date, petitioner points out that a Value Line Investment Survey report (Value Line report) dated August 21, 1992, which was approximately 3 months before the valuation date, reported that "[the NYSE price of Winn-Dixie] stock has risen about 15% in the past few months. As a result, long-term total return prospects have been diminished". We do not believe that the opinion expressed in the Value Line report

[11] Nor did Mr. Thomson apply a premium to the NYSE price of ADDI&C Winn-Dixie stock. That is because, even though ADDI&C owned 1,020,666 shares of the outstanding Winn-Dixie stock, Mr. Thomson considered that block of stock, which represented only about 1.33 percent of the total outstanding shares of Winn-Dixie, to be "too small" to represent a "swing block of shares." It is noteworthy that petitioner's expert Mr. Pratt acknowledges that ADDI&C's stock interest in Winn-Dixie on the valuation date "is generally considered to be a significant investment. An investor would likely find it difficult to quickly accumulate such a large investment without some (typically upward) affect [sic] on the quoted market price on the subject security."

regarding "long-term total return prospects" for Winn-Dixie stock addressed the short-term prospects as of the valuation date regarding the NYSE price of that stock over the relatively short 5-to-6 month period after that date over which the parties and all the experts agree it would have taken ADDI&C to sell its Winn-Dixie stock under the dribble-out method.

Mr. Pratt determined that a 10-percent blockage and/or SEC rule 144 discount should be applied to the NYSE price of Winn-Dixie on the valuation date. However, as stated above, we disagree with Mr. Pratt's view that it was likely that ADDI&C would have sold its Winn-Dixie stock in a private placement, rather than under the dribble-out method. In addition, Mr. Pratt did not explain in his expert report, as required by Rule 143(f), how he arrived at a 10-percent blockage and/or SEC rule 144 discount, and we did not find his limited explanation in his rebuttal report and at trial of how he determined the amount of that discount to be particularly helpful. See Rule 143(f)(1). On the record before us, we shall not rely on Mr. Pratt's opinion as to whether a blockage and/or SEC rule 144 discount should be applied to the NYSE price of ADDI&C's Winn-Dixie stock on that date, nor shall we rely on his view regarding the amount of any such discount that should be applied in the event that we were to find that use of such a discount is warranted in the instant case.

Mr. Howard determined in his rebuttal report that a 4.9-percent blockage and/or SEC rule 144 discount should be applied to

Winn-Dixie's NYSE price on the valuation date in determining the fair market value of ADDI&C's Winn-Dixie stock and its net asset value on that date. He arrived at that percentage discount based on the Black-Scholes options pricing model (Black-Scholes model), which is used to calculate the cost of a call or put option. Mr. Howard used the Black-Scholes model to value a put option, which gives the holder the right to sell a specified asset at a specified price on (or before) a specified date. Mr. Howard explained in his rebuttal report that the cost of a put option can be used to determine the cost of "locking-in" the price of a stock when the future price of that stock cannot be known with certainty. Mr. Howard determined that the Black-Scholes model was a good measure of the discount associated with ADDI&C's exposure to the market risk that the NYSE price of its Winn-Dixie stock would have fallen during the 5-to-6 month period that would have been required to sell that stock under the dribble-out method.

Mr. Howard explained in his rebuttal report that the Black-Scholes model takes into account the following variables in arriving at the value of an option: (1) Current stock price per share, (2) exercise price per share, (3) time to maturity, (4) risk-free interest rate, (5) volatility, and (6) continuous dividend yield. Using the Black-Scholes model, Mr. Howard calculated that the cost of a 3-month put option on Winn-Dixie stock as of the valuation date would be $3.37, or 4.9 percent of Winn-Dixie's NYSE price on that date.

Respondent argues that use of the Black-Scholes model will always result in a blockage and/or SEC rule 144 discount. Mr. Howard agrees, and so do we. The Black-Scholes model takes into account, inter alia, a “risk-free interest rate” variable. Mr. Howard acknowledges in his rebuttal report that "there is always a cost to locking-in the value of a stock price to protect against market risk no matter what the specific inputs of the model", and he testified at trial that it would have taken 5 to 6 months for ADDI&C to sell its Winn-Dixie stock under the dribble-out method "without moving the market, [thereby] exposing that stock to market risks which always results in a decreased value, if for no other reason than present value purposes." On the instant record, we are not persuaded by Mr. Howard’s use of the Black-Scholes model that a blockage and/or SEC rule 144 discount is warranted or that, even if such a discount were warranted, the amount of any such discount should be 4.9 percent.

Petitioner has the burden of establishing that a blockage and/or SEC rule 144 discount should be applied to the NYSE price on the valuation date of ADDI&C’s Winn-Dixie stock and the amount of any such discount. Based on our examination of the entire record before us, we find that petitioner has failed to satisfy that burden. We further find that on the valuation date the fair market value of ADDI&C's Winn-Dixie stock was $70,043,204 and the net asset value of ADDI&C without taking into account any other discounts or adjustments was $80,140,269.

Petitioner and all of the experts, including respondent's expert, agree that, in determining the fair market value on the valuation date of each of the two blocks of ADDI&C stock at issue, it is necessary to reduce ADDI&C's net asset value on that date by applying a discount or adjustment attributable to ADDI&C's built-in capital gains tax. However, there are disagreements as to the amount of such a discount or adjustment. In addition, petitioner and petitioner's expert Mr. Howard disagree with petitioner's expert Mr. Pratt and respondent's expert Mr. Thomson as to the point at which such a discount or adjustment should be taken into account in the valuation process. Petitioner and petitioner's expert Mr. Howard believe that, in calculating ADDI&C's net asset value on the valuation date, the full amount of ADDI&C's built-in-capital gains tax should be subtracted before any minority and lack-of-marketability discounts are applied. Petitioner's expert Mr. Pratt and respondent's expert Mr. Thomson believe that a 15-percent discount or adjustment attributable to ADDI&C's built-in capital gains tax should be taken into account as part of the lack-of-marketability discount that each agrees should be applied to ADDI&C's net asset value on the valuation date after that net asset value has been reduced by a minority discount. Of the 50 percent lack-of-marketability discount equal to $29,254,391 that Mr. Pratt determined should be applied, $8,776,317 is attributable to ADDI&C's built-in capital gains tax. Of the 38-percent lack-of-marketability discount equal to $26,798,906 that Mr. Thomson

determined should be applied, $10,578,516 is attributable to that tax.[12]

It is respondent's position that no discount or adjustment attributable to ADDI&C's built-in capital gains tax should be applied in determining the fair market value on the valuation date of each of the two blocks of stock in question. Respondent thus not only rejects the views of petitioner and petitioner's two experts, but also the opinion of respondent's expert Mr. Thomson, that such a discount or adjustment is warranted. In support of respondent's rejection of Mr. Thomson's opinion, respondent asserts on brief:

> Respondent recognizes that her own expert included the potential capital gains in his determination of an appropriate marketability discount; nevertheless, this inclusion is contrary to Federal tax law.

In support of respondent's position that a discount or adjustment attributable to ADDI&C's built-in capital gains tax is "contrary to Federal tax law", respondent advances the following argument in respondent's opening brief:

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[12] There are differences between the respective dollar amounts of the 15-percent discount or adjustment attributable to ADDI&C's built-in capital gains tax, which both petitioner's expert Mr. Pratt and respondent's expert Mr. Thomson included as part of the respective lack-of-marketability discounts that they concluded should be applied to ADDI&C's net asset value on the valuation date after that net asset value has been reduced by a minority discount. That is because of the differences between those two experts (1) as to whether a blockage and/or SEC rule 144 discount is warranted and (2) as to the amount of the minority discount that each believed should be applied. See chart above showing, inter alia, those differences.

In an established line of cases, this Court has held that projected capital gains taxes do not reduce the value of closely held stock when liquidation is speculative. Ward v. Commissioner, 87 T.C. 78, 104 (1986); Estate of Andrews v. Commissioner, 79 T.C. 938, 942 (1982); Estate of Piper v. Commissioner, 72 T.C. 1062, 1086-1087 (1979); Estate of Cruikshank v. Commissioner, 9 T.C. 162, 165 (1947); Estate of Luton v. Commissioner, T.C. Memo. 1994-539, 68 T.C.M. (CCH) 1044, 1052 (1994); Estate of Bennett v. Commissioner, T.C. Memo. 1993-34, 65 T.C.M. (CCH) 1816, 1825 (1993). These cases reach that conclusion for two reasons.

First, prior to 1986, former I.R.C. §§ 336 and 337 allowed the tax-free liquidation of a corporation; the corporation could thereby completely avoid capital gains taxes upon a subsequent sale of all its assets. Courts reasoned that the corporation's ability to avoid taxes upon liquidation rendered the projected liability so speculative as to be irrelevant. Estate of Piper, 72 T.C. at 1087.

The repeal of those provisions, in the Tax Reform Act of 1986, P.L. 99-514, §§ 631-633, 100 Stat. 2269-2282, as reprinted in 1986-3 C.B. (Vol. 1) 186-199, did not foreclose the possibility of avoiding capital gains taxes at the corporate level upon sale of all assets. A subchapter C corporation can convert to a corporation described in subchapter S (I.R.C. § 1361, et. seq.) and avoid recognition of any gain, if the corporation retains the assets for a period of ten years from the date of conversion to an S corporation. See I.R.C. § 1374(d)(7). One of petitioner's experts recognized this possible alternative. Since Artemus D. Davis was a long term investor in Winn-Dixie stock, electing subchapter S appears to be a reasonable method to avoid the corporate level capital gains tax.

Although the willing buyer might incorporate a reduction in his price for costs of a subsequent liquidation, the willing seller has no incentive to accommodate that reduction. Why would the willing seller, knowing that the capital gains taxes can be deferred or avoided, agree to that reduction? Why would the willing seller, knowing further that the buyer controls the incidence of tax, agree to any reduction based on the buyer's purely speculative tax burden? See Mandelbaum v. Commissioner, T.C. Memo. 1995-254, 69 T.C.M. (CCH) 2852, 2866 (1995), aff'd, 91 F.3d 124 (3d Cir. 1996).

> Second, and more importantly, when the actual facts do not suggest that the shareholders intended to liquidate the corporation, this Court has refused to assume that the hypothetical buyer would do so. Estate of Ford v. Commissioner, T.C. Memo. 1993-580, 66 T.C.M. (CCH) 1507, 1517 (1993), aff'd, 53 F.3d 924 (8th Cir. 1995); Estate of Bennett v. Commissioner, T.C. Memo. 1993-34, 65 T.C.M. (CCH) 1816, 1825 (1993). Here, petitioner stipulated that no liquidation was contemplated at the time of the subject gifts.
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> Petitioner will no doubt argue that the Tax Court has not unequivocally stated that the potential capital gains taxes cannot be considered as a legal matter. Respondent recognizes that valuation is inherently a factual consideration. Nevertheless, this Court has consistently held that when liquidation is speculative, projected capital gains taxes do not reduce value, Ward v. Commissioner, 87 T.C. 78, 104 (1986); Estate of Luton v. Commissioner, T.C. Memo. 1994-539; Estate of Ford v. Commissioner, T.C. Memo. 1993-580; and that unforeseen future events cannot affect value, Messing v. Commissioner, 48 T.C. 502, 509 (1967); Mandelbaum v. Commissioner, T.C. Memo. 1995-255. The only proper construction of this conclusory language is that consideration of these speculative future events, including capital gains taxes, is improper as a legal matter. [Fn. ref. omitted.]

We reject respondent's position that, as a matter of law, no discount or adjustment attributable to ADDI&C's built-in capital gains tax is allowable in the instant case. Indeed, it appears that even respondent abandons, or at least contradicts, that position when respondent acknowledges in respondent's answering brief that

> if a sale or liquidation of ADDI&C's assets was in fact contemplated on the valuation date or if, in fact, avoidance of a corporate level capital gains tax was not available, some reduction in value would be appropriate. * * * [Emphasis added.]

Respondent thus concedes that, irrespective of whether a liquidation of ADDI&C or sale of its assets was planned or contemplated on the valuation date, "some reduction in value would be appropriate if, in fact, avoidance of a corporate level capital gains tax was not available". However, respondent argues that although ADDI&C would have been required under the Federal income tax law in effect on the valuation date to recognize gains on its assets if it had liquidated and distributed those assets, sec. 336(a), made a nonliquidating distribution of one or more of those assets, sec. 311, or sold or otherwise disposed of those assets, sec. 1001(c), it could have avoided the tax on such gains.[13] That is because, according to respondent, ADDI&C could have converted to S corporation status and retained its assets for 10 years from the date of such conversion, see sec. 1374(a), (d)(7), and petitioner's expert Mr. Pratt acknowledged that possibility in his expert report.

[13] The Tax Reform Act of 1986 (1986 Act), Pub. L. 99-514, sec. 631-633, 100 Stat. 2269-2282, inter alia, modified sec. 336(a) in effect prior to passage of the 1986 Act, thereby repealing the doctrine (General Utilities doctrine) that had been established in General Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935). Under the General Utilities doctrine, corporations generally did not recognize gain on certain distributions of appreciated property to their shareholders and on certain liquidating sales of property. See H. Rept. 99-426 at 274-275 (1985), 1986-3 C.B. (Vol. 2) 274-275. The change to sec. 336(a) that was effected by the 1986 Act was intended "to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context." H. Conf. Rept. 99-841, 1986-3 C.B. (Vol. 4) 204.

Although Mr. Pratt recognized in his expert report that as of the valuation date it would have been possible for ADDI&C to convert to an S corporation, he did not consider conversion to S corporation status to be likely as of that date for several reasons. First, according to Mr. Pratt, it is improper to assume, as respondent does, that ADDI&C would have been able to make an S corporation election. That is because such an assumption would have impermissibly limited the hypothetical willing buyer of each of the two blocks of stock at issue to certain individuals and entities who were permitted as of the valuation date to be shareholders of an S corporation, see sec. 1361(b)(1)(B) and (C), thereby improperly excluding as a hypothetical willing buyer of each such block, for example, a C corporation, see sec. 1361(b)(1)(B). In addition, Mr. Pratt believes that the assumption by respondent that none of ADDI&C's assets would be sold for 10 years would have reduced the marketability of each block of ADDI&C stock at issue, and such a requirement would have made it unlikely that ADDI&C's stockholders would have consented to an S corporation election. Mr. Pratt also notes that section 1362(d)(3) could be a problem for an investment company, like ADDI&C, unless ADDI&C were to retain its cattle operations or engage in some other operating business that generated substantially more gross income than the passive income generated by ADDI&C's other assets. That is because pursuant to section 1362(d)(3) an otherwise valid S corporation election will be

terminated if ADDI&C (1) had earnings and profits at the close of each of 3 consecutive taxable years that had been accumulated prior to the S corporation election, see sec. 1362(d)(3)(A) and (B), and (2) had more than 25 percent of its gross receipts for each of those taxable years from passive investment income, which includes dividend income, see sec. 1362(d)(3)(A), (D)(i).

Although we agree with Mr. Pratt that section 1362(d)(3) could have caused an otherwise valid S corporation election by ADDI&C to be terminated if ADDI&C were not to maintain its cattle operations or engage in some other operating business, there are no facts established by the record to indicate that as of the valuation date ADDI&C intended to curtail or eliminate its cattle operations. Nonetheless, we agree with the other two reasons advanced by Mr. Pratt in support of his view that as of the valuation date it was unlikely that ADDI&C would have converted to an S corporation. Based on the record before us, we reject respondent's unwarranted assumptions that ADDI&C could have avoided all of ADDI&C's built-in capital gains tax by having it elect S corporation status and by not permitting it to sell any of its assets for 10 years thereafter, and the record does not establish that there was any other way as of the valuation date by which ADDI&C could have avoided all of such tax.

We turn now to respondent's position in respondent’s opening brief, which, as discussed above, we believe was contradicted by the position in respondent’s answering brief. The former position

was that, irrespective of whether as of the valuation date ADDI&C could have avoided all of ADDI&C's built-in capital gains tax, no discount or adjustment attributable to that tax is permissible, as a matter of law, because as of that date no liquidation of ADDI&C or sale of its assets was planned or contemplated. The record shows that as of the valuation date ADDI&C's built-in capital gains tax relating to ADDI&C's built-in capital gains on all its assets was $26,686,614.[14] The record also establishes that as of the valuation date ADDI&C's Winn-Dixie stock constituted more than 85 percent of the aggregate fair market value of all of its assets; the portion of ADDI&C's built-in capital gains attributable to that stock (viz, $69,704,921) constituted more than 96 percent of such gains; and the portion of ADDI&C's built-in capital gains tax attributable to that stock (viz, approximately $25,660,000) constituted more than 96 percent of such tax. Petitioner and all of the experts believe that a hypothetical willing seller and a hypothetical willing buyer of each of the two 25-share blocks of ADDI&C stock at issue would have taken ADDI&C's built-in capital gains tax into account in

[14] We calculated ADDI&C's built-in capital gains tax by multiplying (1) the stipulated combined Federal and State capital gains tax rate of 37.63 percent by (2) ADDI&C's built-in capital gains reduced by $1,580,217 of net operating loss carryforwards that ADDI&C had as of the valuation date. In computing the amount of such gains, we utilized the stipulated historical cost basis and the fair market value of each of ADDI&C's assets, including its Winn-Dixie stock, as of the valuation date, since we have found on the instant record that petitioner has not established that any blockage and/or SEC rule 144 discount to the NYSE price on the valuation date of that stock is permissible.

arriving at the price on the valuation date at which each such block of stock would have changed hands and that therefore a discount or adjustment attributable to that tax should be applied in determining the fair market value of each such block.[15] On the record before us, we agree.

We are convinced on the record in this case, and we find, that, even though no liquidation of ADDI&C or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of ADDI&C's built-in capital gains tax. We are also persuaded on that record, and we find, that such a willing seller and such a willing buyer of each of the two blocks of ADDI&C stock at issue would have agreed on a price on the valuation date at which each such block would have changed hands that was less than the price that they would have agreed upon if there had been no ADDI&C's built-in capital gains tax as of that date. Respondent's position to the contrary is inconsistent with the record in this case.[16] We have found

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[15] As discussed herein, there are disagreements as to the amount of any such discount or adjustment and the point at which such a discount or adjustment should be taken into account in the valuation process.

[16] Moreover, it is contrary to the record in this case to assume, as respondent apparently does, (1) that a hypothetical willing seller and a hypothetical willing buyer would not have been aware on the valuation date that Winn-Dixie stock, which constituted over 96 percent of ADDI&C's assets on that date,

(continued...)

nothing in the following cases on which respondent relies that requires us, as a matter of law, to alter our view: Ward v. Commissioner, 87 T.C. 78 (1986); Estate of Andrews v. Commissioner, 79 T.C. 938 (1982); Estate of Piper v. Commissioner, 72 T.C. 1062 (1979); Estate of Cruikshank v. Commissioner, 9 T.C. 162 (1947); Estate of Luton v. Commissioner, T.C. Memo. 1994-539, supplemented by T.C. Memo. 1996-181; Estate of Ford v. Commissioner, T.C. Memo. 1993-580, affd. 53 F.3d 924 (8th Cir. 1995); Estate of Bennett v. Commissioner, T.C. Memo. 1993-34.

We note initially that one of the cases on which respondent relies, Estate of Bennett v. Commissioner, supra, involved a valuation date that preceded the repeal of the General Utilities doctrine and did not involve a request by the taxpayer for a reduction in valuing the stock interest in question for the capital gains tax that would have been due upon liquidation of the corporation whose stock was at issue, absent tax planning to avoid that tax which was permissible as of the valuation date in that case. Instead, the taxpayer in the Estate of Bennett case asked the Court to reduce the value of the stock interest in question there by the "estimated costs of liquidation" which consisted of a "discount for commissions", a "discount for losses on

[16](...continued)
could be sold and bought on the open market with none of ADDI&C's built-in capital gains tax being applicable to that stock and (2) that that knowledge would not have affected the price to which they would have agreed on the valuation date for each of the blocks of stock at issue.

liquidation", and a "discount for the costs of overhead and sales costs". Estate of Bennett v. Commissioner, supra.

Turning to the remaining cases on which respondent relies, it is significant to us that, except for Estate of Luton v. Commissioner, supra, none of the cases on which respondent relies indicates that any of the expert witnesses who testified in those cases considered corporate built-in capital gains tax as a factor in appraising the respective stock interests at issue in those cases. In the Estate of Luton case, one of the taxpayer's experts, but not respondent's expert, reduced the asset value of each of the corporations at issue by liquidation costs that included, inter alia, Federal and State capital gains taxes that would have been incurred on liquidation of those corporations. Estate of Luton v. Commissioner, supra. In contrast, in the present case, all of the experts for both parties are of the view that ADDI&C's built-in capital gains tax must be taken into account as a factor in ascertaining the fair market value of each of the two blocks of ADDI&C stock in question.

Except for Estate of Luton v. Commissioner, supra, and Estate of Ford v. Commissioner, supra, the other cases on which respondent relies (like Estate of Bennett v. Commissioner, supra) involved valuation dates that preceded the repeal of the General Utilities doctrine. As we read all of those cases, including Estate of Luton and Estate of Ford, the taxpayers requested the Court for a reduction in valuing the respective stock interests in

question equal to the full amount of capital gains taxes that would have been due upon liquidation of the respective corporations whose stock was at issue in those cases, absent tax planning to avoid those taxes which was permissible as of the respective valuation dates in those cases. The Court denied each of those requests for a reduction for the full amount of such capital gains taxes where there was no evidence as of those respective valuation dates that a liquidation of the corporation in question or sale of corporate assets was planned or contemplated or that the full amount of such taxes could not have been avoided.[17]

In the present case, petitioner and all of the experts, including respondent's expert, believe, and we have found, that, in determining the fair market value on the valuation date of each of the blocks of stock at issue, it is necessary to apply a discount or adjustment attributable to ADDI&C's built-in capital

[17] See Estate of Welch v. Commissioner, T.C. Memo. 1998-167, and Eisenberg v. Commissioner, T.C. Memo. 1997-483, which were decided after the parties filed their briefs in this case and which involved valuation dates that occurred after the repeal of the General Utilities doctrine. In neither of those cases was a liquidation of the corporation in question or a sale of its assets planned or contemplated as of the respective valuation dates. In valuing the respective stock interests at issue in those cases, the taxpayers asked the Court for a reduction equal to the full amount of capital gains taxes that would have been due upon liquidation of the respective corporations involved there, absent tax planning to avoid those taxes which was permissible as of the respective valuation dates. In neither of those cases does the Court indicate that any expert believed that such a reduction was warranted. The Court denied the taxpayers' requests.

gains tax because that is what a hypothetical willing seller and a hypothetical willing buyer would have done under the facts and circumstances existing on that date. Petitioner adopts the view of petitioner's expert Mr. Howard and argues that the full amount of such tax should reduce ADDI&C's net asset value in making that determination. On the record before us, we reject petitioner's position and Mr. Howard's opinion. On that record, we find that, where no liquidation of ADDI&C or sale of its assets was planned or contemplated on the valuation date, the full amount of ADDI&C's built-in capital gains tax may not be taken as a discount or adjustment in determining the fair market value on that date of each of the two blocks of stock in question, even though we have found that as of that date it was unlikely that ADDI&C could have avoided all of ADDI&C's built-in capital gains tax, and the record does not show that there was any other way as of that date by which ADDI&C could have avoided all of such tax. See Ward v. Commissioner, 87 T.C. 78 (1986); Estate of Andrews v. Commissioner, 79 T.C. 938 (1982); Estate of Piper v. Commissioner, 72 T.C. 1062 (1979).

We thus are in agreement with petitioner's expert Mr. Pratt and respondent's expert Mr. Thomson that in the present case it is not appropriate in valuing each of the two blocks of ADDI&C stock in question to apply a discount or adjustment equal to the full amount of ADDI&C's built-in capital gains tax. Nonetheless, on the instant record, we find that on the valuation date there was

even less of a ready market for each of those two blocks because of ADDI&C's built-in capital gains tax than there would have been for each such block without such a tax. We thus also agree with and accept the views of petitioner's expert Mr. Pratt and respondent's expert Mr. Thomson that a discount or adjustment for some amount of ADDI&C's built-in capital gains tax should be taken into account in valuing each block of stock at issue and that such a discount or adjustment should be part of the lack-of-marketability discount that the parties and all of the experts concluded should be applied in that valuation process.[18]

Petitioner's expert Mr. Pratt included $8,776,317 of the total ADDI&C's built-in capital gains tax as part of the lack-of-marketability discount that he applied in valuing each of the

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[18] See Estate of Luton v. Commissioner, T.C. Memo. 1994-539, which involved, inter alia, valuation of a stock interest in a corporation for which an election to be taxed as an S corporation had been made and which was subject to the transitional rules in the Subchapter S Revision Act of 1982, Pub. L. 97-354, sec. 2, 96 Stat. 1669, 1683. Consequently, that corporation was required to recognize certain of its net capital gain for the 3 taxable years immediately following the date of that S corporation election. Although we refused to allow a reduction equal to the full amount of the Federal and State capital gains taxes that would have been incurred if that corporation had liquidated on the valuation date involved in the Estate of Luton case, we found:

> Accordingly, with the exception of the 14-month period from the valuation date until December 31, 1988, RSJ, Inc.,'s built-in capital gains could be recognized without a corporate level tax. Notwithstanding the potential elimination of any corporate level tax, we do recognize that some discount is in order. We believe such discount is appropriately considered in the discount for lack of marketability, discussed below. * * * [Emphasis added.]

Estate of Luton v. Commissioner, supra.

blocks of stock at issue, and respondent's expert Mr. Thomson included $10,578,516 of that total tax as part of the lack-of-marketability discount that he applied in that valuation process. Although those dollar amounts vary because of other differences that those experts have in the valuation process, see chart above, each of those experts independently concluded that a 15-percent discount or adjustment attributable to ADDI&C's built-in capital gains tax should be included as part of the respective lack-of-marketability discounts that they determined. We have examined the manner in which petitioner's expert Mr. Pratt and respondent's expert Mr. Thomson determined the respective amounts attributable to ADDI&C's built-in capital gains tax that they believe should be included as part of the total lack-of-marketability discount which should be applied in valuing each of the blocks of stock at issue. We are satisfied on the record before us that those amounts (i.e., $8,776,317 to $10,578,516) set the appropriate range from which we may determine the amount attributable to ADDI&C's built-in capital gains tax that should be included as part of the lack-of-marketability discount to be applied in determining the value of each such block. Bearing in mind that valuation is necessarily an approximation and a matter of judgment, rather than of mathematics, Hamm v. Commissioner, 325 F.2d at 940, on which petitioner has the burden of proof, Rule 142(a), we find on the instant record that $9 million which is attributable to ADDI&C's built-in capital gains tax should be included as part of the lack-

of-marketability discount that is to be applied in valuing each of the two blocks of ADDI&C's stock at issue.

We now turn to the balance of the lack-of-marketability discount attributable to factors other than ADDI&C's built-in capital gains tax that the parties and all of the experts agree should be applied in ascertaining the fair market value on the valuation date of each of the blocks of stock in question. Petitioner and petitioner's experts believe that the percentage amount thereof should be 35 percent, while respondent's expert Mr. Thomson believes that it should be 23 percent. Because of other differences among them, see chart above, the dollar amount of the lack-of-marketability discount that each determined without regard to any amount included therein that is attributable to ADDI&C's built-in capital gains tax ranges from $15,265,630 (Mr. Howard's determination) to $20,478,074 (Mr. Pratt's determination). Mr. Thomson's determination thereof was $16,220,390.

Mr. Howard determined to apply a 35-percent lack-of-marketability discount[19] by relying on a number of so-called restricted stock studies that are cited in his expert report. Those studies show the amounts of discounts at which private transactions in restricted stock (i.e., stock of public companies

[19] Hereinafter, unless otherwise stated, all references to a lack-of-marketability discount are to such a discount determined without regard to ADDI&C's built-in capital gains tax that we have found should be taken into account in arriving at the total amount of the lack-of-marketability discount that should be applied in this case.

that is restricted from trading on the open market for a certain period) took place compared to the prices on the open market of identical but unrestricted stock (i.e., stock of public companies that is freely tradable on the open market). Mr. Howard also relied on one so-called initial public offering (IPO) study cited in his expert report that shows the amounts of discounts at which private transactions in stock occurring shortly before an IPO took place compared to the prices of such stock after an IPO. In other words, that IPO study analyzed the prices of stock in private transactions compared to the prices of subsequent public offerings of stock of the same companies.

Mr. Pratt determined to apply a 35-percent lack-of-marketability discount by relying on the same restricted stock studies and the same IPO study on which Mr. Howard relied as well as on an additional restricted stock study and an additional IPO study.[20] In addition, Mr. Pratt considered ADDI&C's history as of the valuation date of not paying dividends in determining that discount. In order to ascertain whether the aggregate amount of the minority discount and the lack-of-marketability discount that he separately determined was reasonable, Mr. Pratt also examined certain transactions involving the trading of units of various publicly registered limited partnerships (limited partnership units) that were not trading on a formal exchange such as the

[20] In his rebuttal report, Mr. Howard also considered the additional restricted stock and IPO studies on which Mr. Pratt relied in his expert report.

NYSE. Most of those partnerships were making distributions to their partners (distributing limited partnerships) as of the valuation date. In examining the trading transactions of the limited partnership units, Mr. Pratt focused on those transactions involving publicly registered limited partnerships that, like ADDI&C, were not making distributions to partners (nondistributing limited partnerships) as of the valuation date. After studying the data relating to the trading transactions of the limited partnership units, Mr. Pratt made a number of different calculations regarding the amounts of discounts from net asset value at which those units were trading, including separate calculations of the median amounts of the discounts from net asset value at which limited partnership units of distributing limited partnerships and nondistributing limited partners were trading. Although Mr. Pratt reproduced in an exhibit to his expert report the data from the document (source document)[21] that he had used in making those calculations, he did not use the average discount that was printed in the source document and that was based on the average of the range of trading prices for each of those units that were reflected in that document. Instead, Mr. Pratt admitted

[21] Mr. Thomson included in his rebuttal report a copy of the source document from which Mr. Pratt obtained data with respect to the publicly registered limited partnership units that he examined. That document provided the name of the limited partnership, the value per limited partnership unit, the range of prices at which that unit traded, and the average discount reflected in the trading price from the value of that unit, which was computed by using the average of that range of prices.

at trial that he calculated the amounts of discounts from net asset value at which the limited partnership units were trading based on the lowest trading prices listed in the source document, which resulted in his generating slightly higher discounts (about 3 percent higher) than would have been produced if he had used the average of the range of trading prices for each limited partnership unit that were reflected in the source document.

Mr. Thomson determined to apply a 23-percent lack-of-marketability discount. He stated in his expert report and at trial that the starting point for that discount was 33 to 36 percent (base range), which he identified as the discount for lack of marketability applicable to relatively small minority interests in companies that were for the most part operating companies. In arriving at the base range for his lack-of-marketability discount, Mr. Thomson reviewed certain, but not all, of the restricted stock studies considered by Mr. Howard and/or Mr. Pratt. Mr. Thomson found that the restricted stock studies that he examined showed that the discounts for restricted stock ranged from 26.5 percent to 36 percent, and he used the upper end of that range, i.e., 33 to 36 percent, as the base range for determining the lack-of-marketability discount for each of the blocks of ADDI&C stock at issue. Mr. Thomson also relied on the following factors to determine the specific lack-of-marketability discount applicable to each of those blocks: (1) The size of each block of ADDI&C stock at issue and its ability to influence management decisions;

(2) the swing block potential of each such block; (3) the public awareness or exposure of the business or assets of ADDI&C; (4) the type of business in which ADDI&C was engaged and the composition and relative attractiveness of its assets; (5) the financial strength of ADDI&C and its potential for paying dividends; (6) the basis of value and the method of value used to determine the asset value of ADDI&C; and (7) any other relevant factors that could influence the marketability of each of the blocks of stock at issue. Mr. Thomson concluded that the first six of the foregoing factors tended to lower the lack-of-marketability discount that should be applied to each of those blocks.[22] Consequently, he lowered the base range of 33 to 36 percent that he had used as a starting point to 20 to 24 percent. He then selected 23 percent as an appropriate lack-of-marketability discount.[23]

Respondent points out that neither Mr. Howard nor Mr. Pratt specifies in their respective expert reports and rebuttal reports how each used the restricted stock and IPO studies as well as factors specific to ADDI&C and each of the blocks of stock in question in order to arrive at a 35-percent lack-of-marketability

[22] Mr. Thomson determined that the seventh and last factor, which gives consideration to ADDI&C's built-in capital gains tax, should increase the lack-of-marketability discount that he otherwise determined by $10,578,516.

[23] Taking account of all the factors, including ADDI&C's built-in capital gains tax, that Mr. Thomson concluded were proper in arriving at the lack-of-marketability discount to be applied in valuing each of the two blocks of stock at issue, he determined a 38-percent lack-of-marketability discount.

discount. We agree. Nonetheless, we found those reports and the additional testimony at trial of Mr. Pratt to be quite helpful in ascertaining the lack-of-marketability discount that we shall apply in this case.

Petitioner contends that the 23-percent lack-of-marketability discount determined by Mr. Thomson is too low because, inter alia, Mr. Thomson failed to consider the IPO studies relied on by Mr. Howard and/or Mr. Pratt. In Mr. Thomson's rebuttal report and at trial, he explained that, to the extent that the IPO studies examined data with respect to stock prices subsequent to the valuation date, he believed that those data could not be considered in valuing each of the two blocks of stock at issue because the Uniform Standards of Professional Appraisal Practice provide that the cutoff date for data used in a retrospective appraisal is the valuation date. We agree. However, Mr. Thomson admitted at trial that, to the extent that the IPO studies considered data with respect to stock prices prior to the valuation date, those data were readily available on the valuation date and could have been considered in valuing each such block.[24] We agree and find that Mr. Thomson should have considered the pre-

[24] At trial, Mr. Thomson indicated that he believes that at least one of the IPO studies may be biased because it was based on “insider transactions”. However, Mr. Thomson’s rebuttal report, which was submitted to the Court well before trial, did not reflect any such criticism of that IPO study (or of the other IPO study), which means to us that Mr. Thomson does not consider his criticism at trial about the possible bias of one of the IPO studies to be significant.

valuation date price data reflected in those IPO studies because they, together with the restricted stock studies, would have provided a more accurate base range and starting point for determining the appropriate lack-of-marketability discount than the base range that he determined. Mr. Howard and Mr. Pratt both explained in their rebuttal reports that the restricted stock studies examine stock that, although restricted for a period of time, is freely tradable after that period expires. They point out that the IPO studies, rather than the restricted stock studies, may be more indicative of the lack-of-marketability discount to be applied in the present case because the IPO studies examine the price differences between stock, like ADDI&C stock, that is not freely tradable and stock of the same corporations after it becomes freely tradable in an IPO. The average median price discount (adjusted for industry price/earnings multiples) for years prior to the valuation date (viz, 1975 through 1991) only, based upon an IPO study undertaken by Willamette Management Associates for those years as well as 1992 and 1993, was approximately 52 percent. The average median price discount for years prior to the valuation date (viz, 1980 through 1991) only, based upon an IPO study undertaken by Robert W. Baird & Company for those years as well as 1992 through 1995, was approximately 47 percent. On the record before us, we find that, in determining the lack-of-marketability discount that is applicable here without regard to ADDI&C's built-in capital gains tax, the prevaluation

date data in the IPO studies are relevant and provide some insight into the price differences between stock that is freely tradable and stock, like ADDI&C stock, that is not freely tradable.

Mr. Thomson stated in his expert report that, because each block of ADDI&C stock at issue represented 25.77 percent of the outstanding stock of ADDI&C, no shareholder had control of that corporation on the valuation date. However, Mr. Thomson concluded that each of those blocks could influence management and represented a swing block. Petitioner contends, Mr. Pratt believes, and Mr. Thomson acknowledged at trial that, in determining the value of each of the two blocks of stock in question, the actual owner of the other such block and the actual owner of the remaining ADDI&C stock on the valuation date should be considered. We agree. On that date, one of decedent's sons, who received the other block of stock from his father, and decedent, respectively, were the actual owners of that other block and that remaining stock. Petitioner contends that as of the valuation date it was unlikely that a member of decedent's family would join with an outsider to compel ADDI&C to act or not to act in a specified matter. We agree. On the record before us, we find that Mr. Thomson made invalid assumptions about, and gave undue weight to, the ability of each 25-share block of ADDI&C stock in question to influence management and to be a swing block.

Both Mr. Howard and Mr. Pratt criticize Mr. Thomson for, inter alia, his emphasis in determining a lack-of-marketability discount

on ADDI&C's capacity to pay dividends and his disregard of its 45-year history as of the valuation date of not paying dividends.[25] As of that date, each of those blocks of stock constituted a minority interest, and neither represented a swing block. On the instant record, we find that a hypothetical willing seller and a hypothetical willing buyer would have no reason to believe on the valuation date that ADDI&C's 45-year history of not paying dividends was likely to change. See also Rev. Rul. 59-60, sec. 5, 1959-1 C.B. at 242-243 ("adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment * * * company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.").

On the record before us, we are satisfied that the respective amounts of the lack-of-marketability discounts determined by the experts without regard to ADDI&C's built-in capital gains tax (i.e., $15,265,630 determined by Mr. Howard, $16,220,390 determined by Mr. Thomson, and $20,478,074 determined by Mr. Pratt) set the appropriate range from which we may determine the lack-of-marketability discount without regard to such tax. In making that determination, we bear in mind that valuation is necessarily an approximation and a matter of judgment, rather than

[25] Both of petitioner's experts point out that, except for a shareholder's use of an airplane during 1990 that was treated for that year as a dividend for Federal income tax purposes, ADDI&C had neither declared nor paid any dividends to its shareholders throughout its 45-year history as of the valuation date.

of mathematics, Hamm v. Commissioner, 325 F.2d at 940, on which petitioner has the burden of proof, Rule 142(a). Based on our examination of the entire record in this case, and using the figures in the restricted stock and IPO studies cited in the expert reports of Mr. Howard and Mr. Pratt as benchmarks of the lack-of-marketability discount without regard to ADDI&C's built-in capital gains tax and evaluating various factors specific to ADDI&C and each of the blocks of stock in question, including the factors listed in the expert report of Mr. Thomson, we find that the lack-of-marketability discount without regard to that tax should be $19 million. We further find that the total lack-of-marketability discount that should be applied in this case and that we have found should include $9 million which is attributable to ADDI&C'S built-in capital gains tax is $28 million.

Based on our examination of the entire record in this case, we find that on the valuation date the fair market value of each of the two 25-share blocks of ADDI&C stock in question was $10,338,725, or $413,549 per share.

To reflect the foregoing,

Decision will be entered under Rule 155.

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

DELAWARE OPEN MRI RADIOLOGY ASSOCIATES, P.A.,	)	
Petitioner,	)	Consolidated
v.	)	C.A. No. 275-N
HOWARD B. KESSLER, et al.,	)	
Respondents.	)	
HOWARD B. KESSLER, et al.,	)	
Plaintiffs,	)	
v.	)	
GEORGE J. BRODER, et al.,	)	
Defendants.	)	

OPINION

Date Submitted: February 18, 2006
Date Decided: April 26, 2006

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STRINE, Vice Chancellor.

This case is another progeny of one of our law's hybrid varietals: the combined appraisal and entire fairness action. In this case, the key question is whether the minority stockholders of Delaware Open MRI Radiology Associates, P.A. ("Delaware Radiology") received fair value in a squeeze-out merger with an acquisition vehicle of the majority stockholders, Delaware Open Acquisition, P.A. ("Delaware Acquisition"). The majority and minority stockholders were all radiologists who formed Delaware Radiology to capture additional revenues by owning the centers at which patients would be scanned by MRI machines (the "MRI Centers"). The squeeze-out merger at Delaware Radiology occurred after the radiologists' underlying radiology practice split up, turning the eight Delaware Radiology stockholders into two discrete blocks. The majority group, the "Broder Group," was comprised of five of the stockholders and controlled 62.5% of the Delaware Radiology shares. The minority group, the "Kessler Group," was comprised of three of the stockholders and owned the remaining 37.5% of the Delaware Radiology shares.

Although the dispute requires me to apply both the principles applicable under the appraisal statute and under the common law governing conflicted mergers, the two primary questions of interest to the parties do not differ by the nature of the claim. Those questions are: was the merger price was fair and, if not, what was the extent of the underpayment to the minority stockholders?

In this opinion, I conclude that the merger price of $16,228.55 per share of Delaware Radiology was not fair. Finding no difference between the award the Kessler Group should receive in appraisal or in equity, I award them the amount that I find to be

equivalent to their pro rata share of Delaware Radiology's appraisal value on the date of the merger, $33,232.26 per share, or a total consideration of $4,984,838.71. That award will be supplemented by an award of pre- and post-judgment interest at the 6.9% rate requested by the Kessler Group, compounded monthly.

I. The Procedural Status Of The Litigation

Before describing the relevant facts that are central to this dispute, the procedural underbrush must be cleared away. The merger giving rise to this dispute was effected on January 20, 2004.

The first lawsuit brought in response to the merger was actually filed by Delaware Radiology, as the surviving corporation in the merger, in February 2004. The members of the Kessler Group had expressly preserved their appraisal rights in a letter to the Broder Group, and the members of the Broder Group, through Delaware Radiology, wanted to bring the dispute about value to a head.

In June 2004, the members of the Kessler Group filed a complaint, alleging that the members of the Broder Group (all of whom were directors of Delaware Radiology and Delaware Acquisition, the acquisition vehicle) had breached their fiduciary duties by effecting the merger in a procedurally and substantively unfair manner.

Rather than confuse the reader with references to "respondents/plaintiffs" and "petitioners/defendants," I will generally refer to the minority stockholders, who are seeking damages based upon a determination that the merger was unfair, as simply the Kessler Group. The Kessler Group is comprised of three radiologists: Drs. Howard Kessler, Andrew Shaer, and Locke Barber. Each member of the Kessler Group owned 50

of the 400 outstanding shares of Delaware Radiology. The Kessler Group's cumulative ownership therefore was 37.5%, or three-eighths, of Delaware Radiology.

Likewise, I will refer to the parties seeking to vindicate the fairness of the merger as the Broder Group.[1] The Broder Group is comprised of five radiologists: Drs. George Broder, Michael Clair, William Hartz, Phillip Moldofsky, and Jay Rosenblum. As was the case with the Kessler Group, each member of the Broder Group owned 50 shares of Delaware Radiology. The Broder Group, then, collectively owned 62.5%, or five-eighths, of Delaware Radiology. As a result of the merger, the Broder Group acquired total ownership of Delaware Radiology.

II. Factual Background

A. The Radiology Practice Of The Kessler And Broder Groups

This case has its origins in the common radiology practice in which the Kessler and Broder Groups had interests. Before Delaware Radiology was formed, the members of the Broder and Kessler Groups were practicing together in a radiology practice in Rockledge, Pennsylvania known as Fox Chase Medical Center Radiology Associates, P.C. ("Fox Chase"). Fox Chase was originally formed by four members of the Broder Group: Broder, Hartz, Moldofsky, and Rosenblum. The remaining member of the Broder Group, Clair, joined Fox Chase in September 1985. Kessler joined Fox Chase in

[1] Tri-State Imaging Consultants, L.L.C. ("Tri-State"), which served as the management company of the MRI Centers beginning in 2001, also was named as a defendant in this action based upon its alleged aiding and abetting of Delaware Radiology's fiduciary breaches, but that portion of the litigation was dismissed after summary judgment motion practice. In addition, Delaware Acquisition, the entity used by the Broder Group to merge with Delaware Radiology, also is listed as a defendant in this action.

January 1985, and the remaining two Kessler Group members, Shaer and Barber, joined in approximately 1989-1990.

Each of these doctors had an equal interest in Fox Chase, which derived a large portion of its business from providing radiology services for two Philadelphia-area hospitals: Fox Chase Cancer Center and Jeanes Hospital. Fox Chase also provided radiology services for a small imaging clinic owned by Jeanes Hospital.

B. The Partners Of Fox Chase Decide To Invest In MRI Centers

In 1996, the partners in Fox Chase began considering a strategy to capture more of the total revenue stream flowing from patients who required radiology services.[2] Specifically, they wanted to capture the portion of the revenue stream that went to the entity owning the patient-scanning equipment, in particular, MRI machines. By owning the MRI Centers and doing the diagnostic "reads" of the patient images, the partners at Fox Chase would collect more of the total treatment revenue. As important, because they would own the MRI Centers, the partners at Fox Chase would have control over who did the patients' MRI reads, thus providing them with a more assured stream of this radiology work. As Broder put it, owning the MRI Centers would make radiologists the "masters of [their] own destiny" by allowing them to control the profits of the MRI Centers.[3]

This strategy of opening multiple MRI centers is feasible because a radiologist can read the MRI over the internet at a location remote from the location of the MRI

[2] Shaer was the driving force behind the idea to branch out into the entrepreneurial enterprise of owning MRI Centers. Tr. 678-84.
[3] Tr. 15.

machine. The partners in Fox Chase opened their first MRI Center in 1998 in northeast Philadelphia, through Jeanes Radiology Associates, P.C., which was owned in equal shares by the eight partners of Fox Chase. Jeanes Radiology, essentially the Pennsylvania precursor to Delaware Radiology, was founded to own at least one of the Pennsylvania MRI Centers the partners of Fox Chase hoped to open.

The formation of the entity whose value is at issue in this litigation — Delaware Radiology — resulted from the desire of the partners in Fox Chase to take advantage of the more favorable insurance reimbursement and medical malpractice rates then available in Delaware. To enter the Delaware market, the partners had to form a Delaware entity and obtain licenses to practice medicine in Delaware.[4]

For business reasons, the partners also wanted to join up with a respected Delaware physician who could help secure patients for the MRI Centers they would open in Delaware. To that end, the partners enlisted a locally-renowned doctor, Steven Edell, as a joint venturer. Kessler had a social relationship with Edell, and Kessler and Shaer apparently convinced Edell that investing in the MRI Centers would be beneficial.[5] The division of responsibility was relatively clear. Delaware Radiology would put up capital to form the MRI Centers and would ensure that high-quality MRI reading services were provided to the patients coming through the Centers. Meanwhile, Edell would provide input into possible locations for MRI Centers and use his plentiful contacts in the

[4] For regulatory reasons, it appears that insurance payments for MRI reading fees had to flow through a Delaware-based entity. Likewise, it was necessary for the radiologists diagnosing patients receiving MRI scans in Delaware to be licensed to practice medicine in Delaware.
[5] Tr. 686.

Delaware medical community to ensure that the MRI Centers would benefit from patient referrals. Together, Delaware Radiology and Edell would own, in varying percentages, the MRI Centers that would be opened in Delaware and would share control under the terms of the LLC agreements governing the Centers.

Delaware Open MRI, L.L.C. ("Delaware I"), a Delaware limited liability company, was the first MRI Center they opened. It opened in Newark, DE in 1998. Delaware Radiology received a 70% ownership in Delaware I. Edell received the remaining 30%. Delaware I was profitable quickly, which led Delaware Radiology and Edell to open a second center, Delaware Open MRI II, L.L.C. ("Delaware II"), in Wilmington, DE in 1999. Edell received a higher 40% share of Delaware II, with Delaware Radiology receiving 60%. Delaware Radiology was named as the managing member in the LLC agreements for both Delaware I and Delaware II.

C. The Initial Allocation Of The Revenues For Reading MRI Scans

As has been explained, a central purpose of the formation of the MRI Centers was to enable the partners in Fox Chase to secure a more certain flow of patients needing radiology services. But Fox Chase itself could not directly perform the reads for the Delaware-based MRI Centers because, for various regulatory reasons, a Delaware entity comprised of Delaware-licensed physicians had to be responsible for that function. As a result, not all of the partners in Fox Chase were even shareholders in Delaware Radiology at its formation. Initially, Shaer was named as the sole director, President, Secretary, and

Treasurer of Delaware Radiology because he was already licensed in Delaware.[6] Eventually, all members of the Broder and Kessler Groups became shareholders, and all eventually were added to the board of directors.

Under the operating agreements of Delaware I and Delaware II, Delaware Radiology was assigned the responsibility for providing "MRI diagnostic radiology services."[7] These radiology services were to be provided pursuant to a professional services agreement entered into between each MRI Center and Delaware Radiology. Essentially, these agreements called for Delaware Radiology to provide the reads of the MRI scans that were generated at the MRI Centers. As compensation for these radiology reading services, Delaware Radiology was to be paid 15% of the total revenues of Delaware I and II (the "Reading Fees"). Like Delaware Radiology, Edell got a payment from Delaware I and II for his marketing and administrative work, which, pursuant to the Delaware I operating agreement signed in October 1998, was 5% of the revenues of Delaware I and, pursuant to the Delaware II operating agreement signed in May 1999, was 7.5% of the revenues from Delaware II.

Although the professional services agreements made Delaware Radiology the entity responsible for providing the reads, the actual reads for Delaware I and II upon their opening were performed by radiologists then practicing at Fox Chase. The radiologists who did the work either did the read at Fox Chase or from a home computer. When Delaware I began operating in 1998, there were only three radiologists at Fox

[6] Because he did so much work in connection with opening Delaware I and II, Shaer was paid a development fee. *Id*. at 700.
[7] Op. Agmt. § 6.1.

Chase qualified to provide MRI reads: (i) one member of the Broder Group, Clair; (ii) one member of the Kessler Group, Shaer; and (iii) one employee of Fox Chase, Brumberger. The other members of the Kessler and Broder Groups, at that time, were not qualified to read MRI scans. That reality was not significant then as a business matter. Delaware Radiology simply passed the 15% fee it was entitled to receive through to Fox Chase, and all the read work was performed at Fox Chase by its three qualified readers. Because the eight stockholders of Delaware Radiology were the eight partners of Fox Chase, the reading profits from the Centers were shared equitably among the eight owners — the members of the eventual Kessler and Broder Groups.

D. The Beginning Of The Schism

The stability of this arrangement was short-lived. In June 1999, Kessler, Shaer and Barber — i.e., the Kessler Group — left the Fox Chase practice to form their own radiology practice, Bucks County Radiology Associates, P.C. ("Bucks County"). Bucks County was formed to provide radiology services to two Philadelphia-area hospitals: Graduate Hospital and Warminster Hospital. Brumberger, one of the qualified MRI readers at Fox Chase, also took his services to Bucks County with the Kessler Group. As a result, two of the three MRI readers at Fox Chase — Shaer and Brumberger — were now at Bucks County.

This posed an obvious problem for Delaware Radiology and Fox Chase. Five of the eight owners of Delaware Radiology were now at Fox Chase, while three were at Bucks County. Only one of the qualified MRI readers, Clair, was left at Fox Chase. Thus, the simple funneling of the 15% Reading Fee to Delaware Radiology through to

Fox Chase would no longer result in an equitable distribution of read revenue to the eight Delaware Radiology stockholders, as only five of them remained partners in Fox Chase.

This split created issues for the allocation of MRI reads from the MRI Centers. In contemplation of the Kessler Group leaving Fox Chase, the Kessler Group's attorney proposed that, initially, Fox Chase would be allocated five-eighths of the reads and Bucks County would receive three-eighths.[8] The Kessler Group proposal also contemplated that upon Brumberger becoming a full partner in Bucks County, the MRI Centers would allocate 50% of the reads to Bucks County and 50% of the reads to Fox Chase. But the Broder and Kessler Groups never came to agreement on this proposal.

Instead, immediately after the Kessler Group left Fox Chase, Clair, a Broder Group member, took over the responsibility for allocating the MRI reads. Initially, the Broder and Kessler Groups agreed that two-thirds of the MRI reads would be allocated to Bucks County, because Bucks County had two of the three physicians who had been performing the reads. That is, the number of reads allocated tracked the relative reading capacity of Bucks County and Fox Chase at that time.

In early 2000, Fox Chase's capacity for MRI reads increased when it hired a new radiologist, Dr. Kofsky, who was competent to provide reads, and when Hartz, a Broder Group member, acquired the necessary proficiency to provide MRI reads. Therefore, the

[8] Jt. Ex. 27 at p. 4. This letter also recognized the possibility that Fox Chase would not have adequate personnel to handle five-eighths of the reads and would need to enter into a cross-coverage agreement with Bucks County. *Id*. at 5. Similarly, in May 1999, the Broder Group drafted a proposal to get the Kessler Group to stay on at Fox Chase, which discussed dividing Reading Fees equally. This proposal was not accepted by the Kessler Group. Jt. Ex. 20.

Broder Group, as the controlling block of Delaware Radiology,[9] decided to change the allocation of MRI reads, without apparent complaint from the Kessler Group. Clair, then, began referring 50% of the reads generated by the MRI Centers to Bucks County, and the remaining 50% of the reads went to Fox Chase. This allocation remained in place until November 2001, when Brumberger left the Kessler Group and returned to Fox Chase to work with the Broder Group.[10] At this time, the Broder Group decided to reduce the Kessler Group's reads again, and Clair began referring only one-third of the MRI reads to the Kessler Group. When the reads allocated to Bucks County were reduced to one-third, the Kessler Group's allocation of reads fell slightly below their pro rata ownership, which was three-eighths, of Delaware Radiology.[11] The Kessler Group did not object to this new allocation that began in November 2001.

E. The Broder And Kessler Groups Muddle Through For Awhile

For those with a half-full perspective on life, it is uplifting that the Broder and Kessler Groups were able to muddle through in operating Delaware Radiology until the summer of 2002 without a major meltdown in relations. Having left Fox Chase, the Kessler Group should have recognized that there would be some hard feelings and that its economic interests were now aligned less than perfectly with the Broder Group's.

[9] Broder was less than clear as to the capacity in which the Broder Group acted when determining how to allocate the reads. Initially, he stated it was in the Broder Group's capacity at Delaware Radiology. Tr. 85-86. In response to rather obvious prompting from his own counsel to change his testimony, Broder later stated that the allocation decision was made at Fox Chase. Tr. 335-36. I find that the Broder Group used its majority status to dictate the allocation.
[10] Tr. 806.
[11] Tr. 85.

Nonetheless, the parting of ways at Fox Chase did not initially affect the ability of the Kessler and Broder Groups to conduct the business of Delaware Radiology. All shareholders continued to sit on Delaware Radiology's board of directors.[12] Shaer, a Kessler Group member, continued to serve as President of Delaware Radiology and Medical Director of Delaware I and II. In fact, after the split, the Kessler and Broder Groups opened more jointly-owned MRI Centers in Pennsylvania using various Pennsylvania entities and discussed the possibility of opening a third MRI Center in Delaware through Delaware Radiology.

In addition, in April 2001, the Broder Group retained Michael Carr "to consult and help restructure the management of the non-medical aspects" of Delaware Radiology's business.[13] Initially, Carr was hired as an employee of Fox Chase, and the Kessler Group agreed to "try out" Carr to see if Delaware Radiology would benefit from his management.[14] Carr began providing services to the MRI Centers, including those managed by Delaware Radiology, while he was still on the Fox Chase payroll. Within three to four months of joining Fox Chase, Carr officially became the first employee of Tri-State. Tri-State is an entity that was formed by the Broder Group in 2001, which the Broder Group envisioned would provide management to its Centers. When Carr became an employee, Tri-State then became the entity responsible for the day-to-day, non-

[12] Rosenblum was not yet a shareholder or on the board of directors, presumably because he was not yet a Delaware-licensed physician.
[13] Jt. Ex. 33.
[14] Tr. 737.

medical management of the MRI Centers.[15] Tri-State's responsibilities to the MRI Centers included performing all accounting functions, all human resource functions, facilities management, oversight of information technology, marketing, and business development.[16] Before Tri-State handled the management, the Delaware Radiology shareholders had done that themselves. On December 12, 2001, Delaware Radiology proposed to Edell that Tri-State be paid 1% of the MRI Centers' cash collections in order to compensate it for providing management services. Edell agreed.

After Tri-State began managing Delaware Radiology, it implemented a new system of cash collections and revenue distribution. Before June 2002, insurance reimbursements payable for services rendered at Delaware I and II would go into a Delaware Radiology account. The revenue was then dispersed — 15% for MRI reads, 5% or 7.5% to Edell in the case of Delaware I and II, respectively, 1% to Tri-State, and the remainder to the MRI Center where the scan was performed.[17] The 15% read revenue was passed on to Fox Chase and Bucks County in proportion to the then-existing allocation of reads.

In June 2002, while the Kessler Group still was actively involved in Delaware Radiology and Shaer served as President, Tri-State formed a "concentration account," which received all the incoming reimbursements and collections from the various MRI Centers and sent them up to Fox Chase and the individual MRI Center. The insurance companies, then, made payments directly to the Tri-State concentration account. This

[15] *Id.* at 366.
[16] Jt. Ex. 272.
[17] Tr. 456-57.

essentially commingled the funds of a number of MRI Centers, including the funds of some non-Delaware MRI Centers co-owned by the two Groups and of some MRI Centers owned exclusively by the Broder Group, in one account until the distributions were made. The creation of this concentration account was not a matter of controversy among the directors of Delaware Radiology at that time.

F. The Schism Between The Broder And Kessler Groups Rips Open

The rift between the Kessler and Broder Groups became a chasm in August 2002. On August 13, the Broder Group decided that Fox Chase had "ramped up enough" to handle more reads, and Clair presented Shaer with a schedule of reads, which indicated that the Kessler Group's reads would be reduced from one-third to one-sixth.[18] Now, the Kessler Group objected.

In response to this news, Kessler called Broder on August 15 to express his dismay at the MRI read reduction and to request a meeting. On August 16, Kessler sent a letter to the attorney who represented Delaware Radiology, Arthur Brandolph, requesting "all of the important legal documents for each entity in which [the Kessler Group] own[s] an interest" and "an independent audit of each entity" as well.[19]

Kessler then met with Broder on August 21 in Brandolph's office. After exchanging niceties, Kessler asked Broder, again, to reconsider the reduction in reads. Broder maintained that the reduction in reads was a logical progression and that the

[18] *Id.* at 85.
[19] Jt. Ex. 47.

reduction would occur.[20] Next, they discussed the "divorce" that had occurred when the Kessler Group left Fox Chase, and, for the first time, Broder indicated that the Broder Group would be interested in buying out the Kessler Group's interest in the MRI Centers.[21] Kessler, though, informed Broder that the Kessler Group would prefer to be a buyer, not a seller.[22] Finally, Kessler shared that the Kessler Group would be competing with the Broder Group for the contract to provide radiology services to Jeanes Hospital.

The decision to bid for the Jeanes Hospital contract clinched the mutual enmity between the two Groups. Although the Kessler Group says that it bid only after learning that the Broder Group had no chance of retaining the business, the Kessler Group had to know that this competition would wound the Broder Group, which had provided services at Jeanes Hospital through Fox Chase for nearly twenty years. According to Broder, he had been told in July by the Kessler Group that it would not be bidding on the contract in competition with Fox Chase. Therefore, when Broder learned at the August 21 meeting that the Kessler Group would in fact bid, Broder was "probably . . . the most shocked [he had] ever been in [his] life."[23]

Within a week of learning that the Kessler Group was competing with Fox Chase, Broder received even worse news. On August 26, he met with a representative of Jeanes Hospital who informed him that the Broder Group would lose the contract and that the Kessler Group likely would be awarded the contract. The Broder Group officially

[20] Tr. 109.
[21] *Id.*
[22] *Id.*
[23] *Id.* at 110-11.

received word on October 15 that it would not receive the Jeanes Hospital contract, and the Broder Group ceased providing radiology services for Jeanes Hospital on November 15, the same day that the Kessler Group began providing the services. After losing that contract, the Broder Group's MRI readers had more time on their hands, and within a month, the Broder Group, through Clair, completed the trend in reducing the Kessler Group's reads and no longer allocated any read work to the Kessler Group. As Broder candidly stated at trial, his view was that the Kessler Group's entitlement to read work had ended when the three radiologists left Fox Chase.[24]

Litigation between the Broder Group and the Kessler Group erupted. In November 2002, the Broder Group sued the Kessler Group over its competition for the Jeanes Hospital contract. The Kessler Group responded by suing the Broder Group in Pennsylvania for wrongfully reducing its share of the MRI reads from the commonly-owned MRI Centers in Pennsylvania and Delaware.[25]

The feud also resulted in corporate governance changes at Delaware Radiology. On November 6, in his role as President of Delaware Radiology, Shaer called a special stockholders meeting to discuss financial and ownership matters. In lieu of attending the

[24] *Id*. at 203-04.

[25] Neither party has asserted that findings in the Pennsylvania litigation have any collateral effect on the issues presented to me at trial. The Pennsylvania litigation resulted in an injunction that required the Broder Group to provide one-third of the reads generated by the commonly-owned entities in Pennsylvania and Delaware to the Kessler Group. *See Kessler v. Broder*, 851 A.2d 944 (Pa. Super. 2004); *Kessler v. Broder*, 2003 WL 21782433, at *1 (Pa. Com. Pl. July 28, 2003). Perhaps for that reason, the Kessler Group has not sought a remedy for any allocation of work before the merger in this case, and it does not appear that its expert's valuation was increased by Reading Fees from prior years. But the scope and duration of that injunction is not clear to me. The parties have not expended any effort to elucidate me on the precise status of the Pennsylvania litigation and have proceeded as if it has no effect on this case. Any inefficient overlap, therefore, is a burden they have assumed voluntarily.

stockholders meeting, on November 20, the Broder Group issued written stockholder consents removing the Kessler Group from Delaware Radiology's board of directors and postponing the annual board of director meeting.[26] The Broder Group also installed one of its own, Broder, in place of Shaer as President of Delaware Radiology, and replaced Shaer with Clair as Medical Director of the MRI Centers, including Delaware I and II. The Kessler and Broder Groups next interacted at a contentious Delaware Radiology shareholder meeting held on December 23, 2002.[27]

G. The Final Year Of Joint Ownership

During 2003, a period in which they were battling in litigation, the Broder and Kessler Groups continued to be shareholders in Delaware Radiology. Although they had informally discussed a separation of their interests in Delaware Radiology in August 2002, by spring 2003, the Broder Group began planning for such a division in earnest, albeit in an erratic and confusing manner.

By March 2003, the Broder Group was functioning as a coherent majority block at Delaware Radiology. Using that power, it increased, retroactively to September 2002, Tri-State's management fee to 2% of total cash collections. That same month, the Reading Fees for Delaware I were increased from 15% to 17.5% of revenues; in exchange for this, Edell extracted an increase in his take from 5% to 7.5% of revenues from Delaware I, consistent with his original take from Delaware II.

[26] Jt. Ex. 58.
[27] Jt. Ex. 64.

At a special shareholder meeting of Jeanes Radiology on May 28, 2003,[28] the Broder Group expressed its intent to pursue a valuation of the various MRI Centers, including Delaware I and II, with a view towards some sort of separation. The Broder Group retained Timothy C. Reed of Diversified Medical Management to perform the valuation. On July 15, the Broder Group formed the entity, Delaware Acquisition, that it intended to use as its acquisition vehicle in a squeeze-out merger with Delaware Radiology, although the Kessler Group was unaware of this occurrence. What the Kessler Group did know was that the Broder Group was thinking about a transaction that would eliminate the Kessler Group's ownership in the entities that controlled the various MRI Centers. For example, on July 30, the Broder Group's attorney, Douglas Coopersmith, wrote a letter to the Kessler Group's attorney, Eric Wilenzik, informing him that the Kessler Group could provide information to Reed to assist in the valuation.[29] The Kessler Group apparently declined this invitation.

But the Broder Group's desire to eliminate the Kessler Group's interest was less than firm. In the same time period, Tri-State was performing serious business development work for Delaware Radiology on the opening of new MRI Centers. In May, the Delaware Radiology board of directors — which by then was exclusively comprised of the Broder Group members — discussed the idea of opening a third Delaware MRI Center with Edell in Middletown, DE ("Delaware III"). In July, Delaware III entered into a lease for space that it would use in Middletown. Meanwhile, Tri-State, through

[28] Jt. Ex. 91.
[29] Jt. Ex. 106.

Carr, had also been working for Delaware Radiology on the concept of opening yet a fourth MRI Center with Edell, in this instance in Dover, DE ("Delaware IV"). Planning for Delaware IV was well under way by late autumn of 2003.

By late 2003, the ambiguity about the Broder Group's desires was piquant. In October, while Reed was valuing Delaware Radiology and the Broder Group had begun the steps to squeeze out the Kessler Group, the Broder Group's attorney sought personal guarantees from the Kessler Group, at the request of the Wilmington Savings Fund Society, in connection with financing an expansion of Delaware I.[30] In the exchange of communications, the Kessler Group's attorney developed the impression that the Broder Group was also seeking guarantees from the Kessler Group in connection with a new MRI Center and requested more information.[31] In response, the attorney for the Broder Group sent the pro forma projections for both this new MRI Center, which was Delaware III, and the expansion of Delaware I to the Kessler Group. But his letter otherwise only mentioned the expansion of Delaware I. The Kessler Group then proposed that the Delaware Radiology shareholders and Edell loan the money necessary for the financing, rather than seeking it from a third-party lender. The negotiation over financing continued, albeit in a manner that appears only to have concerned Delaware I, until mid-November, and it appears that the Broder Group and Edell ultimately provided the loans for the expansion.[32]

[30] *See* Jt. Ex. 403 for the various communications.
[31] Jt. Ex. 390.
[32] Jt. Ex. 124.

During this time frame, the Broder Group must have been actively planning the merger because, on December 10, the Broder Group members executed consents in their capacity as directors of Delaware Radiology to approve the merger. On December 15, the Broder Group first formally notified the Kessler Group of a merger whereby the Kessler Group would be squeezed out of Delaware Radiology. By October 31, Reed had finished his valuation work, and his valuation of Delaware Radiology was included in this December 15 notice along with the merger agreement. The merger agreement indicated that Delaware Radiology would merge with Delaware Acquisition, and Delaware Radiology would be the surviving corporation. Using Reed's work as a premise for the merger terms, the merger agreement called for merger consideration of $16,257.33 per share.[33]

Along with the merger agreement, the Broder Group also sent notice of a special meeting of shareholders that would be held on January 5, 2004 to vote on the proposed merger. At the Kessler Group's request, the meeting was postponed until January 19.

On January 9, the individual members of the Kessler Group submitted written demands for appraisal of their shares pursuant to 8 *Del. C.* § 262. In addition, they agreed not to attend the special meeting to be held on January 19. In a January 16 letter, the Broder Group's attorney confirmed the arrangement whereby the Broder Group would meet on January 19 to approve the merger, and the Kessler Group would not attend but still preserved "all of its claims against the Broder Group" except for any

[33] Pursuant to the merger agreement, this price was adjusted downward to $16,228.55, which became the final merger price, based on excess working capital and distributions.

claims "arising out of or related to the propriety of the Notices, the presence of a quorum at the Meeting, the sufficiency of the vote to approve and adopt the merger and the other action items, other needed corporate action to approve, adopt and make the merger legally binding and other claims arising from or related to the manner in which the Meeting was conducted."[34] As contemplated, the Broder Group met and approved the merger, and the merger became effective the next day — January 20. The final per share merger consideration, after adjustments, was $16,228.55, which would have provided each minority stockholder with $811,427.50.

[34] Jt. Ex. 151. In prior summary judgment motion practice, the Broder Group argued that the Kessler Group, through this letter, waived its right to bring any action other than an action for appraisal. Waiver, of course, only occurs when a party voluntarily and knowingly relinquishes a known right. *See Realty Growth Inv. v. Council of Unit Owners*, 453 A.2d 450, 456 (Del. 1982); DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 11.2 (2005). I agreed with the Broder Group that the Kessler Group's agreement that it would not challenge actions required "to approve, adopt and make the merger legally binding" clearly waived any claims for rescission or rescissory damages. Essentially, the Kessler Group recognized that the Broder Group had the necessary number of votes to effect the merger and waived any argument that the merger should be unwound for procedural reasons. But the Broder Group also argued that the January 16 letter precluded an entire fairness claim. I rejected that argument, determining that the January 16 letter did not clearly waive the right to bring equitable claims, such as an entire fairness action, as a matter of law. I did so because the January 16 letter could also reasonably be read, in light of its text and particularly the Kessler Group's reservation of "all of its claims" with certain defined exceptions arguably relating only to the formalities of the merger approval process, as merely waiving any objection to the procedures used to effect the formal approval of the merger and not any equitable claims addressing the merger's substantive fairness. I did leave open the possibility that through extrinsic evidence introduced at trial, the January 16 letter could potentially be proven to foreclose an entire fairness claim. The Broder Group, though, did not address this issue at trial or in its trial briefs in more than a cursory manner, and I therefore permit the progression of the Kessler Group's entire fairness claims.

G. After The Merger, Three New Delaware MRI Centers Open

Soon after the merger, the Broder Group capitalized on the substantial planning already underway for the new MRI Centers in Middletown and Dover. Indeed, as to the Middletown Center, the Broder Group did not even wait until the merger was effected.

In December 2003, Delaware Open MRI III L.L.C. (what was previously defined as "Delaware III") was formed to own the Middletown MRI Center, and in July 2003, Delaware III had leased the space where this Center would be located.[35] The ownership structure of Delaware III was a bit different from Delaware I and II. Delaware Radiology was accorded ownership of 51.4%, Edell 40%, and Carr, of Tri-State, was granted an 8.6% interest. Delaware III became operational in April 2004.

The Dover MRI Center — which was owned through Dover Open MRI LLC (what was previously defined as "Delaware IV") — was opened in July or August 2004. Delaware IV was formed eight days before the merger. Although the Delaware IV lease was not formalized until January 27, the lease was essentially ready for signature before the merger.

No doubt, the decision to hold off the lease signing was tactical and influenced by legal risk. Those tactics also influenced the ownership structure for Delaware IV. Rather than participate in Delaware IV through Delaware Radiology, the Broder Group participated in Delaware IV through a new entity, Tri-State G.P. LLC. Tri-State G.P.

[35] Carr somehow signed this lease on behalf of Delaware III though that entity was not formed until months later. I have little doubt that, had Delaware III somehow defaulted under its lease obligations, the landlord would have had the ability to recover against Delaware Radiology directly because Carr executed the lease on behalf of Delaware III before that entity which Delaware Radiology intended to create even existed.

LLC was owned by the Broder Group, along with Carr. Like the other Delaware MRI Centers, Delaware IV was a joint venture with Edell, who received 40% of Delaware IV.

The southern movement of the MRI Centers continued beyond Dover. In September 2004, Open MRI of Seaford, LLC ("Delaware V") was formed as the entity that would own an MRI Center in Seaford, DE. A lease for the Seaford Center was signed in February 2005, over a year after the merger. As of trial, the Seaford Center was not yet operational. The ownership structure of Delaware V is slightly different than even Delaware IV. Delaware V is owned individually by the members of the Broder Group, along with Brumberger (who is now a partner of Fox Chase), Carr, and Edell. Edell owns 40% of Delaware V, and the remaining individuals each own 8.57%.

As with Delaware I and II, payments for the read work are a substantial portion of the total revenues the Broder Group receives from its investments in Delaware III, IV, and V. In the operating agreements for those new MRI Centers, 17.5% of the total revenues were to be paid to the provider of MRI reading services. In the case of Delaware III, that provider was to be Delaware Radiology. In the case of Delaware IV and V, due to a change in Delaware law that dropped the requirement for a Delaware professional corporation to provide this type of medical service, the operating agreements provided that Fox Chase would receive the Reading Fees.

III. Framework For Analysis

The resolution of this case is complicated by the presence of both an equitable entire fairness claim and a statutory appraisal claim. The key issues relevant to each type

of claim are common, and the differing rubrics have relatively little influence on the bottom line outcome of the case, which turns on whether the merger was financially fair.

Nonetheless, it is required that I address each claim on its own distinct terms. My task in addressing the appraisal aspect of the case is easy enough to state, if more difficult in practice to accomplish with any genuine sense of reliability. Put simply, I must determine the fair value of Delaware Radiology's shares on the merger date and award the Kessler Group a per share amount consistent with their pro rata share of that value, supplemented by a fair rate of interest, regardless of whether that amount is greater or less than the merger price.[36] Fair value is, by now, a jurisprudential concept that draws more from judicial writings than from the appraisal statute itself. In simple terms, to reach a fair value award, I must determine Delaware Radiology's value as a going concern on the merger date and award the Kessler Group the percentage of that value that tracks its members' pro rata interest in Delaware Radiology on that date.[37] In valuing Delaware Radiology, I may consider all relevant, non-speculative factors bearing on its value as of the merger date.[38] That includes the input provided to me by the contending parties' experts.[39] But I cannot shirk my duty to arrive at my own independent determination of value, regardless of whether the competing experts have provided widely divergent estimates of value, while supposedly using the same well-established

[36] *E.g.*, *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 299 (Del. 1996) (hereinafter "*Technicolor*").
[37] *Andaloro v. PFPC Worldwide, Inc.*, 2005 WL 2045640, at *8 (Del. Ch. Aug. 19, 2005).
[38] *See Union Illinois 1995 Inv. Ltd. P'ship v. Union Fin. Group, Ltd*., 347 A.2d 340, 356-57 (Del. Ch. 2004).
[39] *Technicolor*, 684 A.2d at 299 (citations omitted).

principles of corporate finance.[40] Such a judicial exercise, particularly insofar as it requires the valuation of a small, private company whose shares do not trade in a liquid and deep securities market, using a record shaped by adversaries whose objectives have little to do with reaching a reliable valuation, has at best the virtues of a good faith attempt at estimation. That is what I endeavor here.

Unlike a statutory appraisal action, the success of an equitable action premised on the assertion that a conflicted merger is unfair ultimately turns on whether the court concludes that the conflicted fiduciaries breached their duties.[41] Here, there is no question that the merger implicates the entire fairness doctrine, as the Broder Group comprised all the members of the Delaware Radiology board and the acquiring company's board, and used its majority control to vote through the merger. Nor did the Broder Group use any of the procedural devices that could temper (or in some contexts, eliminate) the application of the entire fairness standard, such as a special negotiating committee of disinterested and independent directors or a majority-of-the-minority stockholder vote provision.

Therefore, the Broder Group bears the burden to prove that the merger was entirely fair. That burden has been said to require that the proponents of a conflicted merger demonstrate that they proceeded in a manner that was both procedurally and substantively fair.[42] That is more than a bit of a misnomer, as the overriding consideration is whether the substantive terms of the transaction were fair. Thus, it has

[40] *Gonsalves v. Straight Arrow Publishers*, 701 A.2d 357, 361-62 (Del. 1997).
[41] *Onti, Inc. v. Integra Bank*, 751 A.2d 904, 930 (Del. Ch. 1999).
[42] *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

been said that the two-part fairness test is not a bifurcated one; rather, all aspects of the transaction are examined as a whole in order to aid in coming to the bottom-line conclusion of whether the transaction was fair.[43] In a non-fraudulent transaction, therefore, "price may be the preponderant consideration outweighing other features of the merger."[44]

Given the nature of the merger at issue here, it makes sense to examine the process by which the merger was accomplished as an initial matter. Then, once that is examined, I will consider whether the merger was effected at a fair price, because that inquiry is common to both the entire fairness and appraisal claims.

IV. The Fairness Of The Merger Process

The Kessler Group naturally alleges that the merger process was unfair because the Broder Group did not use any traditional fairness-enhancing procedures in the merger process. The most that the Broder Group did was to commission Reed to conduct a valuation of Delaware I and II so that his valuation could be used to set the price at which the Broder Group would cash-out the Kessler Group.

Unlike the Kessler Group, I am not shocked by this method of proceeding. The record is replete with futile exercises in negotiation between the Broder and Kessler Groups. Moreover, the Kessler Group was invited to submit information to Reed but chose not to participate in Reed's valuation exercise.

[43] *Weinberger*, 457 A.2d at 711.
[44] *Id*. *See also Onti*, 751 A.2d at 930 n.108 ("[W]here the claims of unfair dealing do not rise to the level of fraud . . . the Court should primarily focus on whether the price was unfair.").

But the fact that the Broder Group decided to use its power to cash-out the Kessler Group does not mean, in itself, that it acted unfairly. Assume, for example, that the Broder Group had appointed Warren Buffett and Robert Rubin to act as a special committee, with a distinguished and unconflicted investment bank as their advisor, to value the Kessler Group's interests in Delaware Radiology as fairly as they could, based on full and fair access to company information. Assume further that the Broder Group used the resulting valuation as the basis for setting the Kessler Group's exit price. In that scenario, it would be difficult to perceive any procedural unfairness. I know of no requirement that a controller actually bargain with the minority or give a representative of the minority veto power in order to meet its burden of proving entire fairness; rather, the forsaking of such techniques is what imposes the burden of demonstrating fairness squarely on the controller. In such a circumstance, what will be determinative is whether the chosen appraiser actually came up with a fair exit price for the minority.

What is therefore critical in a case like this is whether the appraiser chosen by the Broder Group, Reed, in fact came up with a fair valuation. If Reed failed in that endeavor and the Broder Group used too low a valuation to set the merger consideration, then the Broder Group will not have met its burden to prove that the merger was fair.

Playing into this analysis are two issues that have both equitable and pure valuation implications. As the factual rendition indicates, one of the principal reasons for this dispute is the Kessler Group's objection to the Broder Group's ascending and eventual total allocation of the Reading Fees to itself, to the exclusion of the Kessler Group. In his valuation that was the premise for the merger price, Reed simply accepted

that Delaware Radiology should be valued on the basis that it had to pay 17.5% of the revenues from Delaware I and 15% of the revenues from Delaware II in Reading Fees. Reed did not consider whether either the 17.5% or even the 15% fee were true market rates, given that the founders of Delaware Radiology intended to benefit not only from owning the MRI Centers but from providing the reading services. Similarly, Reed simply took it as given that the Broder Group's unilateral decision to double the management fees paid to Tri-State was a fair one, which reflected a reasonable market price for the services Tri-State provided.

In evaluating the fairness of the merger, therefore, it becomes essential for me to determine whether the allocation of all the reads by the Broder Group to itself was a breach of fiduciary duty or breach of contract. Even if the allocation was not in itself a breach of duty, I must determine whether the Broder Group used its control of Delaware Radiology to obtain for itself an above-market rate for the Reading Fees and for management services. These inquiries are necessary because the Kessler Group was actively disputing the Broder Group's handling of these issues as of the time of the merger. If the merger terms did not adequately account for the value of these potential claims, then the merger would not be fair. Likewise, in appraising Delaware Radiology, it is relevant to consider the value of claims belonging to the entity, as they are an asset of the firm that is part of its value.[45]

[45] *See, e.g.*, *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1142-44 (Del. 1989); *Nagy v. Bistricer*, 770 A.2d 43, 55 (Del. Ch. 2000).

There is another even more important issue that does not turn solely on an exercise in valuation. Reed seemed to view his task as valuing particular MRI Centers that the Broder Group brought to his attention. Consistent with that narrow prism and, as shall we see, his very incomplete understanding of the nature of Delaware Radiology, Reed did not even consider whether Delaware Radiology was more valuable as of the time of the merger because of the plans it had developed to open Delaware III and IV. His valuation included no value for those expansion plans.

The decision of the Broder Group to cash out the Kessler Group at a price that did not afford it any of the value of the gains expected from Delaware III, IV, and possibly V clearly bears on the fairness of the merger.[46] Not only that, if the concept of opening Delaware III, IV, and V was part of the business plans of Delaware Radiology as of the merger date, then the value of those expansion plans must be taken into account in valuing Delaware Radiology as a going concern, under the teaching of our Supreme Court in *Technicolor* and other precedent.[47]

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[46] *See, e.g.*, *Onti*, 751 A.2d at 910-11 (discussing the need to include value for a company's development plans in order to prevent the majority stockholder from unfairly denying the minority any value by unfairly timing the merger); Lawrence A. Hamermesh and Michael L. Wachter, *The Fair Value of Cornfields in Delaware Appraisal Law* (U. of Penn, Inst. For Law & Econ Research, Paper No. 05-24, 2005) *available at* http://ssrn.com/abstract=810908 ("If the controller could simply choose the moment to squeeze-out the minority when the fortune of the firm was about to improve, the result would be to discourage minority shareholders from becoming minority shareholders and upset the balance that protects minority shareholders while allowing the controller to retain the benefits of control.").

[47] *Technicolor*, 684 A.2d at 300; *see Weinberger*, 457 A.2d at 713 ("Thus, market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts which were known or which could be ascertained as of the date of merger and which throw any light on future prospects of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholders' interest, but must be considered by the agency fixing the value."); *Onti*, 751 A.2d at 911 ("I would suggest to you that a valuation of that company as of the date of

As will be seen, after considering these issues, I determine that the Broder Group's handling of these issues fell well short of what was necessary for them to satisfy their burden of fairness. For that reason, principles of equity infuse my valuation analysis, because I have endeavored to resolve doubts, at the margins, in favor of the Kessler Group, the minority stockholders who were involuntarily squeezed out of Delaware Radiology.[48] By doing so, I attempt to come up with an award that equals what the Kessler Group would have received in a merger negotiated at arm's-length between parties with equal bargaining strength.

V. The Fairness Of The Merger Price

With this framework in mind, I will now resolve the key disputes over value. There are three major issues that divide the parties. The first two I will examine are the ones I have just mentioned: (1) the reading and management fee dispute and (2) the expansion plans. The other major issue involves the proper way to address the reality that Delaware Radiology was an "S" corporation before the merger[49] and that there was no likelihood that it would ever be other than an S corporation, irrespective of the merger.

These three issues account for most of the differences in value found in the reports of the testimonial experts. At trial, the Broder Group relied on the same expert it used to

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the merger that doesn't take into consideration the nonspeculative possibilities of developing this cornfield into something other than a cornfield is not a realistic valuation of the company. The minority shareholders, under those circumstances, are entitled to a valuation that reflects the value of a company that owns a cornfield that can be developed into a major office center."); *Allenson v. Midway Airlines Corp.*, 789 A.2d 572, 585 (Del. Ch. 2001) (stating that even value added by an acquiror's business plan can become cognizable in an appraisal proceeding if it is actually being implemented).

[48] *See Andaloro*, 2005 WL 2045640, at *9.

[49] *See* 26 U.S.C.A. § 1363 (2005) ("The taxable income of an S corporation shall be computed in the same manner as in the case of an individual . . . .").

set the merger price in the first instance, Timothy Reed of Diversified Medical Management. Reed premised his opinion of value on a discounted cash flow analysis that attributed no value to Delaware III, IV, or V, that accepted the reading and management fees as proper expenses of the MRI Centers, and that tax affected Delaware Radiology's earnings as if it were a C, rather than S, corporation. After doing all this, and using high discount rates of 21.4% for Delaware I and 22.4% for Delaware II, Reed came to a value of $6,815,400, or $17,038.67 per share, which translated to $2,555,800 overall to the Kessler Group. This was slightly higher than the value offered to the Kessler Group in the merger, which was a value set in reliance on Reed's earlier work.

For its part, the Kessler Group employed John Mitchell of Gocial Gerstein, LLC as its valuation and damages expert. Like Reed, Mitchell relied on a DCF analysis. But Mitchell: (1) included in his valuation an estimate of the value of Delaware III and IV; (2) treated the majority of Reading Fees entirely as profit to Delaware Radiology rather than as proper expenses to the MRI Centers; (3) reduced the management fee to Tri-State, as well as the fees to Edell, as being excessive; and (4) did not tax affect Delaware Radiology's future earnings at all. Mitchell also used a lower discount rate. Using these inputs, Mitchell arrived at a value for Delaware Radiology on the merger date of $26,429,722, which translates into $66,074 per share or $9,911,100 to the Kessler Group for its 37.5% share.

In determining which side is closer to the mark, I will proceed as follows. For the sake of clarity, I begin by determining how the expansion plans affected Delaware Radiology's value on the merger date. I then address the dispute over reading and

management fees. I next confront the question of whether to tax affect Delaware Radiology's earnings. Finally, I endeavor to put all the pieces together and come to a bottom-line determination of the value of Delaware Radiology as of the merger date, for the purposes of making a determination of fairness and shaping the Kessler Group's award.

A. Should The Value Of Delaware III, IV, And V Have Been Accounted For In The Merger Price?

Delaware law is clear that "elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered."[50] Obviously, when a business has opened a couple of facilities and has plans to replicate those facilities as of the merger date, the value of its expansion plans must be considered in the determining fair value. To hold otherwise would be to subject our appraisal jurisprudence to just ridicule. The dangers for the minority arguably are most present when the controller knows that the firm is on the verge of break-through growth, having gotten the hang of running the first few facilities, and now being well-positioned to replicate its success at additional locations — think McDonald's or Starbucks. Here, the business plan of Delaware Radiology involved the strategy of opening additional MRI Centers in Delaware with Edell. This strategy was part of what the Supreme Court would call the "operative

[50] *Weinberger*, 457 A.2d at 713. *See also Technicolor*, 684 A.2d at 300.

reality" of Delaware Radiology on the merger date and must be considered in determining fair value.[51]

On this record, it is easy to conclude that the value of the expansion plans for Delaware III and IV must be considered in valuing Delaware Radiology as of the merger date. The only hard question is whether there was any non-speculative value for Delaware V as of the merger date to take into account, given the circumstances. Regrettably, the Broder Group did not content itself with fighting about the inclusion of value for Delaware V, but rather insisted that it was perfectly appropriate to attribute no value at all to the expansion plans of Delaware Radiology as of the merger date. For that reason, I must address each of the new MRI Centers that logically arose out of Delaware Radiology's prior efforts in entering Delaware and opening Delaware I and II. Pervading this analysis is an obvious point: Delaware I through V are all premised on the same model of operation and all involve a partnership with Edell, whereby he will stimulate client flow and the stockholders of Delaware Radiology will bring their radiology

[51] In essence, when the court determines that the company's business plan as of the merger included specific expansion plans or changes in strategy, those are corporate opportunities that must be considered part of the firm's value. *See Technicolor*, 684 A.2d at 298-99 (discussing that the company's value should take into account the new strategy implemented by a majority shareholder before the minority was cashed-out). *See also Montgomery Cellular Holding Co., Inc. v. Dobler*, 880 A.2d 206, 222 (Del. 2005). As a thoughtful academic paper notes, there is an obvious relation between the need to evaluate what the business plans of the company being valued in appraisal were as of the merger date, and the equitable corporate opportunity doctrine. *See generally* Hamermesh and Wachter, *The Fair Value of Cornfields in Delaware Appraisal Law*. Conceived this way, the court's task in appraisal incorporates the equitable concerns traditionally policed by the corporate opportunity doctrine. Indeed, the Supreme Court previously has held that corporate opportunity claims can be valued in the context of an appraisal action. *See Cavalier Oil*, 564 A.2d 1137. The Chancellor's decision in *Onti v. Integra* illustrates well the interaction of these concerns. In that case, the Chancellor took into account a corporation's similar plans to expand in shaping his remedy in a combined appraisal/entire fairness proceeding. *Onti*, 751 A.2d at 925-26.

expertise to bear, in order to run profitable MRI Centers in State of Delaware on a consistent model.

1. Delaware III

As was detailed earlier, Delaware Radiology began considering the possibility of opening a third MRI Center in Middletown at least as early as June 2002.[52] At a board meeting in May 2003, after the Groups were feuding, the Delaware Radiology board approved proceeding with Delaware III. In July 2003, a location in Middletown was found and Delaware III, which was not even formed yet, entered into a commercial lease. The Delaware III entity was formed in December 2003, which was before the merger. The MRI magnet for Delaware III was leased on January 9, 2004. All of these events occurred before the January 20, 2004 merger.

Similarly, Delaware Radiology paid Tri-State management fees that were, in part, to compensate Tri-State for business development, including "[evaluating] potential growth sites within current markets" and "[negotiating] possible facility leases."[53] Carr spent considerable time working on Delaware III, consistent with the fees Tri-State was being paid. What is inconsistent and unfair is the Broder Group's insistence that his work on Delaware III, which bore fruit, did not produce value that was part of Delaware Radiology's worth as a going concern on the merger date.

For all these reasons, it is abundantly clear that the plans for Delaware III were part of the operative reality that was Delaware Radiology as of the merger date.

[52] Tr. 399.
[53] Jt. Ex. 272.

The best that the Broder Group can do to defend against the obvious fact that the Delaware III opportunity was Delaware Radiology's is to advance hearsay testimony from Broder and Carr that Edell was supposedly unwilling to go forward with other MRI Centers until Delaware Radiology's owners ended their feud.[54] Frankly, I do not credit that self-serving testimony. Edell lives in Delaware and knows where King Street is. Edell did not testify at trial or in deposition. He has long-standing relations with members of the Kessler Group, closer it appears than his relations with the Broder Group. If Edell had come to court and said that he only wanted to work with the Broder Group, the Broder Group's argument would have had some force. The testimony of Broder and Carr is no substitute for such a clear expression by Edell himself.

What is likely is that Edell was sick of the jejune jousting of his business partners and did not want to be caught between the competing Groups. That understandable sentiment is no safe harbor for the Broder Group to attribute no value to the expansion plans. No doubt Edell would have been equally as happy or even happier to work with Delaware Radiology if the Kessler Group was in charge of it. Likewise, Edell would have been more than happy to work with Delaware Radiology if the Groups healed their relationship. Edell just wanted to make money and not become enmeshed in disputes within the community of healers.

If that was Edell's sentiment, that reality did not grant the Broder Group a license to squeeze-out the minority and usurp all of the value of the expansion plans for itself. The expansion plans for Delaware III were clearly part of the operative reality of

[54] Tr. 133-35.

Delaware Radiology as of the merger date and under *Technicolor* and its progeny must be valued in the appraisal.[55] Although the Broder Group could use the brute power of its majority block to control Delaware Radiology and its opportunities on a future basis, the price of that exercise of clout is the allocation to the minority of its fair share of all the expected gains from the company's business plans. The majority cannot justify its usurpation of those plans by reference to an unresolved dispute with the minority.[56]

It is undisputed that the Broder Group accorded no value to Delaware III in setting the merger terms. That was unfair and resulted in an undervaluation of Delaware Radiology. Even at trial, when faced with the possibility that the court would say that the value of Delaware III had to considered, the Broder Group presented no helpful evidence. Despite the fact that projections for Delaware III had been presented to federally-regulated financial institutions for financing purposes[57] and, even more importantly, that Delaware III represented an extension of a business model that Delaware Radiology already had used successfully twice, the Broder Group's expert Reed testified that it was his "fundamental belief that the projections [for Delaware III] were not relevant for an entity that had not yet opened."[58] In fact, he stated that "it never really even occurred to [him] that there was any value there at all."[59] If that is true, Reed has a jarringly novel

[55] *See Technicolor*, 684 A.2d at 297.
[56] *See Onti*, 751 A.2d at 910-11 (stating that minority shareholders could not be deprived of the development value of undeveloped "cornfields" in a cash-out merger based on the majority shareholder's argument that a transaction would not occur without cashing out the minority).
[57] By federal statute, it is a felony to knowingly obtain any funds from a financial institution by false or fraudulent pretenses or representations. 18 U.S.C.A. § 1344 (2006).
[58] Tr. 494.
[59] *Id*. at 516.

view of corporate finance, in which the value of McDonald's does not include the revenues it expects to make from the new franchises it will open.

2. Delaware IV

The analysis regarding Delaware IV is similar. Delaware IV was formed as a Delaware limited liability company on January 12, 2004 — eight days before the merger. Its location in Dover was leased on January 27, 2004 — seven days after the merger — and the terms of the lease were finalized before the merger but simply not executed. Of course, the Broder Group was careful to invest in Delaware IV through an entity other than Delaware Radiology for tactical reasons, but that conduct actually tends to prove rather than refute the Kessler Group's argument. That is, the use of an alternate vehicle was designed to facilitate the Broder Group's desire to accord the Kessler Group no value for the Delaware IV opportunity in the merger price. Put bluntly, that desire is evidence of substantive unfairness, as it meant that the merger price did not include the complete value of Delaware Radiology's business opportunities.

Delaware IV was an obvious southward expansion for Delaware Radiology and Edell, which built off their prior plans. Put in traditional corporate opportunity terms, Delaware IV was an opportunity that was: (1) in the line of the corporation's business and is of practical advantage to it; (2) within the corporation's financially ability to capture; and (3) one in which the corporation has an interest or a reasonable expectancy.[60]

[60] *Guth v. Loft*, 5 A.2d 503, 511 (Del. 1939). These requirements have been restated and discussed numerous times. *See, e.g.*, *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148 (Del. 1996);

The planning for Delaware IV was simply a continuation of the hope of Delaware Radiology and Edell to fill out a statewide network of MRI Centers. Carr was paid by Delaware Radiology for business development work and performed much of the legwork for Delaware IV before the merger.[61] For all these reasons, I have little difficulty concluding that the plans for Delaware IV constituted part of the operative reality of Delaware Radiology as of the date of the merger. There was nothing speculative about the plans to open an additional MRI Center in Dover using the proven model, and the Broder Group's refusal to include in the merger price any value attributable to Delaware IV was unfair.

3. Delaware V

The harder question that arises relates to Delaware V, which was created at a time more remote from the merger. Delaware V is the Seaford MRI Center that the Broder Group has opened with Edell, using the same model as Delaware I and II. The Delaware V entity was not formed until September 15, 2004. The financing needed for Delaware V to progress was not secured until late October 2004,[62] the lease was not entered into for a

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Kaplan v. Fenton, 278 A.2d 834 (Del. 1971); *Equity Corp. v. Milton*, 221 A.2d 494 (Del. 1966); *In re eBay, Inc. S'holders Litig.*, 2004 WL 253521 (Del. Ch. Feb. 11, 2004); *Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961 (Del. Ch. 2003); *see also* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 4.36 (3d ed. 2006). The Kessler Group, of course, lost standing to bring a corporate opportunity claim on behalf of Delaware Radiology when the merger became effective, but this derivative corporate opportunity claim can be valued in an appraisal action. *See Kohls v. Duthie*, 765 A.2d 1274 (Del. Ch. 2000). Moreover, the Broder Group's failure to value expected cash flows from expansion is a proper challenge in this case to the fairness of the merger itself as that omission is alleged to have materially tainted the merger price. *See Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1245-47 (Del. 1999).

[61] Jt. Ex. 272.

[62] Tr. at 418.

location in Seaford until February 9, 2005,[63] and the Delaware V facility did not open until January 2006, after trial in this matter was over.[64]

The reason I find this issue difficult has less to do with when Delaware V actually began to operate than with the question of when the idea of opening another MRI Center in Delaware began. Although Carr denies that he had begun formulating plans for a Sussex County MRI Center before the merger, I do not find that testimony credible. Carr's trial testimony was more redolent of total loyalty to the Broder Group, with whom his financial interests are aligned, than of a careful attempt to be as accurate as possible.

In this respect, it would ordinarily be comforting to me that the paper record is devoid of evidence that the Broder Group was planning for a Sussex County facility before the merger. But the reality is that the Broder Group resisted discovery into the planning for Delaware III and IV deep into the litigation, and the Kessler Group has raised non-frivolous arguments regarding the absence of production of documents relating to the formation of Delaware V. In the equitable part of this case, the Broder Group bears the burden of showing that its actions are entirely fair. Given its failure to accord any weight to the value of even Delaware III in setting the merger price, the Broder Group's less than forthcoming attitude about the production of evidence regarding Delaware V is disturbing. The Broder Group should have embraced the opportunity to convince me that Delaware V was an initiative completely distinct from Delaware

[63] Jt. Ex. 261.
[64] Tr. 418.

Radiology's previous strategy. It did not but instead left me harboring serious doubts about the bona fides of its document production.

As or more important are the objective business circumstances. The procession of the MRI Centers southward to encompass the entirety of Delaware is, it seems to me, not at all coincidental. By this method, Delaware Radiology and Edell can replicate the successful Delaware I and II model on a statewide basis. In doing so, they are able to capture economies of scale and capitalize on their prior work. To that point, I would note that the operating agreement for Delaware V looks much like that for Delaware I and II. Equally likely is that the Broder Group and Edell were able to obtain much easier access to health insurance and health maintenance organization provider networks for Delaware V precisely because they had already established Delaware I, II, III, and then IV as network providers. Delaware V could then be pitched as an extension and build off the prior contractual relationships.

Stated directly, the creation of Delaware V simply finished off the obvious strategy of creating a statewide network of MRI Centers. That the ultimate success of that strategy was not assured when Delaware Radiology was first formed, or is even guaranteed now, is not the determinative issue. The gravitational direction of Delaware Radiology toward statewide expansion has been clear from the beginning, and is made even more obvious by the business expansion duties given to Tri-State. To keep with the prior analogy, assume that the Broder Group was the majority stockholder of an entity that had the first McDonald's franchise in Delaware and the right to open the rest as the

brand expanded statewide. If it squeezed out the minority, the value would have had to recognize the company's plans to go statewide.

This case presents the same situation. Delaware V is the natural culmination of the Delaware Radiology-Edell business strategy, a strategy that was in active implementation before the merger. Although the plans for a Sussex County MRI Center were more inchoate than the plans for the Middletown and Kent County Centers, I believe that the goal of a Sussex County Center was established before the merger. The greater uncertainty about when a Sussex County Center would open and its value will be taken into account when shaping the award, but I believe it requires that some value be attributed, to address the Broder Group's decision to usurp for itself the exclusive right to control the statewide network for itself.

B. Is Each Shareholder Entitled To A Share Of The Reading Fees Proportionate To His Ownership Interest In Delaware Radiology?

Because the members of the Broder and Kessler Groups are all radiologists, it is not surprising that the allocation of read work from the MRI Centers was a major issue at trial. Both sides took positions that did not have the ring of truth.

For its part, the Kessler Group claimed that there had been an agreement among the original stockholders of Delaware Radiology that entitled them to receive read work, and the corresponding reading fees, in proportion to their stock ownership in Delaware Radiology. To buttress this argument, the Kessler Group cites to a provision in the operating agreements for Delaware I and II that gives Delaware Radiology the exclusive

right to perform the MRI reads for fifteen years.[65] In addition, § 2.1.4 of the Professional Services Agreement between Delaware Radiology and Delaware I states that Delaware Radiology is "solely responsible for the MRI Diagnostic Radiology Services rendered by it or its radiologist employees."[66]

The problem for the Kessler Group is that Delaware Radiology never provided any radiology services for patients at Delaware I and II. Rather, from the get-go, Delaware Radiology farmed out the read work to Fox Chase. As an attorney for the Kessler Group described it:

> Notwithstanding that JRA, Fox Chase Radiology, and Delaware Radiology have provider agreements relating to various facilities, it appears that all of the net income from physician services at all of the facilities is funneled into Fox Chase Radiology which appears further to distribute all of its net income . . . among the Shareholders pursuant to their respective employment agreements. While this arrangement appears to be undocumented, it appears to be based upon a mutual agreement and understanding among the Shareholders . . . .[67]

At trial, Shaer testified that he knew "[Delaware Radiology] itself would not do the reads."[68] Shaer and the other members of the Kessler Group were complicit in that strategy and cannot complain now that Delaware Radiology is not providing the read services itself.[69]

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[65] *See* Jt. Ex. 6 at § 6.3; Jt. Ex. 21 at § 6.3.
[66] Jt. Ex. 7.
[67] Jt. Ex. 19 at 3.
[68] Tr. 707.
[69] *Cf. Balin v. Amerimar Realty Co.*, 1996 WL 684377, at *19 (Del. Ch. Nov. 15, 1996) ("Balin asserts that because the Master Agreement is now the definitive governing document, the Denver fees must flow directly to Amerimar Realty. The fatal infirmity in this argument is that Balin never put the Master Agreement into effect. Instead, he disregarded that agreement and acquiesced in the quite different present fee flow structure . . . . Having disregarded . . . the

The arrangement whereby Delaware Radiology would contract out its right to perform the read work is not at all surprising. Delaware Radiology was the Delaware-based entity that the partners at Fox Chase set up to enter the Delaware market and to meet the regulatory requirements necessary for practice. One of those requirements was that Reading Fees be paid to a Delaware entity in the first instance. When Delaware I and II were opened, Delaware Radiology shareholders were all partners in Fox Chase. Thus, Delaware Radiology's reliance upon Fox Chase to do the read work did not cause any economic controversy, as that arrangement essentially resulted in pro rata treatment of the Delaware Radiology stockholders through their distributions from Fox Chase.

It was only after the Kessler Group left Fox Chase and the Broder Group acted to reduce the Kessler Group's share of the read work from Delaware I and II to one-sixth and then zero that the pro rata argument arose. The Kessler Group believed that it was being cut out of one of the primary economic justifications for the formation of Delaware Radiology. Its argument that read work was supposed to be distributed pro rata to stockholder holdings is a manifestation of their belief that they were being treated unfairly.

But that precise argument lacks merit. As was discussed previously, the read work was never allocated to each stockholder personally in proportion to his or her ownership interest. Indeed, not all the Delaware Radiology stockholders were or are even qualified to do the read work. And the so-called Kessler Group did not even exist as a group as of

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Master Agreement, Balin cannot now be permitted to resurrect it and then attack the very fee structure in which he has acquiesced.").

the formation of Delaware Radiology. Thus, before the Kessler Group left Fox Chase, Delaware Radiology passed on all the read work to Fox Chase, where three of the radiologists did the work, and all of the Delaware Radiology stockholders benefited pursuant to the Fox Chase partnership arrangements.[70]

After the Kessler Group opened Bucks County, it received a disproportionate share of the read work, because it had two of the three MRI readers.[71] As Fox Chase gained additional capacity, it is clear that the Broder Group sought to capture as much of the read work for itself as it could, as is reflected in the steadily decreasing share of the work it allocated to the Kessler Group. Once the Jeanes Hospital contract issue arose, the Broder Group sought to eliminate the Kessler Group's role in read work altogether. From this history, it is impossible to conclude that there was a specific agreement for pro rata allocation of the read work.

But contrary to the Broder Group's hopes, that does not mean that the Kessler Group's claim of unfairness has no force at all. Rather, when properly conceptualized, that claim is meritorious.

Delaware Radiology secured a valuable right in its negotiations with Edell over the MRI Centers. It was the managing partner for the MRI Centers and could direct the read work. The original 15% fee it negotiated with Edell was a healthy one that was intended to allow the provider of the read work to reap healthy gains from doing the

[70] Tr. 46-47.
[71] *Id*. at 841-82.

reads. For his part, Edell was granted a 5% fee for his marketing work at Delaware I and 7.5% for his marketing work at Delaware II.

So long as the Delaware Radiology board was dealing with its right to receive the Reading Fees in a manner that was fair to all of its stockholders, it did not need to consider whether passing on the entire 15% fee was fair to Delaware Radiology as an entity. If the pass-through worked roughly pro rata treatment, then the stockholders' legitimate interests were protected.

The problem arose when the Broder Group began to use its majority control of Delaware Radiology to advance its own interests. As Broder was honest to admit at trial, after the Kessler Group left Fox Chase, Broder wanted Fox Chase to do all the read work and for the Kessler Group to do none of it.[72] By no later than December 2002, Broder had fully implemented that desire.

As a matter of majority control, there is nothing intrinsically wrong with the Broder Group's decision to cut the Kessler Group out of the read work. But the Broder Group could not arrogate all the reads to itself unless it did so in a manner that was entirely fair to Delaware Radiology. And that is where it fell far short of the mark.

The Broder Group failed to demonstrate at trial that the 15% rate that was originally used was a market rate. More likely is that it was a rate that allowed the founders, all of whom were partners at Fox Chase, to make a very nice profit from doing read work for the MRI Centers. After all, the desire to guarantee a profitable flow of captive work was a primary purpose behind the creation of Delaware Radiology. Even

[72] Tr. 203-04.

less debatable is that the 17.5% rate that the Broder Group charged Delaware III and IV pursuant to their operating agreements and charged Delaware I as of March 2003 was not a market rate. It was simply a profit-sharing arrangement with Edell, who was granted an increase in his Delaware I marketing fees from 5% to 7.5% at the same meeting.

By the end of 2002, the Broder Group had assumed firm and exclusive control of the Delaware Radiology board. Rather than consider any other providers of read work, the Broder Group simply chose to allocate as much of the read work as it could to Fox Chase at a price that was higher than Delaware Radiology could have secured after a market check. The record leaves me no doubt that the Broder Group saw no reason for it to look for other sources or to examine the price of the services rendered; it viewed the Kessler Group members as defectors whose voluntary decision to leave Fox Chase left them in no equitable position to complain. In Broder's view, the Kessler Group cut itself out — had its members stayed at Fox Chase, they would still have been sharing in the read revenues, as they had when Delaware I and II were first formed.

Broder's very human reaction, however, is inconsistent with fiduciary principles. Just as there was no contractual obligation for the Delaware Radiology to pass the benefits of the read work to its stockholders on a pro rata basis, there was no contractual obligation for stockholders of Delaware Radiology to remain as partners in Fox Chase. The Kessler Group's decision to leave Fox Chase did not grant the Broder Group a

license to profit at the expense of Delaware Radiology as an entity, but that is what the Broder Group did.[73]

Although the record on this point is not as clear as I would like, I am convinced that Delaware Radiology could obtain a provider of reading services of a quality equal to Fox Chase for a rate lower than 15% and certainly for a rate lower than 17.5%. In so concluding, I want to make the point about equal quality absolutely clear. The Kessler Group pointed to what I would call "bargain-basement" options of contracting work out to radiologists who work at their homes, reading MRIs from home computers, in isolation from other practitioners. I do not premise my ruling on that type of service. As the board majority, the Broder Group was within its legitimate rights to seek to provide patients at the MRI Centers with high-quality read services from radiologists practicing in a group, who could, in debatable situations, call on colleagues to help provide the most accurate diagnosis possible. The Broder Group could also decide to provide those services itself, so long as it did so at a fair market rate.

At trial, the Broder Group put on anecdotal evidence suggesting that a fee of 15-20% of an MRI Center's revenues was a fair fee for reading work. That evidence was flimsy and insubstantial, lacking any reliable basis in actual contracts for comparable work or empirical surveys of market rates for reading work. In this context — where the Broder Group has allocated valuable read work to itself without a market check — it

[73] *Cf. Telxon Corp. v. Meyerson*, 802 A.2d 257, 265 (Del. 2002) ("Like any other interested transaction, directorial self-compensation decisions lie outside the business judgment rule's presumptive protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation.").

bears the burden of showing that it was receiving a rate fair to Delaware Radiology. The Broder Group has fallen well short of the mark. It has left me with the firm impression that the original 15% rate had a healthy profit margin in it for the read provider and did not reflect the rate that Delaware I and II could have secured after a real market check. The 17.5% rate now at Delaware I, III, and IV is even more plush from the reader's perspective.

In coming to that conclusion, I consider a few important factors. Initially, I note that one of the reasons Delaware Radiology was formed was to give the founding radiologists a more certain source of work in a competitive market in which margins were being squeezed. The margin pressure, as of the merger date, was increasing. This was illustrated by the competition between the Broder and Kessler Groups for the Jeanes Hospital contract, as well as the emerging trend of offshoring radiology work. In that latter respect, the reality that radiologists can read most MRI scans from remote computer terminals meant that margins were not likely to widen and that competitive pressures would increase. Although I do not adopt the Kessler Group's view that the Delaware Radiology had to seek a bargain-basement price, I do credit the testimony it put on that qualified radiology reads from a practice group similar in quality to the Broder Group could be procured for rates far less than the 15% rate originally secured for Delaware Radiology.[74] Clinching my conclusion is the Broder Group's own behavior. By

[74] In fact, leading up to this litigation (and no doubt for the purpose of this litigation) the Kessler Group offered to perform the read work at a lower rate. Jt. Ex. 183. Shaer testified that the Kessler Group's best contract rate for performing reads was $72.50 per read, which, based on the reimbursement rate for Delaware I and II, would be a fee of approximately 12%. In addition, the

formulating and acting on a plan to take *all* of the read work for Fox Chase, the Broder Group's conduct demonstrates their belief that this work is very profitable to the readers.

The difficult question in the end is really one of measurement: how big is the gap between a fair market rate and the 15% and 17.5% rates that Delaware Radiology was paying to the Broder Group as of the merger? In a regrettably fulsome record, there is only one piece of genuinely reliable evidence on this important topic. At trial, the Broder Group provided a detailed breakdown of the current Medicare reimbursement rate for MRI professional services, which is equivalent to a 13.7% fee.[75] Although one cannot be certain that it would have cost Delaware Radiology somewhat more or less than the Medicare rate to obtain reading services equivalent in quality to that provided by the Broder Group as of the merger, that uncertainty results from the Broder Group's decision not to do a market check and to allocate all the read work to its Fox Chase entity, using its majority power. By using the objective Medicare rate, I base my award on the most reliable evidence of a market rate in the record, which is premised on what is paid by one of the most important market payers in American health care.

I factor that rate into my award in the following manner. I assume for purposes of my valuation of Delaware Radiology as of the merger date that it could have obtained read services for 13.7%, leaving the difference between the 17.5% it received from Delaware I, III, and IV, and the 15% it received from Delaware II, and that figure as profit that would be available to Delaware Radiology as an entity. That is, the 3.8%

Kessler Group discusses certain reading rates, which start around $45 per read, it pays to contract readers.

[75] Rebuttal Report of Reed Ex. A (hereinafter "Reed Rebuttal").

difference at Delaware I, III, and IV and the 1.3% difference at Delaware II is what I find to be the unfair profit the Broder Group diverted from Delaware Radiology to itself, so that amount will be returned to the value of Delaware Radiology.

This conclusion involves me including my estimate of the value of Delaware Radiology's claims against the Broder Group in the fair value of the Delaware Radiology on the merger date. Because the overage paid to the Broder Group in excess of market reduced the balance sheet profitability of Delaware Radiology, the claim belonged to Delaware Radiology and was surfaced by the Kessler Group as a derivative claim. Whether as a matter of appraisal or a fairness challenge to the merger, the overage is relevant to determining whether the Kessler Group was treated fairly in the merger.

D. Are The Management Fees Paid To Tri-State And Edell Fair To The Minority Shareholders Of Delaware Radiology?

There are two other points of contention between the Broder and Kessler Groups about alleged self-dealing. These points involve whether the management fees paid to Tri-State, a wholly-owned Broder entity, and to Edell, the influential Delaware physician whose marketing efforts were critical to the success of the MRI Centers, were fair to Delaware Radiology. The Kessler Group argues that the fees of 2% and 7.5% of revenues to Tri-State and Edell, respectively, constitute excessive payments resulting from log-rolling between Edell and the Broder Group. The Broder Group contends they are reasonable and fair rates that reflect the important managerial and marketing tasks performed by Edell and Tri-State on behalf of the MRI Centers.

The magnitude of the dispute is actually rather confined. The Kessler Group does not challenge Edell's entire cut, simply that above 5%. Moreover, Tri-State's take is only 2% at maximum and is therefore not very material to the overall valuation determination. But money is money, and the dispute must be decided. I will do so tersely.

As to Tri-State, there is no evidence that it does not perform its duties competently. Although I found the testimony of its principal, Carr, to be more redolent of an overly zealous advocate for his bosses, the Broder Group, than of the core truth, there is nothing in the record to suggest that he is not a competent administrator of the MRI Centers. Before Tri-State's involvement in 2001, the MRI Centers were managed by the doctors themselves, and Carr's involvement took those duties off their hands. Tri-State was retained while the Kessler Group was still on the board of Delaware Radiology and Shaer of the Kessler Group was its President. The 1% management fee payable to Tri-State was proposed by Broder in a memorandum to Edell.[76] At trial, Shaer testified that "[i]n terms of management, while I was intimately involved in the operations of Delaware, at some point, Tri-State began receiving one percent of collections for management."[77] Additionally, Shaer indicated that he spoke with the other members of the Kessler Group and communicated to the Broder Group that Carr, while an employee of Fox Chase, was "doing a pretty good job with the centers . . . and we should go forward with him."[78] Further, Shaer said that the memorandum informing Edell of the 1% management fee was something "that collectively, the board or . . . the shareholders

[76] Jt. Ex. 37.
[77] Tr. 838.
[78] *Id*. at 738.

had decided would be implemented at Delaware Open MRI" and the Kessler Group was apprised that "the Broder group were the shareholders in Tri-State."[79] There is no rational basis, therefore, to question the 1% fee to Tri-State, given that it was approved by the Kessler Group on full information.[80]

The problem is that the fee for Tri-State changed. In 2003, after the Broder Group booted the Kessler Group off the board and out of management, the Broder Group raised the management fee payable to Tri-State, its wholly-owned entity, to 2%. This was an interested transaction that was not ratified or acquiesced to by the Kessler Group, and the business judgment rule does not apply when a decision is made "by a board a majority of whom have a material conflict of interest in the transaction."[81] The Broder Group introduced no reliable evidence indicating the fairness of this increase to the Kessler Group, and I, therefore, will reduce the management fee to the 1% previously agreed upon. In reaching this determination, I am also mindful of the behavior of the Broder Group during this period relating to the read work — behavior that evinces a desire to capture as much of the profit of Delaware Radiology as possible for itself, to the exclusion of the Kessler Group.

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[79] *Id*. at 738-41.
[80] *E.g.*, *In re Cox Comm'n, Inc. S'holders Litig.*, 879 A.2d 604, 615 (Del. Ch. 2005) (recognizing that Delaware law typically "gives ratification effect to approval of the interested transaction by a majority of the disinterested stockholders.").
[81] *E.g.*, *Ryan v. Tad's Enters.*, 709 A.2d 682, 689 (Del. Ch. 1996), *aff'd*, 693 A.2d 1082 (Del. 1997).

The issue involving Edell is a little more subtle.[82] In essence, the Kessler Group argues that Edell exploited the rift between the Broder and Kessler Groups to get a bigger cut for himself in March 2003. In exchange for accommodating the Broder Group's desire for a higher percentage for Reading Fees and for Tri-State, Edell simultaneously extracted an increase to 7.5% for his cut of Delaware I.[83] In fact, at the same March 2003 meeting when these changes were made, the billing services work for the MRI Centers was transferred from an independent entity that received 3% of revenues to an entity controlled by the Broder Group at the same rate.[84] The smell of a deal remains pungent.[85]

Even so, I do not believe that there is a reasonable basis to question the fairness of what Edell extracted. At trial, the Broder and Kessler Groups agreed that Edell's involvement was a boon to Delaware Radiology because both perceived him as having a uniquely valuable relationship with Delaware's community of physicians, which enabled him to generate referrals for the MRI Centers, thereby ensuring their success. In addressing Edell's demands, the Broder Group had an incentive to keep his share down while balancing the need to retain his commitment to the success of the MRI Centers. From what I heard from both groups at trial, the 7.5% fee to Edell was well justified by

[82] Ordinarily, as the directors of Delaware Radiology from the Broder Group would not receive any benefit from an increase in Edell's fees, their decision would be subject to the protection of the business judgment rule.
[83] As was mentioned, Edell already was entitled to 7.5% of the revenues from Delaware II. He had been receiving that cut since it began operating in 1999.
[84] Jt. Ex. 79.
[85] *Ryan*, 709 A.2d at 689-90 (indicating that when a controlling shareholder provides a benefit to a third party in order only to secure a benefit for itself, or has a material interest in the transaction, that decision is not protected by the business judgment rule).

the marketing and development work he did. Moreover, having redressed the Broder Group's extraction of value, at the expense of the Kessler Group, through increased payments to Fox Chase for read work and to Tri-State for management, I have ensured that the Broder Group did not extract any unfair value from its bargaining with Edell. The reduction of the read work percentage to 13.7% and the management fee to 1% in valuing Delaware Radiology accomplishes that result. In other words, I have addressed the "interested" side of the dealings between the Broder Group and Edell directly and do not believe that the record warrants going further.

E. Is It Appropriate To Tax Affect The Earnings Of Delaware Radiology In Order To Determine Its Fair Value?

The proper manner to tax affect the earnings of Delaware Radiology is the next major issue that must be addressed. The Broder Group's expert, Reed, treated Delaware Radiology as if it were a "subchapter C" corporation[86] when he performed the valuation that the Broder Group used to set the merger price. Reed stuck by this approach at trial. To be specific about Reed's methodology, he made the standard move of applying a 40% tax to Delaware Radiology's earnings, the common estimate of federal and state income taxes used in valuing a C corporation.

By contrast, the Kessler Group's expert, Mitchell, asserted the proposition that because Delaware Radiology was an S corporation, it faced no corporate-level income taxes. Relying on this as Delaware Radiology's operative reality, Mitchell did not tax affect its earnings in performing his valuation. Any taxes, Mitchell reasoned, would be

[86] *See* 26 U.S.C.A. § 301 *et. seq.* (2005) (Subchapter C dealing with corporate taxation issues).

paid at the stockholder level and should not be considered in valuing Delaware Radiology as an entity.

This dispute raises an interesting question of valuation, which has elicited a fair amount of attention from judges, appraisers, and academics.[87] After careful consideration, I conclude that neither of the experts has taken the most reasonable approach to valuing Delaware Radiology.

The problem with Reed's approach of treating Delaware Radiology as a C corporation is obvious. Delaware Radiology is a very small entity. The record reveals no set of circumstances in which it is likely that Delaware Radiology will convert to C corporation status. It is a highly profitable entity that generates and distributes income well in excess of the stockholder level taxes its stockholders must pay. The S corporation tax status is a highly valuable attribute to the shareholders of Delaware Radiology, given its profitability and the affluent status of its physician stockholders, who face top marginal tax rates.

Under Delaware law, an appraisal petitioner is "entitled to be paid for that which has been taken from him . . . ."[88] In this case, the Kessler Group was involuntarily deprived of the benefits of continuing as stockholders in a profitable S corporation —

[87] *See, e.g.*, *In re Radiology Assocs.*, 611 A.2d 485 (Del. Ch. 1991); *Adams v. Commissioner of Internal Revenue*, 2002 WL 467235 (U.S. Tax Ct. Mar. 28, 2002); *Heck v. Commissioner of Internal Revenue*, 2002 WL 180879 (U.S. Tax Ct. Feb. 5, 2002); *Gross v. Commissioner of Internal Revenue*, 1999 WL 549463 (U.S. Tax Ct. July 29, 1999); Franklin M. Fisher et. al., *The Sale of the Washington Redskins: Discounted Cash Flow Valuation of S-Corporations, Treatment of Personal Taxes, and Implications for Litigation*, 10 Stan. J.L. Bus. & Fin. 18 (2005) (hereinafter "Fisher"); Z. Christopher Mercer, *S Corporation Valuation Issues*, The American Society of Appraiser's 22nd Annual Business Valuation Conference (Oct. 17, 2003) (hereinafter "Mercer").

[88] *Tri-Continental Corp. v. Battye*, 74 A.2d 71, 72 (Del. 1950).

benefits that were comprised materially of the favorable tax treatment that accompanies S corporation status. As a matter of fairness, the merger price had to take into account these benefits and provide fair compensation for the Kessler Group's loss. Reed's approach denied the Kessler Group members the value they would have received as continuing S corporation stockholders in Delaware Radiology and, therefore, ensured that the merger price was lower than fair value.

At the same time, Mitchell's approach is equally flawed and overstates the value fairly belonging to the Kessler Group. The value of the S corporation structure is one that is experienced at the stockholder level and that is easy to overstate. If an S corporation is to be sold, for example, it will receive no premium over a C corporation if the universe of buyers is principally comprised of C corporations.[89] There is an obvious reason for this: unless the buyer of the S corporation can retain and benefit from that tax status, then the buyer will value an S corporation at the value it would have as a C corporation. Therefore, it would be highly misleading to do a market-based comparable acquisition valuation of an S corporation using sales of comparable C corporations to C corporations, and then assume that the S corporation would be sold at a higher price because of its tax status. In other words, I am not trying to quantify the value at which Delaware Radiology would sell to a C corporation; I am trying to quantify the value of Delaware Radiology as a going concern with an S corporation structure and award the Kessler Group their pro rata share of that value.

[89] *See* Mercer 9-14.

In this case, then, the more relevant problem with Mitchell's approach is that his failure to tax affect Delaware Radiology's earnings at all results in an artificial inflation of the value of S corporation status to the Kessler Group. To capture the precise advantage of the S corporation structure to the Kessler Group, it is necessary to use a method that considers the difference between the value that a stockholder of Delaware Radiology would receive in Delaware Radiology as a C corporation and the value that a stockholder would receive in Delaware Radiology as an S corporation. By using that method, I can make my best estimate of the value that is relevant in this case — the going concern value in an S corporation that was taken from the Kessler Group in the merger.

In undertaking this analysis, I embrace the reasoning of prior decisional law that has recognized that an S corporation structure can produce a material increase in economic value for a stockholder and should be given weight in a proper valuation of the stockholder's interest.[90] That reasoning undergirds not only holdings of the *Adams*, *Heck*, and *Gross* cases in the U.S. Tax Court, but an appraisal decision of this court, which coincidentally also involved a radiology business.[91] The opinion in *In re Radiology Associates* noted that "under an earnings valuation analysis, what is important to an investor is what the investor ultimately can keep in his pocket."[92] In that case, on the record before it, the court held that the way to implement that insight was to ignore tax completely.[93] The *In Re Radiology Associates* decision comported with decisions of

[90] *See Adams*, 2002 WL 467235; *Heck*, 2002 WL 180879; *Gross*, 1999 WL 549463.
[91] In re Radiology Assocs., 611 A.2d at 495.
[92] *Id*.
[93] *Id*.

the U.S. Tax Court, which has given life to the advantages of S corporation status by refusing to tax affect the corporation's earnings at all.[94]

My difference with these prior decisions is at the level of implementation, rather than at the level of principle. Certainly, in this context when minority stockholders have been forcibly denied the future benefits of S corporation status, they should receive compensation for those expected benefits and not an artificially discounted value that disregards the favorable tax treatment available to them. But the minority should not receive more than a fair S corporation valuation. Refusing to tax affect at all produces such a windfall, as I next explain.

The Internal Revenue Code states that "[t]he taxable income of an S corporation shall be computed in the same manner as in the case of an individual . . . ."[95] This tax, though assessed at individual rather than corporate tax rates, is dependent solely upon the corporation's net earnings. Even if Delaware Radiology were to retain 100% of its earnings annually, its stockholders still would owe taxes on Delaware Radiology's income even though they received no distributions. Affording a remedy to the Kessler Group that denies the reality that each shareholder owes taxes on his proportional interest

[94] In this regard, the case of *Gross v. Commissioner* is a good example. In *Gross*, the Tax Court held that "[w]e believe that the principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation." *Gross*, 1999 WL 549463 (page reference unavailable on WL). The Tax Court refused to allow a "hypothetical corporate tax rate in excess of the zero-percent actual corporate tax rate" to be considered in valuing an S corporation and instead required that no corporate tax be applied to the S corporation's earnings. *Id.*

[95] 26 U.S.C.A. § 1363 (2005).

in Delaware Radiology would result in the Kessler Group receiving a higher per share value from the court than it could ever have realized as a continuing shareholder.[96]

The amount that should be the basis for an appraisal or entire fairness award is the amount that estimates the company's value to the Kessler Group as S corporation stockholders paying individual income taxes at the highest rates — an amount that is materially more in this case than if Delaware Radiology was a C corporation. In coming to a determination of how the Kessler Group's interest in Delaware Radiology would be valued in a free market comprised of willing buyers and sellers of S corporations, acting without compulsion, it is essential to quantify the actual benefits of the S corporation status. That is also essential in order to determine the value of what was actually taken from the Kessler Group as continuing stockholders.

Assessing corporate taxes to the shareholder at a personal level does not affect the primary tax benefit associated with an S Corporation, which is the avoidance of a dividend tax in addition to a tax on corporate earnings.[97] This benefit can be captured

[96] *See, e.g.*, Fisher.

[97] *See, e.g.*, *Byrne v. Commissioner of Internal Revenue*, 361 F.2d 939, 942 (7th Cir. 1966) ("We agree with the observation of the Tax Court that the [S Corporation] statute is designed to permit a qualified corporation and its shareholders to avoid the double tax normally paid when a corporation distributes its earnings and profits as dividends and this is accomplished in a specified manner which does not involve ignoring the corporate entity."); Practising Law Institute, 546 PLI/Tax 249 *Organizing the Corporate Venture* § 1301 (2002) ("This re-inversion of rates lessened the S corporation shareholder's advantage of being taxed directly on corporate income. Yet, the primary tax advantage of being an S corporation shareholder — i.e., the ability to receive corporate income with only a single level of tax imposed — remains intact. This must be compared to the double tax paid on a C corporation's income (i.e., once at the corporate level, and again at the shareholder level when distributed) in considering the tax benefit of using an S corporation, rather than a C corporation, for business operations."); Mercer 9 ("The S election relieves one layer of taxation at the corporate level, providing the potential for greater cash flow at the shareholder level.").

fully while employing an economically rational approach to valuing an S corporation that is net of personal taxes.[98] To ignore personal taxes would overestimate the value of an S corporation and would lead to a value that no rational investor would be willing to pay to acquire control.[99] This is a simple premise — no one should be willing to pay for more than the value of what will actually end up in her pocket — that can best be firmly grasped through a concrete example.

Assume that Delaware Radiology receives $100 in annual earnings. If Delaware Radiology was organized as a C corporation, its earnings after tax would be $60, assuming, as is the usual custom, that the effective corporate tax rate is 40%. Then, assume that Delaware Radiology distributes all of its post-tax earnings to its shareholders in the form of a dividend. The shareholders would receive total post-tax distributions of $51, after an assumed dividend tax of 15% is applied to the $60 after-tax earnings. That is, a shareholder would experience an effective tax rate of 49% after corporate income and dividend taxes.

Now, consider the post-tax benefits of $100 in income to Delaware Radiology's stockholders, using its actual status as an S corporation. In that scenario, the shareholders would receive all $100 in earnings as distributions and be subject only to one shareholder-level tax. Thus, the shareholders would be responsible for paying taxes on the $100 at their individual tax rates. I will also assume that rate to be 40% because the

[98] Fisher 22.
[99] *Id.* at 18 ("[W]e demonstrate that ignoring taxes in a DCF analysis when valuing an S corporation potentially leads to an overestimation of value."); *id.* at 22 ("A rational investor will only pay up to the present value of an investment's expected cash flows, net of personal taxes.").

Broder and Kessler Groups are comprised of affluent physicians who pay at the highest marginal rate.[100] Therefore, every dollar of Delaware Radiology's earnings would be taxable at the stockholder level at the highest marginal tax rate. The shareholders in Delaware Radiology, an S corporation, would be able to pocket $60 after tax if all earnings were distributed. The difference is clear: Delaware Radiology's status as an S corporation allowed the shareholders to pocket $60 of $100, whereas if Delaware Radiology was a C corporation, the shareholders could pocket only $51 of the $100.[101]

In valuing Delaware Radiology, therefore, it would overstate the value taken from the Kessler Group to require the Broder Group to pay the Kessler Group $37.50 for its share of every $100 of future pre-tax earnings. That cash flow, after the favorable S corporation tax treatment, would not be worth $37.50 to the Broder Group, but only $22.50. The issue, though, is that tax affecting Delaware Radiology at a 40% level (or C corporation level) would not recognize any S corporation value that flowed to the Kessler

[100] Currently, at the federal level, the highest personal tax rate is 35%, and the highest corporate tax rate is 38%. Thus, taking into account state taxes, it is reasonable to assume a 40% personal tax rate.

[101] This would not be the case if 1) no distributions were being paid by the S corporation to its shareholders or 2) distributions only sufficient to cover tax liability were being distributed to shareholders. The relative value of an S corporation, vis-à-vis a C corporation, to its shareholders is dependent upon the level of distributions paid. For a useful model and analysis, *see, e.g.*, Chris Treharne, *et. al.*, *Valuation of Pass-Through Entities*, American Society of Appraisers 23d Annual Advanced Business Valuation Conference (Oct. 8, 2004). As recognition of the fact that their stockholders must pay taxes on non-distributed earnings, most if not all S corporations distribute a sufficient amount of their profits to cover shareholder tax obligations. Mercer at 17 ("S corporations who attempt to retain all earnings and not pass through the shareholders' tax distributions will likely find themselves C corporations again, as their shareholders arrange to become ineligible to hold S corporation stock."). This makes intuitive and commercial sense. If all earnings are retained, the S corporation's shareholders must dig into their own pockets to fund the tax liability. If all earnings are retained in a C corporation, the entity is responsible for the corporate level tax. If S corporation shareholders elect to receive no distributions, that can be viewed as a reinvestment of their tax savings in that enterprise.

Group or compensate the Kessler Group for its involuntarily removal as shareholders in a profitable S corporation. To be consistent with Delaware law, I must tax affect Delaware Radiology's future cash flows at a lower level that recognizes the full effect of the Kessler Group's ability to receive cash dividends that are not subject to dividend taxes.

In order to accurately capture the value to the Kessler Group of Delaware Radiology's S corporation status, I have estimated what an equivalent, hypothetical "pre-dividend" S corporation tax rate would be. The following table presents that calculation:

	C Corp	S Corp	S Corp Valuation
Income Before Tax	$100	$100	$100
Corporate Tax Rate	40%	--	29.4%
Available Earnings	$60	$100	$70.60
Dividend or Personal Income Tax Rate	15%	40%	15%
Available After Dividends	$51	$60	$60

This calculation allows me to treat the S corporation shareholder as receiving the full benefit of untaxed dividends, by equating its after-tax return to the after-dividend return to a C corporation shareholder. I will, therefore, apply an effective tax rate of 29.4% to the earnings of Delaware Radiology to measure with the greatest practicable precision the fair value of the Kessler Group's interest in the going concern value of Delaware Radiology.

VI. The Appraisal Valuation And Fair Value Determination

The preceding analysis addresses most of the major value-affecting issues in the record. The results of that analysis will provide some of the more important inputs I will

use in reaching a determination of the fair value of Delaware Radiology on the merger date. That appraisal determination will also determine my award of damages for the purpose of the Kessler Group's entire fairness claim.

Both of the experts in the case used a discounted cash flow analysis as the foundation for their valuations of Delaware Radiology. The basic elements of a DCF analysis are not novel and need not be repeated here.[102] In computing my own DCF value for Delaware Radiology on the merger date, I will focus on the major remaining differences between the testimonial experts, then use the resolution of those differences along with the inputs formerly determined to reach a final determination of fair value.

Before I complete that work, a few factors that influence my approach are worth noting. Delaware Radiology is a small, privately owned entity. As shall be seen, using even an income-based approach such as a DCF model to value such an entity has its challenges, principally in the area of calculating a proper cost of capital. In this situation, the absence of both market information about the subject company and good public comparables force the court to rely even more than is customary on the testimonial experts. That reality is inescapable.

That has led me to consider carefully which of the two experts, the Broder Group's expert Reed or the Kessler Group's expert Mitchell, was the more reliable. Although I have done my own independent analysis and reach a conclusion materially

[102] For the standard classroom description, *see* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 75-80 (7th ed. 2003); BRADFORD CORNELL, CORPORATE VALUATION: TOOLS FOR EFFECTIVE APPRAISAL AND DECISION MAKING 100-41(1993). For a good judicial summary, *see Onti*, 751 A.2d at 917.

different than either expert, when there is doubt and there is not a more reliable basis to decide a question, I will use the approach advocated by the expert whose testimony I found more credible and well-grounded in finance and fact. As a general matter, I easily conclude that Mitchell's testimony was far closer to the mark in all respects. Mitchell approached his task in a conservative and restrained manner that, although still reflecting a desire to advance his clients' objectives, reasonably took into account factors limiting the value of Delaware Radiology.

By contrast, Reed's testimony seemed more aggressively driven by his goal of reducing what the Broder Group would be ordered to pay. Moreover, Reed was given marching orders in his work before and after the merger that led him to undervalue Delaware Radiology. Indeed, those orders were such that Reed did not even know he was valuing Delaware Radiology itself before he finished his valuation in October 2003. Rather, he thought he was valuing Delaware I and II until some time between November 2003 and January 2004.[103]

Even when he realized that the value of Delaware III and IV might be considered in this case, Reed took the position that it was impossible to value businesses that were soon to, but not yet, open using a DCF analysis. That position would come as a revelation to finance professors, owners of franchisable retail establishments, and businesspersons of all kinds. Put simply, this did not instill confidence in me and seemed to be a posture designed simply to advance the Broder Group's interest in not according the Kessler Group any share of the value of Delaware III and IV. Likewise, Reed's

[103] Tr. 596.

knowledge of the relevant facts regarding Delaware Radiology seemed unduly constrained by his clients, and his blinkered view of the business impaired his ability to reach a reasoned determination of value. For these reasons, I give more weight to Mitchell's testimony and lean on his analysis when there is no better method to break an impasse.

A. Calculating Net Cash Flows

The most important input necessary for performing a proper DCF is a projection of the subject company's cash flows. Without a reliable estimate of cash flows, a DCF analysis is simply a guess. Fortunately, Delaware Radiology was not engaged in a complex business and the operations of Delaware I and II provided a foundation for making some reasonable estimates of future performance. Of even greater utility, Carr of Tri-State made detailed projections of the performance of Delaware I, III, and IV for non-litigation use.[104] Specifically, the following projections existed on the merger date.

The projections for Delaware I were used in contemplation of securing financing from the Wilmington Savings Fund Society when Delaware I was being expanded and adding a second MRI magnet. The pro forma projections present the anticipated performance for Delaware I, including scan volume projections, for the two years from October 2003 through September 2005. These were provided to the Kessler Group in October 2003 when the Broder Group was requesting personal guarantees for Delaware

[104] Carr also claims that projections for Delaware II were provided to PNC to secure a loan to buy-out the Kessler Group, but no detailed projections are in the record. The only "projections" for Delaware II in the record detail anticipated scan volume and resulting revenue. *See* Jt. Ex. 233. No breakdown of expenses or net income is included in the projections, and Mitchell did not have the Delaware II projections available to him in performing his valuation.

I's expansion. The projections for Delaware III also were disclosed to the Kessler Group in October 2003, and these projections were used to secure financing for the equipment to be used at the Center.[105] The projections for Delaware III, then, were prepared by October 2003.[106] Similarly, Carr prepared two-year projections for Delaware IV to secure financing for that Center's equipment, which was provided by PNC Bank on March 9, 2004.[107] Traditionally, this court has given great weight to projections of this kind because they usually reflect the best judgment of management, unbiased by litigation incentives.[108] That is especially so when management provides estimates to a financing source and is expected by that source (and sometimes by positive law) to provide a reasonable best estimate of future results.[109] Therefore, we have regarded with rightful suspicion attempts by parties who produced such projections to later disclaim their reliability, when that denial serves their litigation objective.

Here, the Broder Group has done that in material ways, especially with respect to Delaware III and IV, by claiming that Carr spent minimal time on those projections and

[105] Jt. Ex. 384 at 44-45 (Deposition of Carr).
[106] At his deposition, Carr recalled coming up with the projections between October 2003 and April 2004, but because the Broder Group provided them October 16, 2003, it is clear the projections were in existence at that time. *Id*. at 47-48.
[107] Jt. Ex. 174.
[108] *See Doft & Co. v. Travelocity.com Inc.*, 2004 WL 1152338, at *5 (Del. Ch. May 20, 2004) ("Delaware law clearly prefers valuations based on contemporaneously prepared management projections because management ordinarily has the best first-hand knowledge of a company's operations.").
[109] Again, it is a felony to knowingly obtain any funds from a financial institution by false or fraudulent pretenses or representations. 18 U.S.C.A. § 1344 (2006). Lenders extract projections as a basis for their lending decision and expect reasonable best estimates, not an acronym bringing to mind the tail of a dog.

that all the projections were merely "throw-ins" after financing was secured.[110] Reed's valuation is evidence of the disavowal of these projections as he used more pessimistic assumptions regarding the volume of scans that the MRI Centers would produce and the amount of revenue the MRI Centers would receive for each scan. Indeed, as to Delaware III and Delaware IV, Reed did not even come up with cash flow projections, as he considered it impossible to value businesses that had not begun to operate.

For his part, Mitchell used the extant projections as the beginning for his analysis and built off of them in a manner that I find to be reasonable and conservative. In fact, in projecting a reimbursement rate, Mitchell took a more conservative approach than the Broder Group's projections — he assumed a $601 reimbursement rate as opposed to the $611 rate used by the Broder Group for Delaware I. Also, Mitchell's scan volume projection mirrors the Broder Group's projections for Delaware I. At the end of the Broder Group's projection period, Mitchell chose to employ a month-to-month approach to scan volume growth for Delaware I, which had added a second MRI machine near the end of 2003. Mitchell assumed, for Delaware I, that scans on the first magnet would

[110] Much was made at the trial that the projections and pro formas were not used to secure financing but rather were "throw-ins" after the deal had been approved on the basis of the personal guarantees of the Broder Group and Edell. Tr. 421-24. Carr, though, testified that even though these were throw-ins, he put together the pro formas and projections "based on the best of [his] knowledge, that [he] thought these things would do." *Id*. at 424. Also, the expansion of Delaware Radiology into Middletown and Dover was not a speculative, new business venture in a new industry — Tri-State was managing several entities and knew the competitive, business, and regulatory landscape. Delaware Radiology explored these opportunities and did its diligence before making the decision to pursue them. *See, e.g.*, Jt. Ex. 83. Carr was instrumental in pursuing the business opportunities for Delaware III and IV and had as much knowledge as anyone as to their prospects and expectations for profitability. Given his role and his fealty to the Broder Group, the Broder Group is in a poor position to disclaim his projections as having no utility.

increase by two per month until it reached its capacity of 435 scans per month. He further assumed that scans on the second magnet at Delaware I would increase by ten per month until its capacity of 435 scans per month was reached.[111] Those assumptions struck me as reasonable and achievable ones.[112]

Mitchell lacked management projections for Delaware II.[113] But Mitchell did know that Delaware II would experience competition from an MRI Center that opened in the Delaware II market area and that this could dampen Delaware II's volume. Mitchell, therefore, projected that any increase in Delaware II's scans would be offset by

[111] Expert Report of Mitchell 24 (hereinafter "Mitchell Report"). It is worth noting that at the end of Carr's two-year projections, Carr assumed a scan volume increase of ten scans per month. Mitchell's approach after the end of the Broder Group's projections resulted in a monthly increase of twelve scans, which is not markedly different.

[112] In contrast, Reed was much more pessimistic. Despite the addition of a second magnet at Delaware I, Reed only projected 23% growth in scans in year one and 24% growth in year two. For the rest of the five-year projection, he assumed 3% annual growth. Expert Report of Reed 34 (hereinafter "Reed Report"). His projection for Delaware II was even more pessimistic — decreasing scans by 14% in year one and 15% in year two. *Id*. He then assumed 3% annual growth. As he did not value Delaware III and IV, there was no scan volume assumption in his original valuation. In order to address the court's desire to have projections that included reading fees at certain rates, he made some basic assumptions in order to complete the post-trial projections, but his methodology is not described at length. Rather, he provided a table of expected monthly scans for the first eighteen months and then increased volume at the rate of inflation.

[113] The record does contain a skeleton projection for Delaware II prepared by Carr. Jt. Ex. 233. As opposed to the projections for Delaware I, III, and IV, that projection does not contain detailed financial projections. Instead, only scan volume and revenue are projected. I should note that this projection uses a reimbursement rate of $720 per scan for the first year — $119 more than any rate used in this litigation. The second year is projected at $620. Mitchell apparently never received this projection. Reed had the projections but did not rely on them. Tr. 493.

competition in year one and then grow at 3.5% annually in years two through five of the five-year projection period.[114] That relatively modest growth rate was achievable.

Finally, Mitchell used the Delaware III and IV estimates prepared by Carr for lenders in determining his scan volume projections used to value these entities. He used Carr's projected growth through month eighteen of the twenty-four month projections and then increased scan volume at Delaware III and IV by five per month through the end of year two and then by two per month until the end of the five-year projection period.[115] Again, Mitchell's projected reimbursement rate was more conservative than Carr's projections — he assumed a $601 rate as opposed to $625 used by Carr.

Overall, I find Mitchell's estimated growth realistic and appropriate when compared to the historic scan volume of the MRI Centers and the management projections for new MRI Centers. The more rapid increase in scans at Delaware I is reasonable, given its increased capacity beginning in 2003. Mitchell also properly took into account the competition Delaware II faced from the entrance of a new, competing center in Delaware II's market by assuming more modest growth for it. Finally, Mitchell's reliance on Carr's estimates for Delaware III and IV as the basis for his projection-period growth estimate was reasonable.

I also find that Mitchell made reasonable assumptions regarding the revenues that Delaware Radiology would receive for doing scans. Mitchell began by using the same

[114] *Id.* It should be noted, as to competition, that a previous center opened less than one-half mile from Delaware II shortly after Delaware II opened, but this center closed within eighteen months because Delaware II "was capturing the market share" due to its "name recognition." Tr 786-87.
[115] Mitchell Report 24-25.

base reimbursement rates as Reed for Delaware I ($601 per scan) and Delaware II ($571 per scan).[116] Mitchell used those reimbursement rates because they were the numbers the Broder Group provided to Reed for the purpose of performing a valuation, and Mitchell found them reasonable. Mitchell held these rates constant throughout his projection period. Reed, by contrast, assumed reductions in reimbursement rates of 9% for Delaware I and II in year two, or 2005, and then increased them at 3%, the rate of inflation, annually.[117] Essentially, the basis for Reed's reduction was speculation by Carr, and Reed's own opinion that Delaware reimbursement rates were high relative to neighboring states and that they were likely to fall. But the record is devoid of information from more objective sources to substantiate that viewpoint, which, like other elements of Reed's and Carr's testimony, fits with the self-interest of the Broder Group.

Notable in this regard is the assumption that Carr made before this litigation about the reimbursement rates that Delaware III and IV would achieve. The projections Carr prepared for the Broder Group to provide to PNC Bank indicated that Delaware III and Delaware IV would receive approximately $625 per scan.[118] As mentioned, Mitchell reduced this rate to $601 per scan in his projections for Delaware III and IV, which was consistent with Delaware I's reimbursement rate.[119] Carr's pre-merger estimates, prepared for financing purposes, of a $625 per scan reimbursement rate are telling

[116] Reed uses $601/scan for Delaware I even though, in testimony, he claimed that by December 2003 that "had dropped to $567 per scan," but he "questioned . . . Mr. Carr . . . and [] could not get a satisfactory answer." Tr. 493.
[117] Reed Report 34.
[118] Mitchell Report 25; Jt. Ex. 232. Again, Carr even projected a reimbursement rate of $720 for Delaware II. Jt. Ex. 233.
[119] *Id.*

evidence of the reasonableness of Mitchell's decision to use a constant reimbursement rate for Delaware I and II, given that reimbursement rates had not been reduced previously, and to use that same reimbursement rate of $601 for Delaware III and IV.[120]

By employing Mitchell's reimbursement rates and scan volume growth, I estimate that the MRI Centers would realize the following revenues throughout the five-year projection period from the merger date:

	Year 1	Year 2	Year 3	Year 4	Year 5
Delaware I	$4,041,725	$4,814,010	$5,661,420	$6,256,410	$6,274,440
Delaware II	2,245,172	2,323,970	2,405,052	2,488,989	2,576,352
Delaware III	549,915	1,544,570	1,860,696	2,033,784	2,206,872
Delaware IV	204,340	1,320,998	1,716,456	1,889,544	2,062,632

Consistent with my conclusion that Mitchell's estimates of cash flows during the five-year projection period are reasonable, I also find his calculation of operating expenses a reliable and accurate representation of Delaware Radiology's historic expense structure. Previously, I addressed my resolution of the parties' dispute about Reading Fees. Because I adopt an approach different from Mitchell's, I deviate from him in handling the Reading Fee expense. To address that issue, I return the excess Reading Fee profit of 3.8% — the difference between the 17.5% the Broder Group paid itself and the market rate of 13.7% — from Delaware I, III, and IV to the value of Delaware Radiology. Similarly, I return the 1.3% excess Reading Fee profit from Delaware II to

[120] It is worth noting that Delaware I's reimbursement rate, if found by dividing gross revenues by the number of scans, appeared to be around $680 per scan in 2003 and Delaware II's reimbursement rate was approximately $686 per scan in 2003. If anything, the reimbursement rates appear to have increased since Delaware I and II were opened. *See* Mitchell Report 11-12.

the value of Delaware Radiology. On this basis, the MRI Centers' operating expenses are:

	Year 1	Year 2	Year 3	Year 4	Year 5
Delaware I	$2,181,146	$2,567,557	$2,975,169	$3,334,909	$3,464,063
Delaware II	1,326,364	1,371,949	1,436,135	1,522,849	1,638,663
Delaware III	376,027	838,327	1,020,320	1,120,355	1,232,720
Delaware IV	257,030	779,713	1,009,823	1,105,131	1,223,999

I then calculate the EBITDA for each MRI Center. To do so, I subtract the income, amortization, and depreciation expenses used by Mitchell in his DCF analysis to calculate earnings before taxes.[121] Consistent with my prior analysis, I also tax affect these earnings — as Mitchell did not — in a manner consistent with Delaware Radiology's status as an S corporation and the shareholder-level benefit received as a result. I apply a tax rate of 29.4% to the before-tax earnings of each MRI Center. The following table states each MRI Center's net income:

	Year 1	Year 2	Year 3	Year 4	Year 5
Delaware I	$1,168,118	$1,450,479	$1,772,360	$1,946,814	$1,915,057
Delaware II	614,067	661,264	680,335	679,059	658,973
Delaware III	26,934	389,689	491,242	549,577	599,153
Delaware IV[122]	($169,566)	186,670	309,336	370,430	415,054

[121] I accept Mitchell's recalculation of amortization and depreciation on a straight-line basis in order to restate the balance sheet on an accrual accounting basis. I should note that in Reed's rebuttal report, he did not indicate any technical errors in Mitchell's calculation of the MRI Centers' expense structure or reformulation of depreciation on a straight-line basis. Reed's only complaints involved the propriety and inclusion of certain expenses, including those already discussed, e.g. Reading Fees and Tri-State management fees. *See generally* Reed Rebuttal.

[122] I should note that, in calculating this negative net income, I did not apply a carryforward on the loss to lessen tax burdens for future years' positive net income. Rather, because the pro rata reporting of a loss would have an effect on the shareholders' individual reported income in this year, I apply the entire 29.4% tax benefit to year one's earnings for Delaware IV. So, earnings before tax was ($240,178).

Using these net income figures, I reconcile the cash flow determinations by adding back in the non-cash expenses of each entity — interest, depreciation, and amortization — and the increases or decreases in cash attributable to that year's change in working capital. The figures used to perform this reconciliation all come from Mitchell because, having used his non-cash expense numbers to calculate income, I use the same numbers to reconcile the cash flows. I also make one adjustment to address a disagreement between Reed and Mitchell about the propriety of adding in an annual capital expenditure during the projection period. Reed, in his DCF model, projected an annual capital expenditure of $75,000 per year for Delaware I and $37,500 per year for Delaware II.[123] Mitchell included no capital expenditures at all.[124] I include a nominal capital expenditure each year of $5,000 for Delaware I and II, given the age of their equipment, and no annual capital expenditure for Delaware III and IV. I find that Reed's addition of very heavy assumed capital investments was unreasonable but also find unrealistic Mitchell's assumption that Delaware I and II would make no capital investments during the projection period.

This results in annual cash flows to invested capital as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5
Delaware I	$1,720,018	$1,513,428	$1,805,757	$2,015,424	$2,015,004
Delaware II	935,897	661,187	671,278	670,393	652,112
Delaware III	75,801	345,667	612,430	658,142	699,250
Delaware IV	(89,921)	317,092	558,054	603,334	640,934

[123] Reed Report 35.
[124] Expert Rebuttal Report of Mitchell 10-11 (hereinafter "Mitchell Rebuttal").

B. Calculating Terminal Value

Both experts use a form of the capitalization method to calculate a terminal value for the MRI Centers.[125] Mitchell assumed a constant perpetuity growth rate of 4%. Reed assumed a perpetuity growth rate of 3%. As between the two, I find Mitchell's rate more realistic. Reed essentially assumes no real growth in the value of Delaware Radiology after the projection period, which I believe is unduly pessimistic. Mitchell captures a modest increment of growth for the MRI Centers above the growth in the entire economy that is realistically achievable, and I adopt his perpetuity assumption.

I depart from Mitchell in one material respect in calculating Delaware Radiology's terminal value. Mitchell assumed no capital expenditures during the terminal period in an alleged attempt to capture value from his assumption that the MRI equipment would last well beyond the end of its period of financing, which would allow the MRI Centers to have a period where they would be making no payments on their equipment.[126] Essentially, I find credible the trial testimony that the useful life of the MRI equipment does exceed the period of financing, but I also find that, at some point, replacement will become necessary. In order to capture both the value of the debt-free period and the future leases, I use a terminal period expense of $130,500 per magnet that is intended to reflect a future operating lease on equipment. This is 75% of the deduction of $174,000 per magnet that Reed proposed, taking into account my determination that Delaware

[125] *See* SHANNON P. PRATT, ET. AL., VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 215-16 (4th ed. 2000) (discussing the two basic methods of calculating terminal value) (hereinafter, "VALUING A BUSINESS").
[126] Tr. 893-94.

Radiology is likely to enjoy periods of relatively greater profitability because of the durability of its paid-off MRI machines.[127] Using these assumptions, the undiscounted terminal value for each entity is:

	Terminal Value
Delaware I	$11,750,133
Delaware II	3,716,104
Delaware III	3,349,820
Delaware IV	2,557,786

C. Calculating The Weighted Average Cost Of Capital ("WACC")

The experts also haggle over the correct discount rate to calculate the value of the future expected cash flows of Delaware Radiology on the merger date. Testimonial feuds about discount rates often have the quality of a debate about the relative merits of competing alchemists. Once the experts' techniques for coming up with their discount rates are closely analyzed, the court finds itself in an intellectual position more religious than empirical in nature, insofar as the court's decision to prefer one position over the other is more a matter of faith than reason.

This unfortunate reality flows from the status of principles of corporate finance. Even as to public companies, there is much dispute about how to calculate the discount rate to use in valuing their future cash flows, even when one tries to stick as closely as possible to the principles undergirding the capital asset pricing model and the semi-strong form of the efficient capital markets hypothesis. Witness the serious academic debate about whether the so-called size premium received by investors in smaller public companies is a durable indicia of their greater risk, or whether there are attributes of

[127] Reed Report 36.

stocks with a low book-to-market ratio that require the consideration of that factor in estimating a discount rate.[128] And not all public companies have a sufficient public float for trading in their shares to provide a reliable beta for use in calculating their cost of capital, forcing a resort to the use of data from the industry or so-called comparable companies.

Situations like this one inspire even less confidence, when experts are required to calculate a cost of capital for a very small, non-public company, for which neither of the experts has identified reliable public comparables. In this context, the ability of the experts or the court to hew literally to the teaching of the high church of academic corporate finance is essentially non-existent. At best, the experts and the court can express their reverence by trying to come up with a proxy that takes into account concerns addressed by CAPM and ECMH.

The experts in this case have used the proxy that has found the most favor among professional appraisers: the so-called "build-up model." The build-up model begins with the core factors considered by CAPM, a risk-free rate and an equity premium rate. From there, however, the build-up model begins to diverge from CAPM. Under the build-up method, beta is not considered. A size premium, used consistently with the practice of

[128] *See* BREALEY & MYERS 201-02, 356-57 (discussing the academic debate about the empirical evidence regarding the relationship of stock returns, firm size, and book-to-market ratio on the proper way to calculate cost of capital); Eugene F. Fama & Kenneth R. French, *The Cross-Section of Expected Stock Returns*, 47 J. FIN. 427 (1992) (hereinafter "Cross Section"); Eugene F. Fama & Kenneth R. French, *Size and Book-to-Market Factors in Earnings and Returns*, 50 J. FIN. 131 (1995).

most current users of CAPM in the appraisal and valuation context,[129] is de rigueur under the build-up model. Much more heretical to CAPM, however, the build-up method typically incorporates heavy dollops of what is called "company-specific risk," the very sort of unsystematic risk that the CAPM believes is not rewarded by the capital markets and should not be considered in calculating a cost of capital. The calculation of a company specific risk is highly subjective and often is justified as a way of taking into account competitive and other factors that endanger the subject company's ability to achieve its projected cash flows. In other words, it is often a back-door method of reducing estimated cash flows rather than adjusting them directly. To judges, the company specific risk premium often seems like the device experts employ to bring their final results into line with their clients' objectives, when other valuation inputs fail to do the trick.

That reality manifests itself in this case, where both Mitchell and Reed used the build-up method to estimate Delaware Radiology's cost of capital.[130] The table below

[129] In other words, there are many adherents of CAPM who believe that the superior performance of small stocks over time is a relevant factor to be considered in calculating a cost of capital. The magnitude of this superiority is a question of great debate, as are the questions of whether the gap is eroding, has eroded to insignificance, or was never significant, when all factors are considered. What appears clear is that serious adherents to the essential reasoning behind ECMH and CAPM — *e.g.*, Fama & French — believe the small stock factor to be important. From my experience, most testimonial experts and investment bankers using CAPM tend to accept the size factor as relevant.

[130] That is, both experts essentially calculated the discount rate consistent with the leading non-academic treatise. *See* PRATT, VALUING A BUSINESS 163. Interestingly, Pratt does not use the precise nomenclature of the "build-up method" in his larger treatise. *See id*. at 160-65 (discussing the build-up method, while never using that name). But, in his valuation text for lawyers, he specifically refers to this method of calculating a discount rate as "the build-up model." SHANNON PRATT, THE LAWYER'S BUSINESS VALUATION HANDBOOK: UNDERSTANDING FINANCIAL STATEMENTS, APPRAISAL REPORTS, AND EXPERT TESTIMONY 120 (2000). To be fair,

shows their application of the build-up method to come up with a cost of capital for Delaware I:

Mitchell's Discount Rate		Reed's Discount Rate	
Risk free rate	5.01%	Risk free rate	4.93%
Equity premium risk	7.20%	Equity risk premium	7.00%
Industry risk premium	(4.51%)	Size risk effect	9.16%
Size premium	9.82%	Specific company risk	3.50%
Specific company risk	2.00%	Equity discount rate	24.59%
Equity discount rate	19.52%	Cost of Debt	3.95%
WACC[131]	18.64%	WACC (84.7% equity, 15.3% debt)[132]	21.4%

As can be seen, the disparity in equity discount rates primarily results from Mitchell's use of a negative industry risk premium, based on Ibbotson's data, of 4.51%. Absent this industry risk, Reed and Mitchell would be approximately 0.5% apart in their equity discount rates. But that difference overstates the similarity of their analyses. After all, Reed uses a company specific risk premium of 3.5% and Mitchell uses only a 2% figure. Neither explained their estimates with any confidence-inspiring precision. Even as to the small stock premium, there is more than a 0.6% difference.

In view of the unavoidable imprecision of the exercise, I adopt Mitchell's approach for use in my remedy award. I do so in large part because of my determination that his analysis is, on balance, the more reliable. I also do so because his approach to

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Pratt recognizes the inherent subjectivity of the specific company risk factor, though, by stating that this factor is a matter of the analyst's judgment. PRATT, VALUING A BUSINESS 163.

[131] This is the WACC for Delaware I only, given the different debt-equity structures of the various MRI Centers.

[132] This is Reed's cost of capital for Delaware I. The cost of capital he used for Delaware II was 22.4%, which was a result of factoring in specific company risk at 4.50% and a slightly higher cost of debt component. Similarly, Reed increased the equity discount rate by an additional 1% for Delaware III and an additional 2% for Delaware IV.

calculating the discount rate comes the closest to putting into practice the thinking behind the CAPM, in circumstances when CAPM cannot be applied in its pure form. Mitchell's inclusion of a small stock premium is consistent with a good deal of academic and practitioner thinking about CAPM.[133]

More important, I regard Mitchell's consideration of the lower industry risk for companies like Delaware Radiology to be a fair proxy for beta in a circumstance when beta cannot be measured directly. Under the CAPM, the equity risk premium is not used in isolation to estimate the subject company's cost of capital. Rather the equity risk premium is adjusted by an estimate of the systematic risk of the subject company reflected by its actual or estimated beta. The industry return data that Mitchell uses is an acceptable substitute for that adjustment in this situation when a beta cannot be estimated.[134] Mitchell testified that the negative risk premium he employed was consistent with market return data from Ibbotson's indicating that investments in a health care industry business present less market risk than average.[135]

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[133] *E.g.*, Rolf W. Banz, *The Relationship between Return and Market Value of Common Stocks*, 9 J. FIN. ECON. 3 (1981); Fama & French, *Cross Section*; PRATT, VALUING A BUSINESS 170.

[134] Essentially, the industry risk is used in place of calculating a beta, and Shannon Pratt states that the equity risk premium "[m]ay be modified by one or more coefficients, such as beta, based on the capital asset pricing model . . . ." *See* MICHAEL BARAD & TARA MCDOWELL, IBBOTSON ASSOCIATES, CAPTURING INDUSTRY RISK IN A BUILDUP MODEL 1 (2002) *available at* http://www.ibbotson.com/download/research/Capturing%20Industry%20Risk%20in%20a%20Buildup%20Model.pdf ("Most appraisers make an industry-based adjustment in calculating a firm's cost of equity. A practitioner using the Capital Asset Pricing Model already includes industry risk through a beta measure; however, when using the buildup method, it must be added in the form of a risk premium.").

[135] Tr. 891-92. Reed does not challenge the industry risk number that Mitchell obtained from Ibbotson's. Rather, he challenges the use of an industry premium for Delaware Radiology because of its size. Tr. 646. Mitchell, though, notes that in Ibbotson's calculation of the industry risk premium, one of the companies analyzed generates approximately $17 million annually in

When viewed as a whole, the equity discount rate that Mitchell calculated for Delaware I, II, III, and IV is quite reasonable, reflecting a substantial rate of over 19%. In coming to his cost of capital determination for each of the MRI Centers, then, Mitchell kept all factors constant except for their various borrowing rates and levels of debt. I find that approach more reasonable than Reed's approach of varying his company specific risk premium MRI Center by MRI Center, largely for reasons already taken into account by his reduction in the projections he used in his DCF analysis.[136] Mitchell's own analysis also contains a subjective specific company risk premium of 2%, the quantification of which cannot be explained by reference to objective factors. I will not quibble with including that factor, which reinforces the conservatism of Mitchell's final cost of capital.

The exhibits to Mitchell's expert report suggest that Mitchell correctly weighted the debt of the MRI Centers and the equity in the MRI Centers as of December 2003.[137] He ran several iterations in order to achieve the correct WACC value, so I will apply his values to determine present value.[138] Those values are:

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revenue, which is not out of line with the revenue achieved cumulatively by the MRI Centers and other Broder Group centers. Tr. 891-92.

[136] *See* PRATT, VALUING A BUSINESS 181 ("The analyst must be especially careful to avoid undue double counting, such as reflecting a negative factor fully by a reduction in the same economic income projection, and then magnifying the effect by an increase in the discount rate.").

[137] *See* Mitchell Report Exs. 18, 31, 43, 54. His initial WACC values were modified slightly after the trial in a submission dated January 31, 2006. I apply the new WACC values detailed in that letter. Gocial Gerstein Letter to Cathy Reese, Esq., Jan. 31, 2006.

[138] Admittedly, the WACC numbers are no longer precisely correct because, in performing my own valuation and arriving at different entity values than Mitchell, the relative debt and equity weights will have changed. These changes, at most, are relatively insignificant, result from the natural imperfect nature of the appraisal inquiry, and do not alter the reality that the use of Mitchell's WACC numbers will provide a responsible present value of Delaware Radiology. This court is not an investment bank and does not have a store of DCF software available to

	WACC
Delaware I	18.64%
Delaware II	18.79%
Delaware III	18.55%
Delaware IV[139]	15.57%

D. Calculating The Fair Value Of Delaware I, II, III, And IV

The projected cash flows and terminal value stated in present value terms result in each MRI Center having the following total enterprise value as of January 20, 2004.

	Total Entity Value
Delaware I	$10,480,021
Delaware II	3,840,299
Delaware III	2,739,876
Delaware IV	2,410,842

E. What To Do About Delaware V?

The preceding analysis leaves one question unresolved: what to do about the value of Delaware V? Because Delaware V was not formed until several months after the merger, no pre-merger projections were available. But the facts convince me that a future Sussex County MRI Center was envisioned by the Broder Group and Edell as the logical next step in the southward movement of Delaware Radiology — indeed, that concept was discussed with Edell as early as 1998.[140] Although Mitchell performed a valuation of Delaware V based on projections calculated by Carr, I find that Mitchell's valuation did not have the same reliability as his valuations of Delaware III and IV based

allow us to run iterative exercises. Instead, as judges, we must do the best we can with the record the parties provide us.

[139] The Delaware IV WACC is significantly lower because of its presumed initial reliance on debt that is available at a lower cost than equity and because that debt comprises a higher proportion of its capital structure in comparison to the other MRI Centers.

[140] *See* Tr. 703.

on the remoteness in time of Delaware V to the merger. That leaves me with a remedial gap, which I fill conservatively. I will set the value of the Delaware V opportunity at a conservative 33% of Delaware IV's total value to Delaware Radiology, including the excess profit from Reading Fees. This gives the Kessler Group value for the Sussex County opportunity open to Delaware Radiology, while taking into account the more inchoate nature of that opportunity. Although this remedy is necessarily imprecise, it is a fitting and conservative one, given the lack of procedural safeguards employed by the Broder Group in effecting the merger, and the refusal to accord the Kessler Group value even for Delaware III.[141] Delaware V's value to Delaware Radiology, then, is $358,845, which is one-third of the total value of Delaware IV.

F. The Total Value Of Delaware Radiology

From the total enterprise value, I deduct each MRI Center's debt as of December 31, 2003. In addition, as Delaware Radiology was not the 100% owner of any MRI Center, each entity value is multiplied by Delaware Radiology's ownership percentage.[142] I then added back the 3.8% above-market profit from the Reading Fees for Delaware I,

[141] In a belated renewal of an earlier application, the Kessler Group seeks fee-shifting on the basis that the Broder Group's conduct was in extreme bad faith. In support of that position, the Kessler Group points to concerns about the adequacy of the Broder Group's production of evidence regarding Delaware V. Given the circumstances in which the claim for fee shifting was raised, I believe the Kessler Group's application was inexcusably tardy. Moreover, in considering the application, I would also have to consider whether the Kessler Group's own overly-aggressive and time-consuming approach to the litigation made the process unduly expensive at times, which I believe it did. Most important, by making an award that includes the value of the Delaware V opportunity, I take into account the concerns raised by the Kessler Group in a fair manner. For all these reasons, I will not shift attorneys' fees. I will, however, award costs to the Kessler Group as the prevailing party.

[142] When determining Delaware Radiology's ownership percentage of Delaware III and IV, I include any percentage owned by a Tri-State entity or Carr.

III, and IV and the 1.3% from Delaware II. This table[143] details the value of each MRI Center, including excess Reading Fee profit:

	Delaware I	Delaware II	Delaware III	Delaware IV	Delaware V
Entity Value	$10,480,021	$3,840,299	$2,739,876	$2,410,842	
Debt at Dec. 31, 2003	(1,153,200)	(421,746)	(442,730)	(1,343,333)	
Control Equity Value	$9,326,821	$3,418,553	$2,297,146	$1,067,509	
DE Radiology Ownership	70%	60%	60%	60%	
Value to DE Radiology	$6,528,774	$2,051,132	$1,378,288	$640,505	$213,502
Excess Read Profit to DE Radiology	$1.291.285	$190,033	$418,009	$436,031	$145,343

As is indicated below, my analysis results in a value of Delaware Radiology of $13,292,903.22, which results in a per share value of $33,232.26. The Kessler Group's 37.5% ownership of Delaware Radiology has a total value, then, of $4,984,838.71.

Total Value of MRI Centers	$13,292,903.22
Shares Outstanding	400
Value per Share	$33,232.26
Kessler Group Shares	150
Delaware Radiology's Value to Kessler Group	$4,984,838.71

The results of this analysis not only serve as the foundation for my appraisal award but as the basis for a conclusion that the merger was not financially fair to the squeezed-out minority, the Kessler Group, as a matter of equity.

[143] The results of this table are rounded.

VII. Pre-Judgment Interest

Of course, no remedial decision would be complete without resolving an expensive debate (in terms of the use of judicial time and the payment of attorneys' and experts' fees) over the rate and frequency of pre- and post-judgment interest. The human energy spent on these disputes is wasteful and dispiriting. But until there is a statutory solution, there is no choice.

The Broder Group sought to resolve this dispute unilaterally by depositing an amount of funds equal to the merger consideration payable to the Kessler Group in an escrow account, which paid a very low money market rate of interest of 2.5%. The Broder Group advocates an award of interest at that rate, or, in the alternative, a combination of the weighted average of that rate and an estimate of Delaware Radiology's weighted borrowing rate, which it estimates at prime minus 0.25%, or 4.64%. This results in a pre-judgment interest rate of 3.57%, which the Broder Group suggests that I compound monthly.[144] The Kessler Group advocates a different approach — one that averages a prudent investor rate, 6.4%,[145] and Delaware Radiology's actual cost of borrowing for the MRI Centers, 7.46%, to come up with a rate of 6.9%, which it seeks to have compounded monthly and stated on an annual basis.[146]

[144] Reed Rebuttal 13-14.
[145] Mitchell's prudent investor portfolio consisted of 20% 91-day U.S. Treasury bills, 20% 10-years to maturity U.S. Treasury notes, 30% investment grade corporate bonds, and a 30% diversified portfolio of stocks using the return on the Standard & Poors 500 Stock Index as a proxy. Mitchell Report 39.
[146] *Id.* at 38-39.

This court is said to have "broad discretion to determine the appropriate rate of interest."[147] Using that discretion I award interest at the rate advocated by the Kessler Group.[148] The Broder Group's placement of funds in escrow might have been well-meaning, but it falls short of convincing me to use a money market rate of interest as a factor. The Broder Group placed the funds in escrow without agreement from the Kessler Group on the nature of the investment vehicle or the amount of funds to be escrowed. As it turns out, the amount of funds escrowed falls well short of my award.

Given those realities and the remedial purposes to be served by this proceeding, I adopt the Kessler Group's approach, which is one that is consistent with this court's precedents. In appraisal cases, prejudgment interest is "typically awarded on the basis of a combination of the plaintiffs' lost opportunity cost, measured by a prudent investor rate; and the benefit realized by the defendant, measured in terms of the reduction in defendants' borrowing costs."[149] The formula employed by Mitchell comports fully with that approach,[150] as does the use of monthly compounding.[151] As a further matter, given the self-interested nature of the merger and my finding that the terms were financially unfair, my discretion is properly exercised in favor of the more generous, but still responsible, rate of interest proposed by the Kessler Group.

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[147] *Montgomery Cellular*, 880 A.2d at 226.
[148] In that regard, I find that Mitchell's use of the actual borrowing rates for the MRI Centers to be permissible.
[149] *Ryan*, 709 A.2d at 705.
[150] *See Gonsalves*, 2002 WL 31057465, at *13.
[151] *Id.*

VIII. Conclusion

For the foregoing reasons, I find that the merger was unfair and that the Kessler Group therefore prevails on its fiduciary duty claim. The remedy for that claim, however, is identical to my appraisal award. Thus, the Kessler Group shall receive a judgment equal in amount to $33,232.26 per share of Delaware Radiology it owned, or a total of $4,984,838.71. The appraisal award is the obligation of Delaware Radiology, as the surviving entity in the merger, but the equitable award is the obligation of the members of the Broder Group, jointly and severally. Interest shall run on that award from the merger date at a rate of 6.9%, compounded monthly until the date of full payment. The defendants shall pay the Kessler Group's costs. The Kessler Group shall present a conforming final judgment, upon notice as to form by the Broder Group, within ten days.

DeMasi v. DeMasi

Case name: DeMasi v. DeMasi
Citation: 366 Pa. Super. 19, 530 A.2d 871, 1987 Pa. Super. LEXIS 8840
Date of decision: August 10, 1987
Country: US
State or Federal: State
State/Jurisdiction: Pennsylvania
Court: Superior Court
Type of action: Marital Dissolution
Judge: Hester
SIC: 8011 Offices and Clinics of Doctors of Medicine (except mental health specialists, HMO medical centers, and ambulatory surgical and emergency centers)
NAICS: 621111 Offices of Physicians (except Mental Health Specialists)

Keywords: Marital dissolution, Sole proprietorship

COUNSEL:

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Carolyn Lasky, York, for Tanya DeMasi.

JUDGES:

Cirillo, President Judge, and Tamilia and Hester, JJ.

OPINIONBY:

HESTER

OPINION:

These are four consolidated appeals: three filed by Rocco J. DeMasi, and one filed by Tanya J. DeMasi. As both parties are appellant and appellee, we shall refer to Rocco J. DeMasi as "husband" and to Tanya J. DeMasi as "wife." The orders under review concern child support, spousal support, alimony pendente lite, equitable distribution of marital property, counsel fees and litigation expenses. n1

n1 We note several errors in the form of wife's brief: omission of the statement of jurisdiction (Pa.R.A.P. 2111(a)(1)); statement of questions not set forth on a separate page nor limited to one page (Pa.R.A.P. 2116(a)); brief exceeds maximum length (Pa.R.A.P. 2135(1)). Wife's preamble requesting this court's indulgence in studying her lengthy brief is procedurally incorrect; parties shall present a motion for leave of court to file briefs exceeding maximum length.

Husband and wife were married on November 25, 1967. Two children were born of their marriage: Vincent M. DeMasi, born December 14, 1970, and John M. DeMasi, born November 23, 1974.

Husband is a medical doctor who graduated from Temple Medical School in 1969. Following an internship and residency, he earned board certification in internal medicine in 1972. He is a 50% shareholder in Associated Internists, Inc., where he primarily practices rheumatology. The owner of the remaining shares is his practicing colleague, William Lampe, M.D.

Wife is a registered nurse and worked in that capacity from 1967 to 1970. From 1970 to 1982, she raised the parties' children and served as a full-time homemaker. She returned to work as a registered nurse in 1982 when the parties separated.

Husband and wife separated on September 10, 1982, and wife filed a support complaint on September 17, 1982. On September 28, 1982, husband filed a complaint in divorce to which wife responded with an answer and claims for alimony pendente lite, counsel fees, costs, alimony and equitable distribution.

Following numerous and lengthy hearings, the trial court, on July 9, 1985, ordered husband to pay wife $ 130.00 per week as alimony pendente lite and $ 264.00 per week as support for sons Vincent and John. Vincent moved in with his father on October 26, 1984, and child support was reduced to $ 130.00 per week as of that date. Husband appealed from the July 9, 1985 order for alimony pendente lite and child support. The parties were divorced on August 6, 1984, while alimony and equitable distribution claims were pending.

On September 4, 1985, the court entered an order disposing of the remaining claims. Husband was awarded his entire interest in Associated Internists, Inc. Wife was awarded husband's entire pension interest, the net equity in the marital residence, all household goods in the marital residence, the personal property in her possession, an automobile, a private life insurance policy, alimony of $ 7,500.00, partial payment of counsel fees and full payment of expert fees and court costs. Both parties appealed from the order of September 4, 1985.

Finally, on March 4, 1986, after appeals were filed from the two orders outlined above, the trial court denied husband's petition to reduce or to terminate alimony pendente lite on grounds that wife had remarried. Husband appealed from the March 4 order.

Husband raises eight arguments in his appeals; wife raises three arguments in her appeal. Husband argues that 1) the trial court entered its order for spousal support, child support and alimony pendente lite without giving him the opportunity to testify concerning his income and earning capacity; 2) the trial court failed to consider the needs of the children and financial abilities of husband and wife in establishing support; 3) the trial court failed to consider wife's income and earning capacity in establishing support; 4) the trial court erred in viewing husband's business perquisites as income; 5) the trial court erred in ordering husband to pay mortgage installments and other expenses on the marital residence after wife moved from the premises; 6) the trial court erred by including good will in the value of husband's medical practice; 7) the trial court erred in continuing alimony pendente lite without considering wife's income, earning capacity and remarriage; and 8) the trial court erred in awarding spousal support and alimony pendente lite in excess of one-third of husband's income.

Wife argues in her cross appeal that 1) the trial court erred in not finding $ 19,800.00 in medical insurance proceeds to be marital property; 2) the trial court erred in valuing husband's pension interest at $ 26,960.00; 3) the trial court erred in holding that it lacked jurisdiction to distribute certificates of deposit which wife owned jointly with her children; and 4) wife remained entitled to lump sum alimony of $ 7,500.00 despite her remarriage.

HUSBAND'S APPEAL

Support and Alimony Pendente Lite

First, husband complains that during the hearing on child support, spousal support and alimony pendente lite, he was not permitted to testify concerning his income and earning capacity. According to husband, the support and alimony pendente lite orders were based on the master's report, not on the court's separate findings.

Pennsylvania Rule of Civil Procedure 1910.11 states that actions for support may begin by an office conference conducted by a hearing officer. Following a review of income tax returns, pay stubs and income and expense statements, the officer may make a recommendation. If an agreement is not reached at the conference, the court may enter an order on the recommendation. Thereafter, if the aggrieved party files a written demand, a hearing de novo shall be held before the court.

An office conference was conducted on December 2, 1982. A recommendation was made, an order was entered and both parties demanded a de novo hearing. The hearing was conducted on April 25, 1983. Wife was the only witness, and it is not clear whether husband elected to forgo testifying or was precluded from testifying.

The support and alimony pendente lite order under review is dated July 9, 1985. That order was not based solely on the hearing of April 25, 1983. Four hearings concerning reconsideration or modification of support and alimony pendente lite followed the April, 1983 hearing. Moreover, seven hearings concerning equitable distribution had been conducted by a master. During the subsequent hearings, husband had an opportunity to testify, call witnesses, offer documentary evidence and cross-examine witnesses. In fact, husband and other witnesses provided exhaustive information concerning his income and the income and expenses of his professional corporation. Among the corporate expenses examined were pension plan contributions, salaries, insurance premiums, travel and entertainment, seminars, automobiles, equipment, taxes, depreciation and general overhead expenses. This information sufficiently defined husband's income and earning capacity.

Husband incorrectly states that the court merely adopted the master's findings and report in establishing support and alimony pendente lite. Transcripts from the seven equitable distribution hearings were part of the record and available for the court's review. The court made its own findings after a review of testimony taken at the support hearings and the hearings before the master. The court did not adopt the master's findings and report. Moreover, the fact that husband had filed exceptions from the master's report, which were pending when the order for support and alimony pendente lite was entered, did not preclude the court from relying on the evidence elicited at the master's hearings.

Husband cites Groner v. Groner, 328 Pa.Super. 191, 476 A.2d 957 (1984), and Agosti v. Agosti, 319 Pa.Super. 426, 466 A.2d 233 (1983), to support his argument that he was entitled to present evidence of his income and earning capacity at the hearing de novo. In Agosti, supra, child support was ordered

following a hearing on divorce, alimony, custody and equitable distribution. The court had not notified the parties that child support would be considered with these other claims; therefore, the parties did not present evidence relevant to child support. Accordingly, the Agosti court remanded for an evidentiary hearing on child support.

In Groner, supra, child support was determined without a hearing even though a de novo hearing had been requested by the father. We held that Pa.R.C.P. 1910.11(i) provided an absolute right to a de novo hearing on child support once properly requested. We also held that a trial court may not rely on the record of other claims in lieu of a hearing de novo on child support.

Here, husband requested a hearing de novo on child support and alimony pendentelite, and such a hearing was conducted on April 25, 1983. Husband was present at the hearing with counsel, but he complains that he was precluded from testifying. The record does not indicate that husband moved to provide testimony or that he was denied the opportunity. It appears that husband's strategy was not to testify.

Although the trial court relied upon evidence from hearings on claims other than child support, these hearings addressed income and earning capacity. In Agosti, child support issues were not addressed to any extent in the hearings. In Groner, the parties' son was mentally retarded, and there was no evidence regarding the extent of his retardation or the effect it had on the amount of support. The hearing on claims other than child support did not address the child's mental retardation; therefore, a de novo hearing was the last opportunity to do so. Here, all issues relevant to child support were addressed in numerous hearings. The court properly relied on evidence from those other hearings to determine child support because husband already had the opportunity to testify on his income and earning capacity at the de novo hearing on April 25, 1983.

Next, husband argues that the trial court failed to follow the guidelines enunciated in Melzer v. Witsberger, 505 Pa. 462, 480 A.2d 991 (1984), in determining child support. In Melzer, the supreme court summarized guidelines for calculating child support: 1) reasonable needs of the children which reflect the needs, custom and financial status of the parents; 2) respective abilities of the parents to provide support which are identified in part by reasonable living expenses; 3) use of a formula to calculate each parent's total support obligation; and 4) credit for support provided directly to the children.

Husband maintains that Melzer was not followed because the court allegedly based the support order on the master's equitable distribution report without conducting a comprehensive support hearing covering the Melzer guidelines. As discussed above, the support and equitable distribution hearings were exhaustive; the needs of the children and the financial abilities of husband and wife were fully addressed. Wife testified concerning utilities, clothing, automobile maintenance, indebtedness, insurance, taxes, medical and dental treatment, food, entertainment, subscriptions and other typical and special living expenses for her and the children. Similarly, husband's expenses were fully covered. Finally, the parties' health, education, skills, actual and prospective incomes, and career plans and opportunities were addressed. This information was gleaned from the record. It was not, as husband maintains, taken from the master's report.

Third, husband argues that the trial court erred in not considering wife's income and earning capacity in determining child support and alimony pendente lite. According to husband, wife can earn in excess of $ 24,000.00 annually as a registered nurse.

Both parents are equally responsible for supporting their children, and the extent of their respective support obligations is determined by their capacity and ability. Fee v. Fee, 344 Pa.Super. 276, 496 A.2d 793 (1985). A parent's ability to pay support is determined primarily by financial resources and earning capacity. Hesidenz v. Carbin, 354 Pa.Super. 610, 512 A.2d 707 (1986); Commonwealth ex rel. Cochran v. Cochran, 339 Pa.Super. 602, 489 A.2d 804 (1985). The obligation of support, then, is measured more by earning capacity than by actual earnings. Hesidenz, supra.

Wife testified at length concerning her employment history and qualifications. She graduated from Temple University School of Nursing in 1967 as a registered nurse. From September, 1967, to October, 1970, she served several hospitals and one school district as a nurse. In October, 1970, she left the workforce in anticipation of Vincent's birth in December, 1970.

From October, 1970, to September, 1982, wife remained in the home to rear the parties' sons and to serve as full-time homemaker. Due to husband's substantialincome, the parties had the opportunity to provide their children with fulltime parental care during the nurturing years. Also during this twelve-year period, wife entertained other physicians in her home and served the Women's Medical Auxiliary, Junior League, Young Women's Club and Parent Teacher Organization. Wife explained that she entertained house guests and joined these organizations to create and maintain good public relations for husband.

In 1983, her first full year back in the work force, wife earned $ 15,000.00. On May 1, 1984, she began employment as the director of nursing for a nursing home and rehabilitation center at $ 22,000.00 annually. Her director's position would continue provided she completed a bachelor's degree in behavioral science. As of June 1, 1984, wife had to complete thirty-five credits to earn this degree.

In Ritter v. Ritter, 359 Pa.Super. 12, 518 A.2d 319 (filed December 5, 1986, at 283 Philadelphia 1986), we iterated the scope of review in child support proceedings: a child support order will not be reversed unless the evidence was insufficient or the court abused its discretion in awarding that amount of support. An abuse of discretion is proven only by clear and convincing evidence. Koller v. Koller, 333 Pa.Super. 54, 481 A.2d 1218 (1984).

With this standard in mind, we find no abuse of discretion. Wife's earning capacity was thoroughly reviewed. It was established by three years of employment during the early years of marriage and by nearly three years of employment following the separation. She earned a customary salary, and her pursuit of a bachelor's degree indicated a willingness to earn maximum income. She cannot be penalized for having remained in the home for twelve years; the nurturing of young children may supersede the economic benefits of full-time employment. Hesidenz, supra; Butler v. Butler, 339 Pa.Super. 312, 488 A.2d 1141 (1985).

These same factors apply to a review of that portion of the order addressing alimony pendente lite. Earning capacity is relevant whether the proceedings concern child support or alimony pendente lite. Pacella v. Pacella, 342 Pa.Super. 178, 492 A.2d 707 (1985).

Fourth, husband argues that the trial court erred in adding the value of certain business perquisites to his actual income. In 1983, husband earned $ 45,189.00 in net income from his medical practice. The trial court added $ 15,000.00 to his net income because of the following perquisites provided by Associated Internists, Inc. on behalf of both shareholders: 1) contributions of $ 37,749.00 to a defined benefit pension plan; 2) $ 2,347.00 in prepaid rent; 3) $ 3,726.00 for automobile expenses; 4) $ 4,329.00

for travel and entertainment; 5) $ 5,903.00 for telephone expenses; 6) $ 4,032.00 for dues and subscriptions; and 7) $ 15,920.54 for premiums on health, disability, life, malpractice, liability, fire and accident insurance.

Husband maintains that only those perquisites which raised his standard of living can be attributed to income. He argues that all of these expenses either benefited the corporation solely or did not raise his standard of living.

When actual earnings do not reflect earning capacity, the trial court is free to investigate a variety of sources to determine a party's true wealth. In Pacella v. Pacella, supra, 342 Pa.Super. at 187, 492 A.2d at 712, we illustrated some factors in addition to actual earnings which determine income:

See e.g., Commonwealth ex rel. Maier v. Maier, 274 Pa.Super. 580, 418 A.2d 558 (1980) (where supporting spouse is sole stockholder of corporation and determines his own salary, court may pierce corporate veil and use corporate income as basis for determining earning capacity); Commonwealth v. Miller, 202 Pa.Super. 573, 198 A.2d 373 (1964) (where supporting spouse is self-employed, net income, as it appears on income tax forms, is not "infallible" measure of real wealth; court accordingly may add back portion of depreciation deduction in calculating amount of support owed); Commonwealthex rel. Gutzeit v. Gutzeit, 200 Pa.Super. 401, 189 A.2d 324 (1963) (in determining supporting spouse's earning capacity, court should consider not only salary paid by wholly owned corporation, but all prerequisites [sic] provided by corporation.)

In McCurry v. McCurry, 279 Pa.Super. 223, 420 A.2d 1113 (1980), we remanded for a hearing to determine the nature of husband's business ventures and assets. We directed the trial court "to consider to what extent [husband's] ability to pay support may be enhanced by corporate perquisites . . . ." Id., 279 Pa.Superior Ct. at 232, 420 A.2d at 1118. Similarly, in Commonwealth ex rel. Swank v. Swank, 266 Pa.Super. 94, 403 A.2d 109 (1979), and Commonwealth ex rel. Gitman v. Gitman, 428 Pa. 387, 237 A.2d 181 (1967), it was held that perquisites derived from part ownership in corporations shall be considered income.

Husband agrees that perquisites affect ability to pay; however, he maintains that the corporate expenses here were not perquisites which enhanced his income. The benefits were allegedly enjoyed by the corporation alone.

We have reviewed the testimony of Leon Butler, a certified public accountant who was employed by wife to value Associated Internists, Inc. Butler testified that several corporate deductions were added to the value of the corporation because they were solely for husband's benefit. Therefore, according to Butler, husband enjoyed the following perquisites which did not directly benefit the corporation: 1) 50% of expenses for maintaining two corporateowned automobiles; 2) 50% of payments for loans on those automobiles;3) certain travel and entertainment expenses; 4) dues to a social organization; 5) insurance premiums for a life insurance policy which funded a buy/sell agreement; 6) contributions to the corporate pension plan; and 7) certain dining expenses.

The master's findings and Butler's testimony indicate that several corporate expenses reduced corporate profits and husband's take-home income. Three employees participated in the defined benefit pension plan, and husband's one-third share of 1983 corporate contributions was $ 12,650.00. Husband and his partner, Dr. Lampe, each operated a corporate automobile. The evidence indicated that husband did not use his vehicle for house calls or other medical business; he used it primarily to drive to his place of

employment and for personal reasons. Husband's one-half share of the automobile expenses was $ 1,242.00. Husband's one-half share of corporate expenses for dues and subscriptions was $ 2,016.00, and his one-half share of insurance premiums was $ 7,960.27.

It is not clear what portion of travel and entertainment expenses of $ 4,329.00 and telephone expenses of $ 5,903.00 were attributable to husband's personal use. Nevertheless,there was testimony that husband did indeed charge some personal travel, entertainment and telephone expenses to the corporation. Also, wife testified that household expenses for drugs, laundry, dry cleaning and books were charged to the corporation.

Irrespective of the travel, entertainment, telephone and household expenses, husband's share of the aforementioned identifiable expenses for 1983 was $ 23,868.27. Considering husband's reported income and tax bracket for 1983, assigning another $ 15,000.00 of net income to his net income of $ 45,189.00 was not an abuse of discretion. Therefore, we find no error in raising husband's 1983 net income by $ 15,000.00 in perquisites.

Husband's fifth attack on the support and alimony pendente lite order concerns his obligation to pay the mortgage and household expenses. Husband alleges that burdening him with these expenses was inequitable, because wife had moved from the premises, and the master had awarded the house to her.

Wife moved from the marital residence in October, 1982; husband lived there until October, 1984. Wife's right to receive the benefit of husband maintaining the marital residence was not affected by her moving. Alimony pendente lite continues pending resolution of all economic issues. Desch v. Desch, 329 Pa.Super. 22,477 A.2d 883 (1984); Wolk v. Wolk, 318 Pa.Super. 311, 464 A.2d 1359 (1983). Wife was not financially able to maintain the marital residence while she supported two children and defrayed rental and utility expenses on her new residence. Wife needed husband's support to preserve the marital residence pending its equitable distribution.

In Gee v. Gee, 314 Pa.Super. 31, 460 A.2d 358 (1983), the wife was entitled to one-half of the fair market rental value of the marital residence while the husband resided there alone. The wife's absence from the home did not affect her right to rental compensation. Similarly, wife's absence from the marital residence here should not affect her right to husband's maintenance of the house until equitable distribution.

Husband overlooks the fact that he resided in the home for two years following wife's departure. Therefore, his payment of the mortgage, taxes and insurance was not entirely for wife's benefit; he enjoyed the house for two years as he had shelter and preserved a valuable asset for equitable distribution.

Husband's contention that the trial court erred in ordering him to maintain the home after the master had awarded it to wife is equally meritless. Husband had filed exceptions from the master's recommendation which prevented an order awarding the house to wife. As long as husband's exceptions were pending, neither party had sole control over the residence. Therefore, it was appropriate and equitable for husband, earning a higher income, to maintain the residence.

Husband's final argument concerning alimony pendente lite involves the order of March 4, 1986. This order was entered after husband had appealed from the child support and alimony pendente lite order and from the equitable distribution order. The March 4, 1986 order responded to husband's petition to

reduce or terminate alimony pendente lite. Husband alleges that alimony pendente lite should have been reduced or terminated because wife had been awarded $ 10,000.00 in attorney fees and had remarried on October 12, 1985.

An award of alimony pendente lite is designed to enable the dependent spouse to prosecute or to defend a divorce action. Orr v. Orr, 315 Pa.Super. 168, 461 A.2d 850 (1983). It is also designed to help the dependent spouse maintain the standard of living enjoyed while living with the independent spouse. McNulty v. McNulty, 347 Pa.Super. 363, 500 A.2d 876 (1985). Therefore, a dependent spouse may be entitled to alimony pendente lite and counsel fees because both are necessary to maintain the divorce proceeding and a certain standard of living. This is particularly true when the dependent spouse is employed and attempting to complete an education.

Even with awards for counsel fees and alimony pendente lite, wife did not reach the standard of living that she had enjoyed with husband. She purchased a modest home with financial assistance from her parents and grandmother. Her absence from the nursing workforce for twelve years limited her employment opportunities and forced her to accept entry level positions. She could no longer enjoy a large residence with a custom-designed interior, frequent entertainment and an extensive wardrobe.

Wife's remarriage similarly did not affect the alimony pendente lite award. This identical issue was addressed in Miller v. Miller, 352 Pa.Super. 432, 508 A.2d 550 (1986). Section 507 of the Divorce Code, 23 P.S. § 101 et seq., provides that cohabitation precludes "any award of alimony . . . ." We held in Miller that § 507 refers only to alimony; cohabitation or remarriage does not bar an award of alimony pendente lite. Contrary to husband's suggestion, then, "any award" does not include alimony pendente lite. n2

n2 Husband also maintains that the award of spousal support and alimony pendente lite was confiscatory because it exceeded one-third of his income. As discussed earlier, husband's income included perquisites which added $ 15,000.00 of annual net income. When considering husband's actual income and the value of his perquisites, the support and alimony pendente lite award does not exceed one-third of his income.

Equitable Distribution

Husband raises one argument concerning the trial court's distribution of marital property. He claims that the trial court erred by including good will of $ 47,666.00 in the value of his medical practice. n3

n3 Husband actually argues that good will was valued at $ 70,245.00. That figure was husband's one-half share of the entire medical practice; $ 47,666.00 is the good will portion of husband's interest.

We note that husband does not challenge the valuation of good will; he argues that good will should not be considered marital property regardless of its worth. Therefore, this is not a valuation question.

Husband supports his contention with several theories: 1) good will is essentially reputation, and he has no reputation in the community as most of his patients are referred by other physicians; 2) good will is earning capacity, not marital property; 3) if good will were marital property, wife would be awarded a

double recovery as it would then be a factor in determining alimony and equitable distribution; and 4) the buy/sell agreement which husband executed with his partner did not value good will.

Wife's experts testified that good will can be valued as property and distributed equitably. Wife cites several opinions from other jurisdictions where good will of a professional practice was held to be marital property. See Hurley v. Hurley, 94 N.M. 641, 615 P.2d 256 (1980); In Re Marriage of White, 98 Ill.App.3d 380, 424 N.E.2d 421 (1981). She also argues that the buy/sell agreement was not admissible evidence because the absence of the original precluded admission into evidence of a copy.

Although Pennsylvania courts have not addressed whether the good will of a medical practice is marital property, we have recently decided that the good will of a law practice, operated as a sole proprietorship, is not marital property. See Beasley v. Beasley, 359 Pa.Super. 20, 518 A.2d 545 (1986).

In Beasley, the husband was an individual practitioner. He employed fifteen attorneys, and earned a substantial annual income. The husband and his associates were trial attorneys, and their compensation was determined by contingent fees.

Several factors led us to hold in Beasley that good will of a law practice, operated as a sole proprietorship, was not marital property. First, the value of a sole proprietor's good will is placed on his person, whereas the value of good will in a partnership, professional corporation or general corporation is placed on the firm. Good will does not survive the death of a sole proprietor, but the good will of a partnership or corporation survives its owners. Second, the value of an ownership interest in a corporation or partnership is measured by contract or the market, whereas the work effort of a sole proprietor determines the value of his interest. Third, while owners of a partnership or corporation have share arrangements, the sole proprietor has only his professional reputation.

In addition to the aforementioned distinctions between sole proprietorships and other business entities, we stated in Beasley that good will of a sole proprietor relates only to future earnings; it is an expectancy only, with no present value and no guarantee of future income. As it related to future earnings only, it was a factor in determining the amount and duration of alimony. If good will diminished, thereby reducing income, alimony could be modified to ease the payor's burden. If, however, good will were also marital property to be paid in installments, declining good will would reduce income but would not affect the payments. An equitable distribution order is nonmodifiable. In Beasley, we refused to allow good will to cause a double charge on future earnings, which would occur if it were both marital property distributed by installments and income for determining alimony.

Finally, the Beasley court noted the contingent fee arrangement that the lawyer husband and his associates had with clients. Contingent fees are collected when a settlement is reached or when the litigantcollects on a judgment. Before collection, no value can be assigned to the attorney's work as payment of the fee is uncertain.

In addition to the opinions and articles concerning good will discussed in Beasley, several other cases from foreign jurisdictions are deserving of comment. In Dugan v. Dugan, 92 N.J. 423, 457 A.2d 1 (1983), the New Jersey Supreme Court held that an attorney's good will in an exclusively owned professional corporation was marital property. Although the business entity in Dugan was a professional corporation, the New Jersey court implied that good will in a sole proprietorship may constitute marital property. In finding good will present in a partnership, corporation, joint venture or individual proprietorship, the

Dugan court seemed less concerned with the form of the business entity and more concerned with the probability of future earnings. If future earnings were probable, there was good will with present value capable of equitable distribution.

The Dugan court was not troubled by the fact that an individual practitioner is generally unable to sell a law practice. Once an attorney retires or dies, only his tangible business assets remain for sale. Although good will or personal reputation cannot be sold by an attorney, the Dugan court held that that "does not eliminate existence of goodwill and its value as an asset to be considered in equitable distribution." Id. at 434, 457 A.2d at 6.

In Beasley, we did not agree with Dugan's approach. We found it significant that once a sole proprietor terminates his practice, nothing is transferable except tangible personal property. Clients could not be sold as they had the unconditional right to choose an unaffiliated attorney for future representation. We concluded that the nontransferable nature of a law practice diminishes the value of good will.

In Levy v. Levy, 164 N.J.Super. 542, 397 A.2d 374 (1978), the New Jersey court held that the good will generated by an attorney who operated a professional association was marital property capable of being valued. In fact, the Levy court quickly identified the good will as marital property and discussed in detail the method of valuing good will.

New York was confronted with a factual situation similar to the matter sub judice in Nehorayoff v. Nehorayoff, 108 Misc.2d 311, 437 N.Y.S.2d 584 (1981). Nehorayoff and another physician were the owners of a closely held professional corporation which provided medical services for the termination of pregnancies. In holding Nehorayoff's share of good will to be marital property, the New York court noted that the physicians operated a clinic which attracted patients by advertisement, reputation or referral. The reputation was generated by the clinic and not by the physicians because there was no personal relationship between doctor and patient. The court also found that there would be no appreciable decline in business if Nehorayoff or his colleague left the clinic. Finally, it was noted that Nehorayoff's skills were not unique; they were shared by many other physicians in the area. The Nehorayoff court focused on the nature of the business at issue and not on whether it was a sole proprietorship, partnership or corporation.

In Geesbreght v. Geesbreght, 570 S.W.2d 427 (Tex.Civ.App., 1978), the husband was a physician who shared equal ownership with another physician in a professional corporation which provided emergency room service for several hospitals. The firm contracted with hospitals to treat emergency room patients, but it did not have patients of its own. The Geesbreght court first stated that had the husband's medical practice been a sole proprietorship, good will would have no value for purposes of partition. However, it was a professional corporation having good will capable of being valued and divided. Had the husband sold his stock to another physician and left the firm, the firm would have retained the service contracts with the hospitals. There were no patients for the husband to take with him.

The Geesbreght court commented on the difference in good will of a sole proprietorship and of a professional corporation.

"Good will" is sometimes difficult to define. In a personal service enterprisesuch as that of a professional person or firm, there is a difference in what it means as applied to "John Doe" and as applied to "The Doe Corporation" or "The Doe Company." If "John Doe" builds up a reputation for service there may be a change in personnel performing the service upon a sale of its business, but the sale of such business

naturally involves the right to continue in business as "The Doe Company." The "good will" built up by the company would continue for a time and would last while the new management performing the same personal services, would at least have the opportunity to justify confidence in such management while it attempted to retain the "good will" of customer clients of the former operator.

At least the opportunity to have time to try to preserve the "good will" already existent and to use it as an entrance into the identical field of operations in a personal service type of business would be present where the name of the business is a company name as distinguished from the name of an individual. Therein does it have value, plus the value of the opportunity to justify confidence in the new management by the customer/clients of the predecessor owners.

570 S.W.2d at 435-36.

Beasley and the aforementioned opinions discussed the distinction between professional practices operated as sole proprietorships and as corporations. They considered the distinction to be critical in deciding whether good will was marital property. Although all agree that the form of the practice is critical,only Geesbreght held it to be conclusive. Presumably, special circumstances may justify holding that the good will of a professional sole proprietorship is marital property while the good will of a professional corporation is not. In Beasley, we discussed at length the importance of contingent fees in determining whether good will has present value. If the outcome had depended exclusively on the form of the professional practice, we would have disregarded the contingent fees factor and held simply that good will is not marital property because the husband practiced law as a sole proprietor. In fact, we implied in Beasley that the form of the law practice was not dispositive: "We, therefore, hold that good will of a sole proprietorship under these facts is not an element of present value [which can be considered marital property]." Id. 359 Pa.Super. at 42, 518 A.2d at 556 (emphasis added).

Our factual analysis compels us to hold that good will has no present value for equitable distribution purposes in this case. Accordingly, the trial court erred by including good will in the value of husband's share of the professional practice.

Husband practices medicine with Dr. Lampe, and they are each 50% shareholders of Associated Internists, Inc. No other physicians are associated with the firm. Husband and Lampe are board certified in internal medicine. After becoming a board certified internist in 1972, husband earned a rheumatology fellowship in 1973. Eighty-five percent of husband's patients are treated for rheumatism, and 70% of his rheumatology patients are derived from physician referrals. Husband is the only rheumatologist in the area of York, Pennsylvania. Since Dr. Lampe does not practice rheumatology, the physicians infrequently treat each other's patients.

With the exception of an informal arrangement with nursing homes which produces only a few patients, husband and Dr. Lampe do not have contracts to provide services for any hospital or medical group. Their patients are privately acquired.

We believe that if husband left the professional corporation, at least his rheumatology patients would follow. It was husband, not the professional corporation, who attracted the rheumatology patients. Therefore, upon his death, retirement or resignation, there would be no other physician at the corporation who could retain husband's patients.

Due to husband's specialty, his minimal sharing of patients with Dr. Lampe, the physician referrals and the absence of competition from other rheumatologists, we hold that husband's practice is similar to that of a sole practitioner. It is similar tothe individual proprietor in Beasley and requires the same treatment: the good will of husband's practice has no present value, is not marital property and cannot be equitably divided.

We recognize that husband performed medical treatment for standard fees unlike the husband in Beasley who was compensated by contingent fee. We further note that Beasley explained that present value of work in progress can be determined when fees are standard and fixed, whereas contingent fees prevent a reliable valuation of pending work. Nevertheless, this factual distinction is not sufficient to overcome the common element that husband here and the husband in Beasley were the essence of any good will in their business interests.

WIFE'S APPEAL

Equitable Distribution

Wife raises four arguments in her appeal, three of which take issue with the equitable distribution of marital property.First, wife argues that the trial court erred in ruling that $ 19,800.00, which was placed in trust for the parties' sons, was not marital property.

In June, 1982, before the parties separated, their older son, Vincent, was seriously injured in an automobile accident. Since Vincent's medical and hospital expenses were covered by separate health and automobile insurance policies, husband and wife received $ 19,800.00 from one policy which was the amount paid to providers of medical treatment under the other policy.

On October 18, 1982, husband placed $ 10,000.00 of these insurance proceeds in a certificate of deposit in trust for son Vincent. On September 24, 1982, another $ 3,000.00 from the same source was placed in a similar account for Vincent. On October 18, 1982, $ 5,000.00 of the insurance proceeds were placed in a trust account for son John. These three accounts were titled in husband's name and created under the Uniform Gifts to Minors Act. 20 Pa.C.S. § 5301 et seq. All three trusts were created after separation. The balance of $ 1,500.00 was used for unrelated expenses.

Wife alleges that husband acquired the certificates without her knowledge. She claims that they had planned to use the money for travel or to redecorate the house, and that husband unilaterally changed those plans by placing the funds in trust for the children. According to wife, husband did so to place these funds beyond her control and outside the realm of marital property.

In Hurley v. Hurley, 342 Pa.Super. 156, 492 A.2d 439 (1985), the wife sued a third party for personal injuries sustained prior to separation, but the verdict was entered and payment received after separation. The Hurley court first noted § 401(f) of the Divorce Code which states that all property "acquired by either party during the marriage is presumed to be marital property regardless" of the form of title, whether it be individual, joint or by tenancy in common or by the entirety. The court then noted the exceptions enumerated in § 401(e) to this general rule. Of these exceptions, the court focused on § 401(e)(4) which provides that "[property] acquired after separation until the date of divorce . . ." is not marital property.

Following these references to the Divorce Code, the Hurley court held that a tort cause of action is unliquidated until either verdict or settlement.While unliquidated, a tort claim is not a property right nor is it assignable. To distribute a tort claim while it remains unliquidated requires speculation and conjecture. Accordingly, the Hurley court held that because the tort claim became liquidated after separation it was property acquired after separation. Under § 401(e)(4), then, it was not marital property.

Here, wife acknowledges that the insurance proceeds were not paid until after separation. She argues, however, that Hurley is not applicable because it was limited to tort causes of action. She maintains that the proceeds here were paid under a contract of insurance that she and husband had with the carrier.

The nature of the wife's accident in Hurley is not stated in the opinion. Since herclaim proceeded to a jury trial, and a verdict was returned for pain, suffering and disfigurement, it may be presumed that payment on the verdict was made by a third person with whom the wife did not contract. Evidently, the wife in Hurley did not have the opportunity to submit her claim to her insurance carrier.

Regardless of who was liable for Vincent's injuries, payment to his parents for the amount of his medical expenses was guaranteed. This guarantee was due to identical coverage provided by the parties' automobile and medical insurance carriers. One carrier paid the provider of the medical services; the other paid the parties for those same services. The amount received did not compensate Vincent for pain, suffering or disability as was done at least in part in Hurley. Furthermore, the amount of the claim was ascertainable as the $ 19,800.00 represented medical services rendered before separation. Therefore, there was nothing conjectural, speculative or nebulous about the validity and amount of Vincent's claim.

We agree with wife's position that Hurley is not applicable. Title to the insurance proceeds was acquired prior to separation. Vincent's medical treatment, which was rendered prior to separation, guaranteed that one carrier would pay the parties for the value of that treatment. n4

n4 Our holding does not extend to medical treatment administered after separation. The need for and amount of medical treatment after separation would be unknown; therefore, the amount collected for such treatment may not be marital property. This may be so even though the parties know before separation that double coverage assures payment to them of the value of medical treatment if administered.

The fact that Hurley is inapposite, however, does not dispose of whether the amount collected for Vincent's injuries is marital property. Two more inquiries remain: 1) whether the insurance proceeds were property acquired by the parties; and 2) if so, whether they were "disposed of in good faith and for value prior to the time" divorce proceedings were commenced. See 23 P.S. § 401(e)(5).

We hold that title to the insurance proceeds passed to the parties despite the fact they were paid for Vincent's injuries. Husband and wife were the owners of the insurance policies and were obligated to pay the premiums. Vincent was merely a subject of coverage. The details of the trusts are not in the record; nevertheless, it is clear that husband maintains title to the trusts and exclusive right to control the funds until Vincent and John reach majority. Therefore, the presumption of § 401(f) is met: the insurance proceeds are marital property because they were acquired by the parties during marriage. n5

n5 An equitable distribution of the insurance proceeds to husband and wife in this context does not necessarily mean that they have the unconditional right to dispose of the assets. Laws protecting minors may limit the parties' use, enjoyment and disposition of these proceeds.

Finally, the exception provided by § 401(e)(5) is inapplicable. Husband may have disposed of the insurance proceeds in good faith by establishing trusts for his sons; however, the trusts were not established in exchange for value. Section 401(e)(5) requires a disposition that brings some value, yet husband disposed of the proceeds as gifts.

Wife's second attack on equitable distribution concerns the valuation of husband's pension benefits. The trial court ruled that the value of husband's share of the corporation's defined benefit plan was $ 26,960.00; wife maintains that the value was $ 51,236.00.

Husband called George Taylor, a consulting actuary, to testify concerning the value of husband's interest in the pension plan. Taylor was enrolled as a member of the Society of Pension Actuaries, and was certified to perform actuarial services under the Employee Retirement Income Security Act (ERISA). Taylor's employer administered the retirement program for husband's professional corporation.

Taylor computed the value of husband's benefit to be $ 26,960.00 as of September 1, 1982, a few days prior to separation. Thisvalue was calculated by applying 5 1/2% interest and 1965 mortality tables to the accrued retirement benefit payable at age sixty-five. Taylor testified that the interest rate of 5 1/2% and the mortality tables were applied to discount the retirement benefit in order to reach a present value.

Wife's expert, Harry Leister, was also a fully qualified actuary. He testified that the asset value of the plan as of June 1, 1982, was $ 197,962.78 and that husband's share was $ 51,236.00. Leister then testified that had the plan terminated on June 1, 1982, the total assets would have been disbursed and husband would have received $ 51,236.00. That is the amount wife believes is marital property.

The retirement plan created for Associated Internists, Inc. was a defined benefit plan. Husband's expert explained that a defined benefit plan provides the employee with a fixed amount per month at retirement for life. In that regard, it is an annuity, and is unlike a defined contribution plan which does not guarantee a specific monthly payment upon retirement. A defined contribution plan may be a profit-sharing plan or stock bonus plan where the employer makes the contributions and the interest earned fluctuates with market conditions.

Valuation is affected by the method of distribution. In Braderman v. Braderman, 339 Pa.Super. 185, 488 A.2d 613 (1985), we adopted two methods of distributing retirement benefits: 1) immediate offset method; and 2) deferred distribution method. The immediate offset method is properly used when the present value of the benefit is sufficient to make a present distribution. Conversely, a deferred distribution does not employ present value because many variables make it too difficult to determine. Instead, the court retains jurisdiction and allocates benefits when they mature or are paid. Deferred distribution is also the preferred method when the parties' other assets are insufficient to offset a pension award.

Here, the immediate offset method is more appropriate because present value can be ascertained, and the parties have sufficient assets to coordinate with a pension award. It is also the preferred method as both parties are prepared to value the pension benefits and to make one lump-sum distribution.

Present value of husband's interest in the defined benefit plan as of September 1, 1982, is the amount available for equitable distribution. The Braderman court adopted a formula for calculating present value. See Troyan, Pension Evaluation and Equitable Distribution, 10 Fam.L.Rep. 3001 (1983). Present value is to be calculated as follows:

1. Calculate the amount of husband's monthly pension benefit, assuming he was at age sixty-five on September 10, 1982, the date of separation.

2. Find husband's life expectancy at the time of separation and subtract his normal retirement age to determine the expected number of months of pension benefits.

3. Select an appropriate discount rate.

4. Find the value of the annuity at age 65.

5. Discount the value at age 65 to present value accounting for mortality, disability and termination.

6. Reduce present value of the plan if it has not yet vested.

7. Apply the coverture fraction if a portion of the pension was earned before marriage.

Step number six is not applicable as husband is fully vested. Similarly, step number seven does not apply because the parties were married five years before the pension plan was created in 1972; their marriage spanned the life of the plan to the date of separation.

Returning to the expert testimony of record, we hold that husband's expert, George Taylor, properly applied the formula in calculating present value. He explained that

. . . the accrued benefit is a benefit which is payable at age 65 or at retirement and to find its present value, you must takethe value of that benefit at retirement and apply appropriate discount factors.

N.T., February 23, 1984, at 152. Taylor then testified that he applied a discount factor of 5 1/2% interest, which is a rate expected over the life of the plan, and 1965 mortality tables. This testimony indicates that Taylor covered steps one through five in arriving at a present value of $ 26,960.00.

Wife values husband's pension interest on date of separation by dividing the total assets in the plan, $ 197,262.78, by three, the number of participants. The result of $ 51,236.00 is unrealistic and inequitable. As husband's expert explained, husband may receive retirement benefits only if he were

eligible for retirement or [he terminates] employment or [he] were to pass away. This is a requirement of law in order to have a plan approved by the Internal Revenue Service . . . .

N.T., February 23, 1984, at 149. If husband had died or terminated his interest in the plan on the date of retirement, he would have received only $ 26,960.00.

The total value of all assets in a defined benefit plan and the employee's proportionate share thereof, do not determine value. Valuation must consider discount rates, mortality and tax penalty laws. Wife's approach to valuation may be more appropriate in a defined contribution plan where an account is assigned to an employee and is composed of the employer's contributions, plus earnings.

Wife's final argument concerning equitable distribution is that the trial court erred in ruling that it had no jurisdiction to distribute three certificates of deposit held in her name and her children's. These three certificates were separate and apart from those established with the insurance proceeds. They

represented funds accumulated over the years. Wife does not want these funds equitably divided between the parties; however, she wants to regain possession of the certificates from husband.

Husband and wife agree that these certificates were established by periodic deposits of savings, titled in wife's name and held for the children's benefit.The evidence is further incontrovertible that husband possesses the certificates.

We agree that wife should be given possession and control of the three certificates, but only for the benefit of the children. Section 401(c) of the Divorce Code provides:

In all matrimonial causes, the court shall have full equity power and jurisdiction and may issue injunctions or other orders which are necessary to protect the interests of the parties or to effectuate the purposes of this act, and may grant such other relief or remedy as equity and justice require against either party or against any third person over whom the court has jurisdiction and who is involved in or concerned with the disposition of the cause.

It is apparent that the parties made gifts of these certificates to their children and that they agreed that wife should control the funds. With the authority provided by § 401(c), we order husband to release possession of these certificates to wife for the sole benefit of the children.

Alimony

Wife's final argument is that the award of alimony of $ 7,500.00 should continue despite her remarriage on October 12, 1985. This argument is not properly before us. Wife raises this argument as a precaution in the event we rule that her remarriage terminated her right to alimony pendente lite. The trial court ruled only on the issue of whether or not wife's remarriage terminated alimony pendente lite; it did not consider the effect remarriage had on alimony. Moreover, no petition to terminate alimony was presented. Without an order terminating alimony, there is nothing to review.

CONCLUSION

Order of July 9, 1985, is affirmed. Order of March 4, 1986, is affirmed.

Order of September 5, 1985, and judgment of September 5, 1985, are affirmed in part and reversed in part. The order andjudgment are reversed to the following extent:

1. Rocco J. DeMasi's share of good will in Associated Internists, Inc. is not marital property;

2. One certificate of deposit established October 18, 1982, in the amount of $ 10,000.00, in the name of Rocco J. DeMasi in trust for Vincent M. DeMasi, is marital property;

3. One certificate of deposit established October 18, 1982, in the amount of $ 5,000.00, in the name of Rocco J. DeMasi in trust for John M. DeMasi, is marital property;

4. One certificate of deposit established September 24, 1982, in the amount of $ 3,000.00, in the name of Rocco J. DeMasi in trust for Vincent M. DeMasi, is marital property;

5. Three certificates of deposit shall be released to wife to be possessed, managed and controlled by her solely for the benefit of her children. These certificates are identified as follows:

a. one established January 14, 1982, in the amount of $ 3,000.00, in the names of Tanya J. DeMasi or John M. DeMasi;

b. one established February 21, 1980, in the amount of $ 3,500.00, in the names of Tanya J. DeMasi or Vincent M. DeMasi;

c. one established January 14, 1982, in the amount of $ 1,000.00, in the names of Tanya J. DeMasi or Vincent M. DeMasi.

We remand for equitable distribution of the three trust accounts of $ 10,000.00, $ 5,000.00 and $ 3,000.00 which were established with insurance proceeds from Vincent's automobile accident. The trial court may or may not find that these trusts should be maintained for the children. We also remand for reconsideration of equitable distribution; our holding which excludes good will from marital property and includes the certificates of deposit as marital property may require modification of the distribution of all other assets. Finally, the trial court must reconsider on remand the wife's entitlement to alimony following the distribution of the marital property. Braderman v. Braderman, supra, 339 Pa.Super. at 202, 488 A.2d at 621.

Dugan v. Dugan

Case name: Dugan v. Dugan
Citation: 92 N.J. 423, 457 A.2d 1, 1983 N.J. LEXIS 2351
Date of decision: February 28, 1983
Country: US
State or Federal: State
State/Jurisdiction: New Jersey
Court: Supreme Court
Type of action: Marital Dissolution
Judge: Schreiber
SIC: 8111 Legal Services
NAICS: 541110 Offices of Lawyers

Keywords: Marital dissolution

COUNSEL:

James C. Orr argued the cause for appellant (Lum, Biunno & Tompkins, attorneys).

James P. Yudes argued the cause for respondent.

JUDGES:

For reversal and remandment -- Chief Justice Wilentz and Justices Clifford, Schreiber, Handler, Pollock and O'Hern. For affirmance -- None. The opinion of the Court was delivered by Schreiber, J.

OPINIONBY:

SCHREIBER

OPINION:

This case involves the equitable distribution of marital property upon divorce, more particularly the evaluation of an attorney's goodwill in his exclusively owned professional corporation.

Plaintiff, James P. Dugan, and defendant, Rosaleen M. Dugan, were married in 1958 and separated in 1978. They had no children. The plaintiff, a member of the New Jersey Bar, carries on his practice as a professional corporation. The defendant had served as a secretary in plaintiff's law office and attended college during the marriage, graduating in 1972. She is certified as a public school teacher, but as of the date of the divorce judgment was unemployed.

The judgment entered for dual no-fault divorce provided for distribution of property, alimony and other relief. Plaintiff appealed from portions of the judgment relating to the assets of the marital estate, alimony, and counsel fees. The Appellate Division affirmed. Plaintiff filed a notice of appeal and a

petition for certification. We dismissed the appeal and granted plaintiff's petition for certification, limited to the issues arising from the valuation of plaintiff's interest in his wholly-owned professional corporation. 89 N.J. 405 (1982). The trial court determined thatthe value of the material part of the marital estate was $ 606,966 as of December 29, 1978, the date the complaint was filed. It awarded the defendant $ 230,864 and the plaintiff $ 376,102 consisting of the following:

Real property	$ 285,400
Law practice	
Goodwill	$ 182,725
Accounts receivable	18,891
Pension plan	50,500
Common stock	1,000
Less	
Retained earnings deficit	1,780
Net value of law practice	n1 251,336
Cash	55,313
Miscellaneous	14,917
	$ 606,966

n1 A primary source of information concerning the corporation's assets and liabilities was its federal income tax return. The balance sheet in that return did not reflect goodwill, accounts receivable or the pension plan.

A major asset in the joint estate was the plaintiff's law practice. It comprised more than 40% of the entire estate and over 70% of the value of that asset consisted of the value placed on goodwill. The trial court's methodology in calculating that value was predicated on the theory that the plaintiff was to be compared with the typical incorporated attorney whose gross assets were roughly equivalent to the plaintiff's. The comparison was limited to the efficiency of the respective operations, that is, the percentage that net income before income taxes bears to gross receipts. The net income of a typical attorney was found to be 38.5% of gross receipts. Plaintiff's gross income was multiplied by 38.5%, yielding what could be termed a typical attorney's net income based on plaintiff's actual gross revenues. The excess of plaintiff's net income over that resulting from the application of the 38.5% standard was then multiplied by a factor of five. The trial court found that this figure equaled goodwill.

We must determine whether goodwill is a part of the value of plaintiff's law practice; if so, whether it constitutes property subject to equitable distribution;and, if so, how it is to be evaluated.

I

In a divorce judgment a court may "effectuate an equitable distribution of the property, both real and personal," acquired during the marriage. N.J.S.A. 2A:34-23. n2 We have acknowledged that the Legislature intended that its reference to "property" be construed comprehensively. Painter v. Painter, 65 N.J. 196, 217 (1974); see Gauger v. Gauger, 73 N.J. 538, 544 (1977). Determining the "property" subject to equitable distribution requires a marshalling of the parties' economic resources. Kruger v.

Kruger, 73 N.J. 464, 468 (1977). These economic resources cover a broad spectrum. Initially a list of the parties' assets and liabilities upon a particular date should be prepared. Personal tangible property is clearly includable. Id. Intangibles may also constitute property. See id. (stating "[t]he right to receive monies in the future is unquestionably such an economic resource") (emphasis in original). See also Kikkert v. Kikkert, 177 N.J. Super. 471 (App.Div.), aff'd o.b., 88 N.J. 4 (1981) (holding a vested pension plan providing future monetary benefits to be equitably distributable).

n2 Gifts, devises or bequests, except interspousal gifts, are excluded. L.1980, c. 181, § 1, effective December 31, 1980.

As distinguished from tangible assets, intangibles have no intrinsic value, but do have a value related to the ownership and possession of tangible assets. Some intangibles, such as a trademark, trade name or patent, are related to an identifiable tangible asset. Goodwill, which is another intangible, is not. Often referred to as "the most 'intangible' of the intangibles," D. Kieso & J. Weygandt, Intermediate Accounting 570 (3d ed.1980), goodwill is essentially reputation that will probably generate future business. Lord Eldon expressed that thought in Cruttwell v. Lye, 17 Ves. 335, 346, 34 Eng.Rep. 129, 134 (Ch.1810): "The good-will, which has been the subject of sale, is nothing more than the probability, that the old customers will resort to the old place."

Justice Cardozo when Chief Judge of the New York Court of Appeals embraced the same concept when he wrote:

Men will pay for any privilege that gives a reasonable expectancy of preference in the race of competition. Such expectancy may come from succession in place or name or otherwise to a business that has won the favor of its customers. It is then known as good will. [In re Brown, 242 N.Y. 1, 6, 150 N.E. 581, 582 (1926) (citation omitted)]

See also J. Story, Commentaries on the Law of Partnership § 99, at 157-61 (7th ed.1881).

There can be no doubt that goodwill exists. It is a legally protectible interest. See J.B. Liebman & Co. v. Leibman, 135 N.J.Eq. 288, 292 (Ch.1944). Indeed, we have enforced a restrictive covenant limiting a seller's right to compete that was designed essentially to protect the goodwill of the business for the buyer. Solari Indus. v. Malady, 55 N.J. 571, 576 (1970). The New Jersey inheritance tax, N.J.S.A. 54:34-1, requires consideration of goodwill. See, e.g., In re Hall's Estate, 99 N.J.L. 1 (Sup.Ct.1923), aff'd o.b., 100 N.J.L. 405 (E. & A. 1924); Schneider v. Zink, 2 N.J. Super. 53 (App.Div.1949); In re Deutz, 105 N.J.Eq. 671 (Prerog.Ct.1930). Upon dissolution of a partnership goodwill has been recognized as an element in determining value for purposes of liquidation. Blut v. Katz, 13 N.J. 374 (1953). In Kanzler v. Smith, 123 N.J.Eq. 602 (1938), the Court of Errors and Appeals held that the legally contemplated liquidation of partnership property upon the death of a partner required "an accounting by the surviving partner for the value of the deceased partner's interest, including the value of goodwill, if any." Id. at 606 (citation omitted).

The basic notion expressed by Lord Eldon in Cruttwell was embellished by Chief Justice Gummere in Hall's Estate, supra, where he observed that goodwill consisted of several elements, including:

the right to continue the business at the same place in which it has been established and where its reputation has been made, carrying with it the probability that old customers will continue to resort to the old place for the purpose of making their purchases, notwithstanding the change in the name under

which the business has been carried on, so long as the service remains satisfactory and the standard of the goods sold is maintained; and this element undoubtedly has value, although perhaps not so much as the continued use of the name under which the business has theretofore been conducted.

But assuming this view to be unsound, a mere right to acquire the good-will of a business, which may be exercised or not at the option of the holder of that right, is not the equivalent of the ownership of the good-will. Good-will is property. [99 N.J.L. at 4-5]

The accounting profession has further expanded the concept of goodwill to encompass other advantages of an established business that contribute to its profitability. J. M. Smith & K. F. Skousen, Intermediate Accounting 283 (7th ed. standard vol. 1982), capture this thought in their definition:

Goodwill is generally regarded as the summation of all the special advantages, not otherwise identifiable, related to a going concern. It includes such items as a good name, capable staff and personnel, high credit standing, reputation for superior products and services, and favorable location.

See also Accounting Principles Board, Op. 17, "Intangible Assets," in FASB Financial Accounting Standards 266-72 (1981). n3 In abroad sense goodwill includes a whole host of intangibles including the quality of management, the ability of the organization to produce and market efficiently, and the existence and nature of competition. Some writers have been careful to differentiate between going concern value and goodwill. See Paulsen, "Goodwill and Going Concern Value Reconsidered," Mergers & Acquisitions, Winter 1980, at 10. Goodwill is keyed to reputation; going concern value to the enhanced value of the assets due to their presence in an established firm. See Danzig & Robison, "Going Concern Value Reexamined," The Tax Adviser, Jan. 1980, at 32. Going concern value has many of the characteristics of goodwill and in many situations will constitute an asset enhancing the value of an enterprise. In that event it will be a component of the property subject to equitable distribution. Going concern value may be prevalent in some law firms. It is probably not significant in an individual law practice, as is probably the case here. We note no claim has been made on that basis.

n3 APB Opinions are authoritative statements by the American Institute of Certified Public Accountants of generally accepted accounting principles. See "Forward," FASB Financial Accounting Standards, supra; 2 APB Acc'ting Principles (CCH) § 510.08, at 33 (1973).

Goodwill can be translated into prospective earnings. From an accounting standpoint goodwill has also been perceived of in terms of the extent to which future estimated earnings exceed the normal return on the investment. Walker, "Why Purchased Goodwill Should be Amortized on a Systematic Basis," 95 J. Acc'tancy 210, 213 (1953); accord,Rev.Rul. 59-60, § 4.02(f), 1959-1 C.B. 237, 241 (stating that value of goodwill "rests upon the excess of net earnings over and above a fair return on the net tangible assets"). The price paid for goodwill then is equivalent to the excess of actual earnings over expected earnings based on a normal rate of return on investment. Walker, supra, at 213; see Kerley, "Intangible Assets," in 1 Accountants' Handbook 23-10 (L. Seidler & D. Carmichael 6th ed.1981). When goodwill exists, it has value and may well be the most lucrative asset of some enterprises.

Variances in the forms of an enterprise do not eliminate goodwill, though they may affect its worth. Goodwill may be present whether that form is a partnership, corporation, joint venture, or individual proprietorship. See Grayer v. Grayer, 147 N.J. Super. 513,520 (App.Div.1977); Scherzer v. Scherzer, 136 N.J. Super. 397, 400 (App.Div.1975) (holding no essential difference so far as equitable distribution principle is concerned between an interest in an individual business and one held in corporate name:

"The form should not control"), certif. den., 69 N.J. 391 (1976). Moreover, goodwill exists in personal service enterprises as well as other businesses. 2 B. Bittker, Federal Taxation of Income, Estates and Gifts para. 51.9.3, at 51-53 (1981).

In a publicly held corporation one can determine the total value of a business whose stock is publicly traded and therefore its goodwill by the market price of the stock. G. Catlett & N. Olson, Accounting for Goodwill 14 (1968). The excess over the book or market value of its assets, however, may also be due to many and diverse conditions affecting the economy as a whole and an industry in particular. The value of stock in a closely held corporation is not fixed by public trading. Its computation depends primarily on the earning power of the business "since goodwill by nature encompasses all those intangible attributes of a business whose quality can be demonstrated only by a company's ability to make profits." Id.

The calculation of goodwill may depend upon the purpose for which the measurement is being made. The federal Internal Revenue Service has prescribed a formula approach for income, gift and estate tax purposes. See Rev.Rul. 68-609, 1968-2 C.B. 327. The market place, as noted above, may often provide a different figure. Accountants will usually not reflect goodwill on a balance sheet until after a business has been sold and then state goodwill in terms of the excess paid for the net assets overbook value. G. Catlett & N. Olson, supra, at 17. Its evaluation may be complex and difficult. Judge Pressler in Lavene v. Lavene, 148 N.J. Super. 267, 275 (App.Div.), certif. den., 75 N.J. 28 (1977), commented:

There are probably few assets whose valuation imposes as difficult, intricate and sophisticated a task as interests in close corporations. They cannot be realistically evaluated by a simplistic approach which is based solely on book value, which fails to deal with the realities of the good will concept, which does not consider investment value of a business in terms of actual profit, and which does not deal with the question of discounting the value of a minority interest.

II

Our limited concern involves the existence of goodwill as property and its evaluation for purposes of equitable distribution under N.J.S.A. 2A:34-23 with respect to attorneys and in particular individual practitioners. Though other elements may contribute to goodwill in the context of a professional service, such as locality and specialization, reputation is at the core. Paulsen, supra, at 10. It does not exist at the time professional qualifications and a license to practice are obtained. A good reputation is earned after accomplishment and performance. Field testing is an essential ingredient before goodwill comes into being. Future earning capacity per se is not goodwill. However, when that future earning capacity has been enhanced because reputation leads to probable future patronage from existing and potential clients, goodwill may exist and have value. When that occurs the resulting goodwill is property subject to equitable distribution.

We held in Lynn v. Lynn, 91 N.J. 510 (1982), that a license to practice medicine and a medical degree were not property. They reflected only a possibility of future earnings. This holding was consonant with the proposition in Stern v. Stern, 66 N.J. 340, 345 (1975), that potential earning capacity is not property within the meaning of the statute, though relevant on the issues of alimony and of determining equitable proportions for the distribution of property.

When, however, the opportunity provided by the license is exercised, then goodwill may come into existence. Goodwill is to be differentiated from earning capacity. It reflects not simply a possibility of future earnings, but a probability based on existing circumstances. Enhanced earnings reflected in goodwill are to be distinguished from a license to practice a profession and an educational degree. In that situation the enhanced future earnings are so remote and speculative that the license and degree have not been deemed to be property. The possibility of additional earnings is to be distinguished from the existence of goodwill in a law practice and the probability of its continuation. Moreover, unlike the license and the degree, goodwill is transferable and marketable. Though there is an apparent limitation on the part of an individual practitioner to sell a law practice, the same is not true in a law firm.

After divorce, the law practice will continue to benefit from that goodwill as it had during the marriage. Much of the economic value produced during an attorney's marriage will inhere in the goodwill of the law practice. It would be inequitable to ignore the contribution of the non-attorney spouse to the development of that economic resource. An individual practitioner's inability to sell a law practice does not eliminate existence of goodwill and its value as an asset to be considered in equitable distribution. Obviously, equitable distribution does not require conveyance or transfer of any particular asset. The other spouse, in this case the wife, is entitled to have that asset considered as any other property acquired during the marriage partnership.

Other jurisdictions have accepted the principle that an attorney's goodwill is property subject to equitable distribution. In In re Marriage of Lopez, 38 Cal.App.3d 93, 107, 113 Cal.Rptr. 58, 67 (1974), in discussinggoodwill, the court quoted approvingly the following language from Golden v. Golden, 270 Cal.App.2d 401, 405, 75 Cal.Rptr. 735, 738 (1969):

[I]n a matrimonial matter, the practice of the sole practitioner husband will continue, with the same intangible value as it had during the marriage. Under principles of community property law, the wife, by virtue of her position of wife, made to that value the same contribution as does a wife to any of [the] husband's earnings and accumulations during marriage. She is as much entitled to be recompensed for that contribution as if it were represented by the increased value of stock in a family business.

See also the following cases in which courts have held goodwill in a law practice to be subject to distribution: In re Marriage of Fenton, 134 Cal.App.3d 451, 460, 184 Cal.Rptr. 597, 600 (1982); Todd v. Todd, 272 Cal.App.2d 786, 78 Cal.Rptr. 131 (1969); In re Marriage of Kaplan, 23 Wash.App. 503, 597 P.2d 439 (1979); In re Marriage of Freedman, 23 Wash.App. 27, 592 P.2d 1124 (1979). New York decisions are split on whether goodwill of a law practice is subject to equitable distribution. See Litman v. Litman, 115 Misc.2d 230, 453N.Y.S.2d 1003 (Sup.Ct.1982) (in the negative); Barton v. Barton, N.Y.L.J., May 20, 1982, at 10 (Sup.Ct.) (in the affirmative); Hirschfeld v. Hirschfeld, N.Y.L.J., May 4, 1982, at 7 (S.Ct.) (in the affirmative). n4 Some jurisdictions have also held with respect to other professions that goodwill is property subject to distribution. In re Marriage of Nichols, 43 Colo.App. 383, 606 P.2d 1314 (1979) (dentist's practice); In re Marriage of White, 98 Ill.App.3d 380, 53 Ill.Dec. 786, 424 N.E.2d 421 (1981) (dentist's practice); Hurley v. Hurley, 94 N.M. 641, 615 P.2d 256 (1980) (doctor's practice), overruled on other grounds, Ellsworth v. Ellsworth, 97 N.M. 133, 637 P.2d 564 (1981); In re Marriage of Goger, 27 Or.App. 729, 557 P.2d 46 (1976) (dentist's practice); In re Marriage of Fleege, 91 Wash.2d 324, 327-30, 588 P.2d 1136, 1138-39 (1979) (dentist's practice). Contra Nail v. Nail, 486 S.W.2d 761 (Tex.1972) (goodwill of a medical practice not properly subject to division by the court).

n4 The New York Court of Appeals recently held that the goodwill of a dental practice could be sold by the deceased dentist's wife who was the sole beneficiary of his estate, noting that the sale of goodwill included something other than the personal attributes of a professional, such as the right to practice at the same location. Spaulding v. Benenati, 57 N.Y.2d 418, 442 N.E.2d 1244, 456 N.Y.S.2d 733 (1982).

In Stern v. Stern, we acknowledged that "[i]t may . . . be possible to prove that [goodwill] does exist and is a real element of economic worth. Concededly, determining its value presents difficulties." 66 N.J. at 346-47 n. 5 (citation omitted). However, difficulty in fixing its value does not justify ignoring its existence. Goodwill should be valued with great care, for the individual practitioner will be forced to pay the ex-spouse "tangible" dollars for an intangible asset at a value concededly arrived at on the basis of some uncertain elements. For purposes of valuing the goodwill of a law practice, the true enhancement to be evaluated is the likelihood of repeat patronage and a certain degree of immunity from competition. See Levy v. Levy, 164 N.J. Super. 542, 554 (Ch.1978). Identification of goodwill in this fashion differs from that utilized in evaluating goodwill in businesses where an identification of a return on tangible assets is made.

For example, the Internal Revenue Service has prescribed a formula approach for federal tax purposes when there is no better basis for valuation. See Rev.Rul. 68-609, supra, 1968-2 C.B. 327. It requires a determination of income from the tangible assets, and subtraction of that income from the total income. The residual is capitalized and the balance is designated goodwill. For similar methods see G. Catlett & N. Olson, supra, at 13-14 (1968); Paulsen, supra, at 11. A law office's tangible asset value is so disproportionately small when compared to the value of the services renderedthat measurement by these methods would not be meaningful.

Other methodologies have been developed in the market place for particular businesses or professions. It is common in evaluating goodwill of an accountant's practice to compute goodwill on the basis of a percentage of annual gross income. "Valuing an Accounting Practice," The Practicing CPA, Mar. 1982, at 1; Wright, "On Buying and Selling a Practice," J. Acc'tancy, Jan. 1982, at 38. In the medical profession a charge per patient card has sometimes been utilized, see Fallon, "What's Your Practice Worth -- in Cash?," Med. Econ., Jan. 22, 1979, at 180, as well as a percentage of annual gross income, see Balliett, "Private Practice: How to Quit at a Profit," Med. World News, Dec. 25,1978, at 40, or a percentage of annual net income, see Cantor, "The Value of a Lawyer's Interest in His Practice," 43 N.Y.St.B.J. 47, 50 (1971) (quoting Bernard D. Hirsh, General Counsel for the American Medical Ass'n).

A significant element in fixing an attorney's goodwill is that an attorney as a sole practitioner cannot sell his law practice, see Geffen v. Moss, 53 Cal.App.3d 215, 125 Cal.Rptr. 687 (1975), and when any attorney severs his relationship with a law practice, a restrictive covenant to protect goodwill is unavailable, see Karlin v. Weinberg, 77 N.J. 408, 418 (1978) (dictum). n5 Contra Hicklin v. O'Brien, 11 Ill.App.2d 541, 138 N.E.2d 47 (1956); Heinz v. Roberts, 135 Iowa 748, 110 N.W. 1034 (1907); Thorn v. Dinsmoor, 104 Kan. 275, 178 P. 445 (1919) (upholding sale of a law practice to a law student not yet admitted to practice). Drinker in his treatise on legal ethics states that "[a] lawyer's practice and good will may not be offered for sale." H. Drinker, Legal Ethics 161 (1953) (footnote omitted); accord R. Wise, Legal Ethics 204 (2d ed.1970) ("Goodwill cannot be sold as clients are not chattels or merchandise and a lawyer is not a tradesman") (footnote omitted). This principle has been accepted and announced by our Advisory Committee on Professional Ethics, Op. 48, 87 N.J.L.J. 459 (1964).

n5 Medical doctors may sell their practices, Tessmar v. Grosner, 23 N.J. 193 (1957), and enter into enforceable restrictive covenants, Karlin v. Weinberg, supra. These factors affect the value of goodwill. See Ferber, "Make the Most of Your Last Business Move," Med.Econ., Mar. 29, 1982, at 144; Balliett, supra, at 40; DeMuth & Achorn, "What You Always Needed to Know About Selling Your Practice," Pa.Med., Sept. 1977, at 34.

The underlying basis for the principle proscribing a restrictive covenant is the prohibition against an attorney selling his practice including goodwill. DR 2-108(A) of our Disciplinary Rules of the Code of Professional Responsibility, prohibiting such restrictions, reads as follows:

A lawyer shall not be a party to or participate in a partnership or employment agreement with another lawyer that restricts the right of a lawyer to practice law after the termination of a relationship created by the agreement, except as may be provided in a bona fide retirement plan and then only to the extent reasonably necessary to protect the plan.

See also Dwyer v. Jung, 133 N.J. Super. 343 (Ch.), aff'd o.b., 137 N.J. Super. 135 (App.Div.1975); N.J. Advisory Comm. on Professional Ethics, Op. 147, 92 N.J.L.J. 177 (1969); Model Rules of Professional Conduct Rule 1.8(h) (Proposed Final Draft 1981).

We do not intend herein to pass upon the soundness of the rule that prohibits the sale of goodwill, but only to note that we have approved of partnership agreements providing for payment upon a partner's retirement or death of an amount in excess of the capital account presumably representing his share of goodwill in the firm. In Stern we observed:

Generally speaking the monetary worth of this type of professional partnership will consist of the total value of the partners' capital accounts, accounts receivable, the value of work in progress, any appreciation in the true worth of tangible personalty over and above book value, together with good will, should there infact be any; the total so arrived at to be diminished by the amount of accounts payable as well as any other liabilities not reflected on the partnership books. [66 N.J. at 346-47 (emphasis supplied) (footnotes omitted)]

Payment to a former partner is excepted from Disciplinary Rule 2-107, prohibiting the division of fees unless services have been performed. n6 N.J.Code of Professional Responsibility DR 2-107(C); see ABA Comm. on Ethics and Professional Responsibility, Formal Op. 327 (1971) (stating that it is permissible to "make payments to a retired partner or for a fixed period to the estate of a deceased partner in accordance with a pre-existing retirement plan, the amount of those payments being measured by subsequent earnings of the firm"). Thus members of a law firm may provide for selling their interest therein, including goodwill, and sole practitioners may not. See Sterrett, "The Sale of a Law Practice," 121 U.Pa.L.Rev. 306, 320-23 (1972) (justifying this distinction). It has been suggested that the individual practitioner may avoid the restriction by entering into a partnership arrangement with another attorney before retiring. Cantor, supra, at 51; see Winter, "Selling a Law Firm: Ethics Rules Eyed," 68 A.B.A. J. 406, 406 (1982) (criticizing the distinction). Indeed, England, Australia and Canada permit the sale of a solicitor's practice, including goodwill, upon death or retirement. See Note, "The Death of a Lawyer," 56 Colum.L.Rev. 606, 617-18 & n. 72 (1956). England also enforces restrictive covenants entered into in connection with such a sale. Id.; see, e.g., Bunn v. Guy, 4 East. 190, 102 Eng.Rep. 803

(K.B.1803). But see Aubin v. Holt, 2 K. & J. 68, 69-70, 69 E.R. 696, 697 (Ch.1855) (suggesting Bunn is limited to agreements between retiring partner and firm); Thornbury v. Bevill, 1 Y. & C. Ch. C. 556, 62 E.R. 1014 (Ch.1842) (similar arrangement between strangers not enforced).

n6 DR 2-107(A)(3) was amended effective April 1, 1979 to permit a certified specialist to pay a referral fee provided the total fee charged the client is reasonable for the legal services rendered.

As matters now stand limitations on the sale of a law practice with its goodwill have an adverse effect upon its value. However, as previously observed, goodwill may be of significant value irrespective of these limitations.

One appropriate method to determine the value of goodwill of a law practice can be accomplished by fixing the amount by which the attorney's earnings exceed that which would have been earned as an employee by a person with similar qualifications of education, experience and capability. This is a fair manner in which to resolve the goodwill constituent. An attorney who earns $ 35,000 per year as an employee would, as any employee, not have goodwill properly ascribable to his employment. The same attorney earning a net income of the same amount from his individual practice should likewise not be considered to have property consisting of goodwill in ascertaining the value of his practice. See Levy v. Levy, supra.

The court should first ascertain what an attorney of comparable experience, expertise, education and age would be earning as an employee in the same general locale. The effort that the practitioner expends on his law practice should not be overlooked when comparing his income to that of the hypothetical employee. A sole practitioner who, for example, works a regular sixty-hour week may have a significantly greater income than an employee who regularly works a forty-hour week, and the income may be due to greater productivity rather than the realization of income on the sole practitioner's goodwill. Next, the attorney's net income before federal and state income taxes for a period of years, preferably five, should be determined and averaged. The actual average should then be compared with the employee norm. If the attorney's actual average realistically exceeds the total of (1) the employee norm and (2) a return on the investment in thephysical assets, the excess would be the basis for evaluating goodwill.

This excess is subject to a capitalization factor. The capitalization factor is generally perceived as the number of years of excess earnings a purchaser would be willing to pay for in advance in order to acquire the goodwill. 2 J. Bonbright, Valuation of Property 731 (1937). The minimum capitalization factor is zero. The precise capitalization factor would depend on other evidence.Such evidence could consist of a comparison of capitalization factors used to measure goodwill in other professions, such as medicine or dentistry, adjusted, however, for ingredients peculiar to law, such as the inability to sell the practice and nonavailability of a restrictive covenant. The age of a lawyer may be particularly important because a sole practitioner's goodwill would probably terminate upon death, contrary to that of a doctor. See Tessmar v. Grosner, 23 N.J. 193, 200-01 (1957); ABA Comm. on Professional Ethics, Formal Op. 266 (1945); Note, supra, at 614. n7 Subject to such adjustments, the method used in a comparable profession may be applied and a figure close to the true worth of the law practice's goodwill may be obtained.

n7 Note the dictum in Kremelberg v. Thompson, 87 N.J.Eq. 655, 659 (E. & A.1917), adopting the view generally that "[t]he good-will of the business of a successful professional man, practicing alone, if good-will it may be called, dies with him. He is employed because of his personal ability and reputation." The validity of this dictum with respect to professions other than lawyers is questionable. See Tessmar, supra.

Other approaches equally or more compelling may be used. If sufficient information about the average income of attorney employees with similar background and expertise is unavailable, partnership agreements covering comparable attorneys that set forth value in excess of capital accounts may disclose a useful figure for goodwill. See Cantor, supra, at 52-53 (referring to surveys of law firms to ascertain policies for valuing a terminating partner's interest). In Stern we agreed that the law partnership agreement may determine the worth of a lawyer's practice including goodwill upon proof that the books are well kept and the partner's interests are carefully reviewed periodically. 66 N.J. at 347.

There may well be other ways in which goodwill may be computed and we do not by the suggestions made herein intend to preclude their use. See, e.g., Hitchman, "The Fair Market Value of a Law Practice," 15 L. Soc'y Upper Can. Gaz. 303 (1981); Dlugatch & Olds, "Goodwill Determination in Professional Practice Evaluation -- Pursuant to a Marriage Dissolution," 4 Glendale L.Rev. 28, 34-36 (1982). In any event the limitations to which we have previously alluded, as well as the expertise and age of the individual should be factored into any evaluation. Moreover, potential federal tax consequences should be considered in determining equitable distribution.

III

Pointing out what not to do is sometimes as illuminating as what to do. In the case at hand the trial court accepted the calculation of the defendant's expert in fixing goodwill. We find several shortcomings in its method. First, it averaged four instead of five years of the plaintiff's income because plaintiff did not operate through the entire year 1974 as a professional corporation. That did not justify its elimination. The form of plaintiff's practice as an individual or as a professional corporation is irrelevant. Plaintiff's income for that year included the salary earned from his professional association and his income from his practice as an individual, or a total of $ 62,553. Instead of a four-year average of $ 104,630 used by the defendant's expert and accepted by the trial court, it would have been preferable to commence with plaintiff's five-year average income of $ 96,214.

Second, in determining plaintiff's actual income, the expert included promotion,travel and automobile expenses incurred in each of the years. These would appear to be appropriate deductible business expenses in the absence of evidence demonstrating that they were not properly incurred as such.

Third, the expert used as a comparison information compiled from the federal Internal Revenue Service data for the twelve months ended June 30, 1976. The comparative group was attorneys generally throughout the United States. There was no showing how New Jersey or northern New Jersey attorneys fit into that milieu. More particularly, there was no evidence that attorneys of comparable age and expertise had assets approximately equivalent to the averages shown.

Fourth, the most troublesome aspect of the expert's estimation process comes to light upon an examination of his use of these statistics. He compared plaintiff with others, relying solely on the dollar amount of assets on a particular date, despite the fact that plaintiff's assets varied widely during the relevant period due to the large fluctuations in the amount of cash on hand. He then found the average

percentage of total receipts retained by attorneys before taxes in the form of executive compensation and net income -- 38.5%. This percentage was applied to plaintiff's gross income for each year. Because of large fluctuations in cash on hand or accounts receivable that may occur during certain periods of the year, attorneys may be placed in one category rather than another by pure happenstance. Moreover, in the absence of some evidence to the contrary, a classification of attorneys based on the assets in their offices does not appear to be relevant in determining the normal or average income for comparison purposes.

The expert concluded that any excess of plaintiff's income for each year over the figure calculated using the average rate of efficiency (38.5%) reflected goodwill. The expert's analysis may be summarized as follows:

	Total Fees Received	38.5%	Actual Net Income	Actual Excess
1978	$ 222,702	$ 87,280 [sic]	$ 124,090	$ 36,810
1977	146,151	56,268	88,610	32,342
1976	185,095	71,262	107,795	36,533
1975	149,435	57,532	98,028	40,496

The underlying fallacy in this approach is that the measurement reflects the relative efficiency of the operation,rather than comparing plaintiff's net income with other attorneys.

Lastly, the expert used a factor of five, that is, he multiplied the average excess earnings which he had calculated to be $ 36,545 by five, in order to fix goodwill. No evidence supported capitalization at that figure. Our New Jersey inheritance practice indicates a frequent use of three in evaluating goodwill in close corporations or partnerships and Bonbright points out that in New York three is the factor regarded as least in need of justification. See 2 J. Bonbright, supra, at 731. n8 When calculating the value of an attorney's goodwill, the court should also consider the risks and competitiveness of the practice. A string of recent successes in contingent fee cases, for example, may lead to overestimating expected income, although averaging over a number of years will correct for many of such distortions. Even a properly adjusted estimate may reflect a portion of income attributable to return on risk-taking by the attorney, rather than on his reputation. Similarly, a practice in a highly competitive field might reduce the estimated value of an attorney's goodwill. If consideration is given to plaintiff's work life expectancy, tohis inability to sell the practice, to his inability to grant a restrictive covenant, and to the competitiveness and risks of the practice, a factor of five is inordinately high.

n8 See G. McCarthy & R. Healy, Valuing a Company 378 (1971) (expressing the thought that usually the price paid for goodwill of a small professional service is low relative to valuations of large businesses and may be two to three times net income before federal income taxes, adjusted by eliminating the compensation a buyer would expect to receive as an employee for the services to be rendered and the profit generated by the business that the buyer does not expect to retain).

IV

Plaintiff raises several other issues. He complains that the trial court erred by including the annual pension payments in calculating his yearly income and also by including accrued pension as an asset subject to equitable distribution. This contention is misplaced. When the funds used for pension purposes were being earned during a particular year, they represented additional compensation in that period. Upon accrual, the pension fund thus created became a distributable asset. This fund is analogous to income accumulated in a bank account which is subject to equitable distribution.

In evaluating the law practice, the trial court did not accept the accounts receivable as of December 31, 1978, because the amount of that account varied so widely. Instead the trial court averaged the receivables on a twelve months basis and used the monthly average in fixing this asset. This was an acceptable and rational normalization method. The plaintiff asserts that the payables averaged $ 17,830 monthly and there should have been a deduction in that amount. We stated in Stern that the total assets should be diminished by the amount of accounts payable. 66 N.J. at 346-47. The record is unclear as to the status of accounts payable. Upon remand, plaintiff may have the opportunity to submit proofs of accounts payable and, if established, he would be entitled to credit for them.

The judgment is reversed and the cause remanded to the trial court for further proceedings to determine the value of plaintiff's law practice with respect to goodwill and accounts payable and for modification of equitable distribution, which may or may not affect the quantum of appropriate alimony.

Full Text of Court Cases

Estate of Dunn v. Commissioner

Case name: Estate of Dunn v. Commissioner
Citation: 301 F.3d 339, 2002 U.S. App. LEXIS 15453
Date of decision: August 1, 2002
Country: US
State or Federal: Federal
State/Jurisdiction: 5th Circuit
Court: United States Court of Appeals
Type of action: Estate and Gift Taxation
Judge: Wiener
Experts: William Frazier, ASA (for estate)
Shannon Pratt, CFA, FASA, CBA (for estate)
Carmen Eggleston, CPA (for IRS)
SIC: 7353 Heavy Construction Equipment Rental and Leasing (rental of construction equipment [except cranes] with operator)
NAICS: 532412 Construction, Mining, and Forestry Machinery and Equipment Rental and Leasing
1400

IN THE UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 00-60614

BEATRICE ELLEN JONES DUNN, Deceased, ESTATE

OF, JESSE L. DUNN III, Independent Executor,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the Decision of the United States Tax Court

August 1, 2002

Before SMITH, DUHÉ, and WIENER, Circuit Judges.

WIENER, Circuit Judge.

The sole issue presented by this appeal from the United States Tax Court (the "Tax Court") is the fair market value of a block of common stock in Dunn Equipment, Inc. ("Dunn Equipment" or the "Corporation") owned by the late Beatrice Ellen Jones Dunn (the "Decedent") on the date of her death (the "valuation date") for purposes of calculating the estate tax owed by Petitioner-Appellant Estate of Beatrice Ellen Jones Dunn, Deceased (the "
Estate"). The Tax Court valued the Decedent's shares higher than had the Estate on the Form 706 (the "estate tax return" or the "return") filed by Jesse L. Dunn III, the Decedent's Independent Executor (the "Executor") but lower than had Respondent-Appellee Commissioner of Internal Revenue (the "Commissioner"). We conclude that the Tax Court erred as a matter of law in the valuation methodology that it selected and applied to facts that are now largely uncontested by virtue of stipulations, concessions, and non-erroneous findings of that court. This legal error produced an incorrect valuation and thus an erroneous final Tax Court judgment as to the Estate's tax deficiency, requiring remand to that court.

We hold that the correct methodology for determining the value of Dunn Equipment as of the valuation date requires application of an 85:15 ratio, assigning a weight of 85% to the value of the Corporation that the Tax Court determined to be $1,321,740(1) when using its "earnings-based approach" and a weight of 15% to the value that the court determines on remand using its "asset-based approach" but only after recomputing the Corporation's value under this latter approach by reducing the market value of the assets(2) by 34% of their built-in taxable gain ---- not by the 5% as previously applied by that court ---- of the built-in gain (excess of net sales value before taxes over book value) of the assets, to account for the inherent gains tax liability of the assets.

We therefore remand this case to the Tax Court for it to (1) redetermine the asset-based value using a 34% reduction for built-in tax liability; (2) recalculate the fair market value of the Corporation based on that 85:15 weighting ratio; (3) calculate the value of the Estate's ratable portion of the total value of the Corporation as thus redetermined; (4) discount the value of that ratable portion by 22.5% for lack of market and lack of super-majority; (5) based on that result, redetermine the estate tax liability of the Estate as well as any resulting overpayment of such taxes by the Estate; and (6) render a final judgment consistent with this opinion and our judgment.

I. Facts and Proceedings

A. Proceedings

In November, 1994, approximately three and one-half years after the Decedent's death and two and one-half years after her estate tax return was filed, the Commissioner issued a notice of deficiency, assessing additional estate taxes of $238,515.05. This litigation ensued. In an amended answer filed in the Tax Court, the Commissioner increased the asserted estate tax deficiency to approximately $1,100,000. This deficiency was predicated on the Commissioner's contention that the Decedent's 492,610 shares of common stock in Dunn Equipment, a closely-
held, family-operated corporation, was undervalued in the estate tax return. The Commissioner argued that such stock should be valued solely on the basis of the fair market value of its assets, discounted only for lack of a market and lack of a super-majority, and with no reduction for built-in tax liability of those assets and no consideration whatsoever of an earnings or cash flow-based approach to valuation.

In June, 1996, trial was held in the Tax Court to determine the fair market value of Decedent's block of stock in Dunn Equipment.
Approximately three and one-half years after trial, the Tax Court issued its Memorandum Findings of Fact and Opinion ("the Tax Court opinion"). The court concluded that the subject block of stock, which constituted 62.96% of the issued and the outstanding shares of Dunn Equipment's
capital stock, was worth $2,738,558 on the valuation date. After the Tax Court entered its final judgment some six months later, the Estate timely filed a notice of appeal.

B. Facts

Based in principal part on stipulations, uncontested evidence,(3) and concessions, the Tax Court found the following facts. Decedent, a longtime resident of Texas, died there on June 8, 1991 at the age of 81. The Executor, Decedent's son, is also a Texas resident, and the Estate was administered there.

Dunn Equipment was incorporated in Texas in 1949. It had been family owned and operated throughout its entire existence. The Corporation actively operated its business from four locations in Texas and, on

the valuation date, employed 134 persons, three of whom were executives and eight of whom were salesmen.

Dunn Equipment owned and rented out heavy equipment, and provided related services, primarily in the petroleum refinery and petrochemical industries. The personal property rented from the Corporation by its customers consisted principally of large cranes, air compressors, backhoes, manlifts, and sanders and grinders. The Corporation frequently furnished operators for the equipment that it rented to its customers, charging for both equipment and operators on an hourly basis. For example, the Corporation's revenues resulted in significant part from the renting of large cranes, with and without operators. For the four fiscal years preceding the valuation date, equipment rented with operators furnished by the Corporation produced between 26.3% and 32.7% of the Corporation's revenues. On the valuation date, Dunn Equipment's assets comprised the aforedescribed heavy equipment, plus industrial real estate valued at $1, 442,580 and a townhouse valued at $35,000, prepaid expenses of $52,643, and prepaid interest of $671,260.

In addition to the shares owned by the Decedent, shares in Dunn Equipment constituting 31.12% of the issued and outstanding common stock were owned individually by Jesse L. Dunn III (the Decedent's son and executor), who also held title to an additional 2.61% as a trustee. Shares representing the remaining 3.31% of the Corporation's issued and outstanding stock were owned in combination by other family members and employees of the Corporation.

The Corporation's Board of Directors consisted of the Decedent; her son and executor, Jesse; and her grandson, Peter Dunn (Jesse's son). Jesse was President, Peter was Vice President, and the Decedent was Secretary- Treasurer. The Tax Court found that compensation paid to the officers of Dunn Equipment was lower than that paid to officers of similarly situated companies.

Over the course of its 42 years of operation preceding the valuation date, Dunn Equipment had emerged as the largest heavy equipment rental business in its part of Texas, holding a substantial share of that market. By virtue of its market dominance and reputation for dependable service, the Corporation was historically able to command rates above the market average. From 1987 through the valuation date, a decline in the worldwide price of feed stock for the oil refining and petrochemical industries created a favorable business climate for the Corporation's principal customers, and Dunn Equipment's gross revenues increased during that period.

During the same period, however, the heavy equipment rental market became increasingly competitive, as equipment such as cranes became more readily available and additional rental companies entered the field. This in turn caused hourly rental rates to decline and flatten. In fact, increased competition prevented Dunn Equipment from raising its rental rates at any time during the period of more than ten years preceding the valuation date. These rates remained

essentially flat for that 10-year period. The same competitive factors forced the Corporation to replace its equipment with increasing frequency, reaching an average new equipment expenditure of $2 million per annum in the years immediately preceding the valuation date.

In addition to the increased annual cost and frequency of replacing equipment during the years of flat rental rates that preceded the Decedent's death, the Corporation's operating expenses increased significantly, beginning in 1988, and continued to do so thereafter: The ratios of direct operating expenses to revenue escalated from 42% in 1988 to 52% in the 12-month period that ended a week before the Decedent's death. The effect of the increase in direct operating expenses on the Corporation's cash flow and profitability was exacerbated by a practice that Dunn Equipment was forced to implement in 1988: meeting its
customers' demands by leasing equipment from third parties and renting it out to the Corporation's customers whenever all of its own equipment was rented out to other customers. Although this practice, which continued through the valuation date, helped Dunn Equipment keep its customers happy and retain its customer base, the Corporation was only able to break even on these re-rentals, further depressing its profit margin.

Based on the foregoing factors, the Tax Court concluded that the Corporation had no capacity to pay dividends during the five years preceding the death of the Decedent. In fact, it had paid none.

As of the valuation date, no public market in the stock of Dunn Equipment
existed, and no recent private transactions in its stock had occurred. There was no current or pending litigation that could have had a material effect on the value of the stock, but large annual capital expenditures for equipment replacement coupled with shrinking profit margins resulting from the combination of increased operating expenses and flat or reduced rental rates, essentially eliminated net cash flow available for debt reduction or dividend payment. On the valuation date, the Corporation had outstanding debt of $7,343,161, producing a debt-to-equity ratio in excess of 6.5 to 1. The Corporation's average net annual cash flow for the 4- year period ending with the valuation date was only $286,421. Given the Tax Court's finding regarding the underpayment of compensation to its officers, the Corporation's cash flow ---- and thus its income-based valuation ---- is actually overstated.

On the basis of these extensive factual findings and reasonable inferences from them, the Tax Court concluded that, as of the valuation date, Dunn Equipment was "a viable operating company...and earned a significant part of its revenues from selling services as well as renting equipment"; that between one-fourth and one-third of the Corporation's gross operating revenue was produced by charges for labor, parts, and equipment rentals with operators supplied; and that there were " significant active operational aspects to the company as of the valuation date."(4)

The Tax Court also found that, even though the Decedent's 62.96% of stock ownership in the Corporation gave her operational control, under Texas law she lacked the power to compel a liquidation, a sale of all or substantially all of its assets, or a merger or consolidation, for each of which a "super-majority" equal to or greater than 66.67% of the outstanding shares is required.(5) The Court further concluded that, in addition to lacking a super-majority herself, the Decedent would not have been likely

to garner the votes of additional shareholders sufficient to constitute the super-majority required to instigate liquidation or sale of all assets because the other shareholders were determined to continue the Corporation's independent existence and its operations indefinitely. The court based these findings on evidence of the Corporation's history, community ties, and relationship with its 134 employees, whose livelihoods depended on Dunn Equipment's continuing as an operating business.(6)

We perceive no clear error in any of the foregoing findings or in the inferences and conclusions that the Tax Court derived from them.

The Tax Court found further that, for Dunn Equipment, the process of liquidation would be expensive and time-consuming, involving sales costs, transportation costs, reduced equipment sales prices because of the increased short-term supply of such equipment that would result from a liquidation's flooding of the market, and the risk of loss of customers during the course of a lengthy liquidating process if that were to be attempted. These findings too are free of clear error. (Again, the Court did not list among Dunn Equipment's costs of liquidation, however, the adverse tax results that would be incurred, particularly the 34% federal income tax on gains to be realized by the Corporation on the sale of its equipment, whether ultimately deemed ordinary income or capital gains.(7))

Having painted this clear and detailed valuation-date portrait of Dunn Equipment, the Tax Court proceeded to confect its valuation methodology. The court selected two different approaches to value, one being an income- based approach driven by net cash flow(8) and the other being an asset- based approach driven by the net fair market value of the Corporation's assets.(9) The court calculated the Corporation's "earnings-based value" at $1,321,740 and its net "asset-based value" at $7,922,892, as of the valuation date. The latter value was calculated using a 5% factor for built-in gains tax liability, not the actual rate of 34% that the Corporation would have incurred on sale to a willing buyer.

As the next step in its methodology, the Tax Court assigned dissimilar weights to the two valuations, expressly rejecting (1) the Estate's expert's method, which assigned equal weight to each, and (2) the Commissioner's contention that no weight whatsoever should be given to earnings or cash flow and that the Corporation be valued entirely on asset value undiminished by any built-in tax liability. Despite having concluded that "the hypothetical investor would give earnings value substantial weight" and acknowledging "that, as a general rule, earnings are a better criterion of value for operating companies [which Dunn Equipment is] and net assets a better criterion of value for holding or investment companies [which Dunn Equipment is not],"(10) the Tax Court confected the weighting factor of its valuation method by assigning a weight of 35% to earnings-based value and 65% to asset-based value (which the court calculated by, inter alia, reducing the value of assets by 5% for built-in gains tax liability).(11) After applying its weighted average to the results of its two valuation approaches to reach the fair market value of the entire Corporation, the Tax Court calculated the Decedent's percentage of ownership (62.96%) to ascertain the pro rata value of her block of stock.

The final step in the Tax Court's methodology involved the determination and application of discounts. In the discount step, the court concluded that the gross pro rata value of Decedent's block of stock should be reduced 15% for lack of marketability and 7.5% for lack of super-majority control, producing a total discount of 22.5%. This is not contested on appeal.

The Executor had returned the Decedent's block of stock at $1,635,465. The Estate's expert appraiser's 50:50 weighting approach produced a minimally lower value of $1,582,185. The Commissioner originally contended that the value was $2,229,043 but ultimately claimed the value to be $4,430,238. And the Tax Court found the value to be $2,738,558.

On appeal, the Estate has stipulated that it is not contesting the Tax Court's determination of the value of Dunn Equipment "under the earnings
based approach, or [the Tax Court's] application of a 15% discount for lack of marketability and a 7.5% discount for lack of super-majority control" to the Decedent's pro rata ownership of the issued and outstanding stock of the Corporation.(12) This reduces our chore to one of reviewing only the aspects of the Tax Court's methodology that the Estate does continue to challenge, i.e., the method employed to determine (1) the appropriate discount to apply to the value of the Corporation's assets to account for built-in tax liability in determining its asset- based value and (2) the relative weights to assign to the two disparate values, income-based and asset-based.

II. Analysis

A. Standard of Review

We review opinions and judgments of the Tax Court under the same standards that we apply when reviewing those of other trial courts: Factual determinations are reviewed for clear error, and conclusions of law are reviewed de novo.(13) We have held that determination of fair market value is a mixed question of fact and law for which "the factual premises [are] subject to review on a clearly erroneous standard, and the legal conclusion[s are] subject to de novo review."(14) The mathematical computation of fair market value is an issue of fact, but determination of the appropriate valuation method is an issue of law that we review de novo.(15)

B. Burden of Proof

On the estate tax return, the Decedent's block of stock in Dunn Equipment
was valued at $1,635,465. The Commissioner's deficiency notice stated a value of $2,229,043. Subsequently, the Commissioner's amended answer upped the value to $4,430,238, roughly doubling the deficiency notice value and increasing the asserted estate tax deficiency by $861,485 for a total of $1,100,000. The Tax Court correctly observed that the Estate has the burden of refuting the value asserted in the Commissioner's original notice of deficiency, but that the Commissioner has the burden of proving any value in excess of that initial amount.(16)

C. The Commissioner's Disparate Positions: Trial Vis-à-Vis Appeal

1. Position On Appeal As appellee, the Commissioner supports the Tax Court's treatment of each aspect of the case and asks us to affirm the court's judgment. Specifically, the Commissioner urges us to accept, inter alia, the Tax Court's dual approach to value; the court's treatment of built-in tax liability; the relative weights assigned by the court to the results of each approach; and the court's discounts for lack of market and lack of supermajority control.

2. Pre-Trial and Trial Position

The Commissioner's posture on appeal is a stark departure from his pre- trial and trial position: amending his answer to quadruple the Estate's tax deficiency as originally assessed, urging the Tax Court to disregard totally the built-in tax liability of the Corporation's assets, insisting that the Corporation be valued solely on asset values, and urging that no consideration whatsoever be given the earnings or cash-flow based approach to valuation. Indeed, at trial, the Commissioner did not favor the Tax Court with testimony of an expert appraiser, even though the Commissioner had affirmatively proposed his own, geometrically higher value for the Decedent's block of stock ---- values that started out higher than the ones reported on the estate tax return and that were then multiplied, by virtue of the Commissioner's amended answer, to almost four times the Estate's figures. Yet, instead of supporting his own higher values (for which he had the burden of proof) by proffering professional expert valuation testimony during the trial, the Commissioner merely engaged in guerilla warfare, presenting only an accounting expert to snipe at the methodology of the Estate's valuation expert. The use of such trial tactics might be legitimate when merely contesting values proposed by the party opposite, but they can never suffice as support for a higher value affirmatively asserted by the party employing such a trial strategy. This is particularly true when, as here, that party is the Commissioner, who has the burden of proving the expanded value asserted in his amended answer.

Using such tactics remains the prerogative of the Commissioner and his trial counsel, at least up to a point. But when his choice of tactics is viewed in the framework of the substantive valuation methodology urged by the Commissioner in the Tax Court, his posture at trial is seen to be so extreme and so far removed from reality as to be totally lacking in probative value.

To keep this in perspective, it must be remembered that this case had been under the scrutiny of the Commissioner for many years before trial, during which time he had to have learned essentially all of the discrete attributes of Dunn Equipment that were eventually stipulated by the
parties or found by the Tax Court: its operating history, its sources of income, the nature of its assets and their use in its operations, the status of the industry, and so on ad infinitum. Thus, as of the commencement of trial, the Commissioner must be held to the knowledge that Dunn Equipment was and had always been, as the Tax Court concluded, "a viable operating company" which "earned a significant part of its revenues from selling services as well as renting equipment" and that there were " significant active operational aspects to the company as of the valuation date."(17) When the nature of the Corporation's assets ---- primarily heavy equipment held not for investment or production of passive

income, like interest and dividends, but for active hourly rental (frequently with operators furnished by the Corporation), in the heavy construction and maintenance of chemical plants and petroleum refineries, rapidly depreciating with use and requiring constant maintenance, repair, and replacement ---- are viewed in pari materia with the myriad specific attributes of the Corporation, the untenability of the Commissioner's trial position in the Tax Court is plain.

Consequently, the Commissioner's insistence at trial that the value of the subject stock in Dunn Equipment be determined exclusively on the basis
of the market value of its assets, undiminished by their inherent tax liability ---- coupled with his failure to adduce affirmative testimony of a valuation expert ---- was so incongruous as to call his motivation into question. It can only be seen as one aimed at achieving maximum revenue at any cost, here seeking to gain leverage against the taxpayer in the hope of garnering a split-the-difference settlement ---- or, failing that, then a compromise judgment ---- somewhere between the value returned by the taxpayer (which, by virtue of the Commissioner's eleventh-hour deficiency notice, could not effectively be revised downward) and the unsupportedly excessive value eventually proposed by the Commissioner. And, that is precisely the result that the Commissioner obtained in the Tax Court.

Any remaining doubt that the Commissioner's pretrial and trial tactics in this case could conceivably evidence a bona fide disagreement over the value of Dunn Equipment is dispelled by the element of timing. In an
estate tax situation, the statute of limitations for assessment and collection by the IRS is generally three years, as specified in Internal Revenue Code ("I.R.C.") § 6501. When the IRS presents a deficiency notice in close proximity to the expiration of I.R.C. § 6501's 3-year time bar, it creates a tactical advantage for itself: Once the statute of limitation expires, the taxpayer can no longer claim a refund even if he then concludes that he was too conservative in his original valuation. This is so because the ability of the taxpayer to claim a refund is controlled by I.R.C. § 6511, which provides that the taxpayer has until the later of three years from the time the return was filed or two years from the time the tax was paid to assert such a claim. The tax due is normally paid with the tax return, by or before the due date. As a result, the only amount that the taxpayer could recover would be for taxes paid in response to the deficiency notice. Consequently, by holding off the filing of a notice of deficiency until more than two years following payment of tax or three years following the filing of the return, the IRS is able to manufacture an advantage with no downside risk: The taxpayer is precluded from claiming a refund except for any taxes paid with the deficiency notice, and the Commissioner is able to assert an excessive value and then use it for leverage in negotiations or at trial.

The Commissioner's abrupt change of position on appeal is so inconsistent and unreconcilable with his pretrial and trial positions that all of his urgings to us are rendered highly suspect. We keep this duplicity in mind as we proceed to examine the Tax Court's valuation methodology.

D. Determination of Fair Market Value

The definition of fair market value is as universally recognized as its determination is elusive: Fair market value 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 to sell and both having reasonable

knowledge of relevant facts.'"(18) As a broad generality, appraising corporations or blocks of corporate stock involves consideration of three approaches: income, market, and assets-based.(19) When, as here, the corporation being appraised is closely held, is not regularly traded on an exchange, has not been traded at arm's length in close proximity of the valuation date, and is not comparable to other corporations engaged in the same or similar businesses of which there is evidence of recent sales of stock, the market approach is inapposite, leaving only the income and assets-based approaches as candidates for analysis. Thus, in cases like this, such features as net worth, prospective earning power and dividend-paying capacity, good will, position in the industry, management, economic outlook of the industry, and the degree of control represented by the block of stock in question must be looked to in the appraisal process.(20)

As is apparent from the essentially uncontested operative facts and inferences of this case, most of the heavy lifting required to reach the ultimate conclusion of fair market value of Decedent's block of stock had been accomplished by the time the question reached us. In addition, most of the penultimate conclusions regarding valuation methodology are conceded or uncontested on appeal: the pre-discount value of the Corporation under the earnings-based approach ($1,321,740); its debts ($7, 343,161); the market value of its assets before adjustment for built-in tax liability ($8,278,342); the discount for lack of marketability (15%); and the discount for lack of super-majority control (7.5%). That is why only two contested questions remain, both of which implicate valuation methodology: Did the Tax Court err as a matter of law in the methodology that it chose for (1) dealing with the assets' built-in tax liability when determining the Corporation's asset-based value, and (2) assigning relative weights to the asset-based and earnings-based values? The parties to this appeal agree with the Tax Court's starting point that "[t]he dispute in the instant case concerns the proper method for valuing an interest in a company in which asset-based value and earnings-based value are widely divergent."(21) We therefore begin by examining de novo the method employed by the Tax Court for dealing with the built-in tax liability of assets in connection with the asset-based approach to value. We then review de novo the method employed by the court in determining the relative weights to be given to Dunn Equipment's "widely divergent" asset-
based and earnings-based values.
Adjustment for Built-In Tax Liability of Assets

None can dispute that if Dunn Equipment had sold all of its heavy
equipment, industrial real estate, and townhouse on the valuation date, the Corporation would have incurred a 34% federal tax on the gain realized, regardless of whether that gain were labeled as capital gain or ordinary income.(22) The question, then, is not the rate of the built-in tax liability of the assets or the dollar amount of the inherent gain, but the method to employ in accounting for that inherent tax liability when valuing the Corporation's assets (not to be confused with the ultimate task of valuing its stock).

The Estate's expert took the position that, when determining the asset- based value to be used in calculating the fair market value of the Corporation, its assets must be treated as though they had in fact been sold, in which event the Corporation would have incurred federal income tax equal to 34% of the gain realized on the sale. This in turn would have instantly reduced the Corporation's fair market value,

dollar for dollar, for taxes payable. But, if the willing buyer were to purchase the Decedent's block of stock with the assets still owned by the Corporation, then regardless of whether thereafter that buyer could and would cause all or essentially all of the Corporation's assets to be sold, either in the ordinary course of business or globally in liquidation, the value to the Corporation of its assets qua assets would still be the amount that the Corporation could realize on disposition of those assets, net of all costs (including gains tax). The Estate contends that, like advertising and transportation costs, commissions, and other unavoidable expenses of disposition of these assets accepted by the Tax Court, the assets' gross value must be reduced by their built-in gains tax liability to reach their net fair market value for purposes of calculating the asset-based value of the Corporation.

In diametric opposition, the Commissioner argued to the Tax Court that no reduction for built-in tax liability should be allowed. He grounded this contention solely on the assertion that liquidation was not imminent or even likely.

Although the Tax Court accepted the 34% rate and acknowledged that the value of the Corporation had to be reduced by some factor to account for inherent tax liability of its assets, the court followed the Commissioner's "no imminent liquidation" red herring and concluded that only if the hypothetical willing buyer of the Decedent's block of stock intended to liquidate the Corporation in the short term ---- which the holder of that block of stock, acting alone, could not force ---- would that buyer seek a substantial reduction for built-in capital gain. The Tax Court then proceeded to discuss such a postulational buyer's alternatives to liquidation and to calculate the present value (actually, negative value) of future tax liability. The court concluded that the asset-based value of Dunn Equipment should be reduced by only 5% for
potential tax costs, not by the full 34% gains tax that the Corporation would have to pay when and if its assets were sold, whether in globo or seriatim.

The Tax Court's fundamental error in this regard is reflected in its statement that ---- for purposes of an asset-based analysis of corporate value ---- a fully-informed willing buyer of corporate shares (as distinguished from the Corporation's assemblage of assets) constituting an operational-control majority would not seek a substantial price reduction for built-in tax liability, absent that buyer's intention to liquidate. This is simply wrong: It is inconceivable that, since the abolition of the General Utilities doctrine and the attendant repeal of relevant I.R.C. sections, such as §§ 333 and 337, any reasonably informed, fully taxable buyer (1) of an operational-control majority block of stock in a corporation (2) for the purpose of acquiring its assets, has not insisted that all (or essentially all) of the latent tax liability of assets held in corporate solution be reflected in the purchase price of such stock.

We are satisfied that the hypothetical willing buyer of the Decedent's block of Dunn Equipment stock would demand a reduction in price for the
built-in gains tax liability of the Corporation's assets at essentially 100 cents on the dollar, regardless of his subjective desires or intentions regarding use or disposition of the assets. Here, that reduction would be 34%. This is true "in spades" when, for purposes of computing the asset-based value of the Corporation, we assume (as we must) that the willing buyer is purchasing the stock to get the assets, (23) whether in or out of corporate solution. We hold as a matter of law that the built-in gains tax liability

of this particular business's assets must be considered as a dollar-for-dollar reduction when calculating the asset- based value of the Corporation, just as, conversely, built-in gains tax liability would have no place in the calculation of the Corporation's earnings-based value.(24)

The Tax Court made a more significant mistake in the way it factored the " likelihood of liquidation" into its methodology, a quintessential mixing of apples and oranges: considering the likelihood of a liquidation sale of assets when calculating the asset-based value of the Corporation. Under the factual totality of this case, the hypothetical assumption that the assets will be sold is a foregone conclusion ---- a given ---- for purposes of the asset-based test.(25) The process of determining the value of the assets for this facet of the asset-based valuation methodology must start with the basic assumption that all assets will be sold, either by Dunn Equipment to the willing buyer or by the willing buyer of the Decedent's block of stock after he acquires her stock. By definition, the asset-based value of a corporation is grounded in the fair market value of its assets (a figure found by the Tax Court and not contested by the estate), which in turn is determined by applying the venerable willing buyer-willing seller test. By its very definition, this contemplates the consummation of the purchase and sale of the property, i.e., the asset being valued. Otherwise the hypothetical willing parties would be called something other than "buyer" and "seller."

In other words, when one facet of the valuation process requires a sub- determination based on the value of the company's assets, that value must be tested in the same willing buyer/willing seller crucible as is the stock itself, which presupposes that the property being valued is in fact bought and sold. It is axiomatic that an asset-based valuation starts with the gross market (sales) value of the underlying assets themselves, and, as observed, the Tax Court's finding in that regard is unchallenged on appeal: When the starting point is the assumption of sale, the " likelihood" is 100%!

This truism is confirmed by its obverse in today's dual, polar-opposite approaches (cash flow; assets). The fundamental assumption in the income or cash-flow approach is that the assets are retained by the Corporation, i.e., not globally disposed of in liquidation or otherwise. So, just as the starting point for the asset-based approach in this case is the assumption that the assets are sold, the starting point for the earnings- based approach is that the Corporation's assets are retained ---- are not sold, (other than as trade-ins for new replacement assets in the ordinary course of business) ---- and will be used as an integral part of its ongoing business operations. This duly accounts for the value of assets ---- unsold ---- in the active operations of the Corporation as one inextricably intertwined element of the production of income.

Bottom Line: The likelihood of liquidation has no place in either of the two disparate approaches to valuing this particular operating company. We hasten to add, however, that the likelihood of liquidation does play a key role in appraising the Decedent's block of stock, and that role is in the determination of the relative weights to be given to those two approaches: The lesser the likelihood of liquidation (or sale of essentially all assets), the greater the weight (percentage) that must be assigned to the earnings(cash flow)-based approach and, perforce, the lesser the weight to be assigned to the asset-based approach.

Belabored as our point might be, it illustrates the reason why, in conducting its asset-based approach to valuing Dunn Equipment, the Tax

Court erred when it grounded its time-use-of-money reduction of the 34% gains tax factor to 5% on the assumption that the corporation's assets would not likely be sold in liquidation. As explained, the likelihood of liquidation is inapposite to the asset-based approach to valuation.

In our recent response to a similarly misguided application of the built- in gains tax factor by the Tax Court, we rejected its treatment as based on "internally inconsistent assumptions."(26) In that case we reversed and remanded with instructions for the Tax Court to reconsider its valuation of the subject corporation's timber property values by using a more straightforward capital gains tax reduction. Similarly, because valuing Dunn Equipment's underlying corporate assets is not the equivalent of valuing the Company's capital stock on the basis of its assets, but is merely one preliminary exercise in that process, the threshold assumption in conducting the asset-based valuation approach as to this company must be that the underlying assets would indeed be sold. And to whom? To a fully informed, non-compelled, willing buyer. That is always the starting point for a fair market value determination of assets qua assets. That determination becomes the basis for the company's asset-based value, which must include consideration of the tax implications of those assets as owned by that company.

We must reject as legal error, then, the Tax Court's treatment of built- in gains tax liability and hold that ---- under the court's asset-based approach ---- determination of the value of Dunn Equipment must include a
reduction equal to 34% of the taxable gain inherent in those assets as of the valuation date.(27) Moreover, the factually determined, "real world" likelihood of liquidation is not a factor affecting built-in tax liability when conducting the asset-based approach to valuing Dunn Equipment stock.(
28) Rather, the probability of a liquidation's occurring affects only (but significantly) the relative weights to be assigned to each of the two values once they have been determined under the asset-based and income- based approaches, respectively ---- which brings us to the second methodology issue presented in this appeal.
Assignment of Weight to Values

a. Cash Flow Vis-à-Vis Earnings

Prior to determining the appropriate method of valuing Dunn Equipment,
the Tax Court reviewed the factors that bear on the fair market value of a block of stock in a closely-held, non-traded, operating corporation and concluded that

the value of Dunn Equipment is best represented by a combination of an
earnings-based value using capitalization of net cash-flow and an asset- based value using fair market value of assets, with an appropriate discount for a lack of marketability and lack of super-majority control.(29)

In so doing, the Tax Court rejected the approach of the Estate's expert, who used capitalized net earnings to determine the income-based value of the Corporation, and went instead with a capitalized

net cash-flow method. As the Estate is not contesting the Tax Court's choice of the cash-flow approach over the earnings approach, we too accept the court's choice.

b. The Tax Court's Determination of Value

To its credit, the Tax Court flatly rejected the Commissioner's legally and factually absurd contention at trial that no weight should be given to the Corporation's earnings-based value and that its value should be based entirely in an asset-based approach, with no consideration of built-in tax liability. In so doing, the Tax Court concluded that the Commissioner " puts too much emphasis on the fair market value of assets"(30) ---- to us, a classic understatement ---- and stated correctly that "because Dunn Equipment was an operating company, the better question is not whether we should disregard the earnings-based value, but whether we should disregard the asset-based value."(31) The Tax Court went on to voice agreement with the basic position urged by the Estate's valuation expert that substantial weight should be given to both the asset-based value and the earnings- based value of the Corporation. Although we wholeheartedly endorse the point made by the Tax Court's rhetorical question whether any weight at all should be given to the asset-based value ---- and see little hyperbole in it ---- we are constrained to proceed, as proposed by the Estate and as done by the Tax Court, with a methodology that assigns some weight to each of the values generated by those two disparate approaches.

The final determination required to complete the pre-discount valuation methodology in this case, then, is the selection of the respective weights (percentages) to be assigned to each of the Corporation's theoretical values, asset-based and earnings-based. As observed in our discussion of the potential effects (or lack thereof) of the likelihood of liquidation and latent gains tax liability on the value of the Corporation's assets, it is in the exercise conducted to determine the relative weights to be accorded to each of the two differently calculated values of the Corporation ---- and only in that exercise ---- that the likelihood of liquidation vis-à-vis the likelihood of indefinitely retaining and using the assets, comes into play.

The Tax Court was of the opinion ---- and we agree ---- that the hypothetical willing buyer of the Decedent's block of stock would be unlikely to provoke liquidation of the company, even if he could. The Tax Court bolstered that conclusion with the recognition that even though the Estate's block of stock represents day-to-day control, the buyer of that block would lack the power to compel liquidation, merger, or consolidation.(32) In this regard, the court cogently emphasized that Dunn Equipment's history, community ties, and relationship with its employees would make it difficult if not virtually impossible for the holder of the Estate's block of stock to secure the votes of additional shares sufficient to institute liquidation. After concluding that the likelihood of liquidation was slight, the Tax Court added:

A rapid liquidation would have flooded the market with equipment, reducing the value obtained for each piece. A lengthy, drawn-out liquidation (also called a "creeping liquidation") would have risked the loss of customers who, at some point, would have realized that Dunn Equipment no longer meant to stay in business and who would therefore have sought other suppliers of equipment.(33)

Despite having asked rhetorically ---- but, in our opinion, insightfully ---- whether the asset-based value of the Corporation should not be disregarded altogether, the Tax Court simply reiterated the factors that should be considered (largely paraphrasing Rev. Rul. 59-60), then conclusionally completed its pre-discount valuation methodology by assigning unequal percentages of weight to the results of its two approaches to valuation.

Given the stipulated or agreed facts, the additional facts found by the Tax Court, and the correct determination by that court that the likelihood of liquidation was minimal, our expectation would be that if the court elected to assign unequal weight to the two approaches, it would accord a minority (or even a nominal) weight to the asset-based value of the Corporation, and a majority (or even a super-majority) weight to the net cash flow or earnings-based value. Without explanation, however, the Tax Court baldly ---- and, to us, astonishingly ---- did just the opposite, assigning a substantial majority of the weight to the asset-based value. The court allocated almost two-thirds of the weight (65%) to the results of the asset-based approach and only slightly more than one-third (35%) to the results of the earnings-based approach. We view this as a legal, logical, and economic non sequitur, inconsistent with all findings and expressions of the court leading up to its announcement of this step in its methodology. We also note that the Tax Court's ratio roughly splits the difference between the 50:50 ratio advanced by the Estate and the 100: 0 ratio advocated by the Commissioner.

Irrespective of whether the crucial step in the Tax Court's methodology, the assignment of relative weights to the results of the different valuation approaches, is deemed to be an issue of law or a mixed question of fact and law, we review it de novo. Our plenary review leads us inescapably to the conclusion that the Tax Court's 65:35 ratio in favor of its asset-based value constitutes reversible error. How, we must ask, can the value of a corporation that possesses all the attributes verbalized by the Tax Court conceivably be governed essentially twice as much by its asset-based value as by its earnings or cash flow-based value, when its assets (1) are not susceptible of appreciation (except, possibly, de minimis by the condo and the plant sites), (2) are physically depreciated and depreciating as a result of their being used as intended, (3) are being replaced constantly with newer models at great cost, and (4) are virtually certain not to be put up for sale because indefinite operation ---- not liquidation ---- is all that can be predicted as the Corporation's future, both long-term and short?

At this point we must emphasize the fact that the lion's share of the Corporation's assets comprised heavy equipment which, to such an operating company, is virtually indistinguishable from consumable supplies ---- and likely would be so regarded were it not for the administratively necessary but economically unrealistic artificiality of 12-month tax years. Those assets are constantly depreciating from heavy use and obsolescence; they are being replaced to the tune of $2 million annually; their highest and best use is short-term rental, frequently impossible to accomplish without the furnishing of operators by the Corporation; and the tax effects of their unlikely sale to third parties would greatly diminish their value to the Corporation. Indeed, it takes eight salesmen and 123 common-law employees, working full time in this highly competitive industry, to make these heavy-equipment assets produce even moderately acceptable levels of profitability.

Throughout its comprehensive and logical background analysis, the Tax Court recognized that Dunn Equipment is an operating company, a going
business concern, the Decedent's shares in which would almost certainly be purchased by a willing buyer for continued operation and not for liquidation or other asset disposition. For purposes of valuation, Dunn Equipment is easily distinguishable from true asset-holding investment companies, which own properties for their own intrinsic, passive yield and appreciation ---- securities, timberland, mineral royalties, collectibles, and the like. For the Tax Court here to employ a valuation method that, in its penultimate step of crafting a weighting ratio assigns only one- third weight to this operating company's income-based value, defies reason and makes no economic sense.(34) Our conclusion is all the more unavoidable when viewed in the light of the Tax Court's disregard of the ubiquitous factor of dividend paying capacity ---- in this case, zero ---- which, if applied under customarily employed weighting methods, would further dilute the weight of the asset-value factor and reduce the overall value of the Corporation as well. The same can be said for the effect on cash flow of the underpayment of officers' compensation.

When we review the objective, factual record in this case ---- which is all that remained for the Tax Court to rely on after it disregarded most expert testimony ---- we are left with the definite impression that an error was committed at the weighting step of the method employed here. This review also mandates that something between zero and a small percentage of weight be assigned to the Corporation's asset-based value, and that the remainder of the weight be assigned to its earnings-based value. Under different circumstances, we might be inclined to remand for the Tax Court to make another try at assigning relative weights and constructing a reasonable ratio. Given the state of the record and the seven-plus years that this case has languished in the courts (over a year now in ours), such a remand, coupled with its potential for yet another appeal, militates against sending this particular issue back to the Tax Court. After all, the record of this case, free as it is of credibility calls and genuine disputes of material fact between the parties (other than as to their experts) places us in exactly the same methodological vantage point as the Tax Court when it comes to assigning relative weights to the results of the valuation approaches employed. This is true regardless of whether that assignment be labeled a question of law or a mixed question of fact and law.

Tempting as it is to follow the implication of the Tax Court's rhetorical question and disregard the asset-based value altogether, we remain cognizant of the venerable Cohan(35) rule, which counsels against assigning a zero value or probability to anything under any circumstances, and therefore resist that temptation. Recognizing the impossibility of ever making an absolutely precise and universally accepted determination of weighting percentages,(36) we nevertheless hold that the proper method of valuing the stock of Dunn Equipment, under all the relevant
circumstances and discrete facts of this case (not the least of which is the "unlikelihood" of liquidation of its assets), requires assigning a weight to its earnings-based value somewhere between 75% and 90%, and to its asset-based value somewhere between 10% and 25%. Within these ranges we select 85% for the earnings-based weight and 15% for the asset-based weight, producing a 85:15 weighting ratio.

III. Conclusion

The Tax Court calculated Dunn Equipment's earnings-based value before discount at $1,321,740, and the Estate does not appeal that determination. Therefore, on remand the Tax Court shall give the results of that approach a weight of 85% in computing the Corporation's value. In contrast, the asset-based value, to which a weight of 15% shall be given, must be recalculated by the Tax Court by applying to the previously determined market value of the Corporation's assets, a reduction equal to 34% of those assets' built-in taxable gains. After thus recalculating the Corporation's asset-based value and computing the pre-discount value of the Corporation by application of this 85:15 ratio, the Tax Court shall then reduce the Estate's 62.96% ratable portion of that value by 22.5% for lack of marketability and lack of super-majority control, pursuant to the unappealed discount methodology originally selected by the Tax Court.

With the correct value of the Estate's block of stock in Dunn Equipment thus determined, the court shall recalculate (or the parties shall stipulate) the correct estate tax liability for Decedent's Estate. This will enable the court to enter an appropriate final judgment to account for the Estate's overpayment of taxes as well as interest and any other relevant factors.

Finally, given the Commissioner's delays in issuing his notice of deficiency and his extreme and unjustifiable trial position in advocating a valuation based entirely on asset value (with no reduction for built-in tax liability and no weight given to income-based value), exacerbated by his failure to adduce expert appraisal testimony in support of his own exorbitant proposed value, the Tax Court shall entertain any claim that the Estate might elect to assert under I.R.C. § 7430, if perchance the re- valuation of the Decedent's block of Dunn Equipment's stock should reduce the net worth of the Estate to a sum below the $2 million cap on entitlement to relief under that section. (37)

REVERSED and REMANDED, with instructions.

1. If need be, this figure can be fine tuned on remand to reconcile the slight discrepancy between the Tax Court's figure and that of the Estate.

2. $8,278,342 according to the Tax Court; $8,268,345 according to the Commissioner's appellate brief.

3. We do not refer here to the testimony and documents submitted by the opposing parties' dueling experts as being uncontested. The Commissioner contested the methodology of the Estate's expert appraisers, and the Estate took issue with the assertions of the Commissioner's accounting (not appraisal) expert; but the Tax Court was not required to credit such testimony and in fact disregarded or disagreed with much of it from both camps. Like the Tax Court, we are not bound to rely on expert testimony proffered by the Estate or the Commissioner.

4. Dunn v. Comm'r, 79 T.C.M. (CCH) 1337, 1339 (2000).

5. Id. at 1340 (citing Tex. Bus. Corp. Act Ann. art 6.03 (West 1991)).

6. Although not mentioned by the court, we speculate that the specter of incurring a 34% tax on the multimillion dollar amount by which the selling price of the assets in liquidation would have exceeded the Corporation's basis for tax purposes was also a deterrent to liquidation.

7. The taxable gain on any sale of used heavy equipment presumably would result from reduction in basis produced by substantial depreciation deductions previously taken, not from appreciation in value of these assets, as age, use, and obsolescence generally produce sales prices for such used equipment substantially below its original cost.

8. The Estate's expert proffered the use of a capitalization-of-earnings rather than a capitalization-of-net-cash-flow approach to an earnings- based valuation, but the results of these two methods produced similar results, and the Estate does not press the issue on appeal.

9. We note in passing that the court did not include dividend-paying capacity as a factor despite its customary inclusion in multifaceted valuation methodology for closely held corporations. See, e.g., Rev. Rul. 59-60, 1959-1 C.B. 237, § 4.01(e) (1959). Although factoring in a "zero" dividend-paying capacity would have further reduced the value of Dunn Equipment, the Estate has not complained to us of that omission so we do not examine it as a possible error in the valuation methodology employed by the Tax Court.

10. Dunn, 79 T.C.M. (CCH) at 1340.

11. For over 40 years, Rev. Rul. 59-60 has counseled against assigning finite percentages to relative weights of the various valuation methods employed by appraisers of stock in closely held businesses; yet that admonition is largely honored in its breach ---- as exemplified by both the Tax Court and the Estate's appraiser in this case.

12. Neither has the Estate contested the Tax Court's finding of the market value of the Corporation's assets, before discount for built-in tax liability, of $8,278,342.

13. See, e.g., McIngvale v. Comm'r, 936 F.2d 833, 836 (5th Cir. 1991).

14. In re T-H New Orleans, Ltd. P'ship, 116 F.3d 790, 799 (5th Cir. 1997).

15. Estate of Palmer v. Comm'r, 839 F.2d 420, 423 (8th Cir. 1988)(citing Powers v. Comm'r, 312 U.S. 259, 260 (1941))("The ultimate determination of fair market value is a finding of fact. ... The question of what criteria should be used to determine value is a question of law subject to de novo review.").

16. See Dunn, 79 T.C.M. (CCH) at 1338.

17. Dunn, 79 T.C.M. (CCH) at 1339.

18. United States v. Cartwright, 411 U.S. 546, 551 (1973)(quoting Treas. Reg. § 20.2031-1(b)).

19. See Shannon P. Pratt et al., Valuing a Business: The Analysis and Appraisal of Closely Held Companies 45 (4th ed. 2000) [hereinafter Valuing a Business].

20. See Treas. Reg. § 20.2031-2(f); see also Rev. Rul. 59-60, 1959-1 C.B. 237, § 4.01.

21. Dunn, 79 T.C.M. (CCH) at 1338 (emphasis added).

22. Id. at 1344, n.9 (referring in its analysis to I.R.C. §§ 1245, 11, and 1201).

23. This is easily illustrated by a simplified example: Buyer B wants an assemblage of assets identical to Corporation C's assets. Those assets are worth $1 million on the open market but are depreciated on C's books to a tax basis of $500,000. B has two options: (1) He can buy the assets from C for $1 million and depreciate them to zero over, e.g., seven years (or buy them on the open market and have the same cash flow and tax experience), leaving C to pay its own 34% tax ($170,000) on its gain; or (2) he can buy C's stock, get no depreciation deductions other than, at the corporate level, to the extent the assets are further depreciable, and have a 34% built-in corporate tax liability at sale of the assets. Surely a buyer of the stock rather than the assets would insist on a price reduction to account for the full amount of the built-in gain tax and the loss of the depreciation opportunity.

24. Pratt et al., Valuing a Business, at 47 ("[T]ax consequences of ownership and/or transfer of stock ... usually are quite different from those of ownership and/or transfer of direct investment in underlying assets. These tax implication often have a significant bearing on value.").

25. Id. at 34 ("[I]f valuing a minority ownership interest, one would normally adopt the premise of 'business as usual...."). Compare id. at 443 ("[T]he asset-based approach tends to be more appropriate when valuing a controlling ownership interest than a noncontrolling ownership interest.") . The Decedent's non-supermajority interest is a hybrid, somewhere between minority and full control, so neither approach trumps the other totally.

26. Estate of Jameson v. Comm'r. 267 F.3d 366, 372 (5th Cir. 2001).

27. We observe a slight discrepancy between the amount of the built-in gain mentioned by the Tax Court in its opinion ($7,109,000) and the gain referred to in the Estate's appellate brief ($7,117,638) to which a 34% tax should be applied. We are satisfied that this minor difference can be resolved by the court and the parties on remand or, alternatively, ignored on the maxim de minimis non curat lex, the net difference to the taxable value of the subject block of stock being roughly $1,200.

28. The likelihood of liquidation is also taken into account in another way, albeit indirectly and implicitly: in the court's assignment of a 7.5% discount to the Decedent's block of Dunn Equipment stock for lack of
supermajority control. For it is liquidation that, absent supermajority, the operational majority stockholder alone cannot force. Thus this discount is grounded in inter alia, the block's inability to make liquidation happen.

29. Dunn, 79 T.C.M. (CCH) at 1339 (emphasis added).

30. Id.

31. Id. at 1340 (boldface ours).

32. See Tex. Bus. Corp. Act Ann. art. 6.03 (Vernon 1991).

33. Dunn, 79 T.C.M. (CCH) at 1340. The Tax Court nevertheless opined that the earnings value of the company appeared to be understated because the earnings projections are based on a low period in a cyclical business. We see this observation as clearly erroneous: Dunn Equipment's business and earnings had been flat for over 10 years ---- hardly a cycle ---- and nothing known to the Corporation or any hypothetical buyer as of the valuation date predicted any kind of sustained upturn in the foreseeable future. The Tax Court's belief, grounded in that erroneous analysis of the business cycle, that a hypothetical buyer and seller would give asset value added weight, is likewise clearly erroneous.

34. See e.g., B. F. Sturtevant Co. v. Comm'r, 75 F.2d 316, 324 (1st Cir. 1935)(holding that good business judgment must prevail, "and a failure or refusal to exercise that judgment constitutes an error of law").

35. Cohan v. Comm'r, 39 F.2d 540, 544 (2d Cir. 1930) (L. Hand, J.) ("But to allow nothing at all appears to us inconsistent....The amount may be trivial and unsatisfactory, but there was a basis for some allowance, and it was wrong to refuse any....").

36. Fomented in significant part by myriad valuation challenges instituted by the IRS over the past decades, a full-fledged profession of business appraisers, such as the American Society of Appraisers, has emerged, generating its own methodology and lexicon in the process; which in turn have contributed to the profession's respect and mystique. Because ---- absent an actual purchase and sale ---- valuing businesses, particularly closely held corporations, is not a pure science replete with precise formulae and susceptible of mechanical calculation but depends instead largely on subjective opinions, the writings and public pronouncements (including expert testimony) of these learned practitioners necessarily contain some vagaries, ambiguities, inexactitudes, caveats, and qualifications. It is not surprising therefore that from time to time disagreements of diametric proportion arise among these practitioners. As the methodology we employ today may well be viewed by some of these professionals as unsophisticated, dogmatic, overly simplistic, or just plain wrong, we consciously assume the risk of

incurring such criticism from the business appraisal community. In particular, we anticipate that some may find fault with (1) our insistence (like that of the Estate's expert) that, in the asset-based approach, the valuing of the Corporation's assets proceed on the assumption that the assets are sold; and (2) our determination that, in this case, the likelihood of liquidation or sale of essentially all assets be factored into the weighting of the results of the two valuation approaches and not be considered as an integral factor in valuing the Corporation under either of those approaches. In this regard, we observe that on the end of the methodology spectrum opposite oversimplification lies over-engineering.

37. See 28 U.S.C. § 2412(d)(1)(B); I.R.C. § 7430(c)(4)(ii).

Eisenberg v. Commissioner

Full Text of Court Cases

Eisenberg v. Commissioner

Case name: Eisenberg v. Commissioner
Citation: 155 F.3d 50, 1998 U.S. App. LEXIS 20109
Date of decision: August 18, 1998
Country: US
State or Federal: Federal
State/Jurisdiction: 2nd Circuit
Court: United States Court of Appeals
Type of action: Estate and Gift Taxation
Judge: Carman
SIC: 6719 Offices of Holding Companies, NEC
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472

Keywords: Fair market value (FMV)

Counsel: Martin A. Stoll, New York, New York, for Petitioner-Appellant.

David I. Pincus, Tax Division, Department of Justice, Washington D.C., (Loretta C. Argrett, Assistant Att. Gen., Tamara W. Ashford, Attorney), for Respondent-Appellee.

Judges: Winter, Jacobs, Carman

n1 Honorable Gregory W. Carman, Chief Judge of the United States Court of International Trade, sitting by designation.

Opnion by: Carman

BACKGROUND

n2 The facts set forth below are drawn from the August 8, 1996 Stipulation of Facts agreed to by the parties and adopted in the Tax Court's opinion and order.

Appellant, Irene Eisenberg, owned all 1,000 shares of the issued and outstanding common stock of Avenue N Realty Corporation (the Corporation), its only class of stock. The Corporation, a C corporation n3 for tax purposes during 1991, 1992 and 1993, the years in issue, was organized under the laws of the State of New York. The Corporation's only fixed asset was a commercial building located at 4901-4911 Avenue N, Brooklyn, New York, which it owned and leased to third parties. The Corporation's only active trade or business was the rental of the building. The Corporation did not have plans to liquidate, or to sell or distribute the building.

n3 A "C" corporation refers to a corporation governed by the tax rules contained in subchapter C of the Internal Revenue Code. See 26 U.S.C. ¡× ¡× 301-385 (1988). Although the Corporation made an election, effective January 1, 1987, to be treated as a subchapter S corporation, its election was revoked on January 1, 1989. Thereafter, the Corporation was a C corporation.

In 1991, 1992 and 1993 appellant gifted shares of the Corporation to her son and two grandchildren. When valuing the stock for gift tax purposes, appellant reduced the value of the stock by the full amount of the capital gains tax n4 that she would have incurred had the Corporation liquidated, or sold or distributed its fixed asset. Appellant computed the potential capital gains tax by assuming hypothetical annual sales of the property, and the parties stipulated to the amount of capital gains that would have been realized from the hypothetical sales. n5

n4 The capital gains tax consists of the aggregated Federal Income Tax, New York State Franchise Tax on Business Corporations, and New York City General Corporation Tax (collectively the capital gains tax).

n5 The parties agreed that on the first transfer date, the fair market value of the property was $ 600,000, and the fair market value of the stock was $ 517.20 per share. The property's adjusted basis was $ 69,500. A hypothetical sale of the property would have led to a capital gain of $ 530,500. On the second transfer date, the fair market value of the property was $ 470,000, and the fair market value of the stock was $ 356.71 per share. The property's adjusted basis was $ 67,906. A hypothetical sale of the property would have led to a capital gain of $ 402,094. On the third transfer date, the fair market value of the property was $ 470,000, and the fair market value of the stock was $ 341.77 per share. The property's adjusted basis was $ 67,108. A hypothetical sale of the property would have led to a capital gain of $ 402,892. See Joint App. at A-25, A-27.

On July 18, 1995, appellant received a notice of deficiency from the Commissioner identifying deficiencies in gift tax of $ 20,157.99, $ 38,257.15 and $ 3,319.55 for the years 1991, 1992 and 1993, respectively. The deficiencies were based solely on the Commissioner's determination that the values reported on appellant's tax return should not have included reductions in the stock's value to account for potential capital gains tax liabilities. On September 5, 1995, appellant filed a petition in the United States Tax Court contesting the Commissioner's determination she was not entitled on her federal tax returns to reduce the fair market value of the gifted stock by the amount of capital gains tax the Corporation would have incurred if it were to liquidate, or to distribute or sell its commercial building.

The parties filed cross motions for summary judgment in August and September, 1996. The parties agreed that the net- asset-value method n6 was appropriate for valuing the gifted stock in this case, stipulated to a 25% minority discount, n7 agreed on the fair market value of the property and agreed on the valuation of the shares of stock as reported on petitioner's gift tax returns. The only issue between the parties, therefore, was the valuation reduction for the capital gains tax liabilities. n8

n6 Under the traditional "net asset value" method, the value of the underlying corporation is considered to be equal to the difference of the fair market value of the corporation's assets and its liabilities. See Andrews v. Commissioner, 1976 T.C. Memo 106, 35 T.C.M. (CCH) 459, 463 (1976).

n7 A minority discount reflects the lower value of minority shares due to the minority shareholder's inability to influence corporate decisions, such as a liquidation or the sale or distribution of the property.

n8 The valuation reduction for unrealized capital gains is the reduction claimed by the appellant with respect to each transfer date for the aggregated Federal Income Tax, New York State Franchise Tax on Business Corporations, and New York City General Corporation Tax.

On October 27, 1997, the Tax Court granted appellee's motion for summary judgment and denied appellant's motion, holding appellant was not entitled on her federal tax returns to reduce the fair market value of the shares of stock she gifted to her relatives by the amount of capital gains tax the Corporation would incur if it were to liquidate, or to sell or distribute its sole asset. The Tax Court held firmly-established precedent dictated no reduction in the value of closely held stock may be taken to reflect the potential capital gains tax liability where evidence fails to establish a liquidation or sale of the corporation or its assets is likely to occur, reasoning the tax liability is purely speculative. The Tax Court also found there was no showing that a hypothetical buyer would purchase the Corporation with a view toward liquidating the Corporation or selling its asset, such that the potential tax liability would be considered a material or significant concern.

On October 31, 1997, the Tax Court entered an order and decision finding deficiencies in gift tax due from appellant for the taxable years 1991, 1992 and 1993 in the amounts of $ 20,157.99, $ 38,257.15 and $ 3,319.55, respectively. Appellant challenges this order and decision.

This Court must decide whether, for gift tax purposes, appellant is entitled to reduce the fair market value of her C corporation stock to take into account potential capital gains tax liabilities that may be incurred if the Corporation liquidated, or distributed or sold its sole asset where no liquidation, sale or distribution was contemplated as of the stock transfer dates.

DISCUSSION

We review de novo a grant of summary judgment. Summary judgment is properly granted where no genuine issue of material fact exists and the movant is entitled to judgment as a matter of law. See, e.g., Briones v. Runyon, 101 F.3d 287, 291 (2d Cir. 1996). This Court has jurisdiction pursuant to 26 U.S.C. ¡× 7482(a)(1) (1994) and 28 U.S.C. ¡× 2106 (1994).

Section 2501 of the Internal Revenue Code imposes a gift tax "on the transfer of property by gift during [the] calendar year by any individual." 26 U.S.C. ¡× 2501(a)(1) (1988). Section 2512(a), which addresses the valuation of gifts, states, "if the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift." 26 U.S.C. ¡× 2512(a) (1988). In interpreting this provision, section 25.2512-1 of the Treasury Regulations on gift tax provides, "the value of the property is the price at

which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." 26 C.F.R. ¡× 25.2512-1 (1992).

The value of a gift on which a tax is paid is generally determined by ascertaining the fair market value of the property at the time the gift is transferred. Where, as here, the gift is stock, its value for gift tax purposes is the fair market value of the stock on the date of the transfer, and "all relevant facts and elements of value as of the time of the gift shall be considered." 26 C.F.R. ¡× 25.2512-1 (1992). For publicly traded stock, valuation can generally be based on market selling prices. See 26 C.F.R. ¡× 25.2512-2(b) (1992). For closely held corporations, such as Avenue N, for which there is no public trading market, valuation of stock is based on of a variety of factors. n9 In this case, the parties stipulated to the fair market value of the property and the shares of stock on each of the transfer dates. See supra, note 5.

> n9 Revenue Ruling 59-60 outlines the general approach, methods and factors to be considered in valuing the shares of stock of closely held corporations for estate and gift tax purposes. The ruling states:
>
> 3.01. A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. ... A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.
>
> Rev. Rul. 59-60, 1959-1 C.B. 237, 238.

Valuation Reduction for Unrealized Capital Gains

The Tax Court has consistently held, in valuing closely held stock using the net asset value method, that a special reduction of the value of the stock for potential capital gains tax liabilities at the corporate level is unwarranted where there is no evidence that a tax-triggering event, such as a liquidation or sale of the corporation's assets, is likely to occur. See, e.g., Ward v. Commissioner, 87 T.C. 78, 103-04 (1986) (finding when liquidation only speculative, costs of selling real estate and taxes that would be recognized upon liquidation not taken into account); Estate of Piper v. Commissioner, 72 T.C. 1062, 1087 (1979) (determining no discount for potential capital gains tax at corporate level where there is no evidence a liquidation of the investment companies was planned or could not have been accomplished without incurring capital gains taxes at corporate level); Estate of Cruikshank v. Commissioner, 9 T.C. 162, 165 (1947) (finding tax on appreciation to be "hypothetical and supposititious" because there was no demonstrated intent to liquidate assets, and in any case, liquidation could occur without taxing the corporation).

In the past, the denial of a reduction for potential capital gains tax liability was based, in part, on the possibility that the taxes could be avoided by liquidating the corporation. The law in this area, embodied in the Internal Revenue Code of 1954, was loosely based on the Supreme Court decision in General Utilities & Operating Co. v. Helvering, 296 U.S. 200, 80 L. Ed. 154, 56 S. Ct. 185 (1935), which held that a corporation did not recognize gain on a dividend distribution of appreciated property. Id. at 206. The General Utilities doctrine operated as an exception to the double taxation that applied to C corporations and their shareholders, i.e., taxation once at the corporate level and a second time at the shareholder level upon the distribution of corporate earnings to shareholders. See United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 452 n.2, 455, 94 L. Ed. 251, 70 S. Ct. 280 (1950) (finding "no gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition" and finding "a corporation may liquidate or dissolve without subjecting itself to the corporate gains tax, even though a primary motive is to avoid the burden of corporate taxation"). By employing the General Utilities doctrine, a corporation could liquidate and distribute appreciated or depreciated property to its shareholders without recognizing built-in gain or loss, and thus could circumvent double taxation. See 26 U.S.C. ¡× ¡× 311, 336, 337 (1958). n10

n10 Section 311 provided:

311. Taxability of corporation on distribution.

(a) General rule.

Except as provided in subsections (b) and (c) of this section and section 453(d), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of-

(1) its stock (or rights to acquire its stock), or

(2) property.

26 U.S.C. ¡× 311(a) (1958). Section 336 provided:

336. General rule.

Except as provided in section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.

26 U.S.C. ¡× 336 (1958). Section 337 provided:

337. Gain or loss on sales or exchanges in connection with certain liquidations.

General rule.

If-

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

> (2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,
>
> then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.
>
> 26 U.S.C. ¡× 337(a) (1958).

Tax Reform Act of 1986

These tax-favorable options ended with the enactment of the Tax Reform Act of 1986 (TRA), Pub. L. No. 99-514, ¡× 631, 100 Stat. 2085, 2269 (codified as amended in scattered sections of 26 U.S.C.), which abrogated the General Utilities doctrine for liquidations after 1986 and rejected tax principles that were more than half a century old. n11 The TRA removed a corporation's ability to avoid recognition of a gain on the distribution of appreciated property to its shareholders, irrespective of whether the gain occurred in a liquidating or nonliquidating context. n12 The TRA's abrogation of the General Utilities doctrine reflected an effort to preserve the integrity of the system of double taxation of corporate gain. n13 See H.R. Conf. Rep. No. 99-841, at 204 (1986), reprinted in 1986 U.S.C.C.A.N. 4075, 4292.

> n11 In addition to several explicit statutory exceptions, Congress created more and more exceptions to the general rule of non-recognition, especially with respect to gains on non-liquidating distributions of appreciated property. See Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders, ¡× ¡× 8.20, 8.21 (6th ed. 1998) (hereinafter Bittker) for further discussion of the legislative repeal of the General Utilities doctrine.
>
> n12 A liquidating distribution is a distribution by a corporation that is in complete liquidation of the entity's trade or business activities. A nonliquidating distribution is a payment made by a corporation to the entity's owner(s) when the entity's legal existence does not cease thereafter.
>
> n13 Congress offered this rationale:
>
> The General Utilities rule tends to undermine the corporate income tax. Under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property, thus assuring that a tax will eventually be collected on the appreciation. Where the General Utilities rule applies, assets generally are permitted to leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax. Thus, the effect of the rule is to grant a permanent exemption from the corporate income tax.
>
> Bitter, supra note 11, at ¡× 8.20 quoting H.R. Rep. No. 99-426, at 282 (1985) (footnote omitted)). Bittker notes the report also asserted that a pre-1986 discrepancy between the treatment of liquidating and nonliquidating distributions may have artificially encouraged corporate mergers and acquisitions, despite economic reasons for a different course of action. Id. at note 319.

The TRA amended 26 U.S.C. ¡× ¡× 336, 337 and 311 and added new provisions 26 U.S.C. ¡× ¡× 311(b) and 336(a) to provide for the corporate level recognition of gain on distributions or sales of appreciated property. Section 336(a), relating to complete liquidations, provides for the recognition of gain or loss to a corporation on the distribution of property in complete liquidation as if the property were sold at its fair market value. The statute states:

(a) General Rule

Except as otherwise provided in this section or section 337, gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.

26 U.S.C. ¡× 336(a) (1988). The statutory rule is subject to only a few exceptions and abrogates the General Utilities doctrine.

Section 311(b), relating to nonliquidating distributions, requires a corporation to recognize gain on nonliquidating distributions of appreciated property as if the corporation had sold the property for its fair market value except as to distributions in tax-free reorganizations and similar transactions. See Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders, ¡× 8.21 (6th ed. 1998). The statute specifically states:

(b) Distributions of appreciated property

(1) In general

If-

(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and

(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

26 U.S.C. ¡× 311(b) (1988).

Since it is a virtual certainty that capital gains tax will ultimately be realized in this case due to the changes brought about by the TRA, n14 the question before us is whether we agree with the reasoning of the Tax Court that the capital gains tax liability is too speculative to be valued as of the date of the gift where no liquidation, sale or distribution of the Corporation was planned.

> n14 Exceptions exist but they do not apply to the facts of this case. For example, a subchapter C corporation can avoid recognition of gain if the corporation converts to a subchapter S corporation and retains the assets for a period of ten years. See generally 26 U.S.C. ¡× ¡× 1374, 1374(d)(7) (1988). If a corporation is eligible for a subchapter S election, therefore, a technique does exist for avoiding recognition of gain. See, id.

Nevertheless, where there was no evidence of intent by a subchapter C corporation to convert to a subchapter S corporation, the Tax Court rejected the likelihood that a subchapter S election would be implemented. Estate of Davis v. Commissioner, 1998 U.S. Tax Ct. LEXIS 35, Daily Tax Report (BNA) No. 126, at K-12, K-19 (T.C. June 30, 1998). In Estate of Davis, the Court rejected the respondent's assumptions that the corporation could have avoided all built-in capital gains tax by having it elect S corporation status and by not permitting it to sell any of its assets for ten years where the record did not indicate it was likely the corporation would have converted to an S corporation and where the record did not establish that there was any other way as of the valuation date by which the corporation could have avoided the tax. Id.

In addition to a ten-year holding period possibly to avoid potential capital gains tax liability, an S corporation election may present other cumbersome consequences. See 26 U.S.C. ¡× 469 (limiting passive activity losses for active participation in a rental activity to a maximum of $ 25,000 per year related to the rental real estate and phasing out deduction for passive activity loss as the taxpayer's adjusted gross income reaches certain levels).

In any event, the practical remoteness of a subchapter C corporation converting to a subchapter S corporation and holding the assets for ten years would seem to be a matter that could easily be taken into account by those valuing the gift for gift tax purposes.

Appellant could also defer gain recognition indefinitely by having the Corporation retain the property and continue leasing it to third parties. This option, however, would not eliminate the fact that gain will be triggered by a sale or distribution in liquidation of the corporate property. The Corporation's sale of the property on any of the transfer dates (and on any future date) would produce gain to the Corporation under 26 U.S.C. ¡× 1001, which would subject the Corporation to taxes on the existing gain either in the year of sale, over a deferred period of years or both, depending on the terms of the sale. The Corporation's distribution of the property to its shareholders not in complete liquidation would also result in recognized gain to the Corporation under 26 U.S.C. ¡× 311(b), which would subject the Corporation to taxes on the existing gain in the year of the distribution. The Corporation's distribution of the property to its shareholders in complete liquidation would also result in recognized gain to the Corporation under 26 U.S.C. ¡× 336(a), which would subject the Corporation to taxes on the existing gain in the year of the distribution.

Determining Fair Market Value for Gift Tax Purposes

Appellant argues as a result of the abrogation of the General Utilities doctrine, Avenue N Realty Corporation cannot avoid the capital gains tax liability on the property and no willing buyer of the Corporation's stock would pay an amount that did not take into account a reduction in the stock's value for the amount of the potential capital gains tax. Appellant contends the cases relied upon by the appellee and the Tax Court have lost their vitality as a result of the TRA and argues any hypothetical willing buyer would likely reduce the purchase price by the tax, thereby justifying a discount for the built-in gain.

Appellee argues a hypothetical willing buyer still has the option of avoiding the imposition of capital gains tax through the purchase of corporate stock and the continuation of the business by leasing the property in question through the corporate form. Appellee also argues based upon the undisputed fact that Avenue N did not have a plan to liquidate, or to distribute or sell the appreciated building, appellant is not entitled to reduce the value of the corporate stock for gift tax purposes based on a purely speculative and uncertain event. Appellee maintains even if it were certain a hypothetical buyer would eventually cause the corporate level capital gains tax to be triggered, the amount of the eventual tax is too speculative to take into account because it would be impossible to determine currently when the tax-triggering event would take place and thus, what the capital gains tax rate would be. Appellee additionally maintains it cannot be known what the value of the property would be when the recognizing event occurs and whether the sale or distribution would result in a gain or loss.

We disagree with appellee's arguments and find appellant's contentions to be more persuasive. Appellee's argument that the best and most likely uses of the property are to continue indefinitely its current use or to make a subchapter S election are not supported by the evidence presented to us. Appellee cites numerous cases addressing the impact of contingent tax liability on fair market value, but the valuation dates in those cases precede the abrogation of the General Utilities doctrine, when corporations could still distribute appreciated assets to shareholders without an additional tax at the corporate level. See, e.g, Estate of Andrews v. Commissioner, 79 T.C. 938, 942 (1982); Estate of Piper, 72 T.C. at 1086-87; Estate of Cruikshank, 9 T.C. at 165.

While appellee argues that prior to the enactment of the TRA, courts disallowed discounts for contingent tax liability because they considered the tax liability to be too speculative, many courts also based their decisions on the ability of the corporation to avoid the corporate taxes altogether. See Estate of Piper, 72 T.C. at 1087 (disallowing a discount for potential capital gains tax at the corporate level where there was no evidence that a liquidation was planned or that it could not have been accomplished without incurring capital gains taxes at the corporate level and citing pre-TRA sections of the Code which allowed avoidance of capital gains taxes at the corporate level); Gallun v. Commissioner, 1974 T.C. Memo 284, 33 T.C.M. (CCH) 1316, 1321 (1974) (disallowing a discount because court found record did not establish management had any immediate plans to liquidate and that it was possible "that the management at some time in the future may dispose of certain or all of the investment assets without incurring a capital gains tax"); Estate of Cruikshank, 9 T.C. at 165 (disallowing a discount as based on "hypothetical and supposititious" tax liability since there was no demonstrated intent to liquidate assets, and, in any case, there could be a liquidation without tax at the corporate level). Now that the TRA has effectively closed the option to avoid capital gains tax at the corporate level, reliance on these cases in the post-TRA environment should, in our view, no longer continue.

As stated above, 26 U.S.C. ¡× ¡× 2501(a)(1) and 2512(a) impose a gift tax on property measured by the value of the property at the time of the gift. In this case, the parties agreed on the fair market value of the property and the shares of stock on the three transfer dates, but disagreed on the issue of whether, in determining the Federal gift tax value of the stock, a discount for the unrealized capital gains tax liability should reduce the fair market value. Fair market value is based on a hypothetical transaction between a willing buyer and a willing seller, and in applying this willing buyer-willing seller rule, "the potential transaction is to be analyzed from the viewpoint of a hypothetical buyer whose only goal is to maximize his advantage. ... Courts may not permit the positing of transactions which are unlikely and plainly contrary to the economic interest of a hypothetical buyer...." Estate of Curry v. United States, 706

F.2d 1424, 1428-29 (7th Cir. 1983) (citations omitted). Our concern in this case is not whether or when the donees will sell, distribute or liquidate the property at issue, but what a hypothetical buyer would take into account in computing fair market value of the stock. We believe it is common business practice and not mere speculation to conclude a hypothetical willing buyer, having reasonable knowledge of the relevant facts, would take some account of the tax consequences of contingent built-in capital gains on the sole asset of the Corporation at issue in making a sound valuation of the property.

We disagree with the Commissioner's reasoning that the critical point in this case is that there was no indication a liquidation was imminent or that "a hypothetical willing buyer would desire to purchase the stock with the view toward liquidating the corporation or selling the assets, such that the potential tax liability would be of material and significant concern." Eisenberg v. Commissioner, 1997 Tax Ct. Memo LEXIS 567, 74 T.C.M. (CCH) 1046, 1048-49, 1997 T.C. Memo 483 (1997). The issue is not what a hypothetical willing buyer plans to do with the property, but what considerations affect the fair market value of the property he considers buying. While prior to the TRA any buyer of a corporation's stock could avoid potential built-in capital gains tax, there is simply no evidence to dispute the fact that a hypothetical willing buyer today would likely pay less for the shares of a corporation because of the buyer's inability to eliminate the contingent tax liability. See John Gilbert, After the Repeal of General Utilities: Business Valuations and Contingent Income Taxes on Appreciated Assets, Mont. Law, Nov. 1995, at 5 (citing a 1994 study that analyzed the impact of contingent tax liability on a buyer of a private, closely-held corporation and concluded a large majority of buyers would discount the stock and negotiate a lower purchase price due to the existence of a contingent tax liability on the corporation's appreciated property).

A recent decision issued by the Tax Court further supports our reasoning in this case. In Estate of Davis, which examines whether to discount the value of stock to account for the corporation's built-in capital gains tax, both petitioner's and respondent's experts recommended the built-in capital gains tax be taken into account as a factor in ascertaining the fair market value of the stock in question, even though no liquidation of the corporation or sale of its assets was planned. See Estate of Davis v. Commissioner, 1998 U.S. Tax Ct. LEXIS 35, Daily Tax Report (BNA) No. 126, at K-17 (T.C. June 30, 1998). The Tax Court "rejected respondent's position that, as a matter of law, no discount or adjustment attributable to [the corporation's] built-in capital gains tax is allowable," id. at K-18, and noted the cases relied on by respondent involved valuation dates that preceded the abrogation of the General Utilities doctrine. The Court found even the respondent acknowledged that irrespective of whether a liquidation of the corporation or a sale of its assets was contemplated on the valuation date, "some reduction in value would be appropriate if, in fact, avoidance of a corporate level gains tax was not available." Id. (quotations omitted). The Court stated:

We are convinced on the record in this case, and we find, that, even though no liquidation of [the corporation] or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of [the corporation's] built-in capital gains tax. We are also persuaded on that record, and we find, that such a willing seller and such a willing buyer of each of the two blocks of [the corporation's] stock at issue would have agreed on a price on the valuation date at which each such block would have changed hands that was less than the price that

they would have agreed upon if there had been no ... built-in capital gains tax as of that date. ... We have found nothing in the ... cases on which respondent relies that requires us, as a matter of law, to alter our view. ...

Id. at K-19 (citations omitted). The Court allowed a discount for the built-in capital gains tax because "that is what a hypothetical willing seller and a hypothetical willing buyer would have done." Id. at K-20. n15

> n15 An example set forth in Bittker also illustrates this point. In the example, A owns 100% of the stock of X corporation, which owns one asset, a machine with a value of $ 1,000 and a basis of $ 200. Bittker assumes a 25% tax rate and points out that if X sells the machine to Z for $ 1,000, X will pay tax of $ 200 on the $ 800 gain. Bittker adds that if Z buys the stock for $ 1,000 "on the mistaken theory that the stock is worth the value of the corporate assets," Z will have lost $ 200 economically "because it paid too much for the stock, failing to account for the built-in tax liability (which can be viewed as the potential tax on disposition of the machine, or as the potential loss from lack of depreciation on $ 800 [of] basis that Z will not enjoy)." Bittker, supra Note 11, at ¡× 10.41[4]. Because of Z's loss, Bittker concludes, "Z will want to pay only $ 800 for the stock, in which event A will have effectively 'paid' the $ 200 built-in gains tax." Id. One might conclude from this example that the full amount of the potential capital gains tax should be subtracted from what would otherwise be the fair market value of the real estate. This would not be a correct conclusion. In this case, we are only addressing how potential tax consequences-the capital gains tax- may affect the fair market value of the shares of stock appellant gifted to her relatives in contrast to the fair market value of the real estate.

Further, we believe, contrary to the opinion of the Tax Court, since the General Utilities doctrine has been revoked by statute, a tax liability upon liquidation or sale for built-in capital gains is not too speculative in this case. Courts previously have allowed discounts for built-in capital gains if, among other factors, payment of tax on a capital gain is likely. See, e.g., Obermer v. United States, 238 F. Supp. 29, 34-36 (D. Haw. 1964) (finding expert testimony showed built-in capital gains tax would necessarily adversely affect value of stock at issue to willing buyer, and in allowing discount, contrasted the facts with Estate of Cruikshank, 9 T.C. 162, a case relied on by appellee); see generally Clark v. United States, 1975 U.S. Dist. LEXIS 12312, No. 1309, 1309, 1975 WL 610, at 4, 5 (E.D.N.C. May 16, 1975) (stating a well-informed willing buyer of stock in corporation would consider that underlying assets of corporation included inactive investment portfolio that, upon liquidation, would incur substantial capital gains tax liability).

Although the Tax Court in this case held that "the primary reason for disallowing a discount for capital gains taxes in this situation is that the tax liability itself is deemed to be speculative," Eisenberg, 74 T.C.M. (CCH) at 1048, we disagree. We believe that an adjustment for potential capital gains tax liabilities should be taken into account in valuing the stock at issue in the closely held C corporation even though no liquidation or sale of the Corporation or its assets was planned at the time of the gift of the stock. We therefore remand this matter to the Tax Court to ascertain the gift tax to be paid by the taxpayer consistent with this opinion. n16

n16 Where there is a relatively sizable number of potential buyers who can avoid or defer the tax, the fair market value of the shares might well approach the pre-tax market value of the real estate. Potential buyers who could avoid or defer the tax would compete to purchase the shares, albeit in a market that would include similar real estate that was not owned by a corporation. However, where the number of potential buyers who can avoid or defer the tax is small, the fair market value of the shares might be only slightly above the value of the real estate net of taxes. In any event, all of these circumstances should be determined as a question of valuation for tax purposes.

CONCLUSION

For the reasons stated above, we vacate the order and decision of the Tax Court granting respondent's motion for summary judgment and denying petitioner's motion for summary judgment and remand this case to the Tax Court to determine the gift tax liability of the appellant-taxpayer consistent with this opinion.

ESTATE OF JAMES A. ELKINS, JR., DECEASED, MARGARET ELISE JOSEPH AND LESLIE KEITH SASSER, INDEPENDENT EXECUTORS, PETITIONERS *v*. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 16597–10. Filed March 11, 2013.

D owned undivided fractional interests in 64 works of contemporary art.

1. *Held*: In valuing certain of those fractional interests, pursuant to I.R.C. sec. 2703(a)(2) we disregard D's agreement by which he waived his right to institute a partition action with respect to some of the works of art and thereby relinquished an important use of his fractional interests in those works.

2. *Held*, *further*, the total fair market value of D's interests in the art determined. *See* I.R.C. sec. 2031.

Donald Frederick Wood, *J. Graham Kenney*, *Harry M. Reasoner*, *Stacey N. Vu*, and *Juliana D. Hunter*, for petitioners.

Warren P. Simonsen, *Sharyn M. Ortega*, and *Susan S. Hu*, for respondent.

HALPERN, *Judge*: By notice of deficiency issued to petitioners (notice), respondent determined an estate tax deficiency of $9,068,265. Petitioners (Ms. Sasser and Ms. Joseph) are the coexecutors of the Estate of James A. Elkins, Jr. (estate), and are decedent's daughters. Their brother, James A. Elkins III (James III), who was also a coexecutor of the estate, died on June 10, 2010, less than a month after respondent issued the notice, and will not be replaced as a

coexecutor. The issue to be decided is the total fair market value of decedent's undivided fractional interests in 64 works of art, which interests are includable in decedent's gross estate.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for 2006, the year in which decedent died, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Residence

When they filed the petition, petitioners resided in Houston, Texas.

The Art

Decedent (sometimes, Mr. Elkins) and Mrs. Elkins purchased 64 works of art (sometimes, when referenced collectively, art) between 1970 and 1999. Mr. and Mrs. Elkins purchased all 64 works during their marriage. The art became community property under Texas law. The art principally consists of works of contemporary art. The collection includes works by a number of famous artists, including Pablo Picasso, Henry Moore, Jackson Pollock, Paul Cezanne, Jasper Johns, Ellsworth Kelly, Cy Twombly, Robert Motherwell, Sam Francis, and David Hockney. Both before and since decedent's death, on February 21, 2006 (valuation date), the art has been displayed primarily in decedent and Mrs. Elkins' family home and at the family office, both in Houston, Texas. Some works are at various other locations in the Houston area or, in one instance, Galveston, Texas. Those other locations are homes belonging to petitioners and to Virginia Arnold Elkins, the widow of James III. One work is on loan to the Museum of Fine Arts, Houston. None of the 64 works have been sold since decedent's death.

Creation of Fractional Interests in the Art

The GRIT Art

On July 13, 1990, Mr. and Mrs. Elkins each created a grantor retained income trust (GRIT) funded by each's undivided 50% interests in three of the works in the collection:

a large Henry Moore sculpture, a Pablo Picasso drawing, and a Jackson Pollock painting (GRIT art).[1] Each trust was for a 10-year period, during which the grantor retained the "use" of the transferred interests in the art. At the conclusion of the 10-year period, each grantor's interests were to go to the Elkinses' three children, which, in effect, would give them 100% ownership of the GRIT art, one-third each.

Mrs. Elkins died on May 19, 1999, before the expiration of the 10-year period of her GRIT. Pursuant to the terms of her GRIT, her 50% undivided interests in the GRIT art passed to Mr. Elkins. Because Mr. Elkins survived the 10-year term of his GRIT, his original 50% undivided interests in the GRIT art passed to his three children in equal shares so that each received 16.667% interests in the GRIT art. Decedent retained the 50% interests in the GRIT art that he received upon Mrs. Elkins' death, which constitute part of his gross estate.

Decedent and the Elkins children executed a lease agreement (art lease) covering two of the three works of GRIT art (the Picasso drawing and the Pollock painting), made effective "as of the 13th day of July, 2000" (the expiration date of decedent's GRIT). Under the art lease, the Elkins children leased their combined 50% interests in the two works to decedent, in effect allowing him to retain year-round possession of those works. There was an initial lease term, with automatic extensions, unless decedent opted out of an extension, which he never did. Section 10 of the art lease provides, in relevant part, as follows: "*Sale*. Lessors and Lessee each agrees not to sell his or her percentage interest in any item of the * * * [leased artwork] during the Initial Term or any Additional Term without the joinder of * * * [the parties to the art lease] for the purpose of selling the item * * * in its entirety." Section 13 states that the lease and the parties' "rights, duties and obligations" under it "may not be transferred or assigned" without the consent of all parties and that, subject to that restriction on assignment, the lease "shall be binding upon and inure to the benefit of Lessors and Lessee and their respective heirs, representatives, successor and assigns."

[1] Mr. and Mrs. Elkins partitioned their community property interests in the GRIT art before creating the GRITs.

The rent due under the lease was left blank in the original agreement and was not computed until May 16, 2006, when Deloitte LLP made a determination of the appropriate monthly rental for the two works. That determination resulted in a finding of rent due of $841,688 for the period from July 13, 2000, through the valuation date. The estate sought to deduct its payment of that amount to the Elkins children. On audit, the parties agreed to reduce the amount of that deduction to $10,000, the propriety of which is not at issue herein.

The Disclaimer Art

Under Mrs. Elkins' will, her 50% community property interests in the other 61 works of art passed outright to decedent. Mr. Elkins decided, however, to disclaim a portion of those interests equal in value to the unused unified credit against estate tax, *see* sec. 2010, available to Mrs. Elkins' estate so that the disclaimed portion could pass to the Elkins children free of estate tax. On the basis of appraisals obtained by Mrs. Elkins' estate, decedent disclaimed a 26.945% interest in each of the 61 works (disclaimer art). Pursuant to Mrs. Elkins' will, those fractional interests passed to the Elkins children, one-third each. As a result, each child received an 8.98167% interest in each item of the disclaimer art, and the balance, a 23.055% interest in each item, passed to decedent. Thus, decedent retained a 73.055% interest in each item of the disclaimer art (his original 50% interest plus the additional 23.055% interest received from Mrs. Elkins that he did not disclaim).

On February 14, 2000, shortly after decedent executed his partial disclaimer, decedent and the Elkins children entered into a "Cotenants' Agreement" (cotenants' or original cotenants' agreement) relating to the disclaimer art. In relevant part, the cotenants' agreement provides as follows:

> This Agreement is made as of the 25th day of February, 2000, by and among James A. Elkins, Jr., Margaret Elise Joseph, James A. Elkins, III and Leslie Keith Elkins (hereinafter referred to individually as "*Cotenant*" and collectively as "*Cotenants*"), all of Houston, Texas.
>
> WHEREAS, each Cotenant is the owner of an undivided interest in each item of property described in Exhibit A attached hereto and made a part hereof (hereinafter, all of such property or any part thereof shall be referred to as the "*Property*").

WHEREAS, Cotenants desire to clarify certain of their responsibilities and duties related to the use, possession and care of the Property.

NOW THEREFORE, in consideration of the above and of the mutual covenants contained herein, Cotetants hereby agree as follows:

1. Beginning on the date of this Agreement, each Cotenant shall have the right of possession, dominion, and control of each item of the Property for a total number of days out [of] a twelve month period that is equal to his or her percentage interest in such item times the number of days in such twelve month period. During a short calendar year, the number of days to which a Cotenant is entitled to possession, dominion and control of each item of the Property shall be prorated.

2. Each Cotenant, with respect to the exercise of his or her right of possession, dominion, and control, shall request possession of an item of the Property by giving 30 days' written notice of such request to the Cotenant in possession of such item. The notice shall specify the number of days to which such Cotenant is entitled to possession and the number of days remaining thereof during the twelve month period (or a fewer number of months for a short calendar year). In the event of a conflict among the Cotenants at any time as to which Cotenant is entitled to possession of an item of the Property, Cotenant James A. Elkins, Jr. shall determine which Cotenant is entitled to possession and the number of days remaining thereof.

3. The Cotenant requesting possession (the "Receiving Cotenant") of an item of the Property shall be responsible for arranging and paying for the transport of such item to the Receiving Cotenant's residence.

* * * * * * *

6. Each Cotenant shall be responsible, to the extent of his or her percentage interest in the Property, for the cost of maintaining and restoring the Property.

7. An item of the Property may only be sold with the unanimous consent of all of the Cotenants. Any net proceeds from the sale of such item shall be payable to the Cotenants in accordance with their respective percentage interests in the Property.

8. This Agreement shall be binding on Cotenants and on their respective heirs, personal representatives, successors and assigns.

9. This Agreement shall be governed and construed under the laws of the State of Texas.

After decedent's GRIT terminated on July 13, 2000, the parties to the cotenants' agreement amended it (amended cotenants' agreement or, when not differentiating between the original and amended agreements, cotenants' agreement), effective as of that date, by incorporating therein one of the three works of GRIT art (the large Henry Moore sculpture that was not included in the art lease). On February 17,

2006, the Elkins children signed the amended cotenants' agreement, both for themselves and (under a January 28, 2000, power of attorney) for decedent.

Decedent's Will

Decedent's will provides that his descendants inherit his personal and household effects, which included his undivided fractional ownership interests in the art. Decedent's residuary estate passed to the James A. Elkins, Jr. and Margaret W. Elkins Family Foundation (Elkins Foundation), a bequest that entitles the estate to a charitable contribution deduction under section 2055. The will provides that all estate taxes, plus any interest and penalties, due by reason of decedent's death (but not including taxes due with respect to the assets in Mrs. Elkins' marital trust includable in decedent's gross estate under section 2044) shall be charged against his residuary estate. Thus, any additional estate taxes payable by the estate as a result of this case will correspondingly reduce the distribution to the Elkins Foundation and the charitable contribution deduction with respect thereto.

Decedent's Estate Tax Return

Petitioners timely filed a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (estate tax return), on May 21, 2007, in which they reported a Federal estate tax liability of $102,332,524. Schedule F, Other Miscellaneous Property Not Reportable Under Any Other Schedule, included in decedent's gross estate his 73.055% interests in the 61 works of disclaimer art that were subject to the original cotenants' agreement, valued at $9,497,650, and his 50% interests in the three works of GRIT art (two of which remained subject to the art lease on the valuation date), valued at $2,652,000. Those amounts were derived by, first, determining decedent's pro rata share of the fair market value of the art as determined by Sotheby's, Inc., and, then, applying a 44.75% combined fractional interest discount (for lack of control and marketability), as determined by Deloitte LLP, to those pro rata share amounts. The parties have stipulated a total (undiscounted) fair market value, as of the valuation date, of $24,580,650 for the dis-

claimer art and $10,600,000 for the GRIT art.[2] A list of the 64 works of art, their status as GRIT art or disclaimer art, and the stipulated fair market value of each work is attached to this Opinion as appendix A.

Notice

In the notice, respondent determined that decedent's gross estate included his 73.055% interests in the disclaimer art at an undiscounted fair market value of $18,488,504[3] and his 50% interests in the GRIT art at an undiscounted fair market value of $5,300,000. As alternative bases for his using undiscounted values of decedent's fractional interests in the art in computing decedent's taxable estate, respondent determined that (1) the restrictions on the sale of art subject to the cotenants' agreement and fractional interests in art subject to the art lease constituted "an option, agreement, or other right to acquire or use such artwork at a price less than the fair market value" and, alternatively, "a restriction on the right to sell or use the decedent's interest in such artwork" so that, pursuant to section 2703(a)(1) and (2), respectively, decedent's interests in the art covered by those agreements "should be valued without regard to" those restrictions; (2) "the discounts used in calculating the fair market value of Decedent's fractional interests in * * * [the art] are overstated and no discount is appropriate." In addition, because decedent's will provided that all estate taxes were to be paid out of his residuary estate passing to the Elkins Foundation, the notice reduces the deduction for the charitable bequest to that foundation by the amount of the proposed estate tax deficiency, i.e., by the amount of additional estate tax payable by the estate.

[2] Sotheby's had derived a date-of-death fair market value of $23,530,650 for the disclaimer art and $9,600,000 for the GRIT art.

[3] That amount is 73.055% of $25,307,650 rather than of $24,580,650, which is the parties' stipulated undiscounted fair market value for the disclaimer art. Thus, the parties now appear to agree that the undiscounted fair market value of decedent's 73.055% interests in the disclaimer art is $17,957,393 (73.055% of $24,580,650), not the $18,488,504 determined in the notice.

Petition

In response to the notice, petitioners timely filed the petition. In it, petitioners, in addition to assigning error to the deficiency determined by respondent, seek a refund of estate tax based upon the estate's (1) overvaluation of the art, (2) entitlement to a greater charitable contribution deduction than claimed on the return in an amount equal to the estate tax refund arising out of its overvaluation of the art, and (3) entitlement to deductions for attorney's, accountant's, and appraisal fees and other administration expenses in excess of the amounts estimated on decedent's estate tax return. [4]

Petitioners' Experts

In defense of their proposed discounts in valuing decedent's fractional interests in the art, petitioners offered the testimony of three expert witnesses.

David Nash

The first, David Nash, has been an appraiser and seller of fine art for over 48 years. He worked at Sotheby's, Inc., for 35 years, was a member of the IRS Art Advisory Panel, and has appraised works for collectors and museums, including the Metropolitan Museum of Art, the Museum of Modern Art, the Art Institute of Chicago, and the National Gallery of Art. The Court accepted Mr. Nash as an expert in the art market, the marketability of art, and art valuation, and we received his written report into evidence as his direct testimony.

In November 2008, before attempting to value decedent's fractional interests in the art as of the valuation date, Mr. Nash viewed each of the 64 works in Houston and met with the Elkins children. He came away from that meeting convinced that any buyer of decedent's interests in the art would have to take into account the fact that the children (whom he refers to as "the other shareholders") are "committed to retaining the art in the family until the last shareholder dies." He was asked to assess the marketability of decedent's

[4] The estate's entitlement to an additional deduction for administration expenses is not at issue herein.

interest in each work "rather than viewing the collection as a whole."

He states, preliminarily, that collectors, museums, dealers, art funds, and other investors or speculators constitute the categories of potential buyers for a work of art. He describes auction houses as retailers on consignment, not as purchasers. He then considers each as a potential buyer of decedent's fractional interests in the art. His analysis is informed by the expert report submitted by William T. Miller (discussed *infra*), regarding the expense and likelihood of a successful partition action with respect to the works subject to the cotenants' agreement.

In general, Mr. Nash concludes that all categories of potential buyers of fine art would demand steep discounts from pro rata fair market value for decedent's fractional interests in the art and that auction houses simply do not market fractional interests in fine art, a fact that, in and of itself, would have "a significant [adverse] impact on the marketability of * * * [decedent's fractional] Interests."

Mr. Nash reasons that a collector would be put off by the uncertainty of his ever being able to acquire the whole work, potential disputes with the Elkins children over periods of possession or, alternatively, over his right to sell a particular work and his recognition that, probably, there would be comparable works by the same artist that he could purchase outright. Mr. Nash states that the collector's only motivation for buying a fractional interest in one of the works of art, even at a steep discount, would be "the expectation or hope that the work is so desirable that it will increase in value over time and that eventually it will be possible to sell the whole or acquire all of the outstanding shares".

Mr. Nash states that it is "highly unlikely" that a museum would pay "anything close [to] the pro rata value of the fractional share where they will never know if or when they will be able to obtain full control" and that he did not "know of any situation where a museum has ever paid for a fractional interest in a work of art or a collection * * * [with] no assurance * * * [of ever acquiring] full ownership." He notes, however, that it is common for two museums to jointly purchase a work (or works) of art and take turns exhibiting the work(s) in proportion to their interests. He concludes, however, that museums would not be interested in purchasing

joint interests in art where the coowners would be the Elkins children rather than another museum or institution.

Mr. Nash similarly concludes that dealers, investors, and art funds would have little interest in buying decedent's fractional interests, mainly because of the difficulty in reselling them to collectors or museums, and that the "logistical difficulties and potential litigation would also be unappealing." He notes that it is "common practice" among dealers to jointly purchase artworks with the goal of reselling the works in their entirety but that, because of the Elkins children's determined refusal to sell any of the works outside the family, that option is essentially a nonstarter in this case.

Mr. Nash summarizes the "key factors" making decedent's fractional interests in the art "unappealing" to potential buyers as follows: (1) the inability to sell the art at auction houses, (2) the lack of exclusive possession and the inability to force a sale of the art without litigation against the Elkins children as coowners, (3) possible litigation involving time of possession and proper care, storage, or transportation of the art, and (4) the difficulty or impossibility of insuring the purchased interest or using it as collateral for a loan. Nonetheless, he concludes that speculators "would be willing to purchase * * * [decedent's] interests if appropriately discounted."

In determining the discounted fair market value of decedent's fractional interest in each of the 64 works of art, Mr. Nash divides those works into three categories, which he identifies as categories I–III.

Category I consists of five works that he characterizes as "highly desirable". He states: "Collectors, Dealers, Investors and Museums might be willing to invest in * * * [those] works * * * due to * * * [their] rarity and importance". The five works range in stipulated fair market value from a high of $8 million (Jasper Johns' Figure 4) to a low of $1.5 million (Robert Motherwell's Elegy to Spanish Republic #134), and Mr. Nash's discounts from the pro rata fair market value of decedent's interests in those works are between 50% and 80%.[5]

[5] For two of the works, Mr. Nash determines a range of discounted values for decedent's fractional interests therein. Mark L. Mitchell is another

Continued

Category II consists of 19[6] works for which, according to Mr. Nash, "alternate choices could be found and purchased outright * * * [noting that the artworks] are good examples, but not masterpieces by the artist and the artist's reputation is more or less on the same level as in Category I, but will include some artists who might not be so internationally recognized." Mr. Nash concludes that, for those works, "a potential buyer would demand a discount of approximately 80–90% of the pro rata value."

Mr. Nash describes the remaining 40 works, which he places in category III, as "not worth the risk at any level", and he opines that "a potential buyer would demand a discount of approximately 95% of the pro rata value" so that "[a]s a result, these interests have only a nominal value." In reaching that conclusion he notes that, although the works "have a real international value, * * * neither the works themselves nor their creators are in the masterpiece category." He does single out five of the works as having "relatively high underlying values" but concludes that decedent's fractional interests in them still had only nominal values because comparable works by the same artists were readily available, in some cases for less money than the stipulated pro rata fair market values of the examples contained in the Elkins family collection.

On the basis of the foregoing, Mr. Nash finds the discounted fair market value of decedent's interests in the art to be as follows:

Category I	$4,336,859
Category II	976,451

of petitioners' expert witnesses, whose valuations of the 64 works of art (based, in part, on Mr. Nash's report) are the valuations upon which petitioners rely herein. For each of the two works for which Mr. Nash determined a range of values, Mr. Mitchell adopts the mean between the high and low ends of the range as Mr. Nash's discounted value of decedent's interests.

[6] Mr. Nash lists 1 of the 19 works (Franz Kline's The Hill) as a category II work on an exhibit listing and categorizing all 64 works, but he inexplicably omits that work from an exhibit separately listing the category II works. He does, however, state that "40 interests are in Category III", and, because 5 category I, 19 category II, and 40 category III works total the 64 works under consideration, we conclude that Mr. Nash did, in fact, intend to include the Kline in category II.

Category III	149,056
Total	5,462,366

William T. Miller

William T. Miller is licensed to practice law in Texas, and he has been a member of the Texas Bar since 1968. As an attorney he has been involved in a number of partition actions in Texas and has had experience with receivers and agents for liquidating personal property, including works of art. The Court accepted Mr. Miller as an expert on the nature, procedure, time, and cost of partition actions litigated in the Texas courts and received his written report into evidence as his direct testimony, with modifications agreed to by the parties.

Mr. Miller is of the opinion that, in Texas, the "right to partition is absolute" and protected by statute but that "it is also well settled that cotenants 'may expressly or impliedly agree not to partition'". (Citation omitted.) He assumes, for purposes of his report, that paragraph 7 of the cotenants' agreement, requiring unanimous consent of the coowners to the sale of any art, "is, in essence, an agreement * * * not to partition", that, therefore, the coowners "impliedly waived their right [under Texas law] to partition", that that agreement, under Texas law, would be binding on the coowners of the art, but that a Texas court would strike paragraph 8 of the agreement, which binds "heirs, personal representatives, successors and assigns" to the terms thereof (leaving the rest of the agreement intact), as "an invalid restraint on alienation". Alternatively, he notes that the court might choose to "reform" paragraph 8 so that it would "terminate after a reasonable period of time", e.g., the lives of the coowners. Mr. Miller opines that, in any event, "the enforceability of the Cotenants Agreement will be a litigated issue in the Partition Actions." He does not view that fact as a "material element", however, as regards "the procedure, time and costs of a * * * partition action." Like Mr. Nash, Mr. Miller was "instructed that the interests in each Work of Art must be valued individually", with the result that he assumes a separate partition action for each work to be "the standard in determining costs and attorneys' fees."

Mr. Miller states that, if the cotenants' agreement is held to be enforceable, "any further partition action would be prohibited", but he assumes, for purposes of his report, that it would be held to be unenforceable so that partition actions "would proceed through a sale of the Work of Art." He describes the various steps and procedures of Texas partition actions and concludes that a partition by sale of the art (with a division of the proceeds among the coowners) is more likely than a partition in kind (which would involve a time-sharing agreement among the coowners) because the latter "would mean * * * indefinite court supervision." He posits that an adversarial partition action would culminate in a public or private sale of the art by a court-appointed receiver, although the buyer of decedent's fractional interests in the art would be "subject to the risk that his interest could be sold at a sheriff's sale * * * [, which] would substantially reduce the amount that might be recovered".

Mr. Miller states that, most likely, any partition action with respect to the art would entail a two-step procedure: a trial to determine (1) the enforceability of the cotenants' agreement, (2) whether partition by sale or in kind is appropriate, (3) the coowners' interests, (4) whether the art is susceptible to partition, and (5) whether to appoint a receiver for any sale of the art, followed by a second trial to determine the terms of any proposed sale, the property to be sold, the method of sale, and the distribution of proceeds among the coowners. He opines that the first trial would take 18 to 24 months and the second, an additional 12 to 18 months. He states that both decisions would be appealable, that each appeal could take an additional 18 to 24 months, and that it was possible, under Texas law, to suspend the sale of any piece of art subject to litigation during the entire appeal process. Thus, assuming appeals (and, worst case, assuming an appeal of the first decision to the Texas Supreme Court, which could take an additional 6 to 12 months), the entire process before the Texas courts could take anywhere from 6 to 9½ years for each partition action, averaging 7 years in duration. Mr. Miller limits that timeframe to litigation involving "the more expensive Works of Art" (pro rata value in excess of $650,000, which would encompass 9 of the 64 works and 8 of the 62 works of cotenant art), reasoning that "a second appeal would not occur" with respect to the less

valuable works (pro rata value below $650,000) because litigation costs would exceed the values of the works. For those works, he estimates a timeframe of three to four years for each partition action.

Mr. Miller estimates that a buyer of decedent's fractional interest in any of the more expensive works would have $650,000 in total legal and receiver fees in a partition action for a court-ordered sale of the works. For works with a pro rata fair market value between $250,000 and $650,000, Mr. Miller reduces that amount to $250,000. For the rest of the works, he assumes fees equal to the pro rata value of each work "because no 'willing buyer' would expend more in litigation than the value of * * * [the purchased fractional interest]". Mr. Miller notes that there would be additional costs for sales commissions, appraisal fees, and auction house fees. Lastly, Mr. Miller assumes that a receiver would take possession of the art so that there would be additional costs for crating, moving, and storing the art, as well as costs for insurance.

In summary, Mr. Miller assumes that, for a hypothetical buyer instituting a partition action with respect to any one of the more valuable works of art in the Elkins family collection, the total costs for legal fees and other expenditures, could be anywhere from $25,000 to over $1,100,000 (for Jasper Johns' Figure 4) from trial through the appeal process.

Mark L. Mitchell

Petitioners' third and final expert witness, Mark L. Mitchell, testified in his capacity as director of valuation services for Clothier & Head, P.S., of Seattle, Washington. He holds a B.S. and an M.B.A. degree from Southern Methodist University and is experienced in providing valuation consulting services in litigation support situations, including tax litigation. He has testified on behalf of the Commissioner and has completed numerous assignments in valuing intangible assets; e.g., patents, trademarks, and trade names. His work has included the valuation of assets where there was no active or regular market, including the valuation of undivided interests in property, but not including (until this assignment on behalf of petitioners) works of art. The Court

accepted Mr. Mitchell as an expert in the valuation of undivided interests in personal property and received the Clothier & Head, P.S. report, prepared by Mr. Mitchell, in evidence as Mr. Mitchell's direct testimony.

Mr. Mitchell states that, in reaching his valuation conclusions, he relied on Mr. Nash's report as the source for the stipulated, undiscounted fair market values of the 64 works of art and for "insight into the potential market for the Undivided Interests", and on Mr. Miller's report regarding partitioning rights and costs related to partition actions including "costs associated with a legal challenge of the Cotenants' Agreement". His final valuation conclusions are based upon those two reports, his analysis of the economics of the art market, and his quantitative methodology.

Mr. Mitchell states that, unlike pure consumption or pure financial assets, art provides both a psychic and financial return to the investor, and, because of that, an art buyer will accept lower financial returns, including less liquidity and certain additional costs (e.g., insurance, maintenance), than will buyers of pure financial assets. He reasons that that is truer of collectors than it is of speculators, who do not seek a psychic benefit and, therefore, normally, will pay less than collectors.

After describing the cotenants' agreement and the nature of an undivided (fractional) interest in a work of art, Mr. Mitchell notes that the limitations that both have on the owner of an undivided interest in any of the 62 works subject to the (amended) cotenants' agreement (e.g., lack of control, limited use of the art as collateral, the need for a lengthy and expensive partitioning process before any sale, a limited market for such interests) justify "substantial" discounts. He also states that "the absence of transaction data involving the fractional ownership of art does not suggest that discounts do not exist for undivided interests in art." Instead, he views the circumstance as "evidence * * * that there are very few willing buyers of such interests, not that there is a limited number of willing sellers."

Mr. Mitchell states that there are two options for the holder of an undivided interest in art (holder) to monetize his holding (absent unanimous consent of all undivided interest holders): option 1, a sale of his undivided interest or, option 2, a successful partition action ultimately leading to a sale of

the work and pro rata distribution of the proceeds among all interest holders.

According to Mr. Mitchell, under option 1, the holder and the hypothetical willing buyer would consider a number of adverse factors in arriving at a price for the holder's undivided interest in any one of the 62 works of art subject to the amended cotenants' agreement, including the need to obtain unanimous consent of all cotenants to sell the work of art, limited possession of the art and, hence, reduced psychic benefit, the cost of transporting the art from another cotenant, joint responsibility for insurance, maintenance or restoration costs with respect to the work of art, and risk of damage to the art by other cotenants, all of which would induce a prospective collector-buyer to demand a substantial return premium (i.e., discount) related to the reduction of both the buyer's psychic and financial returns attributable to fractional ownership. The need for an enhanced return premium would mean a substantial reduction in value from pro rata fair market value. The speculator-buyer's exclusive reliance on marketability (i.e., financial return) means that his financial return premium would be significantly higher than the collector's.

With respect to option 2, Mr. Mitchell concludes that the dollar amount of any discount must exceed anticipated partition litigation costs to make the investment worthwhile. He also notes that, because a partition action will most likely provide a strictly financial outcome (share of proceeds of a court-ordered sale of the art), the buyer will have abandoned any psychic benefit and, therefore, is necessarily a speculator, not a collector.

In valuing decedent's undivided interest in each work of art, Mr. Mitchell assumes, on the basis of the Nash and Miller reports, that the other interest holders have no desire to sell the art so that, under option 1, the hypothetical buyer "faces the prospect of holding a non-marketable interest * * * [indefinitely], with no prospects for * * * [monetizing his interest] and no ability to control decisions regarding the underlying * * * Art", and, under option 2, he is, in effect, purchasing a "litigation claim".

Mr. Mitchell then notes that, because art collectors do not purchase art with the primary intent to profit on a later sale thereof, despite the greater volatility and risk associated

with art as compared with alternative investments (e.g., Government bonds or stock), the financial returns on the former are generally lower than they are on the latter. That apparent anomaly is explained by the psychic benefit that the art collector derives from the art.

On the basis of his analysis of the Nash report, the expected holding period for the art, rates of return data from various art research studies, and anticipated inflation, Mr. Mitchell determines that an option 1 hypothetical buyer of an undivided interest in art would expect a nominal financial return for art in general of 6% and, in this case, need an 8% "consumption return" in order to compensate for diminished psychic benefit. To that 14% incremental return Mr. Mitchell would add "an increment to account for impaired marketability and other risk factors." He concludes that an assumed 10-year holding period "is a reasonable basis on which to assess discounts" and, in general, would require an additional 2% rate of return resulting in a 16% total required rate of return for the hypothetical option 1 buyer (10% "return premium" and 6% financial return), assuming a 10-year holding period for the purchased interest in the art.

Mr. Mitchell modifies the 16% overall rate of return he deems necessary for an option 1 hypothetical buyer's purchase of an interest in art subject to the restrictions the buyer would face in this case in order to account for the varying quality of the works included in the Elkins collection. For that purpose, he adopts Mr. Nash's division of those works into three categories.

Relying on Mr. Nash's opinion of the category I works, Mr. Mitchell differentiates them from his baseline return estimates by reducing his 10% return premium to 8% for works by Jackson Pollock and Henry Moore and increasing it to 12% for works by Sam Francis and Robert Motherwell and 14% for a work by Jasper Johns. He also reduces the required financial return for the Johns work from 6% to 4% because of its fragile condition and the potential ill effects of shared ownership on such a work. Those adjustments result in an overall 14% required rate of return for the Pollock and the Moore and an overall 18% required rate of return for the other three category I works. Using those rates of return, Mr. Mitchell arrives at a 51.7% discount from pro rata fair market value for decedent's interests in the Pollock and the

Moore, a 65.8% discount for decedent's interests in the Francis and the Motherwell, and a 71.7% discount for decedent's interests in the Johns.

Relying on Mr. Nash's description of the category II works, Mr. Mitchell increases the return premium from 10% to 14% and the overall required rate of return from 16% to 20% resulting in a 71.1% discount from pro rata fair market value for decedent's interests in the 19 category II works.

Again, relying on Mr. Nash's description of the remaining (category III) works, Mr. Mitchell increases the return premium to 18% and reduces the financial return to 4% resulting in an overall 22% required rate of return and a 79.7% discount from pro rata fair market value for decedent's interests in those works.

For option 2 buyers, Mr. Mitchell, relying on Mr. Miller's report, factors in the added costs and anticipated duration of partition litigation and posits a 14% required annual rate of return for all category I works (except for the Johns work) and for five of the category II works. For the Johns work, Mr. Mitchell posits an 18% required rate of return, again because of its fragility (which he states "would tend to make the issues * * * with respect to shared ownership [e.g., in-transit damage to the work] more severe") and the high cost of the investment. On the basis of those required rates of return, he computes the option 2 discounts for the art as follows: for decedent's interests in the category I works and five of the category II works, discounts ranging from 60% to 85%; for his interests in the balance of the category II works, a discount of 90% plus, and for his interests in all category III works a 100% discount, presumably on the theory that the costs of litigation would exceed the sale price of all category III works.

Finally, Mr. Mitchell selects the lesser of the option 1 versus option 2 discounts as the appropriate discount for decedent's interest in each work of art.[7] On the basis of those discounts, he determines the discounted fair market value for decedent's interest in each work of art. Mr. Mitchell finds the total discounted fair market value of decedent's interests in the art to be as follows:

[7] With respect to all but two of the works of art, the option 1 discount is lower.

Category I	$5,150,420
Category II	1,904,117
Category III	604,108
Total	7,658,645

That total, although greater than the $5,462,366 total discounted fair market value computed by Mr. Nash, is much less than the $12,149,650 total discounted value for decedent's interests in the art reported on Schedule F of decedent's estate tax return. It is the difference between that last amount and Mr. Mitchell's discounted total fair market value amount that constitutes the basis for the bulk of petitioners' claim for refund in the petition, the balance being attributable to the increase in the charitable contribution deduction arising by virtue of the refund relating to the estate's alleged overvaluation of the art on its return.

A copy of Mr. Mitchell's table of all 64 works of art, the Nash category of each work, Mr. Mitchell's option 1 and option 2 discounts, his concluded discount for each work, and the resulting discounted fair market value of each is attached to this Opinion as appendix B.

Respondent's Experts

Karen Hanus-McManus

Since 2006, Karen Hanus-McManus has been employed by Jacqueline Silverman & Associates, Inc. (Associates), as an associate appraiser. Before that, she held several positions with the Museum of Contemporary Art, Los Angeles, and, since 2009, she has been an adjunct professor at the New York University School of Continuing & Professional Studies, teaching a course entitled "Essentials of Appraising" for which she developed the course materials. She has a B.A. degree in art history from the University of California, Los Angeles, and two M.A. degrees (in art history and museum studies) from Syracuse University. Since 1977, her employer, Associates, has specialized in the appraisal of modern and contemporary art, preparing thousands of appraisals in numerous contexts including appraisals for estate tax purposes, donations to museums, and legal disputes. Ms. Hanus-McManus has also conducted a study on secondary markets for fractional interests in art. She is the sole author of her

written report in this case, although she conferred with Jacqueline Silverman, president of Associates, who edited, proofread, and cosigned the report. The Court accepted Ms. Hanus-McManus as an expert appraiser of modern and contemporary art and received her written report into evidence as her direct testimony.

Ms. Hanus-McManus testified that the market for modern and contemporary art operates on two levels: the primary market, created by the artist or his or her agent, and the secondary market, controlled by art galleries and dealers and auction houses. On the basis of (1) Associates' more than 30 years' experience observing the primary and secondary markets for modern and contemporary art, (2) conversations with art gallery personnel, dealers, auction houses, banks, and art world professionals, and (3) her survey of 40 art dealers and galleries in New York, Los Angeles and other U.S. cities, Ms. Hanus-McManus concludes that "there is no established marketplace for the sale of a partial interest in a work of art." She notes that there are dealer-to-dealer sales of fractional interests in art in what she refers to as "the wholesale market" but that such a sale would be made in connection with an agreement between the dealers to sell the whole work at a profit and split the proceeds. She further concludes that, while there are sales of fractional interests in art, they involve coowners who intend to sell or donate the entire work of art at a later date and, therefore, are not germane to the hypothetical sale of fractional interests in this case. She admits, however, to having no experience with the buying or selling habits of pure speculators who deal in art without regard to its aesthetic quality.

John R. Cahill

John R. Cahill is an attorney practicing in New York as a partner in the law firm Lynn & Cahill. More than 80% of his practice is devoted to legal matters concerning clients involved in art including auction houses, museums, artists, art galleries, art collectors and dealers, appraisers, banks, insurance companies, and foundations. He represents clients in both litigation and transactional planning and counsels them on a variety of art-related matters. He also chairs the Art Law Committee of the New York City Bar Association.

The Court accepted Mr. Cahill as an expert in art transactions and received his written report into evidence as his direct testimony.

On the basis of caselaw and his own observations of museum-related and commercial transactions involving joint ownership of art, Mr. Cahill concludes: "In my opinion, the Sale Restriction and related terms in the Cotenant's Agreement, Amendment to Cotenants Agreement and Art Lease are not comparable to similar arrangements entered into by persons in arms length art market transactions."[8]

OPINION

I. *Introduction*

We must determine the fair market value of decedent's interest in each of 64 works of art for Federal estate tax purposes. Those interests were included in decedent's gross estate and reported on decedent's estate tax return at a total value of $12,149,650. On the basis of the expert testimony of three experts, and, in particular, Mr. Mitchell's expert testimony, petitioners now argue that that total value must be reduced to $7,658,645. The parties have stipulated that the total, undiscounted fair market value of the art on the valuation date was $35,180,650 ($24,580,650 for the disclaimer art and $10,600,000 for the GRIT art), and respondent bases his proposed deficiency herein on his view that that undiscounted value, to the extent it is allocable pro rata to decedent's interest in each of the 64 works of art (i.e., to the extent of 73.055% of the disclaimer art, or $17,957,393, and 50% of the GRIT art, or $5,300,000, a total of $23,257,393[9]),

[8] Mr. Cahill's conclusion supports respondent's argument that the sale restrictions in the cotenants' agreement and the art lease do not satisfy the requirements of sec. 2703(b)(3). That provision constitutes one of the three requirements of the sec. 2703(b) exception to the application of sec. 2703(a)(2), which generally mandates that "any restriction on the right to sell or use * * * property" be ignored in determining the value of any property for estate and gift tax purposes. *See* discussion *infra*. Petitioners concede that neither the cotenants' agreement nor the art lease satisfies the sec. 2703(b) exception. Therefore, we agree with petitioners that Mr. Cahill's report is not germane to the issues in this case.

[9] On brief, respondent argues that the total stipulated fair market value of decedent's interests in the art on the valuation date is $23,788,504. But, given the parties' stipulated agreement that the value of 100% of the art

constitutes the value of decedent's interests in the art for Federal estate tax purposes.

II. *Burden of Proof*

In general, a taxpayer bears the burden of proof. Rule 142(a)(1). However, section 7491(a) shifts the burden of proof to the Commissioner in certain situations if the taxpayer raises the issue, introduces credible evidence with respect to any factual issue relevant to ascertaining the proper tax liability, and demonstrates compliance with the applicable requirements of section 7491(a)(2).

The parties stipulate that the estate has satisfied the section 7491(a)(2) requirements, and petitioners argue that, through the expert testimony of Messrs. Nash, Miller, and Mitchell and through Ms. Sasser's testimony, they have presented credible evidence of value, thereby shifting the burden of proof to respondent pursuant to section 7491(a).

Because we base our decision regarding the value of decedent's interests in the art upon a preponderance of the evidence, it is not necessary that we assign the burden of proof. *See, e.g.*, *Estate of Black v. Commissioner*, 133 T.C. 340, 359 (2009); *Estate of Bongard v. Commissioner*, 124 T.C. 95, 111 (2005). [10]

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on that date was $35,180,650 divided between $10,600,000 for the GRIT art and $24,580,650 for the disclaimer art, the undiscounted fair market value of decedent's interests in the art cannot exceed $23,257,393 (50% of $10,600,000, or $5,300,000, plus 73.055% of $24,580,650, or $17,957,393). Therefore, we view respondent's argument for a greater stipulated value for decedent's interests in the art, presumably based upon the agent's valuations on audit, as an inadvertent oversight, and we give it no credence. *See supra* note 3.

[10] Although we agree with respondent that it is unnecessary to assign the burden of proof, we reject respondent's reliance on *Estate of Jelke v. Commissioner*, T.C. Memo. 2005–131 (and cases cited therein), *vacated and remanded on another issue*, 507 F.3d 1317 (11th Cir. 2007), as requiring that result. In those cases, there was deemed to be no need to assign the burden of proof because the operative facts were fully stipulated and supplemented solely by expert witness testimony. Here, there is disputed fact testimony furnished by Ms. Sasser.

III. *Law*

A. *General Principles*

Section 2001(a) imposes a tax on "the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." Section 2031(a) provides: "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."

Fair market value is the standard for determining the value of property for Federal estate tax purposes. *United States v. Cartwright*, 411 U.S. 546, 550–551 (1973). Section 20.2031–1(b), Estate Tax Regs., defines fair market value as "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 to sell and both having reasonable knowledge of relevant facts." It then states that the fair market value of an item of property is not "to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public" and that, "in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail." The regulation requires that "[a]ll relevant facts and elements of value as of the applicable valuation date shall be considered in every case." The willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the actual buyer or seller. *See Estate of Newhouse v. Commissioner*, 94 T.C. 193, 218 (1990) (citing *Estate of Bright v. United States*, 658 F.2d 999, 1006 (5th Cir. 1981)). The hypothetical willing buyer and seller are presumed to be dedicated to achieving the maximum economic advantage. *Id.*

B. *Expert Opinions*

In deciding valuation cases, courts often look to the opinions of expert witnesses. Nonetheless, we are not bound by the opinion of any expert witness, and we may accept or

reject expert testimony in the exercise of our sound judgment. *Helvering v. Nat'l Grocery Co.*, 304 U.S. 282, 295 (1938); *Estate of Newhouse v. Commissioner*, 94 T.C. at 217. Although we may largely accept the opinion of one party's expert over that of the other party's expert, *see Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. 441, 452 (1980), we may be selective in determining what portions of each expert's opinion, if any, to accept, *Parker v. Commissioner*, 86 T.C. 547, 562 (1986). Finally, because valuation necessarily involves an approximation, the figure at which we arrive need not be directly traceable to specific testimony if it is within the range of values that may be properly derived from consideration of all the evidence. *Estate of True v. Commissioner*, T.C. Memo. 2001–167 (citing *Silverman v. Commissioner*, 538 F.2d 927, 933 (2d Cir. 1976), *aff'g* T.C. Memo. 1974–285), *aff'd*, 390 F.3d 1210 (10th Cir. 2004).

C. *Section 2703*

As noted *supra* note 8: (1) section 2703(a)(2) provides that, for estate and gift tax purposes, the value of any property is determined without regard to any restriction on the right to sell or use such property, (2) section 2703(b) provides that section 2703(a) does not apply to disregard a right or restriction if it meets certain requirements, and (3) petitioners concede that neither the cotenants' agreement nor the art lease satisfies the section 2703(b) exception. Thus, the section 2703 issue herein is whether the restrictions on transferability in the cotenants' agreement and the art lease are restrictions "on the right to sell or use * * * property" within the meaning of section 2703(a)(2). [11]

[11] Although the notice invokes both sec. 2703(a)(1) and (2) as alternative bases for denying any discount in valuing decedent's fractional interests in the art, and although respondent generally invokes the application of sec. 2703, he emphasizes the application of sec. 2703(a)(2). In fact, because neither the cotenants' agreement nor the art lease provides an option, agreement, or other right to acquire property at a bargain price, sec. 2703(a)(1), by its terms, is inapplicable. Therefore, the only sec. 2703 issue for our decision is whether sec. 2703(a)(2) applies herein.

IV. *Summary of the Parties' Arguments*

A. *Respondent*

1. *Introduction*

Respondent argues that no discount from the pro rata fair market value of decedent's interest in each of the 64 works of art is warranted. Respondent sets forth two grounds for that argument: (1) the restrictions on sale in the cotenants' agreement and the art lease are restrictions that must be disregarded under section 2703(a)(2), and (2) because the proper market in which to determine the fair market value of fractional interests in works of art is the retail market in which the entire work (consisting of all fractional interests) is commonly sold at full fair market value, a fractional interest holder (being entitled to a pro rata share of the sale proceeds) is not entitled to any discount for his or her interest.

2. *Application of Section 2703(a)(2)*

In support of the application of section 2703(a)(2) respondent states:

> In view of the irrefutable evidence that the only way to sell a fractional interest in artwork is by selling the entire art by agreement or through a partition action filed with the court, the only apparent reason for including the restriction on sale language in the Cotenants' Agreement and the Art Lease Agreement * * * was to reduce the value of Decedent's retained fractional interests in the Artwork as part of a plan to make a testamentary transfer of his remaining interests in the Artwork to his children at a reduced transfer tax rate—a purpose which section 2703 was specifically intended to prevent.

Respondent concludes that the restrictions on sale in paragraph 7 of the cotenants' agreement and section 10 of the art lease "are restrictions that are controlled by section 2703" and, accordingly, they must be disregarded in determining the value of decedent's fractional interests in the art.

3. *Use of Undiscounted Pro Rata Fair Market Value in Valuing Decedent's Interests in the Art*

In support of his valuation argument, in which he concludes that no discount is warranted with respect to decedent's interests in the art, respondent states that the

Elkins children's opposition to any sale of the art "is not material" in the light of section 20.2031–1(b), Estate Tax Regs. In so arguing, respondent focuses on that regulation's admonition that "an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market", must be valued at "the price at which the item or a comparable item would be sold at retail." Respondent finds additional support for his view in the testimony of Ms. Hanus-McManus, who concludes that, as of the valuation date, "the sale of an undivided fractional interest in a work of art was not an established practice in the art market, and no service, venue or marketplace exists today for an owner of an undivided fractional interest in a work of art to sell his/her share in that work."

Respondent also cites Mr. Nash's testimony that he could not recall ever advising a client to sell a fractional interest in art at a discount, and that he himself had never done so. Respondent states, however, that "[j]ust because there is no direct market for fractional interests in artwork * * * does not mean that * * * fractional interests in artwork are not bought and sold every day." Respondent concludes that the lack of evidence of discounted sales of fractional interests in art supports his position that "fractional interests in artwork are only sold as part of a sale where the entire interest in the artwork is sold", typically by coowners who know each other and who act in concert when purchasing and selling their respective fractional interests, either by direct sale to a buyer who acquires 100% ownership of the art or, assuming coownership of several works, after a partition in kind or by sale. In either event, the sale results (or, if several works are involved, the sales result) in a fair market value price, and each coowner receives a pro rata share of the proceeds. Thus no fractional interest discounts are warranted.

Respondent does note that, in the case of a particularly valuable item of personal property, "a stranger/speculator could perhaps be found to buy a fractional interest * * * for a deeply discounted price." He argues, however, that "this type of a transaction simply does not occur and even if there have been a few of these unrecorded transactions", they do not reflect the retail market in which we are required to value decedent's fractional interests in the art pursuant to section 20.2031–1(b), Estate Tax Regs.

Although his principal argument is that, as a matter of law, no discount is permissible in valuing undivided fractional interests in art, respondent also argues that, as a factual matter, petitioners' proffered discounts are unsupported by the evidence; i.e., by the testimony of their three experts.

He views Mr. Nash's discounts as having been based on unrealistic scenarios, faulty methodology, and a failure to properly account for the interests of the hypothetical seller by improperly positing the seller's position in the context of a forced sale. Because he views Mr. Nash's proposed discounts as without any justifiable basis, respondent concludes that they are essentially guesses.

He argues that, by referring to "general court statistics" not specific to the timespan for partition actions relating to art and by basing his opinions on a "worst case scenario", Mr. Miller overstated both the time for and costs of a partition action with respect to the art. Respondent further argues that Mr. Miller, because he was instructed to consider partition-related costs in terms of a separate partition action for each work of art, improperly failed to consider the likelihood of and the costs associated with a single action for partitioning the entire collection in kind. On a more fundamental level, respondent rejects the notion of any discount from fair market value based upon anticipated partition costs, arguing that such costs are selling expenses, which, if shown to exist, may constitute deductible administration expenses under section 2053(a).

He criticizes Mr. Mitchell's valuations principally on the ground that Mr. Mitchell considered the hypothetical buyer of decedent's interests in the art to be a speculator, uninterested in obtaining the psychic benefits of owning art, thereby, eliminating "approximately 60 percent of the value of the Artwork that a normal purchaser would pay for the Artwork."

Finally, respondent argues that a determination that a discount is appropriate in valuing decedent's fractional interests in the art would be inconsistent with the Commissioner's longstanding position that fractional interests in art are not discounted for purposes of valuing charitable contributions thereof under section 170. See, for example, Rev. Rul. 58–455, 1958–2 C.B. 100, and Rev. Rul. 57–293, 1957–2 C.B. 153, both of which involve the transfer of either a fractional

interest or a remainder interest in a work of art to a section 170(c) organization, and both of which determine the value of the gift without requiring any discount.

B. *Petitioners*

1. *Application of Section 2703(a)(2)*

Petitioners argue that section 2703(a)(2) does not apply to the cotenants' agreement because paragraph 7 thereof restricts only the sale of any of the 62 works of art covered by that agreement (cotenant art). It does not restrict the sale of a cotenant's or coowner's fractional interest in the work, and it is decedent's fractional interests in the cotenant art, not the art itself, that must be valued for Federal estate tax purposes.

As respondent notes in his opening brief, petitioners do not oppose the application of section 2703(a)(2) to the two works of GRIT art subject to the art lease (leased art); i.e., they do not argue that the restriction on sale provision in section 10 of the art lease gives rise to a discounted value for those two works. Petitioners' failure to so argue is based, presumably, on the fact that that restriction (unlike the restriction in paragraph 7 of the cotenants' agreement) is a restriction on the sale of each party's "percentage interest in" the two works; i.e., it is a restriction, on the right to sell property that must be valued for Federal estate tax purposes. We interpret petitioners' silence in this regard as an admission that, pursuant to section 2703(a)(2), we must value decedent's interests in the leased art without regard to the restriction on sale provision in section 10 of the art lease.

2. *Propriety of Petitioners' Discounts With Respect to the Art*

Petitioners argue that they have fully supported the discounts they seek herein for decedent's interests in the art as they have "provided extensive evidence of facts that would be known to a hypothetical willing buyer and * * * seller with reasonable knowledge of relevant facts, as required by * * * [section 20.2031–1(b), Estate Tax Regs.]". Petitioners reject respondent's assertion that *any* discount would contravene the cited regulation. They argue that "Mr. Mitchell's valuation conclusions fully take into account the risks and

impairments to value" inherent in the hypothetical buyer's alternative options (i.e., option 1: hold the purchased fractional interest for enjoyment, appreciation, and eventual sale of the art; option 2: institute an immediate partition action against the Elkins children), and that "he properly relied on the expert reports of Mr. Nash and Mr. Miller in doing so."

Petitioners argue that caselaw (and, in particular, caselaw arising in the Court of Appeals for the Fifth Circuit, to which an appeal of this case normally would lie) mandates the application of discounts when valuing fractional interests in personal property, including art. Petitioners also argue that, in determining the appropriate valuation discount, the cases take into consideration anticipated costs associated with a partition of the property.

Presumably in defense of Mr. Miller's cost analysis based upon a separate partition action for each work of art, petitioners state that the applicable regulations mandate that decedent's fractional interest in each work be valued separately, citing section 20.2031–1(b), Estate Tax Regs. (value determined with reference to "each unit of property"), and section 20.2031–6(a), Estate Tax Regs. (stating the need to provide a separate valuation for "each article" of household and personal effects). Therefore, petitioners conclude that decedent's fractional interests in the art "cannot be valued * * * as a collection; separate hypothetical buyers and sellers must be posited for each Work." They further state that, because the art does not form "a cohesive collection * * * [with a] unifying theme, there is no factual basis * * * for assuming that a single buyer would be interested in purchasing all of the art."

V. *Analysis*

A. *Application of Section 2703(a)(2) to the Cotenant Art*

1. *Introduction*

Should we determine that the restriction on sales of cotenant art in paragraph 7 of the cotenants' agreement constitutes a restriction on the right to sell or use "property" within the meaning of section 2703(a)(2), we must disregard that restriction in valuing decedent's interests in that art.

2. *Analysis*

As noted *supra*, respondent argues that the foregoing restriction on sales of cotenant art constitutes a restriction that must be disregarded under section 2703(a)(2) on the ground that "the only apparent reason for * * * [its inclusion in the cotenants' agreement] was to reduce the value of Decedent's retained fractional interests in the Artwork as part of a plan * * * [to reduce estate taxes]", which respondent characterizes as "a purpose which section 2703 was specifically intended to prevent."

The evidence with respect to intent is inconclusive. The cotenants' agreement was entered into in February 2000, six years before decedent's death in February 2006, and paragraph 7 may have been intended only to keep the art in the family unless there was a work that no one wished to retain. Of greater significance, however, is the fact that section 2703(a)(2) does not refer to intent as a controlling or even relevant factor. The only question is whether the property to be valued, for estate or gift tax purposes, is subject to a restriction on sale or use.

Petitioners argue that, because paragraph 7 of the cotenants' agreement does not restrict the sale of decedent's fractional interests in the cotenant art (the property to be valued for estate tax purposes), section 2703(a)(2) is inapplicable. In connection with that argument, petitioners point to the definitional reference to the term "property" in the cotenants' agreement, which, in pertinent part, states that "[e]ach cotenant is the owner of an undivided interest in each item of property described in Exhibit A [listing the works of art] * * * (hereinafter, all of such property or any part thereof shall be referred to as the 'Property')". Petitioners argue that, although "property" under the foregoing definition "could refer to one, several, or all of the 62 Works in their entirety, under no interpretation does * * * [it] refer to a fractional interest in the Works." Respondent disagrees. He reads the foregoing language, and, in particular, the reference to "any part" of the property as a reference to the cotenants' undivided fractional interests in the cotenant art.

We think that both petitioners' and respondent's analyses miss the mark. During trial, we queried Mr. Miller, petitioners' expert on partition, about paragraph 7 of the coten-

ants' agreement. We pointed out to him that, for a sale of any of the jointly owned properties (i.e., works of art) to occur, *all* of the cotenants would have to agree, and that would be so independent of the language of paragraph 7 of the cotenants' agreement. He agreed. We added: "So that the statement that an item of property may only be sold with the unanimous consent of all of the cotenants is a rather unremarkable statement of the obvious." He responded: "I do agree." With respect to what the language of paragraph 7 accomplished, he testified: "If this language was not in the co-tenancy agreement, any individual interest owner would have the right to commence a partition action." That is in accord with his direct, written testimony, wherein he states that the right to partition is absolute, although cotenants may expressly or impliedly agree not to partition, and that he has "assumed that Provision 7 * * * is, in essence, an agreement by the Co-Owners not to partition." With exceptions not here relevant, section 2703(a)(2) instructs that "the value of any property shall be determined without regard to * * * any restriction on the right to sell or use such property." Whether paragraph 7 of the cotenants' agreement is a restriction on decedent's right to sell the cotenant art or is a restriction on his right to use the cotenant art is not important. It is clear that, pursuant to paragraph 7 of the cotenants' agreement, decedent, in effect, waived his right to institute a partition action, and, in so doing, he relinquished an important use of his fractional interests in the cotenant art. While, as we shall explain, it makes little or no difference to our conclusion as to the value of the art, we shall, in determining the value of each of the items of cotenant art, disregard any restriction on decedent's right to partition.

3. *Conclusion*

We hold that section 2703(a)(2) is applicable to the restriction, in paragraph 7 of the cotenants' agreement, on sales of cotenant art.

B. *Whether and the Extent to Which the Estate Is Entitled To Discount Decedent's Interests in the Art*

1. *Introduction*

Our determination that section 2703(a)(2) negates the restriction on sales of cotenant art in paragraph 7 of the cotenants' agreement, coupled with petitioners' concession that section 2703(a)(2) negates the restriction on sales of the lessor's and lessee's interests in the leased art contained in section 10 of the art lease, leaves the hypothetical willing seller and buyer in the same negotiating position with respect to decedent's interests in all 64 works of art. That is because, as a result of those section 2703(a)(2) determinations, neither the cotenants' agreement nor the art lease may be read as restricting the hypothetical seller's right to sell decedent's interests in the subject art, but the hypothetical buyer's ability to monetize those interests on an undiscounted basis remains subject either to the coowners' (i.e., the Elkins children's) agreement to a sale of the underlying art and a pro rata splitting of the proceeds of sale or to the need to institute a partition action in order to achieve that result.[12]

In resolving the parties' dispute over the proper valuation of decedent's interests in the art, we first address the question of whether any discount from pro rata fair market value is permissible under section 20.2031–1(b), Estate Tax Regs., and, if the answer to that question is yes, we must then determine the proper amount, if any, of that discount.

2. *Whether Any Discount Is Permissible*

a. *Analysis*

Respondent's argument that no discount is warranted in valuing decedent's fractional interests in the art is premised

[12] The parties have not addressed whether the hypothetical seller would constitute a "successor" to decedent's interests in the disclaimer art and the leased art pursuant to sec. 8 of the cotenants' agreement and sec. 13 of the art lease. Nor have they addressed how the hypothetical seller's status as such might affect the value of his or her interests in the art. We do not consider that to be a significant valuation issue, however, because, whether or not the hypothetical seller constitutes a "successor" to decedent's interests under either agreement, no sale of the underlying art can occur without either the consent of the Elkins children, which, presumably, would not be forthcoming, or a successful partition action.

essentially on his view that, (1) under section 20.2031–1(b), Estate Tax Regs., the fair market value of tangible personal property must be determined with reference to the market in which the property is most commonly sold to the public and, (2) in the case of art, that market is the retail market whereby all fractional interest holders agree to sell (or sell after a partition action) the underlying art, i.e., where the art is sold for its undiscounted fair market value, after which each fractional interest holder receives his or her pro rata share of the proceeds.

In support of his position, respondent cites *Estate of Scull v. Commissioner*, T.C. Memo. 1994–211, and *Stone v. United States*, 99 A.F.T.R.2d (RIA) 2007–2992 (N.D. Cal. 2007), *supplemented by* 100 A.F.T.R.2d (RIA) 2007–5512 (N.D. Cal. 2007), *aff'd*, *Stone ex rel. Stone Trust Agreement v. United States*, 103 A.F.T.R.2d (RIA) 2009–1379 (9th Cir. 2009).

In *Stone*, the District Court rejected the plaintiffs' proffered 44% fractional interest discount for the decedent's 50% interest in 19 paintings on the ground that a hypothetical seller would seek to sell each entire work of art (with the coowners' consent or via partition) and take his or her pro rata share of the proceeds or sell the partial interest at a price equivalent thereto. On that basis, the District Court concluded that, "because an undivided interest holder has the right to partition, a hypothetical seller under no compulsion to sell would not accept any less for his or her undivided interest than could be obtained by splitting proceeds in this manner." *Stone*, 99 A.F.T.R.2d (RIA) at 2007–2996. The District Court did, however, decide that "some discount is appropriate to allow for the uncertainties involved in waiting to sell the collection until after a hypothetical partition action is resolved". *Id.* at 2007–2998 (citing *Estate of Scull v. Commissioner*, T.C. Memo. 1994–211). In its supplemental opinion, the District Court determined that the "relatively low" 5% discount proposed by the Government was appropriate in the absence of proof by the plaintiffs that they were entitled to more than a 2% discount to account for selling costs plus a $50,000 discount to account for the hypothetical seller's legal fees in connection with any partition action. Moreover, the District Court was not persuaded that a hypothetical buyer would refuse to buy the decedent's interest in

the collection unless the discount were greater than 5%. *Stone*, 100 A.F.T.R.2d (RIA) at 2007–5514.

In *Estate of Scull*, the decedent died owning a 65% undivided interest in a "pop" and minimalist art collection that he and his wife had accumulated before their divorce. In connection with divorce-related litigation in the New York State courts, there was a court-ordered in-kind division of the collection (65% to the decedent, 35% to Mrs. Scull) that did not go into effect before the decedent's death. Thirty days after the decedent's death, Mrs. Scull appealed that decision, seeking a 50% share of the collection. Just before his death, the decedent had also appealed an earlier New York State appellate court decision sustaining the imposition of constructive trusts on the collection for Mrs. Scull's benefit.

The estate argued that the value of the decedent's 65% interest in the collection was less than 65% of the entire collection. We noted that "[a]ny purchaser of * * * [the estate's] interest in the collection as of * * * [the date of the decedent's death] would consider * * * [Mrs.] Scull's rights in the collection and * * * [the decedent's] pending appeal on the date of death." We then stated as follows:

> However, since * * * [the decedent's] appeal, if successful, would have increased his share, that appeal does not provide any basis for a reduction. Moreover, since * * * [Mrs.] Scull's appeal came later, it probably should not be taken into account. In any event, given the trial court's detailed explanation of its basis for its determination of the 65–35 split, we think that a purchaser would not require a reduction in excess of 5 percent for any uncertainties involved in acquiring decedent's 65-percent interest, despite one or both appeals. * * *

Thus, on the facts of that case, we allowed a 5% valuation discount from pro rata fair market value.

We fail to see how either *Stone* or *Estate of Scull* supports respondent's position. In both cases, the court approved a discount from pro rata fair market value for the decedent's fractional interest in an art collection in order to account for various uncertainties that would confront a hypothetical buyer of the art. Although the 5% discount approved in each case was essentially nominal, that was because of a lack of proof that any greater discount was warranted, not because of any regulatory prohibition against discounts for art that is normally sold at retail. Moreover, the District Court in *Stone* agreed with the plaintiffs that, "contrary to the government's

assertions, the costs of a court-ordered partition must be considered in determining the fair market value of the Estate's interest in the collection." *Stone*, 99 A.F.T.R.2d (RIA) at 2007–2997. That position was based, primarily, on the District Court's view that it could not "assume that the Estate's co-owner in the [art] collection [the estate's trustees actually owned the entire collection] would agree either to a sale of the collection as a whole or to a division of the nineteen paintings among the co-owners." *Id.* at 2007–2997 through 2007–2998. The District Court's refusal to personalize the circumstances surrounding a hypothetical sale was based upon the admonition of the Court of Appeals for the Ninth Circuit in *Propstra v. United States*, 680 F.2d 1248, 1251–1252 (9th Cir. 1982), that the willing seller must be "a hypothetical seller rather than the estate or any of decedent's beneficiaries" and that defining fair market value in terms of that "objective standard" will serve to avoid

> the uncertainties that would otherwise be inherent if valuation methods attempted to account for the likelihood that estates, legatees, or heirs would sell their interests together with others who hold undivided interests in the property. Executors will not have to make delicate inquiries into the feelings, attitudes, and anticipated behavior of those holding undivided interests in the property in question. * * *

Accord Estate of Bonner v. United States, 84 F.3d 196, 198 (5th Cir. 1996); *Estate of Bright v. United States*, 658 F.2d at 1006;[13] *see also Holman v. Commissioner*, 601 F.3d 763, 775 (8th Cir. 2010), *aff'g* 130 T.C. 170 (2008).

In this case, not only, as stated by the District Court in *Stone*, 99 A.F.T.R.2d (RIA) at 2007–2998, are we not entitled to assume that the Elkins children "would agree either to a sale of * * * [the art] or to a division * * * [thereof] among

[13] *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982), and *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), both constitute a rejection of the "family attribution" or "unity of ownership" principle, which takes into account the close relationship among the decedent, executor, or legatee, on the one hand, and the other coowners of real or personal property, on the other hand, in valuing the decedent's minority interest in the property. The Government's argument, rejected by the Court of Appeals for the Ninth Circuit in *Propstra*, was that, in the absence of a showing that such parties, if related, were likely to sell their interests separately, "one can reasonably assume" that those interests, including the decedent's interest, will be sold as a unit. *Propstra*, 680 F.2d at 1251–1252.

the co-owners", but, unlike the circumstances in *Propstra* and *Estate of Bright*, we are presented with unchallenged facts demonstrating that the Elkins children had strong sentimental and emotional ties to each of the 64 works of art so that they treated the art as "part of the family". Those facts strongly suggest that a hypothetical buyer of decedent's fractional interests in the art would be confronted by coowners who were resistant to any sale of the art, in whole or in part, to a new owner, a resistance that the Elkins children specifically communicated to Mr. Nash. In this case, it is not necessary for the executors to speculate or "make delicate inquiries into the feelings, attitudes and anticipated behavior" of the other owners. It is clear that they have a deep and abiding love for the art and, therefore, could be expected to be hostile to a joint sale of any one or all of the 64 works to a new owner, a hostility that they explicitly expressed to Mr. Nash during their meeting with him preparatory to his inspection of the art. That being so, the hypothetical seller and buyer necessarily would be faced with uncertainties regarding the latter's ability to monetize his or her investment in the art. As in *Stone*, "some discount is appropriate to allow for * * * uncertainties". *Stone*, 99 A.F.T.R.2d (RIA) at 2007–2998.

We also reject respondent's argument that consideration of the Elkins children's probable hostility to any sale of the art to a new owner violates the requirement to consider the hypothetical, not the actual, seller. The Elkins children, as coowners of the art, would not be the sellers of decedent's interests therein and cannot be viewed as such. Their hostility would be to any sale to a new owner of one or more of the works in which they, like the hypothetical seller, owned a fractional interest. That probable hostility constitutes one of the "relevant facts and elements of value as of the * * * valuation date [that] shall be considered [by the hypothetical seller and buyer] in every case", as mandated by section 20.2031–1(b), Estate Tax Regs.

As noted *supra*, respondent's no-discount argument is premised upon the requirement in section 20.2031–1(b), Estate Tax Regs., that the value of "an item of property * * * generally obtained by the public in the retail market * * * is the price at which the item or a comparable item would be sold at retail." Respondent describes the market for fractional

interests in art (as well as for other types of personal property) as one in which the holder of the fractional interest either purchases or inherits the interest under circumstances in which the holder and the other coowners (who may be family members, friends, or, in the case of art, art dealers) hold, or simultaneously acquire, their interests with a shared goal of selling (or, if the fractional interests are purchased, of reselling) the entire item of property at retail, either directly or after a partition of the property. Respondent posits that, under any of those scenarios, the interest holders would each receive a pro rata share of the property or of the proceeds from the sale thereof, and no fractional discounts would be applied. Focusing specifically on the facts of this case, respondent argues that it would be in the financial interests of both the Elkins children and the hypothetical buyer to agree to (1) sell the art and divide the proceeds pro rata, (2) divide the art pro rata, or (3) some combination of those two alternatives, none of which would entail a fractional interest discount. Respondent cites *Holman v. Commissioner*, 601 F.3d at 775, and its affirmation of caselaw describing the hypothetical buyer and seller as rational economic actors lacking "motivations that are personal and reflective of the idiosyncracies of particular individuals."

Although respondent's approach to the valuation of personal property would have merit in the absence of "relevant facts" that would render that approach unrealistic and, therefore, inapplicable, here such facts exist in the form of the Elkins children's probable resistance to any sale or partition of the art that would result in new ownership; and although, by opposing such a sale, the Elkins children might not be acting in their best economic interests,[14] they undoubtedly would view continued retention of the entire collection as acting (to paraphrase Mr. Mitchell) in their best psychic interests; i.e., they would be willing to forgo the financial gain from a sale of the art in order to keep the collection intact and continue to enjoy it.

[14] It is, of course, possible that, by holding on to the art, subsequent appreciation of one or more works would allow the fractional interest holders to realize a greater economic benefit than would have resulted from an immediate sale of the art at its fair market value on the valuation date.

We do not interpret section 20.2031–1(b), Estate Tax Regs., as mandating reference to the retail market for entire works of art in determining the fair market value of decedent's fractional interests in the art. As both Mr. Nash (implicitly) and Ms. Hanus-McManus (explicitly) agree, there is no market (retail or otherwise) in which undivided fractional interests in art are "commonly sold to the public". Secondly, the prospect of a fair market value sale of the art followed by a pro rata division of the proceeds among the coowners is manifestly uncertain in this case. The fact that there exists a retail market for works of art with multiple owners does not necessarily mean that all fractional interests in art must be valued as if it is certain that the art will be sold in that market. The regulation should not be read in a vacuum, without reference to actual circumstances. *See, e.g.*, *Estate of Baird v. Commissioner*, T.C. Memo. 2001–258 (agreeing to "an increased discount" in valuing the decedent's interest in jointly owned timberland because of the uncertainty of whether the family-member coowners would force a hypothetical willing buyer to institute a partition action with respect to the property); *Estate of Lauder v. Commissioner*, T.C. Memo. 1994–527 (approving a 40% discount for lack of liquidity with respect to the decedent's interest in a family-owned corporation on the basis of a finding that the coshareholder family members intended to maintain the company "as a privately held, family-controlled company" thereby rendering the sale of the decedent's shares on a public market "remote").

Moreover, respondent's approach ignores the willingness of the courts in *Stone* and *Estate of Scull* to permit discounts for fractional interests in art, provided there is adequate proof of entitlement thereto. Respondent also ignores precedent in the Court of Appeals for the Fifth Circuit permitting valuation discounts for fractional interests in property. *E.g.*, *Estate of Bonner*, 84 F.3d 196; *Estate of Bright*, 658 F.2d 999.

We also reject respondent's argument that partition costs may be deductible as administration expenses under section 2053(a)(2) but may not be cited as justification for a valuation discount. To begin with, respondent's position is directly contrary to the caselaw permitting discounts in the light of uncertainties regarding the possibility of and/or costs associated with partition actions. *E.g.*, *Estate of Bonner*, 84

F.3d at 197–198; *Estate of Baird v. Commissioner*, T.C. Memo. 2001–258; *Stone*, 99 A.F.T.R.2d at 2007–2997, 2007–2999; *accord Estate of Baird v. Commissioner*, 416 F.3d 442, 452–453 (5th Cir. 2005) (citing *Estate of Bonner*, 84 F.3d at 197–198), *rev'g* T.C. Memo. 2002–299. Secondly, the anticipated expense of a partition action is not an anticipated expense of the estate's sale of property to be valued. Rather, as petitioners note, it is an expense that the hypothetical buyer might have to incur after purchasing that property. As we have held, such costs are costs that a potential buyer would have to "take into account in determining the price he would be willing to pay. This, of course, is consistent with the definition of fair market value. See sec. 20.2031–1(b), Estate Tax Regs." *Estate of Smith v. Commissioner*, T.C. Memo. 1993–236. Lastly, the cases upon which respondent relies are inapposite. The court in each of those cases rejected taxpayer claims that the fair market value of property was the net amount received by the seller after payment of excise taxes, sales commissions, or other expenses of sale and held the fair market value to be the gross amount paid by the buyer to the seller. *See Estate of Smith v. Commissioner*, 57 T.C. 650, 659 (1972), *aff'd*, 510 F.2d 479 (2d Cir. 1975); *Estate of Gould v. Commissioner*, 14 T.C. 414, 417 (1950); *Payne v. United States*, 35 A.F.T.R.2d 75–1623 (M.D. Fla. 1975). The costs involved in each of those cases were the seller's costs associated with the sale whereas here, as we have noted, the anticipated partition costs are anticipated costs of the buyer, which are properly considered in determining fair market value. *See Estate of Smith v. Commissioner*, T.C. Memo. 1993–236.

Lastly, we reject respondent's argument that the Commissioner's rulings policy (reflected in both revenue rulings and private letter rulings), whereby undiscounted pro rata fair market value deductions are allowed for charitable contributions of fractional interests in art, controls the valuation of decedent's fractional interests in the art.

Respondent cites two revenue rulings in which the taxpayer donated to a section 170(c) organization either all or a portion of the taxpayer's remainder interest in the art with the taxpayer retaining sole right of possession for life, or an undivided fractional interest in the art resulting in shared possession. Those rulings state that the donor is entitled to

a deduction for either the present value of the remainder interest or for the undiscounted pro rata fair market value of the undivided fractional interest transferred. *See* Rev. Rul. 58–455, *supra*; Rev. Rul. 57–293, *supra*. Respondent argues that any discount in valuing fractional interests in art for estate tax purposes would conflict impermissibly with the position taken in the rulings.

We are not bound by revenue rulings, and the weight (if any) that we afford them depends upon their persuasiveness and the consistency of the Commissioner's position over time. *Taproot Admin. Servs., Inc. v. Commissioner*, 133 T.C. 202 (2009), *aff'd*, 679 F.3d 1109 (9th Cir. 2012). In the earlier ruling, the Commissioner does not provide a rationale for his failure to discount (other than to present value) the value of the charitable contributions of the remainder or fractional interests in the art, and the later ruling cites only the prior ruling as authority. In neither ruling is there any indication of an impediment to a joint, fair market value sale of the art or, if such an impediment does exist, that the Commissioner took it into account. Moreover, in the light of precedent in both this Court and the Court of Appeals for the Fifth Circuit allowing discounts in valuing a fractional interest in property for Federal estate tax purposes where there are potential impediments to a fair market value sale of the interest (e.g., the possible need for a partition action), the rulings do not persuade us to deny any discount for decedent's fractional interests in the art. [15]

[15] Petitioners distinguish the Commissioner's ruling position on the ground that it deals with income rather than estate taxes (a position that finds support in *Stone v. United States*, 99 A.F.T.R.2d (RIA) 2007–2992, 2007–2997 n.9 (N.D. Cal. 2007), *supplemented by* 100 A.F.T.R.2d (RIA) 2007–5512 (N.D. Cal. 2007), *aff'd*, *Stone ex rel. Stone Trust Agreement v. United States*, 103 A.F.T.R.2d (RIA) 2009–1379 (9th Cir. 2009)) and on the further ground that it should be interpreted as applying only to the "common situation" in which the donor "makes a series of fractional donations and ultimately donates the entire work of art in full." Neither effort to distinguish the Commissioner's rulings from the facts of this case is persuasive. There is no basis for concluding that the term "value" has a meaning for income tax purposes different from the one it has for estate tax purposes, i.e., fair market value is fair market value (see sec. 1.170A–1(c)(1), Income Tax Regs., which provides a definition of fair market value identical to that provided by sec. 20.2031–1(b), Estate Tax Regs.); and we fail

Continued

Respondent also cites two cases decided by this Court in which we permitted undiscounted fair market value deductions for charitable contributions of, in one case, undivided fractional interests in an art collection and, in the other case, a collection of "antique stereoscopic" equipment and related material. *See Winokur v. Commissioner*, 90 T.C. 733 (1988); *Mast v. Commissioner*, T.C. Memo. 1989–119. In both cases, the sole valuation issue was the undiscounted fair market value of the collection, there being no dispute over the possible application of a pro rata deduction for the donated fractional interest. The parties did not raise the issue of a fractional interest discount, and we did not consider it. Therefore, we do not view those cases as precedent for denying a valuation discount in this case.

b. *Conclusion*

There is no bar, as a matter of law, to an appropriate discount from pro rata fair market value in valuing, for estate tax purposes, decedent's undivided fractional interests in the art.

3. *The Extent to Which Petitioners Are Entitled To Discount the Pro Rata Fair Market Value of Decedent's Interests in the Art*

a. *Introduction*

Only petitioners' valuation experts, Mr. Nash and Mr. Mitchell (both of whom based their reports, in part, on Mr. Miller's expert testimony), analyze the extent to which a discount from pro rata fair market value for decedent's undivided fractional interests in the art is warranted. Ms. Hanus-McManus essentially opines that there is no market for an undivided interest in art other than in connection with an agreement or understanding among the coowners that they

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to see the basis for petitioners' assumption that respondent's allowance of an undiscounted fair market value deduction for the contribution of an undivided fractional interest in art (in Rev. Rul. 57–293, 1957–2 C.B. 153, 154–155, Ex. 2) is best read to apply to a situation in which the contribution was one in a series of contributions ultimately providing the donee with complete ownership and possession of the art. Thus, although we decline to apply the rulings to the facts of this case, we do so on grounds other than those proffered by petitioners.

will agree to a joint sale of the art at some future time.[16] Respondent offers her testimony solely in support of his argument that no discount is warranted in valuing an undivided fractional interest in art. As noted *supra*, Mr. Cahill also does not address the subject of discounts, opining only that the restrictions on sales of cotenant art "are not comparable to similar arrangements entered into by persons in arms length art market transactions." Respondent offers that report solely in support of his application of section 2703 to the cotenant art.

b. *Analysis*

Having decided that petitioners may introduce facts demonstrating the estate's entitlement to a discount from pro rata fair market value for the art, the issue before us is whether and to what extent we should sustain the discounts proffered by Mr. Mitchell on the basis of the expert testimony of Messrs. Nash and Miller.

The overriding flaw in Mr. Nash's and (derivatively) Mr. Mitchell's analyses is their failure to consider not only the Elkins children's opposition to selling any of the art but also their ownership position vis-a-vis that of the hypothetical willing buyer and the impact that the 73.055–26.945 or 50–50 ownership split would have on the negotiations between seller and buyer. Both experts should have considered the fact that the Elkins children, cumulatively, were entitled to possession of 61 works of cotenant art for a little over three months each year, and to possession of the three works of GRIT art for six months of each year.[17] The relatively brief

[16] Mr. Nash is in apparent agreement with that conclusion, but he nonetheless opines that a collector or speculator might offer to purchase decedent's interests in the art at an appropriate discount, i.e., "at a price that was deeply discounted from the actual market value to justify the risks involved."

[17] The Elkins children were before, and have been since, decedent's death content to leave all but the smaller works of art (which they have rotated among themselves) in place in the Houston area (primarily in Mr. and Mrs. Elkins' family home) where each has ready access to all of the art. Thus, despite their separate, individual rights of exclusive possession, we assume for purposes of this analysis that possession by any one child may be treated as possession by all three. Therefore, we consider their rights of possession as a cumulative or combined right of possession, i.e.,

Continued

period of annual possession and the expense and inconvenience of annually moving the art from the hypothetical buyer's premises back to Houston most likely would have caused the Elkins children to reassess their professed desire to cling, at all costs, to the ownership status quo existing after decedent's death. Thus, the hypothetical buyer would be in an excellent position to persuade the Elkins children, who, together, had the financial wherewithal to do so, to buy the buyer's interest in any or all of the works, thereby enabling them to continue to maintain absolute ownership and possession of the art.[18] Neither Mr. Nash nor Mr. Mitchell considered that possibility.

Ms. Sasser testified that, in the light of a relatively short period of possession of the art to which she and her siblings would be entitled vis-a-vis a hypothetical buyer, and considering that the buyer would, most likely, not reside in the Houston area, she "would be willing to pay * * * a fair price" to purchase the hypothetical buyer's 73.055% or 50% interests in the art. Her testimony confirms what both the hypothetical willing buyer and seller would reasonably suspect during their negotiations: that the Elkins children's strong desire to retain possession of the art in place would motivate them to purchase the hypothetical buyer's interests, most likely in each case for an amount equal or close to the undiscounted fair market value of the interest. It defies logic to assume that, as 27% or 50% owners and possessors of the art, the Elkins children would spend millions of dollars to retain their status as such, perhaps as defendants in multiple partition actions that could drag on for many years, when they would be able to acquire 100% ownership and

26.945% (3 × 8.98167%) of each year for 61 works and 50% (3 × 16.667%) of each year for three works.

[18] During her testimony, Ms. Sasser suggested that, as a means of reducing the number of moves to which the art would be subject under the cotenants' agreement, she might opt to revise the agreement so that the art would be moved only once every three years, i.e., she and her siblings could retain 61 works for some 9 months and 3 works for 18 months every three years. But even if we assume that a hypothetical buyer would agree to such an arrangement, the perennial back-and-forth movement of the art would remain an expensive and undesirable option for the Elkins children.

possession of the art, which, after all, is what they really want. [19]

Petitioners argue that the "fair price" referred to by Ms. Sasser would not exceed "fair market value", meaning the discounted values determined by Messrs. Nash and Mitchell. We disagree. Ms. Sasser's testimony confirms that the Elkins children would be willing to purchase the hypothetical buyer's interests in the art at much higher prices than a disinterested buyer would be willing to pay for the same interests because of the children's added motivation of keeping the art within the family as, in petitioners' words, "a memorial to their parents rather than [as] an investment". That motivation is reflected in the following exchange:

> Q: All right. So, most of the attachment to the art is as a memorial to your parents, and it means more to you than money in this instance?
>
> A: Yes, it does.

Ms. Sasser further testified that by a "fair price" she meant the price determined by "an expert or somebody who knew something about it". Then, during a subsequent colloquy between Ms. Sasser and the Court, Ms. Sasser shed further light on what she considered to be a "fair price":

> THE COURT: Now, I want you to explain to me why you would be reluctant to sell * * * [the art], to sell your piece?
>
> THE WITNESS: I guess honestly that I would be hoping that some day that I could buy, or * * * [maybe] we could buy, me, my brother, and sister, could buy the 73[%] back in some way.
>
> THE COURT: Well, would you be willing to pay a pro rata portion, * * * [73] percent, of the fair market value of the whole piece of art, of each of the ones that you liked, to get back that * * * [73] percent interest that somebody else had?

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[19] As discussed *infra*, the Elkins children most likely would be willing to pay a hypothetical buyer substantially more than the anticipated attorney's fees and related costs they would incur to oppose the buyer's partition action simply because the outcome of a purchase by them would be so much more satisfactory. Moreover, because of their desire to preserve intact and continue to have uninterrupted access to the entire collection, it is reasonable to assume that the Elkins children would be as motivated to purchase the hypothetical buyer's interests in Mr. Nash's category III works as they would be to purchase the buyer's interests in Mr. Nash's category I and category II works. Indeed, Mr. Nash testified that he had met with the Elkins children, who are "committed to retaining the art in the family until the last * * * [of them] dies."

> THE WITNESS: I would be willing to pay if somebody told me that it was a fair price to get that, and I can't say what is fair.

Later, in reference to a particular painting (Pool on Sprayed Blue Paper by David Hockney), the following exchange took place:

> THE COURT: The Pool? Okay. They say that the sales value of it is $900 thousand. Would you then be willing to pay * * * [73] percent of that to get it back, assuming that you were convinced that was a fair price?
>
> THE WITNESS: If somebody who knew the art market assured me that was a fair price, then yes, I would.

We infer from the foregoing exchange that the "fair price" Ms. Sasser was willing to pay was decedent's pro rata share of an expert-verified undiscounted fair market value of the art, as exemplified by her willingness to pay 73% of the $900,000 stipulated fair market value of the Hockney painting were that still a "fair price". At the time she testified, Ms. Sasser obviously was aware of the sharply discounted values posited by Messrs. Nash and Mitchell for decedent's interests in the art and of the fact that those values were based upon the hypothetical buyer's having to confront the Elkins children's unrelenting opposition to any attempt by the buyer to employ a partition action to monetize his or her investment in the art or to obtain full possession of a pro rata portion thereof, circumstances that she knew were irrelevant to her (and her siblings') potential purchase of decedent's interests, which would give them 100% ownership of the art. Had she had those sharply discounted values in mind when responding to the Court's questioning, she would not have left open the possibility that 73% of the $900,000 undiscounted fair market value of the Hockney painting might constitute a "fair price" for decedent's interest therein. Moreover, the hypothetical willing buyer and seller would suspect the Elkins children's willingness to pay pro rata fair market value, or something close to it, and they would price decedent's interests in the art accordingly. Therefore, we reject petitioners' conclusion that a hypothetical owner of decedent's fractional interests in the art, cognizant of the Elkins children's "staying power", i.e., their determination "to outlast any third party who attempted to force a sale of a Fractional Interest by litigation", would have

to sell the art to the Elkins children at the sharply discounted values determined by Messrs. Nash and Mitchell "because he or she could not expect to 'out-negotiate' the Elkins Children and because no one else would offer any more than * * * [those discounted] values." We fail to see the connection between the Elkins children's so-called staying power and the fair market value of decedent's interests in the art in the context of the children's purchase of those interests. Ms. Sasser testified that she would opt to preserve her minority interests in the art, rather than monetize those interests, but only on the assumption that she could not "buy it back". Clearly, then, her preference (and, presumably, that of her siblings) was to repurchase decedent's fractional interests in the art from the hypothetical buyers, and we see no evidence that she or they would limit their offer to an amount not in excess of the discounted values posited by Messrs. Nash and Mitchell.

The actual bargaining position that a hypothetical buyer of decedent's interests in the art would have vis-a-vis the interests of the Elkins children constitutes one of the "relevant facts" that we must deem to be considered by a hypothetical buyer and seller pursuant to section 20.2031–1(b), Estate Tax Regs. See *Estate of Winkler v. Commissioner*, T.C. Memo. 1989–231, where, in valuing a 10% block of voting stock in a closely held corporation, we took into account the fact that the hypothetical buyer thereof would represent the "swing vote" between the two families that owned the other 90% (50% and 40%) of the voting stock. On that basis, we held that a buyer, unrelated to either family, "would be willing to pay a premium for a 10 percent block of voting stock that could be pivotal as between the two families" and that "a minority discount would be inappropriate here." *See also Estate of Andrews v. Commissioner*, 79 T.C. 938, 956 (1982) ("Certainly, the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect the value of the stock in the hands of the decedent[.]"); *True v. United States*, 547 F. Supp. 201, 203 (D. Wyo. 1982) ("Hypothetical analysis can be a valuable tool; however, when real considerations exist, those realities should not and cannot be ignored.").

The logic of assuming that the Elkins children would pay a hypothetical buyer of decedent's interests in the art more

than a disinterested collector or speculator would have paid for those interests is also confirmed by cases recognizing that certain properties possess an enhanced "assemblage" value. *See, e.g.*, *Pittsburgh Terminal Corp. v. Commissioner*, 60 T.C. 80, 90 (1973) (dicta: "[W]e do not quarrel with * * * [the taxpayer's] assertion that aggregation increases the value of coal lands[.]"), *aff'd without published opinion*, 500 F.2d 1400 (3d Cir. 1974); *Serdar v. Commissioner*, T.C. Memo. 1986–504.[20] In *Serdar*, the taxpayer gave two parcels of real property to Smith in exchange for a single parcel valued at more than what the Commissioner considered to be the combined value of the taxpayer's two properties. The Commissioner determined that the difference constituted ordinary income to the taxpayer attributable to a prepayment penalty, owed by Smith to the taxpayer, related to a prior transaction. In rejecting the Commissioner's argument, we reasoned as follows:

> We think that * * * [the Commissioner's] appraisal failed to adequately take into account factors that made the properties peculiarly adaptable to Smith's use, and that their fair market value equaled the value of the consideration received for them. The factors that the appraisal failed to adequately take into account are the value to Smith of the road and railroad access that the properties provided and their assemblage value, and, with respect to the Wadsworth Property, the value to Smith of eliminating a tract of land that would have jutted north into his assemblage.
>
> * * * * * * *
>
> In sum, we believe that Smith was convinced that it was essential to acquire * * * [the two properties] to enable him to develop his property as he planned, that he was therefore willing to pay a high price for those properties, and that * * * [the taxpayer] knew of Smith's plans and drove a hard bargain.

In this case, the hypothetical willing buyer (whether he be a collector or a speculator) and seller of decedent's fractional interests in the art would know of the Elkins children's strong desire to own the art in whole. Therefore, the buyer and seller would recognize the former's ability to drive "a

[20] For a general discussion of cases involving assemblage and other special needs values, see John A. Bogdanski, Federal Tax Valuation, para. 2.01[2][c], at 2–32 through 2–37 (2012).

hard bargain" in negotiating a resale of that art to the children.[21]

Moreover, the hypothetical buyer-collector might very well be content to possess the art for 73.055% (or 50%) of each year. In his written report, Mr. Nash states:

> It is not uncommon for two museums, acting together, to buy a work of art. * * * They each take turns in exhibiting the works in proportion to their interests. This would not work in this circumstance because the other owners would be the Elkins Children, and not another museum or institution. Consequently, museums would not be interested in purchasing the interest.

Mr. Nash offers no reason for his conclusion that a museum would not be as willing to share ownership with the Elkins children as it would with another museum or institution, nor do we see one. Moreover, we see no basis for concluding that only a museum jointly owning art with another museum would be content to retain its fractional interest and shared right of possession with another joint owner for an indefinite period. The point, of course, is that a hypothetical buyer-collector, in no rush to sell his or her acquired interests in the art, would be in an even stronger bargaining position than a speculator or art dealer in negotiating a purchase price with the Elkins children.

In short, we find petitioners' experts' analyses and conclusions to be unreliable because they are based, in large part, on the false or at least highly dubious assumption that the Elkins children would mount an unrelenting defense of the status quo, ignoring the very high probability that, instead,

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[21] We note that the Commissioner made a similar argument in *Estate of Bright*, 658 F.2d at 1007. In that case, the decedent owned 27½% of the common stock of a closely held corporation. Her surviving husband (Mr. Bright) also owned 27½%, and an unrelated party (Mr. Schiff) owned 30%. The Commissioner argued that the decedent's 27½% interest "offered by the 'willing seller' would provide the margin of control for either Mr. Bright or Mr. Schiff, and that the 'willing buyer' might negotiate a resale to either". The Commissioner argued that those facts constituted "relevant facts" that "might affect the value of * * * [the decedent's] 27½% minority interest which is to be valued." The Commissioner stressed that "the 'willing buyer-seller' rule renders irrelevant only the real seller and buyer, not the other stockholders." *Id.* The Court of Appeals for the Fifth Circuit, after noting that "a few cases have acknowledged the relevance of such facts", declined to consider the Commissioner's argument because he made it for the first time on appeal. *Id.* at 1007–1008.

the children would seek to purchase the hypothetical buyer's interests in the art. Because we reject that assumption, we find Mr. Mitchell's discounted values for the art to be unrealistically low. [22]

c. *Conclusion*

Petitioners argue that the Elkins children would spend whatever was necessary to retain their minority (or 50%) interests in the art. It is much more likely, however, that, given their undisputed financial resources to do so, they would be willing to spend even more to acquire decedent's fractional interests therein and thereby preserve for themselves 100% ownership and possession of the art. The question is how much more.

We believe that a hypothetical willing buyer and seller of decedent's interests in the art would agree upon a price at or fairly close to the pro rata fair market value of those interests. Because the hypothetical seller and buyer could not be certain, however, regarding the Elkins children's intentions, i.e., because they could not be certain that the Elkins children would seek to purchase the hypothetical buyer's interests in the art rather than be content with their existing fractional interests, and because they could not be certain that, if the Elkins children did seek to repurchase decedent's interests in the art, they would agree to pay the full pro rata fair market value for those interests, we conclude that a nominal discount from full pro rata fair market value is appropriate.

[22] Our analysis renders moot the dispute between the parties over whether it is proper to assume that the hypothetical buyer might be a collector purchasing multiple works of art who opts to institute a partition in kind, which, if true, would reduce the hypothetical buyer's potential partition costs. Because the hypothetical willing buyer and seller would consider a resale of decedent's interests in the art to the Elkins children to be the most likely alternative in arriving at a price for those interests, and because that price, in our view, would exceed even Mr. Miller's worst case estimate of total partition costs ($11 million plus), it is unlikely that potential partition costs would become a significant factor in the negotiations. For the same reason, the probability, discussed by Mr. Miller, that, under Texas law, the restriction on sales provision in para. 7 of the cotenants' agreement will constitute an implied waiver of the right to partition, is not a significant factor in valuing the cotenant art.

We hold that, in order to account for the foregoing uncertainties, a hypothetical buyer and seller of all or a portion of decedent's interests in the art would agree to a 10% discount from pro rata fair market value in arriving at a purchase price for those interests. We believe that a 10% discount would enable a hypothetical buyer to assure himself or herself of a reasonable profit on a resale of those interests to the Elkins children.

VI. *Conclusion*

Petitioners are entitled to a 10% discount from pro rata fair market value with respect to decedent's interests in the art.

A list of the 64 works of art, decedent's pro rata share of the stipulated fair market value of each work, and the resulting fair market value of each work, for Federal estate tax purposes, after applying the 10% discount permitted herein, is attached to this Opinion as appendix C.

Decision will be entered under Rule 155.

APPENDIX A

THE GRIT ART

Item	*Artist*	*Title/year/description/size*	*Stipulated fair market value*
1	Pollock, Jackson	Untitled, Number 21, 1949 (Oil & enamel paper on masonite, 19¼" × 26¾")	$6,000,000
2	Moore, Henry	Two-Piece Reclining Figure No. 3, 1961 (Bronze, 59" × 113" × 54")	4,000,000
3	Picasso, Pablo	Baigneuse debout, 1925 (Brush & ink on paper, 42" × 26½")	600,000
	Total		10,600,000

THE DISCLAIMER ART

Item	*Artist*	*Title/year/description/size*	*Stipulated fair market value*
4	Johns, Jasper	Figure 4, 1967 (Oil, encaustic & newspaper on canvas, 53½" × 41½")	$8,000,000

Item	*Artist*	*Title/year/description/size*	*Stipulated fair market value*
5	Francis, Sam	Green Gold, 1956 (Oil on canvas, 105" × 78")	2,500,000
6	Motherwell, Robert	Elegy to Spanish Republic #134, 1976 (Acrylic on canvas, 72" × 84")	1,500,000
7	Twombly, Cy	Untitled, 1971 (Oil-based house paint, wax crayon, & pencil on canvas, 69" × 49½")	1,500,000
8	Hockney, David	Pool on Sprayed Blue Paper...1978 (Colored & pressed paper pulp in 6 sheets, 72" × 85")	900,000
9	Kelly, Ellsworth	Yellow Panel, 1985 (Oil on canvas, 108" × 104½")	800,000
10	Moore, Henry	Standing Figure (Internal Form) (Bronze w/green patina, 57½" high)	600,000
11	Cezanne, Paul	Pot de geraniums, ca. 1885 (Watercolor on paper, 12¾" × 10¼")	550,000
12	Soulages, Pierre	8 June 61, 1961 (Oil on canvas, 81½" × 57½")	550,000
13	Magritte, Rene	La lecon des tenebres, 1964 (Gouache on paper, 13½" × 21½")	450,000
14	Albers, Joseph	Study for Homage to a Square in White Light, 1968 (Oil on masonite, 24" × 24")	400,000
15	Johns, Jasper	Three Flags, 1977 (Ink on plastic, image: 6⅞" × 9⅞"; 12½" × 18⅛")	400,000
16	Hofmann, Hans	Adagio, 1962 (Oil on canvas, 48" × 36")	375,000
17	Louis, Morris	Delta Epsilon, 1960 (Acrylic on canvas, 103" × 150")	375,000
18	Ernst, Max	The Elements..., 1962 (Oil on canvas, 45¼" × 35")	350,000
19	Moore, Henry	Family Group, 1944 (Bronze w/ green patina, height 6")	350,000
20	De Kooning, William	Woman in a Garden, 1968 (Oil on paper on canvas, 24⅜" × 19⅜")	300,000
21	Louis, Morris	Achenar, 1962 (Acrylic on canvas, 79½" × 13¾")	220,000
22	Moore, Henry	Working Model for Thin Reclining Figure, 1978 (Bronze w/brown patina, 29" long)	200,000
23	Frankenthaler, Helen	Fathom, 1983 (Acrylic on canvas, 79'× 93")	180,000
24	Bravo, Claudio	Blue and Brown Package, 1971 (Oil on canvas, 59" × 78")	950,000
25	Bravo, Claudio	Wrapped Canvas, 1973 (Oil on canvas, 79" × 47")	950,000
26	Bravo, Claudio	Silver and Gold, 1972 (Oil on canvas, 44" × 57")	300,000
27	Rickey, George	Untitled (Open Rectangles), ca. 1985 (Stainless steel, 180" × 34" × 34")	300,000
28	Botero, Fernando	Parrot, 1981 (Bronze w/green patina, 58" high)	200,000
29	Kline, Franz	The Hill, 1959 (Oil on paper, 11⅝" × 9")	200,000
30	Hofmann, Hans	Untitled (M–418), 1964 (Oil on canvas, 30" × 25")	150,000
31	Olitski, Jules	Carnegie Hall, ca. 1962–64 (Acrylic on canvas, 64" × 76½")	150,000

Item	*Artist*	*Title/year/description/size*	*Stipulated fair market value*
32	Hockney, David	Nichols Canyon Road, Hollywood Boulevard, 1979 (Watercolor and ink on paper, 23¼" × 18")	140,000
33	Heizer, Michael	Untitled, ca. 1985 (Cast stone, 24' × 20')	100,000
34	Di Suvero, Mark	Untitled, ca. 1968 (Steel on mirror plate, sculpture: 18½" × 42"; Plate: ⅛" × 46" × 22")	90,000
35	Bertoia, Harry	Sunburst, 1972 (Brass & bronze suspended mobile, 28" × 28" × 28")	80,000
36	Frankenthaler, Helen	Untitled, ca. 1975 (Watercolor on paper, 59" × 78")	60,000
37	Bertoia, Harry	Untitled (Sounding Sculpture), 1968 (Bronze, 84" × 10" × 10")	50,000
38	Motherwell, Robert	In green with Two Scarlet Spots, 1967 (Paper collage, acrylic & charcoal on paper, 30" × 22")	50,000
39	Held, Al	North by Northwest, 1973 (Acrylic on canvas, 72" × 96")	42,000
40	Hofmann, Hans	Untitled, 1949 (Oil and ink on paper, 17" × 14")	40,000
41	Dine, Jim	Tie, 1961 (Oil & pastel on paper, 23½" × 16")	35,000
42	Bertoia, Harry	Untitled (Stainless & steel wire, 37" × 20")	30,000
43	Frankenthaler, Helen	Canal Street VIII, 1987 (Watercolor & gouache on paper, 25½" × 19¾")	25,000
44	Craig-Martin, Michael	Safety Pin, circa 1990 (Painted steel & wood, 100" × 88" × 13")	22,000
45	Hofmann, Hans	Untitled (N–677–2), 1956 (Gouache on paper, 22¼" × 28¼")	20,000
46	Hofmann, Hans	Fluse #12 (M–1351), 1962 (Oil on canvas board, 13¼" × 11½")	20,000
47	Nagare, Masayuki	Destination, 1996 (Granite, 26½" × 12" × 8")	18,000
48	Motherwell, Robert	Je t'aime avec noir, 1978 (Ink & pencil on tracing paper, 13½" × 16¾")	15,000
49	Graves, Nancy	Four Times Four, 1977 (Acrylic on canvas, 64" × 64")	8,000
50	Hofmann, Hans	Untitled, 1954 (Gouache on paper, 12½" × 9½")	6,000
51	Frankenthaler, Helen	Thanksgiving Day, 1980 (Hand-painted ceramic tile, 13½" × 19")	4,000
52	Frankenthaler, Helen	Thanksgiving Day, ca. 1980 (Hand-painted, ceramic tile, 13½"× 17")	4,000
53	N/A	Japanese Painted and Silvered Paper Four-Panel Screen, 3d Quarter, 19th Century (Silvered paper with silk-framed border; each panel: 52" × 23")	4,000
54	Frankenthaler, Helen	Hand Painted Book Cover #11, 1970 (Acrylic on canvas, 11" × 12")	3,500
55	Graves, Nancy	Omon (Series E) 1976 (Wax crayon on paper, 35" × 47¼")	3,000
56	Meadmore, Clement	Untitled, 1992 (Bronze, Height: 8½")	3,000
57	Noland, Kenneth	Hand Painted Bookcover, 1977 (Acrylic on canvas, 11" × 12")	2,000

Item	*Artist*	*Title/year/description/size*	*Stipulated fair market value*
58	Hamilton, Juan	Abstract Form #52, 1975 (Height: 14½")	1,750
59	Love, Jim	Monday Morning: What to do...What to do, 1992 (Welded steel, 8" × 8")	1,200
60	Love, Jim	Looking for Santa Claus (Welded steel, 9⅜" × 8")	1,200
61	Stella, Frank	Pastel Stack, 1970 (28" × 41")	900
62	Fuller, Sue	String Composition #213, 1963 (Nylon & Saran thread with Plexiglas, 36" × 36")	750
63	N/A	Sepik River Carved Polychrome Wood Mask, 20th Century (Height: 64"; Width: 22")	250
64	N/A	Sepik River Carved and Polychrome-Painted Wood Shield, 20th Century (Height: 69½"; Width: 14")	100
	Total		24,580,650

APPENDIX B

Nash category	*Artist*	*Title/year*	*Option 1 discount*	*Option 2 discount*	*Concluded discount*	*Fair market value of interest*
I	Johns, J.	Figure 4, 1967	71.72%	70.31%	70.31%	$1,735,188
I	Pollock, J.	Untitled, Number 21, 1949	51.69	59.68	51.69	1,449,210
I	Moore, H.	Two-Piece Reclining Figure No. 3, 1961	51.69	66.89	51.69	966,140
I	Francis, S.	Green Gold, 1956	65.78	68.95	65.78	624,926
I	Motherwell, R.	Elegy to Spanish Republic #134, 1976	65.78	84.64	65.78	374,956
II	Twombly, C.	Untitled, 1971	71.08	84.64	71.08	316,948
II	Hockney, D.	Pool on Sprayed Blue Paper..., 1978	71.08	100.00	71.08	190,169
III	Bravo, C.	Blue and Brown Package, 1971	79.74	100.00	79.74	140,640
III	Bravo, C.	Wrapped Canvas, 1973	79.74	100.00	79.74	140,640
II	Kelly, E.	Yellow Panel, 1985	71.08	67.43	67.43	190,350
II	Moore, H.	Standing Figure (Internal Form)	71.08	75.70	71.08	126,779
II	Cezanne, P.	Pot de geraniums, ca. 1885	71.08	79.90	71.08	116,214
II	Soulages, P.	8 June 61, 1961	71.08	80.00	71.08	116,214
II	Magritte, R.	La lecon des tenebres, 1964	71.08	91.19	71.08	95,084
II	Picasso, P.	Baigneuse debout, 1925	71.08	96.83	71.08	86,770
II	Albers, J.	Study for Homage to a Square in White Light, 1968	71.08	98.98	71.08	84,519
II	Johns, J.	Three Flags, 1977	71.08	98.98	71.08	84,519
II	Hofmann, H.	Adagio, 1962	71.08	100.00	71.08	79,237
II	Louis, M.	Delta Epsilon, 1960	71.08	100.00	71.08	79,237
II	Ernst, M.	The Elements..., 1962	71.08	100.00	71.08	73,954
II	Moore, H.	Family Group, 1944	71.08	100.00	71.08	73,954
II	De Kooning, W.	Woman in a Garden, 1968	71.08	100.00	71.08	63,390
II	Louis, M.	Achenar, 1962	71.08	100.00	71.08	46,486
II	Moore, H.	Working Model for Thin Reclining Figure, 1978	71.08	100.00	71.08	42,260
II	Frankenthaler, H.	Fathom, 1983	71.08	100.00	71.08	38,034
III	Bravo, C.	Silver and Gold, 1972	79.74	100.00	79.74	44,413
III	Rickey, G.	Untitled (Open Rectangles), ca. 1985	79.74	100.00	79.74	44,413
III	Botero, F.	Parrot, 1981	79.74	100.00	79.74	29,608
III	Kline, F.	The Hill, 1959	79.74	100.00	79.74	29,608
III	Hofmann, H.	Untitled (M–418), 1964	79.74	100.00	79.74	22,206
III	Olitski, J.	Carnegie Hall, ca. 1962–64	79.74	100.00	79.74	22,206

Nash category	*Artist*	*Title/year*	*Option 1 discount*	*Option 2 discount*	*Concluded discount*	*Fair market value of interest*
III	Hockney, D.	Nichols Canyon Road, Hollywood Boulevard, 1979	79.74	100.00	79.74	20,726
III	Heizer, M.	Untitled, ca. 1985	79.74	100.00	79.74	14,804
III	Di Suvero, M.	Untitled, ca. 1968	79.74	100.00	79.74	13,324
III	Bertoia, H.	Sunburst, 1972	79.74	100.00	79.74	11,843
III	Frankenthaler, H.	Untitled, ca. 1975	79.74	100.00	79.74	8,883
III	Bertoia, H.	Untitled (Sounding Sculpture), 1968	79.74	100.00	79.74	7,402
III	Motherwell, R.	In green with Two Scarlet Spots, 1967	79.74	100.00	79.74	7,402
III	Held, A.	North by Northwest, 1973	79.74	100.00	79.74	6,218
III	Hofmann, H.	Untitled, 1949	79.74	100.00	79.74	5,922
III	Dine, J.	Tie, 1961	79.74	100.00	79.74	5,181
III	Bertoia, H.	Untitled	79.74	100.00	79.74	4,441
III	Frankenthaler, H.	Canal Street VIII, 1987	79.74	100.00	79.74	3,701
III	Craig-Martin, M.	Safety Pin, ca. 1990	79.74	100.00	79.74	3,257
III	Hofmann, H.	Untitled (N–677–2), 1956	79.74	100.00	79.74	2,961
III	Hofmann, H.	Fluse #12 (M–1351), 1962	79.74	100.00	79.74	2,961
III	Nagare, M.	Destination, 1996	79.74	100.00	79.74	2,665
III	Motherwell, R.	Je t'aime avec noir, 1978	79.74	100.00	79.74	2,221
III	Graves, N.	Four Times Four, 1977	79.74	100.00	79.74	1,184
III	Hofmann, H.	Untitled, 1954	79.74	100.00	79.74	888
III	Frankenthaler, H.	Thanksgiving Day, 1980	79.74	100.00	79.74	592
III	Frankenthal er, H.	Thanksgiving Day, ca. 1980	79.74	100.00	79.74	592
III	N/A	Japanese Painted and Silvered Paper Four-Panel Screen, 3d Quarter, 19th Century	79.74	100.00	79.74	592
III	Frankenthaler, H.	Hand Painted Book Cover #11, 1970	79.74	100.00	79.74	518
III	Graves, N.	Omon (Series E), 1976	79.74	100.00	79.74	444
III	Meadmore, C.	Untitled, 1992	79.74	100.00	79.74	444
III	Noland, K.	Hand Painted Bookcover, 1977	79.74	100.00	79.74	296
III	Hamilton, J.	Abstract Form #52, 1975	79.74	100.00	79.74	259
III	Love, J.	Monday Morning: What to do...What to do, 1992	79.74	100.00	79.74	178
III	Love, J.	Looking for Santa Claus	79.74	100.00	79.74	178
III	Stella, F.	Pastel Stack, 1970	79.74	100.00	79.74	133
III	Fuller, S.	String Composition #213, 1963	79.74	100.00	79.74	111
III	N/A	Sepik River Carved Polychrome Wood Mask, 20th Century	79.74	100.00	79.74	37
III	N/A	Sepik River Carved and Polychrome-Painted Wood Shield, 20th Century	79.74	100.00	79.74	15

APPENDIX C

VALUES OF DECEDENT'S INTERESTS IN THE 64 WORKS OF ART FOR FEDERAL ESTATE TAX PURPOSES

Item	*Artist*	*Title/year*	*Decedent's pro rata share of stipulated fair market value*[1]	*Fair market value of decedent's interest after application of 10% discount*
1	Pollock, Jackson	Untitled, Number 21, 1949	$3,000,000	$2,700,000
2	Moore, Henry	Two-Piece Reclining Figure No. 3, 1961	2,000,000	1,800,000
3	Picasso, Pablo	Baigneuse debout, 1925	300,000	270,000
4	Johns, Jasper	Figure 4, 1967	5,844,400	5,259,960
5	Francis, Sam	Green Gold, 1956	1,826,375	1,643,738

Item	*Artist*	*Title/year*	*Decedent's pro rata share of stipulated fair market value*[1]	*Fair market value of decedent's interest after application of 10% discount*
6	Motherwell, Robert	Elegy to Spanish Republic #134, 1976	1,095,825	986,243
7	Twombly, Cy	Untitled, 1971	1,095,825	986,243
8	Hockney, David	Pool on Sprayed Blue Paper...1978	657,495	591,746
9	Kelly, Ellsworth	Yellow Panel, 1985	584,440	525,996
10	Moore, Henry	Standing Figure (Internal Form)	438,330	394,497
11	Cezanne, Paul	Pot de geraniums, ca. 1885	401,803	361,623
12	Soulages, Pierre	8 June 61, 1961	401,803	361,623
13	Magritte, Rene	La lecon des tenebres, 1964	328,748	295,873
14	Albers, Joseph	Study for Homage to a Square in White Light, 1968	292,220	262,998
15	Johns, Jasper	Three Flags, 1977	292,220	262,998
16	Hofmann, Hans	Adagio, 1962	273,956	246,560
17	Louis, Morris	Delta Epsilon, 1960	273,956	246,560
18	Ernst, Max	The Elements..., 1962	255,693	230,124
19	Moore, Henry	Family Group, 1944	255,693	230,124
20	De Kooning, William	Woman in a Garden, 1968	219,165	197,249
21	Louis, Morris	Achenar, 1962	160,721	144,649
22	Moore, Henry	Working Model for Thin Reclining Figure, 1978	146,110	131,499
23	Frankenthaler, Helen	Fathom, 1983	131,499	118,349
24	Bravo, Claudio	Blue and Brown Package, 1971	694,023	624,621
25	Bravo, Claudio	Wrapped Canvas, 1973	694,023	624,621
26	Bravo, Claudio	Silver and Gold, 1972	219,165	197,249
27	Rickey, George	Untitled (Open Rectangles), ca. 1985	219,165	197,249
28	Botero, Fernando	Parrot, 1981	146,110	131,499
29	Kline, Franz	The Hill, 1959	146,110	131,499
30	Hofmann, Hans	Untitled (M–418), 1964	109,583	98,625
31	Olitski, Jules	Carnegie Hall, ca. 1962–64	109,583	98,625
32	Hockney, David	Nichols Canyon Road, Hollywood Boulevard, 1979	102,277	92,049
33	Heizer, Michael	Untitled, ca. 1985	73,055	65,750
34	Di Suvero, Mark	Untitled, ca. 1968	65,750	59,175
35	Bertoia, Harry	Sunburst, 1972	58,444	52,600
36	Frankenthaler, Helen	Untitled, ca. 1975	43,833	39,450
37	Bertoia, Harry	Untitled (Sounding Sculpture), 1968	36,528	32,875
38	Motherwell, Robert	In green with Two Scarlet Spots, 1967	36,528	32,875
39	Held, Al	North by Northwest, 1973	30,683	27,615
40	Hofmann, Hans	Untitled, 1949	29,222	26,300
41	Dine, Jim	Tie, 1961	25,569	23,012
42	Bertoia, Harry	Untitled	21,917	19,725
43	Frankenthaler, Helen	Canal Street VIII, 1987	18,264	16,438
44	Craig-Martin, Michael	Safety Pin, ca. 1990	16,072	14,465
45	Hofmann, Hans	Untitled (N–677–2), 1956	14,611	13,150
46	Hofmann, Hans	Fluse #12 (M–1351), 1962	14,611	13,150
47	Nagare, Masayuki	Destination, 1996	13,150	11,835
48	Motherwell, Robert	Je t'aime avec noir, 1978	10,958	9,862
49	Graves, Nancy	Four Times Four, 1977	5,844	5,260
50	Hofmann, Hans	Untitled, 1954	4,383	3,945
51	Frankenthaler, Helen	Thanksgiving Day, 1980	2,922	2,630
52	Frankenthaler, Helen	Thanksgiving Day, ca. 1980	2,922	2,630
53	N/A	Japanese Painted and Silvered Paper Four-Panel Screen, 3d Quarter, 19th Century	2,922	2,630
54	Frankenthaler, Helen	Hand Painted Book Cover #11, 1970	2,557	2,301
55	Graves, Nancy	Omon (Series E), 1976	2,192	1,973
56	Meadmore, Clement	Untitled, 1992	2,192	1,973
57	Noland, Kenneth	Hand Painted Bookcover, 1977	1,461	1,315
58	Hamilton, Juan	Abstract Form #52, 1975	1,278	1,150

Item	*Artist*	*Title/year*	*Decedent's pro rata share of stipulated fair market value*[1]	*Fair market value of decedent's interest after application of 10% discount*
59	Love, Jim	Monday Morning: What to do...What to do, 1992	877	789
60	Love, Jim	Looking for Santa Claus	877	789
61	Stella, Frank	Pastel Stack, 1970	657	591
62	Fuller, Sue	String Composition #213, 1963	548	493
63	N/A	Sepik River Carved Polychrome Wood Mask, 20th Century	183	165
64	N/A	Sepik River Carved and Polychrome-Painted Wood Shield, 20th Century	73	66

[1] Decedent's share of agreed fair market value with respect to items 1 through 3 is 50%. For all other items, it is 73.055%.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

United States Court of Appeals
Fifth Circuit
FILED
September 15, 2014
Lyle W. Cayce
Clerk

No. 13-60472

ESTATE OF JAMES A. ELKINS, JR., Deceased;
MARGARET ELISE JOSEPH, and
LESLIE KEITH SASSER, Independent Executors,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the Decision of the United States
Tax Court

Before STEWART, Chief Judge, and WIENER and COSTA, Circuit Judges.

WIENER, Circuit Judge:

Petitioners-Appellants Margaret Elise Joseph and Leslie Keith Sasser ("Petitioners"), as Independent Executors of the Estate of their deceased father, James A. Elkins, Jr. ("Decedent"), petitioned the United States Tax Court ("Tax Court") to review and eventually eliminate the federal estate tax deficiency assessed against the Estate by Respondent-Appellee, the Commissioner of Internal Revenue ("the Commissioner"). That deficiency resulted solely from the Commissioner's disallowance of the "fractional-ownership discount" applied by the Estate in determining the taxable values of Decedent's pro rata shares of the jointly stipulated fair market values

("FMV") of 64 original works of modern and contemporary art in which the Decedent owned only fractional interests at his death.

In the Tax Court, the Commissioner steadfastly maintained that absolutely no fractional-ownership discount was allowable. This presumably accounts for his failure to adduce *any* affirmative evidence—either factual or expert opinion—as to the quantum of such discounts in the event they were found applicable by the court.

The Tax Court rejected the Commissioner's zero-discount position, but also rejected the quantums of the various fractional-ownership discounts adduced by the Estate through the reports, exhibits, and testimony of its three expert witnesses—the only substantive evidence of discount quantum presented to the court.[1] Instead, the Tax Court concluded that a "nominal" fractional-ownership discount of 10 percent should apply across the board to Decedent's ratable share of the stipulated FMV of each of the works of art; this despite the absence of any record evidence whatsoever on which to base the quantum of its self-labeled nominal discount.

We agree in large part with the Tax Court's underlying analysis and discrete factual determinations, including its rejection of the Commissioner's zero-discount position (which holding we affirm). We disagree, however, with the ultimate step in the court's analysis that led it not only to reject the quantums of the Estate's proffered fractional-ownership discounts but also to adopt and apply one of its own without any supporting evidence. We therefore affirm in part, reverse in part, and render judgment in favor of Petitioners,

[1] The Estate had applied a fractional-ownership discount of 44.75 percent uniformly to the Decedent's interest in each work of art when preparing the estate tax return, Form 706. It did so based on the appraisal of Sotheby's, Inc. and the report of Deloitte L.L.P. As the IRS disallowed that discount, however, the Estate treated it as a fall-back position in the Tax Court and adduced expert testimony of discrete discounts for the various works.

holding that the taxable values of Decedent's fractional interests in the works of art are the net amounts reflected for each on Exhibit B of the Tax Court's opinion. This, in turn, produces an aggregate refund owed to the Estate of $14,359,508.21, plus statutory interest.[2]

I. FACTS AND PROCEEDINGS

A. Issue on Appeal

Despite the size and complexity of Decedent's estate and the millions of dollars of federal estate tax that it returned and paid, the single question presented in this appeal is narrow, straightforward, and easily posed:

> Given the parties' stipulation of the FMV of each of the works of art in which Decedent owned fractional interests at his death, is the Estate taxable on Decedent's undiscounted pro rata share of those FMVs, as the Commissioner contended on audit and throughout the Tax Court proceedings, or is it taxable only on those values reduced by fractional-ownership discounts of either (1) a uniform 10 percent each, as held by the Tax Court, or (2) the various percentages that the Estate advanced through the testimony and reports of its expert witnesses?

This entire appeal thus begins and ends with the question of the taxable value of Decedent's fractional interests in those 64 items of non-business, tangible, personal property that were jointly owned in varying percentages by Decedent and his three adult children at the instant of his death. And, the answer to that one question begins and ends with the proper administration of the ubiquitous willing buyer/willing seller test for fair market value: "Fair market value is defined as 'the price at which the property would change hands between a willing buyer and a willing seller, neither being under any

[2] The Estate and the Commissioner have jointly stipulated this amount as the tax refund that would be due under these circumstances and have further stipulated that they will confer and calculate the proper amount of statutory interest owed if the stipulated refund is ultimately determined to be due and owing.

compulsion to buy or sell and both having reasonable knowledge of relevant facts.' "[3]

B. Background

Over the course of their marriage, the Texas-domiciled Decedent and his wife acquired property, both real and personal, essentially all of which fell into the community that existed between them and thus was owned equally by the spouses. Among their many and varied acquisitions were race horses, real estate, interests in closely held businesses, and the said 64 works of art. Their interests in each of those works were retained for the remainder of their respective lifetimes, and that art was displayed in their home or office, or those of their adult children, or, occasionally, at an art gallery, museum, or other public place, albeit not as one cohesive collection or assemblage.

Decedent and his wife each created an *inter vivos* Grantor Retained Income Trust ("GRIT") that held title to their respective half interests in three of the 64 works (the "GRIT Art"). After the death of his wife during the terms of the GRITs, and for the remainder of his lifetime, Decedent continued to own his 50 percent interest in those three pieces. His three children received his late wife's 50 percent interest, 16.667 percent each.

By virtue of a bequest to him from his wife of her 50 percent interest in each of the remaining works and his subsequent disclaimer of a 26.945 percent interest in each, Decedent owned at his death an aggregate 73.055 percent interest in each of those 61 pieces (the "Disclaimer Art"), comprising his original 50 percent and the 23.055 percent interest from his wife's bequest that remained after deducting the 26.945 percent interest that Decedent disclaimed. That disclaimed interest passed equally to their three children, as

[3] *Anthony v. United States*, 520 F.3d 374, 377 (5th Cir. 2008) (citing Treas. Reg. § 20.2031-1(b)).

their mother's successor legatees, 8.98167 percent each, and was owned by them at his death.

From time to time following the death of his wife, Decedent and his children voluntarily subjected their respective interests in the works of art to various restraints on possession, partition, and alienation. For example, Decedent's three children leased their combined 50 percent interests in two of the three pieces of GRIT Art to Decedent, thereby ensuring his uninterrupted possession of those two works. That lease, which was still in effect at Decedent's death, specified, *inter alia*, that no co-owner could dispose of his or her interest in a leased work unless joined by all co-owners. The lease also provided that none could transfer or assign his or her "rights, duties and obligations" under the lease without the prior consent of all.

Similarly, Decedent and his children encumbered all 61 items of Disclaimer Art with a "Cotenants Agreement." Among other things, it spelled out each co-owner's right of possession for a specified number of days during any 12 month period. More pertinent to this appeal, that agreement prohibited the sale of an interest in any work by a co-owner without the prior consent of all. The one piece of GRIT Art that had not been subjected to the children's lease to Decedent was eventually added to the list of works covered by the Cotenants Agreement.

C. Proceedings Prior to Tax Court Litigation

Decedent died testate in February 2006. His will was probated in Harris County, Texas, and his three children qualified as co-executors.[4] The Decedent's Estate Tax Return, Form 706, was filed the following May,

[4] Decedent's son, who was one of the three co-executors, died unexpectedly in June 2010, after which his two sisters, Petitioners herein, continued to serve as the Independent Executors of Decedent's estate.

reporting a tax liability in excess of $102 million. It listed, among other assets, fractional interests in various items of real and personal property, including his 73.005 percent interest in the Disclaimer Art and his 50 percent interest in the GRIT Art.[5]

Following its audit of the estate tax return, the Internal Revenue Service ("IRS") accepted net values that remained after deducting various fractional-ownership discounts on essentially every property, real and personal, in which Decedent owned a fractional interest, *with but one exception*: the 64 works of art. The IRS refused to allow *any* discount against the Decedent's pro rata share—his fractional-ownership interest—of the stipulated FMVs of these works. The IRS assessed an estate tax deficiency of $9,068,266.

D. Tax Court Proceedings

The Estate filed the instant action in Tax Court in July 2010, addressing the single substantive issue of the taxable values of Decedent's fractional interest in the 64 items of art.[6] By the time of the trial in September 2011, the parties had narrowed a number of issues by joint stipulations. During that one-day trial, six witnesses testified, five of whom were tendered as experts, three by the Estate and two by the Commissioner. The lone non-expert witness was Mrs. Leslie Keith Sasser, Decedent's daughter and co-executor.

The gist of Mrs. Sasser's responses to questions on direct, on cross, and from the court, was that she and the other Elkins heirs are strongly attached

[5] The Commissioner and the Estate eventually stipulated undiscounted FMVs totaling $24,580,650 for the Disclaimer Art and $10,600,000 for the GRIT Art, differing slightly from the appraisal of $23,530,650 for the Disclaimer Art and $9,600,000 for the GRIT Art previously received by the Estate.

[6] The Estate's petition included additional refund claims that turn on the valuation of the art work, including a greater charitable deduction produced by that valuation and deductions for greater fees and cost of administration than originally projected. Such claims are ancillary to and controlled by the ultimate determination of the taxable value of the art.

to the art work, largely sentimentally; that they do not view those works as business assets, primarily because they simply do not need the money; and that they are determined to retain the art for life, *i.e.*, they would never be sellers. In response to hypothetical questions from the court, Mrs. Sasser did respond—also hypothetically—that she and presumably the other Elkins heirs might be *buyers* of Decedent's interest from a hypothetical willing buyer of that interest, but only if assured by an expert or experts that the price was fair:

> THE COURT: Well, would you be willing to pay a pro rata portion . . . of the fair market value of the whole piece of art, of each of the ones that you liked, to get that [] percent interest that somebody else had?
>
> THE WITNESS: I would be willing to pay if somebody told me that it was a fair price to get that, and I can't say what is fair. . . . If somebody who knew the art market assured me that was a fair price, then, yes, I would.
>
> THE COURT: Such as [the Estate's expert]?
>
> THE WITNESS: Yes, if he assured me that it was a fair price, I would buy it back.

The Estate's three remaining witnesses were tendered as experts in various aspects of the art's values and were "received" as such by the court: David Nash as an expert in the art market, the merchantability of art, and the valuation of art; longtime Texas lawyer William T. Miller as an expert on the nature, procedure, time, and costs of actions of partition and enforcement of restraints on alienation litigated on the basis of Texas law; and Mark L. Mitchell as an expert on the valuation of fractional interests in property. The result of the combined, interrelated, and interdependent testimony and reports of these experts was that a proper application of the willing buyer/willing seller test would produce prices for the Decedent's undivided interests in the works

of art substantially below his pro rata share of their respective FMVs. They concluded that any hypothetical willing buyer would demand significant fractional-ownership discounts in the face of becoming a co-owner with the Elkins descendants, given their financial strength and sophistication, their legal restraints on alienation and partition, and their determination never to sell their interests in the art.

By contrast, the Commissioner adduced no expert testimony or other evidence to establish alternative quantums of fractional-ownership discounts, sticking instead to his no-discount position.[7] He did proffer two experts as rebuttal witnesses. The Tax Court "received" one of them, Ms. Karen Hanus-McManus, as an expert appraiser of modern and contemporary art, and the other, Mr. John R. Cahill, as an expert on "art transactions," but rejected his opinion as "not germane to the issues in this case." Ms. Hanus-McManus's testimony is best summarized by her stated conclusion that "there is no *recognized* market for partial interest[s] in works of modern art and contemporary art within the secondary markets, with the galleries, and with private dealers."[8] She would not state, however, that there had never been, or never could be, sales of undivided interests in such art; only that there was no established or "recognized" market for such fractional interests.

The Tax Court issued its opinion in March 2013.[9] Applying the "fictitious willing buyer/willing seller" test to determine the taxable value of Decedent's undivided interests in the various works of art, the Tax Court ultimately held that such interests are indeed subject to fractional-ownership discounts, but

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[7] The Commissioner appears to have ignored, or been unaware of, the venerable lesson of Judge Learned Hand's opinion in *Cohan*: In essence, make as close an approximation as you can, but never use a zero. *See Cohan v. Comm'r*, 39 F.2d 540, 543–44 (2d Cir. 1930).

[8] Emphasis supplied.

[9] *Estate of Elkins v. Comm'r*, 140 T.C. 86 (2013).

that the price on which the fictitious buyer and seller would finally agree would be the jointly stipulated values reduced by a "nominal" discount of 10 percent only.

II. ANALYSIS

A. Standard of Review

We review appeals from the Tax Court under the same standards which we review appeals from the district courts: *de novo* for purely legal conclusions; clear error for findings of fact.[10] "Clear error exists if we are left with a definite and firm conviction that a mistake has been made."[11] We review mixed questions of fact and law *de novo*.[12] We have long held that "determination of fair market value is a mixed question of fact and law."[13] As noted in the Estate's appellate brief, *de novo* review is appropriate here because "there is a pure question of law imbedded in the valuation calculus."[14]

B. Framework

1. No Special Deference

Preliminarily, we note two factors that *do not* come into play in today's review. First, the Tax Court neither expressed nor implied credibility concerns with any witness, lay or expert, so there are no credibility calls to which we owe special deference. Second, the willing buyer/willing seller test of fair market value truly is ubiquitous: It is not peculiar to federal tax issues. Rather, it is universally employed in myriad legal contexts: civil and criminal;

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[10] *Green v. Comm'r*, 507 F.3d 857, 866 (5th Cir. 2007).

[11] *United States v. Roussel*, 705 F.3d 184, 195 (5th Cir. 2013) (citing *United States v. Griffin*, 324 F.3d 330, 365 (5th Cir. 2003)).

[12] *Succession of McCord v. Comm'r*, 461 F.3d 614, 626 (5th Cir. 2006).

[13] *Estate of Dunn v. Comm'r*, 301 F.3d 339, 348 (5th Cir. 2002).

[14] *Adams v. United States*, 218 F.3d 383, 385–86 (5th Cir. 2000).

tort and contracts; administrative and insurance. We therefore owe no enhanced deference to the Tax Court's application of that test.

2. Burden of Proof

As we affirm the Tax Court's ruling that percentages of fractional-ownership discount are applicable, we need not consider whether it applied the correct burden of proof to reach that conclusion. The second part of today's inquiry—the correct percentages of fractional-ownership discounts to be applied—presents a somewhat thornier question, at least theoretically. The Tax Court failed to require the Commissioner to bear that burden of proof, even though 26 U.S.C. § 7491 mandates that when, as here, the petitioning taxpayer adduces sufficient evidence to establish the material facts—in this case, the amounts of the discounts—the Commissioner has the burden of refuting such facts and proving different ones. Yet he chose not to adduce any evidence of discount *quantum* whatsoever, sticking instead to his no-discount position. By contrast, the Estate adduced a plethora of credible and highly probative evidence in support of both the applicability of such discounts *vel non* and the precise percentages of the discount to be applied to each separate item, as summarized in detail on Exhibit B of the Tax Court's opinion. Under a proper administration of § 7491's burden of proof rule, this case should have ended at that point with a judgment for the Estate. But, as shall be seen, the court's failure to assign the burden of proof of quantum to the Commissioner, although error, makes no difference in the end.

3. Preponderance of the Evidence

After rejecting the Commissioner's no-discount position, the Tax Court announced that the issue of the burden of proof was not important because it would proceed to determine the appropriate quantum of the discounts based on a *preponderance* of the evidence. In most trials, "[a] determination of where the preponderance lies requires a measuring and weighing of all the evidence,

pro and con."[15] But, when, as here, the *only* evidence on an issue is that presented by but one party—and by the one that did not have the burden of proof, at that—there is no "preponderance": It takes two to tango.[16] As with its misapplication of the burden of proof, however, the Tax Court's error in announcing its use of the preponderance standard to determine the amounts of the discounts ultimately makes no difference. This is because, having put all of his eggs in the one, no-discount basket at trial, the Commissioner cannot be heard on appeal to question the quantity, quality, or sufficiency of the evidence adduced by the Estate to prove the *quantum* of the fractional-ownership discounts to be applied.[17] Likewise, given the total absence of substantive evidence from the Commissioner on the issue of quantum, the Tax Court should have accepted and applied the uncontradicted quantums of the partial-ownership discounts that the Estate proved with much more than substantial evidence.

4. Merits

Just as it was obvious to the Tax Court that the Commissioner had no viable basis for rigidly insisting that no fractional-ownership discount was applicable, it should have been equally obvious that, in the absence of any evidentiary basis whatsoever, there is no viable factual or legal support for the

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[15] *United States v. Ricks*, 639 F.2d 1305, 1309 (5th Cir. Unit B Mar.1981).

[16] *Black's Law Dictionary* defines "preponderance of the evidence" as: "The greater weight of the evidence, not necessarily established by the greater number of witnesses testifying to a fact but by evidence that has the most convincing force; superior evidentiary weight that, though not sufficient to free the mind wholly from all reasonable doubt, is still sufficient to incline a fair and impartial mind to one side of the issue rather than the other." *See Black's Law Dictionary* 1301 (9th ed. 2009).

[17] For the first time on appeal, the Commissioner attempts to address the quantum of the fractional-ownership discounts as supporting the Tax Court's 10 percent discount. It is well settled, however, that we do not consider contentions raised for the first time on appeal. *Crawford Prof'l Drugs, Inc. v. CVS Caremark Corp.*, 748 F.3d 249, 267 (5th Cir. 2014).

court's own nominal 10 percent discount. This is particularly ironical when viewed in the light of the Tax Court's correct distinction of this case from, among others, *Estate of Scull v. Commissioner*, 67 T.C.M. (CCH) 2953 (1994), and *Stone v. United States*, No. 06-0259, 2007 WL 2318974, at *3 (N.D. Cal. Aug. 10, 2007). The courts in both of those cases awarded nominal discounts, but, as the Tax Court noted, they were only awarded "because of a lack of proof [by the taxpayer] that any greater discount was warranted." But the exact opposite situation is present here: The Estate, as taxpayer, presented *all* of the discount evidence, and a surfeit at that, further eschewing the propriety of a nominal discount.

At oral argument, appellate counsel for the Commissioner insisted that the Tax Court's sole reason for rejecting the discounts determined by the Estate's experts was their failure to include, or assign sufficient weight to, the Elkins heirs' strong emotional ("psychic") attachment to the family's works of art. Counsel claimed that the court faulted those experts for not concluding that, in and of itself, such psychic attachment would guarantee the hypothetical willing buyer a virtually undiscounted purchase price for the Decedent's fractional interests, regardless of those heirs' strong legal and financial positions as putative hostile co-owners with such a hypothetical willing buyer. According to Commissioner's counsel, this is what led the Tax Court to reject the expert's discounts out of hand. We disagree with counsel's cherry picking of the Tax Court's analysis. But even if counsel's reading of the Tax Court's reasoning were correct, it would not absolve that court of clear error.

We have again reviewed the entire transcript of the testimony of the Estate's experts and their written reports, and we are satisfied beyond cavil that they considered and correctly weighed all factors and characteristics of the Elkins heirs when determining how much a hypothetical willing buyer

would pay for Decedent's fractional interests and thus become a co-owner with them. Those experts took into account both the pros and the cons: the children's financial astuteness and their net worths; their hypothetical desire to acquire Decedent's fractional interests if a hypothetical willing buyer should acquire them first, but also their uncontradicted testimony that they would do so only for a "fair price," as determined by experts (presumably those who testified for them); their legal and financial ability to prevent any hypothetical willing buyer from quickly "flipping" his fractional interests in the art to third parties, particularly given the heirs' contractual restraints on alienation and partition, as well as their predictable determination to rid themselves of unrelated co-owners regardless of how much time it might take. In sum, we do not read the Tax Court to have rejected the importance of all aspects of the children's legal relationships to the art *other than* their "psychic" interests.

We repeat for emphasis that the Estate's uncontradicted, unimpeached, and eminently credible evidence in support of its proffered fractional-ownership discounts is not just a "preponderance" of such evidence; it is the *only* such evidence. Nowhere is there any evidentiary support for the Tax Court's unsubstantiated declaration that "a 10% discount would enable a hypothetical buyer to assure himself or herself of a reasonable profit on a resale of those interests to the Elkins children." Besides the error in logic of presuming that the hypothetical willing buyer *must* turn right around and sell his fractional purchases to those heirs, we cannot escape the conclusion that, under the facts of this case and the way the parties tried it, such a determination constitutes reversible error under any standard of review.

5. Correct Quantum of Fractional-Ownership Discounts

In turning to the question of the appropriate quantum of discount, the Tax Court acknowledged that (1) only the Estate's experts thoroughly analyzed

the extent of the discount, (2) the *relevant* testimony of the Commissioner's expert Ms. Hanus-McManus boiled down to the single fact that there is no "recognized" market for fractional interests in art, and (3) the several co-owners' agreements that regulated and restricted alienation, partition, and possession of essentially all of the art are distinguishable from such arrangements among persons engaged in arm's length, for-profit, art transactions. We agree. In fact, this increases the level of our comfort in concluding that nothing in the testimony of the Commissioner's experts, in his appellate brief, or in his appellate counsel's oral argument, detracts from or calls into question the Estate's unilateral discount evidence.[18]

It is principally within the last few pages of its opinion that the Tax Court's reversible error lies. While continuing to advocate the willing buyer/willing seller test that controls this case, the Tax Court inexplicably veers off course, focusing almost exclusively on its perception of the role of "the Elkins children" as owners of the remaining fractional interests in the works of art and giving short shrift to the time and expense that a successful willing buyer would face in litigating the restraints on alienation and possession and otherwise outwaiting those particular co-owners. Moreover, the Elkins heirs are neither *hypothetical* willing buyers nor *hypothetical* willing sellers, any more than the Estate is deemed to be the hypothetical willing seller.

We acknowledge, of course—as did the Estate's experts—that a hypothetical willing buyer would be aware of and take into account *all* aspects

[18] Indeed, the testimony of Ms. Hanus-McManus that there is no recognized or established market for undivided interests in art lends support to a *greater* discount. The absence of an established market would be a factor that a willing buyer would consider as calling for a deeper discount of fractional interests in art. Such absence does not, however, mean that willing buyers and willing sellers of fractional interests in art do not exist and cannot find one another through means other than an established market, *e.g.*, eBay, art galleries, art dealers' networks, conventions, social networking, and the like.

of the remaining fractional interests in the art that the Elkins heirs owned, not just the likelihood of their hypothetical desire to acquire the Decedent's fractional interests in the art from any successful hypothetical buyer thereof. An objective reading of the entirety of those experts' written reports and their testimony at trial demonstrates beyond question that the heirs' financial strengths, their out-of-hand rejection of the idea of ever selling their interests, and the time and money that the legal restraints in their arsenal would cost a willing buyer, combine to minimize any effect to the contrary that their "psychic" attachment to the art might otherwise have on the discounts that apply here. To repeat, Mrs. Sasser testified that if, hypothetically, she and her siblings were to purchase such interests, it would only be after first determining *from experts* that any price was fair and reasonable. And the experts consulted would likely be those persons whom the Tax Court accepted at trial; experts whose ultimate values were based on their substantial discounts below FMV.

Furthermore, like the absence of an established market, the subjective characteristics of the Decedent's descendants as the owners of the remaining fractional interests would likely cut the other way: A potential willing buyer would undoubtedly insist that his potential willing seller *further discount* the sales price to account for the virtual impossibility of making an immediate "flip" of the art. Such a fully informed willing buyer would be well aware that, by virtue of becoming a co-owner with the sophisticated, determined, and financially independent Elkins heirs, he could not possibly make such a quick resale—absent a deep discount, that is. And, the situation is only exacerbated by the effect of the various restrictions on partition, alienation, and possession that survived the death of the Decedent.

III. CONCLUSION

We conclude our review by examining the entire record to see if we can determine the correct quantums of the fractional-ownership discounts and thereby avoid remand. When we do so, we conclude that the discounts determined by the Estate's experts are not just the only ones proved in court; they are eminently correct. We are never comfortable in disagreeing with, much less reversing, a jurist of the experience, reputation, and respect enjoyed by the Tax Court judge whose work product we are called on to review today. Yet, our review of the court's extensive explication of this case and its ultimate conclusion that the proper discount is 10 percent, leaves us with the "definite and firm conviction that a mistake has been made."[19]

At bottom, we find nothing in this record or in the Tax Court's opinion that would justify any conclusion other than that the Estate is entitled to a final determination of the estate tax owed that produces a tax refund calculated on the basis of the fractional-ownership discounts and net taxable FMVs set forth on Exhibit B to the court's opinion. The record on appeal is sufficient for us to render a final judgment and dispose of the sole issue in this case without prolonging it by remand at the cost of more time and money to the parties. Accordingly, we (1) affirm the Tax Court's rejection of the Commissioner's insistence that no fractional-ownership discount may be applied in determining the taxable values of Decedent's undivided interests in the subject art work; (2) affirm the Tax Court's holding that the Estate is entitled to apply a fractional-ownership discount to the Decedent's ratable share of the stipulated FMV of each of the 64 works of art; (3) reverse the Tax Court's holding that the appropriate fractional-ownership discount is a nominal 10 percent, uniformly applied to each work of art, regardless of

[19] *Green v. Comm'r*, 507 F.3d 857, 866 (5th Cir. 2007).

distinguishing features; (4) hold that the correct quantums of the fractional-ownership discounts applicable to the Decedent's pro rata share of the stipulated FMVs of the various works of art are those determined by the Estate's experts and itemized on Exhibit B to the Tax Court's opinion; and (5) render judgment in favor of the Estate for a refund of taxes overpaid in the amount of $14,359,508.21, plus statutory interest in a sum to be agreed on by the parties, based on the timing of the payment of that refund to the Estate, all as jointly stipulated to us by the parties.

AFFIRMED in part; REVERSED in part; and RENDERED.

Full Text of Court Cases

Elkus v. Elkus

Case name: Elkus v. Elkus
Citation: 572 N.Y.S.2d 901,1991 N.Y. App. Div. LEXIS 9373
Date of decision: July 2, 1991
Country: US
State or Federal: State
State/Jurisdiction: New York
Court: Supreme Court
Type of action: Marital Dissolution
Judge: Rosenberger
SIC: 7929 Bands, Orchestras, Actors, and Other Entertainers Entertainment Groups (musical groups, musical artists, and orchestras)
NAICS: 711130 Musical Groups and Artists

Keywords: Marital dissolution

COUNSEL:

Alfred Ferrer, III, of counsel (Stacey Hallerman with him on the brief; Bass & Ullman, attorneys), for appellant.

Jeanne Wilmot Carter of counsel (Raimonde L. Schwarz with her on the brief; Raoul Lionel Felder, P. C., attorney), for respondent.

JUDGES:

Rosenberger, J. Milonas, J. P., Asch, Smith and Rubin, JJ., concur.

OPINIONBY:

ROSENBERGER

OPINION:

OPINION OF THE COURT

In this matrimonial action, the plaintiff, Frederica von Stade Elkus, moved for an order determining, prior to trial, whether her career and/or celebrity status constituted marital property subject to equitable distribution. The parties have already stipulated to mutual judgments of divorce terminating their 17-year marriage and to joint custody of their two minor children. The trial on the remaining economic issues has been stayed pending the outcome of this appeal from the order of the Supreme Court, which had determined that the enhanced value of the plaintiff's career and/or celebrity status was not marital property subject to equitable distribution. Contrary to the conclusion reached by the Supreme Court, we

find that to the extent the defendant's contributions and efforts led to an increase in the value of the plaintiff's career, this appreciation was a product of the marital partnership, and, therefore, marital property subject to equitable distribution.

At the time of her marriage to the defendant on February 9, 1973, the plaintiff hadjust embarked on her career, performing minor roles with the Metropolitan Opera Company. During the course of the marriage, the plaintiff's career succeeded dramatically and her income rose accordingly. In the first year of the marriage, she earned $ 2,250. In 1989, she earned $ 621,878. She is now a celebrated artist with the Metropolitan Opera, as well as an international recording artist, concert and television performer. She has garnered numerous awards, and has performed for the President of the United States.

During the marriage, the defendant traveled with the plaintiff throughout the world, attending and critiquing her performances and rehearsals, and photographed her for album covers and magazine articles. The defendant was also the plaintiff's voice coach and teacher for 10 years of the marriage. He states that he sacrificed his own career as a singer and teacher to devote himself to the plaintiff's career and to the lives of their young children, and that his efforts enabled the plaintiff to become one of the most celebrated opera singers in the world. Since the plaintiff's career and/or celebrity status increased in value during the marriage due in part to his contributions, the defendant contends that he is entitled to equitable distribution of this marital property.

The Supreme Court disagreed, refusing to extend the holding in O'Brien v O'Brien (66 NY2d 576) in which the Court of Appeals determined that a medical license constituted marital property subject to equitable distribution, to the plaintiff's career as an opera singer. The court found that since the defendant enjoyed a substantial life-style during the marriage and since he would be sufficiently compensated through distribution of the parties' other assets, the plaintiff's career was not marital property.

There is a paucity of case law and no appellate authority in New York governing the issue of whether a career as a performing artist, and its accompanying celebrity status, constitute marital property subject to equitable distribution. The plaintiff maintains that since her career and celebrity status are not licensed, are not entities which are owned like a business, nor are protected interests which are subject to due process of law, they are not marital property. In our view, neither the Domestic Relations Law, nor relevant case law, allows for such a limited interpretation of the term marital property.

Domestic Relations Law § 236 (B) (1) (c) broadly defines marital property as property acquired during the marriage "regardless of the form in which title is held". In enacting the Equitable Distribution Law (L 1980, ch 281, § 9), the Legislature created a radical change in the traditional method of distributing property upon the dissolution of a marriage (Price v Price, 69 NY2d 8, 14). By broadly defining the term "marital property", it intended to give effect to the "economic partnership" concept of the marriage relationship (supra, at 15; Majauskas v Majauskas, 61 NY2d 481). It then left it to the courts to determine what interests constitute marital property.

Things of value acquired during marriage are marital property even though they may fall outside the scope of traditional property concepts (O'Brien v O'Brien, supra; Florescue, "Market Value", Professional Licenses and Marital Property: A Dilemma in Search of a Horn, 1982 NY St B Assn Fam L

Rev 13 [Dec]). The statutory definition of marital property does not mandate that it be an asset with an exchange value or be salable, assignable or transferable. (Freed, Brandes and Weidman, "What is Marital Property?", NYLJ, Dec. 5, 1990, at 3, col 1.) The property may be tangible or intangible (ibid.).

Medical licenses have been held to enhance the earning capacity of their holders, so as to enable the other spouse who made direct or indirect contributions to their acquisition, to share their value as part of equitable distribution (O'Brien v O'Brien, supra; Maloney v Maloney, 137 AD2d 666; Raff v Raff, 120 AD2d 507). A MedicalBoard certification (Savasta v Savasta, 146 Misc 2d 101 [Sup Ct, Nassau County]), a law degree (Cronin v Cronin, 131 Misc 2d 879 [Sup Ct, Nassau County]), an accounting degree (Vanasco v Vanasco, 132 Misc 2d 227 [Sup Ct, Nassau County]), a podiatry practice (Morton v Morton, 130 AD2d 558), the licensing and certification of a physician's assistant (Morimando v Morimando, 145 AD2d 609), a Masters degree in teaching (McGowan v McGowan, 142 AD2d 355) and a fellowship in the Society of Actuaries (McAlpine v McAlpine, 143 Misc 2d 30 [Sup Ct, Suffolk County]) have also been held to constitute marital property.

Although the plaintiff's career, unlike that of the husband in O'Brien (supra), is not licensed, the O'Brien court did not restrict its holding to professions requiring a license or degree. In reaching its conclusion that a medical license constitutes marital property, the O'Brien court referred to the language contained in Domestic Relations Law § 236 which provides that in making an equitable distribution of marital property, "the court shall consider:

"(6) any equitable claim to, interest in, or direct or indirect contribution made to the acquisition of such marital property by the party not having title, including joint efforts or expenditures and contributions and services as a spouse, parent, wage earner and homemaker, and to the career or career potential of the other party [and]

"(9) the impossibility or difficulty of evaluating any component asset or any interest in a business, corporation or profession" (Domestic Relations Law § 236 [B] [5] [d] [6], [9] [emphasis added]).

The court also cited section 236 [B] [5] [e] which provides that where, equitable distribution of marital property is appropriate, but "the distribution of an interest in a business, corporation or profession would be contrary to law", the court shall make a distributive award in lieu of an actual distribution of the property (O'Brien v O'Brien, supra, 66 NY2d, at 584).

The Court of Appeals' analysis of the statute is equally applicable here. "The words mean exactly what they say: that an interest in a profession or professional career potential is marital property which may be represented by direct or indirect contributions of the non-title-holding spouse, including financial contributions and nonfinancial contributions made by caring for the home and family" (O'Brien v O'Brien, supra, at 584). Nothing in the statute or the O'Brien decision supports the plaintiff's contention that her career and/or celebrity status are not marital property. The purpose behind the enactment of the legislation was to prevent inequities which previously occurred upon the dissolution of a marriage. Any attempt to limit marital property to professions which are licensed would only serve to discriminate against the spouses of those engaged in other areas of employment. Such a distinction would fail to carry out the premise upon which equitable distribution is based, i.e., that a marriage is an economic partnership to which both parties contribute, as spouse, parent, wage earner or homemaker (Assembly mem, 1980 NY Legis Ann, at 130; Governor's mem of approval, 1980 McKinney's Session Laws of NY, at 1863; O'Brien v O'Brien, supra, at 585).

In Golub v Golub (139 Misc 2d 440 [Sup Ct, NY County]), the Supreme Court agreed with the defendant husband that the increase in value in the acting and modeling career of his wife, Marisa Berenson, was marital property subject to equitable distribution as a result of his contributions thereto. Like Ms. von Stade, Ms. Berenson claimed that since her celebrity status was neither "professional" nor a "license", and, since her show business career was subject to substantial fluctuation, it should not be considered "marital property".

The court disagreed, concluding at page 447 that "the skills of an artisan, actor, professional athlete or any person whose expertise in his or her career has enabled him or her to become an exceptional wage earner should be valued as marital property subject to equitable distri bution" (see also, Getz v Getz, NYLJ, Mar. 2, 1989, at 28, col 6 [Sup Ct, Westchester County]). As the Golub court found, it is the enhanced earning capacity that a medical license affords its holder that the O'Brien court deemed valuable, not the document itself. There is no rational basis upon which to distinguish between a degree, a license, or any other special skill that generates substantial income.

As further noted by the Golub court, there is tremendous potential for financial gain from the commercial exploitation of famous personalities. While the plaintiff insists that she will never be asked to endorse a product, this is simply speculation. More and more opportunities have presented themselves to her as her fame increased. They will continue to present themselves to her as she continues to advance in her career. The career of the plaintiff is unique, in that she has risen to the top in a field where success is rarely achieved.

Like the parties here, after Joe Piscopo and his wife married in 1973, they focused on one goal -- the facilitation of his rise to stardom (Piscopo v Piscopo, 231 NJ Super 576, 555 A2d 1190, affd 232 NJ Super 559, 557 A2d 1040, certification denied 117 NJ 156, 564 A2d 875). The defendant wife claimed that her husband's celebrity goodwill was a distributable asset and that she was entitled to a share in his excess earning capacity to which she contributed as homemaker, caretaker of their child, and sounding board for his artistic ideas.

Rejecting Mr. Piscopo's argument that celebrity goodwill is distinguishable from professional goodwill since professional goodwill has educational and regulatory requirements while celebrity goodwill requires ineffable talent, the court held that "it is the person with particular and uncommon aptitude for some specialized discipline whether law, medicine or entertainment that transforms the average professional or entertainer into one with measurable goodwill" (Piscopo v Piscopo, supra, 231 NJ Super, at 580-581, 555 A2d, at 1191). We agree with the courts that have considered the issue, that the enhanced skills of an artist such as the plaintiff, albeit growing from an innate talent, which have enabled her to become an exceptional earner, may be valued as marital property subject to equitable distribution.

The plaintiff additionally contends that her career is not marital property because she had already become successful prior to her marriage to the defendant. As noted, supra, during the first year of marriage, the plaintiff earned $ 2,250. By 1989, her earnings had increased more than 275 fold. Further, in Price v Price (supra, at 11), the Court of Appeals held that "under the Equitable Distribution Law an increase in the value of separate property of one spouse, occurring during the marriage and prior to the commencement of matrimonial proceedings, which is due in part to the indirect contributions or efforts of the other spouse as homemaker and parent, should be considered marital property (Domestic Relations

Law § 236 [B] [1] [d] [3])" (see, Capasso v Capasso, 119 AD2d 268; Clerk v Clerk, 132 AD2d 456, lv denied 70 NY2d 611). In this case, it cannot be overlooked that the defendant's contributions to plaintiff's career were direct and concrete, going far beyond child care and the like, which he also provided.

While it is true that the plaintiff was born with talent, and, while she had already been hired by the Metropolitan Opera at the time of her marriage to the defendant, her career, at this time, was only in the initial stages of development. During the course of the marriage, the defendant's active involvement in the plaintiff's career, in teaching, coaching, and critiquing her, as well as in caring for their children, clearly contributed to the increase in its value. Accordingly, to the extent the appreciation in the plaintiff's career was due to the defendant's efforts and contributions, this appreciation constitutes marital property.

In sum, we find that it is the nature and extent of the contribution by the spouse seeking equitable distribution, rather than the nature of the career, whetherlicensed or otherwise, that should determine the status of the enterprise as marital property.

We have considered the parties' remaining contentions and find them to be without merit.

Accordingly, the order of the Supreme Court, New York County (Walter M. Schackman, J.), entered September 26, 1990, which determined that the plaintiff's career and/or celebrity status was not "marital property" subject to equitable distribution, should be reversed, on the law, without costs, and the matter should be remitted to the Supreme Court for further proceedings.

Full Text of Court Cases

Elliotts, Inc. v. Commissioner

Case name: Elliotts, Inc. v. Commissioner
Citation: 716 F.2d 1241, 1983 U.S. App. LEXIS 16571
Date of decision: September 26, 1983
Country: US
State or Federal: Federal
State/Jurisdiction: 9th Circuit
Court: United States Court of Appeals
Type of action: Federal Taxation
Judge: Hug
SIC: 7699 Repair Shops and Related Services, NEC (farriers)
NAICS: 811310 Commercial and Industrial Machinery and Equipment (except Automotive and Electronic) Repair and Maintenance

Keywords: Dividends, Income tax

COUNSEL:

William H. Adams, Esq., for Appellant/Petitioner.

David Pincus, Jonathan S. Cohen, Richard M. Wilson, Jr., Washington, District of Columbia, for Appellee/Respondent.

JUDGES:

Hug, Skopil, and Fletcher, Circuit Judges.

OPINIONBY:

HUG

OPINION:

HUG, Circuit Judge:

Elliotts, Inc. ("Taxpayer"), challenges the Tax Court's determination of deficiencies in its 1975 and 1976 tax returns. It argues that the Tax Court erred in finding that part of the compensation paid Taxpayer's chief executive and sole shareholder during those years constituted a dividend distribution and thus was not deductible under section 162(a)(1) of the Internal Revenue Code. We reverse.

I

BACKGROUND

Taxpayer is an Idaho corporation that sells equipment manufactured by John Deere Co. and services equipment made by Deere and several other manufacturers. Its principal place of business is Burley, Idaho. During the period relevant here, Taxpayer had business locations in both Burley and Idaho Falls, Idaho. n1 The Idaho Falls location dealt only in industrial equipment; the Burley office sold and serviced a wide range of agricultural and industrial equipment. Out of approximately 168 John Deere agricultural dealers in the zone comprising seven western states, Taxpayer remained, at the time of trial, one of only three dealers handling both agricultural and industrial equipment.

n1 Taxpayer sold its Idaho Falls business on March 1, 1975. It has since done business only from its Burley location.

Taxpayer was incorporated in 1952. During its first year, it grossed $500,000 in agricultural equipment sales in the Burley area. It employed about eight people at that time. By 1975, Taxpayer was employing 40 people, selling both agricultural and industrial equipment throughout southeast Idaho, and achieving gross annual sales in excess of $5 million.

Edward G. Elliott has been Taxpayer's chief executive officer since its incorporation and he has also been its sole shareholder since 1954. He has always had total managerial responsibility for Taxpayer's business. In addition to being Taxpayer's ultimate decision and policy maker, he has performed the functions usually delegated to sales and credit managers. It is undisputed that he works about 80 hours each week.

For several years, Taxpayer has paid Elliott a fixed salary of $2000 per month plus a bonus at year's end. Since Taxpayer's incorporation, Elliott's bonus has been fixed at 50% of net profits (before subtraction of taxes and management bonuses).

On its return for the fiscal year ending February 28, 1975, Taxpayer claimed a $181,074 deduction for total compensation paid Elliott. It claimed a similar $191,663 deduction on its return for the fiscal year ending February 28, 1976. The Commissioner of Internal Revenue ("Commissioner") found these deductions to be in excess of the amounts Taxpayer properly could deduct as reasonable salary under section 162(a)(1). On June 16, 1978, the Commissioner issued Taxpayer a notice of deficiency which limited deductions for Elliott's salary to $65,000 for each fiscal year.

Taxpayer petitioned the Tax Court for a redetermination of liability. The court, after reviewing the testimony and statistical evidence, concluded that the payments to Elliott, in addition to providing compensation for personal services, were intended in part to distribute profits. Although the Tax Court acknowledged that it could not determine what amounts paid Elliott actually were dividends, it found that the total amounts paid him were in excess of reasonable compensation. It determined that $120,000 was reasonable compensation for the year 1975 and that $125,000 was reasonable for 1976. The deficiencies assessed to Taxpayer by the Commissioner were reduced accordingly. Taxpayer appeals the Tax Court's determination of reasonable compensation.

II

THE SHAREHOLDER-EMPLOYEE PROBLEM

The issue presented by this case concerns the deductibility by a corporation of payments ostensibly made as compensation for services to an employee who is also a shareholder. If the payments are reasonable compensation for services rendered, the corporation may deduct them. 26 U.S.C. § 162(a)(1). If, however, they are actually dividends, they are not deductible. Thus, it will normally be in a corporation's interest to characterize such payments as compensation rather than dividends. n2

n2 The recipient is taxed at ordinary income rates on both dividends and wages. If the recipient is a significant shareholder, his interest in the corporation may cause him to prefer to characterize such payments as compensation. Moreover, for payments made between 1971 and 1981, as is the case here, a high-income recipient has a strong incentive to characterize such payments as compensation rather than dividends: pre-1982 dividends are taxable at a maximum rate of 70% while the maximum tax rate for wages received between 1971 and 1981 is 50%. 26 U.S.C. § 1 (amended 1983) and § 1348 (repealed 1981). (Since 1982, the maximum tax rate for both wages and dividends has been 50%. 26 U.S.C. § 1 (1983).)

The general problem is that of distinguishing between dividends and compensation for services received by a shareholder-employee of a closely held corporation. What makes this situation troublesome is that the shareholder-employee and the corporation are not dealing with each other at arm's length. It is likely to be in the interests of both the corporation and the shareholder-employee to characterize any payments to the shareholder-employee as compensation rather than dividends. For this reason, a taxpayer's characterization of such payments may warrant close scrutiny to ensure that a portion of the purported compensation payments is not a disguised dividend. See Nor-Cal Adjusters v. Commissioner, 503 F.2d 359, 361 (9th Cir. 1974).

The problem of determining whether compensation payments contain an element of disguised dividend is exacerbated in a case such as this one where the shareholder-employee is the corporation's sole shareholder. Not only is a sole shareholder likely to have complete control over the corporation's operations, he will also be the only recipient of its dividends. If a corporation has multiple shareholders, the existence of a plan which compensates shareholder-employees in proportion to their ownership interests may be evidence that compensation payments contain disguised dividends. In the case of a sole shareholder, such evidence is meaningless.

Section 162(a)(1) of the Internal Revenue Code permits a corporation to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." There is a two-prong test for deductibility under section 162(a)(1): (1) the amount of the compensation must be reasonable and (2) the payments must in fact be purely for services. Treas. Reg. § 1.162-7(a) (1960); Nor-Cal, 503 F.2d at 362.

Proof of the second prong, which requires a "compensatory purpose," can be difficult to establish because of its subjective nature. See Note, Reasonable Compensation and the Close Corporation: McCandless, the Automatic Dividend Rule, and the Dual Level Test, 26 Stan. L. Rev. 441, 447 (1974) (hereafter "Note, Reasonable Compensation"). The existence of a compensatory purpose can often be inferred if the amount of the compensation is determined to be reasonable under the first prong. For these reasons, courts generally concentrate on the first prong -- whether the amount of the purported compensation is reasonable. See, e.g., Pacific Grains, Inc. v. Commissioner, 399 F.2d 603 (9th Cir.

1968); Note, Reasonable Compensation, 26 Stan. L. Rev. at 447; Coggin, The Status of the McCandless Doctrine, 55 Taxes 720, 720 (Nov. 1977) (hereafter "Coggin"). Courts have generally not delved into whether a compensatory purpose exists under the second prong except in those rare cases where the Commissioner has come forward with evidence that purported compensation payments, although reasonable in amount, were in fact disguised dividends. See, e.g., Klamath Medical Serv. Bureau v. Commissioner, 29 T.C. 339, 348-49 (1957), aff'd, 261 F.2d 842 (9th Cir. 1958), cert. denied, 359 U.S. 966, 3 L. Ed. 2d 834, 79 S. Ct. 877 (1959). See generally Note, Reasonable Compensation, 26 Stan. L. Rev. at 447 & n. 35. By and large, the inquiry under section 162(a)(1) has turned on whether the amounts of the purported compensation payments were reasonable.

One court has departed from this practice of restricting the inquiry in most cases to the reasonableness of the payments. In Charles McCandless Tile Serv. v. United States, 191 Ct. Cl. 108, 422 F.2d 1336 (1970), the Court of Claims held that ostensible compensation payments paid to two shareholder-employees, even though reasonable in amount, "necessarily" contained disguised dividends because the closely held corporation had been profitable and had not paid out any dividends since its formation. Id. at 1339-40. n3 This has become known as the "automatic dividend rule," and has been subjected to much criticism. E.g., Coggin, 55 Taxes 720; Walthall, McCandless -- Implications for Compensation Planning and Dividend Policy, 6 Cum. L. Rev. 1 (1975) (hereafter "Walthall"); Note, Reasonable Compensation, 26 Stan. L. Rev. 441.

n3 It appears that the Court of Claims subsequently adopted a narrow interpretation of McCandless. Giles Indust., Inc. v. United States, 204 Ct. Cl. 202, 496 F.2d 556, 567 (1974).

We reject the automatic dividend rule of McCandless for several reasons. First, there is no statute requiring profitable corporations to pay dividends. Congress has chosen to handle abuses in this area through the accumulated earnings tax. 26 U.S.C. § § 531-537; see Walthall, 6 Cum. L. Rev. at 16-19; Note, Reasonable Compensation, 26 Stan. L. Rev. at 449-50. Beyond the penalties contained in the accumulated earnings tax, Congress has not indicated that it wants the Commissioner or the courts to require the payment of dividends as a matter of federal tax policy. See Casey v. Commissioner, 267 F.2d 26, 30 (2d Cir. 1959); Laure v. Commissioner, 70 T.C. 1087, 1098 (1978).

Second, the automatic dividend rule is based on the faulty premise that shareholders of a profitable corporation will demand dividends. See McCandless, 422 F.2d at 1339-40. Shareholders are generally concerned with the return on their investment. While some shareholders may prefer to see their return in the form of dividends, others will prefer to have the corporation reinvest its profits so that their return will be in the form of appreciation and the potential of greater future return. See, Note, Reasonable Compensation, 26 Stan. L. Rev. at 450-53. If the shareholders prefer to have their return in the form of appreciation rather than dividends, there is nothing in the law precluding the corporation from reinvesting its profits.

Third, it may well be in the best interests of the corporation to retain and reinvest its earnings. As the Supreme Court has noted, "Directors of a closely held, small corporation must bear in mind the relatively limited access of such an enterprise to capital markets. This may require a more conservative policy with respect to dividends than would be expected of an established corporation with securities listed on national exchanges." United States v. Byrum, 408 U.S. 125, 140, 33 L. Ed. 2d 238, 92 S. Ct. 2382

(1972). Not only may retained earnings be the most rational source of financing for a small corporation, "suppliers or outside lenders may insist upon the retention of earnings as a cushion for the credit which they extend or to insure that the firm has sufficient operating funds to continue functioning as a going concern." Walthall, 6 Cum. L. Rev. at 15.

For these reasons, we will not presume an element of disguised dividend from the bare fact that a profitable corporation does not pay dividends.

In determining the deductibility of compensation payments paid to shareholder-employees, we will continue to concentrate on the reasonableness of those payments. In the rare case where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness. But where, as here, the evidence focuses only on reasonableness and the failure to pay dividends, and there is no other evidence of an intent to hide dividends in compensation payments, our inquiry will be confined to the reasonableness issue. The inquiry into reasonableness is a broad one and will, in effect, subsume the inquiry into compensatory intent in most cases.

In evaluating the reasonableness of compensation paid to a shareholder-employee, particularly a sole shareholder, it is helpful to consider the matter from the perspective of a hypothetical independent investor. A relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he was compensated. The nature and quality of the services should be considered, as well as the effect of those services on the return the investor is seeing on his investment. The corporation's rate of return on equity would be relevant to the independent investor in assessing the reasonableness of compensation in a small corporation where excessive compensation would noticeably decrease the rate of return.

Bearing in mind the preceding discussion, we now turn to the reasonableness of the compensation paid by Taxpayer to Elliott.

III

REASONABLENESS DETERMINATION

Section 162(a)(1) provides that a taxpayer may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," including "a reasonable allowance for salaries or other compensation for personal services actually rendered." 26 U.S.C. § 162(a)(1). That Elliott actually rendered services as an employee of Taxpayer is not disputed. At issue is whether the payments made to Elliott are attributable to that employment relationship or to his role as Taxpayer's sole shareholder. Our inquiry focuses on whether the Tax Court, in finding that a part of the payments made to Elliott could not be attributed to his employment status, correctly defined and applied the factors that determine what is "reasonable compensation" under section 162(a)(1).

Although we accord deference to the Tax Court's special expertise, definition of the appropriate factors is reviewable by this court as a question of law. See Keller Street Development Co. v. Commissioner, 688 F.2d 675, 678 (9th Cir. 1982); Sibla v. Commissioner, 611 F.2d 1260, 1262-63 (9th Cir. 1980). The Tax Court's findings of fact, derived from application of the appropriate factors, must be affirmed unless clearly erroneous. Keller Street, 688 F.2d at 678; Estate of Skaggs v. Commissioner, 672 F.2d 756, 757 (9th Cir. 1982), cert. denied, 459 U.S. 1037, 103 S. Ct. 448, 74 L. Ed. 2d 603 (1982).

Our cases have defined a number of factors that are relevant to this attribution determination, "with no single factor being decisive of the question." Pacific Grains, 399 F.2d at 606. For analytical purposes, these factors may be divided into five broad categories.

A. Role in Company

The first category of factors concerns the employee's role in the taxpaying company. Relevant considerations include the position held by the employee, hours worked, and duties performed, American Foundry v. Commissioner, 536 F.2d 289, 291-92 (9th Cir. 1976), as well as the general importance of the employee to the success of the company, American Foundry, 536 F.2d at 291-92. If the employee has received a large salary increase, comparing past duties and salary with current responsibilities and compensation also may provide significant insights into the reasonableness of the compensation scheme. Pacific Grains, 399 F.2d at 605, 607.

The Tax Court found that Elliott worked 80 hours per week, performed the functions of general manager, sales manager, and credit manager, and made all policy decisions concerning the parts and service department. Elliotts, Inc. v. Commissioner, 1980 T.C. Memo 282, 40 T.C.M. (CCH) 802, 804 (1980). These are all appropriate considerations. The Tax Court also considered Elliott's qualifications and found that although he was a "capable executive" he had no "special expertise." Id. at 813. The Tax Court did not seem, however, to consider Elliott's extreme personal dedication and devotion to his work. See id. at 811. To the extent that this benefited the corporation, it is surely something for which an independent shareholder would have been willing to compensate Elliott. Because we reverse and remand on other grounds, we point this out so that the Tax Court may consider it on remand.

B. External Comparison

The second set of relevant factors is a comparison of the employee's salary with those paid by similar companies for similar services. See Hoffman Radio Corp. v. Commissioner, 177 F.2d 264, 266 (9th Cir. 1949); E. Wagner & Son v. Commissioner, 93 F.2d 816, 819 (9th Cir. 1937).

The Tax Court did compare Elliott's compensation to that of managers at other John Deere dealers. 40 T.C.M. at 813. In making these comparisons, it appears that the Tax Court considered that Elliott was performing the functions that two or three people performed at other dealers. This was correct. Such comparisons should be made on the basis of services performed. See E. Wagner, 93 F.2d at 818; Treas. Reg. § 1.162-7(b)(3). If Elliott was performing the work of three people, the relevant comparison would be the combined salaries of those three people at another dealer.

C. Character and Condition of Company

The third general category of factors concerns the character and condition of the company. The focus under this category may be on the company's size as indicated by its sales, net income, or capital value. See E. Wagner, 93 F.2d at 819; General Water Heater Corp. v. Commissioner, 42 F.2d 419, 420 (9th Cir. 1930). Also relevant are the complexities of the business and general economic conditions. To the extent that they are relevant to this case, the Tax Court did adequately consider these factors.

D. Conflict of Interest

The fourth category focuses on those factors that may indicate a conflict of interest. The primary issue within this category is whether some relationship exists between the taxpaying company and its employee which might permit the company to disguise nondeductible corporate distributions of income as salary expenditures deductible under section 162(a)(1). n4 Such a potentially exploitable relationship may exist where, as in this case, the employee is the taxpaying company's sole or controlling shareholder, see Nor-Cal, 503 F.2d at 361; Pacific Grains, 399 F.2d at 607; E. Wagner, 93 F.2d at 817, 819, or where the existence of a family relationship indicates that the terms of the compensation plan may not have been the result of a free bargain, Harolds Club v. Commissioner, 340 F.2d 861, 865 (9th Cir. 1965). Other factors also may point toward an attempt to distribute income through "compensation," including the existence of a bonus system that distributes all or nearly all of the company's pre-tax earnings, Nor-Cal, 503 F.2d at 362; Klamath Medical, 261 F.2d at 846; Sunset Scavenger Co. v. Commissioner, 84 F.2d 453, 455 (9th Cir. 1936), that amounts to a disproportionately large percentage of gross income when combined with salary, Pacific Grains, 399 F.2d at 607; General Water Heater, 42 F.2d at 420, or that provides large bonuses to owner-executives, but none to non-owner management, Nor-Cal, 503 F.2d at 361.

n4 This may also be probative of a presence or absence of compensatory intent.

In this case, where Elliott was the sole shareholder, the sort of relationship existed that warrants scrutiny. The mere existence of such a relationship, however, when coupled with an absence of dividend payments, does not necessarily lead to the conclusion that the amount of compensation is unreasonably high. Further exploration of the situation is necessary.

In such a situation, as discussed earlier, it is appropriate to evaluate the compensation payments from the perspective of a hypothetical independent shareholder. If the bulk of the corporation's earnings are being paid out in the form of compensation, so that the corporate profits, after payment of the compensation, do not represent a reasonable return on the shareholder's equity in the corporation, then an independent shareholder would probably not approve of the compensation arrangement. If, however, that is not the case and the company's earnings on equity remain at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company disguised as salary. n5

n5 It should be noted that there are situations in which the compensation paid to employees is reasonable and yet the corporation may suffer a loss or an inadequate return on equity.

During the fiscal year ending February 28, 1975, Taxpayer reported equity of $415,133 and net profits (profits less taxes and compensation paid Elliott) of $88,969 -- a return of 21%. For fiscal year 1976, Taxpayer reported equity of $513,429 and net profits of $98,297 -- a return of 19%. 40 T.C.M. at 804. Thus, the average rate of return on equity during these years was 20%. The Tax Court failed to consider the significance of this data. It seems clear, however, that this rate of return on equity would satisfy an independent investor and would indicate that Taxpayer and Elliott were not exploiting their relationship. n6

n6 Over the period from 1968 to 1978, during which the bonus formula was in effect, the average rate of return on equity was 15%, based on corporate profit in relation to net book value. There was also evidence, which was not disputed, that the market value of the corporation had increased from the initial shareholder investment of $19,000 to a current market value at the time of trial of $5,000,000. Utilizing these market value figures, Professor Albrecht, an expert witness, testified that this resulted in an annual compounded return of 56%.

This is also probative of Elliott's management contributions to Taxpayer.

The Tax Court erred by limiting its analysis in this area to the facts that Elliott was Taxpayer's sole shareholder and Taxpayer paid no dividends. These are relevant factors, but they cannot be viewed in isolation. Taxpayer's no-dividend policy does not by itself demonstrate that the relationship between Taxpayer and Elliott was being exploited.

E. Internal Consistency

Finally, evidence of an internal inconsistency in a company's treatment of payments to employees may indicate that the payments go beyond reasonable compensation. n7 Bonuses that have not been awarded under a structured, formal, consistently applied program generally are suspect, see Nor-Cal, 503 F.2d at 362, as are bonuses consistently designated in amounts tracking either the percentage of the recipient's stock holdings, id.; General Water Heater, 42 F.2d at 420, or some type of tax benefit, Pacific Grains, 399 F.2d at 607 (bonus adjusted according to available surtax exemption). Similarly, salaries paid to controlling shareholders are open to question if, when compared to salaries paid non-owner management, they indicate that the level of compensation is a function of ownership, not corporate management responsibility. Sunset Scavenger Co., 84 F.2d at 456. On the other hand, evidence of a reasonable, longstanding, consistently applied compensation plan is evidence that the compensation paid in the years in question was reasonable.

n7 This may also be probative of a presence or absence of compensatory intent.

There was evidence in this case of a longstanding, consistently applied compensation plan. Since Taxpayer's incorporation, it had paid to Elliott an annual bonus equal to 50% of its net profits. Taxpayer contended before the Tax Court that because the yearly bonuses paid Elliott were derived from a predetermined formula that had been in use for over 20 years, it could be inferred that the bonuses constituted compensation for services rather than a dividend distribution. It noted that under the bonus formula Elliott's salary in some prior years had been too low to compensate him for the services he had rendered to Taxpayer, so that the higher salaries in the years in issue "resulted in average reasonable compensation during the 10-year period . . . . 1968 through 1978." 40 T.C.M. at 809-10.

In considering the significance of this longstanding bonus formula, the Tax Court erred in several respects.

The Tax Court failed to consider the reasonableness of the contingent formula itself; it concentrated instead on the amounts paid under the formula in two particular years. Such a formula may overcompensate in good years and undercompensate in bad years. This feature, however, does not necessarily make the formula unreasonable. It is permissible to pay and deduct compensation for services performed in prior years. Lucas v. Ox Fibre Brush Co., 281 U.S. 115, 119, 74 L. Ed. 733, 50 S. Ct. 273 (1930).

Whether payments under such a formula are reasonable will depend on whether the formula is reasonable. The reasonableness of a longstanding formula should not be determined on the basis of just one or two years. Taxpayer persuasively argues that, accepting the Tax Court's determination of reasonable compensation for 1974 and 1975, Elliott was severely undercompensated in terms of constant dollars in six of the seven preceding years. n8

n8 A formula which is reasonable at its inception may later become unreasonable because of changed circumstances. Where a formula has proved reasonable over a long period of time, however, it should normally not be deemed unreasonable solely because it has overcompensated in one or two years.

Also relevant to the reasonableness of the formula used in this case is the return on equity an independent investor would have achieved. A formula which would not allow a reasonable return on equity is likely to be unreasonable. In this case, however, as discussed earlier, the return on equity in the years at issue was about 20%.

Over the long run, such a formula should reasonably compensate for the work done, the performance achieved, the responsibility assumed, and the experience and dedication of the employee. At the same time, it should not stand in the way of a satisfactory return on equity.

The Tax Court also discounted the significance of the bonus formula on the ground that "no special incentive is necessary to insure [Elliott's] best efforts since he would 'receive the fruits of success through his status as the majority shareholder. '" 40 T.C.M. at 811, quoting Charles Schneider & Co. v. Commissioner, 500 F.2d 148, 153 (8th Cir. 1974), cert. denied, 420 U.S. 908, 42 L. Ed. 2d 837, 95 S. Ct. 826 (1975). To the extent that this implied that incentive payment plans for shareholder-employees are unreasonable, it was error.

Incentive payment plans are designed to encourage and compensate that extra effort and dedication which can be so valuable to a corporation. There is no reason a shareholder-employee should not also be entitled to such compensation if his dedication and efforts are instrumental to the corporation's success. In this case, there is no doubt that Elliott's extreme dedication and hard work were valuable to Taxpayer. If an outside investor would approve of such a compensation plan, that plan is probably reasonable. The fact that the recipient is a shareholder-employee does not make the plan unreasonable.

IV

CONCLUSION

We reverse and remand to the Tax Court for reconsideration in light of this opinion. On remand, the Tax Court should begin its analysis by looking at the reasonableness of the compensation payments and should consider the bonus payments in the context of the reasonableness of the formula used. It should

not be assumed solely from Elliott's role as sole shareholder and the absence of dividends that the compensation payments necessarily contained disguised dividends. These are just two of many factors to be considered.

REVERSED and REMANDED.

Full Text of Court Cases

Estate of Feldmar v. Commissioner

Case name: Estate of Feldmar v. Commissioner
Citation: T.C. Memo 1988-429, 56 T.C.M. 118
Date of decision: September 12, 1988
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Fay
SIC: 6719 Offices of Holding Companies, NEC
NAICS: 551112 Offices of Other Holding Companies

Keywords: Estate tax, Holding company

COUNSEL:

Rex A. Guest and Francis Grossi, for the petitioners.

Judith Picken and James S. Stanis, for the respondent.

OPINIONBY:

FAY

OPINION:

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, Judge: Respondent determined a deficiency of $ 9,649,113.69 in the estate tax due from the Estate of Milton Feldmar. After concessions, the sole issue for decision is the date of death fair market value of 767,800 shares of United Equitable Corporation common stock owned by Milton Feldmar at his death.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts, the addendum to the stipulation of facts, and attached exhibits are incorporated herein by this reference.

Petitioner is the Estate of Milton Feldmar. On March 30, 1982, Milton Feldmar (the decedent) died unexpectedly. At the time of his death, decedent's domicile was Northfield, Illinois. The co-executors of petitioner are Gary Feldmar and Dorothy Feldmar. Gary Feldmar resided in Lincolnshire, Illinois, and Dorothy Feldmar resided in Highland Park, Illinois, at the time the petition in this case was filed.

Petitioner's Federal estate tax return was timely filed. The alternate valuation date was not elected. Included with the estate were 767,800 shares of common stock in United Equitable Corporation (UEC). Petitioner's return listed the value of this stock as $ 7,678,000, or $ 10 per share. In his notice of

deficiency, respondent determined that the fair market value of the UEC stock in the state should be $ 35,776,524, or $ 46.60 per share.

Nature of UEC's Business

At the time of decedent's death, UEC was an Illinois-based holding company which, through the companies it owned, was in the business of selling and underwriting several different types of insurance coverage. The companies UEC owned, directly or indirectly, were, among others, as follows: (1) United Equitable Life Insurance Company (UELIC) and its wholly owned subsidiary, United Equitable Insurance Company (UELIC), both of which UEC acquired in 1972; (2) American Warranty Corporation (AWC), acquired by UEC in December 1976; and, (3) Action Associates (Action), acquired by UEC in July, 1980.

The types of insurance coverage UEC's family of companies sold and underwrote included the traditional forms of insurance: life, and individual and family accident and health. In addition, the companies UEC owned were also involved in marketing and administering two specialty forms of insurance products: vehicle warranty/service contracts, and collateral protection services.

The vehicle warranty/service contract business (hereinafter referred to as warranty services) conducted by AWC involves the marketing of such contracts to factory-authorized new car dealerships. The car dealerships in turn sell the warranty contracts to buyers of both new and used cars, and thus provide such buyers a warranty against power train mechanical breakdowns. When a car buyer purchases the contract from a dealer, the buyer is buying a warranty. When a dealer purchases the contract from AWC, the dealer is basically purchasing insurance against the liability they will incur in satisfying the terms of the warranty they have given the car buyer.

The collateral protection services of UEC are marketed and administered by Action. Action is a Los Angeles, California, based insurance broker that provides collateral protection services to financial institutions engaged in consumer lending. In the performance of its services, Action manages a client's consumer loan portfolio by ensuring that the collateral securing each loan is insured in an amount at least equal to the outstanding loan balance. Underinsured collateral is insured by Action through a third-party underwriter, and Action is compensated for its services in the form of a commission.

Through the early 1970s, UEC's major emphasis was on low cost limited indemnity accident and health policies. After UEC's acquisition of AWC in 1976, and of Action in 1980, however, UEC's revenue mix shifted away from such accident and health policies to an emphasis on the warranty services and collateral protection services. Of UEC's 1981 consolidated revenue, 57% consisted of warranty and collateral protection services income, and 40% consisted of accident and health and life insurance income. The remaining 3% came from UEC's corporate investment portfolio. By comparison, in 1977 62% of UC's revenue came from accident and health insurance sales.

Economic Trends Facing UEC

Accident and Health Insurance. Historically, UEC had specialized in the sale of individual and family accident and health insurance. This line of UEC's business was a major source of UEC's total earning power at the time of decedent's death.

UEC's accident and health insurance policies were, as of the date of decedent's death, marketed through the use of direct mail solicitations (hereinafter referred to as direct response marketing), and through the use of agents, UEC's own or agents which operated independently thereof (hereinafter

referred to as agency marketing). In prior periods, UEC's concentration was upon the direct response form of marketing; such direct response marketing techniques were considered to be the core of UEC's business. In 1976, approximately 71% of UEC's accident and health premiums resulted from direct response marketing, and approximately 29% came from agency marketing. In contrast, in 1981 approximately 54% of UEC's written premiums for UEC's accident and health insurance resulted from direct response marketing, and 46% from agency marketing.

With respect to UEC's accident and health insurance first year premium income trends, i.e., premium income on newly sold policies, direct response marketing was, as of decedent's date of death, increasingly less successful. To counter this increasing ineffectiveness, UEC developed and began marketing, in 1979, an add-on policy which provided to existing accident and health policy holders additional protection. Such add-on policies were also sold through a direct response marketing program. Even considering such add-on policies as additional first year premiums, however, UEC's total first year premiums from direct response marketing continued to decline after 1979. n1 Total direct response marketing first year premiums declined, in relation to the prior year's premiums, by 35.8% in 1980 and by 46.6% in 1981. Exclusive on the add-on policy premiums, accident and health insurance first year premium income from direct response marketing fell by 84.9% between 1980 and 1981.

n1 UEC's direct response marketing new policy premium income was as follows:

Year	New Policy Premiums	Change	Add-On Sales To Existing Policy holders	Total New Policy Premiums	Change
1978	1,628,000		N/A	1,628,000	
1979	1,375,000		1,422,000	2,797,000	
					(35.8%)
1980	1,004,000		791,000	1,795,000	
		(84.9%)			(46.6%)
1981	152,000		806,000	958,000	

The most important reason for such a precipitous decline in sales from direct response marketing was because UEC has not been able to develope a successful direct response marketing campaign since 1979. UEC did continuously test newly developed direct response marketing programs during 1980 and 1981. However, the marketing test results were unsatisfactory. Specifically, the marketing test results indicated that the expected amount of net new policy sales from the proposed new direct response marketing programs would not be large enough to justify the initial costs UEC would have to incur in implementing such new direct response marketing program.

Another reason for the decline in UEC's sales of accident and health policies through direct response marketing in 1980 and 1981 was the intense competition UEC faced in the industry. In the years preceding the date of decedent's death, competition in the industry was intensifying and regulatory constraints were increasing. These influences, increasing competition and regulatory concerns, caused

the sellers of accident and health insurance to provide to the consumer more complete disclosure of policy benefits and the seller's related costs. Because of this, UEC's policies appeared less attractive to the consumer than did the policies of UEC's competitors.

Although the direct response marketing's successive failures were somewhat offset by steady growth in the sales produced by agency marketing, such offset was not without its costs. In order to give the agents a product which would sell, and which would enable the agent to make a livelihood selling, UEC was required to develop a product costing a larger premium but offering additional coverage for nursing home or extended care costs. Inherent in such policy coverage was greater potential risks to the policies' underwriter, UEIC.

The costs incurred by UEC in selling its accident and health policies, by direct response or agency marketing, were capitalized by UEC as an asset labeled "deferred policy acquisition costs." That asset, i.e., the cost of newly acquired policies, is amortized by UEC over the expected life of those policies. The "deferred policy acquisition costs" asset is the second largest of all assets on the corporate balance sheet and represents approximately 24.8% of UEC's total assets as of December 31, 1981. Moreover, in relation to the total stock outstanding, deferred policy acquisition costs represented $ 23.21 per share as of December 31, 1981.

Life Insurance. UEC began emphasizing its life insurance sales in 1980. Prior to that time, earned insurance premium income was less than $50,000 a year. In 1981, earned insurance premium income from UEC's life insurance sales increased to approximately $ 1,700,000. The profitability of this product line was negatively affected, however, by the costs UEC incurred in connection with making the initial sales of the policies. The costs so incurred are those associated with selling a new policy and are recurring expenses so long as UEC remains in the life insurance business. For example, part of a policy's acquisition costs consists of the commission paid an agent for the sale of that policy. Generally, UEC expects to recoup such deferred policy acquisition costs as premiums on the life insurance policy are paid in future years. If a policyholder allows a policy to lapse, however, the initial costs incurred by UEC are never recovered and UEC's profitability suffers.

UEC's experience with respect to the lapse rate of life insurance policies, in relation to premiums paid, n2 has been as follows:

Year	First Year Life Insurance Premiums	Total Life Insurance Premiums	Lapse Rate
1978	$ 13,000	$ 36,000	1.2%
1979	10,000	45,000	3.5
1980	1,223,000	1,351,000	22.7
1981	1,003,000	2,016,000	33.4

n2 This is based upon statutory accounting procedures, as opposed to generally accepted accounting principles.

Vehicle Warranty/Service Contracts. There are two distinct aspects of the warranty services business which contribute to UEC's earnings. Operating revenue is first generated from the sale of the contracts to the automobile dealerships, from which AWC expects to earn a profit after all expenses. Second, the pricing of the contracts includes a provision for a premium for the warranty insurance coverage provided the automobile dealership under the contract. AWC would remit such premium to UEIC, the underwriter of the warranty insurance coverage. Thus, UEC generates revenue in the form of AWC's contract sales in excess of expenses therefor, where such expenses include the premium for warranty insurance, and in the form of UEIC's premiums in excess of losses for which UEIC must reimburse the automobile dealers. UEC's experience with respect to its warranty contract sales, and its warranty insurance premiums earned, as been as follows:

Year	Warranty Contract Sales	Pretax Earnings (Losses)	Warranty Insurance Premiums Eaned	Loss Ratio n3
1979	10,984,000	120,000	9,885,000	71.3%
1980	12,330,000	(234,000	9,865,000	77.2
1981	10,293,000	(521,000)	12,143,000	78.6

n3 As an example of how the loss ratio is computed, in 1981, the loss ratio represents the UEIC paid out 78.6 cents of every dollar it received in premiums. Such ratio is based upon information generated under statutory accounting procedures, as opposed to generally accepted accounting principles.

In 1979, AWC's contract sales represented an estimated 30% market share for new U.S. manufactured automobiles and a 5% market share for foreign manufactured automobiles. By early 1982, AWC's estimated domestic market share had declined to 5% to 10%, whereas its foreign market share had increased to an estimated 20% to 25%. Such shift in emphasis was partially in response to the shift American purchasers made from domestically produced automobiles to foreign produced automobiles. AWC's rate of growth in total contract sales slowed sharply in 1980, and declined by 16.5% in 1981.

The reasons behind AWC's increasingly poor performance are multifaceted. First, new car sales steadily declined following the record results the automobile industry realized in 1978 and, therefore, the warranty contract sales made in connection therewith also declined. Second, competition in the market increased because, in an attempt to off-set the declining market, automobile manufacturers themselves started competing with AWC by offering additional warranties or warranty contracts through their respective automobile dealerships. Finally, in an attempt to stem its declining market share, AWC changed its compensation program offered to major automobile dealerships. In 1979, AWC began offering such dealers a compensation plan for the sale of AWC warranty contracts, under which the dealers would be able to participate in the profits UEIC was realizing in its underwriting capacity. Such a compensation plan, however, was ineffective and was discontinued in 1981. This resulted in an additional disruption in AWC's marketing program in that year and added to UEC's decline in total contract sales.

Another negative impact upon AWC's profitability in 1981 was caused in connection with its 1979 attempt to change its compensation scheme for major car dealerships. Such change in its compensation scheme required, in 1979, a major revamping of AWC's computer system. When such compensation scheme proved to be ineffective as an incentive for marketing AWC's warranty service contracts, and was terminated in 1981, AWC was required to again reprogram its computer system. Such reprogramming of computers often occurs in the insurance industry. The 1981 reprogramming had not been completed as of early 1982, and the costs associated with the reprogrammming during 1981 further decreased AWC's earnings for that year.

The second aspect of UEC's revenues flowing from its warranty services comes from the premium income UEIC receives upon underwriting the warranty insurance coverage incorporated into the contracts sold. UEIC's earned premiums from its underwriting activities grew gradually in the years 1979 through 1981; however, such was only in response to AWC's successful contract sales during the period 1977 through 1979. Due to the nature of insurance accounting, however, changes in earned premiums for UEIC's underwriting activities lag, by approximately two to four years, behind AWC's contract sales... Consequently, over the period from 1982 to 1984, it can be expected that UEIC's experience in earned premiums will begin to decline in response to AWC's dismal contract sales performance during the 1980 to 1981 period.

Even considering the growth UEIC experienced in earned premiums from its warranty services underwriting activities in 1981, UEIC still suffered a $ 569,000 pre-tax operating loss in that year from such activities. Further, in 1981 UEIC experienced a loss ratio of 78.6% on its warranty services underwriting activities; such losses were deemed excessive. To ensure that it had sufficient funds available for future claims under its warranty services' coverage, UEIC engaged an actuarial consulting service to evaluate the sufficiency of UEIC's claim reservs. Such actuarial service found that, in relation to the expectations under which UEIC originally operated in establishing its reserves, consumers were beginning to retain their automobiles for longer periods of time. Such a change in consumer habits had the potential of requiring UEIC to reimburse automobile dealers for more warranty claims than were anticipated by UEIC in establishing its claim reserves. For this reason, the actuarial service advised UEIC to increase its claims reserve by $ 2,000,000 in 1981, and to expect similar increases in subsequent years. The $ 2,000,000 adjustment UEC made to its warranty services claim reserves in 1981 negatively impacted its net income, and thus partially caused the pre-tax operating loss.

Collateral Protection Services. Action's business of providing collateral protection services is closely tied to the demand for automobile loans because the majority of the loans managed by Action have automobiles as their underlying collateral. For this reason, Action's revenue growth is heavily influenced by automotive industry sales, which historically have been cyclical and closely tied to the business cycle. As of early 1982, the automotive industry was, as was the whole of the United States, in the midst of a recession.

Furthermore, Action was purchased by UEC in 1980 in a transaction under which UEC was required to pay, in addition to the initial purchase price of $ 1,900,000, additional contingent consideration amounting to a substantial portion of the pre-tax income of Action through 1983. The initial consideration of $ 1,900,000 was paid by UEC in 1980 and 1981. The contingent consideration earned and accrued amounted to $ 745,000 and $ 490,000 in 1981 and 1980, respectively. Of the contingent consideration so accrued and owed by UEC, $ 1,166,000 remained unpaid on December 31, 1981, and was payable

at various times through June, 1985. This, together with the effect the recession was having on Action's growth rate, effectively eliminated any prospect of return to UEC from this segment of its business until 1984.

UEC's Revenues and Earnings

In UEC's annual reports, the consolidated balance sheets for the fiscal years ending December 31, 1979, 1980, and 1981, appeared as follows n4 (in 000's):

ASSETS	1981	1980	1979
Cash	$ 1,588	$ 2,615	$ 948
Investments			
Bonds, at amortized cost	40,614	35,411	35,420
Short-term investments, at cost	3,406	6,652	1,321
Mortgage loans, at unpaid principal	896	--	--
Other	1,767	1,114	270
Total investments	46,683	43,177	37,011
Other Assets			
Uncollected premiums	4,357	3,185	3,255
Uncollected commissions	1,381	1,738	--
Accrued investment income	939	852	889
Deferred policy acquisition costs	22,400	21,021	20,984
Funds held by reinsurers	576	421	--
Land and buildings, net	5,541	4,101	910
Equipment, net	2,321	1,617	1,600
Cost in excess of net assets of purchased subsidiaries, net	2,679	1,808	622
Other	1,716	1,175	736
Total other assets	41,910	35,918	28,996
Total Assets	$ 90,181	$ 81,710	$ 66,955

n4 The consolidated financial statements of UEC were prepared in conformity with generally accepted accounting principles which, as to UEC's insurance subsidiaries, vary in some respects from statutory accounting practices which are prescribed by such subsidiaries' respective domiciliary states' insurance department.

LIABILITIES AND SHAREHOLDERS' EQUITY

Insurance Reserves

Unearned premiums	$ 34,638	$ 25,570	$ 21,474
Claim reserves	5,082	4,348	4,376
Life reserves	606	168	96
Total insurance reserves	40,326	30,086	25,946
Other Liabilities			
Premiums payable	2,727	3,200	--
Short-term notes payable to banks	2,585	2,635	1,990
Accrued expenses and other liabilities	4,170	4,489	4,804
Notes payable to former stockholders and former owners of purchased subsidiary	1,644	2,318	1,354
Income taxes payable - current	191	1,732	917
deferred	8,170	8,950	7,935
Funds held for reinsurers	--	37	365
Total other liabilities	19,487	23,361	17,365
Total Liabilities	59,813	53,447	43,311
Shareholders' Equity			
Common stock	429	429	429
Additional paid-in capital	3,372	3,359	3,359
Rtained earnings	31,253	29,203	24,584
	35,054	32,991	28,372
Less common stock in treasury, at cost.	4,686	4,728	4,728
Total shareholders' equity	30,36y8	28,263	23,644
Total Liabilities and Shareholders' Equity	$ 90,181	$ 81,710	$ 66,955

The 1981 financial report also set forth consolidated statements of income for the same fiscal years ending December 31 (in 000's) as follows:

	1981	1980	1979
Income			
Insurance premiums	$ 31,110	$ 27,176	$ 24,069
Investment income (principally			

interest)	5,123	3,654	2,742
Net warranty/service sales	10,293	12,330	10,984
Collateral protection commissions	3,343	1,62	--
Other	523	332	289
Total Income	50,392	45,113	38,084
Costs and Expenses			
Insurance benefits	17,508	13,588	9,772
Mailing costs	1,056	1,431	4,323
Commissions	9,234	6,390	5,461
Salaries	7,402	6,199	5,094
Other administrative expenses	13,498	9,972	9,407
Policy acquisition costs - deferred	(9,734)	(7,305)	(8,721)
- amortized	8,355	7,268	6,172
Premium taxes	878	551	701
Total costs and expenses	48,197	38,094	32,209
Income before income taxes	2,195	7,019	5,875
Provision for income taxes	145	2,400	1,855
Income before realized gains (losses) on investments	2,050	4,619	4,020
Realized gains (losses) on investments	--	--	--
Net income	$ 2,050	$ 4,619	$ 4,020
Retained Earnings			
Balance, beginning of year	$ 29,203	$ 24,584	$ 20,564
Net income	2,050	4,619	4,020
Balance, end of year	$ 31,253	$ 29,203	$ 24,584

UEC's financial records are generated annually. Therefore, information similar to that which is presented above and which concerned UEC's performance between January 1 and March 30, 1982, was not available on the date of decedent's death.

From the preceding tables, it can be seen that UEC consolidated gross revenues increased, in relation to the immediately preceding year, by approximately 18.5% in 1980 and 11.7% in 1981. The principal factors to which such growth may be attributed are the acquisition of Action in 1980, and the growth in

net investment income UEC experienced in 1980 and 1981. The decrease in the growth rate, i.e., an increase of only 11.7% in 1981 down from the 1980 increase of 18.5%, in large part reflects the problems UEC encountered with respect to its direct response marketing of accident and health policies and its warranty service contracts sales.

As evident from the above tables, UEC's consolidated expenses also grew, in relation to the immediately preceding year, by approximately 18.3% in 1980 and 26.5% in 1981. The net result of the increases in revenues and the increase in expenses, in 1980 and 1981, is that, in relation to the preceding year, net income rose by approximately 14.9% in 1980 and fell by approximately 55.6% in 1981. Overall, UEC's net profit margin was 10.5% in 1979, 10.2% in 1980, and 4.2% in 1981.

The precipitous drop in UEC's net income and profit margin between 1980 and 1981 is attributable to a multitude of problems UEC encountered during that period. First, UEC was performing poorly in connection with its direct response marketing of the accident and health insurance lines. Second, UEC was suffering a very high lapse rate in connection with its life insurance sales which caused an accelerated amortization of those policies' acquisition costs. Third, UEC was required to make a large adjustment in 1981 to AWC's reserve for claims losses. Fourth, UEC's earnings were also impacted by the accruals UEC made for payment of the contingent consideration owed in connection with the acquisition of Action in 1980. Finally, UEC experienced, in 1981, a combination of a relatively low revenue gain and a narrowed profit margin caused by an inability to control salary and administrative expenses. Throughout 1979 and 1980, salary and administrative expenses grew in line with revenues. In 1981, however, such expenses grew, in relation to 1980, by approximately 29.2% whereas revenue declined sharply.

What is also evident from the above tables is that an additional source of earnings for UEC came from investment income, which primarily flows from assets underlying UEC's claims reserves. Such revenue grew, in relation to the preceding year, by 33.3% in 1980 and by 40.2% in 1981, approximately. This favorable investment income record reflects UEC's policy of investing in short and intermediate-term securities, i.e., securities with a life of one to four years, and reflects the benefits such policy reaped because of the record high interest rates prevailing in the 1979 to 1981 period. In early 1982, however, interest rates were falling and were expected to decline even further. The result caused by UEC's reliance upon such securities and by the declining interest rate, with respect to UEC's investment income trend, would be that the investments it held in early 1982 would roll off the corporate books and would be replaced with securities bearing a smaller yield. Thus, the expectations concerning future investment income, based on UEC's investment portfolio as it existed on the date of death, were that such income source would be less successful than it had been in the recent past.

Miscellaneous Factors Effecting Value of Stock

Suit by former employee. When UEC acquired AWC, UEC entered into with AWC's then-existing management certain employment contracts which, inter alia, limited such management's ability to compete with UEC in the event they left that corporation's employ. In 1981, AWC's former president, Jerry R. Farrar (Farrar), was terminated from his position as president and chief operating officer of AWC. Following such termination, Farrar was employed by another insurance agency. As a result of such other employment, AWC sued, inter alios, Farrar and his employer at that time on the grounds that, as UEC asserted, Farrar was competing against AWC in violation of the above-mentioned employment

contract. The relief UEC sought was primarily in the nature of an injunction under which Farrar would be prohibited from utilizing AWC's actuarial reports and dealer lists in competition with AWC. UEC also sought punitive damages of an unspecified amount.

In response to the suit brought by AWC, Farrar and his employer at that time bought a cross-claim against AWC and UEC which may be characterized as an anti-trust suit. Such cross-claim sought, inter alia, salary, bonuses, vacation and severance pay, and amounts due from Farrar's profit sharing plan, all as were allegedly due Farrar under the employment contract he had with UEC. In addition, Farrar also sought punitive damages against UEC. The relief sought by Farrar against UEC was in an amount of approximately $ 40,000,000. At the time of decedent's death, no resolution of the suit filed by UEC against Farrar, or of the cross-claim filed by Farrar against AWC and UEC had been reached.

Management. UEC was founded by decedent in 1972. From its inception until the date of decedent's death, UEC has been a company highly dependent upon specialized marketing techniques which are employed in selected markets to encourage the sale of UEC's non-traditional insurance products and services. Throughout the company's history, decedent had been heavily involved in the daily operation of UEC. Decedent was the creative driving force behind both UEC's innovative marketing techniques, and UEC's creation of, or acquisition and exploitation of, new products and services.

In 1981, decedent was paid a salary of $ 270,000 by UEC and of $ 98,466 by AWC for his services. Such salary was, as compared to the salaries of the executives in positions and companies comparable to decedent's, approximately $ 100,000 higher than the norm. However, decedent never received any payments from UEC in the form of dividends. Despite the higher salary decedent received, UEC recognized that the prospects for finding someone to replace decedent as the head of UEC's management team were not hopeful. In recognition of UEC's probable inability to acquire the services of a competent leader to replace decedent, UEC attempted to partially ameliorate that eventuality by obtaining an insurance policy on decedent's life under which UEC was the beneficiary. Such insurance policy provided for proceeds of $ 2,000,000 upon decedent's death.

Prior Sales of UEC Stock. Immediately following incorporation, UEC was operated as a privately held corporation. In March, 1973, UEC converted from private to public ownership through the sale of its common stock to the public on the over-the-counter market. UEC reverted to private ownership in September, 1976, following a tender offer at $ 6 per share to public shareholders.

The parties have stipulated that as of October 1, 1979, the fair market value of the common stock of UEC was $ 8 per share. In 1981, UEC purchased 367 shares of its common stock for $ 10 per share. Further in 1981, under the terms of a stock purchase plan, UEC sold 12,500 shares of its common stock from its treasury stock holdings to the then-existing president of UEC at a price of $ 10 per share.

Testimony of Experts

Petitioner's Expert. In an attempt to prove its asserted value of $ 10 per share, petitioner offered the testimony of Milton L. Meigs (Meigs), an investment and financial analyst engaged for the purpose of valuing the UEC corporation and, in particular, the stock in question. In the course of his examination, Meigs conducted an in-depth and thorough evaluation of UEC, its subsidiaries, the business conducted thereby, and the economic trends existing at the time of decedent's death. From such analysis, Meigs made a forecast concerning what could be expected by UEC in the form of future economic trends.

Relying upon his analyses and forecasts, Meigs devised a valuation of UEC under a comparative market analysis approach. n5 The approach Meigs used relied solely upon UEC's 1981 earnings figures as such figures were, Meigs felt, indicative of the earnings UEC could expect in the future.

n5 Such approach entails an examination of corporations which are publicly traded, and which are comparable to the corporation under examination. From the examination of the comparable corporations, an appraiser is able to ascertain a number of quantitative factors which are then applied to the information of the corporation whose value is being determined. Theoretically, the application of such quantitative factors to the information concerning the corporation under examination will yield estimates of that corporation's value.

From his examination of five publicly traded companies he found to be comparable to UEC, Meigs found two quantitative factors to be of primary importance. First, Meigs determined that the price/earnings ratio n6 for the comparable companies' stock ranged, at the time of death, from 5.6:1 to 7.7:1. Second, Meigs considered the relationship that the market value of the stock traded on the market bore to the book value of the stock's corporation. From such determination, Meigs found that the market value of the comparable corporation's stock was generally between 63% to 148% of that corporation's book value.

n6 Such ratio shows the relationship a stock's price bears to the earnings that stock's corporation realizes.

After having made such determinations concerning the price/earnings ratios and the market to book value percentages of corporations comparable to UEC, Meigs then opined that UEC's stock was worth $ 10 per share as of the date of decedent's death. The value Meigs ascribed to UEC's stock is equivalent to approximately 4.7 times UEC's reported operating earnings and represents 32% of UEC's yearend 1981 book value. The value Meigs ultimately reached with respect to UEC's stock did not comport with the numbers at which he arrived in analyzing the corporations comparable to UEC because Meigs considered two qualitative factors which did not avail themselves to the application of strict formulae. First, Meigs concluded that UEC's value should be lower than that value which would be reached using the quantitative factors of the comparable companies because there was a "serious management vacuum" created by the death of decedent. From this, Meigs vaticinated that UEC's earnings would be negatively impacted in the future. Second, Meigs reasoned that UEC's value should be even lower still, as such related to the comparable companies, because the pending litigation brought by Farar would cast a cloud on UEC's attractiveness to any potential investor.

As further support for the $ 10 per share value he ascribed to UEC's stock, Meigs referred to the price/earnings ratios and the market to book value percentages UEC's stock experienced while it was being publicly traded during the period 1973 through 1976. n7 The market conditions for that period for stocks generally, and insurance stocks specifically, were, on the average, not materially dissimilar to the market conditions of early 1982. Because of this, Meigs concluded that his ascribed $ 10 per share value was the fair market value of UEC's stock as of the date of decedent's death.

n7 The market statistics of UEC's common stock as it was publicly traded during 1973 through 1976 appear as follows:

	Price earnings ratio		Market % of book value	
Year	Low	High	Low	High

1973	2.3	9.9	39%	163%
1974	1.0	4.0	12	49
1975	1.1	3.7	11	38
1976	1.7	3.4	23	46

Respondent's experts. Respondent first offered the testimony of Robert v. McMahon (McMahon), an independent contractor associated with a national business brokerage firm, for the purpose of valuing UEC. For his valuation, McMahon relied almost exclusively upon UEC's financial records from 1976 through 1981. However, such records did not include UEC's Federal income tax returns for those years. At no time did McMahon interview any of the management personnel surviving decedent. In the course of his valuation, McMahon employed an approach based upon an investor's anticipated return on investment. Further, the analysis McMahon used is based upon projections he made concerning UEC's future earnings, rather than upon UEC's past earnings experience.

To calculate a projection of UEC's net income for the years 1982 through 1988, McMahon first looked to UEC's performance during 1977 through 1981 and determined: (1) that UEC had an average annual increase in total income of 21.5%; (2) that net income as a percent of assets was an average of 5.6%; and, (3) that assets increased an average of 9.2% annually. McMahon next used UEC's data from 1977 through 1981 to determine that UEC had: (1) An average total income of $ 36,500,000; (2) An average net income of $ 3,700,000; and, (3) Average asset holdings of $ 67,300,000. By using the average total income and average asset holdings, and by applying them to the average percentage increases listed above, McMahon calculated UEC's net income for each year from 1982 through 1988. Finally, by taking one more average, the average of his projected annual net incomes, McMahon concluded that UEC would realize, for years after 1981, average annual net income of $ 6,900,000. McMahon reached this conclusion despite having observed that UEC's profitability between 1977 and 1981 was in decline.

McMahon next computed the return an average investor would require on investments in UEC as of December 31, 1981. To make such a computation, McMahon considered the yield on 10 years United States Treasury Notes, which was 13% as of such date, and added an additional 2% for the inherent risk, and for the lack of liquidity an investor would face with an investment in UEC. Thus, McMahon concluded that an average investor would require a 15% rate of return on investments in UEC as of December 31, 1981.

McMahon took the average projected annual earnings, $ 6,900,000, and divided that by the rate of return an investor would require, 15%, to compute the investment which would be required to return $ 6,900,000 at 15%. Such investment equaled $ 46,000,000. From this number, McMahon subtracted the difference between the liabilities owed by UEC, and the cash and equivalents UEC retained, both as of December 31, 1981. The result of $ 46,000,000 less the $ 2,633,000 differences of liabilities over liquid assets is $ 43,367,000. This figure is McMahon's estimate of the fair market value of UEC as of December 31, 1981. McMahon further stated that this value would prevail as of the date of decedent's death.

To arrive at the value of the stock held by decedent at the date of his death, as such related to the value of the corporation as a whole on such date, McMahon next concluded that the shares held by decedent, 767,800 shares, were not in fact the 79.5% of UEC's outstanding stock which such shares represented. That is, through a convoluted weighting formula for which he offered no explanation, McMahon

concluded that, in reality, the 767,800 shares decedent held were equivalent to 82.48% of UEC's total shares outstanding. This is tantamount to applying a premium to decedent's holdings for the reason that an investor would be acquiring control of UEC when such investor bought decedent's shares in UEC. Thus, McMahon concluded that the 767,800 shares decedent held at the time of his death should be valued at 82.48% of the total value of UEC, i.e., that decedent's holdings had a fair market date of death value of $ 35,776,524, or a value of $ 46.60 per share.

Respodent next offered the testimony of Steven R. LaMantia (LaMantia), a professional appraiser engaged by respondent for purposes of valuing decedent's holdings in UEC as of the date of decedent's death. In the report prepared in connection with such valuation, following a brief description of the lines of business in which UEC was engaged, LaMantia performed a comparative market analysis similar to, but distinct from, that analysis which was conducted by Meigs.

From an examination of nine corporations he found to be comparable to UEC, LaMantia determined that a value for UEC could be determined by applying a capitalization rate of 6.5, i.e., a price/earnings ratio of 6.5:1, to UEC's net income. LaMantia first applied such rate to only UEC's net income. LaMantia first applied such rate to only UEC's 1981 net income and arrived at a value of $ 13,325,000. Next, LaMantia applied the capitalization rate of 6.5 to an average of UEC's net income from the preceding five years, 1977 through 1981, to arrive at an alternative value of $ 23,106,200.

Because LaMantia felt UEC's 1981 earnings were being skewed by losses incurred by Action, LaMantia focused upon the value achieved by the capitalization of UEC's average earnings from the preceding five year period. Lamantia's analysis operated under the impression that Action had incurred losses in 1981 of approximately $ 1,500,000. In fact, Action's 1981 losses were only $ 100,000.

Despite his focus on the value derived from capitalization of the five-year average of UEC's earnings, LaMantia did determine that UEC's lowered earnings in 1981 indicated that UEC would continue to realize decreased earnings in the future. For this reason, LaMantia discounted the value he reached for the whole of UEC of $ 23,106,200 to $ 20,000,000. Such value for UEC reflects a price per share of $ 20.72.

To the $ 20.72 per share indicated value, LaMantia then applied a premium of 20% in recognition of a premium the average investor would pay when purchasing a controlling share of a corporation's stock. Thus, the value LaMantia attributed to decedent's holdings, 767,800 shares, at the death of death is, rounded to the nearest million, $ 19,000,000, or $ 24.75 per share.

Notice of Deficiency

Petitioner listed the value of decedent's UEC's holdings at $ 10 per share in the estate tax return petitioner filed. In his notice of deficiency, respondent determined that the fair market value of such UEC stock in the estate of decedent should be $ 46.60 per share, in reliance upon McMahon's appraisal.

OPINION

The sole issue for decision is the date of death value of 767,800 shares of UEC common stock owned by decedent at his death.

Section 2031(a) n6 requires that the property be included in a decedent's gross estate shall be taxed on the basis of that property's fair market value at the time of the decedent's death. Section 20.2031-1(b) of the Estate Tax Regulations defines fair market value as "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 to sell and both having reasonable knowledge of relevant facts."

n6 All section references are to the Internal Revenue Code of 1954, as amended and in effect as of the date of decedent's death, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

With respect to stock or securities of a corporation, where such are traded on a national stock exchange, the value of those stocks or securities is easily determined by reference to the relevant market price thereof. Where the corporate stocks or securities are not listed on an exchange but are closely held, however, the proper method of valuation is made "by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange." Sec. 2031(b). Unfortunately, such a method of valuation may be reduced to the application of rote formulae. See Messing v. Commissioner, 48 T.C. 502 (1967). Clearly the question here presented is purely one of fact which is better disposed of through settlement negotiations between the parties, rather than through an adjudication process which put the onus upon us to make a Solomon-like pronouncement. See Buffalo Tool and Die Mfg. Co. v. Commissioner, 74 T.C. 441 (1980).

In looking at the surrounding facts and circumstances, we are limited to those which were available on the date of decedent's death; using hindsight at the time of trial would be inappropriate. Estate of Jephson v. Commissioner, 81 T.C. 999 (1983). When the date of death is the valuation date, post-mortem events may be considered, however, for the limited purpose of establishing that the willing buyer and seller's expectations were on the valuation date and whether these expectations were reasonable and intelligent. Estate of Jephson v. Commissioner, supra. Further, in determining the buyer and seller's expectations, events occurring after decedent's death are considered only if such events were reasonably foreseeable at that time. Estate of Gilford v. Commissioner, 88 T.C. 38 (1987). That is, reasonable expectations entertained at the date of death are of substantial importance; "subsequent events may serve to establish both that the expectations were entertained and also that such expectations were reasonable and intelligent." Couzens v. Commissioner, 11 B.T.A. 1040, 1165 (1928).

The question of the fair market value to be attributed UEC's stock is a question of fact. Petitioner bears the burden of proof in showing that the value determined by respondent is incorrect. Welch v. Helvering, 290 U.S. 111 (1933). As the triers of fact, we are required to weigh all relevant evidence and draw appropriate inferences therefrom. Estate of Andrews v. Commissioner, 79 T.C. 938 (1982). Included within the ambit of relevant evidence are the valuations made by the parties' respective experts.

After reviewing the valuation methods adopted by the parties' experts, we are not satisfied that any one method, or the result reached thereby, should be adopted by us in toto. Meigs' report does provide a comprehensive review of UEC and its major lines of business. However, it appears that Meigs merely chose a value of $ 10 per share and then attempted to justify that value by referring to the sales of UEC stock occurring between the remote period of 1973 and 1976 when UEC's stock was publicly traded. Further, although Meigs did do a comparative market analysis, the valuation he ascribes to the stock in

question in no way comports with such analysis. For example, although Meigs found that comparative market price/earnings ratios ranged from 5.6:1 to 7.7:1, Meigs' value is equivalent to a price/earnings ratio of 4.7:1.

McMahon's method of valuation is even less supported by the facts. Initially, we observe that McMahon relied upon market numbers generated in the abstract by Forbes magazine. Further, in applying the numbers so generated, McMahon is caught in the trappings presented by the application of rote formulae. That is, as is apparent from the method by which he arrives at an average annual net income, McMahon is enticed into a false sense of security in his numbers merely because they are averages. With respect to the use of averages, it has been said:

averages may be deceiving. Two corporations with 5-year earnings going from the past to the present represented by the figures in one case of 5, 4, 3, 2, and 1, and in the other by the same figures of 1, 2, 3, 4, and 5, will have the same 5-year averages, but investors will quite naturally prefer the stock of the later whose earnings are consistently moving forward.

Central Trust Co. v. United States, 305 F.2d 393, 403 (Ct. Cl. 1962).

Finally, LaMantia's method of valuation ignores the significant problems UEC faced with respect to its claims reserve, and further ignores the effect a declining interest rate would have upon UEC's future investment portfolio's income. Further, LaMantia too relied upon a five-year average earnings figure although he did observe that UEC's 1981 earnings had dropped substantially. These are not all of the shortcomings we found in each method of valuation but they are principal reasons why we will not adopt in whole the report of any one expert, nor will we weigh the reports one against the other to arrive at a value for the decedent's UEC stock. Rather, we have evaluated UEC's financial history using the experts' reports as a reference and have arrived at a value for such stock using a different methodology.

From our review of the facts concerning UEC and its family of companies, as such facts existed on the date of decedent's death, we find that UEC was suffering from a serious decline in its profitability without much hope for a recovery in the near future. UEC's sales of accident and health insurance through direct response marketing, its historical marketing mainstay, were progressively decreasing. UEC's life insurance sales, although increasing in volume, were facing an ever increasing lapse rate with the result that the policy acquisition costs incurred in connection with the increased sales were necessarily being expensed at a faster rate. UEC's warranty services, its major source of revenue in 1981, were suffering from a decline in related automobile sales, increased competition from automobile manufacturers, and disruptions in its marketing program, all of which resulted in decreased sales. Further, UEC's warranty services insurance coverage was, as of 1981, found to be backed by reserves which were found to be dangerously insufficient to meet future warranty claims. Finally, UEC's investment portfolio income, which was highly dependent upon intermediate and short-term securities, was sure to decrease as such securities rolled off of UEC's books and were replaced with securities which would bear lower interest rates because such rates were on the decline in 1981. All of these factors reflect that UEC's future would not bode well to a potential investor.

Taking into consideration UEC's past economic performance and future economic prospects, we find that the stock in UEC held by petitioner should be valued by use of a comparative market analysis. Under such method of valuation we shall first derive a per share value based upon the following:

(1) The price/earnings ratios of corporations comparable to UEC;

(2) The relationship the market price of comparable corporations' stock bore to the book value of their respective corporations; and,

(3) The value ascribed to UEC's stock when such was previously sold.

After arriving at a value per share of UEC's stock using the above three methods, we shall derive a weighted average price per share based upon the relative trustworthiness of those three methods.

Price/Earnings ratios. To establish a value for the UEC stock in question by using the price/earnings ratios of comparable corporations, it is first necessary that we establish an earnings base to which the ratio will be applied. In calculating such earnings base, we rely only upon that information which would have been available to an investor on the date of decedent's death. For this reason, we do not look to UEC's 1982 financial records because such would not have been generated until after the valuation date. We have chosen to consider the earnings UEC experienced during 1979, 1980, and 1981. We do so because, in recognition of UEC's relative success in the past, the earnings for 1979 and 1980 would have some importance to an investor in UEC at the time of valuation. The earnings from those two years would not be given the same weight of importance as would the earnings from 1981, however. For this reason we shall weight UEC's earnings for 1980 as being more important than those for 1979. Further, because all three experts offered by the parties found 1981's earnings to be on the decline and, more importantly, indicative of the earning UEC could expect in the future, we have chosen to weight that year's earnings as being of primary importance. Therefore, our earnings base is calculated as follows (in 000's):

Year	Earnings		Weight Factor		Weighted Earnings
1981	2,050	x	.7	=	1,435.0
1980	4,619	x	.2	=	923.8
1979	4,020	x	.1	=	402.0
Earnings base					$ 2,760.8

Generally, it would be appropriate to adjust UEC's past earnings to take into consideration items which are non-recurring and extra-ordinary in nature, and which have the tendency to distort UEC's prior earnings. Central Trust Co. v. United States, supra. Respondent argues that the adjustments UEC made to its claim reserve, and that the costs AWC incurred in revamping its computer system, should be so characterized, and that UEC's 1981 earnings should, therefore, be adjusted.

In the realm of economic reality, we find that the increase to UEC's claims reserve is neither extraordinary, nor nonrecurring. As an on-going business, UEC is required to continually and accurately evaluate the estimations it makes with respect to its claim reserves. Such is the nature of the insurance industry that it must constantly make estimates despite the uncertainties it faces, and that it must continually make adjustments to such estimates as the operative facts of such estimate change. The claim reserves account is such an estimate and the increase UEC made thereto in 1981 is such an adjustment. Further, that such an adjustment could be expected to again occur in the future is shown by UEC's actuary advising UEC to anticipate additional modifications to that account.

With respect to the revamping of AWC's computer system, we also find such to neither be nonrecurring, nor extraordinary. UEC, as is the whole insurance industry, is heavily dependent upon computers in the conduct of its business. For this reason, in the case at hand we find that AWC's modification of its computer system was an ordinary and necessary expense, and that such expense can reasonably be expected to be incurred in the future.

To their respective earnings bases, Meigs applied a capitalization rate of 4.7, i.e., a price/earnings ratio of 4.7:1, and LaMantia applied a rate of 6.5. Because of the claim reservers problems UEC was facing in 1981, because of the drastic decrease in profitability UEC saw in that year, and because UEC's investment portfolio promised to see reduced income in the future, we find that the proper capitalization rate should be at the lower end of the spectrum presented by the parties' experts; we will apply a price/earnings capitalization rate of 5:

(Earnings Base) (in 000's) x (Capitalization rate) = Aggregate Value of UEC (in 000's)

$ 2,760.8 x 5 = $ 13,804

The aggregate value of UEC, therefore, yields a per share value of $ 14.30 as of December 31, 1981 using the price/earnings ratio method.

Book value. The book value of a corporation indicates how much of that corporation's net assets, valued as a going concern, stand behind each share of its stock. See Central Trust Co. v. United States, supra. Such value is, therefore, an important factor in valuing the shares in question.

UEC's book value as of December 31, 1981, was $ 30,368,000. Included within this value is the life insurance policy UEC held on decedent's life. The value of said policy, as included within UEC's book value on December 31, 1981, is not the amount UEC would receive on decedent's death; rather, it is the amount UEC paid for the acquisition of the policy. To accont for the $ 2,000,000 in proceeds UEC would receive from the policy, we find that it would be appropriate to include that amount within the book value when computing a market to book value for UEC's stock. Therefore, for our purposes, the book value of UEC will be $ 32,368,000. This amount includes the amount UEC paid for the policy; however, we cannot take such policy cost into consideration because that cost is not in the record.

In his examination of UEC, Meigs found that the price of a stock, as a percentage of that stock's book value, ranged from 63% to 148%. LaMantia found such percentages to range from 50% to 220%.

As of December 31, 1981, the asset "deferred policy acquisition costs" represented 24.8% of total assets. At that time there existed considerable risk that such asset was substantially overstated and subject to an accelerated rate of amortization if UEC's lapse experience also deteriorated. Considering this, and considering the increases UEC was experiencing in its lapse rates, we find that a proper value for the aggregate of UEC's outstanding stock will be found by applying a book-to-market value percentage of 45%. Accordingly, the aggregate value of UEC stock outstanding is:

$ 32,368,000 x .45 = $ 14,565,600

Such value represents $ 15.09 per share as of December 31, 1981.

Prior sales. The prior sales here under consideration are those sales which involvved a material number of shares, and which occurred at the time that UEC converted from public to private ownership or thereafter. Such sales were as follows:

Year	Price
1976	$ 6
1979	8
1981	10

We find that such history of shares sold is relevant to our present inquiry for two reasons. First, that the prices at which the stock sold over the years increases in line with the overall growth of UEC reflects that such prices do indicate the stock's relative fair market value on those dates. Second, the prior sales are relevant because of the close proximity in time the most recent of such sales bears to the valuation date.

For our purposes, we shall rely only on the sales of stock occurring in 1981. Such sale was of 12,500 shares made to the then-existing president of UEC under the terms of a stock purchase plan. Because such sale involved a relatively small number of shares of stock and was made to an officer of UEC under a stock purchase plan, however, we find that it would be appropriate to apply a premium to the sales price to determine the stock's true fair market value. Such premium shall be one of 30% as of December 31, 1981. Accordingly, we find that the fair market value of UEC's stock as of December 31, 1981, based on the prior sales experience of such stock, is $ 13 per share.

Per Share Weighted Average Value

To reach a per share value of UEC's stock as of December 31, 1981, we shall use a weighted average of the results reached under the above three approaches. Of least value is the price determined from an examination of the prior sales. The results reached from use of the price/earnings method is of most importance because the earnings of UEC are more indicative of what can be expected following decedent's death than is the book value of the stock. Accordingly, we weight the results reached above as follows:

Method	Result Reached	Weight Factor	Weighted Value
Price/earnings	$ 14.30	.6	$ 8.58
Book value	15.09	.3	4.53
Prior sales	13.00	.1	1.30
Per share weighted average value			$ 14.41

Adjustments. The per share weighted average fair market value of $ 14.41 is computed above based upon December 31, 1981 information. We find that additional adjustments to such value are required by the facts of this case.

Initially, we recognize that an investor would be willing to pay a premium above fair market value for a block of shares which represent a controlling interest in UEC (control premium). See Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987). The shares held by decedent at the date of death represent such a controlling interest and a control premium should, therefore, be applied.

We further recognize, however, that where a corporation is substantially dependent upon the services of one person, and where that person is no longer able to perform services for the corporation by reason of death or incapacitation, an investor would expect some form of discount below fair market value when purchasing stock in the corporation to compensate for the loss of that key employee (key employee discount). See Estate of Huntsman v. Commissioner, 66 T.C. 861 (1976: Edwards v. Commissioner, a Memorandum Opinion of this Court dated January 23, 1945. We find that Milton Feldmar was an innovative driving force upon which UEC was substantially dependent for the implementation of new marketing strategies and acquisition policies. Therefore, we find that a key employee discount is appropriate.

Respondent asserts that no key man discount should be applied becuase, respondent argues, any detriment UEC suffered from the loss of decedent's services is more than compensated for by the life insurance policy upon decedent's life. We do not find merit in such a position. The life insurance proceeds UEC was to receive upon decedent's death are more appropriately considered as a non-operating asset of UEC. See Estate of Huntsman v. Commissioner, supra. We did this when we determined a value of UEC's stock by using the market-to-book valuation method.

Respondent also argues that the key employee discont should not be applied because, respondent asserts, UEC could rely upon the services of the management structure already controlling UEC, or UEC could obtain the services of a new manager, comparable to the decedent, by using the salary decedent had received at the time of his demise. With respect to the existing management, Meigs conducted interviews of such managers and found them to be inexperienced and incapable of filling the void created by decedent's absence. By contrast, neither of respondent's experts offered an opinion on such management's ability to replace decedent. From the evidence presented, we conclude that UEC could not compensate for the loss of decedent by drawing upon its management reserves as such existed on the valuation date.

Taking into account the control premium and key employee discount, we find that an investor would be willing to pay a 15% premium for a controlling block of shares in UEC, but the same invfstor would expect a 35% discount for the loss of a key employee. A control premium of 15% is proper in the case at hand because, although an investor would be acquiring a corporation over which he could exercise dominion, that investor would also be acquiring a corporation which was already facing declining profitability and serious concerns regarding the adequacy of its claims reservs. A key man discount of 35% is appropriate in this case because UEC suffered a serious loss when decedent took to his grave his considerable expertise in finding and expoloiting innovative insurance products and services. Such 35% discount should be reduced, however, to account for UEC's potential for finding a new leader, from outside of its existing management, to replace decedent. Although we find it to be a very remote possibility that UEC might find a new helmsman with knowledge, experience, innovative skills, and resources comparable to those of the decedent, we shall reduce the key employee discount to be applied forrm 35% to 25% to account for such potentiality.

Combining the control premium of 15% and the key employee discont of 25%, the result is an overall downward adjustment of 10% to the per share weighted average fair market value of $ 14.41. Accordingly, the per share fair market value of UEC's stock on December 31, 1981, is computed:

$ 14.41 - $ 1.44 = $ 12.97

This value, $ 12.97 per share, must now be adjusted to take into consideration two other variables. First, the value determined above must be adjusted to account for the potential loss UEC might face in connection with the anti-trust suit brought by Farrar. We find that such suit would, in an investor's mind, cast a cloud upon UEC's financial stability, and that such investor would take such into consideration when determining what price to pay for the stock. Further, the value determined above must be adjusted so as to bring that value up to the date of decedent's death; the value above determined is as of December 31, 1981, and the proper valuation date is March 30, 1982. To account for such difference in valuation dates, we find that UEC could expect to experience the same decline in profitability and could expect the same lessening of its revenues in the first 90 days of 1982 as it experienced in 1981. To give due consideration to the concerns presented by the suit facing UEC, and to account for the decreases in value UEC's stock would suffer between December 31, 1981, and March 30, 1982, we find it to be appropriate to decrese the above-determined value by an additional 4%, which is equivalent to a per share discount of $ 0.52 to arrive at a date of death fair market value of $ 12.45 per share. Accordingly, the date of death value of 767,800 shares of United Equitable Corporation common stock owned by the decedent at his death is $ 9,559,110.

To reflect the foregoing,

Decision will be entered under Rule 155.

Full Text of Court Cases

Foltz v. U.S. News and World Report

Case name: Foltz v. U.S. News & World Report
Citation: 106 F.R.D. 338,1985-1 Trade Cas. (CCH) P66,585
Date of decision: November 30, 1984
Country: US
State or Federal: Federal
State/Jurisdiction: District of Columbia
Court: United States District Court
Type of action: ERISA
Judge: Parker
SIC: 2721 Periodicals: Publishing, or Publishing and Printing (except Internet periodical publishing)
NAICS: 511120 Periodical Publishers

Keywords: ERISA

JUDGES:

Barrington D. Parker, District Judge.

OPINIONBY:

PARKER

OPINION:

ORDER

The named plaintiffs in this class action proceeding have filed an application to solicit litigation expenses from the members of the class. Although the named plaintiffs have accepted responsibility for the full cost of this action, they wish to defray these expenses through contributions from other class members who stand to benefit from the litigation. Several defendants have filed pleadings in response to the plaintiffs' request.

In support of their application, the plaintiff rely on Norris v. Colonial Commercial Corp., 77 F.R.D. 672 (S.D. Ohio 1977). There, the court approved a communication which sought post-certification solicitation of contributions from class members, subject to certain conditions. The court limited the distribution of the communication to class members who had not opted out of the litigation, and directed that the communication should advise class members that their contributions were voluntary and would not affect their right to recovery in the event that the litigation was ultimately successful. Id. at 673. With respect to the management of any money collected through the plaintiffs' efforts, the court ordered that the funds should be deposited in a bank account approved by the court and be withdrawn only with court approval, must be accounted for at the conclusion of the litigation, and could not be used to pay attorneys' fees. Id.

Later decisions have cautioned against the imposition of restrictions on communications by parties and their counsel with other class members. See, e.g., Gulf Oil Co. v. Bernard, 452 U.S. 89, 101 S. Ct. 2193, 68 L. Ed. 2d 693 (1981), aff'g 619 F.2d 459 (5th Cir. 1980). The theory underlying these decisions is that such restrictions often constitute invalid prior restraints on constitutionally protected expression, id. at 2202, or alternatively, that they exceed the rule-making authority of the lower courts because they frustrate the policies underlying class action proceedings brought under Fed. R. Civ. P. 23. Id. at 2195, 2202; Williams v. United States District Court, 658 F.2d 430, 434-35 (6th Cir.), cert. denied sub nom. Southern Railway Co. v. Williams, 454 U.S. 1128, 102 S. Ct. 980, 71 L. Ed. 2d 116 (1981). As the Fifth Circuit noted in Bernard, communications which are designed to raise funds to support litigation are often "a necessary adjunct to obtaining meaningful access to the courts," and as such, are particuarly deserving of protection. 619 F.2d at 473 n.25.

This Court agrees with the reasoning of the above decisions, and concludes that the plaintiffs should not be prohibited from soliciting funds to defray the cost of litigation expenses. The ruling which follows is designed to incorporate the concerns addressed in Norris, supra. The content of the communication to the class and the mechanics of the solicitation will be addressed at the next status conference.

Accordingly, it is this 20th day of November, 1984,

ORDERED

That the Plaintiffs' Application to Solicit Expenses from Class Members is granted subject to the following conditions:

1. Plaintiffs may direct the communcation only to those members of the certified class who have not exercised a right of exclusion.

2. All funds collected must be deposited in a bank approved by this Court which conducts business in the District of Columbia, conditioned as follows:

a. Funds may be withdrawn only for payment of litigation expenses other than attorneys' fees.

b. Funds may be withdrawn only with Court approval.

c. An accounting of all receipts and disbursements shall be made to members of the class at the conclusion of the litigation.

ORDER

Upon consideration of the relevant facts and circumstances, it is hereby

ORDERED, that the Profit Sharing Plan of U.S. News & World Report may file a memorandum in support of the motion of Save the fund et al. to intervene in this action, and that said memorandum is hereby deemed to be filed.

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLUMBIA

CHARLES S. FOLTZ, et al., Individually and as respresentatives of the class, Plaintiffs, v. U.S. NEWS & WORLD REPORT, INC., et al., Defendants.

Civil Action No. 84-0447

ORDER

It is this 20th day of November, 1984,

ORDERED

That a status conference will be held in this proceeding on November 30, 1984 at 2:00 p.m. The purpose of the status conference is to discuss scheduling matters, the status of new parties, class notice and certification, and the proposed Notice to Class Members for Solicitation of Expenses.

MEMORANDUM OPINION

Barrington D. Parker, District Judge:

BACKGROUND

This Memorandum Opinion is issued in support of this Court's Order Declaring a Class Action and Directing Notice to Class Members, filed September 10, 1984 ("September 10 Order"). The plaintiffs in this action, Charles S. Foltz, Howard M. Handleman, Bem Price, M. Eugene Williamson, Richard J. Theobald, Nathan J. Margolin, and Edward H. Castens, have been certified as class representatives. They are retired employees of defendant U.S. News & World Report, Inc. ("U.S. News" or "Company"), and each of them retired in a different year during the period 1975-1981. n1 At the time of retirement, the plaintiffs, as well as other employees of U.S. News, sold their stock in U.S. News back to the Company or liquidated their interests in the Company's profit-sharing plan. The plaintiffs assert that with respect to these transactions, the defendants severely undervalued the interests of U.S. News employees. They allege violations of federal securities and antitrust laws, in addition to breach of ERISA and common law duties.

The Court also certifies plaintiff Robert deVogelaere, who left U.S. News in 1974, as a class representative. Mr. deVogelaere moved to intervene in this action after the Court's September 10 Order. The Court granted his motion to intervene, but reserved ruling on whether he was a suitable class representative until after the defendants had the opportunity to depose him. After considering Mr. DeVogelaere's deposition testimony and the relevant pleadings, the Court determines that he is an adequate class representative. The accompanying order modifies the September 10 Order to reflect this ruling.

In addition to U.S. News, the defendants include several former directors of U.S. News, the American Appraisal Company, the entity which determined the value of the stock, and the Madana Realty Company, a wholly-owned subsidiary of U.S. News.

In the September 10 Order, the Court conditionally certified this case as a class action proceeding, pursuant to Rule 23 of the Federal Rules of Civil Procedure. The class certified was composed of:

all persons who retired from employment with, or were otherwise separated as employees of, U.S. News from 1975 to 1981, and who during their tenure as employees were shareholders of the Company, participants in the Company's profit-sharing plan, or beneficial owners of the stock of the Company; and who, upon their retirement or separation from the Company, sold to the Company their legal or beneficial interest in the Company's stock or surrendered their interest in the Company's profit-sharing plan.

The Court now addresses the criteria which support the certification of a class in this action.

CLASS ACTION CRITERIA

A case may proceed as a class action if the four prerequisites of Rule 23(a) are met, and one of the three elements of 23(b) is satisfied. The four elements of Rule 23(a) require that: (1) the class is so numerous that joinder is impractical; (2) that there are questions of law or fact which are common to the class the plaintiff seeks to represent; (3) that the claims or defenses of the representative parties are typical of the claims of the class; and (4) that the representative parties will fairly and adequately protect the interests of the class.

The defendants' opposition to class certification focuses on the adequacy of the plaintiffs as class representatives under Fed. R. Civ. P. 23(a)(4). With one exception, the defendants have not challenged the plaintiffs' showing with respect to numerosity, typicality or commonality. n2 In their lone challenge to typicality and commonality, the defendants suggest that even if class certification is appropriate, subclasses should be certified for each pertinent retirement year.

n2 Although the defendants' challenges focus on the adequacy of representation requirement, some of these challenges could also be asserted in connection with commonality and typicality. These requirements are often interchangeable and their dividing lines are not hard and fast. Donaldson v. Pillsbury, 554 F.2d 825, 829-30 (8th Cir.), cert. denied, 434 U.S. 856, 54 L. Ed. 2d 128, 98 S. Ct. 177 (1977).

Apart from the question of subclasses, the Court is satisfied the plaintiffs have satisfied the first three requirements of Fed R. Civ. P. 23(a). The plaintiffs' claims concerning the undervaluation of U.S. News stock are common to all members of the class, and the claims of the class representatives "exhibit the essential characteristics" of those of the class. Pendleton v. Schlesinger, 73 F.R.D. 506, 509 (D.D.C. 1977) (citation omitted), aff'd sub nom. Pendleton v. Rumsfeld, 202 U.S. App. D.C. 102, 628 F.2d 102 (D. C. Cir. 1980). Moreover, the plaintiffs' undisputed estimation that the class consists of at least 200 members is sufficient to satisfy the numerosity requirement. The Court now turns to the defendants' objections to class certification, and their alternative suggestion that subclasses should be certified.

Rule 23(a)(4): Adequacy of Representation

The two-part standard for fair and adequate representation of a class under Rule 23(a)(4) requires that:

counsel for the class must be qualified, experienced and generally able to conduct the proposed litigation and [] the interests of the representative party [must] be coextensive with the interests of the entire class.

Equal Employment Opportunity Commission v. Printing Industry of Metropolitan Washington, D.C., Inc., 92 F.R.D. 51, 54 (D.D.C. 1981). Here, the defendants argue that the plaintiffs are inadequate representatives for the following reasons: failure to plead fraud with particularity and statute of limitations problems; and failure to adequately investigate the grounds for their allegations pursuant to Fed. R. Civ. P. 11. n3

n3 None of these arguments concerns the ability of plaintiff's counsel. The affidavit filed by plaintiffs' lead counsel on July 17, 1984 demonstrates that he is amply qualified to conduct this litigation on behalf of the plaintiffs.

These arguments must be rejected. In Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177-178, 40 L. Ed. 2d 732, 94 S. Ct. 2140 (1974), the United States Supreme Court cautioned against reliance on merits considerations in determining whether class certification is appropriate. Accord E.E.O.C. v. Printing Industry, 92 F.R.D. at 54 (citations omitted). Here, the dispute concerning the adequacy of the plaintiffs showing of fraud is at the heart of this litigation. In view of the fact that the plaintiffs have presented a colorable case on the merits, the sufficiency of their fraud allegations does not enter into the class certification equation.

The same rationale applies to the defendants' argument that the statute of limitations bars the claims for a portion of the relevant class period. Both of these merits considerations may be dealt with after the parties file any appropriate dispositive motions. If this Court subsequently determines that the claims of certain class members are barred by the statute of limitations, it may order that those individuals or their representative class years be deleted from the class. Cohen v. District of Columbia National Bank, 59 F.R.D. 84, 90 (D.D.C. 1972).

Moreover, the defendants' assertions challenging the adequacy of plaintiffs' investigation and knowledge of the facts underlying this lawsuit raise no serious concerns. Class representatives are not required to possess detailed substantive knowledge of the nature of their lawsuit. E.E.O.C. v. Printing Industry, 92 F.R.D. at 54. Moreover, the huge increase in the value of U.S. News stock in 1982 was sufficient to put the plaintiffs on notice of possible grounds for a lawsuit. See, e.g., Foltz Deposition at 49, filed July 3, 1984; Price Deposition at 45, filed July 3, 1984; Williamson Deposition at 24-25, filed July 3, 1984.

The Appropriateness of Subclasses

Next, the defendants argue that if a class is certified, separate subclasses for each pertinent class year should be established. They point to distinct factual issues which must be adjudicated for each annual appraisal, and conflicts of interest among retirees in different years. The allegation of conflict among class members stems from the defendants' complex speculations on the apportionment of damages between class members. They assert that each plaintiff's recovery will depend on the mix of undervaluation in the years preceding his retirement, creating different sets of incentives for recovery between members of each class year.

While these assertions are not frivolous, the concerns which are common to all class members far outweigh their individual interests. The key issue in this action is whether the defendants fraudulently undervalued U.S. News stock during the relevant class period. If conflicting interests become more apparent at a later stage in this litigation, the Court will have the opportunity to create subclasses to resolve the conflicts. See Blackie v. Barrack, 524 F.2d 891, 909 (9th Cir. 1975), cert. denied, 429 U.S. 816, 50 L. Ed. 2d 75, 97 S. Ct. 57 (1976).

Rule 23(b)(3)

In addition to satisfying the criteria of Rule 23(a), the plaintiffs also meet the requirement of Rule 23(b)(3) that common questions of law and fact predominate over questions affecting individual members of the class. Here, the factual and legal questions concerning the alleged undervaluation of the plaintiffs' interests in U.S. News are the primary issues in this case, and are common to all members of the class. Moreover, a class action is superior to individual actions due to the efficiencies achieved through economies of scale. Indeed, separate litigation of these individual claims would be both wasteful and unnecessary when the major issues can be resolved in a single proceeding. The Court perceives no procedural unfairness or any other undesirable consequences from certifying this case as a class action. Advisory Committee Notes to Rule 23(b)(3), 39 F.R.D. 69 (1966) at 102-03.

CONCLUSION

In sum, the Court concludes that the class of retired U.S. News employees certified in the September 10 Order, as modified to include the year 1974, meets the requirement of Rule 23, Federal Rules of Civil Procedure. This finding is provisional, and may be modified in light of subsequent proceedings.

T.C. Memo. 1998-157

UNITED STATES TAX COURT

MAUDE G. FURMAN, DONOR, DECEASED, AND ESTATE OF MAUDE G. FURMAN, DECEASED, ROBERT G. FURMAN, EXECUTOR, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

ROYAL G. FURMAN, DONOR, DECEASED, AND ESTATE OF ROYAL G. FURMAN, DECEASED, ROBERT G. FURMAN, EXECUTOR Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 11568-96, 11569-96. Filed April 30, 1998.

Stanley W. Rosenkranz and James R. Freeman, for petitioners.

James F. Kearney, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

BEGHE, Judge: Respondent determined deficiencies in petitioners' Federal gift taxes and Federal estate tax and additions to tax as follows:

Estate of Maude G. Furman

	Deficiency	Additions to Tax Sec. 6651(a)	Additions to Tax Sec. 6653(a)
Gift tax--1981	$75,460	$18,865	$3,773
Estate Tax	115,649	--	--

Estate of Royal G. Furman

	Deficiency	Additions to Tax Sec. 6651(a)	Additions to Tax Sec. 6653(a)
Gift tax--1981	$75,460	$18,865	$3,773

After concessions regarding the estate tax deficiency, the issues for decision are:

1. Whether for purposes of computing the taxable gifts of Royal G. Furman (Royal) and the taxable gifts and taxable estate of Maude G. Furman (Maude), the fair market value of 24 shares of Furman's, Inc. (FIC) common stock exchanged by each of Royal and Maude in 1981 for preferred stock of FIC was $300,000 ($12,500 per share) as petitioners contend, $540,540 ($22,522 per share) as respondent contends, or some other amount. We hold that the fair market value was $424,552 ($17,690 per share).

2. Whether for purposes of computing Maude's taxable estate, the fair market value of six shares of FIC common stock that she transferred to Robert G. Furman (Robert) in 1980 was $62,016 ($10,336 per share), as petitioners contend, $147,600 ($24,600 per share), as respondent contends, or some other amount. We hold that the fair market value was $82,859 ($13,810 per share).

3. Whether Royal and Maude had reasonable cause for failing to file gift tax returns for the period ending September 30, 1981, and whether their failures to pay gift taxes for that period were due to negligence or intentional disregard of rules and regulations. We hold that Royal and Maude had reasonable cause for failing to file gift tax returns and were not negligent in failing to pay gift taxes.

FINDINGS OF FACT

Some of the facts have been stipulated and are incorporated herein by this reference. Unless otherwise noted, all section references are to the Internal Revenue Code in effect for the years at issue, and all Rule references are to the Tax Court Rules of Practice & Procedure. All amounts have been rounded to the nearest dollar.

A. Decedents

Royal died testate on June 29, 1990. His wife Maude died testate on June 12, 1992 (collectively decedents). Royal and Maude were residents of Florida at the times of their deaths. Robert, the personal representative of decedents' estates, resided in Florida at the time of filing the petitions.[1] Decedents weresurvived by five children, including Robert, their son.

[1] Under Florida law, the terms "executor" and "personal representative" are synonymous. Fla. Stat. Ann. sec. 731.201(25) (West 1995) defines "personal representative" as a court-appointed fiduciary who administers a decedent's estate. For purposes of the Florida Probate Code, the definition supersedes "executor" and other synonymous terms. Id.

B. Furman's, Inc.

FIC is a Florida corporation that was organized in 1959. The principal place of business of FIC is Florida. Throughout its existence FIC has been a C corporation, and the stock of FIC has never been publicly traded. FIC was founded by Maude, Royal, and Robert for the purpose of acquiring and operating a Burger King[2] restaurant franchise after Royal had retired from a 35-year career as a mail carrier. Until the founding of FIC, Maude, Royal, and Robert resided in Chicago, Illinois.

From its organization in 1959 until February 1980, FIC was capitalized with 100 shares of no-par common stock issued and outstanding, held as follows:

Maude	30 shares
Royal	30 shares
Robert	40 shares

Although Royal and Maude had five children, Robert is their only child who has ever had a common stock ownership interest in FIC or been active in its management.

Burger King Corp. (BKC), a Florida corporation headquartered in Miami, Florida, is the franchisor of the second largest restaurant chain in the world, after McDonald's. Since 1967, BKC has been a wholly owned subsidiary of Pillsbury, Inc. Pillsbury was acquired by Grand Metropolitan PLC in 1989.

[2] Burger King Corp. is the exclusive licensee of the Burger King® registered trademark used in this opinion.

FIC, since its formation, has been engaged solely in the business of owning and operating franchised Burger King restaurants. At the date of trial, FIC operated 27 Burger King restaurants, primarily in Manatee, Sarasota, Charlotte, and Lee Counties, on the west coast of Florida.

FIC entered the fast-food business in May 1959 by opening Burger King Store No. 12 (Store No. 12) in North Miami Beach, Florida, one of the original restaurants in the Burger King chain. Royal and Maude relocated to Florida to operate the new restaurant, while Robert had intended to stay in Chicago, where he was employed as a special agent for an insurance company.

Just 2 weeks after the opening of Store No. 12, Robert received a call from James McLamore, one of the cofounders of BKC, informing him that Royal had been hospitalized. Robert traveled to Florida and immediately went to work in Store No. 12. After Royal's recuperation, Robert decided to stay in Florida and help manage FIC. Robert has remained in the fast-food business ever since.

In 1961, FIC purchased a 20-percent interest at a cost of $15,000 in three corporations that were opening Burger King restaurants in the greater Chicago area (the Chicago Operation). In 1962, at the request of Mr. McLamore, Robert moved back to Chicago to participate in the management and operation of the Chicago Operation of which he ultimately became executive vice president and a member of the board of directors. Robert's

management duties in the Chicago Operation included the approval of new restaurant locations, supervising the construction of new restaurants, and the hiring and training of their employees. As of November 1969, the Chicago Operation directly operated 37 Burger King restaurants and was subfranchisor of 29 other Chicago-area Burger King restaurants.

In 1970, after a corporate reorganization of the Chicago Operation, FIC sold its interest in the Chicago Operation to Self-Service Restaurants (Self-Service), a publicly traded Burger King franchisee. In exchange for all of FIC's shares in the Chicago Operation, FIC received shares of Self-Service common stock that FIC later sold for approximately $222,000, as well as Self-Service's promissory note in the principal amount of $868,500. Following the sale, Robert was employed by Self-Service to assist during the period of transition to Self-Service management.

In 1971, Robert terminated his employment with Self-Service. Robert remained in Chicago, where he managed five Burger King restaurants that he owned directly, and participated in the management of six Burger King restaurants in Milwaukee, Wisconsin, in whose corporate franchisee he had acquired a 27-percent stock interest.

In 1973, FIC purchased an existing Burger King restaurant in Fort Myers, Florida. Thereafter, in 1976, after Robert returned to Florida, FIC acquired three existing Burger King restaurants,

in Sarasota, Bradenton, and Port Charlotte on the west coast of Florida (the 1976 Purchase), with an exclusive territorial agreement (the Territorial Agreement). The purchase price for the 1976 Purchase was $500,000, payable $300,000 in cash and $200,000 over 5 years. FIC allocated $200,000 of the $500,000 purchase price to the Territorial Agreement.

The Territorial Agreement granted FIC, for a period of 5 years, an exclusive territorial right to build, own, and operate Burger King restaurants in Manatee, Sarasota, and Charlotte Counties in Florida (the Exclusive Territories) and a right of first refusal to build, own, and operate Burger King restaurants in Lee County, Florida (collectively, the Protected Territories). The Territorial Agreement also provided that if FIC had six Burger King restaurants open and in operation on or before August 26, 1981, it would be entitled to a right of first refusal on all Burger King restaurants to be subsequently franchised in the Exclusive Territories through August 1986.

After his return to Florida, Robert moved to Sarasota, Florida, and worked full time for FIC selecting and developing real estate sites, securing financing, and supervising the construction of new restaurants, while continuing to supervise the operations of existing FIC-owned restaurants.

As of February 2, 1980, FIC had seven Burger King restaurants in operation in the Exclusive Territories. As of August 24, 1981, FIC had a total of nine Burger King restaurants.

Inasmuch as FIC had more than six Burger King restaurants in operation before August 26, 1981, FIC became entitled to the right of first refusal in the Exclusive Territories through August 1986.

C. FIC's Advisers

1. Hugh B. Shillington

After opening Store No. 12 in 1959, FIC retained Hugh B. Shillington, C.P.A. (Mr. Shillington), as its outside accountant, to assist in tax and financial accounting matters. Mr. Shillington was a principal of Shillington & Fay (S&F), a Coral Gables, Florida, accounting firm. Mr. Shillington served as outside accountant to other Burger King franchisees and had been recommended to FIC by BKC. S&F reviewed[3] FIC's annual financial statements, including financial statements for FIC's fiscal years ending September 30, 1979, 1980, and 1981 (FY 1979, FY 1980, and FY 1981). Mr. Shillington, who advised FIC to retain its financial records for 7 years, died in 1995.

2. Louis B. Tishler, Jr.

Louis B. Tishler, Jr. (Mr. Tishler), is an attorney who has been practicing law in the Chicago area since his graduation from

[3] S&F annually reviewed the balance sheets, income statements, and statements of changes in financial position of FIC (the financial statements) in order to provide an opinion letter of limited assurance that S&F was aware of no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The scope of a review is substantially less than that of an audit.

Northwestern University School of Law in 1959. Mr. Tishler's primary area of practice is franchising, in which he has been engaged since 1962. Mr. Tishler has represented many well-known franchisors, including Dunkin' Donuts and McDonald's, among others. Mr. Tishler has also represented numerous franchisees of Burger King and Church's Fried Chicken. In the 1960's and 1970's, he represented Burger King franchisees in the acquisition of more than 100 restaurants. Mr. Tishler began his representation of FIC in 1966 or 1967. Both Messrs. Tishler and Shillington had assisted FIC in the making of its decision to allocate $200,000 of the purchase price of the 1976 Purchase to the Territorial Agreement.

D. 1980 Gift

By 1976, when the Territorial Agreement was executed, BKC had adopted a new policy requiring that corporate franchisees be operated by a shareholder with voting control of the corporation (the Control Requirement). FIC did not then satisfy the Control Requirement, but Robert made an oral promise to BKC to acquire a controlling interest in FIC. Despite Robert's promise, no such action was taken until 1980, when BKC demanded that Robert acquire voting control of FIC. To satisfy BKC's demand, on February 2, 1980, decedents each transferred by gift 6 shares of FIC's common stock to Robert (the 1980 Gifts). By the time of the 1980 Gifts, neither of decedents was actively participating in the day-to-day management or operations of FIC.

As of September 30, 1979, the book value of FIC's common stock was $1,033,601. As of February 2, 1980, no dividends had ever been declared or paid on FIC's common stock. With the assistance of Robert, Mr. Shillington, and Mr. Tishler, decedents valued their respective gifts of 6 shares of FIC stock at $62,016 ($10,336 per share) and timely filed the requisite gift tax returns reporting the 1980 Gifts. The period of limitations on assessment of additional gift tax on the 1980 Gifts has expired.

Following the 1980 Gifts, the outstanding common stock of FIC was owned as follows:

Royal	24 shares
Maude	24 shares
Robert	52 shares

Following the 1980 Gifts, decedents executed codicils to their wills providing that their remaining shares of FIC's common stock would be distributed equally among all their children, to the exclusion of Robert.

E. 1981 Recapitalization

In 1980 or 1981, BKC requested that all shareholders of FIC personally guarantee the debt of FIC to BKC. Neither decedent was willing to accede to BKC's request, while Robert was willing to become liable as the sole guarantor only if decedents agreed to relinquish their voting rights in FIC. Robert's reluctance to be the sole guarantor emanated, in part, from the terms of decedents' wills, under which Robert's siblings would eventually

own all decedents' remaining shares in FIC, while Robert would be left the sole guarantor of FIC's debt. Decedents, who were then over 70 years of age, acknowledged their diminished participation in FIC's affairs and Robert's leading role and agreed to relinquish their voting rights only under the following conditions: (i) Robert would continue to actively direct FIC; (ii) FIC would be kept intact; (iii) decedents would receive a fixed income from their investment in FIC; (iv) decedents would be released from any obligation to guarantee FIC's debt; and (v) decedents would receive some kind of equity interest that they could pass on to their children other than Robert.

In order to provide Robert with all the voting stock of FIC and satisfy decedents' conditions, Robert and decedents agreed to a recapitalization of FIC whereby decedents would exchange their common stock for preferred stock. Before the recapitalization, with the assistance of Mr. Tishler, FIC requested and received a private letter ruling from the Internal Revenue Service that the proposed exchange of common stock for preferred stock would qualify as a reorganization for income tax purposes within the meaning of section 368(a)(1)(E).

On August 24, 1981, FIC's articles of incorporation were amended to authorize 5,000 shares of no-par voting common stock and 6,000 shares of par value $100, nonvoting, 10-percent cumulative preferred stock (the Preferred Stock). The Preferred Stock contained no participation, conversion or redemption rights. On August 24, 1981, each of decedents exchanged 24

shares of common stock for 3,000 shares of Preferred Stock (the Recapitalization).

While the Recapitalization indirectly addressed BKC's requirement that each common shareholder personally guarantee the debt of FIC, the Recapitalization had not been required by any condition imposed by BKC.

As of September 30, 1981, the book value of FIC's common stock was $1,109,400. Decedents did not file any 1981 gift tax returns reporting any donative transfers that they may have made by reason of their participation in the Recapitalization.

After the Recapitalization, decedents executed new wills devising their shares of Preferred Stock to their children other than Robert.[4] As of the date of trial, all the Preferred Stock has remained outstanding, all dividends on the Preferred Stock have been timely declared and paid, and Robert has been the only shareholder to personally guarantee the debts of FIC.

F. Estate Tax Returns

Royal died on June 29, 1990, and Maude died on June 12, 1992. Robert, as personal representative, executed and timely filed the required estate tax returns. The adjusted taxable gifts reported on line 4 of the estate tax returns for Royal's

[4] In a distinction dating from the 19th century, a testator devises real property to a devisee and bequeaths personal property to a legatee. Dukeminier, Wills, Trusts, and Estates 36 (1984). However, the Florida Probate Code uses the term "devise" to describe the transfer at death of personal property as well as real property. Fla. Stat. Ann. sec. 731.201(8) (West 1995).

and Maude's estates reflected the 1980 Gifts as reported by Royal and Maude on their respective 1980 gift tax returns. The period of limitations on assessment of additional estate tax against Royal's estate has expired.

G. Notices of Deficiency

On March 11, 1996, respondent issued three deficiency notices: (i) For gift tax for the period ending September 30, 1981, to Maude G. Furman, donor, deceased, Estate of Maude G. Furman, deceased, and Robert G. Furman, Executor (the Maude Gift Tax Notice); (ii) for estate tax to the Estate of Maude G. Furman, deceased, and Robert G. Furman, Executor (the Estate Tax Notice); and (iii) for gift tax for the period ending September 30, 1981, to Royal G. Furman, donor, deceased, Estate of Royal G. Furman, deceased, Robert G. Furman, Executor (the Royal Gift Tax Notice).

The Estate Tax Notice determined that the fair market value of the shares transferred by each decedent in the 1980 Gifts was $147,600 ($24,600 per share), rather than the $62,016 ($10,366 per share) that they had reported on their 1980 gift tax returns. Both the Maude Gift Tax Notice and Royal Gift Tax Notice determined that the fair market value of the 24 shares of FIC common stock exchanged by each decedent in the Recapitalization was $540,540 ($22,522 per share), while the 3,000 shares of preferred stock received by each decedent in the Recapitalization

had a fair market value of only $300,000 ($100 per share),[5] resulting in gifts by each of them to Robert of $240,540, before allowance for the $3,000 annual exclusion.[6]

After concessions by Maude's estate, the remaining items at issue in the Estate Tax Notice are respondent's determinations that for purposes of the estate tax: (i) The fair market value on February 2, 1980, of the donative transfer of 6 shares of FIC's common stock from Maude to Robert was $147,600, rather than

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[5] Respondent has not contested that the preferred shares of FIC had a fair market value equal to their par value when received by decedents. Valued at par, FIC's preferred shares, with no participatory or residual rights beyond the stated dividend and par value, would yield 10 percent if dividends were declared and paid in a timely fashion by the directors elected by the holder(s) of the common stock of this small, closely held corporation. Inasmuch as the parties have stipulated that returns on a 20-year Treasury bond (risk-free rate) in 1980 and 1981 were 11.86 percent and 14.4 percent, respectively, respondent's acceptance of par as the value of the preferred shares appears to be highly questionable. In addition, the closely held character of FIC, the nonvoting characteristics of the preferred, and the resulting inability of the preferred holders to compel the payment of dividends or bring about redemption of their preferred shares or liquidation of the company would have justified substantial minority and lack-of-marketability discounts for the preferred. Despite our misgivings, we decline to revalue the preferred shares on our own motion.

[6] See sec. 2503(b). The Economic Recovery Tax Act of 1981, Pub. L. 97-34, sec. 441(a), 95 Stat. 319, which does not apply in this case, amended sec. 2503(b) by increasing the annual exclusion to $10,000, for transfers made after Dec. 31, 1981.

Respondent determined that Royal and Maude had made gifts of $240,540 before allowance for the $3,000 annual exclusion. Royal was determined to have made a taxable gift of $237,540, while Maude was determined to have made a taxable gift of $237,840. This discrepancy appears to be the result of a computational error by respondent.

the $62,016 reported, so that for purposes of computing the tentative estate tax, an additional $85,584 in adjusted taxable gifts should have been added to the taxable estate;[7] and (ii) on August 24, 1981, when Maude exchanged her 24 shares of FIC's common stock for 3,000 shares of FIC's preferred stock, the fair market value of the common stock was $540,540 ($22,522 per share) and the fair market value of the preferred stock, $300,000 ($100,000 per share). Consequently, the Estate Tax Notice determined that there was a taxable gift in the amount of $237,540 ($240,540 less $3,000 annual exclusion), thereby increasing the adjusted taxable gifts that are added to the reported taxable estate for purposes of computing the tentative estate tax.

H. Discounts and Premiums

1. Minority Interests

On both February 2, 1980, and August 24, 1981, each decedent was a minority shareholder.

Neither decedent had the power to compel FIC to purchase key person insurance.

2. Absence of Swing Vote

On February 2, 1980, no FIC shareholder could obtain voting

[7] Any increase found in the fair market value of the 1980 Gifts will trigger an increase in taxable gifts of like amount, because decedents' 1980 gift tax return has already taken into account the annual exclusion provided by sec. 2503(b). Decedents reported additional taxable gifts to Robert on their respective gift tax returns for the first quarter of 1980 that are not at issue in this case.

control of FIC through the receipt of 6 shares of issued and outstanding FIC common stock. On February 2, 1980, no shareholder of FIC other than Robert could obtain voting control of FIC through the receipt of 12 shares of issued and outstanding FIC common stock. Because only one person, Robert, could gain control through the 1980 Gifts, no swing vote premium would have been paid by a hypothetical third-party buyer of shares of FIC owned by Maude and Royal.

On August 24, 1981, voting control of FIC could not be affected by the transfer of Maude and Royal's respective holdings of FIC common stock, singularly or collectively.

3. Lack of Marketability

On both February 2, 1980, and August 24, 1981: (1) BKC had not established a buy-back program or policy for acquiring Burger King franchises; (2) high interest rates contributed to a depressed market for the sale of Burger King franchises; and (3) there was no readily available market for the stock of FIC. Each of the foregoing factors contributed to a lack of marketability of FIC stock.

4. Combined Minority and Lack of Marketability Discount

On February 2, 1980, the fair market value of each decedent’s gratuitous transfer of 6 shares of FIC's common stock was subject to a combined minority and marketability discount of 40 percent. On August 24, 1981, the fair market value of the 24 shares of FIC's common stock transferred by each decedent in the

Recapitalization was subject to a combined minority and marketability discount of 40 percent.

5. Robert Furman a Key Person

At the times of the 1980 Gifts and the Recapitalization, Robert actively managed FIC, and no succession plan was in effect. FIC employed no individual who was qualified to succeed Robert in the management of FIC. Robert's active participation, experience, business contacts,[8] and reputation as a Burger King franchisee contributed to the value of FIC. Specifically, it was Robert whose contacts had made possible the 1976 Purchase, and whose expertise in selecting sites for new restaurants and supervising their construction and startup were of critical importance in enabling FIC to avail itself of the expansion opportunities created by the Territorial Agreement. The possibility of Robert's untimely death, disability, or resignation contributed to uncertainty in the value of FIC's operations and future cash-flows. Although a professional manager could have been hired to replace Robert, the following risks would still have been present: (i) Lack of management until a replacement was hired; (ii) the risk that a professional manager would require higher compensation than Robert had received; and (iii) the risk that a professional manager would not perform as well as Robert.

[8] Robert developed close friendships with the cofounders of BKC, especially James McLamore, along with Art Rosewall, BKC's chief executive officer.

Robert was a key person in the management of FIC. His potential absence or inability were risks that had a negative impact on the fair market value of FIC. On February 2, 1980, the fair market value of each decedent's gratuitous transfer of 6 shares of FIC's common stock was subject to a key-person discount of 10 percent. On August 24, 1981, the fair market value of the 24 shares of FIC's common stock transferred by each decedent in the Recapitalization was subject to a key-person discount of 10 percent.

ULTIMATE FINDINGS OF FACT

On February 2, 1980, the fair market value of the gratuitous transfer of 6 shares of FIC's common stock by each of Maude and Royal to Robert was $82,859 ($13,810 per share).

On August 24, 1981, when Maude and Royal each exchanged 24 shares of FIC common stock for 3,000 shares of FIC's preferred stock, the fair market value of the common stock transferred by each of them was $424,552 ($17,690 per share).

OPINION

A. Fair Market Value of FIC Stock

Section 2501(a) provides for a tax on gifts by individuals. Section 2512(a) provides that the value of a gift of property at the date of the gift shall be considered the amount of the gift.

The principal issues we must decide in this case are the value of the shares of common stock in FIC that decedents gratuitously transferred to Robert on February 2, 1980, and the

amount, if any, of the excess of the value of the shares of common stock that decedents surrendered in the Recapitalization of August 24, 1981, over the value of the shares of preferred stock that they received in the exchange. The amount of any such excess, by augmenting the value of Robert's common stock in FIC, would be a taxable gift from decedents to Robert. See Estate of Trenchard v. Commissioner, T.C. Memo. 1995-121 supplemented by T.C. Memo. 1995-232; sec. 25.2511-1(h)(1), Gift Tax Regs.

Valuation is a question of fact, and the trier of fact must weigh all relevant evidence to draw the appropriate inferences. Commissioner v. Scottish Am. Inv. Co., 323 U.S. 119, 123-125 (1944); Helvering v. National Grocery Co., 304 U.S. 282, 294-295 (1938); Anderson v. Commissioner, 250 F.2d 242, 249 (5th Cir. 1957), affg. in part and remanding in part T.C. Memo. 1956-178; Estate of Newhouse v. Commissioner, 94 T.C. 193, 217 (1990); Skripak v. Commissioner, 84 T.C. 285, 320 (1985).

Fair market value is defined for Federal estate and gift tax purposes as the price that a willing buyer would pay a willing seller, both having reasonable knowledge of all the relevant facts and neither being under compulsion to buy or to sell. United States v. Cartwright, 411 U.S. 546, 551 (1973) (citing sec. 20.2031-1(b), Estate Tax Regs.); see also Snyder v. Commissioner, 93 T.C. 529, 539 (1989); Estate of Hall v. Commissioner, 92 T.C. 312, 335 (1989). The willing buyer and the willing seller are hypothetical persons, rather than specific

individuals or entities, and the individual characteristics of these hypothetical persons are not necessarily the same as the individual characteristics of the actual seller or the actual buyer. Estate of Curry v. United States, 706 F.2d 1424, 1428-1429, 1431 (7th Cir. 1983); Estate of Bright v. United States, 658 F.2d 999, 1005-1006 (5th Cir. 1981); Estate of Newhouse v. Commissioner, supra at 218; see also Estate of Watts v. Commissioner, 823 F.2d 483, 486 (11th Cir. 1987), affg. T.C. Memo. 1985-595. The hypothetical willing buyer and willing seller are presumed to be dedicated to achieving the maximum economic advantage. Estate of Curry v. United States, supra at 1428; Estate of Newhouse v. Commissioner, supra at 218. This advantage must be achieved in the context of market and economic conditions at the valuation date. Estate of Newhouse v. Commissioner, supra at 218.

For Federal gift tax purposes, the fair market value of the subject property is determined as of the date of the gift; ordinarily, no consideration is given to any unforeseeable future event that may have affected the value of the subject property on some later date. Sec. 2512(a); sec. 20.2031-1(b), Estate Tax Regs.; see also First Natl. Bank v. United States, 763 F.2d 891, 893-894 (7th Cir. 1985); Estate of Newhouse v. Commissioner, supra at 218; Estate of Gilford v. Commissioner, 88 T.C. 38, 52 (1987).

Special rules apply to the valuation of the stock of a

closely held corporation. While listed market prices are the benchmark in the case of publicly traded stock, recent arm's-length transactions generally are the best evidence of fair market value in the case of unlisted stock. Estate of Andrews v. Commissioner, 79 T.C. 938, 940 (1982); Duncan Indus., Inc. v. Commissioner, 73 T.C. 266, 276 (1979). Where the value of unlisted stock cannot be determined from actual sale prices, value is determined by taking into consideration the value of listed stock in comparable corporations engaged in the same or a similar line of business, as well as all other factors bearing on value, including analysis of fundamentals. Sec. 2031(b); Estate of Newhouse v. Commissioner, supra at 217; Estate of Hall v. Commissioner, supra at 336. The factors that we must consider are those that an informed buyer and an informed seller would take into account. Hamm v. Commissioner, 325 F.2d 934, 940 (8th Cir. 1963), affg. T.C. Memo. 1961-347. Rev. Rul. 59-60, 1959-1 C.B. 237, "has been widely accepted as setting forth the appropriate criteria to consider in determining fair market value", Estate of Newhouse v. Commissioner, supra at 217; it lists the following factors to be considered, which are virtually identical to those listed in section 20.2031-2(f), Estate Tax Regs.:

> (a) The nature of the business and the history of the enterprise from its inception.
> (b) The economic outlook in general and the condition and outlook of the specific industry in particular.
> (c) The book value of the stock and the financial condition of the business.

> (d) The earning capacity of the company.
> (e) The dividend-paying capacity.
> (f) Whether or not the enterprise has goodwill or other intangible value.
> (g) Sales of the stock and the size of the block of stock to be valued.
> (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.
> [Rev. Rul. 59-60, 1959-1 C.B. at 238-239.]

Because valuation may not be reduced to the rote application of formulas, and because of the imprecision inherent in determining fair market value of stock that lacks a public market (and the Solomon-like pronouncements that often follow), we again remind the parties that these matters are better resolved by agreement rather than trial by ordeal in which conflicting opinions of the experts are pitted against each other. See Estate of Hall v. Commissioner, supra; Messing v. Commissioner, 48 T.C. 502, 512 (1967); see also Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441 (1980).

As is customary in valuation cases, the parties rely primarily on expert opinion evidence to support their contrary valuation positions. We evaluate the opinions of experts in light of the demonstrated qualifications of each expert and all other evidence in the record. Anderson v. Commissioner, supra; Parker v. Commissioner, 86 T.C. 547, 561 (1986). We have broad discretion to evaluate "`the overall cogency of each expert's analysis.'" Sammons v. Commissioner, 838 F.2d 330, 334 (9th Cir. 1988) (quoting Ebben v. Commissioner, 783 F.2d 906, 909 (9th Cir. 1986), affg. in part and revg. in part T.C. Memo. 1983-200),

affg. in part and revg. in part T.C. Memo. 1986-318. Expert testimony sometimes aids the Court in determining values and sometimes it does not. See, e.g., Estate of Halas v. Commissioner, 94 T.C. 570, 577 (1990); Laureys v. Commissioner, 92 T.C. 101, 129 (1989) (expert testimony is not useful when the expert is merely an advocate for the position argued by one of the parties). We are not bound by the formulas and opinions proffered by an expert witness and will accept or reject expert testimony in the exercise of sound judgment. Helvering v. National Grocery Co., supra at 295; Anderson v. Commissioner, 250 F.2d at 249; Estate of Newhouse v. Commissioner, 94 T.C. at 217; Estate of Hall v. Commissioner, 92 T.C. at 338. Where necessary, we may reach a determination of value based on our own examination of the evidence in the record. Lukens v. Commissioner, 945 F.2d 92, 96 (5th Cir. 1991) (citing Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo. 1974-285); Ames v. Commissioner, T.C. Memo. 1990-87. Where experts offer divergent estimates of fair market value, we decide what weight to give these estimates by examining the factors they used in arriving at their conclusions. Casey v. Commissioner, 38 T.C. 357, 381 (1962). We have broad discretion in selecting valuation methods. Estate of O'Connell v. Commissioner, 640 F.2d 249, 251 (9th Cir. 1981), affg. on this issue and revg. in part T.C. Memo. 1978-191, and the weight to be given the facts in reaching our conclusion because “finding market value is, after all, something for judgment, experience, and reason”, Colonial

Fabrics, Inc. v. Commissioner, 202 F.2d 105, 107 (2d Cir. 1953), affg. a Memorandum Opinion of this Court dated January 22, 1951. Moreover, while we may accept the opinion of an expert in its entirety, Buffalo Tool & Die Manufacturing Co. v. Commissioner, supra at 452, we may be selective in the use of any part of such opinion, or reject the opinion in its entirety, Parker v. Commissioner, supra at 561. Finally, because valuation necessarily results in an approximation, the figure at which this Court arrives need not be one as to which there is specific testimony if it is within the range of values that may properly be arrived at from consideration of all the evidence. Silverman v. Commissioner, supra at 933; Alvary v. United States, 302 F.2d 790, 795 (2d Cir. 1962).

1. Respondent's Expert

Respondent relies on the expert report of Hugh Jackson Shelton (Mr. Shelton). Mr. Shelton has been employed by respondent as a valuation engineer since 1987, in which time he has completed approximately 10 business valuations. Mr. Shelton holds a bachelor of science degree in industrial engineering from the University of Tennessee and a master of arts degree in business management from Webster University.

In the expert report submitted by respondent, Mr. Shelton represents that he has certain qualifications and credentials to perform business valuations that he does not in fact have, including courses on valuation that he has not successfully completed. Mr. Shelton's report also suggests that he is a

member of the American Society of Appraisers, to which he has never belonged. Since Mr. Shelton has not demonstrated that he is qualified to perform a business valuation, we will evaluate his opinion accordingly. See Anderson v. Commissioner, supra at 249.

Mr. Shelton used a capitalized earnings method to value the FIC stock at the time of the 1980 Gifts. Using the capital asset pricing model (CAPM), Mr. Shelton calculated a cost of equity and then computed FIC's weighted average cost of capital (WACC). Earnings before interest, depreciation, and taxes (EBIDT), a variant of EBITDA (earnings before interest, taxes, depreciation, and amortization), were then capitalized using the WACC to arrive at a total enterprise value. In valuing the 1980 Gifts, Mr. Shelton projected 12-month earnings from FIC's 10-month income statement for FY 1979, which he then capitalized to arrive at a February 1980 enterprise value. Mr. Shelton determined August 1981 enterprise value by capitalizing FY 1980 EBIDT and then adding 5 percent to reflect FIC's value in August 1981.

After determining that FIC had a beta of 1.0., Mr. Shelton used the standard CAPM formula to arrive at a cost of equity of 18.44 percent. See description and discussion of beta infra pp. 28-30. Finding that Burger King was the number two fast food chain, Mr. Shelton reasoned that Burger King would be no more or less volatile than the fast food industry as a whole, justifying a beta of 1.0 for FIC's common stock. In his report, Mr. Shelton

gave no further explanation of his choice of beta and did not provide evidence that he had investigated the betas of comparable public companies, or even of BKC, on which his selection of beta was based.[9]

After determining a cost of equity using CAPM, Mr. Shelton purported to compute the WACC of FIC in order to arrive at a capitalization rate. Without providing any explanation, Mr. Shelton computed WACC in a manner that did not conform to the accepted method. See Brealey & Myers, Principles of Corporate Finance 465-469 (4th ed. 1991); Pratt et al., Valuing a Business 180, 184, 189-190 (3d ed. 1996). First, Mr. Shelton modified the WACC formula by weighting FIC's debt and equity based on book value, rather than market value, to arrive at a WACC of 11.0 percent. Considering that the parties have stipulated risk-free rates of 11.86 percent and 14.4 percent in 1980 and 1981, respectively, it is obvious that Mr. Shelton's result is incorrect.

The calculation of WACC provides an after-tax figure, because it is computed using an estimate of the firm's marginal corporate income tax rate. After finding that FIC had a WACC of 11.0 percent, Mr. Shelton tried to convert WACC to a pretax figure. Mr. Shelton calculated what he referred to as a pretax

[9] At the time of the Recapitalization, as discussed supra, BKC was a wholly owned subsidiary of Pillsbury. Because BKC stock did not trade publicly, it did not have a beta. See discussion and explanation of beta, infra pp. 28-30.

WACC of 18.4 percent, which he then used to value FIC. Not only is the calculation of pretax WACC not accepted in the financial community; we are puzzled as to why Mr. Shelton would want to apply a marginal tax rate to compute an after-tax figure, only to then attempt to convert it back to a pretax figure. Finally, we question Mr. Shelton's use of a 40-percent marginal tax rate in computing WACC, when the marginal tax rates derived from FIC's income statements for FY 1979, FY 1980, and FY 1981 are 4.96 percent, 1.25 percent, and 31.69 percent, respectively.

After capitalizing the FY 1979 and FY 1980 EBIDT's of FIC, Mr. Shelton arrived at total enterprise values of $2,764,114, $3,481,369, and $3,655,427 on February 2, 1980, September 30, 1980, and August 24, 1981, respectively. Mr. Shelton then discounted the 1980 and 1981 enterprise values by 17 percent to reflect a combined minority, lack of marketability, and "control premium discount [sic]", to arrive at a fair market value of $22,942 per share as of February 1980 and $30,340 as of August 1981. Applying the annual exclusion to the 1981 gifts only, acceptance of respondent's position would result in taxable gifts by each decedent of $137,652 and $425,160 in 1980 and 1981, respectively. Understatements of taxable gifts by each decedent would then amount to $75,636 and $425,160 for 1980 and 1981, respectively.

With the exception of his assessment of the prospects for economic growth on the west coast of Florida, we reject, in toto,

Mr. Shelton's analysis and conclusions. Although we do not rely on any aspect of Mr. Shelton's opinion, we will discuss some of the major shortcomings for the sake of completeness.

We do not believe that CAPM and WACC are the proper analytical tools to value a small, closely held corporation with little possibility of going public. CAPM is a financial model intended to explain the behavior of publicly traded securities that has been subjected to empirical validation using only historical data of the two largest U.S. stock markets. Raabe & Whittenburg, "Is the Capital Asset Pricing Model Appropriate in Tax Litigation?", Valuation Strategies 12-15, 36 (Jan./Feb. 1998); see Brealey & Myers, supra at 166 (citing Fama & MacBeth, "Risk, Return and Equilibrium: Empirical Tests," 81 Journal of Political Economy 607-636 (1973)). Contrary to the assumptions of CAPM, the market for stock in a closely held corporation like FIC is not efficient, is subject to substantial transaction costs, and does not offer liquidity. Mr. Shelton did not increase our confidence in his choice of method when he computed the cost of equity using an unsubstantiated risk-free rate and risk premium that were not in conformance with the amounts stipulated, and when he arbitrarily assigned a beta to FIC's common stock. Beta, a measure of systematic risk,[10] is a

[10] For purposes of capital market theory, risk is defined as the degree of uncertainty that expected future returns will be realized. Capital market theory divides risk into two components: Systematic risk and unsystematic risk. Systematic, (continued...)

function of the relationship between the return on an individual security and the return on the market as a whole. Pratt et al., supra at 166. Betas of public companies are frequently published, or can be calculated based on price and earnings data. Because the calculation of beta requires historical pricing data, beta can not be calculated for stock in a closely held corporation. The inability to calculate beta is a significant shortcoming in the use of CAPM to value a closely held corporation; this shortcoming is most accurately resolved by using the betas of comparable public companies. Id. at 175. Mr. Shelton's unsubstantiated statement regarding the standing of BKC in the fast food industry is hardly a sufficient basis for arriving at a beta of 1.0 for FIC. Mr. Shelton did not provide any evidence that he had researched or calculated the betas of BKC or any other public company. He seems to have assumed, without further explanation, that FIC and BKC were comparable

[10](...continued)
or market, risk represents the sensitivity of the future returns from a given asset to the movements of the market as a whole. Unsystematic, or unique, risk reflects those elements of risk that are specific to the asset held, such as company characteristics, industry conditions, and the type of investment interest held. Capital market theory assumes that investors hold or have the ability to hold, diversified portfolios that eliminate, on a portfolio basis, the effects of unsystematic risk. Consequently, since capital market theory assumes that an investor holding a diversified portfolio will encounter only systematic risk, the only type of risk for which an investor can be compensated, is systematic risk, the degree of which can be measured by beta. Brealey & Myers, Principles of Corporate Finance 137-138, 143-144 (4th ed. 1991); Pratt et al., Valuing a Business 166 (3d ed. 1996).

companies for this purpose. Finally, we reject Mr. Shelton's methodology for estimating FIC's beta, since it was based on BKC's industry standing and not on references to the volatility of stock in FIC in comparison to the market as a whole.[11] See Brealey & Myers, supra at G2 (defining beta as a "measure of market risk").

Mr. Shelton's use and application of the WACC fares no better under our scrutiny. WACC is generally used to calculate a discount rate that reflects the weighted average cost of each of the components of a firm's capital structure. To compute WACC, it is necessary to know the market value of the firm's debt and equity, which if known, would go far toward negating the need to perform a valuation. In computing WACC, Mr. Shelton used FIC's book value weighting of debt and equity, rather than market value, without justifying his departure.

We also find fault with Mr. Shelton's computation of EBIDT and the manner in which he arrives at an enterprise value as of August 24, 1981. Since the parties have stipulated the proper EBIDTA amounts for the periods in question, we abstain from further comment on Mr. Shelton's computation of EBIDT. We do,

[11] Mr. Shelton's conception of beta as a measure of the relative volatility of a specific security in comparison to an industry should not be confused with industry beta, which is often used to calculate discount or capitalization rates. Industry beta is calculated from the individual betas of a portfolio of securities within the same industry and reflects the market risk of that industry portfolio. See Brealey & Myers, supra at 189. Unlike Mr. Shelton's method, industry beta focuses on market risk.

however, question Mr. Shelton's failure to incorporate the reported FY 1981 earnings of FIC into his August 24, 1981, valuation; his estimate of 5-percent growth could hardly be viewed as reasonable where actual EBIDTA growth for FY 1981 was 61 percent.[12] We also fault Mr. Shelton's failure to deduct the outstanding debt of FIC from his capitalization of EBIDT in determining FIC's enterprise value.

Mr. Shelton's report also contains detailed calculations from which he attempts to determine the replacement cost of building 10 Burger King restaurants. We are unsure what relevance such a calculation has to the valuation of a business where value is determined by the prospect of future earnings rather than net asset value. Moreover, Mr. Shelton's use of 1992 data in computing replacement cost is of no relevance to the valuation of stock in 1980 and 1981.

Our final criticism of Mr. Shelton's report has little if any bearing on his valuation conclusion but has again caused us to doubt his expertise. In his report, Mr. Shelton attempted to analyze the FY 1979 and FY 1980 balance sheets of FIC. Using the FY 1979 balance sheet data of FIC, Mr. Shelton "projected" a 12-month balance sheet for 1979 by substantially increasing the amounts of some of the balance sheet items, without indicating what items on the income statement would lead to such growth in the amounts reported on the projected balance sheet.

[12] Employing a larger growth factor would have led to a higher valuation.

2. Petitioners' Expert

Petitioners rely on the expert report of Francis X. Burns (Mr. Burns) and Brian R. Oliver (Mr. Oliver) of IPC Group, LLC (IPC). Messrs. Burns and Oliver are both experienced in business valuation and, in addition to their undergraduate degrees, hold master's degrees in finance from Northwestern University's Kellogg School of Management. Although Messrs. Burns and Oliver are not formally accredited as appraisers, we are satisfied that they are qualified to perform a business valuation. Fed. R. Evid. 702; see Martin Ice Cream Co. v. Commissioner, 110 T.C. ___, ___ (1998) (slip op. at 52).

IPC valued the FIC shares using two approaches: A capitalized income method (income method) and a multiple of EBITDA method (EBITDA multiple method).

Applying the income method, IPC determined per-share values for the stock transferred in the 1980 Gifts and the 1981 Recapitalization of $7,388 and $4,273, respectively. Value was determined under the income method by capitalizing a measure of normalized earnings, adding the fair market value of nonoperating assets, and then applying a marketability discount to the per-share value. IPC determined normalized earnings using net operating cash-flow available to equity holders (NCF), adjusted to reflect noncash charges. In valuing the 1980 Gifts, IPC used the NCF for FY 1979, a 10-month fiscal year. A weighted average of the net operating cash-flows for the previous 3 years was used

to compute the August 1981 fair market value of the stock.

IPC applied CAPM principles to determine the rate of return an investor would expect in February 1980 and August 1981. IPC used market data from Ibbotson Associates[13] and determined that the expected rate of return an investor in FIC stock would demand would be equal to the sum of the applicable risk-free rate, risk premium, and small-stock premium, as well as an additional premium to account for the risk specific to FIC. To reflect the effect of nominal long-term earnings growth, IPC subtracted a growth factor[14] from the expected rate of return and determined a capitalization rate of 21.38 percent for valuing the 1980 Gifts and a 25.50 percent capitalization rate for valuing the stock transferred in the Recapitalization.

After capitalizing normalized earnings to determine enterprise value from operations, IPC added the market value of FIC's nonoperating assets to determine total equity value. IPC computed a per-share equity value of $11,366 for the 1980 Gifts

[13] The parties stipulated that the Ibbotson Associates figures used by IPC were correct for the dates in question. They have not stipulated: (1) The proper capitalization rate; (2) the correctness of any FIC specific risk premium; or (3) the correctness of any particular method of computing a capitalization rate.

[14] IPC determined growth factors of 8 percent for the 1980 Gifts and 7 percent for the Recapitalization, on the basis of the long-term inflation outlook of the Value Line Investment Survey on Feb. 1, 1980, and Aug. 21, 1981. Apparently, IPC did not take into account the likelihood of real earnings growth attributable to FIC's ability to open more restaurants in its expanding market, as well as the likelihood of increasing sales in the existing restaurants.

and $6,574 per share for the Recapitalization. IPC then determined that a marketability discount of 35 percent should be applied because of the following factors: (1) The transactions at issue involved minority interests, which are harder to sell; (2) the size of FIC precluded the possibility of a public offering; and (3), as of the relevant dates, no dividends had ever been paid by FIC on its common stock. After applying the marketability discount, IPC determined that the fair market value of the stock, per share, was $7,388 in 1980 and $4,273 in 1981. In comparison, book value per share after applying a 30-percent minority interest discount and a 35-percent marketability discount was determined to be $4,703 in 1980 and $5,048 in 1981. Applying book value as a floor in the valuation, IPC determined that use of the income method resulted in an undervaluation.

Petitioners have relied upon IPC's second method of valuation, the EBITDA multiple method. Under this method, a multiple of net earnings before interest, taxes, depreciation, and amortization (EBITDA) was used to determine total enterprise value. IPC determined the EBITDA of FIC for the FY 1979 through FY 1981. In valuing the 1980 Gifts, IPC used a multiple of FY 1979 EBITDA; a multiple of the weighted average of EBITDA for FY 1979 through FY 1981 was used to value the stock transferred in the Recapitalization. The parties have stipulated FIC's EBITDA for FY 1979 through FY 1981, using the figures determined by IPC.

IPC determined that a multiple of 4 to 6 times EBITDA was a

commonly used valuation guideline that should be applied in this case. IPC determined that high interest rates, a sluggish economy, and the high returns required by investors in small companies were factors that would depress the value of FIC stock, leading to a multiple in the order of 4.0 to 4.5, while the modestly successful sales growth of FIC between 1979 and 1981 suggested a multiple of 5.0 to 5.5. IPC concluded that FIC should be valued using an EBITDA multiple of 5.0 for both 1980 and 1981.

After determining total enterprise value, IPC made various adjustments, such as subtracting the value of outstanding debt, to determine total equity value, which was then converted to equity value per share. Equity value per share was determined to be $20,842 in February 1980 and $26,245 in August 1981. After applying a 30-percent minority discount, a 35-percent marketability discount, and a 10-percent key-person discount, or a total of 59.05 percent in discounts, IPC determined a fair market value per share of $8,535 in February 1980 and $10,747 in August 1981; following these conclusions would result in an overstatement of $10,806 for Royal and Maude's 1980 taxable gifts, and zero taxable gifts for their transfers in 1981.

We found Messrs. Burns and Oliver to be qualified, experienced, and credible expert witnesses. We agree with them that valuing FIC using the income method would not be appropriate inasmuch as the income method produces a value less than book

value for August 1981. While it is odd that the use of an accepted method like this one would produce a value lower than book value, this oddity is explained by IPC's incorrect computation of book value for August 1981,[15] and, we suspect, an overstated capitalization rate.

Our major criticism of IPC's application of the income method was their construction of the capitalization rate. In deducting a long-term growth factor from the expected rate of return, IPC deducted 8 percent for the 1980 capitalization rate and 7 percent for the 1981 rate. Since these figures are identical to the inflation estimates of the Value Line Investment Survey that were cited by IPC in its report, the growth factors used represented only the expectation of nominal earnings growth: the growth in earnings caused by price inflation. FIC was a growing business; real sales and earnings growth could be expected, both from increased volume at existing restaurants and from the construction of new stores in the Exclusive Territory,

[15] IPC calculated discounted book value for August 1981 using the FY 1981 balance sheet. Discounted book value of the common stock was calculated as total stockholders' equity, less $600,000 to reflect the preferred stock issued in the Recapitalization, and then minority and marketability discounts were applied. Because the relevant valuation period is immediately before the Recapitalization, at which time only one class of stock existed, it was improper to use the unadjusted FY 1981 balance sheet figures reflecting the capital structure of FIC after it had been recapitalized. Discounted book value should have been computed as total stockholder's equity, subject to the minority and marketability discounts, which would have produced a discounted book value per share of $7,778 per share, rather than the $5,048 per share determined by IPC.

which was an area of rapid population growth.

We accept IPC's valuation under the EBITDA multiple approach as the most accurate measurement of value available, but we do not accept the percentages of minority interest and marketability discounts that were applied. We also reject IPC's use of a multiple rate of 5.0 as unreasonable in light of FIC's growth potential and the prevailing economic conditions.

At time of the Recapitalization, FIC had only nine Burger King restaurants open but held a right of first refusal that provided FIC with a protected territory in four southwest Florida counties that were experiencing rapid population growth. Because many of the FIC restaurants were new at the time of the Recapitalization, we think that a prospective purchaser of stock in FIC would expect earnings from existing restaurants to increase as an area presence was established and store sales were increased; the fact that FIC had the ability to block potential Burger King franchisees from entering its market would only strengthen such an expectation. Since the exercise of the right of first refusal would enable FIC to open additional restaurants in the Protected Territories, we think that a prospective purchaser would be bullish regarding FIC's potential for earnings growth from expansion.

Because we think that IPC has not properly taken into account FIC's potential for growth, we find 6.0 times EBITDA to be the proper multiple to be employed in the valuation of the FIC

stock. We approve petitioners' weighting of EBITDA in determining an August 1981 value, since we believe that the use of 3 years of financial statements provided a more accurate earnings picture than the capitalization of any single year.[16] Finally, we approve of the adjustments made by IPC after calculating a multiple of EBITDA. We find that the stock in FIC had an equity value per share of $25,574 in February 1980 and $32,759 in August 1981.

3. Discounts

a. Minority Interest Discount

A minority interest discount reflects the minority shareholder's inability to compel either the payment of dividends or liquidation in order to realize a pro rata share of the corporation's net earnings or net asset value. Discounts for a minority interest and for lack of marketability are conceptually distinct, and the appropriate percentage rate of each of them is a question of fact. Estate of Newhouse v. Commissioner, 94 T.C. at 249.

Because the blocks of stock transferred in the 1980 Gifts and in the 1981 Recapitalization were minority interests, it is appropriate to apply a minority interest discount in their valuation. Since the willing buyer-willing seller test is an objective test, requiring that potential transactions be analyzed

[16] FY 1979, FY 1980, and FY 1981 EBITDA were weighted 10 percent, 30 percent, and 60 percent, respectively.

from the viewpoint of a hypothetical seller, whether a block of stock is a minority interest must be determined without regard to the identity and holdings of the transferee. See Estate of Watts v. Commissioner, 823 F.2d 483, 486-487 (11th Cir. 1987), affg. T.C. Memo. 1985-595; Estate of Bright v. United States, 658 F.2d at 1005-1006. Consequently, the fact that the 1980 Gifts enabled Robert Furman to gain control of FIC can not be considered.

Both parties agree that a minority discount should be applied in valuing both the 1980 Gifts and 1981 transfers by decedents in the Recapitalization, although we do not understand how respondent's expert determined that both a minority discount and a control premium should be applied, since the two are essentially opposites. We recognize that a hypothetical investor would not be willing to purchase a minority interest in FIC without a significant discount; no matter how successful the corporation, a minority interest in a corporation that does not pay dividends and whose stock does not have a ready market is of limited value.

Petitioners' expert cited three articles on minority discounts. The first, Bolten, "Discounts for Stocks of Closely Held Corporations", 129 Tr. & Est. 47 (Dec. 1990), summarized nine studies regarding discounts for minority interests that indicated a mean discount of 29.63 percent. The second article, "Survey Shows Trend Towards Larger Minority Discounts", 10 Est. Planning 281 (Sept. 1983), summarized the results of a study

conducted by H. Calvin Coolidge that compared the actual sales of minority interests in closely held corporations to the reported book value of those corporations. The Coolidge study found an average discount of 39.9 percent and a median discount of 39 percent against book value. The third article cited by IPC, Pratt, "Discounts and Premia", in Valuation of Closely Held Companies and Inactively Traded Securities 38 (Dec. 5, 1989) (on file with The Institute of Chartered Financial Analysts), summarized several empirical studies regarding both minority and marketability discounts. By analyzing control premium data, Pratt found an implied minority discount of approximately 33 percent for 1980 and 1981 in the studied transactions. Based on the cited articles, IPC determined that a 30-percent minority interest discount was appropriate.

We do not believe that any control premium is warranted. We reject respondent's argument that a swing vote potential existed, since we have found that the transferred shares did not have swing vote potential. We are required to value the shares as if they were transferred to a hypothetical buyer and are not permitted to take into account the circumstances of the actual transferee in valuing the shares.

b. Marketability Discount

Both petitioners and respondent acknowledge the necessity of applying a marketability discount in the valuation but disagree as to the proper percentage. A lack of marketability discount

reflects the fact that there is no ready market for shares in a closely held corporation. Ascertaining the appropriate discount for limited marketability is a factual determination. Critical to this determination is an appreciation of the fundamental elements of value that are used by an investor in making his or her investment decision. Some of the relevant factors include: (1) The cost of a similar company's stock; (2) an analysis of the corporation's financial statements; (3) the corporation's dividend-paying capacity and dividend payment history; (4) the nature of the corporation, its history, its industry position, and its economic outlook; (5) the corporation's management; (6) the degree of control transferred with the block of stock to be valued; (7) restrictions on transferability; (8) the period of time for which an investor must hold the stock to realize a sufficient return; (9)the corporation's redemption policy; and (10) the cost and likelihood of a public offering of the stock to be valued. See Estate of Gilford v. Commissioner, 88 T.C. 38, 60 (1987); Northern Trust Co. v. Commissioner, 87 T.C. 349, 383-389 (1986).

The factors limiting the marketability of stock in FIC in February 1980 and August 1981 included the following: (1) FIC had never paid dividends on its common stock; (2) the corporation was managed and controlled by one individual; (3) the blocks of stock to be transferred were minority interests; (4) a long holding period was required to realize a return; (5) FIC had no

custom or policy of redeeming common stock; (6) because FIC's annual sales were only in the $7 million range, it was not likely to go public; and (7) there was no secondary market for FIC stock. While FIC had significant potential for controlled growth, a healthy balance sheet, and robust earnings growth, we find the factors limiting marketability to be significant.

In concluding that a 35-percent marketability discount should be applied, petitioners' expert cited four articles, including three studies on the sale of restricted stock[17] that have been frequently brought to the attention of this Court. See, e.g., Estate of Jung v. Commissioner, 101 T.C. 412, 435-436 (1993); Mandelbaum v. Commissioner, T.C. Memo. 1995-255 (1995), affd. without published opinion 91 F.3d 124 (3d Cir. 1996); Estate of Lauder v. Commissioner, T.C. Memo. 1992-736; Estate of Friedberg v. Commissioner, T.C. Memo. 1992-310; Estate of Berg v. Commissioner, T.C. Memo. 1991-279, affd. in part and revd. and remanded in part 976 F.2d 1163 (8th Cir. 1992); Estate of O'Connell v. Commissioner, T.C. Memo. 1978-191, affd. in part and revd. in part 640 F.2d 249 (9th Cir. 1981). The first restricted stock study, Gelman, “An Economist-Financial Analyst's Approach to Valuing Stock of a Closely-Held Company”, 36 J. Taxn. 353 (June 1972), studied the transactions of four large, closed-end

[17] Restricted stock is stock acquired from an issuer in a transaction exempt from the registration requirements of the Federal securities laws. Sales of restricted stock are generally restricted within the first 2 years after issuance.

publicly traded investment companies that specialized in restricted securities. The study found mean marketability discounts of 33 percent after analyzing 89 restricted stock investments by the four investment companies. The second study, Moroney, "Most Courts Overvalue Closely Held Stocks", 51 Taxes 144 (Mar. 1973), is based on 10 registered investment companies that held a total of 146 blocks of restricted equity securities. The Moroney study found an average discount on the restricted stock transactions of 35.6 percent. The third study, Maher, "Discounts for Lack of Marketability for Closely Held Business Interests", 54 Taxes 562 (Sept. 1976), is based on reports filed with the Securities and Exchange Commission by four mutual fund companies reporting their restricted stock transactions. The Maher study found a mean discount of 34.73 percent. The final study cited was an IPO study, Emory, "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock February 1992 through July 1993", Bus. Valuation Rev. 3 (Mar. 1994). The Emory study found an average marketability discount of 46 percent after comparing the share price in private transactions that occurred within 5 months of an IPO by the same corporation. We find petitioners' reliance on the restricted stock studies to be misplaced, since those studies analyzed only restricted stock that had a holding period of 2 years. Inasmuch as we expect the investment time horizon of an investor in the stock of a closely held corporation like FIC to be long term, we

do not believe that marketability concerns rise to the same level as a security with a short-term holding period like restricted stock.[18] In light of the foregoing, we find no persuasive evidence in the record to support our reliance on the restricted stock studies in determining an appropriate marketability discount.[19]

c. Combined Minority and Lack of Marketability Discount

Respondent has chosen to apply a combined minority and lack of marketability discount of 17 percent, while petitioners seek a minority discount of 30 percent and a marketability discount of 35 percent, which would result in a combined discount of approximately 54.5 percent. While we take into account the articles cited by petitioners, we are by no means bound by the report of petitioners' expert. We also recognize that while the minority and marketability discounts may be conceptually distinct, Estate of Newhouse v. Commissioner, 94 T.C. at 249 (1990), the boundaries are often less clear in practice, and the empirical studies cited by petitioners may in fact reflect the

[18] That all investors have identical investment horizons is one of the most widely criticized assumptions of CAPM. See Gilson, "Value Creation by Business Lawyers: Legal Skills and Asset Pricing", 94 Yale L.J. 239, 252 (1984).

[19] For further discussion and criticism of the use of the Moroney, Maher, and Emory studies to support the application of a marketability discount in the valuation of stock in a closely held corporation, see Mandelbaum v. Commissioner, T.C. Memo. 1995-255, affd. without published opinion 91 F.3d 124 (3d Cir. 1996).

resulting uncertainties; see e.g., Dockery v. Commissioner, T.C. Memo. 1998-114 (40-percent combined minority and marketability discount); Estate of Mitchell v. Commissioner, T.C. Memo. 1997-461 (35-percent combined minority and marketability discount); LeFrak v. Commissioner, T.C. Memo. 1993-526 (30-percent combined discount); Estate of Gallo v. Commissioner, T.C. Memo. 1985-363 (36-percent marketability discount, with references to minority issues). We reject both respondent's combined discount of 17 percent and petitioners' separate 30-percent minority discount and 35-percent marketability discount and conclude that a 40-percent combined minority and marketability discount is appropriate in this case.

d. Key-Person Discount

Where a corporation is substantially dependent upon the services of one person, and where that person would no longer be able to perform services for the corporation by reason of death or incapacity, an investor would expect some form of discount below fair market value when purchasing stock in the corporation to compensate for the loss of that key employee. See Estate of Huntsman v. Commissioner, 66 T.C. 861 (1976); Estate of Mitchell v. Commissioner, supra; Estate of Feldmar v. Commissioner, T.C. Memo. 1988-429; Estate of Yeager v. Commissioner, T.C. Memo. 1986-448. Although FIC could have purchased key-person life insurance on Robert's life, a minority shareholder could not compel FIC to purchase such insurance, and FIC had no such

insurance in effect.

We have found as facts that Robert was a key person in the management of FIC, that FIC had no second layer of management, and that Robert's contacts, experience, and managerial expertise were critically important to the success of FIC. While the operation of a franchised Burger King restaurant might appear to be formulaic, FIC was a growing organization, and Robert's responsibilities extended well beyond the operation of existing restaurants. Moreover, since BKC had considerable control over FIC's costs, expansion opportunities, competition, and ultimately profits, Robert's personal relationships with the founders of BKC were very helpful to the success of FIC. We therefore agree with petitioners and find that a key-person discount of 10 percent was appropriate in determining the value of FIC stock as of February 1980 and August 1981.

Accordingly, we allow a total discount of 46 percent in valuing the FIC common stock transferred by decedents in 1980 and 1981, reflecting a combined minority and marketability discount of 40 percent and a key-person discount of 10 percent.

4. Valuation Conclusions

On the basis of the foregoing, we find that for purposes of computing the taxable gifts of Royal and the taxable gifts and taxable estate of Maude: (1) The fair market value of 24 shares of FIC common stock exchanged by each decedent in 1981 for preferred stock of FIC was $424,552; (2) the fair market value of

the 3,000 shares of preferred stock of FIC received by each decedent in the Recapitalization was $300,000; and (3) after applying the $3,000 annual exclusion, each decedent made a taxable gift to Robert in the Recapitalization in the amount of $121,552. For purposes of computing Maude's taxable estate, we also find that the fair market value of 6 shares of FIC common stock that she transferred to Robert in 1980 was $82,859, resulting in a taxable gift of the same amount.

B. Additions to Tax

1. Failures To File 1981 Gift Tax Returns

For the 1981 taxable year, individuals who were required to file a timely gift tax return but did not do so are subject to an addition to tax equal to 5 percent of the amount of tax that should have been shown on the return, for every month in which the failure to file continues, subject to a maximum of 25 percent. Sec. 6651(a)(1).

The addition to tax for failure to timely file a gift tax return may be avoided if the taxpayer can show that his failure to file was due to reasonable cause and not due to willful neglect. Sec. 6651(a)(1); United States v. Boyle, 469 U.S. 241, 245 (1985); Logan Lumber Co. v. Commissioner, 365 F.2d 846, 853 (5th Cir. 1966) (citing Breland v. United States, 323 F.2d 492 (5th Cir. 1963)), affg. in part and remanding in part T.C. Memo. 1964-126; Home Builders Lumber Co. v. Commissioner, 165 F.2d 1009 (5th Cir. 1948); Estate of Reynolds v. Commissioner, 55 T.C. 172,

202-203 (1970). Reasonable cause exists if a taxpayer exercised ordinary business care and prudence and nevertheless did not timely file a gift tax return. Hollingsworth v. Commissioner, 86 T.C. 91, 108 (1986) (citing Estate of Kerber v. United States, 717 F.2d 454, 455 (8th Cir. 1983)); sec. 301.6651-1(c)(1), Proced. & Admin. Regs.; see Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950). Willful neglect means a conscious, intentional failure or reckless indifference. United States v. Boyle, supra at 245-246; sec. 301.6651-1(c)(1), Proced. & Admin. Regs. Whether a failure to timely file a gift tax return was due to reasonable cause, and not to willful neglect, is a factual matter to be decided on the basis of the facts and circumstances of each case. The Commissioner's determination of an addition to tax is presumed to be correct and must be disproven by the taxpayer. Welch v. Helvering, 290 U.S. 111, 115 (1933); Epstein v. Commissioner, 53 T.C. 459, 477 (1969).

"Courts have frequently held that `reasonable cause' is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney that it was unnecessary to file a return, even when such advice turned out to have been mistaken." United States v. Boyle, supra at 250 (citing United States v. Kroll, 547 F.2d 393, 395-396 (7th Cir. 1977)); Commissioner v. American Association of Engg. Employment, Inc., 204 F.2d 19, 21 (7th Cir. 1953); Burton Swartz Land Corp. v.

Commissioner, 198 F.2d 558, 560 (5th Cir. 1952); Haywood Lumber & Mining Co. v. Commissioner, supra at 771; Orient Inv. & Fin. Co. v. Commissioner, 166 F.2d 601, 602-603 D.C. Cir. (1948); Hatfried, Inc. v. Commissioner, 162 F.2d 628, 634 (3d Cir. 1947); Girard Inv. Co. v. Commissioner, 122 F.2d 843, 848 (3d Cir. 1941); Dayton Bronze Bearing Co. v. Gilligan, 281 F. 709, 712 (6th Cir. 1922)). Thus in some cases, reliance on the opinion of a tax adviser may constitute reasonable cause for failure to file a return. United States v. Boyle, supra at 250-251; Commissioner v. Lane-Wells Co., 321 U.S. 219 (1944).

Reasonable cause based upon reliance on the opinion of a competent adviser has been found where the reliance concerned a question of law, such as whether the filing of a return was required; a taxpayer's reliance on an adviser ordinarily cannot supplant his personal duty to ensure the timely filing of any required return.

> When an accountant or attorney advises a taxpayer on a matter of tax law * * * it is reasonable for the taxpayer to rely on that advice * * *
>
> By contrast, one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due. [United States v. Boyle, supra at 251.]

Compare Haywood Lumber & Mining Co., supra at 770-771 (reasonable cause for failure to file personal holding company surtax returns where corporation had relied on competent certified public accountant to prepare income tax returns) and Hollingsworth v. Commissioner, supra at 108-109 (reasonable cause for failure to

file a gift tax return where attorneys advised the taxpayer that no gift tax liability resulted from transfer of property at fair market value) with Logan Lumber Co. v. Commissioner, supra at 853 (forgetting to file a tax return or failing through inadvertence to see that it is filed does not constitute reasonable cause), and Millette & Associates, Inc. v. Commissioner, 594 F.2d 121, 124-125 (5th Cir. 1979) ("responsibility for assuring a timely filing is the taxpayer's"), affg. T.C. Memo. 1978-180.

Decedents were advised not to file a gift tax return by Messrs. Tishler and Shillington in connection with the transfers made in the Recapitalization. Messrs. Tishler and Shillington concluded that the fair market values of the common stock exchanged and the preferred stock received in the recapitalization were equal, so that no taxable gift had been made.

Respondent argues that the addition to tax is nonetheless applicable because decedents did not rely on a formal appraisal of FIC to determine whether they had made taxable gifts. Respondent's argument is unwarranted on the facts of this case. As we have discussed in our findings of fact, supra, Mr. Tishler is highly experienced in restaurant franchising, and at the time of the Recapitalization, had served as FIC's attorney for approximately 15 years. Mr. Tishler's representation of FIC included tax matters; for instance: (1) In connection with the 1980 Gifts, he had advised decedents to file gift tax returns,

and had signed those returns as preparer; and (2), as discussed, supra, Mr. Tishler had acted on FIC's behalf in requesting a private letter ruling in connection with the Recapitalization. Like Mr. Tishler, Mr. Shillington, a C.P.A., had a longstanding relationship with FIC at the time of the Recapitalization. Having prepared FIC's income tax returns and financial statements since 1959, it is obvious that Mr. Shillington was intimately familiar with FIC's financial affairs. Moreover, as the accountant to other Florida-based Burger King franchisees, Mr. Shillington could draw on his knowledge of industry trends, averages, and conventions in valuing FIC. In sum, in light of the expertise of Messrs. Tishler and Shillington, we think that it was not unreasonable for decedents to rely on their advice not to file a gift tax return.

That decedents received advice that ultimately proved erroneous does not alter our conclusion; valuation is an area of inherent uncertainty. See United States v. Boyle, 469 U.S. at 250. Consequently, we conclude that decedents' failure to file was due to reasonable cause and do not sustain any portion of respondent's additions to gift tax under section 6651(a)(1).

2. Negligence

Section 6653(a) provides for an addition to tax of 5 percent of the underpayment if any part of the underpayment of tax is due to negligence or intentional disregard of rules or regulations. For purposes of this section, an underpayment generally can be

viewed as the equivalent of a deficiency. Sec. 6653(c)(1). For purposes of section 6653(a), negligence is defined as a lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances. Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), affg. on this issue 43 T.C. 168 (1964) and T.C. Memo. 1963-66; Elliott v. Commissioner, 90 T.C. 960, 974 (1988), affd. without published opinion 899 F.2d 18 (9th Cir. 1990); Larotonda v. Commissioner, 89 T.C. 287, 292-293 (1987); Neely v. Commissioner, 85 T.C. 934, 947-948 (1985); Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972). Petitioners bear the burden of proving that the additions to tax determined by respondent should not be applied. Pollard v. Commissioner, 786 F.2d 1063 (11th Cir. 1986), affg. T.C. Memo. 1984-536; Luman v. Commissioner, 79 T.C. 846, 860-861 (1982); Axelrod v. Commissioner, 56 T.C. 248, 258 (1971).

For the same reasons that we have found that decedents had reasonable cause for their failures to file gift tax returns, we do not find them to have been negligent by reason of having underpaid their gift taxes. In light of the qualifications and expertise of Mr. Tishler, FIC's attorney, and Mr. Shillington, FIC's accountant, we think that decedents acted reasonably in relying on their opinions. Finally, although the advice rendered to decedents by Messrs. Tishler and Shillington has proven to be erroneous, we do not think, in light of the uncertainty associated with valuation, that their determination of fair

market value was so unreasonable as to render decedents' reliance thereon negligent. Consequently, we do not sustain any portion of respondent's addition to gift tax under section 6653(a).

To reflect the foregoing,

Decisions will be entered under Rule 155.

B 7925
NO. 17985

JUL 13 1979

IN THE COURT OF CIVIL APPEALS FOR THE
SECOND SUPREME JUDICIAL DISTRICT OF TEXAS

MARY LEE GEESBREGHT — APPELLANT

VS.

JOHN GEESBREGHT — APPELLEE

FROM THE DISTRICT COURT OF TARRANT COUNTY

OPINION

In this divorce case we affirm those portions of the trial judgment which granted a divorce and awarded custody of the parties' minor children to the father; and at the same time reverse and remand for another trial that portion of the trial court's judgment decreeing division of the property involved.

The trial court's judgment was rendered upon both the petition for divorce filed by John Geesbreght against his wife Mary Lee and upon the cross-petition for divorce by Mary Lee. Each will be hereinafter referred to by their first names. Declaration for relief by each party was upon the generally termed "no fault" ground of TEX. FAMILY CODE ANN. § 3.01, (Supp. 1978) "Insupportability" of Chapter 3, "Dissolution of Marriage".

ON THE JURISDICTION

Mary Lee desired that that part of the judgment which decrees the parties' divorce be affirmed on appeal. Nevertheless, she has a point of error founded upon the trial court's decision that it had jurisdiction of the case. Mary Lee left her husband's domicile in Fort Worth, Texas, on January 20, 1976; on January 22, 1976, she filed a suit against him in the Circuit Court of Cook

County, Illinois for separate maintenance and for custody of the parties' children. A suit for separate maintenance is not valid by Texas law. On February 10, 1976 John filed his suit for divorce in the Tarrant County court from which there is this appeal. Both suits pended until August 17, 1976 when the Illinois court dismissed that of Mary Lee for want of prosecution. There was reinstatement of such case on September 14, 1976 upon the petition of Mary Lee. The Tarrant County suit continued to pend. Before the Illinois case was reinstated and on August 30, 1976 Mary Lee appeared before the Tarrant County court at a hearing in connection with her plea to be temporarily appointed managing conservator of her children. The circumstance presents a situation where Mary Lee has waived her right to complain of jurisdiction. The jurisdiction of the Tarrant County court was secure as of the time of dismissal of Mary Lee's suit in Illinois even though a question might have persisted (had she filed a plea to the jurisdiction - and none was filed either in compliance or non-compliance with the "due order of pleading" rules) had the dismissal not occurred and/or had there been no waiver during the period during which the Illinois case was a dismissed case. At no time was the Tarrant County court ever requested to take judicial notice of Illinois law, and such law was not proved.

What we have said in the preceding paragraph does not necessarily cover Mary Lee's contention that the Tarrant County court did not have the requisite jurisdiction which authorized it to make an enforceable decree concerning custody of the children. By the circumstances we consider the question moot. Mary Lee appealed the judgment of the Tarrant County trial court to this appellate court while withholding custody of her children from John, contrary to the provisions of the trial court judgment. John presented such facts to this court and moved for dismissal of Mary Lee's appeal.

The proper order of an appellate court is to dismiss the appeal where an appellant is in obvious contempt of the judgment of the trial court from which the appeal has been taken. See Strange v. Strange, 464 S.W.2d 216 (Tex. Civ. App.--Fort Worth 1970). See also the opinion of the supreme court answering certified questions upon other aspects of the same case at 464 S.W.2d 364 (Tex. 1971). The day before John's motion to dismiss the appeal was scheduled to be heard Mary Lee caused or permitted the children to be delivered to John in Tarrant County, Texas, making proof to this court that such had been done. The motion to dismiss the appeal was withdrawn. We have continued to honor Mary Lee's appeal.

Apart from the foregoing we nevertheless have considered the question of jurisdiction of the trial court, as of the time it rendered judgment and as of the time its jurisdiction passed (for necessary purposes) to this appellate court. We hold that the court below had jurisdiction of the children and authority to make the adjudication upon their custody.

Though the adjudication is as upon a case in rem in that is upon the status of the children (so that there is the legal requisite that the trial court have jurisdiction not only of the husband and wife but also of their children for purposes of an enforceable custody decree) we hold that by the circumstances the domicile of the children was in Texas. Of course the trial court had jurisdiction for purposes of divorce.

The facts were not in dispute. Mary Lee took the children from Fort Worth on January 20, 1976 and removed them to Illinois.

John did not know, if it was the fact, that Mary Lee did not intend to return to Texas or did not intend to return the children to Texas. He did not consent to any change of the domicile of the children. He did not refuse to continue support. John provided support for the family at all times. Mary Lee did not work outside the home. Regardless of her unhappiness in her marital relationship

there existed no danger or threat to her security or to that of the children which occasioned a change of domicile. Mary Lee did not return the children to Texas until after jurisdiction existed in this court by reason of her appeal. The children were not in Texas at time of the divorce and custody decree nor at time Mary Lee's appeal was perfected.

Of course we are considering "domicile by operation of law", i.e., analagous to what was formerly that of a wife arising upon her marriage. Of little value are the cases prior to the adoption of Texas' Constitutional Equal Rights Amendment: TEX.CONST. art. 1, § 3a, "Equality under the law shall not be denied or abridged because of sex, race, color, creed, or national origin. This amendment is selfoperative". The Amendment was adopted November 7, 1972. See Vol. 5, No. 2, Symposium, 1974, Tex. Tech L. Rev., Sampson, "The Texas Equal Rights Amendment and the Family Code: Litigation Ahead". To be kept in mind, however, are the old cases bearing upon the question. See 4 A.L.R. 2d, p. 7, Annotation: "Jurisdiction to award custody of child having legal domicile in another state", and 9 A.L.R. 2d p. 434, "Jurisdiction of court to award custody of child domiciled in state but physically outside it."

We hold that Texas has effectively legislated, in the Texas Family Code, by its § 12.04, "Rights, Privileges, Duties, and Powers of Parent" where there is provision that, except as provided by judicial order or by an affidavit of relinquishment of parental rights executed under § 15.03, the parent of a child has, among other rights, privileges, duties, and powers, "the right to have physical possession of a child and to establish its legal domicile". (The provisions of § 15.03, "Affidavit of Relinquishment of Parental Rights" are inapplicable to this case.) Prior to the separation of Mary Lee from John they had jointly established Tarrant County, Texas, as their legal domicile and also that of their children.

TEX. FAMILY CODE ANN. § 3.26 (Supp. 1978) "Acquiring Jurisdiction over Nonresident Respondent" provides that when the petitioner in a suit for divorce is a resident or a domiciliary of this state at the time the suit is filed personal jurisdiction by the court shall exist over the respondent, although the respondent is not a resident or domiciliary of Texas, if this is the last state in which marital cohabitation between petitioner and respondent occurred and the suit is commenced within two years after the date on which cohabitation ended, - and that a court acquiring jurisdiction under the section also acquires jurisdiction in a suit affecting the parent-child relation if § 11.051 of the Code is applicable.

TEX. FAMILY CODE ANN. § 11.051 (Supp. 1978) "Acquiring Jurisdiction Over Nonresident", provides that in a suit affecting the parent-child relationship, the court may exercise personal jurisdiction over a person on whom service of citation is required, though a non-resident or domiciliary of this state, if the person on whom service is required has resided with the child in this state, and even where the section might otherwise be deemed inapplicable, if there is any basis consistent with the constitutions of this state or the United States for the exercise of the personal jurisdiction. Note the Law Review Commentaries listed under this section. § 11.051 is applicable in the situation posed by the case at bar.

On the "long-arm jurisdiction" of TEX. FAMILY CODE ANN. § 3.26 (Supp. 1978) it has been held that a Texas court properly exercised its jurisdiction over a non-resident defendant where suit was filed within two years after the termination of a 2 1/2 month period of cohabitation of the parties in Texas. Scott v. Scott, 554 S.W.2d 274 (Tex. Civ. App.--Houston [1st Dist.] 1977, no writ hist.). The case involved custody of a child as well as divorce.

ON THE JURY TRIAL UPON CUSTODY

The matter of custody of the parties' minor children was tried to a jury before the Honorable Gordon Gray, District Judge.

Without objection two special issues were submitted along with a definition of the term Managing Conservator which in general "tracked" the language of TEX. FAMILY CODE ANN. § 14.02 (Supp. 1978) "Rights, Privileges, Duties, and Powers of Managing Conservator", save that there was not included in the definition the provision that the managing conservator has "the right to have physical possession of the child and to establish its legal domicile". There was not an objection to the definition.

By ultimately returned answers to the two issues submitted the jury found for John to be awarded care and custody of the child (1) Andrea Marie Geesbreght would be to best serve her welfare and best interests; and (2) for him to be awarded care and custody of the child John Alexander Geesbreght would be to best serve that child's welfare and best interests. Time when the special issues were answered came after additional issues were submitted, to be subsequently explained.

In connection with the above the jury was told, as a part of the instructions given, that "CHOICE Without Regard to Sex of Parent: You are instructed that the rights of the father and mother are equal with respect to the custody of their child, but that the welfare and best interests of the child is of controlling importance, and it will be your duty to find according as you may believe from a preponderance of all the evidence as to what would be for the welfare and best interest of the child, and you will answer this issue as you may find the facts to be."

The state of the evidence was such that the jury knew that if there were findings that John Geesbreght should be awarded the care and custody of the children (or that such would serve their best interests) he would become the managing conservator. There was additional clarification in the arguments made to the jury. Not made clear to the jury was any right of a "possessory conservator". What was clearly shown to the jury by the evidence

was that if the father was granted custody of the children (made managing conservator) that, if the mother would move to Texas, he was willing that she should have "unlimited visitation rights".

At 10:05 o'clock A.M., after the case was argued, the jury received the case and began deliberations. At 2:50 o'clock P.M. the jury sent out word that it would like to see the judge. The judge sent back his note that the jury should put any requests in writing. About 5:00 o'clock P.M. a written notice was sent to the judge stating that the jury was deadlocked. The jury was brought into the courtroom. Upon inquiry of the judge, the foreman advised that the jury stood nine to three. The jury was directed to return to the jury room for further deliberations. At this point in time the foreman asked whether the jurors were compelled to reach a verdict. The judge answered "I wouldn't say that you are compelled. What I said in the charge is true. If you don't reach a verdict, the same jury will have the same problem and they won't find it any easier than this jury. You are making progress if it's nine to three. All right, you may retire to the jury room." No objection was made by either party. After about 20 minutes the jury was excused to return the following court-day.

On the next day for proceedings in the business of the court deliberations were begun by the jury at 9:00 A.M. Soon after the jury sent out Note A-3 inquiring "Is conservatorship up for review periodically?", and thereafter Note A-4 inquiring "What would be legal assurance that Mary Lee can, in fact, have unlimited visitation rights if John is awarded managing conservator". In answer the court asked the jury to review the Charge as previously submitted. About 2:00 o'clock P.M. the jury sent in a note informing the judge that it was deadlocked. At about 2:30 P.M. the jury sent the judge a note which read: "As stated by law, define 'Unlimited Visitation'".

At this point the court prepared a supplemental charge, reading:

> The definition of Possessory Conservator is as follows:
>
> A Possessory conservator has the following rights, privileges, duties, and powers during the period of possession, subject to any limitations expressed in the decree:
>
> (1) the duty of care, control, protection, and reasonable discipline of the child;
>
> (2) the duty to provide the child with clothing, food, and shelter;
>
> (3) the power to consent to medical and surgical treatment during an emergency involving an immediate danger to the health and safety of the child; and
>
> (4) any other right, privilege, duty or power of a managing conservator expressly granted in the decree awarding possession of the child.
>
> SPECIAL ISSUE NO. 3.
>
> What rights, privileges, duties, and powers do you find that the possessory conservator should have?
>
> ANSWER: (Ultimately answered by the jury as: "Items 1, 2, 3, 4 as stated under definition of possessory conservator of page one of this document. In addition, the option to review as necessary to insure that the Possessory Conservator's right to unlimited visitation is, in fact, adhered to.")
>
> SPECIAL ISSUE NO. 4.
>
> What should be the visitation rights of the possessory conservator?
>
> ANSWER: (Ultimately answered by the jury as: "Unlimited".)

Before calling the jury from the jury room into the court room the judge asked if there were any objections to the court's submission of the supplemental charge. Mr. Meyer, attorney for Mary Lee, replied "Yes, Your Honor, we object to it on the grounds that it constitutes a submission of an issue which has not been tried to the jury by the evidence. And, on the contrary, the Court instructed the jury at the beginning of the trial and during the submission of the instructions to the jury that the Court would

decide all matters other than Managing Conservatorship including the rights, duties and responsibilities of the Possessory Conservator."

The objection was overruled. The jury was brought back into court and, with other oral statements made to the jury by the court to which there was no objection, was told the supplemental charge would be submitted and it was submitted. There was no argument thereupon and there was no request therefor. The jury took the supplemental along with the original charge into the jury room. Rather promptly thereafter the jury returned its verdict as embraced by its answers to all special issues of both the original and supplemental charges.

No reversible error appears. The questions asked in the supplemental charge were in neither case such as required a finding upon an ultimate issue. The answers could amount to no more than recommendations, at least other than that as the possessory conservator Mary Lee should have all the rights of that office. This she did receive by the judgment. As already noticed, the jury was not misled in any failure to understand that the managing conservator should have the paramount custodial rights in and to the children, with visitation rights of any other and with rights of any possessory conservator subject thereto. It does appear that the failure of the original charge to show the jury what rights by law were vested in one who was a possessory conservator and, perhaps, an inability to express its desire to state an opinion that Mary Lee should have the most extensive of visitation rights upon the face of the instrument, caused difficulty in arriving at an agreement to make the finding that John should have the paramount rights of managing conservator. We see no error on trial which amounted to reversible error by TEX. R. CIV. P. 434, the Texas "harmless error" rule.

Submission of the immaterial Special Issue No. 3 was not subject to the only complaint made in the objection, which was that it presented new issues of fact which had not been tried.

That being the only complaint, any additional complaints which might have been made were waived. By provision of TEX. R. CIV. P. 286, "Jury May Receive Further Instructions" there is authority for instructions to the jury, even after it has retired and begun deliberations. Even a new and different controlling issue in the case may be submitted under TEX. R. CIV. P. 286, though there would be reversible error if there was denial of the right to make additional jury argument upon an issue thus submitted in a supplemental charge. In the denial of such it has been held there would be probable harm, though not merely because there was a supplemental charge given by the court. Boler v. Coughran, 304 S.W.2d 290 (Tex. Civ. App.--San Antonio 1957, writ ref'd).

The answers to Special Issues nos. 1 and 2 were not so contrary to the greater weight and preponderance of the whole of the evidence in the case as to be clearly erroneous. There was not reversible error by trial before the jury of the issues submitted.

SEVERABILITY OF JUDGMENT ON CHILD CUSTODY AND DIVORCE FROM JUDGMENT RELATIVE TO PROPERTY PARTITION.

7 ST. MARY'S L.J. 1 (1975), "Try, Try, Again . . .", "A Proposal to Limit the Scope of New Trials in Texas" by Justice Jack Pope with Daniel J. Sheehan, Jr., contained recommendations which were adopted and made effective January 1, 1978, in TEX. R. CIV. P. 320, "(New Trials) Motion and Action of Court Thereon". The Rule so adopted, and also - since January 1, 1976 - provisions of TEX. R. CIV. P. 434, "If Judgment Reversed" authorizes new trial of the part of the controversy which is clearly separable without unfairness to the parties. We can now affirm the trial court's judgment insofar as it grants the decree of divorce, and as it decrees the custodial rights to the parties' children, though we might find ourselves obligated to remand for another trial the issues upon the division of property upon the grant of divorce. Young v. Hicks, 559 S.W.2d 343 (Tex. 1977).

In the instant case, we have concluded that there should be a new trial on the issues appropriate to the determination of correct property division.

PARTITION OF PROPERTY UPON DIVORCE.

By agreement issues on property were tried by the court without a jury.

The date of the trial court's judgment was August 30, 1977. In the event of retrial, issues relative to the property of the parties, as existent upon that date, would be those to be retried. This is so because we have affirmed the part of the judgment which decrees divorce, meaning that from August 30, 1977 each party was divorced from the other though no proper division of their property was made at the time.

The occasion for what is considered to require remand of the case relative to property division lies in the court's having treated the stock held by John Geesbreght in a Professional Corporation not to have been enhanced above its book value by any "good will" of the corporation developed during the period when he owned it. John not only held the stock but worked as an employee. In the approximate eighteen months of John's interest there had been an improvement of corporate business to the extent that it had become unusually profitable.

John is a physician. Had his practice been that of an individual, then, in the event of divorce, the "good will" existent and which might have a value upon a sale of his practice or interest therein to another member of the same profession (with whom he might agree not to compete) would not be properly considered as part of the property to be taken into consideration in the property division to be made as part of the parties' estate because there was a divorce. Nail v. Nail, 486 S.W.2d 761 (Tex. 1972). The case appears in 52 A.L.R. 3d p. 1338, followed, at p. 1344 by ANNOTATION: "Accountability for Good Will of Professional Practice in Actions Arising from Divorce or Separation". In that case there was the

implied holding that the trial court had erroneously considered as evidence that which was "no evidence" or "not legal evidence" because it was improperly considered. Of course, what resulted by the trial court, which was reversed, was an amount of judgment contrary to the greater weight and preponderance of the evidence. Posed was actually a "no evidence" question for the supreme court would not otherwise have had jurisdiction.

In Nail, supra at p. 764, the court took occasion to state: "It is to be understood that in resolving the question at hand we are not concerned with good will as an asset incident to the sale of a professional practice, or that may exist in a professional partnership or corporation apart from the person of an individual member . . . . "

Here we have that very question with which the supreme court stated itself not to be concerned, i.e., good will in Emergency Medicine upon which there was the necessity to find what portion, if any, apart from John's person as an individual employee member, existed in that the corporation occasioning enhancement in the value of its corporate stock. We hold that there was "value" of such good will and that the trial court erred in the failure to take it into consideration in rendering the judgment from which the appeal was taken.

From the record we understand that in the field of medicine there has apparently arisen at many hospitals a need for the services of physicians at unusual hours in rendering emergency services, primarily at the emergency rooms. In ordinary medical practice the average doctor naturally prefers normal hours and the opportunity to know when he will probably be able to be with family or friends. Such a doctor, and no doubt there are many, is pleased to be relieved of the emergency duties performed at hospitals.

Some time ago, apparently in Dallas, Texas, a Dr. Lambert conceived the idea of making such emergency room services by

physicians a specialized form of endeavor. Subsequently a Dr. Riggs became associated, and as applied to this particular work they called their organization the Emergency Health Services Associates, apparently a professional corporation. Dr. Riggs bought Dr. Lambert's 50% ownership (of stock if it was a corporation) and himself became what we will call the Emergency Health Services. This has remained an entity, probably still doing business.

In August of 1974 John Geesbreght made a contract of employment with Emergency Health Services (Dr. Riggs) and for it performed the work of a physician in emergency room service at a Fort Worth hospital which will for convenience be called Harris. By subsequent arrangement, concluded in the spring of 1974, John became a partner of Dr. Riggs. When this partnership was formed Emergency Health Services ceased to supply the emergency services at Harris in Fort Worth. The partnership of Dr. Riggs and John, which they chose to call Emergency Medicine Consultants, took from Emergency Health Services the contract it had with Harris. Emergency Medicine Consultants began handling the Harris' account as its own. This continued until November of 1975 when the partnership ceased as such, with the organization of the corporation Emergency Medicine Consultants, a Professional Corporation under the provisions of V.A.T.S. Title 32, "Corporation", Art. 1528e, et seq. "Professional Corporation Act". Dr. Riggs paid in $500.00 and John paid in $500.00, each receiving 500 shares of stock. They were the only stockholders. The business was that of supplying emergency room services of physicians at hospitals, but upon an expanded scale. The corporate business so begun proved successful; by time the divorce suit of John and Mary Lee Geesbreght was tried in July 1977 it was supplying hospital emergency room service by physicians in its employ at eight (8) different locations. There had been three (3) additional hospitals where the services had begun but at which they had been terminated to time of trial. One year's gross receipts of Emergency Medicine Consultants for these services amounted to more than $1,000,000.00. The corporation

will hereafter be referred to as Emergency Medicine.

At a time prior to the divorce trial Emergency Medicine (50% Dr. Riggs) had had occasion to pay Emergency Health Services Associates (100% Dr. Riggs) the sum of $36,000.00 for contract negotiations by the latter in behalf of Emergency Medicine. As a result, Emergency Medicine acquired four (4) of the aforementioned eleven (11) hospital contracts. The Harris hospital contract was transferred to Emergency Medicine by agreement and without any payment and Harris' contract evidently became that of Emergency Medicine. There John had begun to personally perform the emergency room hospital services in 1974, continued by him during the partnership period beginning in the spring of 1975, and still continuing when Emergency Medicine was incorporated in November of 1975. Little, if any, of the hospital emergency room services at locations other than Harris was ever personally performed by John, but all, or nearly all, the services at Harris were performed by him. The Harris contract with Emergency Medicine provides for cancellation at any time. Here would be the contract where any "good will" built up by and through satisfaction with John's services would be, percentagewise, more personal to him and, to the extent it might be found personal, not proper to be taken into consideration in the division of property upon divorce.

However, over the entire field of operations by Emergency Medicine there are about ten full-time, and 50 to 100 part-time physicians with whom Emergency Medicine has employment contracts to fulfill its obligations to furnish emergency services at the hospitals with which it has contracted. By the evidence each of these physicians receives 80% of what is received by the hospital from third persons for services he has rendered at the hospital, of the 100% which is received by Emergency Medicine. (Emergency Medicine is paid the 100% and Emergency Medicine pays 80% to each physician entitled thereto.)

There may be minor discrepancies in what we have stated and will state relative to the business operations, though if that be true it would make no difference in our ultimate conclusions and holdings.

Of the 20% resultant gross profit of Emergency Medicine after each employed physician is paid John receives 5% for his services as "director" as applied to payment for the corporate services at Harris, and/or as "regional director" of the services rendered at other locations. Emergency Medicine receives 5% as earnings in the form of "contract fee". The remaining percentage to explain is thus made 10%. Of this 10% in receipts the majority is applied to pay for necessary services as by a secretary, book-keeper, etc.; with something between 2% and 4% going into Emergency Medicine's treasury as profit. This "profit", whatever the monetary amount, would become the ultimate entitlement of the two stockholders - on a 50-50 basis, because 50% of the shares belonged to Dr. Riggs and 50% to John. We need not at this point concern ourselves with the earnings represented by the term "contract fee".

"Good will" is sometimes difficult to define. In a personal service enterprise such as that of a professional person or firm, there is a difference in what it means as applied to "John Doe" and as applied to "The Doe Corporation" or "The Doe Company". If "John Doe" builds up a reputation for service it is personal to him. If "The Doe Company" builds up a reputation for service there may be a change in personnel performing the service upon a sale of its business but the sale of such business naturally involves the right to continue in business as "The Doe Company". The "good will" built up by the company would continue for a time and would last while the new management, performing the same personal services, would at least have the opportunity to justify confidence in such management while it attempted to retain the "good will" of customer clients of the former operators.

At least the opportunity to have time to try to preserve the "good will" already existent and to use it as an entrance into the identical field of operations in a personal service type of business would be present where the name of the business is a company name as distinguished from the name of an individual. Therein does it have value, plus the value of the opportunity to justify confidence in the new management by the customer/clients of the predecessor owner(s).

It is as applied to the foregoing that we consider Emergency Medicine to possess what we treat as "good will" as part of its worth and value under the circumstances of this case, and therefore an asset which would have value to some extent apart from John's person as a professional practitioner.

It is clear that in the event John sold his stock to another physician then - save perhaps at Harris Hospital - there would be an opportunity to retain the contracts of Emergency Medicine if the services of its employed physicians in the various emergency rooms continued to be satisfactory.

On this it was shown that the Emergency Medicine contracts generally had either a 30 or 60 day cancellation provision "without cause", and a 24 hour cancellation provision "with cause". Also shown was that Dr. Riggs had a contract with John relative to sale or transfer of John's stock. In the event of John's death, Dr. Riggs is by this contract entitled to all of John's stock at the price of $50,000.00, and in the event John desires to sell his stock before that time, Dr. Riggs has the privilege of purchasing it at a price of $50,000.00.

We think it obvious that to take the figure of $16,000.00, which was proved to have been the "book value" of John's 500 shares of stock in Emergency Medicine Consultants, and use it as the "actual value" of the stock as its worth to be taken into consideration by the court in the division of the estate upon divorce was, under the circumstances of the case, reversible error.

We hold that it resulted in gross inadequacy in the award on property division as applied to Mary Lee; that it also resulted in an award to her which was so contrary to the greater weight and preponderance of the whole of the evidence on trial as to be clearly erroneous. Further, we hold that the court erred in considering as "no evidence" that which was evidence in that under the circumstances of the case. The value of the stock in Emergency Medicine Consultants was enhanced by some "good will" which was existent as applied to that professional corporation apart from the person of John Geesbreght.

It is error for a court not to take into consideration all relevant property interests in reaching equitable division of the property on divorce. Gillis v. Gillis, 435 S.W.2d 171 (Tex. Civ. App.--Fort Worth, 1968, writ dism'd); Matter of Marriage of Butler, 543 S.W.2d 147 (Tex. Civ. App.--Texarkana, 1976, writ dism'd); Matter of Marriage of Long, 542 S.W.2d 712 (Tex. Civ. App.--Texarkana, 1976, no writ hist.).

In this case, for reasons stated, we hold that the trial court erred in failure to take into consideration all relevant property interests.

We have discussed the important matters necessary to disposition of the appeal. We have considered all points of error presented and they are overruled except for those whereby our action, below stated, has been determined.

Judgment is affirmed insofar as it granted the divorce and determined the custodial rights of the parties' children. Judgment is reversed and remanded for another trial on the matter of the appropriate property division.

Cost of the appeal are taxed 50% to John Geesbreght and 50% to Mary Lee Geesbreght.

FRANK A. MASSEY,
CHIEF JUSTICE.

JUL 13 1978

THE STATE OF TEXAS §
§
COUNTY OF TARRANT §

I, Yvonne Palmer, Clerk of the Court of Civil Appeals in and for the Second Supreme Judicial District of Texas, certify that the foregoing is a full, true and correct copy of the opinion delivered by said Court on the 13th day of July, 1978, in the above numbered and entitled cause.

Given under my hand and seal of the Court of Civil Appeals on this 5th day of October, 1978.

YVONNE PALMER, CLERK

Yvonne Palmer

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

RICHARD S. GESOFF,	)	
	)	
Plaintiff,	)	
	)	
v.	)	C.A. No. 19473
	)	
IIC INDUSTRIES INC., CP HOLDINGS LIMITED, KENYON PHILLIPS ACQUISITION, LLC, BERNARD SCHREIER, JOHN SMITH, ROBERT M. LEVY, ROBERT GLATTER, and ALFRED L. SIMON,	)	
	)	
Defendants.	)	
CEDE & CO.,	)	
	)	
Petitioner,	)	
	)	
v.	)	C.A. No. 19600
	)	
IIC INDUSTRIES INC. and KENYON PHILLIPS ACQUISITION, LLC,	)	
	)	
Respondents.	)	

MEMORANDUM OPINION AND ORDER

Submitted: February 9, 2006
Decided: May 18, 2006

Joseph A. Rosenthal, Esquire, Jessica Zeldin, Esquire, ROSENTHAL MONTHAIT & GODDESS P.A., Wilmington, Delaware; Harold B. Obstfeld, Esquire, HAROLD B. OBSTFELD P.C., New York, New York, *Attorneys for the Plaintiff and Petitioner.*

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LAMB, Vice Chancellor.

This case arises out of a decision by a foreign holding company which controlled a publicly traded United States subsidiary to simplify its internal structure by removing the minority stockholders of that subsidiary in a going-private transaction. To achieve that goal, the controlling stockholder first initiated a voluntary tender offer at a price supposedly determined through a negotiation with a special committee. When the tender offer failed, the controller successfully executed a statutory long-form merger at the same price.

The present class action was filed by one of the minority stockholders, claiming that the merger evidenced unfair dealing and produced an unfair price. Additionally, the minority stockholder has brought a statutory appraisal claim, seeking a determination of the fair value of the U.S. subsidiary's shares at the time of the merger. The defendants argue that the merger process was fair, or at least harmlessly flawed, and that the price determined by the merger process was fair in view of the fact that the terrorist attacks of September 11, 2001 intervened between the determination of the merger price and the transaction itself. They also urge the court to decide that the fair appraisal value of the shares is well below the consideration offered in the merger. Additionally, one of the defendants claims that his actions in approving the merger were exculpated by the corporation's provision under 8 *Del. C.* § 102(b)(7), and therefore that he cannot be personally liable for any damages.

The court held trial from May 25, 2005 to May 31, 2005. The parties submitted post-trial briefs and argument was presented on February 9, 2006. In this opinion, the court finds that the merger process between the controlling stockholder and the subsidiary was marked with grave examples of unfairness, and led to a plainly unfair price for the going-private transaction. Consequently, the court awards damages to the class and to those stockholders seeking appraisal based on the court's determination of fair value at the time of the merger, a figure that is significantly in excess of the consideration offered in the going-private transaction. Nonetheless, the court finds that the subsidiary corporation's Section 102(b)(7) provision does act to protect the one defendant who raised that affirmative defense, and therefore assigns him none of the liability.

I.

A. The Parties

1. The Plaintiff

The plaintiff in this case, Richard Gesoff, was a stockholder of IIC Industries Inc. until the transaction at issue. He owned approximately 50,000 shares of IIC common stock. As a result of the transaction, Gesoff's shares have been cashed out at the disputed price, $10.50 per share. His class action claim has been brought on behalf of all persons who were owners of the common stock of IIC on the effective date of the merger, March 27, 2002, except for affiliates of IIC

or CP, and those stockholders who properly opted out of the class. Gesoff's statutory appraisal proceeding is on behalf of 402,476 IIC shares, slightly less than half of the shares owned by class members.

2. The Defendants[1]

CP Holdings is an English holding company with its principal place of business in Watford, England. This conglomerate owns approximately 80% of the defendant in this case, IIC Industries, Inc., a Delaware corporation with its principal place of business in New York City. In essence, the only business of IIC is to act as an intermediate holding company for certain overseas assets.

As an investment company, IIC controls various companies engaged in businesses throughout the world. The most significant of these is Danubius Hotel & Spa Rt., a Hungarian corporation, listed on the Budapest Stock Exchange, that operates hotels and spas in Hungary and the Czech Republic.[2] Overall, the Danubius group owns and manages approximately 3,100 four-star rooms, and

[1] The plaintiff has also sued Kenyon Phillips Acquisition LLC, a subsidiary formed specifically for purposes of the merger, and wholly owned by Kenyon Phillips Limited, itself a wholly owned subsidiary of CP Holdings. The individual named defendants, Bernard Schreier, John Smith, Robert M. Levy, Robert Glatter, and Alfred L. Simon, are discussed below, but, in summary, were the directors of IIC. Except for Simon, all were also directors of CP Holdings.
[2] Formally, IIC owns a 49% voting interest in Danubius, and CP owns another 5% of the company. JX 237.

2,300 three-star rooms. It claims to be the leading hotel chain in Hungary, and attracts many tourists from Western Europe and elsewhere.[3]

IIC also controls Investor Rt., a Hungarian holding company, whose principal subsidiaries are Agrimill Rt., in which Investor has a 65% interest, and Interag Rt., in which Investor has a 79% interest.[4] Agrimill is also listed on the Budapest Stock Exchange and is engaged in the processing of agricultural products. Agrimill's business strategy has been to produce flour, animal feeds, and maize products to be sold both on the domestic Hungarian and export markets.[5]

Additionally, IIC controls ITE and Equipment Company Limited, an Israeli corporation that distributes tractors and other heavy equipment in Israel through its 70% owned subsidiary, Zoko Ltd. Zoko is listed on the Tel Aviv Stock Exchange, and manufactures and distributes products such as construction equipment, diesel engines and trucks, and spare parts for such equipment. Zoko is also the exclusive dealer in Israel for Caterpillar and Navistar trucks, and is a dealer for Ingersoll-Rand equipment. In addition to selling the aforementioned heavy machinery, Zoko offers service and maintenance of these machines.[6]

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[3] JX 32.
[4] Interag is a Hungarian company involved in the warehousing and warrant business, and automobile dealerships.
[5] *Id.*
[6] *Id.*

Finally, IIC controls Balton CP Limited, which sells agricultural, communications, and electrical equipment in Nigeria, Zambia, Ghana, Kenya, Tanzania, Uganda, and the Ivory Coast. In summary, Balton uses its expertise in agriculture to provide modern flower, fruit, and vegetable growing facilities in greenhouses and fields, including greenhouse structures, full irrigation systems, cold storage, and packing lines. In addition, Balton acts as a distributor for Motorola, Inc. in Nigeria and Ghana in West Africa, distributing Motorola two-way radios, walkie-talkies, mobile phones, base stations, repeaters, and telephones.[7]

B. CP Decides To Take IIC Private

The events that led to this trial began when Paul Filer was appointed as Finance Director of CP Holdings in 2000.[8] As part of his initial duties, he was assigned by the board of CP Holdings and its chairman, Sir Bernard Schreier, to undertake a review of the company's corporate structure. Filer decided, as a result of this review, that IIC was serving little purpose in its current form. Indeed, IIC was exposing CP to the U.S. regulatory environment and its associated costs, including possible tax liability, while CP was failing to take advantage of its presence in the U.S. to raise funds through the capital markets.[9] In December

[7] *Id.*
[8] Tr. 700:19.
[9] JX 48.

2000, Filer prepared a report setting out his findings. This report first noted the potential benefits of removing IIC as an intermediate holding company:

> There have been extensive discussions internally on simplifying the group structure. The purpose for doing this is:
>
> • Improve the ability to extract cash by CP
>
> At present it is expensive to remit cash from Hungary to CP. This is firstly because the funds have to be split with the relevant minorities . . . .
>
> • Reduce the costs within the current structure
>
> The cost of maintaining a quoted company in the US seems an unnecessary expense. No use is being made of the quote; overall it is a burden, not a benefit . . . .[10]

The report observed that CP owned only 78% of IIC, and therefore the minority would have to be removed either by a "rights issue to dilute the minority" or by a "tender offer to the minority to acquire their shares."[11] The report then noted that a "separate paper on the mechanics of buying out the minority" was attached.[12]

The information in that separate document was provided by IIC's and CP's U.S. lawyer for purposes of the going-private transaction, Samuel Ottensoser,[13] who would soon play an important role in the tender offer. In addition to setting out the two options described above for removing the minority, this report noted that the minority was likely to negotiate aggressively as to the price at which they

[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] Tr. 707:8-10.

would be cashed out. At this relatively early stage, indeed, CP and its counsel expected the minority to demand $16.20 per share:

> Any price that is below $16.20, the disclosed net assets, will yield a book gain to CP on the shares tendered. Equally any price below $16.20 will be difficult to sell to the minority, as they will be sustaining a loss against the disclosed book value. The best argument is that they could never realize the $16.20, so that figure is not a realistic disposal value.[14]

But the document also included information that indicated that CP had paid only $10 per share for IIC in the recent past.[15]

On January 25, 2001, the CP board authorized Filer to continue investigating the removal of the IIC minority, but did not yet authorize any approach to those stockholders.[16] Following the board's authorization, Filer produced another report in March 2001 explaining his progress. This report reiterated much of the information available in the December 2000 report, but included new information as to Filer's progress in securing financial advice. As Filer noted, "we have received from our U.S. lawyers the name of a small investment bank that would be willing to do the company valuation necessary to support the tender offer . . . ."[17]

[14] JX 49.
[15] *Id.*
[16] JX 50; Tr. 711:8-14.
[17] JX 9.

Filer testified at trial that this small investment bank, that had been recommended by Ottensoser, was Jesup & Lamont.[18] This was CP's first contact with that firm.[19]

In the following months, Filer continued preparing the groundwork for a possible transaction. On May 17, 2001, Filer presented a more comprehensive report describing his conclusions as to the going-private transaction to Schreier, John Smith, and Robert Levy,[20] who together comprise the CP Holdings executive team.[21] In that document, Filer described the work that had been done to date, including a quote received from Jesup & Lamont, an assessment of the possible fees involved in the transaction, and a discussion of possible consequences that might result.[22] This document included new information that showed that CP was now required to pay $13 for shares of IIC in the open market.[23] Filer testified at trial that, at this point, neither he nor the board had prepared a valuation of IIC to determine the value of the company.[24]

At a subsequent board meeting of CP Holdings on May 24, 2001, the board adopted Filer's plans, and expressly authorized that a "bid approach" be made to

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[18] Tr. 712:13-18. The court notes, in passing, that Ottensoser's son was employed at Jesup & Lamont during this time.
[19] Tr. 714:7-8.
[20] Smith and Levy are the joint managing directors of CP Holdings. Tr. 715:1-2.
[21] Tr. 715:1-2.
[22] JX 2.
[23] Tr. 717:1-4.
[24] Tr. 717:10:13.

the board of IIC at $13 per share for the minority stockholdings,[25] which was envisioned to be in the form of a tender offer followed by a short-form merger under 8 *Del. C.* § 253.[26] This price, although not based on a formal discounted cash flow analysis, was based on the price at which CP had been paying in the market at that time for shares of IIC.[27] The board also authorized that $100,000 be spent to obtain a fairness opinion, but decided that the process through which IIC board approval would be obtained was subject to later discussion because "those members of the board requesting [the fairness opinion] should be independent."[28]

C. IIC Appoints A Special Committee

Apparently on the basis of Ottensoser's advice, the IIC board of directors decided to appoint a special committee to help comply with Delaware law for fundamental transactions between parents and subsidiaries. The only IIC directors independent of CP Holdings were Alfred L. Simon and Wilfred Wyler. Wyler, however, was elderly, and unable to fulfill the responsibilities of the supplemental appointment.[29] On May 24, 2001, therefore, Filer called Simon, and asked him to

[25] JX 54.
[26] A short-form merger, of course, allows a parent company holding more than 90% of a subsidiary's shares to squeeze out the remaining minority without a stockholder vote.
[27] Tr. 721:15-18.
[28] JX 54.
[29] Wyler passed away in January 2002. Tr. 723:18-22.

become the sole member of the special committee.[30] Simon accepted the commission in principle, although he had not yet been officially empowered.[31]

Filer's next step was to visit New York and meet personally with the key players in the plan to privatize IIC. On June 18, 2001, Filer met with Jesup & Lamont, before speaking in person with Simon. This meeting, Filer testified, was a "courtesy visit," although Filer was never able to articulate what such a visit entailed,[32] or whether details of Jesup & Lamont's eventual representation were discussed. The next day, Filer met with both Simon and Michael Zarriello of Jesup & Lamont. At that meeting, Zarriello was given the opportunity to "pitch" his firm to Simon for the appointment as financial advisor to the special committee.[33] Simon attended the presentation, and testified at trial that he reserved judgment on whether to formally hire Jesup & Lamont.[34]

In June 2001, Simon was appointed by undated consent as the sole director of the special committee tasked with examining CP's tender offer on behalf of IIC's minority stockholders.[35] Simon's authorization formally invested him with

[30] JX 55.
[31] JX 55; Tr. 821:19-22.
[32] Tr. 725:21-24; Tr. 726:1; Tr. 782:1-6 ("I went to see [Jesup & Lamont]. It was, I guess, out of courtesy, and just to see who they were.").
[33] Tr. 726:11-16; Tr. 825:14-23.
[34] Tr. 726: 9-11.
[35] JX 6.

the power to present a recommendation to the IIC board as to the CP tender offer only, in the following form:

> RESOLVED, that the Board hereby appoints Alfred L. Simon, the Company's only director not affiliated with CPH . . . to examine the Tender Offer and to prepare and present a recommendation to the Board and the public stockholders on the Company's position on the Tender Offer.[36]

In connection with that recommendation, the consent gave Simon the authority to appoint outside auditors and/or counsel to assist him in preparing the recommendation.[37] The resolution further authorized Simon to spend $100,000, the same price as quoted by Jesup & Lamont, for a fairness opinion, and granted Simon a director's fee of $10,000 for the additional work the position would require.

While this formal grant seems relatively broad, the court notes that the evidence adduced at trial and the defendants' own testimony demonstrate convincingly that Simon's authority was closely circumscribed even from the beginning of his role as the sole member of the special committee. First, Simon had no real authority to choose either his own lawyer or his own financial advisor. Ottensoser was presented to Simon as the choice of the conflicted IIC board, and

[36] *Id.*
[37] *Id.*

CP's choice, for counsel.[38] He had long been IIC's main outside counsel, and had already spent considerable time working on the proposed transaction on behalf of CP.[39] And as Simon testified at trial, when he pressed Ottensoser about the clear conflict of interest in representing IIC and CP on the one hand and the special committee on the other, Ottensoser answered that no conflict existed between the two roles.[40]

Simon had no more latitude as to his choice of financial advisor. On June 12, 2001, Jesup & Lamont had already sent a draft engagement letter to Simon, then still working only in the role of director of IIC.[41] As early as June 15, 2001, four days before Simon was officially granted any power to hire financial or legal advisors, Filer emailed Zarriello promising that "we are very close to having you signed up for the project."[42] As Filer confirmed at trial, this email was motivated by a desire to hurry the privatization process toward a conclusion.[43] Zarriello, as described above, was then allowed to make a pitch to Simon on June 19, even

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[38] Q: Why did you wait? [to decide whether to retain Jesup & Lamont for a week after the meeting in which the investment bank first pitched their services?]
A: First, I wanted to digest this. I wanted to speak to Sam Ottensoser, who *had been appointed, and I had accepted him,* as my counsel. Tr. 828: 22-25 (emphasis added).
[39] Tr. 708: 17-22.
[40] Simon testified that Ottensoser responded to this question by saying "something to the effect that . . . IIC and [Simon] were really on the same side of this, and looking to get the best price from CP Holdings, and there was no conflict." Tr. 831: 18-22.
[41] JX 12.
[42] JX 56.
[43] Filer testified that this email "confirm[ed] his desire to get on with . . . the privatization project." Tr. 787:14-18

before Simon was officially empowered, and before he was able to do any independent research on investment banking firms.[44] Simon spoke to no other investment banking firms before appointing Jesup & Lamont to assist him in his duties, relying on Ottensoser's advice that "Jesup would do fine."[45] Nor did Simon discover the relationship that had arisen between Filer and Jesup & Lamont in the months prior to the creation of the special committee. Indeed, Simon failed to even ask whether Jesup & Lamont had any prior relationship with either CP or IIC, assuming that an "honest" investment banker would volunteer this information on his own.[46]

D. CP Negotiates With Simon And The Special Committee As To The Tender Offer

The evidence adduced at trial creates a clear picture of what, as will be discussed below, was an entirely inadequate negotiation between Simon and CP. At the heart of this process was an email exchange between Filer and Ottensoser on May 17, 2001, which clearly outlines the manipulative way in which CP envisioned the negotiation process with the special committee, even at this very early stage. In Filer's words, in an email seeking to "confirm the process," CP would first make a "lowish bid" to the board of IIC, which would respond by

[44] Tr. 825:14-20.
[45] Tr. 830:6-8.
[46] Tr. 830:12-24.

hiring Jesup & Lamont, named specifically, to evaluate the bid. Jesup & Lamont was then expected to recommend a bid that was a "bit higher." CP would meet that new price, Jesup & Lamont would approve it, and the door would then be open for CP to make its tender offer for the shares of IIC.[47] Ottensoser's response to this frank outline was clear. As he wrote, "I just spoke to Michael [Zarriello] again and he confirms that this is the process."[48] Asked at trial about this email, Filer equivocated by saying that the term "lowish" in the email meant, to him, a "realistic bid with room to maneuver,"[49] in the context of the price that CP had paid previously for shares of IIC.[50]

The way the negotiation proceeded in the next several months confirms that CP adhered in spirit to the plan set forth in this email. In accordance with CP's obvious wishes, and the fact that Jesup & Lamont had been afforded advance access to Simon and had been recommended by the special committee's conflicted lawyer, Ottensoser, Jesup & Lamont was hired as the special committee's financial advisor on June 22, 2001. Filer confirmed this by sending a retainer check to Zariello on June 26, and by faxing the signature page of Jesup & Lamont's engagement letter to Zarriello on the same day.

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[47] JX 36.
[48] *Id.*
[49] Tr. 719:14-15
[50] Tr. 719:18-19.

Concurrently, CP made its "lowish" initial offer for IIC, dropping the previously authorized $13 price, about which Simon had full knowledge,[51] to a new price of $10 per share.[52] At trial, Filer explained this decision as a result of a conversation with Schreier.[53] In essence, the two had decided to lower the price because they felt that $10 was "the price that we would wish to start this process,"[54] leaving room to negotiate later. This conversation was confirmed in a letter issued by Schreier on June 22, 2001 informally announcing the transaction, noting that CP intended to "commence a tender offer shortly for any and all of the Common Shares, other than those beneficially owned by [CP], for $10 per share, net to seller in cash."[55]

In the following several months, Jesup & Lamont conducted a valuation of IIC, purportedly for the special committee. This process involved considerable interaction between Simon and the professionals at Jesup & Lamont, with Simon suggesting various alternative ways of valuing IIC that Jesup ultimately rejected.[56] In order to gather information, Jesup & Lamont were also engaged in discussions with Filer. Filer testified that he acted as a conduit for financial information to be

[51] Tr. 819:15-24.
[52] Tr. 820:6-7.
[53] Tr. 728:5-8.
[54] Tr. 728:9-12.
[55] JX 4.
[56] Tr. 841-843; JX 24.

prepared for the investment bank.[57] Apparently unbeknownst to Simon, however, Filer was also receiving significant information from Jesup & Lamont.[58] Specifically, Filer testified under cross-examination that he received draft valuations from Jesup & Lamont of IIC's subsidiaries or investments.[59] Filer also testified that he received Jesup & Lamont's valuation ranges for IIC.[60] These were shared in a memorandum sent to certain members of CP's board of directors, including Schreier, on August 8, 2001.[61] Throughout the entire process, therefore, CP had almost full access to the special committee's valuation numbers and analysis.

On August 7, 2001, Simon told Filer during a telephone conversation that he could not recommend an offer of $10 per share to the stockholders. Simon asked CP to increase its offer to something above $10.30, the midpoint of the preliminary valuation range determined by Jesup and Lamont.[62] The next day, Filer issued a report to certain members of the CP board, again including Schreier, which set out Simon's position at that point. As Filer explained,

> Al Simon recognizes that the $10 offer is fair, but would be more comfortable if he felt he had succeeded in raising it. A further $0.50

[57] Tr. 732:17-21.
[58] Tr. 787.
[59] Tr. 787:20-24.
[60] Tr. 790:6-12.
[61] JX 30; Tr. 791:3-8.
[62] Tr. 858; JX 29.

> would be sufficient to satisfy him in this regard. However, a decision on the offer price can be delayed until the Board meeting.[63]

Filer testified that he had no independent knowledge of how he knew that an extra $0.50 would satisfy Simon aside from a reference in his handwritten notes of the August 7 telephone call.[64] At first, Filer refused to raise CP's offer.[65] Indeed, Simon testified at trial that the period between August 2001 and September 10, 2001 was characterized by continued negotiations concerning any additional consideration over $10 per share that the IIC minority would receive in the tender offer. As Simon explained,

> I think it's just really a repeat of what I have said, that - my looking for reasons to get CP to make a higher bid and CP telling me that they have done their work, this is what the company is worth to them, and that is all they are going to pay for it.[66]

What followed is not entirely clear. On August 21, 2001, Filer produced another memorandum to the CP board confirming that CP would move its offer up to $10.50, as Simon had requested.[67] This memo also noted that Simon would definitely recommend the offer to the stockholders at the new price, and that Simon had almost finalized the fairness opinion with the investment bank.[68] But Simon

[63] JX 30.
[64] Tr. 741:12-14; Tr. 742:9-11.
[65] Tr. 857:2-4.
[66] Tr. 857:11-16.
[67] JX 31.
[68] *Id.*

testified at trial that, in August, no such agreement had been reached. In Simon's view, the critical negotiation occurred on September 10, 2001, when Simon claims that he finally agreed to recommend the tender offer so long as it came in above the midpoint of the Jesup & Lamont valuation.[69]

What is clear, in any case, is that both Filer and Simon agreed on September 10, 2001 to the $10.50 per share tender offer price.[70] Based on this price, and supported by a fairness opinion by Jesup & Lamont,[71] the IIC board met later that day. Simon discussed the process leading up to the $10.50 offer, and then announced his decision to recommend the tender offer to the stockholders as fair from a financial point of view.[72] The full IIC board, however, decided not to make a recommendation with respect to the tender offer.[73]

E. The CP Tender Offer Is Initiated And Comes Up Short

Although the CP board had approved an immediate tender offer approach, matters were understandably delayed by the tragic events of September 11. It took until October 15, 2001 for CP to formally commence the tender offer. According

[69] JX 858:1-12.
[70] Tr. 859:1-8.
[71] JX 32.
[72] Tr. 860.
[73] "However, because of the conflict of interest as a result of the fact that a majority of the Company's directors consist of principals and management of CP Holdings, the Board will not make a recommendation to the stockholders of the Company with respect to the Tender offer." JX 39.

to the tender offer statement filed with the SEC, the offer was designed with the intention of effectuating a merger between IIC and CP after it terminated.

> On May 24, 2001, the Board of Directors of CP Holdings met to discuss the possibility of launching a tender offer for all of the Common Shares that CP Holdings did not already own . . . . The Board was advised of the requirements under Delaware law of long- and short-form mergers, and since CP Holdings already owned nearly 80% of the Company's outstanding common stock, the Board authorized the commencement of a tender offer for all the outstanding shares of the Company, with the intention of receiving at least enough stock to bring CP Holdings' percentage of ownership up to 90% to thus enable CP Holdings to effectuate a short-form merger with the Company.[74]

Although CP clearly hoped to reach the 90% threshold for short-form merger under 8 *Del. C.* § 253, the tender offer resulted in only 20% of the unaffiliated shares being tendered,[75] despite three extensions of the tender offer. This meant that CP's ownership of IIC increased from 78.8% to 84.1%. Unable to garner sufficient support in the tender offer to acquire the remaining shares of IIC by short-form merger, CP determined to proceed with the merger in some other way.[76]

F. The Merger

After the tender offer was closed, CP decided to move forward immediately with the second step of the merger, after a discussion between Schreier and Filer in

[74] JX 42.
[75] JX 7.
[76] JX 111; JX 113.

which the two ruled out the possibility of lowering the offered consideration as a result of the altered international situation.[77] The CP board met on January 24, 2002, in part to confirm that the merger process was going forward. The minutes of that meeting specifically note that Filer hired the law firm Shaw Pittman to provide a "second opinion on the work being done by Sam Ottensoser."[78] There is no indication, however, that Shaw Pittman ever conducted work in an independent way for the special committee.

Filer forwarded a document to Simon on January 25, 2005 summarizing the performance of the businesses within the IIC group since the preparation of the Jesup & Lamont report.[79] This document pointed out various challenges facing the IIC group companies in the coming year, including fallout from the terrorist attacks, and concerns about the strength of various currencies, especially the Hungarian forint (HUF), in IIC's portfolio.[80] In a conference call on that same day, having provided Simon with the aforementioned information, Filer discussed the merger with Simon. Specifically, he told Simon of the need to include the "independent Director's view on the fairness of the price offered per share" in the proxy materials sent to IIC stockholders in connection with the merger and

[77] Tr. 755:17-24; Tr. 756:1-10.
[78] JX 113.
[79] Tr. 748:3-6.
[80] JX 70.

explained the need for Simon "to be happy that the offer remained fair from a financial point of view."[81]

In response to Filer, Simon conducted no new research as to the fairness of the transaction. Indeed, Simon's view seems to have been that the merger transaction he was asked to approve was substantively the same transaction as he had approved on September 10, 2001. Asked whether he was retained as a member of the special committee in connection with the merger, for example, Simon answered:

> I'm sorry. I'm confusing the two . . . [the merger] [w]ith the tender offer . . . I believed that my responsibility continued – as long as there were independent shareholders and – this is sort of like a continuation of the same transaction. I was still applying due diligence to what was happening at the companies. I was keeping up with what was going on. I think I assumed at the time that I still was responsible . . . to act in the interests of the independent shareholders, although maybe legally, I was not.[82]

Apparently acting on the belief that he had already satisfied his duty to represent the minority, Simon relied "solely" on information given to him by Filer in the course of the aforementioned conversations.[83] Specifically, Simon concluded that he was prepared to recommend the merger without receiving any new fairness opinion, and without conducting any new formalities on behalf of the minority

[81] *Id.*
[82] Tr. 880:11-20.
[83] Tr. 882:22.

even in light of the failure of the tender offer to attract more than a scant number of tenders. When asked during trial why he felt no need for further information, given the events of September 11, 2001, Simon explained that he was concerned that new information would reflect a lower price for IIC than the merger price.[84] In any case, Simon testified that he concluded that the merger too was fair.[85] As a result, a meeting of the IIC board was held on February 1, 2002 to review and vote on the merger. Simon was not in attendance, and did not personally vote on the merger,[86] but did give his proxy to Filer to vote in favor of the transaction.[87] The IIC board approved the combination on the same day.[88] The IIC stockholder meeting was held on March 27, 2002, and the merger was officially approved by CP's vote.

II.

The plaintiff makes two primary arguments. First, in the entire fairness class claim, Gesoff argues that the merger between IIC and CP described above was a product of unfair dealing, and produced an unfair price. Therefore, he demands that the court award him damages for those failures of fiduciary duty on the part of the CP and IIC boards. Second, in the statutory appraisal action, the plaintiff

[84] Tr. 873-883; Tr. 884: 5-10.
[85] Tr. 872.
[86] Tr. 874-75.
[87] JX 164.
[88] JX 169.

presents the expert report of David N. Fuller of Value Incorporated in support of his position that the fair value of IIC's common stock should be determined by this court to be $20.17 per share. The appraisal action has been brought on behalf of dissenting IIC stockholders who held 402,476 shares, somewhat less than half of the shares owned by class members.[89]

The defendants argue in response that the merger was entirely fair because any irregularities in the merger dealings did not affect the fairness of the merger price. Most importantly, the defendants argue, the events of September 11, 2001, which they claim necessarily depressed the value of IIC, made the merger price, determined before that date, "more than fair." Second, the defendants rely on the expert report of Neil J. Beaton to assert that the fair appraisal value of IIC was somewhere between $6.22 and $12.98 on a per share basis as of March 27, 2002, with a midpoint of $9.60 per share. Third, Simon argues that the plaintiff's claims

[89] The defendants contend that those stockholders who accepted the merger consideration or who voted in favor of the merger, acquiesced in the transaction, and are therefore barred from recovery. In this context, the court is well aware of the apparent inconsistency between *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840 (Del. 1987), which held that well-informed stockholders who accept merger consideration cannot seek an entire fairness remedy, and more recent cases in this court which hold otherwise. *See In re JCC Holding Co. Inc. S'holders Litig.*, 843 A.2d 713 (Del. Ch. 2003); *In re Best Lock Corp. S'holders Litig.*, 845 A.2d 1057 (Del. Ch. 2001); *but see Norberg v. Security Storage Co.*, 2000 Del. Ch. LEXIS 142 (Del. Ch. Sept. 19, 2000) (holding that the rule in *Bershad* precluded recovery in a minority squeeze out transaction). Whether it is because minority stockholders who are squeezed out in an unfair transaction cannot, by definition, be well informed, or because, as this court has held, *Kahn v. Lynch* implicitly overruled the holding in *Bershad*, it seems extremely unlikely to the court that Delaware law denies a remedy to minority stockholders battered into accepting unfair merger consideration.

against him, even if supported by the evidence adduced at trial, constitute at most duty of care violations. Therefore, Simon argues, those claims are barred against him personally by IIC's Section 102(b)(7) provision, as provided for in Article Tenth of the IIC charter.

III.

A. The Entire Fairness Standard

It is well established that a statutory long-form merger between a parent and a subsidiary invokes the entire fairness standard of review.[90] The usual deference courts give to corporate boards of directors, as embodied in the business judgment rule, is inappropriate in these circumstances because the self-interested directors have an interest that diverges from that of the minority stockholders,[91] and, to the extent that the minority resists, the process is entirely suffused with the parent's coercive power.[92] Entire fairness review, in other words, serves to protect the minority stockholders where the law's normal range of protections are insufficient.

The meaning of the phrase "entire fairness" was definitively set out by the Supreme Court in *Weinberger v. UOP, Inc.*[93] According to the now familiar words

[90] *Kahn v. Lynch Commc'n Sys.*, 669 A.2d 79 (Del. 1994) (*Kahn II)* .
[91] *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490 (Del. 1990); RODMAN WARD, EDWARD P. WELCH, & ANDREW TUREZYN, FOLK ON THE DELAWARE GENERAL CORPORATION LAW, § 251.6 (2005 ed.).
[92] *In re Cysive Inc. S'holders Litig.*, 836 A.2d 531, 547 (Del. Ch. 2003).
[93] 457 A.2d 701 (Del. 1983).

of that opinion, entire fairness has two aspects: fair dealing and fair price. This test, however, is not a "bifurcated one between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness."[94] In the specific context of a merger between a parent and a subsidiary, this review requires the parties to be assiduous in fulfilling their fiduciary duties. Not even an honest belief that the transaction was entirely fair will be sufficient to establish entire fairness. Rather, the transaction itself must be objectively fair, independent of the board's beliefs.

1. The Legal Standard Of Fair Dealing

Most of the cases in which Delaware courts have closely examined the procedural safeguards surrounding parent-subsidiary mergers have focused on how a defendant can shift the burden of proving entire fairness from itself to the plaintiff.[95] Such differentiations are most important at preliminary stages of

[94] *Id.* at 708 ("Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued. Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the standard of fairness.") (internal citations omitted).

[95] As this court has recently observed, the entanglement between the substantive doctrine of entire fairness and the burden-shifting force of a special committee or an informed majority of the minority vote means that defendants must act like they have the burden of persuasion throughout the entire trial court process. *In re Cysive*, 836 A.2d at 549.

litigation. By the time a case comes to trial, however, the standards for shifting the burden of entire fairness, and those factors establishing fair dealing, are highly intertwined. What can shift the burden of entire fairness can also establish fair dealing.[96] The following summary of our courts' entire fairness cases, therefore, assumes that indicators of fairness are interchangeable between those two doctrinal divisions.[97]

The Supreme Court observed as early as *Weinberger* that the establishment of an independent special committee can serve as powerful evidence of fair dealing. Since that case was decided, parties have relied increasingly on such committees to prove entire fairness, seeking to assure themselves that important transactions will withstand scrutiny. This trend has necessarily occasioned attention from our courts. If the parties in a parent-subsidiary merger decide to proceed by establishing an independent bargaining structure through a special committee, the court takes that establishment seriously, and examines the special committee process closely for indicators of fairness. To summarize Delaware cases, the goal of the process established by the board of the subsidiary must be to

[96] *Id.*

[97] To the extent that burden shifting and the ultimate determination of fairness are separate inquiries at trial, the court finds that the burden of proving entire fairness lies with the defendants in this case.

come as close as possible to simulating arm's-length bargaining with the parent.[98] For obvious reasons, a transaction that is by its terms dependent on the special committee process will struggle to evidence fair dealing if that process withers under scrutiny.

The court's investigation of a special committee process for fairness is highly fact intensive, and our courts commonly look to a range of well known factors to evaluate fair dealing. A comprehensive discussion of all the possible ways to prove fair dealing in a parent-subsidiary context in this opinion would not be practical. Several of these factors, however, are of importance in this case, or are especially central to any evaluation of a special committee. These factors are discussed briefly below.

As a threshold matter, the composition of the special committee is of central importance. Members of a special committee negotiating a parent-subsidiary merger must, of course, be independent and willing to perform their job.[99] This independence is the *sina qua non* of the entire negotiation process. The court

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[98] *Rabkin v. Olin Corp.,* 1990 Del. Ch. LEXIS 50, *18-19 (Del. Ch. Apr. 17, 1990) (in order to shift the burden of proving entire fairness, a "special committee must have real bargaining power that it can exercise with the majority shareholder on an arms' length basis").

[99] This court has held, for example, that leaving negotiations in the hands of directors who are not independent is evidence of unfairness. *Sealy Mattress Co. v. Sealy, Inc.*, 532 A.2d 1324, 1337 (Del. Ch. 1987) (noting, in the context of a case that set out a "textbook study of how one might violate as many fiduciary precepts as possible in the course of a single merger transaction," that the "directors were not independent and that they 'functioned in a ministerial capacity to carry out the parent [corporation's] bidding'").

necessarily places more trust in a multiple-member committee than in a committee where a single member works free of the oversight provided by at least one colleague.[100] But, in those rare circumstances when a special committee is comprised of only one director, Delaware courts have required the sole member, "like Caesar's wife, to be above reproach."[101]

In addition to being independent and, preferably, having more than one member, a well constituted special committee should be given a clear mandate setting out its powers and responsibilities in negotiating the interested transaction. Evidently, this mandate should include the power to fully evaluate the transaction at issue, and, ideally, include what this court has called the "critical power" to say

[100] Vice Chancellor Hartnett's common sense intuition that two heads are better than one in the context of special board committees has since been bolstered, in some sense, by economic and empirical research. *See, e.g.*, Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 12 (2002) ("In sum, groups appear to outperform their average member consistently, even at relatively complex tasks requiring exercise of evaluative judgment . . . . Corporate law's strong emphasis on collective decisionmaking by the board thus seems to have a compelling efficiency rationale.").

[101] The source of this formulation is, perhaps, somewhat more obscure today than when it first entered our law. In short, when Julius Caesar was asked why he chose to divorce his wife after a false accusation of adultery, Caesar's laconic answer is said to have been that "Caesar's wife must be above suspicion," or as it is usually rendered, "Caesar's wife must be above reproach." PLUTARCH, PLUTARCH'S LIVES 206 (Arthur Hugh Clough ed., John Dryden trans., 2001). Since Vice Chancellor Hartnett first cited Caesar's famous aphorism in *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985), in the context of a special litigation committee, it has been used repeatedly to describe the responsibilities of directors charged with managing committees of the sort at issue here.

"no" to the transaction.[102] The controller's commitment to leave the essential fate of the transaction in the hands of the special committee is a significant one, because it ensures that the merger offer is not negotiated in the shadow of punitive action by the controller if the minority resists the merger. Our courts have also noted that, when questioned, members of a special committee should be able to articulate the extent of their authority.[103] The source of that requirement, simply enough, is the common sense principle that no mandate, however clear, is sufficient if the special committee does not understand its considerable powers.

As has been repeatedly held, special committee members should have access to knowledgeable and independent advisors, including legal and financial advisors.[104] Two recent cases clearly illustrate the adverse consequences of depriving the special committee of such support.

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[102] *In Re First Boston, Inc. S'holders Litig.*, 1990 Del. Ch. LEXIS 74, *20 (Del. Ch. June 7, 1990) ("It is that power [to say no] and the recognition of the responsibility it implies by committees of disinterested directors, that gives utility to the device of special board committees in charge of control transactions."); *Kahn v. Lynch*, 638 A.2d 1110, 1119 (Del. 1994) (*Kahn I)*.
[103] *In Re Tele-Commc'ns, Inc. S'holders Litig.*, 2005 Del. Ch. LEXIS 206, *37 (Del. Ch. Dec. 21, 2005) ("A special committee's clear understanding of its own mandate is an important factor facilitating the knowledgeable and careful fulfilment of its purpose."); *Clements v. Rogers*, 790 A.2d 1222, 1241 (Del. Ch. 2001) (holding that a special committee's misunderstanding of its purpose and mandate could be combined with other factors to show that a special committee's effectiveness was "compromised from the get-go").
[104] *In Re Tele-Communications*, 2005 Del. Ch. LEXIS at *41 ("The effectiveness of a Special Committee often lies in the quality of the advice its members receive from their legal and financial advisors.")

In *In Re Tele-Communications, Inc. Shareholders Litigation,*[105] this court denied summary judgment for the defendants in an entire fairness action. The transaction at issue raised entire fairness concerns because the company's equity structure was divided into three groups of paired stock series, each group tracking one of the company's three operating divisions. For each division's two series of stock, the A shares were entitled to one vote per share, and the B shares were entitled to ten votes per share. When the defendant company (TCI) entered into merger negotiations with AT&T, TCI's board decided to establish a special committee to ensure fairness, in view of the fact that certain B series stockholders insisted on receiving a premium for their shares in any transaction. The special committee retained the same legal and financial advisors as TCI when evaluating the claim. Although the court's ultimate decision was based on a broad range of troubling facts about the negotiation process, the court noted that a special committee's decision to use the legal and financial advisors already advising the parent "alone rais[ed] questions regarding the quality and independence of the counsel and advice received."[106] This was particularly true where, as in that case, the financial advisor with the dual role was motivated by an incentive fee structure to close the deal on behalf of the full board, thus further splitting its loyalties.

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[105] *Id.*
[106] *Id.* at *41.

Similarly, in *In re Emerging Communications, Inc. Shareholders Litigation,*[107] this court found that a special committee had been prejudiced when its financial and legal advisors were co-opted by the parent. As the court observed in that case, the special committee was prejudiced by the fact that the advisors best placed to assist the special committee were made unavailable by the parent itself.[108] The point, critically, was not that other advisors were unqualified, but that the parent's action in robbing the subsidiary of these trusted advisors betrayed the unfairness of the transaction itself.[109]

Structural protections embedded in the merger offer are also of some importance in establishing the fair dealing aspect of entire fairness. As the Supreme Court held in *Kahn v. Lynch,* a majority of the minority voting provision, even without an independent special committee, can shift the burden of entire fairness to the plaintiff.[110] Similarly, this court has suggested repeatedly that the presence of a non-waivable "majority of the minority" provision is an indicator at

[107] 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004).
[108] *Id.* at *119.
[109] *Id.* ("[T]he board–or at the very least the Special Committee–should have insisted that Prudential and Cahill recuse themselves from the negotiations. By [failing to do so], ECM was deprived of the advantage of knowledgeable advisors. That advantage was conferred upon ECM's controlling stockholders and to-be adversary in the transaction–Prosser. There is no evidence that either the full board or the Special Committee ever considered that issue.").
[110] *Kahn I,* 638 A.2d at 1117.

trial of fairness[111] because it disables the power of the majority stockholder to both initiate and approve the merger.[112]

Finally, the discussions between the parent and the special committee should be conducted in a way that is consistent with arm's-length negotiations. These negotiations need not, of course, be a "death struggle."[113] But they should be vigorous and spirited, and provide evidence that the special committee and the parent are not colluding to injure the minority stockholders. At a minimum, the special committee should have control over its own sources of information and should have the loyalty of its advisors throughout the process.[114]

While this list of factors is not exhaustive, the lesson it should collectively teach to transactional planners faced with conducting such a process is unmistakably clear. If a parent seeks to satisfy the high standard of entire fairness by establishing a special committee, its burden to show fair dealing cannot be satisfied by orchestrating a stylized mockery of arm's-length negotiation.[115] In

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[111] *Jedwab v. MGM Grand Hotels*, 509 A.2d 584, 599-600 (Del. Ch. 1986) (a majority of the minority provision "typically constitute[s] indicia of fairness").
[112] *In re Pure Resources S'holders Litig.*, 808 A.2d 421, 442 (Del. Ch. 2002).
[113] *In re Cysive*, 836 A.2d at 543.
[114] *Id.* at 554. ("Once [the parent] became a buyer, [the investment bank's] reporting authority went straight to the special committee, and it acted as a vigorous negotiator on the committee's behalf.").
[115] *See, e.g*, *Rabkin*, 1990 Del. Ch. LEXIS 50.

order to satisfy entire fairness, the committee must act with informed diligence, and seek the best result available for its constituents, given the facts at hand.

2. Was The CP Merger With IIC The Product Of Fair Dealing?

CP's defense of fair dealing is necessarily based on the purportedly arm's-length negotiating process it instituted in order to establish the merger price.[116] Other factors that have shown fair dealing in the past are simply inapplicable here. Neither CP nor IIC claim to have sought alternative, third-party buyers for the company,[117] for example, or to have undertaken any other action that might make the CP/IIC merger process the product of fair dealing. In sum, therefore, the question of whether this merger evidenced fair dealing is entirely dependent on the quality of the negotiations between Simon, as the sole member of the special committee, and the team at CP.

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[116] The court does not reach the plaintiff's numerous disclosure claims. Simply put, while it is settled law that adequate disclosure is part of the duty of fair dealing, FOLK *supra* note 91, at § 251.6.3.6, the alleged disclosure violations in this case are entirely overshadowed by the plaintiff's substantive allegations of unfair dealing. Even if the defendants had disclosed all material facts in their proxy materials, the court would not be persuaded that the entirely coercive CP/IIC merger, which never depended on the minority's vote, would have been any more fair. *See e.g., Kahn II*, 669 A.2d at 89 (holding that a finding of adequate disclosure in a parent-subsidiary merger was persuasive evidence of entire fairness, because "although the merger was not conditioned on a majority of the minority vote . . . more than 94 percent of the shares were tendered in response to Alcatel's offer").

[117] *In re Cysive*, 836 A.2d at 553 (discussing factors that supported the conclusion that an interested transaction met the "exacting standard of entire fairness," the court observed, "first, the decision to enter into the Snowbird Agreement was preceded by an active and aggressive search for a third-party buyer").

It is unfortunate, therefore, that the process designed by Schreier, Filer, and the rest of the CP board to effectuate the merger between CP and IIC in the case *sub judice* fails at the very threshold to establish fair dealing. Indeed, redolent as they are with cynicism and corruption, the facts in this case serve as a singular example of the pitfalls inherent in organizing any sort of self-dealing transaction. This court cannot allow so clear a breach of fiduciary duty to escape without remedy.

The flaws in the special committee process begin with the appointment of Simon as the sole member of the committee. Although the court acknowledges that no other independent director was available, and that Simon was independent of CP, this lone appointment necessarily causes the court to examine the entire process with a higher level of scrutiny, and equally causes the court to require more of Simon than it would had he been joined by other independent directors. Unfortunately, the facts of this case serve to illustrate exactly why a single-member special committee has been thought such a worrisome portent of unfair dealing. On numerous occasions during the course of negotiations, a second director might have ameliorated the process by counseling Simon to think again, or by making it more difficult for CP to exert the control it exerted over the special committee. But that moderating influence was never available.

At the heart of the court's conclusion that the negotiation process was flawed is the fact that Simon's mandate as a special director, whether embodied by the June 2001 IIC board consent or otherwise, was fatally incomplete. The mandate entirely failed to set out a clear range of authority for Simon in terms of his power to approve or disapprove the merger. The plain language of the June 2001 board resolution allows Simon only to provide a vague recommendation as to the transaction, a power that Simon was unsure included any right to veto the merger.[118] This seemingly willful vagueness in Simon's mandate, and of CP's authority to proceed with or without minority approval, sits in contrast to those cases where special committee negotiations have been held to help establish entire fairness.[119]

Additionally, and somewhat uniquely, the record in this case evidences the parties' deep confusion about the nature of the contemplated transaction. The evidence shows clearly that when this transaction was first negotiated during the summer and fall of 2001, the parties all envisioned a tender offer followed by a short-form merger. It is unclear whether they considered the consequences of the fact that the tender offer could fail to provide CP with 90% ownership of IIC. The

[118] Tr. 833:7-13.

[119] *See, e.g.*, *In re Cysive*, 836 A.2d at 554 (noting, in the course of finding that a transaction evidenced entire fairness, a fully empowered special committee was an important factor in that conclusion) ("Second, once the Snowbird offer was made, a special committee was set up that had *full authority* to negotiate with Carbonell on Cysive's behalf regarding that transaction.").

tender offer materials, as described above, show the same intent when the offer was initiated in October 2001, although those documents evidence CP's intention to later consummate an unspecified merger regardless of the result of the tender offer. At this point, therefore, CP was in no sense contemplating the type of long-form merger transaction our courts usually are asked to assess, characterized by a full negotiation between the parent and the subsidiary's special committee, the signing of an agreement of merger, and a possible tender offer in connection with that finalized transaction. Rather, CP appears to have initiated a process that was in some ways like the unilateral tender offer process approved in *In re Siliconix Shareholders Litigation*[120] and in *In re Pure Resources, Inc. Shareholders Litigation*, but mimicked the traditional merger route by including the subsidiary intimately in the process even before the tender offer was officially made.[121]

When the tender offer failed, however, the short-form merger became impossible. It was only then that CP decided to proceed definitively with a long-form merger. It chose to do so, however, without undertaking any further formalities to ensure that this somewhat new transaction would be fair to the minority stockholders, other than having Filer, apparently on behalf of CP, hire

[120] 2001 Del. Ch. LEXIS 83 (Del. Ch. June 19, 2001).
[121] The court need not reach the question of exactly what level of scrutiny would have attached to that transaction had the tender offer succeeded in driving CP's ownership of IIC over 90%. Certainly, the lack of a non-waivable majority of the minority provision in the October 15, 2001 tender offer would have raised serious questions about its lack of coercion.

Shaw Pittman to review Ottensoser's work. The court cannot be sure whether CP proceeded in this way because it felt that the negotiations between Simon and the special committee with regard to the initial tender offer were sufficient to establish the fairness of the merger or because it simply failed to understand that the change in transactional form could, at least, have some consequences in terms of judicial scrutiny. Simon's testimony, in any case, betrays a deep confusion as to the distinction between a tender offer and a merger. Whatever the truth of the matter, the validity of the merger approved on March 27, 2002 rests primarily on work done months earlier, formally to approve a tender offer approach. That disjunction, never addressed internally either by IIC or CP, casts serious doubt on whether Simon's inadequate mandate was even intended to apply to the later long-form merger, or whether his role as a special committee director was really designed exclusively to evaluate the tender offer.

The court does not mean to imply that a change from one transactional form to another requires a wholesale retreading of ground previously covered, and corporations can change their minds as to how they choose to structure fundamental transactions, even in mid-stream.[122] But neither Simon's testimony,

[122] *See e.g., Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990).

nor any other part of the record, convince the court that the parties in this case acted from the beginning with a view toward a long-form merger.

Even if Simon had clearly been granted the power to say "no," his efforts were crippled by the special committee's complete lack of independent legal and financial advice. Doubtless, Simon's mandate formally gave him the authority to hire financial and legal advisors to evaluate the tender offer. But the reality of these appointments was that both the special committee's financial and legal advisors were handpicked by CP. Jesup & Lamont were effectively selected by CP and Filer, having been contacted months earlier, and having essentially been promised employment by Filer rather than the special committee. That conflict of interest robs Jesup & Lamont's fairness opinion of its value as an indicator of fairness, and is itself an indicator that the parties did not structure the process in a way that was entirely fair. The situation in this case, in sum, is of a more alarming kind than the dual representation in *In re Tele-Communications, Inc*., where the skewed incentives of the special committee's financial advisor merely suggested possible disloyalty. Here, as shown indisputably at trial, Jesup & Lamont were actively and persistently disloyal to the special committee and to its aims of ensuring a fair transaction for IIC's minority stockholders.

Simon's decision to retain Ottensoser as the special committee's legal counsel was, if anything, even more damaging to the special committee's duty to

be well and independently informed. Ottensoser was IIC's outside counsel, was beholden for his job to a board entirely dominated by CP, and had indeed been advising CP on its approach to the tender offer from the beginning. No reasonable observer could have believed that Ottensoser was an appropriate independent counsel for the IIC special committee. It is most unfortunate, therefore, that Simon accepted Ottensoser's frankly incredible statement that his dual representation of IIC and the special committee presented no conflict of interest. Both Ottensoser's work as counsel for the IIC special committee, and Simon's blithe acceptance of his representation, are evidence of unfair dealing. Indeed, as the Supreme Court observed in a similar case, the fact that the parent's "General Counsel suggested the name of appropriate legal counsel to the Special Committee, and that individual was promptly retained," was a notable indicator that the special committee's process was not to be trusted.[123] Here, CP ensured its control over the special committee process by the simple expedient of inserting its own outside counsel directly into the opposition camp.[124]

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[123] *Kahn v. Tremont,* 694 A.2d 422, 429 (Del. 1997).

[124] *In re Cysive,* 836 A.2d at 531, presents an important limitation on the court's suspicion as to advisors shared between the parent or subsidiary and the special committee. In that case, the subsidiary in a proposed merger between a parent and a subsidiary formed a "pristine" special committee composed of two independent directors. The committee then retained the same investment bank as its own advisor as the subsidiary had retained in its initial, failed, efforts to sell the company to a third party. The court found that this dual representation did not conflict the investment bank, because the bank's responsibilities now clearly ran to the special committee. As the court noted, "once [the parent] became a buyer, [the investment bank's] authority went straight to the special committee, and it acted as a vigorous negotiator on the

Even had Ottensoser been a fully independent advisor, the court is troubled by Simon's failure to investigate Ottensoser's qualifications to serve as transactional counsel. As Simon flatly testified, he considered no other lawyers, and in fact accepted CP's "appointment" of IIC's counsel as his own. But the ramshackle way in which the merger between IIC and CP was organized raises, to say the least, very serious doubts about Ottensoser's familiarity and competence to give a client advice about Delaware fiduciary duty law. This case, therefore, presents a situation in which the special committee's advisors are of little use in establishing the entire fairness of the merger transaction. As the Supreme Court observed in *Kahn v. Tremont*, "professional advisors have the ability to influence directors who are anxious to make the right decision but who are often *in terra [in]cognito.*"[125] No evidence in this case suggests that Simon was able to rely on his conflicted and inexperienced advisors for the help he so obviously needed.

The court can take no comfort, therefore, in the prophylactics established by the IIC board to ensure that the CP/IIC merger was the product of fair dealing. Regrettably, moreover, the negotiation between CP and IIC was rife with substantive unfairness.

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committee's behalf." *Id.* at 554. The differences between that case, and the situation in this case, where the special committee's advisors fed information to the parent throughout the process, are substantial and determinative.

[125] 694 A.2d at 429.

Considered alone, the most disturbing email sent on May 17, 2001 between Ottensoser, Filer, and Zarriello is enough to cast a dark shadow over the entire merger process. The plain text of the message shows that CP had no intention of negotiating at arm's length with the special committee, but rather planned from the beginning to orchestrate an unfair process with a predetermined result. Even more problematic, the defendants were successful in carrying out the plan described in that letter. CP managed to dupe Simon into hiring Jesup & Lamont as his financial advisor. It then proceeded to make precisely the "lowish" offer envisioned in the email message, which Simon approved exactly as the letter said he would after a nominal increase in consideration. This email was not, in other words, a merely descriptive piece of work recording the process that CP hoped would transpire. It prescribed, in advance, the process that Jesup & Lamont would convince Simon to follow in the future on behalf of the subsidiary. As such, it is clear and startling evidence that the facade of arm's-length negotiation constructed by CP was nothing more than a sham.

Equally troubling, as was entirely obvious from trial, was the fact that information flowed freely from Jesup & Lamont to Filer at CP. The evidence shows that Filer knew Simon's private valuations of IIC at all relevant times. In fact, without Simon's knowledge, Filer was receiving a stream of draft valuation reports on which to base his negotiating strategy against the special committee.

This sieve-like separation between Jesup & Lamont and CP was obviously inimical to the special committee's power to negotiate a fair transaction. Any transaction that relies on so transparently corrupt a process cannot possibly be found to satisfy the high standard of entire fairness.

To summarize the collected weight of the evidence, the court finds that the process established by the defendants unilaterally imposed on the minority a price of the parent's own choosing, established a deceptive negotiation between the parties, and left the minority's putative special committee almost entirely powerless against its parent. This muddled, dishonest, process is emphatically not what the Supreme Court meant by fair dealing in *Weinberger*, and will not be tolerated here.

3. Fair Price

The defendants' arguments as to the procedural fairness of the underlying merger are halfhearted, and their papers walk the line of conceding that the negotiations between CP and IIC were, as this court has held, severely lacking in fairness.[126] But, the defendants argue, the price paid in the transaction was entirely fair. Not because $10.50 was a fair price at the time Simon approved the tender

[126] Def.'s Opening Post-Trial Br. at 36. ("[D]ue to poor legal advice from their American lawyer, IIC and CP Holdings were unaware of procedural safeguards . . . that would have insulated the going-private process from challenge . . . . Despite any procedural missteps of IIC and CP Holdings . . . the minority shareholders received more than fair value for their shares in the March 2002 merger.").

offer on September 10, 2001, but because September 11, 2001 intervened between Simon's approval and the merger.[127] The defendants argue that whatever the fairness of the price on September 10, the next day's cataclysm so depressed IIC's intrinsic value that $10.50 became a fair price. Indeed, the defendants' valuation expert testified at trial that IIC was worth only $9.60 on the date of the merger. Therefore, the defendants contend, the merger between IIC and CP was entirely fair.

As a logical matter, of course, the defendants are right to note that if $10.50 was even in the vicinity of a fair price on September 10, and if the defendants had shown that IIC was affected to the same extent as many American companies on September 11, then the fair price on September 12 would be somewhat below $10.50. Neither of these assumptions, coincide with the evidence presented in this case.

Initially, the defendants have frankly failed to show, as is their burden, that the September 11 terrorist attacks had a significant effect on IIC. The defendants' papers simply rely for this causal link on a combination of common sense and the

[127] Our courts have held that the correct test of fair price is that "upon a merger the minority stockholder shall receive the substantial equivalent in value of what he had before." *Rosenblatt v. Getty Oil*, 493 A.2d 929, 940 (Del. 1985). This "involves all relevant economic factors of the proposed merger, such as asset value, market value, earnings, future prospects, and any other elements that affect the inherent or intrinsic value of a company's stock." *Id.* Therefore, in general, the techniques used to determine the fairness of price in a non-appraisal stockholder's suit are the same as those used in appraisal proceedings. FOLK, *supra* note 91, at § 251.6.2.

fact that the CP board discussed lowering the offer price after the attacks but declined to do so. The evidence adduced at trial, however, does not support the conclusion that September 11 had a material affect on IIC's intrinsic value. The component of IIC most likely to be affected by September 11 was Danubius, a hotel company, and the largest part of IIC's valuation. Filer testified that September 11 certainly would have some effect on Danubius's business, because Americans would be less likely to visit Hungary and the Czech Republic.[128] But Filer also testified that Americans formed a smaller part of the business than other customers. And it is not at all obvious to the court that Germans, the key Danubius client, would stop vacationing in eastern Europe because of an attack on New York,[129] especially when, as Filer also testified, any decline in German tourism could just as easily be explained by the fact that the "German economy was starting to suffer from a recession"[130] which in fact much predated 2001. Danubius was also under pressure from increased competition in Hungary, due in part to government subsidies for spa hotels.[131] Further, as is clear, world currency trends leading to a strong Hungarian forint were hurting revenues.[132] The

[128] Tr. 751:4-10.
[129] Danubius Hotels' own Annual General Meeting report notes, in reference to the Czech hotels, that they "did not feel the September 11 events (as most of their guests are European, the majority is from Germany"). JX 156.
[130] Tr. 750:16-24.
[131] Tr. 751:12-24.
[132] Tr. 750: 20-24.

defendants have produced no credible evidence that all of these developments were somehow localized to the time after the $10.50 price was approved by Simon. If Danubius was suffering, no evidence shows that September 11 was the cause.

Nor is it especially obvious to the court that IIC's other businesses were materially affected by September 11. It is hardly credible that Balton, a company operating in environments so risky that the defendants' own expert imposed a 12.5% specific country risk premium on its revenues,[133] was likely to become any more risk-prone due to terrorist attacks, or that its market for basic food products would decline substantially. And IIC's companies in Israel had surely already factored into their plans the extreme risk of terrorism on their front step, rather than thousands of miles away in New York. The second intifada, for example, began in September 2000, a full year before September 11 supposedly weakened ITE's and Zoko's prospects. None of this in any way is meant to minimize the effects of the attacks of September 11, which were felt so acutely and so intimately in this country. But the defendants have failed to show that they materially undercut the value of IIC, a company wholly based overseas.

Nor have the defendants given any reason for this court to believe that the price was fair on either side of September 11. Of course, the price of $10.50 per

[133] JX 311 at 39.

share was well below the $13 determined to be an acceptable price at the beginning of the process by CP, a fact known to Simon and Jesup & Lamont. It was below what the court determines an appraisal process would show. It was, as the evidence adduced at trial demonstrated, even below the illiquid market price of IIC shares. As this court has held in the past, reliance on a price determined in a thinly traded, illiquid, market is evidence of a price's unfairness.[134] Yet, in this case, the minority stockholders would actually have been better off had CP bought the shares in exactly that sort of market. The only indicator of fairness the price adhered to was Jesup & Lamont's valuations during the negotiation process. But as already discussed, Jesup & Lamont was deeply conflicted, ostensibly hired by the special committee, but plainly loyal to CP. In sum, the price of $10.50 per share for IIC was unfair, and is obviously so from the evidence adduced at trial. The defendants have failed to show that September 11 changed that basic truth.

C. Remedy

As this court has held in the past, and as affirmed by the Supreme Court, the calculation of damages in a consolidated entire fairness and appraisal action decided on the basis of entire fairness is a flexible process. As such, significant discretion is given to the court in fashioning an appropriate remedy. In

[134] *Seagraves v. Urstadt Property Co.*, 1996 Del. Ch. LEXIS 36, *22 (Del. Ch. Apr. 1, 1996).

determining damages, the court's "powers are complete to fashion any form of equitable and monetary relief as may be appropriate . . . ."[135] Or, as the Supreme Court has described this court's authority, "the Court of Chancery has greater discretion when fashioning an award of damages in an action for a breach of the duty of loyalty than it would when assessing fair value in an appraisal action."[136] Obviously, the court cannot award punitive damages. But the court can, and has in the past, awarded damages designed to eliminate the possibility of profit flowing to defendants from the breach of the fiduciary relationship.[137]

This case presents exactly such a situation. Plainly, IIC is extremely difficult to accurately value. It was difficult to value before September 11 due to its wide ranging holdings in highly divergent markets. It became, perhaps, even more difficult to value after September 11 because this court cannot know how to factor the effects of terrorism into a company already exposed to terrorism in Israel, unreliant on American visitors in Hungary, and otherwise exposed to sovereign risks in Africa that must far outstrip the effects of September 11. The court will, therefore, evaluate the reports of the experts produced by both sides, conduct its own DCF analysis based on the findings of those experts,[138] and test the

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[135] *Weinberger v. UOP*, 457 A.2d 701, 714 (Del. 1983).
[136] *Int'l Telecharge v. Bomarko, Inc.*, 766 A.2d 437, 441 (Del. 2000).
[137] *Id.*
[138] As this court has recently noted, "[t]he DCF model of valuation is a standard one that gives life to the finance principle that firms should be valued on the expected value of their future cash

results of that financial analysis against the facts of this case in order to ensure that the value produced by that analysis is consistent with what the court believes is the proper measure of damages.[139] Because the court is convinced this process yields a value at least as high as a formal appraisal, the court will not perform a separate statutory appraisal, but instead, uses the value ascertained as a basis on which to compensate all individual and class plaintiffs.

1. DCF Analysis

The court concludes that the evidence adduced at trial does not support the conclusions of the plaintiff's expert, David Fuller. First, Fuller's opinion relies to a material extent on expert valuations, by Russell Kett for Danubius and Ofer Nir for the Zoko real estate. As proven at trial, however, both of these valuations are seriously suspect.

Kett is a managing director at HVS International, a firm based in London, Egland, specializing in the valuation and financial analysis of hotels.[140] He was

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flows, discounted to present value in a manner that accounts for risk. The DCF method is frequently used in this court, and [the court] . . . prefer[s] to give it great, and sometimes even exclusive, weight when it may be used responsibly." *Andaloro v. PFPC Worldwide*, 2005 Del. Ch. LEXIS 125, *35 (Del. Ch. Aug. 19, 2005).

[139] Even in a case that is purely a matter of statutory appraisal, this court retains considerable discretion to arrive at a fair value. *Union Ill. 1995 Inv. L.P. v. Union Fin. Group*, 847 A.2d 340, 356-57 (Del. Ch. 2003) ("I am free to consider all non-speculative elements of value, provided that I honor the fair value definition articulated by the Delaware Supreme Court. This does not mean that I must perform every conceivable valuation technique in the universe and then give some arithmetic weight to each of them. Rather, I am empowered to come up with a valuation, drawing on what I reasonably conclude is the most reliable evidence of value on the record.").

[140] Tr. 5:23-24.

hired by Fuller, on the plaintiff's behalf, to conduct a valuation of eight hotels owned by Danubius in Budapest, and the values that he derived for those hotels were incorporated into Fuller's valuation for that company, which is by far the largest component of IIC's overall value. Kett's testimony concerning his valuation report, however, led to serious suspicions regarding its reliability. Two of his most significant errors demonstrate particularly why the court can give no weight at all to his opinion.

The first of these errors concerns the franchise fee that the Budapest Hilton Hotel was required to pay to the international Hilton company for the privilege of using the well known brand name. As Kett forthrightly conceded in his initial report, that fee was necessarily part of any valuation of Danubius, and would reduce the company's value:

> The Hotel is operated under a franchise agreement with Hilton Hotels. We have not had sight of any of the terms of this agreement, nor are we aware of the fees payable to Hilton Hotels. We note that the fees in 2001 were approximately 7.7% of total revenue and have allowed this amount to increase with inflation in our projections.[141]

When Kett actually did the calculations to derive the value of the Budapest Hilton in his initial report, he inexplicably omitted this substantial expense,[142] thus greatly overvaluing the hotel. When this clear mistake became evident, Kett issued a

[141] JX 137 at 23.
[142] *Id.* at 24.

revision to his report purportedly fixing the error.[143] As Kett testified, this revision was meant to do nothing but correct the omission of the franchise fee.[144] At trial, however, it became clear that although Kett purported to have fixed the error in his calculations, he had somehow made yet another mistake. This time, although his calculations included a franchise fee, that fee was self-evidently too low.[145] Again, therefore, Kett's valuation was plainly wrong, and overstated the Budapest Hilton's value.[146] When Kett was questioned about his mistakes at trial, he could provide no explanation and no indication of what the value of Danubius would be if he had done the calculation correctly.[147]

Kett's second serious error concerned the calculation of the sale value of the Budapest Hilton, which was incorporated into the tenth year net income of the hotel's DCF value.[148] In his original report, completely omitting the franchise fee, Kett had arrived at a sale value for the hotel of roughly 20.1 million HUF. His revised report, taking into account the (admittedly too low) franchise fee, replaced this figure with a new value of 19.5 million HUF,[149] a difference of approximately 600,000 HUF. When questioned at trial about how he arrived at this number, it

[143] JX 262.
[144] Tr. 59:12-16.
[145] Tr. 62:12-18.
[146] Tr. 63:17-20.
[147] Tr. 63:14-24.
[148] JX 137 at 25.
[149] JX 262 at 25.

became apparent that this revised calculation had no basis in fact. Rather, taking Kett's own calculations on their face, the correct sale value of the Budapest Hilton was about 16.4 million HUF,[150] a difference of about 3 million HUF from the number he incorporated into his calculations of Danubius's value. During cross-examination, Kett had no explanation whatsoever for this significant, and easy to conceal, mistake.[151] He conceded, however, that using the correct value would substantially lower his valuation.[152]

The court gave the plaintiff the evening after Kett's testimony to provide some further explanation of these two mistakes. What emerged the next morning were completely novel rationalizations of Kett's valuations, none of which Kett had so much as alluded to when he was questioned at trial.[153] Given that Kett repeatedly assured the court that he had been personally involved with the valuations at every stage,[154] the court finds it extremely unlikely that Kett could have simply forgotten these important aspects of his own valuation. Rather, as the court observed at trial, the more plausible explanation of Kett's failure to testify as to these explanations when he was first asked about them is that they were

[150] Tr. 65:6-12.
[151] Tr. 66:13-16.
[152] Tr. 67-1-14.
[153] Tr. 269-279.
[154] *See, e.g.*, Tr. 13.

concocted only after his mistakes became apparent. Kett's after-the-fact revisions to the plain text of his report, therefore, do nothing to reassure the court as to the reliability of his work, and are fatal to Fuller's report as it relates to Danubius.

Fuller also relied on Nir's valuation of certain pieces of real estate owned by ITE and used by Zoko in order to run its business. Specifically, these included a 23,199 square meter lot at Kiriyat Beyalik, and a smaller lot at Holon.
The court believes that Nir's valuation, and its use by Fuller, was more reliable than Kett's flawed analysis. When incorporating Nir's valuation into ITE's balance sheet, for example, Fuller was careful to use only the lower of the valuations found by Nir, and to eliminate any value for a third, smaller, property, for which Nir was unable to provide either a book or market value. Moreover, Nir correctly anchored his valuation at the low end of the price per square meter for somewhat similar properties in the Israeli market.[155] However, Nir's valuation was heavily based on documents that either could not be found and presented as evidence, or were produced only shortly before trial and were available only in Hebrew. This fact prejudiced the defendants and reduces the court's confidence in Nir's opinion. Further, Nir conceded that he had only been hired to conduct a "short version" valuation, and had not even been inside the properties he was

[155] Tr. 400:5-11.

meant to value.[156] On the whole, therefore, the court believes that Fuller's complete reliance on Nir's opinion was unjustified.

Additionally, the court finds that Fuller made certain other mistakes in his valuation analysis that render his testimony unreliable. In his initial report, Fuller relied on forecasts for the IIC constituent companies that differed considerably from the forecasts produced by management. Later, Fuller adopted Beaton's DCF analysis for Danubius, Agrimill, and Balton, apparently conceding that management analysis was a better basis for valuation than his own subjective valuations.[157] Further, he used country-specific risk premia that the court believes were too low for all the IIC constituent companies, incorrectly applied control premia to DCF analysis, and entirely discounted the existence of a small-stock risk premium in all circumstances.[158] These troubling weaknesses in Fuller's valuation mean that the court cannot adopt the plaintiff's fair value conclusion of $20.17.

In contrast, the court believes that the evidence adduced at trial substantially supports the report of the defendant's expert, Neil J. Beaton. Thus, the court will adopt it as the general framework for its own valuation. Specifically, the court believes that using a scenario analysis, averaging conservative and optimistic possibilities, is the most appropriate valuation technique for a company in the

[156] Tr. 161; Tr. 162: 13-15.
[157] Tr. 354:2-15.
[158] Tr. 243:21-24; Tr. 244:1-10.

somewhat uncertain position of IIC at the time it was to be valued. The plaintiff has, however, raised significant questions about certain aspects of Beaton's methodology. The court is convinced, therefore, that a proper valuation of IIC would require several material adjustments to Beaton's report. These are discussed in turn below.

a. Beaton's Application Of Specific-Company Risk Premia

A so-called "specific-company risk premium" (SCRP) is added to a discount rate when valuing an asset "to the extent that the company has risk factors that have not already been reflected in the general equity risk premium as modified by beta and the small company size premium."[159] In his value determination, Beaton applied a SCRP to all constituent parts of IIC. In valuing Danubius, for example, Beaton applied a SCRP of 3% under his optimistic scenario, and 2% under the conservative scenario. In his view, these premia were justified due to a variety of risks faced by the constituent companies of IIC not reflected in the industry beta. For Danubius, therefore, Beaton "identified the over-supply of hotels in the Budapest market, and in Hungary overall, [and a major cut-back in] capital expenditures."[160]

[159] SHANNON PRATT, THE LAWYER'S BUSINESS VALUATION HANDBOOK 125 (2000).
[160] Tr. 533.

As a commonly used reference in Delaware case law explains, "estimating [the SCRP] necessarily requires some subjective judgment on the part of the appraiser." But, as the same source explains, "the more the judgment is based on rigorous financial analysis, the more reliable the result is likely to be."[161] As a result of the inherent subjectivity of the SCRP, our courts have been ambivalent in their approach to the use of that premium. In *Union Illinois 1995 Investment L.P. v. Union Financial Group, Ltd.*,[162] for example, this court rejected the use of a company-specific risk premium, without purporting to decide in general whether such premia are appropriate to a financial analysis. Although, as the court noted, "investors do consider company-specific risks in calculating the cost they will use in investing capital, . . . pure proponents of CAPM argue that only systemic risk as measured by beta is relevant to the cost of capital and that company-specific risks should be addressed by appropriate revisions in cash-flow estimates."[163] This court has also explained that we have been "understandably . . . suspicious of expert valuations offered at trial that incorporate subjective measures of company-specific risk premia, as subjective measures may easily be employed as a means to smuggle improper risk assumptions into the discount rate so as to affect dramatically the expert's ultimate opinion on value."[164] As this court observed in *ONTI, Inc. v.*

[161] PRATT, *supra* note 159 at 121.
[162] 847 A.2d at 340.
[163] *Id.* at n.28.
[164] *Solar Cells, Inc. v. True N. Partners*, 2002 Del. Ch. LEXIS 38, *21 (Del. Ch. Apr. 25, 2002).

Integra Bank,[165] applying a company-specific premium in the *absence* of beta, "the concept of a company-specific risk premium is not so prevalent as [defendants] imply."[166] In accordance with that sentiment, our courts have not applied company-specific risk premia without fact based evidence produced at trial on which to base that discount.

In this case, the court finds that the defendants did not carry their burden of proving the appropriateness of company-specific premia for IIC constituent companies. As Beaton conceded at trial, his application of the SCRP was based almost entirely on his subjective beliefs as to the correct discount rate for each IIC company. He was unable, crucially, to point to specific financial analyses on which the court could rely to derive such a discount. Indeed, when discussing the correct SCRP to be applied to Balton, Beaton flatly admitted that he applied only 100 basis points of risk to that company because he felt that to add more would "be, actually, punitive at that point."[167] The court recognizes that some level of subjectivity is inherent in the calculation of SCRP. Beaton's analysis, however, is

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[165] 751 A.2d 904, 920 (Del. Ch. 1999).
[166] *Id.* at 920; *see also, Hintmann v. Weber*, 1998 Del. Ch. LEXIS 26 (Del. Ch. Feb. 17, 1998) ("a company specific risk premium 'remains largely a matter of the analyst's judgment, without a commonly accepted set of empirical support evidence.' Thus, the factors relied upon in assessing an investment specific premium should be carefully explained to the court. As with all aspects of a party's valuation for purposes of Section 262, the proponent of a company specific premium bears the burden of convincing the court of the premium's appropriateness.") (internal citations omitted).
[167] Tr. 563:22-23.

unmoored to any objective financial analysis the court can reasonably evaluate, and thus cannot be the basis of what are, in aggregate, substantial discounts to IIC's fair value. In view of that conclusion, the court has applied no SCRP for any IIC constituent company, whether in the conservative or optimistic DCF scenarios.

b. Beaton's Application Of Small-Company Risk Premia

In deriving the value for IIC, Beaton applied small-company risk premia to all IIC constituent companies, relying on the Ibbotson Associates chart, *Size Premium in Excess of CAPM*, for guidance on incorporating the size effect into the equity discount.[168] Specifically, relying on that source, Beaton adds a small-size premium of 5.33% to the Weighted Average Cost of Capital (WACC) of all the IIC companies, including Danubius, arguing that all of these companies' market capitalizations fall within the tenth decile of the companies observed by Ibbotson.

In short, a small-stock premium arises from empirical observations that the common stocks of small firms generally provide higher mean returns than do the stocks of large firms.[169] Studies have also shown, however, that smaller companies tend to experience higher risk than larger companies.[170] Financial analysts have, on

[168] PRATT, *supra* note 159, at 125.
[169] Christopher B. Barry, et al., *Robustness of Size and Value Effects in Emerging Equity Markets 1985-2000* at 1 (Texas Christian Univ. Center for Fin. Studies, Working Paper, 2001).
[170] PRATT, *supra* note 159, at 125 .

that basis, applied a further discount to the valuation of small companies in order to reflect that increased risk.

The small-size premium, although somewhat controversial, is a generally accepted premise of both financial analyses and of this court's valuation opinions.[171] What differentiates the facts in the present case from other circumstances in which the small-size premium has been applied, however, is that the IIC constituent companies all operate entirely outside the U.S., while the Ibbotson charts rely solely on observations of the U.S. market. The general question that Beaton's decision to apply small-size premia raises, therefore, is whether size risk premia developed for the U.S. market are applicable in any sense to a foreign corporation. In other words, Beaton's valuation calls on the court to decide whether there is something inherently risky about the stock of companies that are small compared to their global competitors, or whether the small-stock premium arises only when a company is small in relation to the market on which it trades.

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[171] *ONTI,* 751 A.2d at 920 ("this court has traditionally recognized the existence of a small stock premium in appraisal matters"); *Hintmann,* 1998 Del. Ch. LEXIS at *14 ("a small stock premium is appropriate to reflect that 'on average, smaller companies have higher rates of return than larger companies.' This Court has accepted the addition of small stock premia."); *Emerging Communications,* 2004 Del. Ch. LEXIS at *71 ("although plaintiffs contend that there is no basis in the finance literature or theory for adding a 'small firm/small stock' premium to the cost of equity, that is not entirely accurate. There is finance literature supporting the position that stocks of smaller companies are riskier than securities of large ones, and therefore, command a higher expected rate of return in the market. Our case law also recognizes the propriety of a small firm/small stock premium in appropriate circumstances.").

Our courts have never squarely considered the question of the international application of U.S. small-size premia, especially in developing or newly developed markets. The finance literature, further, is deeply conflicted, and indeterminate, on the correct application of such premia in foreign valuations. As multiple important sources have noted, the small-size premium almost certainly does not apply in a uniform way in all markets. Rather, local factors and local conditions necessarily change whether a corporation can expect to experience the higher risk and higher returns that small corporations evidence in the U.S. One study states, for example:

> Initially, we define size for each firm relative to each firm's local market average. Unlike BE/ME, which suffers from incomparability across markets due to differences in accounting, size is entirely comparable across markets: $100 million in Brazil is exactly the same value as $100 million in Zimbabwe. However, if size matters at the local level, then using absolute size in portfolios may mask the effect that size has in distinct markets and in fact could capture differences in performance across markets rather than the effect of size *per se.* For example, the <u>average</u> size of a stock in Brazil in our data is $1.7 billion. The <u>largest</u> stock from Zimbabwe in our data is $1.5 billion . . . . In Section VI of the paper, we also report results using absolute size, or size not adjusted by the average size in the local market. The choice of relative size versus absolute size is ultimately a question of the degree to which emerging capital markets are integrated globally. In a perfectly integrated global capital market in which investors freely select from among all securities in global markets, absolute size would be the preferred measure of size. If, alternatively, global capital markets were completely segmented, relative size would be the appropriate measure to employ in testing for the existence of a size effect.[172]

[172] *See* Barry, *supra* note 169, at 6-7.

There are various reasons that the global capital markets might be segmented, thus leading to results for small stocks that differ somewhat from those observed in the U.S. and in other leading developed economies:

> Foreign investors may be first attracted to large (blue chip) shares, which would tend to increase their returns relative to smaller stocks. In addition, in some countries, larger firms may have had increasing access to cheaper capital over this period, either domestically through government-subsidized credit or, more likely, through lower-cost international financing, which would make their equity more attractive. Finally, it is possible that trade and other reforms that occurred in many of these countries could have benefitted large firms more than their smaller counterparts.[173]

The end result of this uncertainty is reflected in recent empirical studies. Some scholars have discovered that small stocks enjoy premiums over large stocks in developing economies, just as in more developed economies.[174] But others believe that "in many cases, the signs of those coefficients are contrary to those found in many developed markets. This is especially true for size."[175] The general weight of the scholarship, in summary, seems to be that the small-size premium might well apply in the same way as in the U.S. in more highly developed foreign

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[173] Stijn Claessens et al., *The Cross-Section of Stock Returns* 12 (The World Bank, Policy Research Department, Policy Research Working Paper No. 1505, 1995).
[174] K. Geert Rouwenhorst, *Local Return Factors and Turnover in Emerging Stock Markets* (Yale University, School of Management, Working Paper Series, 1998) ("The paper shows that the factors that drive cross-sectional differences in expected stock returns in emerging equity markets are qualitatively similar to those that have been found in developed equity markets. In a sample of more than 1700 firms from 20 countries, I find that emerging market stocks exhibit momentum, small stocks outperform large stocks, and value stocks outperform growth stocks.").
[175] Claessens, *supra* note 173, at 15.

markets, and would not apply to the same extent, or at all, in newly developing markets.

Based on the evidence presented at trial, the court does not believe that a small-stock premium can possibly be justified in connection with Balton, which operates in countries with very few of the ties to the global capital markets which point towards use of that premium. The specific risks that accompany investment in Balton, in any case, are well represented in the high country-specific risk premium applied to the company's valuation, which takes into account the risk of operating a company in the African markets where Balton does business.

Danubius, Agrimill, Investor, and Zoko/ITE, however, are based in countries that the evidence shows are relatively well connected to the global capital markets. They are traded on major stock markets, and have access to international capital. The court, therefore, believes that some small-stock premium should be applied to the value of these companies, and that the best data available to the court is that represented by the Ibbotson numbers.

Taking into account the Ibbotson chart, and the size of the IIC constituent companies in relation to their home markets, the court is convinced by the defendants' argument that Investor, Agrimill, and Zoko/ITE would probably evidence behavior characteristic of small companies in the U.S., and should thus be subject to a further discount for their small size in the court's determination of fair

value. Therefore, the court will apply the Ibbotson Decile 10 small-size risk premium of 5.33% as a factor in deriving the WACC of those two companies.

Danubius is quite a different matter. Most important, Danubius forms part of the index for the Budapest Stock Exchange, a strong indication that it may not evidence the full 5.33% risk premium for a company of its size in the U.S.[176] Also, the Ibbotson numbers suggest, at least, that the hotel industry itself may be less subject to the size premium than other industries.[177] On those and other bases, the court believes that the 5.33% Decile 10 risk premium applied to both the conservative and optimistic scenarios of Danubius does not properly reflect Danubius's position within its own market. In order to balance the court's belief that some small-stock premium should apply to Danubius, the court will apply the Decile 9 small-stock risk premium of 2.41% to both of the Danubius valuation scenarios.[178]

c. The ITE Real Estate

ITE owns certain real estate at Kiriyat Beyalik and in Holon, both of which are leased by Zoko, an ITE subsidiary, for its operations. In Beaton's analysis, this

[176] Tr. 506:5-20.
[177] JX 158 at 142.
[178] The court also notes that under Beaton's optimistic DCF value, Danubius would be a Decile 9 company even in the U.S. Tr. 683-684.

real estate was valued at the book value of 18.8 million NIS, because Beaton felt that any value this land had above book would be consumed if the land were sold and Zoko made to move elsewhere. As the Beaton report explains, "[w]e did not make any adjustment for ITE's real estate assets since the transfer payment to ITE is significantly captured by ITE's majority ownership in Zoko. Because these properties are single purpose assets built to accommodate Zoko's particular operation, any value derived from the sale of these properties over their book value would most likely be consumed by tenant and leasehold improvements of new facilities needed to replace the sold properties."[179] When questioned further at trial about this conclusion, Beaton affirmed his written statement, refusing to put any specific number on Zoko's moving costs other than to say that these costs would be "equal to the value that they believed the properties could be sold for over book value,"[180] no matter what that number might eventually be.[181]

The court cannot accept Beaton's Panglossian approach to valuation. The ITE real estate, as Beaton seems to concede, had some value, apparently above book value. Beaton, for example, entirely discounts the very real possibility, raised by both Nir and Fuller, that ITE would be able to sell the real estate, and the new

[179] JX 311, at 50.
[180] Tr. 622:19-22.
[181] Tr. 623:2-10.

buyer would allow Zoko to remain on the property to the end of its lease in exchange for the rent previously paid to ITE.[182]

On this basis, the court believes that some upward adjustment to book value for the ITE real estate is justified. The only available number to use to derive that value is provided by Nir's preliminary analysis. The number, 51.8 million NIS for the two main properties, is incorporated into Fuller's valuation report as a component of Net PPE, constituting a 33.012 million NIS adjustment to the land's book value.[183] As the court has already held, however, neither Nir's report nor Fuller's use of the report in his calculations is entirely reliable. To the extent the court is compelled to use Nir's report as a starting point, the court believes it should apply a significant discount to that calculation to take into account the fact that Nir failed to sufficiently consider the amount of time it would take to sell the very large Kiriyat Beyalik property, failed to consider the potential expense if Zoko was forced to move or forced to accommodate itself with a new landlord, and failed to consider whether selling the property (and thus forsaking the rent it received from Zoko) would have any effect on ITE's balance sheet.[184]

To reflect those failures, the court will apply a 67% discount to Fuller's and Nir's adjustment to the book value of the Zoko properties. This calculation, which

[182] Tr. 402:3-13.
[183] PX 5, at 17.
[184] Tr. 403:3-6.

reduces Fuller's and Nir's adjustment to 10.89 million NIS, produces a Net PPE value for ITE of 29.69 million NIS. Further, in order to reflect the inherent uncertainty of deriving a value for real estate in this way, the court will apply this adjustment only to the optimistic ITE balance sheet, and not to the conservative valuation.

d. The Zoko Forecasts

In his initial valuation report, Beaton used "the conservative and optimistic forecasts prepared by management for the years 2002 through 2005" in deriving his valuation for Zoko as part of ITE.[185] As Beaton admitted at trial, however, this statement was misleading.[186] Rather, Beaton personally prepared the forecasts used in his valuation for Zoko, purportedly based on management forecasts, but adjusted downward for various reasons having to do with Zoko's business situation as of the valuation date. The court is not persuaded that Beaton's revisions to the Zoko management projections are reliable, and their use would cut against this court's belief that management projections are generally preferable to projections by third parties, especially projections by third parties created after the fact.[187] In deriving

[185] JX 311 at 45.
[186] Tr. 608:7-8.
[187] *See e.g., Doft & Co. v. Travelocity.com*, 2004 Del. Ch. LEXIS 75, *22 (Del. Ch. May 20, 2004) ("Delaware law clearly prefers valuations based on contemporaneously prepared management projections because management ordinarily has the best first-hand knowledge of a company's operations.").

both the conservative and optimistic value for Zoko, therefore, the court has used the management forecasts for that business from 2002 through 2005, and has reflected the resultant values for Zoko in the ITE balance sheet.[188]

e. Value Conclusion

In summary, the court accepts the Beaton valuation with four substantive changes. First, the court rejects Beaton's use of SCRP, and therefore applies no SCRP for any of the IIC companies. Second, the court rejects Beaton's use of a small-size premium for Balton, adopts Beaton's use of that premium for Agrimill, Investor, and Zoko/ITE, and reduces that premium from 5.33% to 2.41% for Danubius. Third, the court rejects, in part, Beaton's belief that the ITE real estate leased to Zoko has no value above book value, and therefore applies an adjustment of 10.89 million NIS to ITE's optimistic balance sheet to reflect the court's view as to the potential value of that land. Finally, the court rejects Beaton's forecast for Zoko, and applies management's forecasts to both the conservative and optimistic valuation of Zoko.

Having made these changes to the Beaton valuation, the court derives a conservative DCF valuation for IIC of $9.55 per share and an optimistic valuation

[188] The new optimistic value for Zoko under this valuation method is in excess of the market capitalization of Zoko, which represented the optimistic value of Zoko under Beaton's valuation. JX 311 at 49. Following Beaton's method of using the highest indicated value for the optimistic value, the court has incorporated that new value into the ITE balance sheet.

of $19.05 per share. The midpoint of these results is $14.30 per share of common stock. The table below shows the effect of each of the four described changes on the conservative, optimistic, and midpoint values of the IIC stock. The table includes a column describing the incremental effect of each change over the value under the immediately previous version of the court's DCF valuation. In other words, the fifth column of the table shows how much the described DCF adjustment adds to the value per share of IIC without that change, but with all changes previously made.

Version of DCF Valuation	***Conservative Value Per Share***	***Optimistic Value***	***Midpoint Value***	***Incremental Change***
Beaton 5/26 Revised Report	$6.22	$12.98	$9.60	-
SCRP removed from WACC for all IIC Companies	$7.29	$15.36	$11.33	$1.73
Small-size Premium for Balton removed from WACC	$7.50	$15.71	$11.61	$0.28
Danubius Small-size Premium Adjustment	$8.68	$18.30	$13.49	$1.88
Zoko Real Estate adjusted in Optimistic ITE BS	$8.68	$18.71	$13.69	$0.20
Zoko Forecasts adjusted to fit Management Forecasts	$9.55	$19.05	$14.30	$0.61

The fact that CP's initial approach to Simon and to the special committee was at $13 per share provides validation for the court's value determination, as does the fact that CP paid $13 per share at one point in what was, admittedly, a

thinly traded market. On that basis, the court will give the DCF approach described above 100% weight in its final value determination, and will thus award $14.30 per common share.

E. The Question Of Simon's Liability

As explained above, the plaintiff has brought claims not only against CP and IIC, but against the former directors of IIC, namely Schreier, Smith, Levy, Glatter, and Simon, as individual defendants. All the individual defendants other than Simon implicitly concede, by failing to raise any affirmative defenses, that they cannot claim exculpation under Article Tenth of IIC's certificate of incorporation, the company's Section 102(b)(7) provision.[189]

Alone among the individual defendants, Simon claims that his actions in negotiating and approving the unfair CP/IIC merger are exculpated under Article Tenth. Even if the IIC merger was unfair, as this court has already concluded, and even if he breached his duty of care in authorizing that unfair merger, Simon argues that he neither violated his fiduciary duty of loyalty nor failed to evidence good faith in any way.[190] Therefore, Simon believes that he has access to Section 102(b)(7) as an affirmative defense, and cannot be liable for monetary damages.

[189] All these defendants clearly have personal financial interests in the CP/IIC merger, and therefore cannot avail themselves of Section 102(b)(7) exculpation.
[190] Pl.'s Opening Post-Trial Br. 38.

Section 102(b)(7) was added to Delaware law in 1986 in the wake of the landmark case, *Smith v. Van Gorkom.*[191] It provides that corporations may limit the personal liability of directors for all breaches of fiduciary duty other than for "breach of the duty of loyalty, failure to act in good faith, intentional misconduct," and certain other violations. Crucially, Section 102(b)(7) is regarded as an affirmative defense or limited immunity. Therefore, in an entire fairness case where the court has found that a challenged transaction is not entirely fair, a director seeking to rely on the exculpatory provision must show that any liability of his is "exclusively attributable to a violation of the duty of care."[192]

Our courts have issued numerous opinions describing the line between violations of the duty of care, which can be exculpated under Section 102(b)(7), and violations that preclude exculpation under that provision.[193] In the context of the instant case, the most pertinent of these decisions is this court's recent opinion in *Emerging Communications,* a case that similarly involved a parent-subsidiary merger, found to have failed the entire fairness test, where each of the directors raised the defense to liability of Section 102(b)(7). The court explained the standard for Section 102(b)(7) and then proceeded to examine each director's conduct in turn. The court found that one director, who was also the majority

[191] 488 A.2d 858 (Del. 1985).
[192] *Emerging Commc'ns,* 2004 Del. Ch. LEXIS at 70.
[193] FOLK, *supra* note 91, at § 102.15.

stockholder of the parent entity gaining from the entire fairness transaction, was "liable in his capacity as a director for breach of his duty of loyalty, conduct that is not exculpated under [Section 102(b)(7)]."[194] That director was not exculpated because he "derived an improper personal benefit"[195] from the transaction, another express carve-out in Section 102(b)(7). That is to say, the fact that the unfair transaction directly benefitted that director took him outside the realm of exculpation.

The court found that a second director was liable for the same reasons, because his economic interests were so intertwined with those of the controlling stockholder that he clearly violated either his fiduciary duty of loyalty or evidenced a lack of good faith.[196] A third director was also held culpable despite Section 102(b)(7) because he knew or should have known, on the basis of his extensive knowledge of the relevant industry and his financial expertise, that the price was unfair.[197] Although the court conceded that it could not divine the director's mental state when he made the decision to vote for the merger, it held that the director was liable for damages because of the burden of proof imposed by Section 102(b)(7) on a director seeking to avail himself of the statute's protections. The

[194] *Emerging Commc'ns*, 2004 Del. Ch. LEXIS at *140.
[195] *Id.*
[196] *Id.* at *142.
[197] *Id.* at *144.

possibility [that the director was acting in good faith] is "not sufficient to carry the day, because to establish a director's exculpation from liability under 8 *Del. C.* § 102(b)(7), the burden falls upon the director to show that 'his failure to withstand an entire fairness analysis is exclusively attributable to a violation of the duty of care.'"[198]

Finally, the court found certain other directors to have proved that they were entitled to Section 102(b)(7) protection. The court found that no evidence showed that those directors "affirmatively colluded with [the controller] to effectuate the [p]rivatization, or that they otherwise deliberately engaged in conduct disloyal to the minority stockholders' interests."[199] The court considered the plaintiffs' allegations that the directors had participated in a "scripted minuet" to approve an unfair price, but found that there was no evidence in that case that the directors "actually engaged in such improperly motivated conduct, or otherwise acted with disloyal intent."[200] The court also noted that if good faith meant adopting a "'we don't care about the risks attitude' concerning a material corporate decision,"[201] the plaintiffs had also failed to show that those particular defendants had acted with conscious disregard or made decisions with knowledge that they lacked material

[198] *Id.* at *145-146.
[199] *Id.* at *148.
[200] *Id.* at *152.
[201] *Id.* at *153.

information. Therefore, those directors were exculpated from liability under Section 102(b)(7).

The facts in this case closely resemble those at issue in *Emerging Communications*. At the threshold, the challenged merger is clearly unfair. Further, just as in *Emerging Communications*, the director seeking exculpation violated his fiduciary duty of due care in approving the unfair merger. Therefore, this court is faced only with the question of whether the director violated his fiduciary duty of loyalty or acted with a lack of good faith.[202] After careful consideration, the court finds that, like the independent directors in *Emerging Communications,* Simon is entitled to the benefit of Section 102(b)(7) exculpation.

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[202] Simon also claims that "the fact that [he] did not vote in favor of the Merger [but rather was absent for scheduling reasons from the IIC board meeting that approved the transaction] is fatal to plaintiff's claims against him." Simon's Post-Trial Opening Br. 17. The case on which Simon relies for this proposition, however, does not support his position. In *In re Tri-Star Pictures, Inc. S'holders Litig.*, 1995 Del. Ch. LEXIS 27, *8 (Del. Ch. Mar. 9, 1995), this court noted that a director who plays "no role" in a challenged transaction cannot be held liable on a claim that the board's approval of that transaction was unlawful. But the court also recognized that "no per se rule unqualifiedly and categorically relieves a director from liability solely because that director refrains from voting on the challenged transaction." *Id.* at *8. Ultimately, the court in that case concluded that certain directors who had no "role, open or surreptitious, in formulating, negotiating, or facilitating the transaction complained of," could not be held liable. Nor did those directors have some "fiduciary duty not to abstain" from voting on such a transaction. In this case, by contrast, Simon was closely involved with the challenged merger from the very beginning. Its completion was literally premised on his involvement, and this court's conclusion that the transaction was unfair is based, in large part, on Simon's failures to properly conduct the parent-subsidiary negotiation. Simon's contention, therefore, that he cannot be held liable for the unfair merger because he was away at a fraternity reunion on the day of the vote, is, frankly, badly mistaken, and is entirely outside the scope of the limited defense envisioned in *Tri-Star*.

The court finds no evidence that Simon was personally conflicted in the CP/IIC transaction, or derived a personal benefit from that transaction to the exclusion of the minority stockholders. Nor did any evidence adduced at trial show that Simon "affirmatively colluded" with Filer, Schreier, and IIC in their scheme to squeeze out the IIC minority at an unfair price. To the extent that such a plan existed, as demonstrated by the May 17 email, Simon was not included in the inner circle. Whatever Simon's liability, therefore, the case against him does not rest on allegations of deliberate or self-interested misconduct.

The question remains whether Simon's conduct betrays that he knew or should have known that the merger process and price was unfair. But, unlike the director found culpable on that basis in *Emerging Communications*, the evidence adduced at trial here shows that Simon was unaware of the key facts that made the merger transaction so clearly unfair from a procedural point of view. Always laboring under CP's efforts to deprive him of information, Simon failed to discover that Jesup & Lamont had divided loyalties and had funneled crucial information to Filer and CP that belonged to the special committee. Similarly, although he knew that Ottensoser was retained by IIC, Simon apparently failed to discover until this litigation began that Ottensoser had also been engaged by CP in connection with the transaction. His ignorance of that key fact ensured that Simon could not appreciate the serious and evident conflicts of interest that burdened Ottensoser's

representation of the special committee. And Ottensoser did nothing to remedy Simon's misconception.

As to fair price, it is true that Simon knew about the $13 price authorized on May 24, 2001, and unaccountably failed to ask for it during the negotiations for the initial tender offer. Whether that failure would have evidenced a lack of good faith had the tender offer been successful in securing 90% ownership for CP, it seems likely that the same price was not available some months later in connection with the merger. In contrast, Simon was able to achieve a price above the midpoint of the flawed Jesup & Lamont valuation, which, though still unfair, evidences some good faith effort to negotiate with CP within the disabling strictures of CP's unfair merger process.

In short, the evidence adduced at trial shows that Simon attempted to fulfill his responsibilities as the sole member of the special committee, but failed to do so effectively in part as a result of carelessness and negligence, through which he failed to fulfill his duty of due care, and in part because of the manipulative efforts of the controlling stockholder and its agents to squeeze out the minority at an unfair price. Like those directors found to be exculpated in *Emerging Communications*, in other words, Simon did nothing during the CP/IIC merger

process to "[cover] himself in glory, or merit commendation."[203] But it is equally true that "negligent or even gross negligent conduct does not equate to disloyalty or bad faith," and nothing in the record in this case suggests that Simon "intentionally conspired . . . to engage in a process that would create the illusion, but avoid the reality, of arm's length bargaining to obscure the true purpose of benefitting [CP] at the expense of the minority . . . ."[204] In hindsight, the court believes that a more diligent independent director would have uncovered the controlling stockholder's nefarious plan to conclude an unfair merger. But to impose liability for a lack of good faith based on those facts would expand the holding of *Emerging Communications* beyond that required to protect the IIC stockholders' expectations, as evidenced by their decision to extend protection under Section 102(b)(7) to their directors. As such, holding Simon personally liable in this case would be fundamentally inconsistent with the purpose and language of Section 102(b)(7).

IV.

For the reasons set forth herein, the court finds that the defendants have failed to prove that the IIC merger was a product of fair dealing, or that the merger consideration of $10.50 was a fair price, and therefore have failed to prove the

[203] *Emerging Commc'ns*, 2004 Del. Ch. LEXIS at *149.
[204] *Id.* at *153.

entire fairness of the merger transaction. Consequently, the court exercises its equitable powers to award the appraisal claimants $14.30 per share, and all other claimants the difference between the merger price and $14.30 per share. This damages award will include pre-judgment interest at the legal rate, compounded quarterly. Finally, the court finds that Simon has proved his entitlement to exculpation under Section 102(b)(7), and is therefore not liable for the damages the court assigns in this case. IT IS SO ORDERED.

T.C. Memo. 2011-141

UNITED STATES TAX COURT

ESTATE OF NATALE B. GIUSTINA, DECEASED,
LARAWAY MICHAEL GIUSTINA, EXECUTOR, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 10983-09. Filed June 22, 2011.

D. John Thornton and Kevin C. Belew, for petitioner.

Kelley A. Blaine, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

MORRISON, Judge: The IRS issued a notice of deficiency determining (1) a $12,657,506 deficiency in estate tax and (2) a $2,531,501 accuracy-related penalty under section 6662 of the Internal Revenue Code.[1] The notice of deficiency was issued to

[1]Unless otherwise indicated, all citations of sections refer (continued...)

Laraway Michael Giustina ("Larry Giustina"), the executor of the estate of his deceased father, Natale B. Giustina. Larry Giustina brings this case pursuant to section 6213(a), asking this Court to redetermine the deficiency. We refer to Larry Giustina as "the estate" when referring to him in his capacity as a party to this case. The two issues for decision are:

(1) the value of the 41.128-percent limited partner interest in Giustina Land & Timber Co. Limited Partnership owned by Natale Giustina at his death on August 13, 2005 (the estate contends the value is $12,995,000, but the IRS contends the value is $33,515,000);[2] and

(2) whether the estate is liable for the section 6662 accuracy-related penalty.[3]

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[1](...continued)
to the Internal Revenue Code (26 U.S.C.) as in effect for the date of death, and all citations of Rules refer to the Tax Court Rules of Practice and Procedure.

[2]Although the 41.128-percent limited partner interest was owned by a trust, rather than by Natale Giustina directly, the estate concedes that the value of the partnership interest must be included in the gross estate. For convenience, we sometimes discuss the partnership interest as if it was held by Natale Giustina rather than through the trust.

[3]The parties have stipulated that the marital deduction at issue is a computational issue and that the amount of the allowable marital deduction will depend on the value of the 41.128-percent limited partner interest in Giustina Land & Timber Co. owned by Natale Giustina at his death on Aug. 13, 2005. The parties also stipulated that administrative expenses incurred by the estate shall be allowable to the extent substantiated.

We find that the value of the partnership interest is $27,454,115 and that the estate is not liable for the penalty.

FINDINGS OF FACT

1. Introduction

The parties stipulated some facts; those facts are so found. Larry Giustina resided in Eugene, Oregon, when the petition was filed. The decedent, Natale Giustina, was born in 1918 and died on August 13, 2005, at the age of 87. He was a resident of Eugene, Oregon, when he died, and his estate is administered in the State of Oregon.

Natale Giustina was the trustee of the N.B. Giustina Revocable Trust.[4] The trust owned a 41.128-percent limited partner interest in Giustina Land & Timber Co. Limited Partnership. This partnership is sometimes referred to here as "the partnership".

2. History of the Giustina Family and Its Business: 1917 to 1989

Erminio Giustina was the father of Natale Giustina, the decedent. In the summer of 1917, Erminio Giustina and two of his brothers entered the lumber industry. The three brothers bought a lumber mill in Molalla, a small town in Clackamas County, Oregon. In the 1920s the brothers moved their base of operations to Lane County, Oregon, where they were joined by another

[4]Natale Giustina's middle initial was "B".

brother, Anselmo. Over time, the Giustina family bought land and mills around Eugene, the largest town in Lane County. The family business was operated through several entities.

Until the 1960s the family timberlands were held by Giustina Bros., a partnership. In the 1960s the timberlands that contained young trees were transferred from Giustina Bros. to a newly formed partnership called Giustina Timber Co. The shares of Giustina Timber Co. were then transferred to heirs of the original four brothers. The mills, meanwhile, were owned by Giustina Bros. Lumber & Plywood, a corporation that employed 200 people.

For many years the family business was run by Natale Giustina and his brother, Ehrman Giustina. The Giustina family eventually sold all of its mills. By 1988 the Giustina family's business holdings consisted primarily of timberlands owned by Giustina Bros. and by Giustina Timber Co.

3. Formation of Giustina Land & Timber Co. in 1990

By the time the mills closed, the family business was managed by two family members: Larry Giustina, who was the son of Natale Giustina, and Dan Giustina, who was the son of Ehrman Giustina. The two cousins found that their managerial roles were redundant and that they had conflicting ideas about how to run the business. They therefore proposed to divide the family properties so that they each would manage separate properties.

Their proposal was adopted by the other members of the family. As a result, the assets of the family business entities, Giustina Bros., Giustina Timber Co., and Giustina Bros. Lumber & Plywood, were transferred to three new partnerships, each of which was owned by a separate set of Giustina family members.

The first new partnership was Giustina Land & Timber Co. Limited Partnership. This partnership received 51.875 percent of the assets of (1) Giustina Bros. and (2) Giustina Timber Co. The parties have stipulated that this partnership was owned by "the Natale Giustina and Anselmo Giustina families, as well as another relative named Dolores Fruiht". The value of a 41.128-percent limited partner interest in this partnership is the major issue in this case.

The second new partnership was Giustina Resources. This partnership received 30.625 percent of the assets of (1) Giustina Bros. and (2) Giustina Timber Co. The parties have stipulated that this partnership was owned by "members of the Ehrman Giustina family". It was operated by Dan Giustina.

The third new partnership was Giustina Woodlands. It received 17.5 percent of the assets of (1) Giustina Bros. and (2) Giustina Timber Co. The parties have stipulated that this partnership was owned by "the Greg Giustina family".

The extended Giustina families made every effort to ensure not only that the assets were divided according to each family's

proportionate ownership interests in Giustina Bros. and Giustina Timber Co., but also that the timber species, revenues, and income were divided in the same manner. Even though substantially all of its assets were distributed, the Giustina Bros. partnership remained in existence. All of the assets of Giustina Timber Co. were distributed.

4. Operations and Ownership of Giustina Land & Timber Co.

Giustina Land & Timber Co. was formed effective January 1, 1990. The partnership was governed by a written partnership agreement from the day the partnership was formed. The agreement has been amended several times since then. Unless otherwise noted, all provisions of the partnership agreement that we discuss were in effect when Natale Giustina died in August 2005.

The partnership agreement provides that the general partners have full control over the business of the partnership. The general partners have the power to sell the partnership's timber, land, and other property. The general partners also have the power to make distributions of cash or property to the partners in proportion to each partner's respective interest in the partnership. All decisions of the general partners must be made with the concurrence of a majority of the general partners.

The partnership agreement initially provided that the general partners were Larry Giustina and Ansel James Giustina, their survivors, and any other person admitted to the partnership

as an additional general partner in accordance with the provisions of the agreement. Ansel James Giustina is the son of Anselmo Giustina. We refer to him as James Giustina.

The partnership agreement allows a general partner to voluntarily resign. A general partner can be removed by the concurrence of limited partners owning two-thirds of the interests in the partnership. If a general partner resigns or is removed, a successor general partner may be designated by the limited partners owning two-thirds of the interests in the partnership. An additional general partner can be admitted to the partnership if all the partners consent to the admission.

The partnership agreement allows a limited partner interest to be transferred to (1) another limited partner, (2) a trust for the benefit of a limited partner, or (3) any other person approved by the general partners. A limited partner may not withdraw from the partnership unless all of the limited partner's interests have been transferred.

The partnership agreement provides that the partnership will continue to exist until December 31, 2040, unless the partnership is terminated earlier pursuant to section 12.2 of the partnership agreement. Section 12.2 provides that the partnership shall be dissolved: (1) automatically on December 31, 2040, (2) if the limited partners fail to designate a successor general partner within 90 days after the resignation or removal of the sole

general partner, or (3) if the limited partners owning two-thirds of the interests in the partnership vote to dissolve the partnership. If the partnership is dissolved, its affairs must be wound up, its assets may be sold, and its assets and any proceeds from the sale of assets must be distributed to its partners in accordance with their capital accounts.

Schedule A of the original partnership agreement listed the limited partners when the partnership was formed in 1990:

Limited Partner	Number of Units
N.B. Giustina	44.128
Anselmo Giustina	31.940
Dolores Giustina Fruiht	4.809
Natalie Giustina Newlove	4.198
L.M. Giustina	3.195
Irene Giustina Goldbeck	4.198
Sylvia B. Giustina	3.266
A.J. Giustina	2.266
Total	98.000

Each general partner owned one unit in his capacity as a general partner. N.B. Giustina refers to Natale Giustina, the decedent. Anselmo Giustina died in 1993. Dolores Giustina Fruiht's exact relationship to the other partners is not revealed by the record. Natalie Giustina Newlove is a daughter of Natale Giustina. L.M. Giustina, we infer, refers to Larry Giustina, i.e., Laraway Michael Giustina. Irene Giustina Goldbeck is a daughter of

Natale Giustina. Sylvia B. Giustina, we infer, is the sister of James Giustina and the daughter of Anselmo Giustina. A.J. Giustina refers to James Giustina, i.e., Ansel James Giustina.

A buy-sell agreement, dated November 21, 1994, bars a limited partner from transferring a partnership interest unless (1) the transfer is to a member of the transferring partner's family group, or (2) the transferring partner offers the other limited partners the right of first refusal. For these purposes, there are three family groups:

- "Sylvia B. Giustina, A.J. Giustina, children of Sylvia B. Giustina, and children of A.J. Giustina."
- "N.B. Giustina, Natalie Giustina Newlove, L.M. Giustina, Irene Giustina Goldbeck, and children of Natalie Giustina Newlove, L.M. Giustina, and Irene Giustina Goldbeck."
- "Dolores Giustina Fruiht, her children, and grandchildren."

The provisions of the buy-sell agreement were in effect in August 2005.

On January 1, 2002, Larry and James Giustina resigned as general partners. Each was replaced by a limited liability company. LMG, LLC, is controlled by Larry Giustina. AJG, LLC is controlled by James Giustina.

Some transfers of limited partner interests occurred after formation of the partnership. The parties stipulated that as of August 13, 2005, the partnership had the following owners:

Ownership of Giustina Land & Timber Co.
as of Aug. 13, 2005

	Percentage Interest
General Partners:	
LMG, LLC	1.000
AJG, LLC	1.000
Limited Partners:	
N.B. Giustina, Trustee of the N.B. Giustina Revocable Trust	41.128
Sylvia B. Giustina	17.236
A.J. Giustina	16.236
Natalie Giustina Newlove	5.198
Irene Giustina Goldbeck	5.198
Dolores Giustina Fruiht	4.809
L.M. Giustina	4.195
Anselmo Giustina Family Trust	4.000
Total	100.000

Under the terms of the N.B. Giustina Revocable Trust agreement, Natale Giustina had the right to revoke the trust or to withdraw the principal and accumulated income of the trust estate. The terms of the trust agreement required that the trust's 41.128-percent limited partner interest be distributed as follows at Natale Giustina's death: 17 percent to Natalie

Giustina Newlove, 17 percent to Larry Giustina, 17 percent to the Irene Giustina Goldbeck Trust, and 49 percent to the N.B. Giustina Marital Trust.

By August 13, 2005, Giustina Land & Timber Co. owned 47,939 acres of timberland in the area of Eugene, Oregon. It employed approximately 12 to 15 people. Three or four worked in forestry; four worked on the roads crew; and six worked at administrative tasks. Although James Giustina and Larry Giustina both controlled general partners of the partnership (their respective LLCs), the primary decisions regarding the management of the timber were made by Larry Giustina. James Giustina provided assistance to Larry Giustina in the decisionmaking.

5. Tax Reporting, Notice of Deficiency, and Positions of the Parties

Natale Giustina died on August 13, 2005. He was survived by his spouse, Jacqueline L. Giustina, and his three children: Natalie Giustina Newlove, Larry Giustina, and Irene Giustina Goldbeck. On the estate tax return, the value of the 41.128-percent limited partner interest was reported to be $12,678,117. On April 3, 2009, the IRS issued the notice of deficiency determining a $12,657,506 deficiency and a $2,531,501 accuracy-related penalty under the provisions of section 6662. The notice of deficiency determined that the value of the 41.128-percent limited partner interest was $35,710,000. The notice made a computational adjustment to the marital deduction claimed on the

return. At trial, the IRS contended that the value of the limited partner interest was $33,515,000 (a lesser amount than it had earlier determined). The estate contended that the value of the limited partner interest was $12,995,000 (a greater amount than it had reported on its return).

OPINION

Generally, the taxpayer has the burden of disproving the determinations in the IRS notice of deficiency. Rule 142(a)(1). The IRS has the burden of proof regarding any factual issue for which the taxpayer has presented credible evidence and met other requirements. Sec. 7491(a)(1). Our conclusions, however, are based on a preponderance of the evidence, and thus the allocation of the burden of proof is immaterial. See Martin Ice Cream Co. v. Commissioner, 110 T.C. 189, 210 n.16 (1998).

1. Introduction

Each party called an expert witness to opine on the value of the 41.128-percent limited partner interest. Of the methods used by the expert witnesses, we believe that there are two appropriate methods that are helpful in valuing that interest. The first method (the cashflow method) is based upon how much cash the partnership would be expected to earn if it had continued its ongoing forestry operations. The operations, which consisted of growing trees, cutting them down, and selling the logs, have historically generated almost all of the partnership's

cashflows. The second valuation method (the asset method) is based upon the value of the partnership's assets if they were sold. The value of the timberlands, which constitute most of the partnership's assets, is agreed to be $142,974,438. The value includes a 40-percent discount for the delays attendant to selling the partnership's approximately 48,000 acres of timberland.

2. The Cashflow Method

a. The Expert Witnesses

Both expert witnesses relied in part on the cashflow method to determine the value of Natale Giustina's interest in the partnership. John Thomson, the IRS expert, estimated that the partnership's annual cashflow would be $9,979,969 in the first year after Natale Giustina's death. He estimated that the total future cashflows, once discounted to present value, would be $65,760,000. Robert Reilly, the estate's expert, estimated that annual cashflow would be $4,560,000 in the first year after Natale Giustina's death. He estimated that the total future cashflows, once discounted to present value, would be $33,800,000.

b. Calculation of Cashflows

Thomson's cashflow estimates were not persuasive. First, as Reilly explained on pages 17-18 of his rebuttal report, there was an internal inconsistency between Thomson's cashflow estimates

and his calculation of the effect of lack of control on the value of the 41.128-percent limited partner interest. The inconsistency led Thomson to overvalue it. Second, Thomson unrealistically assumed that the partnership's operating expenses would remain fixed, even though he projected that its revenues would increase 3 percent annually. Third, Thomson's estimate of annual cashflows was extrapolated from the actual cashflow results of the most recent year. By contrast, Reilly extrapolated from the cashflow results of five consecutive years. Reilly's use of five years of data is sounder because it reduces the effect of a temporary variation in cashflow. But Reilly's application of the cashflow method to value the partnership interest has its own problems. As we explain, however, his computations can be adjusted.

One problem with Reilly's computations is that he reduced each year's predicted cashflows by 25 percent to account for the income taxes that would be owed by the owner of the partnership interest on that owner's share of the partnership's income. The 25-percent reduction is inappropriate because the rate at which Reilly discounted the cashflows to present value was a pretax rate of return, not a posttax rate of return. An appraiser should not reduce cashflows by income tax while simultaneously using a pretax rate of return to discount the cashflows to present value. Gross v. Commissioner, T.C. Memo. 1999-254, 78

T.C.M. (CCH) 201, 209, affd. 272 F.3d 333 (6th Cir. 2001). Thus, Reilly's cashflow estimates must be recomputed to eliminate the 25-percent discount for income tax liability.

c. The Discount Rate

Another problem with Reilly's application of the cashflow method is that the rate at which he discounted the cashflows to present value--18 percent--was too high. As we explain below, the discount rate should be 16.25 percent.

Reilly's 18-percent discount rate had four components. Only the fourth needs to be corrected. The first component was the risk-free rate. Reilly assumed that the risk-free rate was the 4.5-percent rate of return earned by owners of 20-year U.S. Treasury bonds.

The second component of Reilly's discount rate was a beta-adjusted equity risk premium. According to Reilly, beta is a "measure of the systematic risk (i.e., risk relative to returns in a measure of the overall equity market, such as the S&P 500 index) inherent in a company's investment returns." Reilly determined that the risk premium for an equity investment in the S&P 500 common stock index was 7.2 percent. Reilly estimated that the beta for an investment in companies in the timber industry was 0.56. He then estimated that a beta of 0.5 was appropriate for the partnership because it had less debt than

other timber companies. He therefore calculated a beta-adjusted risk premium of 3.6 percent (7.2 percent x 0.5).

The third component of Reilly's discount rate was a small stock equity risk premium. Reilly estimated that this component was 6.4 percent. Reilly calculated that an investment in a small company, defined as a company with a total equity capitalization between $1.4 million and $263 million, had an annual return of 6.4 percent above the overall equity risk premium exhibited by the S&P 500 common stock index.

The fourth component of Reilly's 18-percent discount rate was a partnership-specific risk premium of 3.5 percent. Reilly explained that this risk premium was justified because the partnership's timberlands were not geographically dispersed. All were in Oregon. He also explained that the partnership's operations were nondiversified. The partnership's sole source of revenue was timber harvesting. Thus, it is apparent that a portion of the 3.5-percent premium reflects the unique risks of the partnership. But unique risk does not justify a higher rate of return. Investors can eliminate such risks by holding a

diversified portfolio of assets.[5] We conclude that the partnership-specific risk premium should be only 1.75 percent.

After this adjustment is made, the correct discount rate is 16.25 percent. This is equal to the sum of 4.5 percent, 3.6 percent, 6.4 percent, and 1.75 percent.[6]

Reilly reduced his 18-percent discount rate by 4 percent to reflect his assumption that cashflows would increase by 4 percent each year. After making this reduction, his "direct capitalization rate" was 14 percent. We have no dispute with the

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[5]Richard A. Brealey and Stewart C. Myers explain:

> The risk that potentially can be eliminated by diversification is called unique risk. Unique risk stems from the fact that many of the perils that surround an individual company are peculiar to that company and perhaps its immediate competitors. But there is also some risk that you can't avoid, regardless of how much you diversify. This risk is generally known as market risk. Market risk stems from the fact that there are other economywide perils that threaten all businesses. * * *

Brealy & Myers, Principles of Corporate Finance 168 (7th ed. 2003) (fn. refs. omitted); see also Booth, "The Uncertain Case for Regulating Program Trading", 1994 Colum. Bus. L. Rev. 1, 28 ("Because diversification can eliminate the unique risks associated with investing in individual companies, the market pays no additional return to those who assume such risks.").

[6]The discount rate Thomson used in his cashflow method, 16.22 percent, is almost equal to the 16.25-percent rate that we find to be the appropriate discount rate. Thomson's discount rate was equal to: (1) a 4.52-percent risk-free rate, plus (2) an 11.7-percent equity risk premium paid for small stocks (i.e., stocks in the fifth capitalization quintile of companies traded on the New York Stock Exchange for 1926-2004). We did not use Thomson's method of determining a discount rate.

4-percent assumption. Therefore, the 16.25-percent discount rate should be reduced by 4 percent, resulting in a direct capitalization rate of 12.25 percent.

d. Value of Marketable Noncontrolling Interests in the Partnership

Using the cashflow method, Reilly determined that the value of 100 percent of the interests of the partnership (on a freely marketable basis) is equal to the discounted present value of the cashflows. Reilly estimated that the discounted present value of the cashflows was $33,800,000, but our adjustments result in an estimate of $51,702,857. The adjustments are set forth in the table below:

Valuation of All Partnership Interests on a Marketable Basis Using the Cashflow Method

	Reilly's Calculations in Exhibit 10 of His Report	As Adjusted by Court
Normalized pretax income	$6,120,000	$6,120,000
Normalized net income (normalized pretax income reduced 25% by Reilly for income taxes)	$4,590,000	$6,120,000
Total adjustments to estimated cashflow	-$30,000	-$30,000
Normalized net cashflow	$4,560,000	$6,090,000
Projected normalized net cashflow (normalized net cash flow, increased by long-term growth rate of 4%)	$4,743,000	$6,333,600
Direct capitalization rate	14%	12.25%
Total equity value on a marketable, noncontrolling ownership interest basis (Reilly's estimate is rounded)	$33,800,000	$51,702,857

e. Discount for Marketability

Reilly discounted the cashflows in order to reflect the inability of the owner of the 41.128-percent limited partner interest to easily sell it. This discount for lack of marketability is 35 percent in Reilly's view.[7] Thomson's lack-of-marketability discount was only 25 percent. Both Reilly and Thomson formed their opinions from two types of studies: (1) restricted-stock studies and (2) pre-IPO studies. Thomson relied more on the restricted-stock studies because, he testified, the pre-IPO studies "tend to overstate their discount for just lack of marketability". In particular, Thomson relied on the SEC Institutional Investor Study, a restricted-stock study that showed an average discount of 26.4 percent. Reilly relied more on the pre-IPO studies than the restricted-stock studies. Reilly did not rebut Thomson's testimony that the pre-IPO studies overstated the discount for lack of marketability. We therefore adopt Thomson's marketability discount of 25 percent.

f. Weight Given to the Cashflow Method

Reilly gave a 30-percent weight to the cashflow method.[8] Thomson gave the cashflow method a weight of 20 percent. In our view, the cashflow method is appropriate to reflect the value of

[7]Reilly testified that 25 percent was also reasonable.

[8]Reilly referred to the cashflow method as the direct capitalization method.

the partnership if it is operated as a timber company, and the asset method is appropriate to reflect the value of the partnership if its assets are sold. Accordingly, the percentage weight to be accorded the cashflow method should be equal to the probability that the partnership would continue to be operated as a timber company.

We believe that there was a 75-percent probability that the partnership would have continued its operations rather than liquidating its assets. The Giustina family had a long history of acquiring and retaining timberlands. We take this into account, but we also assume that the owner of the 41.128-percent limited partner interest is a hypothetical third party, see sec. 25.2512-1, Gift Tax Regs., who seeks the maximum economic advantage from the asset.[9] As Reilly testified, the optimal strategy to maximize the value of the partnership would be to sell the timberland and "get $143 million today." Selling the timberlands would generate about $143 million; continuing to operate the partnership would generate only about $52 million.

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[9]As we said in Estate of Davis v. Commissioner, 110 T.C. 530, 535 (1998) (citations omitted):

> The willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the individual characteristics of these hypothetical persons are not necessarily the same as the individual characteristics of the actual seller or the actual buyer. The hypothetical willing buyer and the hypothetical willing seller are presumed to be dedicated to achieving the maximum economic advantage.

Reilly opined that the value of the timberlands is irrelevant because a holder of Natale Giustina's interest could not unilaterally force the sale of the partnership's assets. It is true that the owner of a 41.128-percent limited partner interest could not alone cause the partnership to sell the timberlands. However, there are various ways in which a voting block of limited partners with a two-thirds interest in the partnership could cause the sale. The members of such a voting block could replace the two general partners, who have the power to sell assets and make distributions. Alternatively, a two-thirds voting block could dissolve the partnership, an act that must be followed by the distribution of the partnership's assets. We are uncertain how many partners would share the view that the timberland should be sold. The uncertainty does not prevent us from estimating the probability of the sale:

> The entire valuation process is a boundless subjective inquiry: To value an asset the court has to make guesses or assumptions about the future. These inquiries require speculation about the composition of management * * *

Repetti, "Minority Discounts: The Alchemy in Estate and Gift Taxation", 50 Tax L. Rev. 415, 445 (1995). Some of these family members would perhaps prefer that the partnership remain in operation. But people also tend to prefer $143 million to $52 million, or, in this case, a share of $143 million to a share of $52 million. We believe that there is a 25-percent probability

that a sufficient number of limited partners would cause the sale of the partnership's assets.

Conversely, there was a 75-percent probability the timberlands would not be sold. We assign a weight of 75 percent to the value of the partnership as measured by the cashflow from its continued operations.

3. Asset Method

a. Significance of Value of Timberlands and Other Assets

The timberland assets of the partnership were worth approximately $143 million. The total assets of the partnership were worth $150,680,000, according to an estimate by Thomson that is essentially unchallenged by the estate. Therefore, we assume that if the partnership had liquidated its assets and distributed the proceeds to the partners, the amount of the distribution would have been $150,680,000. This figure should be weighted by the 25-percent probability that the partners would have caused the sale of the timberlands and other assets.

b. No Discount for Lack of Control

In determining the value of the 41.128-percent limited partner interest if the timberland assets were sold, it is not appropriate to subtract a discount for the inability of the owner to control the affairs of the partnership. The IRS expert, Thomson, applied a lack-of-control discount of 12 percent. However, our calculations already assume that there was a

75-percent chance that the owner of the interest would have been unable to garner enough support from the other limited partners to sell the timberland. The inability to cause the sale of the timberland is an aspect of the lack of control.[10] Thus, lack of control is already reflected by the 75/25 percentage weighting. No additional discount is needed.

c. No Discount for Lack of Marketability

In calculating the value of the partnership interest if the assets were sold, it is not appropriate to subtract a discount for lack of marketability. A discount for lack of marketability reflects the inability of the owner of a business enterprise to quickly sell the interest.[11] But in valuing the partnership interest as if there were a sale of the timberlands, we have

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[10] James R. Repetti writes:

> Additional benefits of control, however, become available only as the percentage of stock ownership increases. For example, many state statutes require a two-thirds vote of shareholders to liquidate a corporation, sell substantially all the corporation's assets, merge the corporation or amend the certificate of incorporation. The ability to compel liquidation of a corporation or sale of its assets may be valuable if the value of the corporation's assets exceeds the value of its ongoing business. * * *

"Minority Discounts: The Alchemy in Estate and Gift Taxation", 50 Tax L. Rev. 415, 426-427 (1995) (fn. refs. omitted).

[11] As Reilly testified: "The concept of investment marketability relates to the liquidity of an investment--that is, how quickly and certainly the investment can be converted into cash at the owner's discretion."

assumed that the timberland could be sold for $143 million, a stipulated value that includes a 40-percent discount to reflect the delays in selling the land. It would be a double discount to reduce the value further to reflect the delays in selling the partnership interest.

4. Value of the 41.128-Percent Limited Partner Interest

In our view, the value of all interests in the partnership is equal to (75% x $51,702,857) + (25% x $150,680,000), or $76,447,143. The discount for lack of marketability (which is applicable only to the value of the partnership interest as if the partnership continued operations, not to the value as if the timberland is sold, see supra Opinion parts 2.e and 3.c) is equal to 25% x (75% x $51,702,857), or $9,694,286. This discount reduces the value to $66,752,857. Multiplying $66,752,857 by 41.128 percent equals $27,454,115, which we conclude is the correct value of the partnership interest in question. These calculations can be compared to the approaches taken by the two expert witnesses as set out in the following chart:

Valuation of the 41.128-Percent Limited Partner Interest:
Comparison of Approaches

	Reilly (Estate Expert)	Thomson (IRS Expert)	Court
Methods and adjustments			
Asset-accumulation method	10% x $51,100,000	--	--
Cashflow method	30% x $33,800,000	20% x $65,760,000	75% x $51,702,857
Capitalization-of-distributions method	30% x $52,100,000	--	
Price-of-shares-of-other-companies method	30% x $59,100,000	20% x $99,550,000	--
Asset method		60% x $150,680,000	25% x $150,680,000
Total	$48,610,000	$123,470,000	$76,447,143
Discount for lack of marketability	35%	25%	25% (applied to value from cash-flow method only, for a weighted discount of $9,694,286)
Discount for lack of control	0%	12%	0%
Total after discounts	$31,597,000	$81,490,200	$66,752,857
X 41.128%	$12,995,000	$33,515,000	$27,454,115

5. Valuation Methods That We Did Not Adopt

a. Reilly's Capitalization-of-Distributions Method

The estate's expert witness, Reilly, attributed a 30-percent weight to the value given by the capitalization-of-distributions method. Using this method, Reilly estimated the present value of the distributions that he expected the partnership to make to the partners. We did not attribute independent weight to this method for two reasons. First, the cash earned by the partnership is a more reliable indicator of value than the cash distributed to the partners.[12] Second, the capitalization-of-distributions method and the cashflow method share the assumption that the partnership would remain in operation and not liquidate its timberland holdings. In this respect the methods are duplicative.

b. Reilly's Asset-Accumulation Method

Reilly also ascribed a 10-percent weight to what he called the asset-accumulation method. Applying this method, Reilly first aggregated the distributions that he predicted the partnership would make to the partners from 2005 until 2040, the end of the term of the partnership agreement. Reilly then discounted these distributions to present value. To this sum Reilly added the value of the timberlands, $143 million, as discounted to present value from the year 2040. The asset-

[12]Undistributed cash that is used by the partnership to increase the value of the partnership assets increases the value of the limited partner interests.

accumulation method is effectively a hybrid of the capitalization-of-distributions method and the asset method. Because we reject the capitalization-of-distributions method for the reasons given in Opinion part 5.a, and because we adopt the asset method (as weighted by the probability of an asset sale), we accord no independent weight to the asset-accumulation method.

c. Prices of Stock of Similar Companies

Reilly ascribed a 30-percent weight to what he called the "guideline publicly traded company" method. Applying this method, Reilly used the value of two publicly traded businesses to derive the value of the interest in the partnership. The first business was Plum Creek Timber Co., Inc., which is a real estate investment trust. Plum Creek owned 7.8 million acres of timberlands and 10 wood product conversion facilities. It derived only 52 percent of its revenue from timber sales. The second business was Pope Resources LP, a partnership. This business derived 81 percent of its revenue from timber sales. The remaining revenue was earned from two other operations: timberland consulting and a multifaceted real estate operation.

Like Reilly, Thomson used the value of other businesses to value the interest in the partnership. He relied on four businesses: Plum Creek Timber Co., Inc., Pope Resources LP, Deltic Timber Corp., and Potlatch Corp. Both Deltic and Potlatch

have substantial operations other than owning timberland and selling timber.

In our view, neither expert appropriately considered that the other companies have assets other than timberland assets and that they earn income from sources other than timber sales. Because of this failure, and because other methods are available, we accord no weight to the "guideline publicly traded company" method used by Reilly or the similar method used by Thomson.

6. The Accuracy-Related Penalty Under Section 6662

If there is an underpayment of tax, the penalty imposed is equal to 20 percent of the portion of the underpayment that is attributable to a "substantial estate * * * tax valuation understatement." Secs. 6662(a), (b)(5), 6664(a). For estate-tax returns filed before August 17, 2006, like the return in this case, there is a substantial estate-tax valuation understatement if the value of property shown on the estate-tax return is 50 percent or less of the correct value. Sec. 6662(g)(1) (effective for tax returns filed before the August 17, 2006, amendment by the Pension Protection Act of 2006, Pub. L. 109-280, sec. 1219(a)(1)(B), 120 Stat. 1083). On its estate-tax return, the estate claimed that the value of the 41.128-percent limited partner interest was $12,678,117. This is less than 50 percent of the correct value of $27,454,115. Therefore there was a substantial estate-tax valuation understatement.

However, no penalty is imposed with respect to an underpayment if there was reasonable cause for the underpayment and the taxpayer acted in good faith. Sec. 6664(c)(1). Whether an underpayment of tax is made in good faith and due to reasonable cause will depend upon the facts and circumstances of each case. Sec. 1.6664-4(b)(1), Income Tax Regs. In determining whether a taxpayer acted reasonably and in good faith with regard to the valuation of property, factors to be considered include: (1) the methodology and assumptions underlying the appraisal; (2) the appraised value; (3) the circumstances under which the appraisal was obtained; and (4) the appraiser's relationship to the taxpayer. Id. Although the IRS bears the burden of production under section 7491(c) that the section 6662 penalty is appropriate, the taxpayer bears the burden of proof in demonstrating reasonable cause. See Higbee v. Commissioner, 116 T.C. 438, 446-448 (2001).

The executor of the estate is the decedent's son, Larry Giustina. Larry Giustina hired a lawyer, Steven Lane, to prepare the estate-tax return. Lane hired Columbia Financial Advisors to appraise the 41.128-percent limited partner interest. Larry Giustina relied on the Columbia appraisal in filing the return.

The Columbia appraisal, like the Reilly report, valued the limited partner interest on the basis of capitalized cashflows, capitalized distributions, and the market values of other companies. Even though the Columbia appraisal did not incorporate the asset method, it was reasonable for the executor to rely on the Columbia appraisal. The partnership had been in operation for 15 years. It was reasonable to conclude that the partnership would continue to maintain its timberland assets without liquidating them.

The underpayment of tax on the estate's tax return resulted from its valuation of the 41.128-percent limited partner interest. The valuation was made in good faith and with reasonable cause. The estate is not liable for the section 6662 penalty.

To reflect the foregoing,

Decision will be entered under Rule 155.

FILED

DEC 05 2014

MOLLY C. DWYER, CLERK
U.S. COURT OF APPEALS

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ESTATE OF NATALE B. GIUSTINA, DECEASED, c/o Laraway Michael Giustina, Executor, Petitioner - Appellant, v. COMMISSIONER OF INTERNAL REVENUE, Respondent - Appellee.	No. 12-71747 Tax Ct. No. 10983-09 MEMORANDUM[*]

Appeal from a Decision of the
United StatesTax Court

Argued and Submitted March 5, 2014
Portland, Oregon
Submission Withdrawn March 6, 2014
Resubmitted December 1, 2014

Before: GOODWIN and W. FLETCHER, Circuit Judges, and BLOCK, Senior District Judge.[**]

[*] This disposition is not appropriate for publication and is not precedent except as provided by 9th Cir. R. 36-3.

[**] The Honorable Frederic Block, Senior District Judge for the U.S. District Court for the Eastern District of New York, sitting by designation.

The Estate of Natale B. Giustina appeals the Tax Court's conclusion that its 41.128% interest in Giustina Land and Timber Company Limited Partnership was worth $27,454,115 for estate tax purposes, rather than $12,678,117 as stated in the Estate's tax return.

We have jurisdiction under 26 U.S.C. § 7482. "We review the Tax Court's factual determinations, including valuation of assets . . ., for clear error." *Estate of Trompeter v. Comm'r*, 279 F.3d 767, 770 (9th Cir. 2002).

The Tax Court concluded that there was a 25% likelihood of liquidation of the partnership. It therefore gave a 25% weight to an asset-based valuation and a 75% weight to the valuation of the partnership as a going concern. Although the Tax Court recognized that the owner of the limited interest could not unilaterally force liquidation, it concluded that the owner of that interest could form a two-thirds voting bloc with other limited partners to do so, and assigned a 25% probability to this occurrence. This conclusion is contrary to the evidence in the record. In order for liquidation to occur, we must assume that (1) a hypothetical buyer would somehow obtain admission as a limited partner from the general partners, who have repeatedly emphasized the importance that they place upon continued operation of the partnership; (2) the buyer would then turn around and seek dissolution of the partnership or removal of the general partners who just

approved his admission to the partnership; and (3) the buyer would manage to convince at least two (or possibly more) other limited partners to go along, despite the fact that "no limited partner ever asked or ever discussed the sale of an interest." Alternatively, we must assume that the existing limited partners, or their heirs or assigns, owning two-thirds of the partnership, would seek dissolution. We conclude that it was clear error to assign a 25% likelihood to these hypothetical events. As in *Estate of Simplot v. Commissioner*, 249 F.3d 1191, 1195 (9th Cir. 2001), the Tax Court engaged in "imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect" with the existing partners. *See also Olson v. United States*, 292 U.S. 246, 257 (1934) (explaining in a condemnation case that, when a court estimates "market value," "[e]lements affecting value that depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable[,] should be excluded from consideration"). We therefore remand to the Tax Court to recalculate the value of the Estate based on the partnership's value as a going concern.

The Estate further claims that the Tax Court clearly erred by using pretax (non-tax-affected) cash flows for the going-concern portion of its valuation. The

Estate itself admits in its brief that "tax-affecting is . . . an unsettled matter of law." We therefore cannot say that the Tax Court clearly erred in adopting a pretax rather than a posttax methodology. Further, the Tax Court did not clearly err by using the Commissioner's proposed 25% marketability discount rather than the Estate's proffered 35% discount, *see, e.g.*, *Estate of O'Connell v. Comm'r*, 640 F.2d 249, 253 (9th Cir. 1981), especially considering that the Estate's expert acknowledged that such discounts typically range between 25% and 35%.

We do, however, hold that the Tax Court clearly erred by failing to adequately explain its basis for cutting in half the Estate's expert's proffered company-specific risk premium. Even under the deferential clear error standard, "[i]n drawing its conclusions . . . the Tax Court is obligated to detail its reasoning." *Estate of Trompeter*, 279 F.3d at 770. We recognize that diversification of assets is a widely accepted mechanism for reducing company-specific risk. However, the Tax Court stated only that "[i]nvestors can eliminate such risks by holding a diversified portfolio of assets," without considering the wealth a potential buyer would need in order to adequately mitigate risk through diversification.

REVERSED and REMANDED for recalculation of valuation.

EFiled: Apr 23 2010 11:37AM EDT
Transaction ID 30741650
Case No. 3698-VCS

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

GLOBAL GT LP and GLOBAL GT LTD,	)	
	)	
Petitioners,	)	
	)	
v.	)	C.A. No. 3698-VCS
	)	
GOLDEN TELECOM, INC.,	)	
	)	
Respondent.	)	

OPINION

Date Submitted: January 27, 2010
Date Decided: April 23, 2010

John L. Reed, Esquire, Paul D. Brown, Esquire, K. Tyler O'Connell, Esquire, Aleine M. Porterfield, Esquire, EDWARDS ANGELL PALMER & DODGE LLP, Wilmington, Delaware, *Attorneys for Petitioners.*

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STRINE, Vice Chancellor.

I. Introduction

This is an appraisal action. The petitioners Global GT LP and Global GT Ltd. owned nearly 1.4 million shares of respondent Golden Telecom, Inc. ("Golden"), a Russian-based telecommunications company that was listed on the NASDAQ. The petitioners claim that Golden was undervalued in a 2007 merger in which Golden was purchased for $105 per share by Vimpel-Communications ("VimpelCom") — a major Russian provider of mobile telephone services whose two largest stockholders were also the largest stockholders of Golden.

As is typical, the outcome of this appraisal proceeding largely depends on my acceptance, rejection, or modification of the views of the parties' valuation experts. Both experts were well qualified to testify about the appropriate inputs to use in valuing a public company; but neither had a deep knowledge of the Russian telecommunications market or of Golden itself. Both these men of valuation science purported to apply the same primary method of valuation — the discounted cash flow ("DCF") method — but the expert for the petitioners came up with a value of $139 per share and the expert for Golden came up with a value of only $88 per share — a modest $51 per share value gap.

In this decision, I reach a valuation of Golden using the DCF methodology, which is the method that both experts viewed as the most reliable. I eschew any reliance on methods based on analogizing to comparable companies or transactions because the experts themselves had even less knowledge of the comparables than they did of Golden and both viewed it difficult to find a good

sample of comparables. Thus, I focus on coming up with a solid, if necessarily imperfect, valuation using the DCF method that both experts embraced as the technique most susceptible to useful application.

In focusing on a DCF valuation, I reject Golden's argument that I should give weight to the merger price itself on the grounds that the merger reflected a market-tested price. I reject that proposition for several reasons. First of all, the Special Committee that negotiated the merger never engaged in any active market check either before or after signing the merger agreement with VimpelCom. Second and most important, the passive market check that is supposed to instill confidence in me required market participants to assume that Golden's two largest stockholders, Altimo Holdings and Investments Limited ("Altimo") and Telenor ASA ("Telenor"), would both sell their Golden stake to another bidder, despite the fact that they had an economic interest in VimpelCom that was far more substantial than their stake in Golden — an unlikely prospect made even more doubtful by Altimo's public announcement that it did not intend to sell its 26% stake in Golden in another transaction. Given these market realities, it is not surprising that Golden's Special Committee chairman admitted that the Committee had focused on getting the best deal they could from VimpelCom. There was no open market check that provides a reliable insight into Golden's value.

After rejecting that argument, I wade through the discrete differences that explain the experts' differing DCF valuations, which primarily involve Golden's terminal growth rate, and the appropriate equity risk premium and beta to use in

calculating a discount rate. After making my determinations as to these disagreements, I plugged them into the petitioners' DCF model and generated a per share value of $125.49 per share, which I supplement with an award of interest at the applicable statutory rate.

II. Factual Background[1]

The trial record was largely dominated by the testimony of the experts. For their part, the petitioners presented the testimony of Paul Gompers, a Professor of Business Administration at Harvard Business School.[2] Golden offered Marc Sherman, a Managing Director of Alvarez & Marshal, to respond.[3] Both experts are well qualified generally in the literature of valuation. Although Sherman has a bit more practical telecommunications experience, having done some valuation work involving other telecommunications firms, neither struck me as anything

[1] These are the facts as I find them after trial.

[2] Gompers graduated from Harvard College, and later earned a M.Sc. in Economics from Oxford University and a Ph.D. in Business Economics from Harvard University. He teaches courses at the graduate level and conducts research in areas including corporate finance, the valuation of companies, and entrepreneurial finance and management. Gompers has authored numerous case studies and technical notes, articles in peer-reviewed journals on finance and economics, and has co-authored four books. In the past, he has been retained as a valuation expert for a variety of companies, including a telecommunications company. *See* JX 728 (Expert Report of Paul A. Gompers) ("Gompers Report") at 1.

[3] Sherman graduated from the University of Baltimore, and received his J.D. from the University of Maryland School of Law. Before joining Alvarez & Marshal, Sherman was a Managing Director at Huron Consulting Group, and a partner at KPMG. He has also authored or co-authored several books. He is a certified public accountant, an attorney, a Certified Insolvency and Reorganization Advisor, a Certified Fraud Examiner, and is certified by the American Institute of Certified Public Accountants in Financial Forensics. Sherman has served as a valuation expert for businesses in a variety of industries, including communications, and has worked on a number of valuation projects involving the telecommunications industry. *See* JX 730 (Expert Report of Marc B. Sherman) ("Sherman Report") at 4-5, Ex. A.

close to an industry expert. Moreover, neither had a deep knowledge of Golden itself or the Russian telecommunications industry.

Golden has tried to impress me with the fact that Sherman spoke with management for Golden *after* the merger and *during* the litigation, and therefore supposedly gained a deeper sense of the firm and industry than did Gompers, who did not do so. Of course, the managers for Golden working for the VimpelCom corporate empire had an incentive to cooperate with Sherman, and doubtless Golden would not have given Gompers unfettered access to them. In that respect, the testimony of the two fact witnesses who testified about Golden was not particularly helpful in terms of conveying a good sense of Golden's prospects.

Fortunately, the experts did agree that there were a reliable set of projections prepared by Golden's management that existed for the first five years beyond the merger. Given the existence of those projections and the general evidence in the record regarding the telecommunications industry both in Russia and internationally, and the predicted future of the Russian economy, there is a rational, if far from fully satisfying, record from which to resolve the discrete areas of opinion where the experts differ.

What precedes my resolution of those issues is my distillation of the record, such as it is, regarding Golden and its prospects.

A. Golden's Business And Plans For Expansion

Golden, a telecommunications company, operated in the former Soviet Union, and was publicly traded on the NASDAQ.[4] Its initial public offering took place in September 1999 and, after that time, Golden grew primarily through self-financed acquisitions of regional-based telecommunications companies in Russia and other countries in the Commonwealth of Independent States (the "CIS").[5] Although Golden was, at first, predominately focused on providing long-distance services, its acquisitions of local telephone companies throughout Russia and certain CIS countries gave Golden the capacity to provide local service to homes and businesses.[6]

Golden traditionally focused on providing fixed-line services, meaning that it provided telephone services through fiber or copper wiring,[7] and derived its revenues primarily from corporate customers and from services provided to other telecommunications and mobile operators.[8] By 2006, Golden had begun to

[4] Before it was incorporated, Golden was a majority-owned subsidiary of Global TeleSystems, Inc., which was among the first foreign telecommunications operators in the former Soviet Union. *See* JX 16 (Golden 2007 10-K (Mar. 17, 2008)) ("2007 10-K") at 4.
[5] The CIS includes: the Azerbaijan Republic; the Republic of Armenia; the Republic of Belarus; Georgia; the Republic of Kazakstan; the Kyrgyz Republic; the Republic of Moldova; the Russian Federation; the Republic of Tajikistan; Turkmenistan; the Republic of Uzbekistan; and the Ukraine. *See* Commonwealth of Independent States: CIS States, http://cis.minsk.by/main.aspx?uid=3360.
[6] Tr. at 80-81 (Gallagher).
[7] Tr. at 82 (Gallagher), 472 (Gompers).
[8] 2007 10-K at 36; JX 646 (Golden Investor Presentation (October 2007)) (the "2007 Investor Presentation") at 5-7.

expand its focus to include Wi-Fi,[9] which was in the early stages of development in Russia and the CIS, and broadband internet,[10] which was available only in major Russian cities.[11] By the end of 2007, Golden had completed approximately thirty acquisitions of smaller companies, and had become a leading facilities-based provider of integrated telecommunication and internet services in the most populated areas of Russia and other countries of the CIS, and the largest independent telecommunications operator in Russia.[12] In particular, Golden acquired a 51% stake in Corbina, a telecommunications service provider that offers broadband internet in several Russian cities, which allowed Golden to offer bundled services including broadband internet, voice over internet protocol, internet protocol television, and mobile virtual network-based services.[13]

B. Golden's Management Creates A Five Year Plan

Despite its expansion into other areas of the internet and telecom market and its goal to sell a wide variety of related services to the customers on the ends of its cables, Golden remained primarily a fixed-line telecommunications provider for the business sector. Golden's Board of Directors established a five-year

[9] Wi-Fi is a trademarked term, owned by the Wi-Fi Alliance, which applies to certified local area network devices that meet a class of technical standards — specifically, the IEEE 8.0211 standards. *See* GORDON A. GOW & RICHARD K. SMITH, MOBILE AND WIRELESS COMMUNICATIONS: AN INTRODUCTION (2006), at § 7.4.
[10] Broadband refers to high-speed internet access, which can be delivered through various means, such as fiber optics, cable modems, or wirelessly. *See* FEDERAL COMMUNICATIONS COMMISSION — CONSUMER & GOVERNMENTAL AFFAIRS BUREAU, WHAT IS BROADBAND (2009), http://www.fcc.gov/cgb/broadband.html.
[11] Tr. at 82-83 (Gallagher).
[12] 2007 Investor Presentation at 5.
[13] 2007 10-K at 5, 27, 44.

business plan for Golden (the "Five Year Plan") in October 2007 to chart the company's continued expansion.[14] The Five Year Plan established a three-pronged strategy for Golden. First, Golden would continue to widen its corporate customer base in large cities, such as Moscow and St. Petersburg.[15] Second, Golden would continue regional expansion to become a "national market player in both corporate and retail market segments."[16] Third, Golden would enter the emerging broadband market, and seek to become a "leading provider of broadband access in Russia and the CIS."[17] Although Gompers contends that Golden's strategy reflected a marked move away from its prior consistent involvement in mergers and acquisitions activity, my reading of the record suggests that to accomplish this three-pronged strategy, Golden would be required to continue to engage in M&A activity to enter additional markets (which are comprised of cities smaller than Moscow but still far larger than, say, Wilmington, Delaware) and to gain scale in the product markets it wished to enter.[18]

The Five Year Plan projected revenue to grow annually at a declining rate:

2007	47.8%
2008	34.8%
2009	20.2%

[14] JX 412 (Five Year Plan, 2007-2012, Board of Directors Meeting (Oct. 3, 2007)) (the "Five Year Plan").
[15] *Id*. at 4.
[16] *Id*.; Tr. at 85 (Gallagher).
[17] Five Year Plan at 4.
[18] *See* JX 416 (Transcript of Golden's Third Quarter Earnings Release Conference Call (Nov. 22, 2007)) at 10-11 (stating that Golden's growth strategy included expansion into fifty cities, instead of the twenty in which it presently operated); Tr. at 816-18 (Svetlichny) (explaining that Golden had a number of smaller acquisitions "in the pipeline" before it was acquired by VimpelCom).

2010	19.5%
2011	13.0%
2012	8.5%[19]

The Five Year Plan also estimated that Golden's EBITDA margins would grow for three years, and then level off:

2007	25.9%
2008	31.8%
2009	32.1%
2010	32.6%
2011	32.6%
2012	32.5%[20]

The projections of Golden's management were based on Golden's business plan of expanding its corporate customer base, broadband service, and regional expansion throughout Russia and the CIS.[21] The Five Year Plan considered the increased competition that Golden would face in all segments of its business as the Russian telecom market continued to grow,[22] and a variety of potential risks, including political risk.[23]

The predictions in the Five Year Plan are reasonable when considering the trends in the Russian market generally, and the telecom industry in particular. For example, the projected compound annual growth rate ("CAGR") of the Russian

[19] JX 502 (Golden Five Year Plan (Oct. 3, 2007)) at 1.
[20] *Id*. at 2.
[21] Five Year Plan at 4.
[22] Tr. at 91 (Gallagher).
[23] *See* JX 17 (Golden Telecom, Inc., Schedule 14D-9 (Jan. 18, 2008)) (the "Proxy") at 43, 36 (explaining that Golden's projections considered "the commercial and execution risks associated with implementing [Golden's] business plan, [Golden's] ability to enter the media market, the potential costs for possible future acquisitions, the potential effect of the regulatory regime on [Golden's] operations, . . . the political, economic, and legal environment in the markets in which [Golden] operates").

nominal GDP was expected to be 14.6% from 2007 to 2012, which is consistent with the average projected CAGR predicted for Golden in the Five Year Plan of 14.5%.[24] The projected CAGR of the Russian nominal GDP of 8.5% from 2012-2017 is in line with Golden's projected revenue growth in 2012 of 8.5%.[25] And, the decline in Golden's growth rate is consistent with the decline in the (still healthy) growth rate of Russia's overall telecom sector since 2004.[26]

C. Russia's Expanding Telecom Market And Golden's Predicted Growth

Golden's Five Year Plan was based, in part, on the reasonable expectation that the Russian telecommunications market would continue to expand. Russia was one of the few remaining growth markets in Europe, and its telecom industry was predicted to grow rapidly, particularly the broadband retail market.[27] Golden was particularly well-poised to grow with the Russian market because it was the only operator present in all segments of Russia's fixed-line market in 18 of Russia's 20 largest cities.[28] Renaissance Capital, for example, opined in February 2007 that Golden was "well positioned to maintain its leadership in the corporate

[24] *See* JX 414 (Five Year Plan Executive Summary (2007)) at 4; Sherman Report at 46, 53 (citing *The Economist Intelligence Unit* (Jan. 2008)).
[25] *See* Sherman Report at 21, 53 (citing *The Economist Intelligence Unit* (Jan. 2008)).
[26] *Id*. at 25, 53 (citing Paul Budde Commc'n Pty. Ltd., *Russia — Key Statistics and Telecommunications Market* (Jan. 27, 2008), http://www.budde.com.au, at 3-4 (showing that the revenue growth in the Russian telecom market declined from 43% in 2003 to 25% in 2006)).
[27] *See* JX 221 (HSBC, *Golden Telecom* (Oct. 23, 2007)) at 7 (stating that "the growing consumer market will reshape the profile of the Russian economy, with domestic-oriented companies such as banks and telecom operators enjoying the strongest growth"); JX 168 (Renaissance Capital, *Golden Telecom — Loaded and Ready to Fire* (Aug. 8, 2007)) at 13 ("Given the level of broadband penetration, we expect to see rapid growth continue [in Russia] for the next three-to-four years.").
[28] 2007 Investor Presentation at 18, 20.

[telecom] segment," and Golden's residential internet market would become Golden's "second-largest contributor to operating income in 2010" largely because Golden's "fiber-to-the-home" internet service was "the best option on the market."[29] Golden was also in a position to expand because it had very low levels of debt compared to other telecom companies.[30]

D. Golden And VimpelCom Agree To Merge

Of course, just as Golden hoped to become a major competitor in the Wi-Fi and broadband markets, so too did other industry players have their eye on Golden's space. One industry player in particular had box seats from which to contemplate Golden. That was VimpelCom.

Golden's two largest stockholders, Altimo and Telenor, also happened to be the largest stockholders of VimpelCom. Indeed, Altimo and Telenor's combined stake in VimpelCom was larger in both percentage terms and value. Specifically, Sunbird Limited, which owned 26% of Golden's outstanding common stock, and Eco Telecom Limited, which owned 44% of VimpelCom's outstanding voting capital, are both subsidiaries of Altimo. And, Nye Telenor East Invest AS, the beneficial owner of 18.3% of Golden's outstanding common stock, and Telenor East Invest AS, the beneficial owner of 33.6% of VimpelCom's outstanding

[29] JX 126 (Renaissance Capital, *Golden Telecom: What's Going On With These Shares?* (Feb. 21, 2007)) at 6, 10, 14.
[30] *See* JX 129 (FIM Fin. Servs., *The TeliaSonera-Telenor-Altimo Triangle: A Soap Opera With A Shakespearean Ending?* (Mar. 14, 2007)) at 5 (noting that Golden was "underleveraged and could acquire more [local fixed-line] exposure through M&A's"); Tr. at 271 (Gallagher) (explaining that Golden had $250 million in debt, which was minimal compared to other companies in the industry).

common stock, are both subsidiaries of Telenor. Moreover, Altimo and Telenor not only had board representatives on the VimpelCom board, but also had appointed members of the Golden Board.[31] Four nominees of Eco Telecom Limited served on the VimpelCom board, including Oleg Malis and Alexey Reznikovich, who also served on the Golden Board.[32] Four nominees of Telenor East Invest served on the VimpelCom board, including Kjell Morten Johnsen, who also served on Golden's Board.[33] Together, Altimo and Telenor appointed a majority of the nine-member VimpelCom board, suggesting how deep their interest in VimpelCom was.

Given the cross-holdings and the reality that Golden was strong in fixed-line services and weak in mobile capabilities, and VimpelCom had just the opposite qualities, it was perhaps inevitable that a merger of the two firms would be considered.[34] At first, in February 2007, Golden's CEO, Jean-Pierre Vandromme, and VimpelCom's CEO, Alexander Izosimov, began to discuss the possibility of the two companies working together by, for example, cross-selling their services.[35] Discussions between senior management of Golden and VimpelCom continued throughout 2007 and, in furtherance of those discussions,

[31] Proxy at 4.
[32] *Id*.
[33] *Id*.
[34] Tr. at 91 (Gallagher).
[35] Proxy at 14.

the two companies entered into a confidentiality agreement and exchanged non-public information.[36]

In April 2007, Izosimov met with Vandromme, and suggested that the two companies explore a transaction whereby VimpelCom would acquire 100% of Golden.[37] Golden's Board met on May 17, 2009 to discuss VimpelCom's proposal and decided to establish a Special Committee made up of the four Golden non-management directors who were not affiliated with Altimo or Telenor.[38]

The Special Committee retained Skadden, Arps, Slate, Meagher & Flom, LLP as outside counsel, and Credit Suisse Securities (USA), LLC as its financial advisor.[39] On July 3, 2007, VimpelCom gave Golden a summary sheet of proposed terms for a combination of the two companies. But because the summary sheet did not specify an offer price, the Special Committee decided not to respond until a more detailed proposal was presented.[40] Around this time, the news of VimpelCom's interest in Golden leaked into the market. In early September 2007, VimpelCom proposed to pay $80 per share of Golden's stock, which the Special Committee rejected,[41] and, in late September 2007, VimpelCom changed its proposal to a range of $80 to $95 per share.[42] The Special Committee felt that the upper end of the range was "sufficiently attractive" to justify

[36] *Id*.
[37] *Id.*
[38] *Id*. at 14.
[39] Tr. at 248-49 (Gallagher).
[40] Proxy at 15-16.
[41] JX 605 (Special Committee Meeting Minutes (Sept. 12, 2007)) at 3.
[42] Proxy at 17-18; JX 402 (Special Committee Meeting Minutes (Oct. 1, 2007)) at 2.

continuing the negotiations process and entered into a second confidentiality agreement with VimpelCom, which gave VimpelCom access to Golden's non-public information and Golden's management.[43]

VimpelCom raised its offer price again to $100 on November 12, 2007.[44] But the Special Committee felt that this amount was inadequate, and rejected the offer on November 15, 2007.[45] On November 28, 2007, VimpelCom raised its offer to $103 per share, and the Special Committee again rejected the offer. Although VimpelCom initially told the Special Committee that $103 per share was its final offer, VimpelCom raised its offer to $105 per share on December 1, 2007, which the Special Committee agreed to accept provided that all other material terms for the merger were fully resolved.[46]

According to Patrick Gallagher, Chairman of the Special Committee, VimpelCom's offer of $105 per share represented the "highest per share consideration reasonably obtainable" when considering the inherent risks in Golden's business plan, such as the increased competitiveness in Golden's key markets, political uncertainty in Russia, adverse changes in the global credit markets, and VimpelCom's intention to directly compete with Golden in the broadband market.[47] The Special Committee recommended that the full Board

[43] Proxy at 18.
[44] JX 404 (Letter from Alexander Izosimov to Jean-Pierre Vandromme (Nov. 12, 2007)).
[45] Proxy at 20; JX 406 (Letter from Jean-Pierre Vandromme to Alexander Izosimov (Nov. 15, 2007)).
[46] Proxy at 22-23.
[47] Tr. at 230, 231-32 (Gallagher) (quoting the Proxy at 27).

accept the merger and, on December 3, 2007, the Board unanimously approved the merger. Credit Suisse completed a fairness opinion for the $105 per share price (the "Fairness Opinion") and, at a December 20, 2007 meeting of the Special Committee, opined that the price was fair.

The discounted cash flow ("DCF") analysis conducted by Credit Suisse came up with a range of $85-$128, and a median value of $102.[48] Importantly, this valuation was premised on a nominal GDP growth rate for the Russian economy of 5.6%.[49] That was supposedly taken from an Economist Intelligence Unit ("EIU") forecast for 2013 to 2017. The number used, however, does not track the December 2007 EIU data, which forecasted nominal GDP growth of 7.4%.[50] If the figure in the December 2007 EIU data was used in Credit Suisse's model, its DCF value for Golden would have had a median value of $110 per share.

The merger agreement between Golden and VimpelCom (the "Merger Agreement") was executed the next day, on December 21, 2007.[51] The Merger Agreement required that at least 63.3% of Golden's outstanding shares be tendered before the merger could close.[52] Additionally, the merger provided for: (1) an $80 million termination fee, which represented 2% of the $4 billion transaction;

[48] JX 503 (Credit Suisse Fairness Opinion) ("Fairness Opinion") at 11; Proxy at 37.
[49] Fairness Opinion at 15.
[50] JX 324 (EIU real and nominal Russian GDP data including forecasts (1996-2003) as of December 20, 2007).
[51] Proxy at 28.
[52] *Id*. at 29.

(2) a $120 million fee for Golden if VimpelCom's financing fell through; and (3) a matching right for VimpelCom to address superior offers.[53] But Altimo, which owned 26% of Golden, publicly indicated that it did not intend to sell its Golden stake to another bidder.[54] Telenor was more coy, but gave no affirmative indication that it would sell to another bidder, and its representative on the Golden Board had voted for the merger.[55] Unsurprisingly, given the objective facts regarding Altimo and Telenor's ownership interest in VimpelCom, no third party came forward after the Merger Agreement was signed to express an interest in buying Golden.

E. The Market Reacts Negatively To The Merger Price

After the merger price was announced on December 21, 2007, market analysts commented that the $105 per share price was very favorable to VimpelCom and, perhaps most important, VimpelCom's stock price rose substantially.[56] Morgan Stanley, for example, downgraded Golden on the day that

[53] *Id*. at 28.
[54] *Id*. at 19-20.
[55] *Id*. at 26.
[56] After rumors about the proposed VimpelCom/Golden merger were leaked, the price of VimpelCom stock steadily increased until a few days after the Merger Agreement was announced. VimpelCom stock traded at $22.12 on July 5, 2007, increased slightly to $22.31 on July 6, 2007, the day that the first rumor of the merger was leaked, rose to $41.98 on December 21, 2007, the day that the merger was announced, and peaked three days later at $44.98 on December 24, 2007. *See* Google Finance, Vimpel-Communications (ADR), *available at* http://www.google.com/finance?q=NYSE:VIP (last visited Apr. 18, 2010); Yahoo Finance, Vimpel-Communications (VIP), http://finance.yahoo.com/echarts?s =VIP#chart2:symbol=vip (last visited Apr. 18, 2010). In fact, VimpelCom's stock price increased from $37.73 on December 19, 2007, to $39.38 on December 20, 2007, before reaching $41.98 on the day of the merger announcement. *See id.*; BusinessWeek, Historical Stock Quotes for VimpelCom,

the price was announced, and expressed its concern that although "Golden offer[ed] attractive organic growth and prospects . . . the net realizable value for [Golden's minority stockholders] may [have been] limited only to the level of the bid price."[57] Renaissance Capital also commented that the transaction was favorable to VimpelCom shareholders, stating that "even purely taking the difference between [Renaissance Capital's] valuation of Golden Telecom ($136/ share) and the tender offer ($105 per share) add[ed] about $1.2 per VimpelCom share."[58]

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http://investing.businessweek.com/research/stocks/snapshot/historical.asp?ticker=VIP:US (last visited Apr. 18, 2010); *see also* Sherman Cross Examination Demonstratives 7-9; Tr. at 1052-54 (Sherman). The rise in VimpelCom's price per share is difficult to attribute to general market trends. The DOW Jones Industrial Average, for example, was at 13,611 on July 6, 2007, and a bit lower at 13,450 on December 21, 2007. *See* Yahoo Finance, Dow Jones Industrial Average Index Chart, http:///finance.yahoo.com/echarts?s=^DJI (last visited April 10, 2010). Similarly, the NASDAQ closed at 2,666.51 on July 6, 2007, and at 2,691.99 on December 21, 2007. *See* Yahoo Finance, NASDAQ Composite Historical Prices, http://finance.yahoo.com/q/hp?s=^IXIC (last visited April 10, 2010). Nor can the rise in VimpelCom's stock price be easily attributed to the performance of the global telecom industry, which remained stable from early July 2007 to late December 2007. *See* Yahoo Finance, iShares Dow Jones US Telecom Historical Prices, http://finance.yahoo.com/q/hp?s=IYZ&a=05&b=26&c=2007&d=11&e=30&f=2007&g=d&z=66&y=0 (last visited April 22, 2010) (showing that the Dow Jones US Telecom index fund traded at $31.98 on July 6, 2007, and at $28.03 on December 21, 2007); Yahoo Finance, iShares S&P Global Telecommunications Historical Prices, http://finance.yahoo.com/q /hp?s=IXP&a=06&b=1 &c=2007&d=11&e=30&f=2007&g=d&z=66&y=0 (last visited April 22, 2010) (showing that the S&P Global Telecommunications index fund traded at $65.56 on July 6, 2007, and at $71.18 on December 21, 2007).

[57] JX 301 (Morgan Stanley, *Golden Telecom: Downgrading to EW on VimpelCom Bid; PT Moves Down to US$105* (Dec. 21, 2007)).

[58] JX 302 (Renaissance Capital, *VimpelCom Buying Golden Telecom* (Dec. 21, 2007)).

F. Shareholders Overwhelmingly Tender Their Shares At The $105 Price

Although the movement in VimpelCom's stock price suggested that the market believed that VimpelCom was getting a good deal, an overwhelming majority of Golden's shareholders tendered their shares at the $105 price. Under the terms of the Merger Agreement, Lillian Acquisition, Inc., a wholly owned subsidiary of VimpelCom, was to acquire 100% of Golden in a two step transaction. First, VimpelCom would commence a cash tender offer of $105 per share for the outstanding shares of Golden common stock.[59] Second, a back-end merger would convert all Golden shares not tendered — other than those Golden shares subject to the exercise of appraisal rights — into the right to receive $105 per share in cash.

VimpelCom commenced the tender offer on January 18, 2008. Altimo had already indicated that it intended to tender its shares and did so, but Telenor decided to first conduct its own analysis to determine whether the price was adequate,[60] and finally tendered its shares on February 5, 2008. A total of 94.4% of Golden's shareholders tendered at the $105 price before the offer expired on February 26, 2008. The merger closed on February 28, 2008, and Golden became a wholly-owned subsidiary of VimpelCom.

[59] Proxy at 28; JX 19 (Golden Form SC TO-T/A (Feb. 27, 2008)).
[60] JX 807 (Telenor Form 13E-3 (Jan. 18, 2008)).

G. The Petitioners Request An Appraisal

The petitioners filed their request for an appraisal on April 18, 2008. Following extensive expert discovery, a trial was held on October 14-15, 19, and 30, 2009. This is my opinion on the fair value of Golden.

III. Legal Framework

Under 8 *Del. C.* § 262(h), this court must, upon finding that a stockholder is entitled to an appraisal, "determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with interest, if any, to be paid upon the amount determined to be the fair value."[61] The entity must be valued as a going concern based on its business plan at the time of the merger,[62] and any synergies or other value expected from the merger giving rise to the appraisal proceeding itself must be disregarded.[63]

IV. Analysis

In addressing the question of fair value, I proceed in two steps. First, I explain why I reject Golden's argument that the merger price is itself a reliable indication of fair value. Then, I grapple with the contending positions of the

[61] 8 *Del. C.* § 262(h); *see also Cavalier Oil Corp. v. Harnett*, 1988 WL 15816, at *9 (Del. Ch. Feb. 22, 1988) (explaining that, in a § 262 action, the court must "determine the fair value of 100% of the corporation [and award] the dissenting stockholder his proportionate share of that value"), *aff'd*, 564 A.2d 1137 (Del. 1989).
[62] *M.G. Bancorp. Inc. v. LeBeau*, 737 A.2d 513, 524 (Del. 1999).
[63] *Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Group, Ltd.*, 847 A.2d 340, 343 (Del. Ch. Jan. 5, 2004).

parties' experts about the value of Golden, in particular regarding the valuation of Golden in light of its future expected cash flows.

A. Deference To The Merger Price

As an initial matter, I find the price that VimpelCom paid for Golden in the merger to have no reliable bearing on my appraisal valuation. Golden argues that deference should be given to the merger price of $105 per share because the Special Committee, assisted by outside advisors, was able to determine for itself the fair price of Golden, and because no other interested bidders came forward despite rumors of the potential merger that leaked to the market in July 2007. It is, of course, true that an arms-length merger price resulting from an effective market check is entitled to great weight in an appraisal. For example, in *Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Group, Ltd.*, this court held that the merger price was the best indicator of fair value for appraisal purposes because the merger "resulted from a competitive and fair auction, which followed a more-than-adequate sales process and involved broad dissemination of confidential information to a large number of prospective buyers."[64] But, as Gallagher, the Special Committee chairman, admitted at trial, the Special Committee did not engage in any sales efforts at all and instead concentrated solely on getting as good

[64] *Id*. at 357-58; *see also Highfields Capital, Ltd. v. AXA Fin., Inc.*, 939 A.2d 34, 59 (Del. Ch. 2007) (deferring to the merger price where an arms-length process was conducted, and no material impediments prevented another bidder from entering the sales process during an eight-month market check period).

a deal as it could from VimpelCom.[65] In essence, the Special Committee treated the context as one closer to a merger proposal by a controlling stockholder, given the reality that Golden's two largest shareholders — Altimo and Telenor — owned more of VimpelCom, the buyer, than Golden, the seller. Now, in appraisal, Golden acts as if the Special Committee was simply locking in a floor, and creating the perfect conditions for an effective passive market check. That after-the-fact litigation argument is without any factual foundation.

The reality is that any bidder peering in from the outside was confronted by a merger agreement that did not contain an active go-shop provision, and by a public statement by Golden's largest stockholder, Altimo, that it would not sell its 26% stake in another transaction.[66] Although Golden argues that Telenor was more equivocal about whether it was willing to sell its 18% stake, equivocation in this context does not help Golden. The idea that a rational third-party bidder would make a blind expression of interest in a situation where the economic interests of Golden's largest stockholders was more heavily weighted toward doing what was best for VimpelCom — a corporation on whose board they had seated eight designees — and each stood to gain hugely if the merger generated synergy gains for VimpelCom is not one that I accept. In a situation such as this, to actually entice bids, the Special Committee, if it was relying on a market check to obtain the highest value, should have affirmatively sought guarantees from

[65] Tr. at 249-50 (Gallagher).
[66] *Id*. at 161-63, 186 (Gallagher); *see also* Proxy at 20.

Altimo and Telenor that they would support a higher bid and used those guarantees to attract bidders. Instead, the Special Committee created a situation where other market players would rationally infer that the merger was the deal supported by Golden's two largest stockholders (and the three directors that Altimo and Telenor appointed to Golden's Board) whose interest in VimpelCom gave them special reasons to support that deal and not to sell into another transaction.

Golden also makes a more novel argument. It contends that the fact that only a single investor has brought an appraisal claim demonstrates the fairness of the merger price. But analyzing a deal price based on the size of the appraisal class is not supported by the appraisal statute itself, and would require this court to speculate about the reasons for the size of the appraisal class. Investors may choose to forego appraisal for any number of reasons. Appraisal claims are expensive to pursue, and the petitioners get none of the merger consideration during the pendency of the case, making such claims beyond the means of some investors to fund. And, certain institutional investors may be happy to take a sizeable merger-generated gain on a stock for quarterly reporting purposes, or to offset other losses, even if that gain is not representative of what the company should have yielded in a genuinely competitive sales process.

Critically, if market evidence were to be considered, the weight of the evidence suggests that the market believed that VimpelCom was getting a bargain. As discussed earlier, a number of market analysts felt that the $105 price

undervalued Golden, and downgraded Golden after the merger was announced.[67] For example, Alfa Bank suggested that VimpelCom's offer undervalued Golden, and estimated that $129 per share would have been a more appropriate price.[68] More importantly, VimpelCom's stock rose substantially from $22.31 per share at the time that rumors about the proposed merger were leaked in July 2007 to $41.98 on December 21, 2007, the day that the Merger Agreement was announced, although the overall market remained relatively stable.[69] When the definitive terms of the merger were announced on December 21, 2007, VimpelCom's stock rose $2.60 for a price of $41.98 per share, and continued to rise in the immediate days following the merger announcement to $44.98.[70] These realities are noteworthy given that the stock price of an acquiring company will generally drop when it announces that it intends to merge with another company.[71]

For all these reasons, I reject Golden's argument that the merger price is a reliable indication of value.

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[67] *See supra* page 15-16.
[68] *See* JX 309 (Alfa Bank, *VIP Report* (Jan. 15, 2008)) at 1; Gompers Report at 22.
[69] *See supra* note 56; Sherman Cross Examination Demonstrative 4; Tr. at 1050 (Sherman).
[70] *Id*.
[71] *See, e.g.*, MATTHEW TAGLIANI, THE PRACTICAL GUIDE TO WALL STREET: EQUITIES AND DERIVATIVES 64 (2009) (noting that the "standard reaction to the announcement of a merger is that the stock of the acquiring company drops in price while that of the target rises"); Nandkumar Nayar & Jeannette Switzer, *Firm Characteristics, Stock Price Reactions, and Debt as a Method of Payment for Corporate Acquisitions*, 37 QUARTERLY J. OF BUS. & ECON. 51, 52 (1998) (stating that "the announcement of an acquisition for stock typically is associated with a drop in stock price for the acquiring firm") (citations omitted).

B. The Experts' DCF Analyses

The petitioners argue that the fair value of Golden as of February 28, 2008 (the "Valuation Date") was $138.37 per share.[72] Golden, on the other hand, argues that the $105 merger price is generous because $88.14 is the fair value of Golden as of the Valuation Date.[73] The parties' assertions are based on the reports of their valuation experts — Gompers and Sherman.[74] As I noted earlier, neither Sherman nor Gompers is an expert in Russia or in the telecom industry generally, although Sherman has more experience in conducting valuations of telecom companies in the context of litigation.[75]

Both experts conducted a DCF analysis, a comparable companies analysis, and a comparable transactions analysis. But, both give little weight to the latter two analyses. Sherman weighted his comparable companies and transactions analyses at only 20% of his conclusion.[76] Gompers did not give those methods any actual weight in his valuation, using them only as a check on his DCF findings.[77] Both experts admitted that there were few, if any, appropriate

[72] JX 725 (Letter from Paul A. Gompers to John L. Reed, Esquire (Aug. 28, 2009)) ("Gompers Supplement"); Tr. at 435 (Gompers).
[73] JX 727 (Letter from Marc B. Sherman to David M. Zensky, Esquire (Aug. 3, 2009)) ("Sherman Supplement").
[74] *See supra* page 3-4.
[75] *Id.*
[76] Sherman Report at 77-78. Giving 100% weight to his DCF analysis, Sherman's estimate of Golden's fair value is $88.58 per share. *See* Sherman Supplement at Updated Table 1.
[77] Gompers Report at 6.

comparables for Golden and the Golden-VimpelCom merger.[78] As important, neither of the experts convinced me that he really knew Golden deeply as a company, much less that he knew anything substantial about the sparse number of potential comparables, and their expert reports and the information they use to support them do not, in my view, provide me with any reliable basis to come up with a sound group of comparable companies or transactions myself.[79] The lack of confidence I have in this aspect of the experts' analyses is confirmed by the slight weighting they gave these methods. I am also not going to pretend that I am personally qualified or have the time to engage in a from-scratch construction of comparable companies and transactions analyses using such public resources as I could obtain.

Therefore, rather than engage in a speculative exercise based on tinkering with analyses that the two experts themselves essentially do not stand behind, I concentrate my valuation analysis on deploying the method that each expert

[78] Sherman Report at 71; Tr. at 308-09 (Gompers) (stating that Golden lacked "true comparables"), 1024 (Sherman) (explaining his view that Golden had only one true comparable).

[79] Despite supposedly applying similar methodologies, Sherman used just one company in his comparable company analysis, while Gompers used five. Gompers and Sherman only agreed on one company as a common comparable for Golden. That company is Comstar-United Telesystems ("Comstar"), a Russian integrated telecommunications company that operates in Russia and the CIS. Happily for Golden, Comstar's metrics lagged Golden on almost all measures. *See* Gompers Report at Ex. 15; JX 729 (Rebuttal Report of Paul A. Gompers) ("Gompers Rebuttal") at 33; Tr. at 1055-56 (Sherman). For example, both Golden and VimpelCom markedly outpaced Comstar in the pre-merger period, and after rumors of the merger had leaked into the market. Tr. at 1055-57 (Sherman) (citing Petitioners' Demonstratives 7 and 8). Sherman rejected as comparable another telecom company selected by Gompers — OAO Rostelecom — that would have generated a higher valuation for Golden if used in a sample.

believed was the most reliable and pertinent — the discounted cash flow method — and use that as the basis for my award.[80]

The components of a DCF analysis are familiar, and do not require repetition.[81] Both experts largely adopted the projections of Golden's management, including the Five Year Plan, which I have already found to be reasonable.[82] This provides the court with a largely-agreed upon projection of Golden's estimated cash flows for the period from 2008 to 2012.

The major area of disagreement between the experts about Golden's cash flows is the terminal growth value to be used in applying the Gordon growth model version of the DCF, which has been employed by both experts. The smaller argument about the cash flows is the tax rate to be applied to them.

After resolving those arguments, I then address the two critical differences the experts have that are relevant to determining the rate at which Golden's expected future cash flows are to be discounted back to present value. Both experts purport to apply the capital asset pricing model ("CAPM"). The weighted

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[80] *See Gesoff v. IIC Indus. Inc.*, 902 A.2d 1130, 1155 n.138 (Del. Ch. 2006) (noting that "[t]he DCF method is frequently used in this court" and will be given "great, and sometimes even exclusive, weight when it may be used responsibly" (quoting *Andaloro*, 2005 WL 2045640, at *9)).

[81] For the standard description, see RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 75-80 (7th ed. 2003).

[82] *See supra* pages 6-9. The key difference is that Gompers uses the management projections provided to Credit Suisse for its Fairness Opinion, while Sherman used earlier forecasts. *See* Gompers Rebuttal at 10. The two sets of projections are very close, and differ in ways that are not relevant to my findings about the value of Golden. But I find that the projections given to Credit Suisse are more reliable because they (1) are more recent, and (2) undergirded the Credit Suisse Fairness Opinion that was presented in the Proxy.

average cost of capital they derive, however, is different because the equity risk premium and beta they use in coming up with their cost of equity diverge markedly.

1. Terminal Growth Rate

In a DCF analysis, future cash flows are projected for each year during a set period, typically five years.[83] After that time, a terminal value is calculated to predict the company's cash flow into perpetuity. Generally, once an industry has matured, a company will grow at a steady rate that is roughly equal to the rate of nominal GDP growth.[84] In this case, the experts had access to assumptions by Golden's management as to its growth rate for a full ten years. The first five years (2008 to 2012) of those assumptions were quite specific projections of future cash flows in the Five Year Plan, and the next five years were based on an assumption that Golden would grow at the rate of Russia's overall GDP. That is, the management projections assumed that Golden would keep up with Russia's overall growth during that period, even though, as I shall note, that is a conservative assumption. A viable company should grow at least at the rate of

[83] *See Cede & Co. v. JRC Acquisition Corp.*, 2004 WL 286963, at *4 (Del. Ch. Feb. 10, 2004).

[84] *See* MICHAEL C. EHRHARDT & EUGENE F. BRIGHAM, CORPORATE FINANCE: A FOCUSED APPROACH 242 (2009) ("Expected growth rates vary somewhat among companies, but dividend growth for most mature firms is generally expected to continue in the future at about the same rate as nominal gross domestic product."); JOSHUA ROSENBAUM & JOSHUA PEARL, INVESTMENT BANKING: VALUATION, LEVERAGED BUYOUTS, AND MERGERS & ACQUISITIONS 132 (2009) ("The perpetuity growth rate is typically chosen on the basis of the company's expected long-term growth rate, which typically tends to be within a range of 2% to 4% (i.e., nominal GDP growth)."); *see also* Gompers Report at 42.

inflation and, as Golden's expert Sherman admits,[85] the rate of inflation is the floor for a terminal value estimate for a solidly profitable company that does not have an identifiable risk of insolvency.[86] Sherman argues that the growth rate of the Russian economy will decline significantly in 2017 and beyond, and that Russia will reduce its inflation rate to a level below that which the United States has experienced in the last century.[87] Nowhere in his report or at trial did Sherman explain the basis for his prediction, which also tends to conflict with his suggestion that the risk of revolutionary changes in Russia that could put Golden out of business hangs over Golden.[88] In other words, Sherman somehow suggests

[85] Tr. at 1082 (Sherman) ("As a general rule . . . practitioners look at GDP as the ceiling and inflation as the floor . . . . If . . . the inflation rate turns out to be greater than [the terminal growth rate], then [the company being valued] will disappear one day."); Sherman Dep. at 159-60 ("Unless you have some specific reason to believe that a company is going to be a short term company, and short term for this purpose means a company that isn't going . . . to last into perpetuity, then using the inflation rate is the appropriate . . . number to use as . . . the floor.").

[86] *See Lane v. Cancer Treatment Ctrs. of Am., Inc.*, 2004 WL 1752847, at *31 (Del. Ch. July 30, 2004) (rejecting a terminal growth rate below inflation as unreasonable because "it must be assumed that [the company] would continue to grow at least at the rate of inflation"); PETER A. HUNT, STRUCTURING MERGERS & ACQUISITIONS: A GUIDE TO CREATING SHAREHOLDER VALUE 51 (2009) ("As a proxy for long-term growth, inflation assumes a company can pass along increases in its costs, but cannot necessarily increase its volume."); SHANNON P. PRATT & ALINA V. NICULITA, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 248 (5th ed. 2008) ("If the company is in an industry subject to vigorous competitive pressure, with little prospect for real growth without large capital expenditures, then perpetual growth at the rate of expected long-term inflation may be reasonable (i.e., zero real growth)."); *see also* Gompers Report at 42; JX 731 (Rebuttal Report of Marc B. Sherman) ("Sherman Rebuttal") at 14.

[87] Sherman Rebuttal at 17-18. For most of the 20th century, inflation in the United States averaged 3.5%. *See* Hoover Institution, Stanford University, Facts on Policy: Historical Inflation Rates, http://www.hoover.org/research/factsonpolicy /facts/4804201.html (last visited April 18, 2010).

[88] Tr. at 1118-1120 (Sherman) (discussing the binary risks associated with operating in Russia).

that Russia will whip inflation now and have a very low inflation, low growth economy, and that, despite the world-wide popularity of telecommunications-related products, Golden will grow only at that whipped rate of inflation.

But Sherman's position does not translate, in my view, into a reasonable approach to developing a terminal growth rate. Although Golden was a well-positioned, low-leverage firm that had a demonstrated history of profitability and above-average growth in an industry with above-average growth prospects in a market (the former Soviet Union) with above-average growth prospects, Sherman adopted a terminal growth rate for Golden based on his assumption about the rate of inflation. That is, Sherman assumed that as soon as the ten-year projection period ended, Golden would only grow with the rate of inflation in Russia. That is an unduly pessimistic assumption.

Not only that, Sherman used a 3% estimate for inflation, an estimate that he largely made up himself with no rational basis.[89] Notably, data from the EIU in February 2008 estimates Russian inflation to be an average of 3.9% from 2018 to 2030. For some unexplained reason, Sherman's terminal rate is below the floor. If Sherman is correct, it is not clear why VimpelCom was interested in buying Golden in the first place, as it was buying a firm that was not expected to even keep pace with Russia's overall growth, much less provide the above-market returns that, if the projected growth rate of the Russian telecommunications

[89] Tr. at 1082 (Sherman).

industry was consulted, might have been expected.[90] If the telecom industry in the United States, which grew at an annualized real rate of 9.3% from 1963 to 2003 while the annualized real growth rate of the U.S. GDP was just 3.3%, is any indication, the Russian telecom industry will exceed GDP growth for quite some time.[91] Thus, I believe Sherman's approach is unduly pessimistic and reject it.

Although Gompers, perhaps even more than Sherman, had a less than ideal understanding of Golden itself, Gompers knew enough about Golden and the telecommunications industry in Russia and worldwide to come to a much more responsible estimate than Sherman did. Sherman gave too slight a weight to Golden's good financial health, solid record of growth, and to the growth prospects of the Russia telecommunications industry. By contrast, Gompers came to a measured conclusion that gave responsible, but not overenthusiastic, weight to each of these factors. Although the relevant factors might have supported a terminal growth rate equal to the long run growth rate of Russia's GDP, Gompers used a 5% terminal growth rate. Gompers' rate is the mid-point between the

[90] *See, e.g.*, JX 206 (Aton Bank, *Golden Telecom: Triple-Pronged Growth Strategy Still Not Priced In* (Sept. 19, 2007)) at 10-11 (reporting that in 2006, the Russian telecom industry increased 32% year to year compared to the nominal GDP growth of 29%, and projecting the Russian telecom industry to grow at a 20% rate from 2006-2010 compared with a projected nominal GDP growth of 15%); *see also* JX 168 (Renaissance Capital, *supra* note 27) at 20 ("We forecast the Russian corporate telecoms market to grow at a 22% CAGR over 2006-2010 . . . .").

[91] *See* JX 316 (TIM KOLLER, MARC GOEDHART & DAVID WESSELS, MEASURING AND MANAGING THE VALUE OF COMPANIES 154-55 (5th ed. 2005)).

forecasted long-term Russian nominal GDP growth of 6.2%, and a forecasted inflation rate to 2030 of 3.9%.[92]

Gompers' use of a 5% terminal growth rate is based on a respected source of such projections, the EIU. That approach was measured and realistic given that the Russian telecom industry was expected to grow at a rate significantly exceeding the Russian GDP.[93] The reasonableness of expecting the Russian telecommunication sector to outpace the overall Russian economy is buttressed by actual history in the United States, where the telecom industry has grown at nearly three times the rate of the United States GDP.[94] Gompers' estimate accounts for the fact that the Russian telecommunications market is continuing to grow and that, with the increase of the broadband and Wi-Fi markets, companies such as Golden would have the opportunity to reach new customers and offer bundled services to existing customers. By choosing the average of the Russian GDP and inflation rate, Gompers accounted for the very real possibility that Golden will be close to (or in my view, likely exceed) the GDP rate for a period of time, but then,

[92] Gompers Report at 42-43 (citing the EIU Forecast Data for February 2008).
[93] *See, e.g.*, JX 168 (Renaissance Capital, *supra* note 27) at 20 (explaining that the Russian corporate telecoms market would grow at a 22% CAGR from 2006 to 2010); JX 206 (Aton Bank, *supra* note 90) at 10 (explaining that the Russian telecom industry was expected to continue to grow faster than the Russian GDP after 2006, and was "set to continue expanding by double digits").
[94] Gompers Rebuttal at 24 (citing JX 316 (Koller, *supra* note 91)).

as the telecom market matures, settle closer to the inflation rate. I therefore adopt a 5% terminal growth rate.[95]

2. Golden's Tax Rate

Sherman and Gompers also disagree about the tax rate to use. The tax rates in the Five Year Plan for 2008 to 2012 ranged from 30.1% to 35.3%, and the tax rate Credit Suisse used in connection with the DCF analysis undergirding its Fairness Opinion was 30%.[96] Gompers adopted the tax rate used by Credit Suisse in the Fairness Opinion. He also reasoned that a 30% tax rate was "consistent with the numbers forecasted by [Golden's] management."[97] Sherman, on the other hand, selected a tax rate of 31.6% based on the predictions of Golden's management, and on Golden's average historical tax rate for 2004 to 2006,[98] which ranged from 23.7% to 32.4%. Gompers simply adopted Credit Suisse's calculations without explaining convincingly why those calculations are reasonable.[99] By contrast, Sherman adjusted management's projections to reflect the average of Golden's historical tax rate, a rate that is at the conservative end of management's predictions, which called for tax rates ranging from 30.1% to

[95] *Cf. Lane*, 2004 WL 1752847, at *26 (adopting a 5% terminal growth rate by combining a 4% rate of inflation with a 1% growth rate for a company that had limited opportunities for growth).
[96] Five Year Plan at 25; Fairness Opinion at 15.
[97] Gompers Report at 40.
[98] Sherman Report at 59.
[99] Tr. at 470 (Gompers).

35.3% for the period from 2008 to 2012.[100] I therefore adopt Sherman's tax rate of 31.6% for purposes of my DCF analysis.

3. Equity Risk Premium

To figure out the cost of capital by which to discount Golden's future cash flows, both Sherman and Gompers had to come up with a cost of equity. One of the two major sources of disagreement between the experts was over what equity risk premium ("ERP") to use.[101] Sherman relied on an ERP of 7.1%. The ERP Sherman selected is from the 2008 Ibbotson SBBI Valuation Year Book, which is based on long-term historical data from 1926 to year-end 2007.[102] Gompers used an ERP of 6.0%, which he selected based on his teaching experience, the relevant academic and empirical literature, and the supply side ERP reported in the 2007 Ibbotson Yearbook.[103]

In a theme that will be continued when I next examine the debate about beta, the parties spar about the approach to take, with the petitioners portraying themselves as using the most reliable, market-accepted method because their method is "forward looking" and thus consistent with the purpose of this valuation, which is to determine the value of Golden based on its prospects in a future, not past, market. For its part, Golden portrays the petitioners as advancing

[100] Five Year Plan at 25; Tr. at 967 (Sherman).
[101] The ERP is the premium an investor should receive for the risk associated with investing in equities versus riskless assets, such as U.S. government short-term bonds. *See* SHANNON PRATT & ROGER GRABOWSKI, COST OF CAPITAL: APPLICATIONS AND EXAMPLES 89, 91 (3rd ed. 2008); Sherman Rebuttal at 14; Gompers Report at 37.
[102] JX 501 (IBBOTSON ASSOC., SBBI: 2008 YEARBOOK VALUATION (2008)) ("Ibbotson Yearbook"); Tr. at 938 (Sherman).
[103] Gompers Report at 38.

novel, unaccepted approaches that are more speculative and less reliable than the more traditional approaches it advances.

In reality, the debate is not nearly so stark. Although the petitioners, through Gompers, advance techniques that are designed to be forward-looking, those techniques are of course entirely based on using past data to predict the future, just like the techniques advanced by Golden, through Sherman. Each technique depends to a certain extent on taking some combination of past data and using it to predict a necessarily uncertain future.

In the case of their debate about the ERP, that reality can easily be discerned. For its part, Golden uses the most traditional estimate of the ERP, the historic ERP published by Ibbotson. That estimate is based on Ibbotson's consideration of stock returns from 1926 to the present (or as relevant to this case, to year end 2007). Sherman testified that the Ibbotson historic ERP (the "Historic ERP") is the best estimate of predicting long-term future performance because it relies on a long period of history,[104] while a predictive ERP is "an attempt at predicting the future as opposed to just letting history be the guide . . . ."[105] Golden buttresses its reliance upon the Historic ERP with three primary sources. First, Golden cites an article by Peng Chen and James Harrington which explains that "the historical equity risk premium estimate is a very solid estimate, and should continue to serve as a starting point for applying the equity risk premium in

[104] Ibbotson Yearbook at 80.
[105] Tr. at 945 (Sherman).

portfolio optimization and business valuation."[106] Second, Golden cites an article by James Hitchner and Katherine Morris which states that "[i]n practice, valuation analysts rarely rely on predictive models to forecast equity risk premiums. Risk premium components based directly on historical stock market return data are widely accepted and relied upon by the valuation community."[107] Finally, Golden relies on Ibbotson's 2008 Valuation Yearbook, pointing to a section where Ibbotson states that both Ibbotson's supply side and Historical ERP estimates are "from actual market statistics over a long historical period of time."[108] Crucially, all three of these sources include both historic and supply side ERP models.[109]

The petitioners, through Gompers, say that continued rote use of the Historic ERP will lead to unreliable results. Speaking most directly to that point, Gompers notes that Ibbotson and his co-authors have themselves developed an alternative model to forecast the long-term expected equity return because of their view that the historic approach wrongly assumes that the relationship between stocks and bonds observed in the past would remain stable into the future.[110] As Gompers notes, Ibbotson indicates "[o]ver the long run, the equity return should

[106] JX 724 (Peng Chen & James Harrington, *Ibbotson Authors Discuss Historical and Supply Side Estimates of ERP* (Jan. 2008), *available at* http://www.bvlibrary.com /BVUpdatePlus/bvuPlusArticles3Print.aspx?docRef=9543).
[107] JX 801 (James Hitchner & Katherine Morris, *Cost of Capital Controversies: It's Time To Look Behind the Curtain*," (Jan. 2008), *available at* http://bvlibrary.com/BVUpdatePluls/bvuPlusArticles3Print.aspx?docRef=5089).
[108] Ibbotson Yearbook at 98.
[109] *Id*. at 92 (explaining the benefits of a supply side ERP); JX 724 (Chen & Harrington, *supra* note 106) at 4 (noting that the historic and supply side "models do not conflict" and will "converge over time"); JX 801 (Hitchner & Morris, *supra* note 107) at 5 (describing a variety of approaches to ERP, including supply side risk premiums).
[110] Ibbotson Yearbook at 71.

be close to the long-run supply estimate."[111] The supply side estimate that Ibbotson publishes uses the Ibbotson historical sample from 1926 to the present, but estimates which components of the equity risk premium are driven by the price-to-earnings ratio of a stock, and which components are driven by expected earnings growth.[112] The supply side rate assumes that actual returns to equity will track real earnings growth, not the growth reflected in the price-to-earnings ratio.[113]

In arguing that continued use of the simple Historic ERP is unjustifiable, Gompers has substantial support in the professional and academic valuation literature.[114] Shannon Pratt, for example, has urged his readers who still use an ERP of 7% to "immediately make a downward adjustment to reflect recent research results,"[115] and has written that the "ERP as of the beginning of 2007 should be in the range of 3.5% to 6%."[116] Gompers also cites to a survey of finance professors, which found that the mean ERP taught by 369 professors is

[111] JX 109 (Robert G. Ibbotson & Peng Chen, *Long-Run Stock Returns: Participating in the Real Economy*, FIN. ANALYSTS J. (Jan./Feb. 2003)) at 88, 94; Ibbotson Yearbook at 92 (stating the same principle).
[112] Ibbotson Yearbook at 95-96, 98 (discussing how the supply side model is structured); Tr. at 420-22 (Gompers).
[113] *Id*. at 96 ("[T]he main difference between the historical and forecast equity returns is the exclusion of growth in P/E ratio in the forecasted earnings model.").
[114] *See, e.g.*, JX 113 (Jeremy Siegel, *Perspectives on the Equity Risk Premium*, FIN. ANALYSTS J. (2005)) at 62-64, 70 (setting forth the "persuasive reasons [that] support a lower forward-looking real return on equity than the return found in the historical data").
[115] JX 319 (Shannon Pratt, "Valuers Should Lower Equity Risk Premium Component of Discount Rate," *Business Valuation and Resources*, BUSINESS VALUATION UPDATE (Nov. 2003)).
[116] JX 318 (PRATT, COST OF CAPITAL, *supra* note 101).

5.96%,[117] and a report of JP Morgan estimating the ERP to be in the range of 5% to 7%.[118] Although the surveys cited by Gompers are not so compelling as to be conclusive, they suggest that current academic thinking puts the ERP closer to 6.0% than to 7.1%.

The question is not free from doubt, but I believe that Gompers has the better of the argument for the following reasons. First, to cling to the Ibbotson Historic ERP blindly gives undue weight to Ibbotson's use of a single data set. 1926 might have been a special year because, for example, that was the year when Marilyn Monroe was born, but it has no magic as a starting point for estimating long-term equity returns. If one is going to use an approach that simply involves taking into account historical equity returns, then one has to consider that very well-respected scholars have made estimates in peer-reviewed studies of long-term equity returns for periods much longer than Ibbotson, and have come to an estimate of the ERP that is closer to the supply side rate Ibbotson himself now publishes as a reliable ERP for use in a DCF valuation.[119] For example, Professor Jeremy Siegel has examined the period from 1802 to 2004 and come up with an

[117] JX 114 (Ivo Welch, *The Consensus Estimate For the Equity Premium by Academic Financial Economists in December 2007* (Jan. 2008), *available at* http://ssrn.com/abstract=1084918)) at Table 2. Of the professors who responded to the survey, the middle 50% of respondents teach an ERP between 4% and 6%. Of the other fifty percent of respondents, five percent teach an ERP of 2-4%, twenty percent teach 4-5%, twenty percent teach 7-8.5%, and five percent teach 8.5-20%. *Id*.

[118] JX 112 (JP Morgan, *The Most Important Number in Finance: The Quest for the Market Risk Premium* (May 2008)) at 2.

[119] *See* JX 828 (Michael Devaney, *Will Future Equity Risk Premium Decline?*, J. OF FIN. PLANNING (Apr. 2008)) at 47 (finding that a mean equity risk premium of 5.5% covers the period from 1870-2002).

ERP of 5.36%.[120] Likewise, Professors Eugene Fama and Kenneth French considered the period from 1872 to 2000, and calculated an average ERP of 5.57%.[121]

Relevantly, the literature also suggests that the ERP for companies operating in foreign markets is, if anything, lower than the Historic ERP for a domestic company.[122] Importantly, these studies reach results that are consistent with the actual logic used by Ibbotson in recent volumes. Although it is true that Ibbotson does not disavow the use of the Historic ERP as a basis for valuing

[120] JX 113 (Siegel, *supra* note 114) at 63.

[121] JX 833 (Eugene Fama & Kenneth French, *The Equity Premium*, 57 J. OF FIN. 637, 638 (Apr. 2002)) (considering different measures of the expected ERP utilized by the market, such as the dividend growth model, and comparing those measures to the historical ERP). Golden argues that, because Fama and French advocate a three-factor model that differs from the CAPM in determining the cost of equity, their ERP findings cannot be compared to those of Ibbotson. But, whatever differences may exist between the CAPM and Fama-French models for calculating the cost of equity, those differences do not affect the applicability of Fama and French's ERP estimate, which is an input to both models. *See* BREALEY & MYERS, *supra* note 81 at 208-09; *see also* PRATT, COST OF CAPITAL, *supra* note 101 at 102 (discussing the ERP calculated by Fama and French from 1951 to 2000 and comparing it to other ERPs calculated by, among others, Ibbotson). Nothing suggests that the ERPs derived by Fama and French are only appropriately used in the Fama-French, and not the CAPM, model.

[122] *See, e.g.*, JX 318 (PRATT, COST OF CAPITAL, *supra* note 101) at 109 (noting that equity returns and historical equity premiums for foreign companies should be adjusted *downward* to account for the fact that corporate cash flows in most foreign countries typically exceed investors' expectations (citing Dimson, Marsh & Stauton, *Global Evidence on the Equity Premium*; *The Worldwide Equity Premium: A Smaller Puzzle*, EFA 2006 Zurich Meetings Paper, April 7, 2006; Global Investment Returns Yearbook 2007)); JX 113 (Siegel, *supra* note 114) at 63 (explaining that due to the "survivorship bias," ERPs based on the United States market typically overstate the returns on equities, particularly in markets "where stocks have faltered or disappeared outright, such as they did in Russia"); *see also* Aswath Damodaran, *Equity Risk Premiums (ERP): Determinants, Estimation and Implications* at 12, *available at* http://ssrn.com/abstract=1274967 (describing a view "backed by a study of large equity markets over the twentieth century" that "[t]he historical risk premium obtained by looking at U.S. data is biased upwards because of a survivor bias").

corporations on a going forward basis, the text is utterly devoid of any explication of why the Historic ERP should used. By contrast, the 2003 article by Ibbotson and Chen explains that "investors' expectations for long-term equity performance should be based on the supply of equity returns produced by corporations" because "[t]he supply of stock market returns is generated by the productivity of the corporations in the real economy."[123] And, Ibbotson's 2008 Valuation Yearbook makes a strong argument for the supply side method by stating that "over the long run, equity returns should be close to the long-run supply estimates."[124]

Ibbotson's reasoning comports with the strong weight of professional and academic thinking, which is accurately represented by Gomper's view that the most responsible estimate of ERP is closer to 6.0% than 7.1%. I come to this conclusion with full realization that any estimate of ERP is just that, an estimate of something that is highly uncertain, and that the relevant academic and professional community — and not this court — should develop the accepted approach. Sherman's approach has met with the approval of this court on prior occasions,[125] but, when the relevant professional community has mined additional data and pondered the reliability of past practice and come, by a healthy weight of reasoned opinion, to believe that a different practice should become the norm, this court's duty is to recognize that practice if, in the court's lay estimate, the practice is the

[123] JX 109 (Ibbotson and Chen, *supra* note 111) at 94.
[124] Ibbotson Yearbook at 92.
[125] *See In re PNB Holding Co. S'holder Litig.*, 2006 WL 2403999, at *30 (Del. Ch. Aug. 18, 2006) (choosing to adopt a historical ERP of 7% because a long-term supply side ERP had not yet gained "universal acceptance").

most reliable available for use in an appraisal.[126] Here, there is solid academic and professional thinking that supports the view that 6.0% is the most responsible ERP to deploy, and I do so. In reaching this conclusion, I give heaviest weight to the published literature, but also find the admittedly squishier academic survey data supportive. Although that data is far from perfect, it does reveal that the weight of academic thinking at our nation's finest finance departments places the ERP much nearer to Gomper's estimates than Sherman's. For all these reasons, I adopt Gompers' ERP of 6.0%.

4. Beta

In round two of their theoretical debate, Gompers and Sherman spar over what beta to use in calculating Golden's cost of equity capital.[127] As in the prior debate, Gompers claims that he is using the best forward-looking, academically

[126] *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983) (interpreting 8 *Del. C.* § 262 to require that appraisal actions "include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court"); *Union Ill.*, 847 A.2d at 363 (adopting the Fama-French approach to cost of capital over the more widely accepted CAPM approach because the court determined the former approach to be more reliable and more appropriate for use in that valuation of a regional bank). As in any complex area involving the prediction of future human events, one can expect that academic and professional thinking on the expected ERP will not remain static but will evolve as more data and additional thinking is done. That is the nature of things. What, of course, makes the use of such thinking of piquancy in this context is that ideas that academics and professionals throw around to create ranges of value are used by a law-trained judge to come to a single point estimate of value that could require a party to pay another party millions of dollars. The law-trained judges who must perform such analyses are more conscious than anyone of the inherent risk of error in such an endeavor, and indeed of the reality that no one can really tell if an error was made. That is why many of us eschew the hoary term "intrinsic value," a term best reserved for judgments of the divine than ones made by human judges.

[127] Sherman Rebuttal at 10.

and professionally sound approach while Sherman is using a backward-looking, outdated approach. Again, the petitioners overstate their case and, in this instance, also fail to put forward reliable academic and professional support for their position.

It is true that Sherman uses a more traditional approach to beta. Sherman uses the Bloomberg five-year weekly historic beta for Golden of 1.32.[128] The Bloomberg beta is based on a publicly-available regression calculation, and is computed in the standard way by examining the co-variance of a company's stock performance with that of the stock exchange on which the firm's shares are listed.[129] Although there is a fairly substantial amount of imprecision and a general disagreement in the finance industry and academia over the proper way to select a beta value,[130] the Bloomberg historic beta is considered to have a fair amount of predictive power, and to be a reliable proxy for unobservable forward-looking betas.[131]

Sherman argues that his use of a historic beta is appropriate because Golden's operating and capital structure would have remained substantially the same going forward as it had during the five years captured in the Bloomberg

[128] Sherman Rebuttal at 11; JX 465 (Bloomberg Historical Beta for Golden Telecom).
[129] Sherman Report at 62 n.200.
[130] *See* JX 106 (Robert Bruner et al., *Best Practices in Estimating the Cost of Capital: Survey and Synthesis*, FIN. PRACTICE AND EDU. (Spring/Summer 1998)) at Ex. 4 (showing that beta values for a sample company given by Bloomberg, Value Line, and Standard and Poor's range from a mean beta of 1.03 to 1.24).
[131] *Id*. at 19; Tr. at 603 (Gompers).

historical beta.[132] Sherman also accurately points out that the Bloomberg historical beta for Golden remained relatively stable during the five year period, suggesting that the market had a good bead on its systematic risk.[133]

By contrast, Gompers eschews reliance on Golden's historical beta and advocates a lower beta of 1.2, based on a so-called predictive beta from the financial consultancy MSCI Barra ("Barra").[134] Gompers argues that his approach is forward-looking and more reliable because beta estimates are not stable over long periods of time, and thus the use of a historical beta is not the best basis for predicting the future, especially because there is some evidence that the betas of companies tend to eventually revert towards the mean.[135] Gompers also claims that because Golden was seeking to evolve its business strategy from one heavily reliant on acquisitions for growth toward one that was less dependent on M&A and more on organic growth, Golden's historical beta is not a good predictor of its future beta.

The petitioners ask that if this court declines to adopt the Barra beta, a Bloomberg adjusted beta of 1.17 be used, but it is not clear why they advocate the Bloomberg adjusted beta as an appropriate alternative to the Barra beta. Aside from the fact that the Bloomberg adjusted beta produces a value close to 1.2, the methodology used by Bloomberg to adjust the beta value bears no apparent

[132] Tr. at 913 (Sherman).
[133] Sherman Rebuttal at 11-13.
[134] Gompers Rebuttal at 18.
[135] *Id*. at 17.

relationship to that used by Barra. Unlike the 13-factor Barra model, Bloomberg uses only two factors for its adjusted beta, giving 66% weight to a corporation's historic beta, while taking into account the possibility of later mean reversion by giving 33% weight to 1, or the average market beta.[136]

This battle of the experts is one that I am poorly positioned to resolve, and it appears unlikely that a finance professor would fare any better. Even after asking the parties to go back and submit relevant literature on beta, and even after doing an independent review, I admit to finding no literature that sheds reliable light on this question of whether to use a historical or the supposedly forward-looking Barra beta. The standard texts do not explore the reliability of different approaches to calculating beta in any useful depth.[137] I suppose that is not surprising because most practitioners who use beta are not looking for precision but for a reasonably reliable tool to make range of value estimates. But, whatever the reason, the reality is that the available literature is far from helpful, and does not aid Gompers or his client, the petitioners.

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[136] JX 106 (Bruner, *supra* note 130) at 21.

[137] *See, e.g.*, BREALEY & MYERS, *supra* note 81 at 173-75, 232-34 (defining beta, and giving a cursory discussion of how beta reflects market sensitivity, and how beta is calculated relative to foreign markets for foreign investments in the United States); PRATT, VALUING A BUSINESS, *supra* note 86 (discussing beta as a measure of systematic risk, extreme betas that are above and below the average beta of 1.0, beta measurement problems, and listing problems that arise when applying betas estimated for guideline companies to the valuation of the subject company); BRADFORD CORNELL, CORPORATE VALUATION: TOOLS FOR EFFECTIVE APPRAISAL AND DECISION MAKING 219-22 (1993) (noting that certain analysts adjust beta toward 1.0, or toward the industry average, but stating that a more detailed discussion was "beyond the scope of [the] book").

Gompers touts the Barra beta as one that has been relied upon by the financial community for equity valuations.[138] I accept that that is the case, although I also recognize, as Gompers does, that the use of the Bloomberg historical beta is also a common, indeed probably more common, practice. [139] But for several reasons that I now explain, Gompers has not given me the confidence to embrace the Barra beta technique as reliable one.

For starters, the Barra forecasting model is proprietary, and cannot be reverse-engineered. The Barra predictive beta, which is a forecast of a stock's future looking beta using past data, is based on a thirteen-factor model,[140] but the weight given to each of the factors is not publicly available.[141] In fact, Barra has used three different versions of its model without explaining why or what changes have been made,[142] and it is not apparent whether Barra retroactively updates its past beta calculations as it tinkers with? improves? changes for changes' sake? or lessens? the reliability of its model. Consistent with these realities, Gompers himself does not fully understand the details of how the Barra model works and,

[138] Tr. at 351-52; *see also* JX 106 (Bruner, *supra* note 130) at 20 (stating that "[t]he best known provider of fundamental beta estimates is the consulting firm BARRA"); JX 115 (Scott Widen, *Delaware Law, Financial Theory and Investment Banking Valuation Practices*, 4 NYU J. OF L. & BUS. 579, 585-86 (2008)) (citing numerous sources for the notion that "[m]any investment banks now use predicted Barra betas in their fairness opinion analyses").
[139] Tr. at 618 (Gompers).
[140] The thirteen factors used in Barra's model include: volatility, momentum, size, size nonlinearity, trading activity, growth, earnings yield, value, earnings variability, leverage, currency sensitivity, dividend yield, and a non-estimation universe indicator. *See* JX 117 (BARRA, RISK MODEL HANDBOOK UNITED STATES EQUITY: VERSION 3 75-76 (1998)).
[141] *Id*. at 93 (explaining that the method of computing the Barra beta "is proprietary to Barra").
[142] Tr. at 616 (Gompers).

thus, I cannot rely on his advocacy of it. The only thing Gompers knows about the model is that it lists certain valuation-relevant factors, including factors relevant to the historical beta such as volatility, leverage, and trading activity, and throws them in a stew pot in undisclosed proportions to come up with an outcome.[143] Put simply, despite his impressive academic credentials, Gompers himself could not cook me up a Barra beta of Golden, Microsoft, or any other company if I asked him to do so.

In a critically important difference from the ERP controversy I just decided, the Barra beta's reliability is not buttressed by the weight of any reliable academic or professional literature. The only evidence that the petitioners have produced showing that the Barra beta has a greater reliability than other beta providers such as Bloomberg or Morningstar is a quarter-century old paper authored by Barr Rosenberg, the creator of the Barra beta.[144] No neutral academic support for the predictive power of the Barra beta has yet been published.[145] And, as discussed, the undisclosed recipe for the Barra beta has changed several times since the Rosenberg paper was published.

Finally, Gompers' advocacy of the Barra beta is inconsistent with a DCF valuation that Gompers submitted to this court in *Doft & Co. v. Travelocity.com*

[143] *See supra* note 140.
[144] *See* JX 111 (Barr Rosenberg, *Prediction of Common Stock Betas*, J. OF PORTFOLIO MGMT., Winter 1985) at 5-14 (discussing the overall predictive performance of the first Barra beta model).
[145] Tr. at 378-81 (Gompers).

Inc.[146] Tellingly, in that valuation, Gompers utilized a historic raw beta similar to Sherman's approach covering various time periods during the two-year period before the relevant merger,[147] which was lower than the Barra beta that would have applied to Travelocity at that time.[148] Gompers testified in this case that his opinion in *Travelocity* was in line with what he taught and understood about beta at that time and, since 2006, he has switched to using a Barra beta or an adjusted beta.[149] But, oddly, he cannot point to an epiphanic moment or any academic or other studies that prompted him to change his approach. In fact, the Barr Rosenberg article that Gompers predominantly relies on was published in 1985 — nineteen years before Gompers used a raw historic beta in *Travelocity*.[150] This is in strong contrast to the ERP question, where Gompers is able to cite a wealth of recent academic and professional writings that supports a lower ERP estimate.

I wish to emphasize that I do not reject the Barra beta for use in later cases. Rather, I decline to adopt the Barra beta for purposes of this appraisal, given both Gompers' inability to shed light on the inner workings of the Barra beta model and his unexplained shift from advocating the historical beta in *Travelocity* to the Barra beta in this case. If the Barra beta is to be used in appraisal proceedings, a more detailed and objective record of *how* the Barra beta works and *why* it is

[146] 2004 WL 1152338 (Del. Ch. May 21, 2004). The court in *Travelocity* declined to conduct a DCF analysis in determining the fair value of the company because the underlying management projections were unreliable. *Id*. at *5.
[147] *See Doft & Co. v. Travelocity.com, Inc.*, C.A. No. 19734, 309-10 (Sept. 25, 2003) (TRANSCRIPT); *see also* Tr. at 603-04 (Gompers).
[148] Tr. at 608-09 (Gompers).
[149] *Id*. at 744-46 (Gompers).
[150] JX 111 (Barr Rosenberg, *supra* note 144).

superior to other betas must first be presented. To this point, it is more persuasive to a judge to know that a testimonial expert who is an academic has written about the reliability of a valuation methodology in an academic study in a peer-reviewed journal than to be among those first privileged in the world to hear from the academic about that issue in his expert reports and seat-of-the-pants testimony in a valuation assignment for a self-interested litigation client.

Although I reject Gompers' use of a Barra beta, I am persuaded that the simple use of historical beta is not the best method to use in calculating Golden's cost of equity. Although beta is a somewhat metaphysical concept, the literature does tend to suggest that, as a matter of theory anyway, companies that are more unstable and leveraged, less established and financially and competitively secure, and in colloquial terms "riskier," should have higher betas.[151] Betas can also take into account considerations like political risk to the extent they are priced by the market.[152]

Given these realities, a more substantial, if still less than ideal, part of the valuation literature comes into play. As even Golden admits, there is support for

[151] *See, e.g.*, PRATT, COST OF CAPITAL, *supra* note 101 (explaining that companies with higher levels of debt are "riskier" than the equity of companies with less leverage); PRATT, VALUING A BUSINESS, *supra* note 86 ("Securities that have betas greater than 1.0 are characterized as aggressive securities and are more risky than the market."); JX 312 (Pablo Fernandez, *Are Calculated Betas Worth for Anything?*, IESE Business School, Working Paper (Oct. 16, 2008)) at 13 (pointing out a problem with historic betas that high-risk companies often have smaller historical betas, although riskier companies should have higher betas).

[152] Tr. at 685 (Gompers) (explaining that, by accounting for the "historical correlation of the stock return with the market," the beta values account for political risk).

the notion that more extreme betas tend to revert to the industry mean over time.[153] The historical beta of Golden is quite high, especially given its low leverage, and might reflect, among other things, its geographic concentration in an emerging market with some higher risk of political instability, its high growth strategy and its position in the telecom sector.

But Sherman has premised his valuation of Golden on the notion that its growth will slow, its domestic market will become a place friendly for those desirous of Volcker-style inflation policing, and that Golden will become a steady, staid company. To my mind, this view is consistent with the notion that Golden will, over time, revert toward the telecom industry's typical beta.

Unlike Gompers, however, I do not believe the immediate use of a lower beta is in order. The record supports the conclusion that Golden will continue to engage in a good deal of M&A activity, will enter new product markets, and continue to operate in a market with some political risk.[154] Rather, the more

[153] *See* JX 318 (PRATT, COST OF CAPITAL, *supra* note 101) at 130 (stating that "[o]ver time, a company's beta tends toward its industry's average beta").

[154] Although Golden had a substantial presence in the largest Russian cities as of the valuation date, there were substantially-sized markets it still wished to enter and new product markets it hoped to join. *See* JX 416 (Transcript of Golden's Third Quarter Earnings Release Conference Call, *supra* note 18) (announcing that Golden's growth strategy included expansion into thirty additional cities); Tr. at 814, 816-17 (Svetlichny) (explaining that Golden was exploring a number of smaller acquisitions before it was acquired by VimpelCom). The likelihood is that to do so, M&A activity would have remained an important element of its growth strategy, as would risky product launches. Even if Gompers were correct that Golden was shifting its strategy to one of predominantly organic growth, Gompers fails to explain why such a strategy would result in a lower beta. Beta values measure systematic risk, and it is not clear that organic growth is less risky than M&A. Furthermore, Gompers' argument that the Barra, and not historical beta, would better account for this supposed strategy shift is belied by the fact

balanced approach is to give the predominant weight to Golden's historical beta, while giving some substantial weight to the industry beta.[155]

In doing so, I reject Gompers' argument that if I decline to adopt the Barra beta, I should instead adopt a Bloomberg adjusted beta of 1.17, which begins with the historic beta used by Sherman and adjusts it towards 1.0 on the theory that "extreme" betas eventually revert toward the overall average market beta of 1.0.[156] As an initial matter, Gompers' advocacy of the Bloomberg adjusted beta is not

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that Gompers selected a Barra beta from June 2007 while Golden's Five Year Plan announcing its strategy is from October 2007. *See* Gompers Report at 37.

[155] The petitioners argue that it is not appropriate to use an historic beta because such a beta gives weight to political risk, which was already accounted for by Golden's management in estimating Golden's future cash flows. But, although the Proxy explained that the Special Committee based its recommendation that Golden's shareholders accept VimpelCom's tender offer on factors that included "political uncertainty in the Russian market," and noted that risks inherent in the forward-looking statements in the Five Year Plan included "the political, economic and legal environment in the markets in which [Golden] operate[d]," Golden's cash flow projections did not incorporate any specific value for political risk. *See* Proxy at 27, 46; Tr. at 828-29 (Svetlichny) (explaining that the Five Year Plan's projected cash flows did not account for political risk because such "risks are . . . binary in nature" and could not "be predicted and incorporated"). Moreover, it is difficult to estimate what value to place on political risk; in the case of Russia, the only real concern in the record seemed to be about some radical change in which companies like Golden might be expropriated. Management could not really price that risk, but it may be, I cannot say for sure, that the reported beta does capture some of that risk and, if the market does that, I cannot see why this court should not consider that real-world valuation factor. I also think it odd that the petitioners would have courts, and I suppose all those performing valuations, parse betas for factors that might have also been accounted for (e.g., leverage or the riskiness of certain industries) in management estimates of cash flow. The petitioners have not explained how or why one would do that. By giving weight to the industry beta, I also take into account the idea that Sherman embraced, which is that Russia is becoming more, not less, like markets such as the United States in terms of inflation and other relevant factors. Thus, I am confident that I am not giving some undue weight to political risk by relying heavily on Golden's historical beta.

[156] *See* JX 311 (Marshall Blume, *Betas and Their Regression Tendencies*, 30 J. OF FIN. 785, 794 (1975)) (explaining that "extreme" betas "tend to regress towards the grand mean of all betas over time"); Tr. at 626 (Gompers).

convincing because he simply suggests it as an alternative to the Barra beta, without any rational linking of these two disparate methods.[157] Moreover, he offers no explanation as to why adjusting the Bloomberg beta to 1.0 makes more sense for Golden — a company with low leverage, fast growth, and consistent performance in the telecom sector — than the raw five-year beta or, to the extent there is a reversion, an industry-based beta.

In my view, no reliable literature or evidence was presented to show that the beta of a telecom company like Golden, which operates in a risky market, will revert to 1.0. Instead, it makes more sense that companies in emerging markets will become more like their industry peers in more mature markets.[158] That intuition is also line with the views of both Gompers and Sherman that Russia's growth rate will slow, its telecom industry will approach maturity, and that Golden's growth rate will eventually settle closer to the Russian rate of inflation.[159]

According to the Ibbotson telecom (SIC 4813) beta, which gives the beta values for approximately 50 telecom companies that are traded in the United States including Golden, the median industry beta as of December 2007 was 1.45,

[157] *See supra* pages 41-42.
[158] *See* PRATT, COST OF CAPITAL, *supra* note 101 at 130 (stating that "[o]ver time, a company's beta tends toward its industry's average beta").
[159] *See supra* pages 26-30; Sherman Report at 21-21, 31.

and the SIC composite beta was 1.24.[160] Similarly, the Bloomberg CUTL Index, which is a telecommunications index of companies traded on the NASDAQ, including Golden, puts the five year weekly industry beta at 1.249.[161] Golden was a much larger, less levered company than the median company on the Ibbotson SIC 4813 list and, therefore, the composite beta of 1.24 is more appropriate than the median beta of 1.45.[162] I adopt it as the industry beta for purposes of this analysis.

I find that a beta that gives 2/3 weight to the Bloomberg historic raw beta of 1.32 and 1/3 weight to the 1.24 industry beta is the best approach to this DCF analysis. By predominantly adopting the historic raw beta, I give weight to the fact that Golden presently operates in a riskier, emerging, high-growth market, while tempering that number to account for the evidence that Russia is normalizing and that Golden is a stable company that would eventually have had a beta closer to its more mature, NASDAQ-traded peers. I thus apply a beta of 1.29 to the DCF analysis for a cost of equity of 12.3%.

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[160] Sherman Demonstrative 26 (citing the Ibbotson Cost of Capital 2007 Yearbook December 2007 Quarterly Update, SIC Code 4813, and the Bloomberg CUTL Index as of Feb. 5, 2007); Tr. at 917-18 (Sherman).

[161] Sherman Demonstrative 26; Tr. at 917-18 (Sherman).

[162] The median company listed by Ibbotson in the SIC 4813 industry code has median sales of $141 million and median total capital of $389 million. Golden had sales over $1 billion and its total capitalization was over $4 billion. Tr. at 1135-36 (Sherman) (citing Sherman Cross Examination Demonstrative 18). And, the median company in the SIC 4813 had debt equal to 30% of its total capital, while Golden had debt equal to only 5% of its total capital. Sherman Cross Examination Demonstrative 18; 2007 10-K at 34; Tr. at 1137-38 (Sherman).

V. Conclusion

For the reasons I have explained, I adopt a terminal growth rate of 5.0%, a tax rate of 31.6%, an equity risk premium of 6.0%, and a beta of 1.29. I applied those inputs to Gompers' DCF model, and came up with a value of $125.49 per share. The parties should confer and make sure that I used the model correctly. Assuming that I did, they should present a final judgment using an amount of $125.49, plus interest from the Valuation Date to the date of payment at the legal rate, compounded quarterly.[163] If the dollar figure is different, they should explain why they use the different figure and submit the corrected amount. The parties shall submit an order within five days. IT IS SO ORDERED.

[163] 8 *Del. C.* § 262(h) (setting the interest rate for appraisal cases at the legal rate at 5% over the Federal Discount Rate, compounded quarterly, unless there is "good cause" to deviate from that rate).

Full Text of Court Cases

Golub v. Golub

Case name: Golub v. Golub
Citation: 527 N.Y.S.2d 946,1988 N.Y. Misc. LEXIS 176
Date of decision: March 8, 1988
Country: US
State or Federal: State
State/Jurisdiction: New York
Court: Supreme Court
Type of action: Marital Dissolution
Judge: Silbermann
SIC: 7929 Bands, Orchestras, Actors, and Other Entertainers Entertainment Groups (musical groups, musical artists, and orchestras)
NAICS: 711510 Independent Artists, Writers, and Performers

Keywords: Marital dissolution

COUNSEL:

Breed, Abbott & Morgan, P. C. (James Ziren of counsel), for plaintiff.

Cohen & Shalleck, P. C. (Jeffrey Cohen of counsel), for defendant.

JUDGES:

Jacqueline W. Silbermann, J.

OPINIONBY:

SILBERMANN

OPINION:

OPINION OF THE COURT

This matrimonial action was commenced by service of a summons in June 1986. After a timely appearance by defendant, a verified complaint was served on or about August 29, 1986. Issue was thereafter joined on November 4, 1986. A sufficient showing having been made at trial that the marriage which had been dying in 1984 was moribund as of 1985, a dual divorce on the grounds of constructive abandonment and abandonment was granted and the trial proceeded as to the ancillary relief.

After listening to the many days of testimony, observing the witnesses' demeanor and manner of testifying and studying the many exhibits offered in evidence, the court makes the following findings.

STATEMENTS OF FACTS

The parties were married amidst a great deal of fanfare including television coverage on February 14, 1982. Although there are no children of this marriage, plaintiff has a daughter, Starlite, by a former marriage.

Plaintiff, Marisa Berenson, is a renowned and celebrated film and television actress and model. At the time of the marriage she apparently enjoyed enormous entree to the world of arts and fashion both in her own right and as the granddaughter of Elsa Schiaparelli, the celebrated couturiere.

At the time of the marriage, defendant A. Richard Golub was a successful attorney who had been in private practice for many years and who attracted media and celebrity attention. Indeed, at the time immediately preceding their marriage, defendant was engaged in the trial of a matter involving Brooke Shields which was getting a substantial amount of media coverage.

It is clear that both parties coveted and gained the attention of the press and the company of the"Rich and Famous".

After living at several different locations during the first few months of their marriage, in the fall of 1982, the parties purchased a four-story townhouse at 209 East 83rd Street. This house was found by defendant and purchased for $ 575,000. The purchase was accomplished by the parties' assumption of a then existing small mortgage, and a contribution by plaintiff of $ 58,000 and defendant of $ 75,065.61.

On February 1, 1984 the 83rd Street property was sold for $ 950,000. Defendant had acquired the contract to purchase the townhouse at 42 East 64th Street for $ 50,000 and paid an additional $ 55,787.65 for a total cash payment of $ 105,787.65. Because the purchase of East 64th Street preceded the sale of 83rd Street property by six days, the remainder of the purchase price was covered by a purchase-money mortgage of $ 675,000 and a bridge loan of $ 250,000.

An examination of the various checks introduced into evidence as well as the testimony of the parties reveals the fact that the parties in effect pooled their income and defrayed their expenses using a flexible and/or pragmatic approach.

Plaintiff's funds, including income from films, television, modeling and a book, were placed mainly in two accounts. (Plaintiff had a separate Paris account as well.) One was called "A. Richard Golub Special Account No. 2" and the second "Echoes of Eternity". Defendant had signatory powers on both these accounts. Throughout the marriage it is evident that defendant made many of the decisions concerning the management of plaintiff's financial matters and how their moneys would be spent. Thus, their moneys were used interchangeably to pay their various expenses including expenses for the East 83rd Street house, the East 64th Street house, taxes and general living costs.

Beginning at the start of the marriage and continuing thereafter, plaintiff spent almost half of every year in Europe. In September 1985, plaintiff found an apartment in Paris which she leased in her name. Defendant contributed $ 32,500 toward obtaining the Paris apartment. Plaintiff has had exclusive use of the Paris apartment.

Throughout the marriage plaintiff appeared to have been engaged in pursuing her career both in the United States and abroad, concededly successfully. While in New York, the parties ate frequently in restaurants and seemingly entertained little at home. Housekeeping and child care were tended to by hired help. These homemaking services were solely supervised by the defendant for approximately half

of every year while plaintiff was in Europe. Likewise, defendant supervised the renovations made to the marital real estate as well as the negotiations and litigation necessary to vacate the rental apartments that were contained therein.

CONCLUSIONS OF LAW

Maintenance

In deciding plaintiff's request for maintenance, the court considered the statutory standards embodied in section 236 (B) (6) of the Domestic Relations Law.

The court notes that this is a short childless marriage in which both parties are in excellent health. Plaintiff has been a model since she was a teen-ager, appearing on the covers of such magazines as Vogue, Bazaar, Time and People. She is also a successful film and television actress. She works in this country as well as abroad, since she speaks several foreign languages. Plaintiff also wrote a book on fashion titled "Dressing Up" which was published by G.P. Putnam & Sons. Her talent and beauty have enabled plaintiff to become a substantial wage earner.

During the course of the marriage due in part to defendant's assistance by dint of his legal skills and business acumen plaintiff's earnings have appreciated. In this connection, defendant assisted plaintiff, inter alia, by getting her personal financial affairs in order at the inception of the marriage and making efforts throughout the marriage to advance her career. Indeed, plaintiff's income has significantly increased during the marriage to a point where she earned in excess of $ 150,000 in 1987.

Plaintiff is clearly able to maintain out of her own resources, as well as the equitable distribution to be awarded herein, the standard of living she has enjoyed during the marriage to defendant. Thus, an award of maintenance is inappropriate and none is awarded.

Marital Property and Separate Property

Marital property is defined in section 236 (B) (1) (c) as "all property acquired by either or both spouses during the marriage". (See also, Price v Price, 69 NY2d 8 [1986].) That is, the assets that represent the capital product of what was essentially a partnership entity. (Wood v Wood, 119 Misc 2d 1076 [Sup Ct, Suffolk County 1983].)

The court finds the following items to be marital property: the marital residence at East 64th Street; the increase in value of defendant's practice; the increase in value in plaintiff's career; the furnishings in the marital residence; the furnishings in the Paris apartment; and the dollar sign painting by Andy Warhol.

Equitable Distribution

In deciding the issue of the equitable distribution of the marital property the court has duly considered the factors enumerated in Domestic Relations Law § 236 (B) (5) (d) and being cognizant that "[the] function of equitable distribution is to recognize that when a marriage ends, each of the spouses, based on the totality of the contributions made to it, has a stake in and right to a share of the marital assets accumulated while it endured" (McGowan v McGowan,136 Misc 2d 225,227 [Sup Ct, Suffolk County] [emphasis supplied]).

Increase in Value of Acting and Modeling Career

Defendant contends that the increase in value of plaintiff's acting and modeling career is marital property and he seeks equitable distribution thereof as a result of his contributions thereto. The law of this State is clear that any increase in the value of separate property of a spouse occurring during the marriage which is due in part to the direct or indirect contributions of the other spouse may be considered property. (Price v Price., 69 NY2d 8 [1986], supra.) Further, the law is clear that professional licenses are included in the definition of property (O'Brien v O'Brien, 66 NY2d 576) and that this definition has been extended to include academic degrees as well as professional licenses (McGowan v McGowan, 136 Misc 2d 225 [Sup Ct, Suffolk County 1987], supra).,

Plaintiff, citing Morimando v Morimando (NYLJ, Feb. 6, 1987, at 16, col 1 [Sup Ct, Nassau County]), contends that her celebrity status is neither "professional" nor a "license" and hence not an "investment in human capital subject to equitable distribution." Moreover, plaintiff argues that because a career in show business is subject to substantial fluctuation, it should not be considered.

In O'Brien (supra), the fact that the professional license itself had no market value was irrelevant. It is the enhanced earning capacity that the license affords the holder that is of value. In this respect, all sources of enhanced earning capacity become indistinguishable. "Could it rationally be concluded that, for purposes of equitable distribution upon divorce, the Court of Appeals intended to limit as marital property, licenses enumerated in the Education Law? Hardly, given the definition of a license's value as enunciated in O'Brien as being enhanced earning capacity." (McGowan v McGowan, 136 Misc 2d 225, 228, supra.)

McGowan (supra) gives "enhanced earning capacity" an expansive meaning. The same logic used in McGowan to extend marital property to include degrees can be applied to include as marital property a spouse's unique ability to commercially exploit his or her fame. In O'Brien (66 NY2d 576, supra), it was the privileges conferred by the license that were critical to the court's decision, not the piece of paper itself. In McGowan, it was not the spouse's degree that was divisible; it was the income generated by exercising the privileges associated with the degree that the nondegreed spouse was seeking to share.

In O'Brien (supra), the court appears to bespeaking of an intangible asset or "res". (See, Morimando v Morimando, supra.)

In fairness, just as McGowan (supra) was a logical extension of O'Brien (supra), the right of a spouse to share in other valuable assets must be the next step forward.

There is tremendous potential for financial gain from the commercial exploitation of famous personalities (25 UCLA L Rev 1095). There is a proprietary interest in the product of a celebrity's labors. The right to exploit a celebrity's fame has been held to descend to his heirs (Price v Roach Studios, 400 F Supp 836). This exemplifies the property nature of a celebrity's fame. A commercial endorsement is essentially a "license" to use a person's fame. "Recognition of the community's interest in certain of these intangible interests indicates a disposition on the part of the judiciary to re-evaluate old notions of property. In light of this, consideration of the community property issues posed by the right of publicity seems overdue" (25 UCLA L Rev 1095, 1113).

There is an analogy to be made between the right of publicity and professional goodwill. In bothrights, there is a secondary meaning generated by a name and benefits derived therefrom. In either case, the right becomes an income-producing source.

The courts should treat all matrimonial litigants equally and should not prejudice nor penalize a spouse who is married to a nonprofessional who may nevertheless become an exceptional wage earner. The O'Brien remedy should be applied evenhandedly to all spouses. (Samuelson, The Valuation of Non-Tangible Assets of Non-Professionals, 19 [No. 2] Fam L Rev 1 [NY St B Assn, June 1987].) Otherwise, what will result is an economic windfall to some and an unfair deprivation to others. Clearly, there are certain fields in which the earning capacity exceeds that of other fields which require licensure. When a person's expertise in a field has allowed him or her to be an exceptional wage earner, this generates a value similar to that of the goodwill of a business.

In Morimando (supra), the spouse of a physician's assistant sought to have that spouse's licence declared marital property for equitable distribution purposes upon divorce. The court distinguished this case from O'Brien (66 NY2d 576,supra) because a physician's assistant does not share the same level of opportunity as does an M.D. A physician's assistant was said to always rely on an employer. The court also referred to the statute applicable to physician's assistants and noted that it "clearly imposes limitations upon the exercise of their functions." The physician's assistant is "destined to remain an employee." Unlike a physician's assistant, an actress/model often functions independently, on a free-lance basis and is not at the mercy of his or her employer.

O'Brien (supra) is the law. If it is to remain as good law, the rule should be uniformly applied. There seems to be no rational basis upon which to distinguish between a degree, a license, or any other special skill that generates substantial income. In determining the value of marital property, all such income-generating assets should be considered if they accumulated while the marriage endured. If one spouse has sacrificed and assisted the other in an effort to increase that other spouse's earning capacity, it should make no difference what shape or form that asset takes so long as it in fact results in an increased earning capacity. The rationale in both O'Brien and McGowan (supra) for awarding the spouse an economic interest in the intangible asset seems to have been based on a view of the asset as "investments in the economic partnership of the marriage and * * * the product of the parties' joint efforts". (McGowan v McGowan, supra, at 230.)

The noncelebrit spouse should be entitled to a share of the celebrity spouse's fame, limited, of course, by the degree to which that fame is attributable to the noncelebrity spouse (25 UCLA L Rev 1095). The source of the fame must still be traced to the marital efforts.

Thus, as in O'Brien (supra), if a spouse devotes himself or herself to the family throughout the marriage, giving up career opportunities, and no liquid assets exist, the court should compensate this spouse for his or her contribution enabling him or her to pursue his or her career and not just a terminable maintenance award. For example, if instead of medical school the spouse went to music school and became a celebrated pianist, in equity both accomplishments must be treated equally.

The question, therefore, presented is should O'Brien (supra) be extended so as not to prejudice a spouse who is married to a nonprofessional?

This court answers the question in the affirmative and holds that the skills of an artisan, actor, professional athlete or any person whose expertise in his or her career has enabled him or her to become an exceptional wage earner should be valued as marital property subject to equitable

distribution. Thus, although plaintiff's celebrity status is neither "professional" nor a "license" (Morimando v Morimando, NYLJ, Feb. 6, 1987, at 16, col 1, supra) its increase in value is marital property, despite the difficulties presented in valuing such property.

[Portions of opinion omitted for purposes of publication.]

44 So.3d 1092 (2009)

Rebecca R. GRELIER
v.
Maximilian J. GRELIER III.
Maximilian J. Grelier III
v.
Rebecca R. Grelier.

2060810.

Court of Civil Appeals of Alabama.

December 30, 2009.
Certiorari Denied February 12, 2010 Alabama Supreme Court 1090464.[1]

Nancy S. Gaines of Gaines & Gaines, L.L.C., Magnolia Springs, for appellant/cross-appellee Rebecca R. Grelier.

Dinah P. Rhodes of Rhodes & Creech, Huntsville, for appellee/cross-appellant Maximilian J. Grelier III.

On Application for Rehearing

PER CURIAM.

This court's opinion of December 19, 2008, is withdrawn, and the following is substituted therefor.

Rebecca R. Grelier ("the wife") appeals from a judgment divorcing her from Maximilian J. Grelier III ("the husband"); in particular, she challenges the trial court's valuation of and division of certain business interests of the husband's and the trial court's failure to reserve jurisdiction to award periodic alimony in the future. The husband cross-appeals, asserting that the trial court erred in requiring him to pay certain fees and in ordering him to purchase an automobile for the wife.

The wife and the husband were married on May 13, 1995; the parties' two children, who were born during the marriage, were 4 and 8 years old at the time of trial. On June 28, 2004, the wife filed a complaint that sought, among other things, a divorce on the ground of adultery, an award of custody of the parties' children, and an equitable division of the marital assets and debts. The husband filed an answer to the complaint 11 days later; he subsequently filed his own complaint in which he sought a divorce on the ground of incompatibility of temperament.

[1] Note from the reporter of decisions: This decision was released by the Alabama Supreme Court under the date February 12, 2010. This decision was actually released to the public on February 16, 2010.

On June 10, 2005, the wife filed a motion requesting that the trial court appoint a special master for the purpose of auditing, examining, and inspecting the accounting books, records, and physical assets of the husband's business interests and reporting its findings to the court. During a subsequent hearing, the trial court instructed the wife's attorney to draft an order appointing a special master and to obtain the husband's attorney's approval of the proposed order before submitting the order to the trial court. On August 2, 2005, the trial court, using an order drafted by the wife's attorney, appointed Gary Saliba to serve as a special master "for the purpose of identification and determination of the fair market value of all business entities in which the [husband] possesses any interest as well as analysis and determination of the fair market value of Queen Bee of Beverly Hills, the business operated by the [wife]." That order bore the signatures of the wife's counsel and the husband's counsel indicating their approval of the order at the time it was rendered by the trial court.

The trial court conducted an ore tenus proceeding over 6 days: November 13-15 and December 20-22, 2006. During the ore tenus hearing, the trial court heard testimony from the husband, the wife, the special master, and numerous witnesses; the testimony alone comprises over 1,800 pages of the 2,400-page record on appeal. Various documentary exhibits, including pertinent financial computations regarding the parties' business interests, were also admitted into evidence.

Although the testimony revealed that both parties had earned undergraduate business degrees, the evidence also indicated that the wife had worked primarily as an accountant before the birth of the parties' children and as a home-based entrepreneur following the birth of the children. In contrast, the husband had been self-employed, primarily as a commercial retail-property and office-property developer and broker, and he was serving as executive vice president of Chase Commercial Properties, LLC, at the time of trial. In addition, the husband regularly participated in real-estate and commercial ventures through a variety of closely held corporations: Flint Crossing, LLC; Trinity Associates, LLP; Chase Commercial Properties, LLC; Village Builders, Inc.; Rosemary Corners, LLC; Research Park Associates, LLC; and RMC Investors, LLC. Those entities, in turn, owned wholly or in part a number of other business entities, namely: Park Place Associates, LLC; Hughes Retail Associates, LLC; Bradford Associates, LLC; and The Falls at Grants Mill, LLC. In December 2005, while the divorce action was still pending, the husband and his three business partners (his father; his brother; and Remy Gross, his college friend) reorganized all the previously listed business entities under one entity, CG Partners, LLC, with each partner owning a 25% interest in that entity. The husband testified that consolidating the businesses was necessary to handle the outstanding debt that he and his father still owed from the financial failures of Village Builders, Inc., and The Ledges, an expensive residential-subdivision development. The husband also testified that during the pendency of the divorce action he had been forced to borrow $30,000 from Gross to employ his attorney and to pay child support. Additionally, the husband testified that he had borrowed a total of $40,000 from Chase Commercial Properties, LLC, to hire Sam Wessinger, a financial expert witness; he also stated that he owed the United States Internal Revenue Service $15,000.

The husband testified that he had earned $63,227 in 2005; he also stated that his annual income had peaked sometime between 1999 and 2000, when he had earned more than $100,000 in commissions. The husband testified that all of his various business interests had undergone financial trouble beginning in 2001; those troubles began with The Ledges,

a residential subdivision whose lots and expensive houses failed to sell before the construction loans were due to be paid. He stated that in 2003 he and his father had signed a promissory note representing the outstanding debt secured by that development and that as of August 1, 2005, the principal amount owed on that debt was $973,954.20. The husband testified that the parties had lived beyond their means throughout their marriage, defraying expenses through the use of credit cards, salary advances, and loans. At the time of trial, neither party had a retirement account; the wife testified that she had liquidated her retirement account to pay the parties' living expenses during a period when they had no income.

The wife testified that during the parties' worst financial period, which had occurred during the three years before the divorce complaint was filed, the parties had borrowed substantial sums from the wife's mother and stepfather. The trial court admitted into evidence a promissory note executed by the parties and payable to the wife's mother and stepfather on demand and no later than September 20, 2006, in the amount of $100,735.15; she stated that the total amount, including interest, owed on that note by the time of trial was $118,833.15. In addition, the wife testified that the parties had incurred large balances on joint credit-card accounts during the same period. She stated that at the time of the parties' separation her father had paid several of the parties' credit-card debts and was still owed $30,000 for those payments. Moreover, the wife testified that her mother had "rolled over" two other credit-card account balances onto her own credit-card accounts when the wife was unable to make required payments after the parties had separated; she stated that her mother was owed $8,800 in reimbursement for paying those marital debts.

The wife testified that her attorney had billed her a total amount of $50,345.29. By the time of trial, she had paid $31,770.74 to her attorney by borrowing from her mother, but she stated that she still owed $18,574.55 to her attorney. The husband testified that he had paid his attorneys over $30,000 by the time of trial, and, he stated, although he knew that he would owe more, he did not have a final bill from his attorneys.

The parties had purchased a lot in The Ledges in 1999 for approximately $165,000; they had built a house costing about $750,000 on that lot. Because the parties did not have enough money to complete construction of the house, they had borrowed $50,000 from the wife's aunt, Betty Ladas, in order to finish building the house. At the time of trial, the parties owed $592,379.67 on the first mortgage and $74,070 on the second mortgage on the house; additionally, there were two liens recorded against the house totaling $10,500. Moreover, the wife testified that the house needed major repairs, including repair of a leaking roof, before the property could be sold.

The trial court entered a judgment divorcing the parties on January 8, 2007.[2] In that judgment, the trial court, among other things, awarded to the husband all of his business interests. The trial court's judgment noted:

> "In making an equitable distribution of the marital assets and liabilities accumulated by these parties during their marriage, and in determining the fair market value of the interest owned by the [husband] in the above entities, this Court finds that it is

[2] Although the husband admitted to having conducted an adulterous relationship during the latter part of the parties' marriage, the trial court divorced the parties on the ground of incompatibility of temperament.

> reasonable to apply a combined forty percent (40%) minority discount and marketability discount to the evaluations made by the Special Master in this case. In addition, this Court has taken into account the fact that some of the underlying projects owned by the above awarded entities have a negative fair market value; and ha[s] also taken into account the substantial debt for which the [husband] is personally liable, on a joint and severable basis, which exceeds the total amount of $1,000,000.00. To do otherwise would be to ignore the reality of the financial condition of these parties."

In the divorce judgment, the husband was also ordered to pay rehabilitative alimony to the wife in the amount of $1,500 per month for 36 months. In addition, the husband was instructed to pay the necessary educational expenses for the wife to renew her license to practice as a certified public accountant, so long as those expenses did not exceed $5,000. The judgment also ordered that the marital residence be sold and that the wife was to receive the first $200,000 of the proceeds from that sale; in the event that the net sale proceeds did not amount to $200,000, the judgment instructed the husband to pay any such deficiency in monthly installments of $1,000 per month as an additional property settlement.

The wife filed a timely notice of appeal; she alleges that the trial court erred in its valuation of the husband's business interests, in its division of those business interests, and in its failure to reserve jurisdiction of the issue of periodic alimony. The husband cross-appealed, claiming in his docketing statement that the trial court had erred in ordering him to pay a portion of the wife's attorney fees, to pay a majority of the special-master's fee, and to purchase an automobile for the wife; however, the husband failed to present those issues or arguments in his appellate brief.[3] Therefore, we affirm the trial court's judgment as to the husband's cross-appeal, and we address only the wife's allegations of error.

Our standard of review in divorce cases is well established. A trial court's judgment based on ore tenus evidence will be presumed to be correct and will not be reversed on appeal absent a showing that the trial court acted outside its discretion or that the judgment is unsupported by the evidence so as to be plainly and palpably wrong. *See Clements v. Clements,* 990 So.2d 383, 389 (Ala.Civ. App.2007); *see also Harmon v. Harmon,* 928 So.2d 295, 298 (Ala.Civ.App.2005). However, questions of law are not subject to the ore tenus standard of review. *See, e.g., Ex parte Perkins,* 646 So.2d 46, 47 (Ala.1994), and *L.R.M. v. D.M.,* 962 So.2d 864, 873 (Ala.Civ.App.2007).

The wife first asserts on appeal that the trial court erred in applying minority and marketability discounts when valuing the husband's business interests. Heretofore, no Alabama case has addressed whether a divorce court should use minority and marketability discounts when assessing the value of a divorcing spouse's interest in a closely held business organization. However, that issue has been addressed by many other jurisdictions. *See* Stephen A. Hess, Annotation, *Use of Marketability Discounts in Valuing Closely Held Corporation or Its Stock,* 16 A.L.R.6th 693 (2006). Many jurisdictions, either by legislation or by caselaw, have adopted a "fair market value" standard by which the value of all marital property must be determined by gauging the price a willing buyer would pay to a

[3] This court has consistently held that when a party does not make an argument or cite any authority to support an allegation of error, that allegation of error is deemed waived on appeal. *See* Rule 28, Ala. R.App. P.; *see also Cain v. Howorth,* 877 So.2d 566, 581 (Ala. 2003).

willing seller in a hypothetical sales transaction. *See, e.g., Crismon v. Crismon,* 72 Ark.App. 116, 34 S.W.3d 763 (2000). Pursuant to that standard, it makes sense to apply minority and marketability discounts because those discounts reflect the economic reality that, unlike the case with publicly traded companies, no ready pool of willing buyers exists to purchase an interest in a private business organization that does not carry with it the ability to control that organization. *See generally In re Marriage of Barlow,* 111 Or.App. 179, 826 P.2d 18 (1992).

However, Alabama law has not adopted a "fair market value" standard for assessing marital property. Rather, under Alabama law, a trial court must determine the value of property with the only limitation being that the value must be equitable under the circumstances of the particular case. *See generally Yohey v. Yohey,* 890 So.2d 160 (Ala.Civ.App.2004). That standard implies that the valuation must be fair to all parties concerned. *See generally Black's Law Dictionary* 578 (8th ed.2004) (defining "equitable distribution" as the "fair ... allocation" of marital property). In cases in which a divorce court does not contemplate the sale of a business in which one of the spouses holds a minority interest but, instead, intends that the business shall remain a going concern, it makes little sense to determine fair value by the measuring stick of a hypothetical sales price. That methodology would artificially reduce the value of the marital asset in almost every case, which would be unfair, i.e., inequitable, to the party receiving only a portion of the reduced value or the property equivalent to that reduced value but would be advantageous to the party retaining the business interest, including its actual value to him or her as the holder.

In *Brown v. Brown,* 348 N.J.Super. 466, 792 A.2d 463 (App.Div.2002), the court held that a divorce court correctly declined to apply minority and marketability discounts when valuing the husband's minority interest in a family-owned floral business. The New Jersey court stated:

> "`A minority discount adjusts for lack of control over the business entity on the theory that non-controlling shares of stock are not worth their proportionate share of the firm's value because they lack voting power to control corporate actions.... A marketability discount adjusts for a lack of liquidity in one's interest in an entity, on the theory that there is a limited supply of potential buyers for stock in a closely-held corporation.' *Lawson [Mardon Wheaton, Inc. v. Smith],* 160 N.J. [383,] 398-99, 734 A.2d 738 [(1999)].... Whether marketability or minority discounts are appropriate to the valuation of a less than controlling interest in the entity are questions of law which we review *de novo,* giving no special deference to the trial judge's determination. *Balsamides [v. Protameen Chems., Inc.],* 160 N.J. [352,] 372-73, 734 A.2d 721 [(1999)]; *Lawson,* 160 N.J. at 398, 734 A.2d 738."

348 N.J.Super. at 483, 792 A.2d at 473-74. Noting that the minority and marketability discounts are intended to account for the limited liquidity of minority interests in business entities, the court reasoned that the discounts should not apply when liquidity concerns are not at issue, such as when the business will continue to be an ongoing concern following the divorce. 348 N.J.Super. at 488, 792 A.2d at 477. The court held that, in such circumstances, "[t]he distinction between fair value and fair market value appears to us equally applicable in the valuation of one spouse's interest in his family's closely-held corporation for purposes of equitable distribution." *Id.* The court explained that distinction at

length in discussing the fair-value standard applicable to sales of stock by a dissenting minority shareholder:

> "Statutory appraisal rights accorded to dissenting shareholders in New Jersey (and in most states) include the right to a determination of the `fair value' (not `fair market value') of their shares. N.J.S.A. 14A:11-3; *see* Bobbie J. Hollis, II, *The Unfairness of Applying Lack of Marketability Discounts to Determine Fair Value in Dissenter's Rights Cases,* 25 J. Corp. L. 137, 139 (1999), explaining the distinction between `fair value' and `fair market value':
> "`"Fair value" is not the same as, or short-hand for, "fair market value." "Fair value" carries with it the statutory purpose that shareholders be fairly compensated, which may or may not equate with the market's judgment about the stock's value. This is particularly appropriate in the close corporation setting where there is no ready market for the shares and consequently no fair market value.
> "`A closely-held corporation is one that has few shareholders and little market for the stock, or one that has an integration of ownership and management. When appraising shares of a close corporation, fair value cannot be fairly equated with the company's fair market value. Close corporations by their nature have less value to outsiders, but at the same time their value may be even greater to other shareholders who want to keep the business in the form of a close corporation.'"

348 N.J.Super. at 487, 792 A.2d at 476.

Like New Jersey law, Alabama law recognizes the concept of "fair value" in the dissenting-shareholder context. *See* Ala. Code 1975, § 10-2B-13.01(4). Our statute is silent as to the applicability of a marketability discount, but in *Ex parte Baron Services, Inc.,* 874 So.2d 545 (Ala.2003), the Alabama Supreme Court quoted with approval the explanation of the distinction between fair value and fair-market value contained in *Brown.* 874 So.2d at 549-50. The court held that fair-market value does not apply in dissenting-shareholder cases because the dissenting shareholder is not acting as a willing seller. 874 So.2d at 550. Rather, to accord the dissenting shareholder fair value, the trial court should determine the proportionate value of the company as a going concern without applying any discounts. *Id.* Because the Alabama Supreme Court has adopted the same reasoning that is applied in New Jersey in dissenting-shareholder cases, it seems reasonable to conclude that it would follow the same reasoning in divorce cases involving minority ownership of closely held business organizations. *See* Jay E. Fishman et al., *Standards of Value-Theory and Application* 167 (2007) (analogizing divorce cases to dissenting-shareholder cases). Thus, we conclude that the trial court erred in applying the minority and marketability discounts in this case.

Alabama law is firmly established that

> "[m]atters of alimony and property division are interrelated, and the entire judgment must be considered in determining whether the trial court abused its discretion as to either of those issues. *Willing v. Willing,* 655 So.2d 1064 (Ala. Civ.App.1995)."

Henderson v. Henderson, 800 So.2d 595, 597 (Ala.Civ.App.2000). "[T]here is no rigid standard or mathematical formula on which a trial court must base its determination of

alimony and the division of marital assets." *Yohey v. Yohey,* 890 So.2d at 164. In this case, the trial court awarded the husband 100% of his interest in the various business entities in which he was involved. In so doing, the trial court considered the husband's interest to be worth $602,108.40 instead of $1,003,514 because of the application of a combined 40% minority/marketability discount ($1,003,514 minus 40% discount = $602,108.40). Because we have determined that the trial court erred in its valuation of the husband's closely held business interests, we reverse the divorce judgment and remand the case with instructions to reconsider its property division and its award of alimony in light of the proper valuation of the husband's business interests. Because the entire judgment is hereby reversed, we pretermit discussion of the other issues raised in the wife's appeal.

The husband's request for an award of an attorney fee on appeal is denied.

APPLICATION GRANTED; OPINION OF DECEMBER 19, 2008, WITHDRAWN; OPINION SUBSTITUTED; REVERSED AND REMANDED WITH INSTRUCTIONS AS TO THE APPEAL; AFFIRMED AS TO THE CROSS-APPEAL.

THOMPSON, P.J., and BRYAN, THOMAS, and MOORE, JJ., concur.

PITTMAN, J., concurs in part and dissents in part, with writing.

PITTMAN, Judge, concurring in part and dissenting in part.

In this court's opinion on original deliverance, which today's opinion withdraws, this court made an initial determination that the decision whether to apply discounts in valuing the husband's business interests was a matter to be determined by the trier of fact. Writing for the court, I noted that:

"The trial court heard testimony from three experts, received substantial documentary evidence, and accepted posttrial legal memoranda from both the wife's attorney and the husband's attorney addressing whether the two discounts should be applied to the husband's business interests. The trial court has wide discretion to accept or to reject evidence and testimony presented ore tenus. *See Clements [v. Clements*], 990 So.2d [383,] 389 [(Ala.Civ.App.2007)], and *Harmon [v. Harmon],* 928 So.2d [295,] 298 [(Ala.Civ.App.2005)]. Based upon the disputed evidence as to the value of the husband's business interests, as well as the conflicting testimony of the financial experts who testified for the wife and the husband, we conclude that the trial court acted within its discretion in making the determination that computing the fair market value of the husband's business interests necessitated applying both minority-interest and marketability discounts."

I would prefer to leave the trial courts of this state with the discretion to determine, on the specific facts at issue in each divorce action, whether or not to apply discounts in valuing various types of business interests; therefore, I dissent from the reversal of the trial court's divorce judgment in that respect.

I concur in the main opinion to the extent that the cross-appeal is affirmed.

Full Text of Court Cases

Grimes v. Vitalink Communications

Case name: Grimes v. Vitalink Communications
Citation: 1997 Del. Ch. LEXIS 124
Date of decision: August 26, 1997
Country: US
State or Federal: State
State/Jurisdiction: Delaware
Court: Court of Chancery
Type of action: Dissenting Shareholder
Judge: Chandler
Experts: William Becklean (for petitioner) Kevin Dages (for respondent)
SIC: 8743 Public Relations Services
NAICS: 541820 Public Relations Agencies
300

Keywords: Discounted cash flow method (DCF), Dissenting stockholder action, Fair value, Terminal value

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Richard D. Heins, Esquire, of ASHBY & GEDDES, Wilmington, Delaware; OF COUNSEL: Jack M. Graves, Esquire, of CHRISMAN, BYNUM & JOHNSON, P.C., Boulder, Colorado, Attorneys for Respondent.

Judge: Chandler.

Petitioners and respondent in appraisal proceeding seek to determine fair value of petitioners' shares based on corporation's future cash flows. Petitioners' proposed cash flow is rejected for failing to reflect the risk that the corporation will not be able to develop or to obtain critical products, for failing to use the proper tax rate, and for failing to base the value of the cash flow's terminal value on comparable companies. Respondent's cash flow is accepted as accurately reflecting the corporation's value on the date of the merger. Interest on the fair value, which shall be compounded monthly from the date of merger to the date of payment, is set at the legal rate of interest.

I. BACKGROUND

This is an appraisal action pursuant to 8 Del. C. § 262. After completion of a tender offer whereby Network Systems Corporation ("NSC") obtained just over ninety percent of Vitalink Communications Corporation ("Vitalink"), NSC merged NSC Acquisition Corp., a wholly owned subsidiary of NSC, into Vitalink pursuant to 8 Del. C. § 253. n1 Charles L. Grimes ("Grimes"), owner of 200,000 shares of

Vitalink common stock, and Gadfly Foundation, Inc. ("Gadfly"), owner of 1,900 shares, dissented from the merger. Grimes and Gadfly ("petitioners") seek to have their shares appraised as of the effective date of the merger, July 1, 1991.

n1 Respondent Storage Technology later acquired NSC.

Both parties have retained appraisal experts and have submitted valuations of petitioners' shares. That the parties have agreed to the use of a single valuation method significantly eases this Court's burden of determining the fair value of Vitalink and minimizes problems that may result from an attempt to combine results from several valuation methods. n2 In this case, the parties have valued Vitalink using a discounted cash flow model--increasingly the model of choice for valuations in this Court. n3 The parties also agree that Vitalink's cash flows should be projected out over a five-year period commencing at the date of the merger. This Court has previously accepted valuations based upon such a time period. n4 Another area of agreement is the use of a comparable company analysis to value the terminal (residual) value of Vitalink at the end of the five-year forecast period, although the parties disagree as to which companies are comparable with Vitalink. The parties also agree that Vitalink's future cash flows should be discounted to present value at a rate of 20.83%. Finally, the parties agree on a number of adjustments that must be made to the present value of Vitalink's cash flows in order to arrive at the net present value of Vitalink's equity. With no reason to conclude that any of the areas in which the parties agree are not reflective of appropriate valuation methods and assumptions, I accept these methods and conclusions as accurate measures of Vitalink's fair value. Despite the numerous areas of agreement, this Court must still resolve several conflicting issues which lead to a $ 4.82 discrepancy between the fair value of the petitioners' shares as calculated by petitioners ($ 13.32) and as calculated by the respondent ($ 8.50). These issues involve the assumptions underlying the selection or development of Vitalink's product and sales forecast, the selection of comparable companies by which to estimate Vitalink's terminal value, and the selection of Vitalink's tax rate as well as several issues surrounding the appropriate rate of interest which should accrue on the fair value of petitioners' shares from the merger date to the date of payment.

n2 See In the Matter of the Appraisal of Shell Oil Co., Del. Ch., Consol. C.A. No. 8080, at 82, Hartnett, V.C. (Dec. 11), aff'd, Del. Supr., 607 A.2d 1213 (1990) (noting difficulty of interchanging data between different valuation methods).

n3 See, e.g., Kleinwort Benson Ltd v. Silgan, Del. Ch., C.A. No. 11107, 1995 Del. Ch. LEXIS 75, Chandler, V.C. (June 15, 1995); TV58 Ltd. Partnership v. Weigel Broadcasting Co., Del. Ch., C.A. No. 10798, 1993 Del. Ch. LEXIS 146, Chandler, V.C. (July 22, 1993).

n4 See Kleinwort Benson Ltd., Del. Ch., C.A. No. 11107. A five-year period may not, however, always be appropriate. Any time period selected should provide a representative forecast or historical sample of data. Cf. Gonsalves v. Straight Arrow Publishers, Del. Ch., C.A. No. 8474, 1996 Del. Ch. LEXIS 144, *14-15, Allen, C. (Nov. 27, 1996) (noting, in connection with an earnings capitalization model, that although the standard earnings base was five years, that time period is not necessarily the only period on which the method may be based.)

The focus of an appraisal proceeding is narrow. "In a section 262 appraisal action the only litigable issue is the determination of the value of the appraisal petitioners' shares on the date of the merger, the only party defendant is the surviving corporation and the only relief available is a judgment against the

surviving corporation for the fair value of the dissenters' shares." n5 The discussion below focuses only on the methods and data relied upon by the parties to arrive at their independent calculations of the fair value of petitioners' shares, and the extent to which the accuracy of the results might be affected by the credibility of the expert witnesses, their methods, and the sources of their information. n6 Further detail on the background of the events leading up to the merger may be found in this Court's opinion In re Vitalink Communications Corporation Shareholders Litigation. n7

n5 Cede & Co. v. Technicolor, Inc., Del. Supr., 542 A.2d 1182, 1187 (1988).

n6 Rapid-American Corp. v. Harris, Del. Supr., 603 A.2d 796, 802 (1992) ("the trial judge, as finder of fact in appraisal cases, enjoys the unique opportunity to examine the record and assess the demeanor and credibility of witnesses"); Alabama By-Products Corp. v. Neal, Del. Supr., 588 A.2d 255, 258 (1991) ("Where those assumptions [underlying expert valuations] are values supplied by others, the conduct of such other persons is probative of their credibility and of the information being supplied to the expert.").

n7 Del. Ch., 1991 Del. Ch. LEXIS 195, Consol. C.A. No. 12085, Chandler, V.C. (Nov. 8, 1991).

II. VITALINK'S PRODUCT AND SALES FORECAST

The selection of the proper product and sales forecast accounts for just over fifty percent of the dollar difference between the two competing valuations. Petitioners argue that the proper forecast is that forecast developed by Vitalink's Assistant Vice President for Finance, Keith Glover ("Glover"). Respondent Storage Technology (NSC's successor in interest) asserts that Glover's forecast improperly reflects the existence and sale of products to which Vitalink did not have access and argues that the proper forecast results from a weighing of three forecasts reflective of the three most likely scenarios that Vitalink would encounter absent the merger.

A. Petitioners' Forecast

Petitioners' expert valuation witness is William Becklean ("Becklean"). n8 His estimate of Vitalink's projected cash flow for 1991 to 1995 is based on a financial forecast prepared by Glover. n9 Wes Saia ("Saia"), Vitalink's Chief Financial Officer, directed Glover to prepare the forecast for the benefit of Salomon Brothers Inc. ("Salomon") and Kidder, Peabody & Co. ("Kidder"). n10 Salomon, who was preparing a fairness opinion for NSC, and Kidder, who was preparing a fairness opinion for Vitalink, provided Glover with guidance as to what types of information were required. n11

n8 Becklean is currently senior Vice President of Tucker Anthony Incorporated where he heads the technology research group. He holds degrees in engineering and business and is a Certified Financial Analyst. A friend of petitioner Grimes since 1954 (Tr. 22-24, 76-77), he has provided Grimes with investment advice (Id. at 130-31) and appears to have been a partner with Grimes in Capital Counsel, an investment management firm, from the late 1960s to the early 1970s (Id. at 130), although he also testified at trial that he was not involved in businesses other than Quantum Associates from 1968 to 1976. Id. at 63-64. While at Kidder, Peabody in 1988, he served as a research analyst for Vitalink's initial public offering. Id. at 69. He published several research reports on Vitalink from 1988 to 1991. Id. at 69-70. Becklean has never served as an expert witness in an appraisal action or any other litigation. Id. at 116.

n9 Id. at 83-84, 204.

n10 Id. at 204-06.

n11 Id. at 206.

The foundation of Glover's forecast was based on Vitalink's existing internal business plan. This document, which Vitalink generally updated every six months, projected Vitalink's net income, by quarter, for the next two years. n12 Glover began his task by updating the existing two-year 1991-1992 forecast to reflect actual results for the first and second quarters of 1991. n13 With information derived from Vitalink's internal models that projected Vitalink's sales out further than two years, and guidance from Vitalink's President and Chief Executive Officer Leslie Denend ("Denend") and Saia as to the appropriate overall growth rates, Glover extended the two-year forecast through to 1995. n14 Glover's final forecast, which he provided to Salomon and Kidder on April 19, 1991, provided Vitalink's estimated revenues by product line. n15 Becklean testified that he did not have any reason to believe that Glover's report was "anything but an accurate reflection of [Vitalink's] belief of what the business was going to produce over the next five years." n16

n12 Id. at 212. 131cL

n13 Id.

n14 Id. at 210, 233.

n15 See PTX 39 (Project Star Analysis Prepared by Keith Glover, April 19, 1991); Tr. 232.

n16 Tr. 85.

B. Respondent's Forecast

Respondent's expert witness Kevin Dages ("Dages") n17 did not directly rely on Glover's forecast. Dages began his appraisal by examining valuations prepared by Kidder, Salomon and Ernst & Young in May and June 1991. He also examined previous reports prepared by Becklean and other industry analysts. Reviews of these reports and conversations with former Vitalink personnel convinced Dages that he would need to construct his own valuation. n18 Dages spoke to Denend, Vitalink's 1991 Vice President of Marketing, Vitalink's 1991 Vice President of Sales, and Vitalink's 1991 Associate Vice President of Software Engineering n19 and developed three separate forecasts reflective of the three most likely scenarios Vitalink would encounter absent the merger. n20 The first scenario assumes that Vitalink would obtain router products through OEM relationships and supply these products to its existing customers while it simultaneously pursued internal development of its own router product. n21 This scenario assumes that Vitalink could retain its current bridge customers by providing them with third-party router products while developing its own product. The second scenario assumes that Vitalink is unable to negotiate an OEM relationship for the ELYNX and TLYNX products. Thus, Vitalink is unable to supply its customers with router products for 24 months while Vitalink develops these products internally. n22 The third scenario builds upon the second by assuming that the delayed development of a router product will hinder Vitalink's efforts to enter the market. n23 Dages estimated that Vitalink faced a sixty percent chance of experiencing the first scenario and a twenty percent chance of experiencing the second or third. n24

n17 Dages is currently a principal at Chicago Partners, a litigation and economic consulting firm. Id. at 240. He has seven years of litigation consulting experience and several times has served as a consulting and testifying expert. Id. at 242-45. He has been a guest lecturer at the University of Chicago School of Business on the subject of valuations (Id. at 246-47), although he has no formal business education. He had no knowledge of Vitalink until he was hired for this case. (Id. at 353).

n18 Id. at 249.

n19 Id. at 221, 275-76, 305-06; Denend Dep. 64-66.

n20 Tr 249, 287-90; RTX 1 at 9.

n21 Tr. 287-89.

n22 Id. at 289.

n23 Id. at 290.

n24 RTX 1 at 35.

C. Analysis

Glover's forecast admittedly does not reflect the going concern value of Vitalink on the date of the merger. By the time of the merger, Vitalink had fallen from its position as a leader in the computer internetworking industry. In the late 1980s and the early 1990s, Vitalink held a significant share of the market for wide-area bridges, which allowed users to connect local area computer networks ("LANs") and to form wide-area networks ("WANs") by which information from one LAN could be transferred to a second LAN located on the same WAN. Each LAN in the WAN was attached to a bridge. All the bridges in the WAN were interconnected. Packets of information transmitted from a location on one LAN to that LAN's bridge would be forwarded by the bridge to each of the other bridges on the WAN. Each of these other bridges could then determine if the information was addressed to a location on its LAN. Bridges were limited by their inability to recognize addresses for any location other than locations on their own LAN. Thus, when they received a packet of information from their LAN, addressed to a location outside that LAN, the bridge forwarded the packet to each of the other bridges, rather than to only the bridge on the LAN containing the packet's intended recipient.

A second form of technology, routers, also allowed users to connect LANs and to transmit information from one LAN to another. Unlike bridges, however, routers were able to determine to exactly which bridge a packet of information should be transmitted. The advantages of routers were clear and by the early 1990s development and production of routers was the fastest growing segment in the industry. n25

n25 Tr. 75 (Becklean).

Denend, who had been hired as Vitalink's President and CEO in October 1990, and appointed as Vitalink's Chairman in January 1991, recognized the need for Vitalink to obtain a competitive router for its customers. Vitalink considered two different router sources: internal development and provision by third parties either through a relationship with an original equipment manufacturer or a merger with a company that had developed its own router product. n26

n26 Denend Dep. at 32, 42.

The need for Vitalink to obtain a router product was urgent. Revenues were declining rapidly. Vitalink was late in entering a market that Denend believed was growing at least fifty percent per year. n27 There were concerns that its loyal customers would not remain loyal while Vitalink sought to provide them with routers or technology that would enable them to make the transition to routers. n28

n27 Id. at 87-88.

n28 Id. at 41-42.

Some customers were already leaving. n29 Vitalink's management knew that survival depended upon Vitalink's ability to assist its customers in making the transition from bridges to routers. At the time of the merger, Vitalink did not have a competitive router product for its customers. Nor did Vitalink have access to a product through a third party OEM. It was attempting to develop a router internally. To ease the pressure from its bridge customers, who wished to switch to routers, Vitalink provided them with the TransPATH router consisting of bridge hardware linked to router software that provided minimal router functions. n30 Vitalink viewed the TransPATH as a stepping stone from its past leadership in bridges to its future in routers. n31 Vitalink planned to upgrade the TransPATH software while working to develop the LYNX--its own internal version of a router. n32 Initially Vitalink had intended to create a new code for the LYNX but this was abandoned in favor of adapting the code for TransLAN, its bridge product, for use with the LYNX. n33 The difficulties in working with this code were significant. n34 Denend was concerned about Vitalink's ability to have a functional router code available by the time the router hardware was complete. n35 In his presentation to the Board in March, Denend stated that Vitalink's customer base was looking elsewhere for router products, that "Vitalink's credibility as a company capable of developing or introducing leadership products has eroded severely" and that Vitalink would not have a competitive product ready "until the end of 1991, at the earliest." n36

n29 Id. at 31.

n30 Id. at 25-26.

n31 Id. at 27.

n32 Id. at 26.

n33 Id. at 32-33.

n34 Id. at 16-18, 27-31.

n35 Id. at 33.

n36 PTX 22 at VC006026 (Documentation for Vitalink's Feb. 25, 1991, Board Meeting).

Denend's Rebuilding Shareholder Value Report dated April 1, 1991 (an earlier version of which had been prepared for presentation to Vitalink's Board of Directors in March), states that Vitalink's current strategy was based on the assumption that Vitalink would be able to return to "market leadership" within 18 to 24 months. n37 It also notes that "recent market developments have increased the risk of implementing Vitalink's strategy successfully" and that Vitalink faced a threat "that there will not be enough time for Vitalink to return to market leadership position before a dominant supplier emerges in the interconnect market." n38

n37 PTX 35 at VC002765.

n38 Id.

Kidder's April 9, 1991 report to Vitalink's Board listed several factors that were viewed as hindering Vitalink's ability to make a successful transition from bridges to routers:

* Expertise is concentrated in shrinking remote bridge market

* Multi-protocol offerings are currently not available

* Multi-protocol offerings will be late and not competitive with current products offered by industry leaders

* Low-product development credibility

* Engineering resources are inefficient

* Customer base migration is accelerating n39

n39 RTX 29 at KP000009.

As a result of these factors "Kidder, Peabody recommended that Vitalink proceed with a negotiated sale process." n40

n40 Id. at KP000021.

In May 1991, Maureen Lawrence, Vitalink's Vice President of Marketing, authored a short presentation entitled Vitalink Product Plans that revealed that if the merger with NSC were not completed, Vitalink would need to develop an entirely new software code. n41

n41 RTX 24 at VA003503; Denend Dep. at 58.

Salomon also completed its evaluation of Vitalink in preparation for the merger and presented its conclusion to NSC's Board in May 1991. It reported that Vitalink's sales of bridges were declining, that the stock market lacked confidence in Vitalink's "ability to introduce a successful router product," n42 and noted that even a combined Vitalink-NSC entity would be "playing 'catch-up'" in the router market that was dominated by other companies who "already have an established and growing position." n43

n42 PTX 50 at S 0000008, S 0000009 (Project Highway).

n43 Id. ($ 6,821,000 from TLYNX + $ 22,467,000 from ELYNX represents approximately forty-five percent of the $ 65,000,000 total revenue forecasted for 1992.

Glover's forecast does not reflect Vitalink's difficulties in providing a router product to its customer base. His forecast, which was broken down by product line, n44 reveals that Vitalink projected that the LYNX products would provide approximately forty-five percent of Vitalink's sales revenues in 1992. n45 Petitioners argue that such a percentage is entirely consistent with Vitalink's position, acknowledging that Vitalink had initially predicted release of a router product in July but noting that no Vitalink document places release of the router later than the end of 1991. They argue that the 18-24 month time period to return to "market leadership" was just that--a time estimate for leadership, not initial product sales. Respondent notes that Vitalink documents admit the need to develop entirely new software only after the report containing the 18-24 month schedule was released. Thus, respondent contends that only its scenarios, which reflect the existence of this delay, are an accurate projection of Vitalink's prospects absent the merger.

n44 PTX 37 at S0001556.

n45 Id. ($ 6,821,000 from TLYNX + $ 22,467,000 from ELYNX represents approximately forty-five percent of the $ 65,000,000 total revenue forecasted for 1992).

I do not find it necessary to resolve the exact date by which Vitalink would have a router product available for its customers. Glover, the author of the forecast upon which Becklean relies, testified that he understood that the ELYNX and TLYNX product development programs were late and that this delay could have affected the two-year forecast. n46 When asked if that concern was reflected in the five-year forecast, Glover explained that in preparing the five-year forecast Vitalink was "assuming availability, if you will, of a router product. It was just going to be supplied by Network Systems vis-a-vis the merger." n47 Petitioners attack Glover's testimony claiming that it "makes no sense," n48 that no one ever instructed Glover to exclude the risk that Vitalink would not be able to develop or obtain router products according to the schedule reflected in the two-year business plan, and that Kidder and Salomon both thought they were receiving a "stand-alone" forecast. Whether this is true or not, does not matter. Glover prepared the forecasts. Glover testified that the forecast did not reflect what he knew to be a fact (that the development of the router was late) and that the forecast assumed the router would be available, if not from Vitalink, then from NSC. Glover, in fact, testified that it was not his forecast, but Dages' three forecasts which were the three most likely scenarios Vitalink would encounter absent the merger although he placed slightly different weights on the three scenarios, believing that Vitalink had a fifty percent chance of experiencing the first scenario (the OEM scenario) and a twenty-five percent chance of experiencing the second and third scenarios. n49 Glover, thus, believed Vitalink had an even lower chance of being able to pursue the OEM scenario (the most favorable scenario of the three) than Dages. Moreover, Glover's forecast inappropriately includes sales revenues from products (other than the LYNX or companion router products) to which Vitalink did not have access. These revenues were expected to be captured through the sales of ENS and SNA products provided by Coral and Netlink, but neither product was available at the time Glover prepared the forecast and petitioners have provided no evidence that the OEM relationships existed and that the products were available at the time of the merger. n50 Glover's forecast may have been helpful to Vitalink as a prediction of what Vitalink might sell in the event that it merged with NSC, obtained router products from a third source or developed a router product internally, as Vitalink recognized the need to pursue one of these paths to make the transition from bridges to routers. The forecast is not, however, an appropriate forecast for a section 262 appraisal proceeding. Because it assumes the existence and sale of products that Vitalink did not then have the ability or right to provide, Glover's report is not an accurate projection of Vitalink on a stand-alone basis prior to the merger.

n46 Tr. 216, 238.

n47 Tr 216-17.

n48 Petitioners' Post-Trial Reply Br. at 13.

n49 Tr. 223.

n50 Id. at 214-15.

Petitioners, relying on Cede & Co. v. Technicolor, n51 argue that even if Glover's report assumed the availability of routers from another source, that Glover's forecast is nonetheless the proper forecast upon which to base an appraisal because it reflects the assumptions under which Vitalink was operating immediately prior to the merger. Petitioners assert that Vitalink's plan to sell routers is similar to Technicolor's assumption that it would proceed with the "Perelman plan" to sell certain assets of Technicolor and is, therefore, according to Cede & Co. v. Technicolor, an operating assumption that this Court must include when determining the fair value of petitioners' shares on the date of the merger.

n51 Del. Supr., 684 A.2d 289 (1996).

Focusing on the similarities, petitioners ignore the significant differences between the ability of Technicolor to sell its assets and the ability of Vitalink to sell routers. There were no barriers in the way of Technicolor. What petitioners refer to as the "Perelman plan" was a course of action which "was the operative reality on the date of the merger." n52 The plan involved the sale of certain assets that Technicolor already owned. Vitalink, by contrast, did not own the assets it intended to sell and petitioners have provided no evidence that NSC, owner of just over ninety percent of Vitalink as of the date of the merger was willing or even able, to provide router products. Petitioners, in fact, provide no evidence of any value added by NSC between the date on which it obtained majority control and the date on which petitioners became entitled to appraisal rights. As of the date of the merger, Vitalink did not have an agreement with a third party to supply routers, Vitalink did not have the power to force a third party to provide routers, and Vitalink did not have the ability to provide those products internally. Vitalink' power was limited to the ability to negotiate with others and to continue to seek to overcome its own internal development problems and to produce a competitive router.

n52 Id. at 298.

The risk that Vitalink might not be able to consummate an OEM relationship or that Vitalink might not be able to develop a competitive router product must be, but is not, reflected in the product sales forecast prepared by Glover and relied upon by Becklean. Accordingly, Glover's forecast is not an accurate reflection of the future prospects of Vitalink on the date of the merger. Petitioners argue that Dages' product forecasts are also subject to criticism. First, petitioners contend that Dages unjustifiably pushed back development of router products. Considering the fact that petitioners' time frame for development is reflected in Glover's forecast, and Glover concedes that that time frame assumed away risks of development, I find Dages' time frame for development to be reasonable, especially since Vitalink experienced further developmental setbacks between the time when Glover's forecast was first prepared and the time at which petitioners obtained the right to seek appraisal. Petitioners also criticize Dages for supporting his forecast on external documents and fairly limited contact with Vitalink employees. Yet petitioners' expert, Becklean, did not contact anyone at Vitalink to confirm Glover's report. It appears that Becklean simply assumed that Glover's report was an accurate reflection of Vitalink as of the date of the merger. Because I find otherwise, I reject Becklean's reliance on Glover's report and accept the three product forecasts constructed by Dages because I find that Dages' weighting of these three forecasts accurately reflects the value of Vitalink on July 1.

III. COMPARABLE COMPANY ANALYSIS

The parties' use of different comparable companies to calculate the terminal value accounts for just over forty percent of the dollar difference between the two valuations. The differences in the lists of selected companies largely result from the two different views of the expected profitability and success of Vitalink in 1995--at the end of the cash flow period.

A. Petitioners' Selection

Both parties employed a comparable company analysis to determine Vitalink's terminal value in 1995. A company's terminal value is the estimated value of the company at a date in the future. To determine this value, the parties each selected a list of companies whose current performance they believed would be comparable to Vitalink in 1995. Each party's list of comparable companies was a subset of ten comparable companies selected by Kidder which had divided these ten companies into an "upper tier" and a "lower tier" based on the differences among their sales, earnings before interest and taxes, net income, return on assets and return on equity. As Kidder's report explained, the upper and lower tier groups exhibited "dramatically different valuation multiples" with the disparity between the sets of numbers resulting from "recent financial performance as well as the perception that upper tier companies are well positioned for the future." n53 Becklean's selected comparable companies were Cabletron, cisco, SynOptics and 3Com. Three of these four companies appeared in Kidder's upper tier. Becklean selected these companies because he believed they "were the only publicly traded companies at the time primarily engaged in the design, manufacture and marketing of hardware for use in constructing local and wide area data networks (LANs and WANs)" and that this was "the same market served by Vitalink." n54

n53 RTX 29 at KP 000006.

n54 PTX 4 at 2-3 (Valuation of Vitalink Communications Corporation prepared by William R. Becklean, Nov. 18, 1996).

In his report, Becklean explained that price/earnings (P/E), price/earnings before accounting for interest and taxes (P/EBIT), price/earnings before interest but after taxes (P/EBIAT), and price/earnings before interest, taxes and depreciation (P/EBITD) are ratios commonly used to determine a company's terminal value through comparison to similar companies. Because of Vitalink's large cash position, Becklean did not believe that a P/E ratio would accurately reflect Vitalink's terminal value. Accordingly, he employed each of the above ratios except for P/E.

Dividing each comparable company's market capitalization by its EBIT, EBITD, and EBIAT, Becklean obtained a series of three figures representing that comparable company's "multiples." n55 He then averaged the four companies' results for each multiple to obtain an average EBIT multiple of 11.5, and average EBIAT multiple of 18.7 and an average EBITD multiple of 10.0. Applying these averages to Vitalink's EBIT, EBIAT and EBITD, he obtained three comparable values of Vitalink's terminal value that averaged to $ 240 million.

n55 For example, Becklean determined Cabletron's market capitalization was $ 997.7 million and its EBIT was $ 63.0 million. Therefore, Cabletron's EBIT multiple was 15.8 ($ 997.7/$ 63).

B. Respondent's Selection

Dages performed a similar analysis but based his comparison on Digital Communications Associates, General Datacomm Industries, Network Equipment Technologies, Network Systems, Newbridge Networks, and 3Com. These are the companies appearing in Kidder's lower tier group and are the companies on which Kidder based its May 5, 1991 valuation of Vitalink's future terminal value. n56

n56 PTX 2 at KP000064; Valdez Dep. at 30.

C. Analysis

The difference between Kidder's upper and lower tier multiples was addressed by this Court in In re Vitalink Communications Corporation Shareholders Litigation. n57 The focus of the inquiry at that time was whether Kidder's valuation was reliable information on which Vitalink's Board could judge on May 6, 1991; the fairness of NSC's offer. I concluded that Kidder's exclusion of the upper tier companies from its comparable company analysis was appropriate and that such exclusion made the valuation more reliable than a valuation based on exclusion of both the upper "upper tier" and the lower "lower tier" companies. My reasoning at that time was based on the fact that "Vitalink clearly had become a lower tier company." n58 Petitioners provide no evidence that Vitalink's outlook had improved, rather than continued to decline, between May 6, 1991 and July 1, 1991. Moreover, I find no support for Becklean's conclusion that the upper tier companies were more closely comparable to Vitalink than the remaining companies on Kidder's list. n59 Accordingly, I find no reason to conclude that Vitalink or the comparable companies had changed sufficiently to warrant the selection of Becklean's rather than Kidder's/Dages' selection of comparable companies.

n57 Del. Ch., 1991 Del. Ch. LEXIS 195, Consol. C.A. No. 12085, Chandler, V.C. (Nov. 8, 1991).

n58 Id. at *28-29.

n59 See Valdez Dep. at 14-15.

IV. VITALINK'S TAX RATE

The final difference between the two valuations is the selection of Vitalink's tax rate. This difference accounts for just under ten percent of the difference between the two valuations. An adjustment to the tax rate is the only adjustment Becklean made to Glover's forecast. Becklean adjusted the 20.8 to 28 percent tax rates contained in Glover's forecast to reflect the fact that tax-free investments represented thirty-five percent of Vitalink's investment portfolio. Thus, assuming that Vitalink would maintain the same percentage of tax-free investments, Becklean adjusted Glover's forecast to reflect effective tax rates of 30.9 to 34.1 percent. n60

n60 Tr. 89-90, PTX 4 Ex. 1.

Dages also adjusted upward the tax rates in Glover's report. Noting that Vitalink's most recent annual report listed a forty-percent tax rate for 1988 to 1990, Dages applied that rate across the five-year time period 1991 to 1995.

I find that the appropriate tax rate is Dages' tax rate of forty percent, which is Vitalink's tax rate for the previous three years. In addition, Dages' forty-percent tax rate is similar to the tax rates used in the analyses of Kidder and Salomon.

V. POST-MERGER INTEREST RATE

In addition to the differences between the two estimates of value, the parties differ as to 1) the proper method of calculating the rate at which interest should accrue on the fair value of petitioners' shares from the date of the merger to the date of the payment and 2) whether the awarded interest should be simple or compound. These are issues with which this Court is most familiar. n61

n61 Kleinwort Benson Ltd, Del. Ch., C.A. No. 11107; Wacht v Continental Hosts, Ltd., Del. Ch., C.A. No. 7954, 1994 Del. Ch. LEXIS 216, Chandler, V.C. (Dec. 23, 1994); Chang's Holdings v. Universal Chems. & Coatings, Inc., Del. Ch., C.A. No. 10856, 1994 Del. Ch. LEXIS 222, Chandler, V.C. (Nov. 22, 1994); Neal v. Alabama By-Products; Del. Ch., C.A. No. 8282, Chandler, V.C. (Jan. 10, 1994); TV58 Ltd., Del. Ch., C.A. No. 10798; Cooper v. Pabst Brewing Co., Del. Ch., C.A. No. 7244, 1993 Del. Ch. LEXIS 91, Hartnett, V.C. (June 8, 1993); Salomon Brothers Inc. v. Interstate Bakeries Corp., Del. Ch., C.A. No. 10054, 1992 Del. Ch. LEXIS 100, Berger, V.C. (May 1, 1992); In the Matter of the Appraisal of Shell Oil Co., Del. Ch., Consol. C.A. No. 8080, Hartnett, V.C. (Dec. 11), aff'd, Del. Supr., 607 A.2d 1213 (1990); Harris v. Rapid-American Corp., Del. Ch., C.A. No. 6462, 1990 Del. Ch. LEXIS 166, Chandler, V.C. (Oct. 2, 1990), aff'd in part, rev'd in part on other grounds, Del. Supr., 603 A.2d 796 (1992); Neal v. Alabama By-Products Corp., Del. Ch., C.A. No. 8282, 1990 Del. Ch. LEXIS 127, Chandler, V.C., (Aug. 1, 1990), aff'd, Del. Supr., 588 A.2d 255 (1991); Pinson v. Campbell-Taggart, Inc., Del. Ch., C.A. No. 7499, 1989 Del. Ch. LEXIS 50, Jacobs, V.C. (Feb. 28, 1989).

An award of interest is discretionary but "the general rule is that an award of interest is routinely made unless the petitioner brought the action in bad faith." n62 Each party bears the burden of proving an appropriate rate under the circumstances. n63 There is no specific formula used to establish an appropriate rate of interest. n64 When the parties fail to develop a sufficient record, the legal rate of interest may be appropriate. Eight Del. C. § 262(h) provides that "the Court may consider all relevant factors, including the rate of interest which the surviving or resulting corporation would have had to pay to borrow money during the pendency of the proceeding." Furthermore, pursuant to section 262(i), the award of interest "may be simple or compound, as the Court may direct." n65

n62 Cooper, Del. Ch., C.A. No. 7244, at 26.

n63 Pinson, Del. Ch., C.A. No. 7499, at 17 ("In an appraisal action, each side has the burden of proving its respective valuation position. No presumption, favorable or unfavorable, attaches to either side's valuation, including the actual merger price.").

n64 Chang's Holdings, Del. Ch., C.A. No. 10856, at 1-2; Charlip v. Lear Siegler, Inc., Del. Ch., C.A. No. 5178, 1985 Del. Ch. LEXIS 455, *5-6, Walsh, V.C. (July 2, 1985); Pinson, Del. Ch., C.A No. 7499, at 55.

n65 See also Rapid-American Corp., 603 A.2d at 808 "§ 262(i) clearly gives the trial court absolute discretion to determine the form of interest it will award in a statutory appraisal action.").

An award of interest serves two purposes. First, an award of interest recognizes that petitioners, by electing to pursue appraisal rather than accepting the amount offered in the merger, have been denied the use of the fair value of their shares. n66 Second, an award of interest recognizes that the corporation has received a benefit from the use of the fair value of petitioners' shares during the pendency of the proceeding. n67 Neither purpose is intended to reflect culpability on behalf of either party. This Court, recognizing that a single rate may not perfectly reflect both purposes, has frequently considered two rates: one reflecting the rate necessary to compensate petitioners for the loss of the use of their funds and one reflecting the benefit obtained by the corporation. n68 While the decision to enact

a short-form merger, as well as the decision to seek appraisal, are statutory rights, which are not accompanied by presumptions of wrongdoing, n69 there may be times when the actions of one party cause a delay in the appraisal proceedings and place an unfair burden on the opposing party. Any such burden may be recognized by weighting the compensatory and restitutionary rates to reflect the extent to which each party contributed to a delay, if any, in the proceedings. Petitioners, noting that one purpose of an award of interest is to compensate the dissenting or cashed-out shareholders for the loss of the use of their money, argue that the only way in which petitioner Grimes will be compensated for the loss of the use of his funds is for this Court to award a rate of interest equal to the rate of return on Grimes' investments. n70 In the alternative, petitioners suggest that interest be awarded at the rate of 20.83%, which is the rate at which the parties have agreed to discount Vitalink's future cash flows back to the date of the merger. In either case, petitioners seek interest compounded monthly.

n66 Chang's Holdings, Del. Ch., C.A. No. 10856, at 2.

n67 Kleinwort Benson Ltd., Del. Ch., C.A. No. 11107, at 23; Chang's Holdings, Del. Ch., C.A. No. 10856, at 2; Cede & Co. v. Technicolor, Inc., Del. Ch., C.A. No. 7129, 1990 Del. Ch. LEXIS 259, *109, Allen, C. (Oct. 19, 1990), rev'd in part on other grounds, Del. Supr., 634 A.2d 345 (1990). Prior to the 1981 amendment of the appraisal statute, this Court frequently recognized only the first of these purposes. See, e.g., Lebman v. National Union Elec. Corp., Del. Ch., 414 A.2d 824, 829 (1980); Universal City Studios, Inc. v. Francis I. duPont & Co., 334 A.2d 216 (1975). The 1981 amendment, which specifically invited this Court to consider the corporation's cost of borrowing, recognizes the second purpose. See Chang's Holdings, Del. Ch., C.A. No. 10856, at 2-3; Cede & Co. v. Technicolor; Inc., Del. Ch, C.A. No. 7129, at 81, Allen, C. (Oct. 19, 1990), rev'd in part on other grounds, Del. Supr., 634 A.2d 345 (1990). But see Rapid-American Corp., 603 A.2d at 809 (Court addresses only the first factor).

n68 See, e.g., Kleinwort Benson Ltd, Del. Ch., C.A. No. 11107; Wacht, Del. Ch., C.A. No. 7954; Chang's Holdings, Del. Ch., C.A. No. 10856; Cooper, Del. Ch., C.A. No. 7244; Salomon Brothers Inc., C.A. No. 10054.

n69 Rapid-American Corp., Del. Supr., 603 A.2d at 808 (1992) ("There is no punitive aspect of an appraisal proceeding.").

n70 For reasons explained below, evidence of Grimes' investment returns was excluded at trial.

Respondent offers two sets of interest rate calculations. The first, a slight modification on the prudent investor rate adopted by this Court in Chang's Holdings, reflects a compensatory goal. The second is a rather elaborate calculation of the benefit that NSC and respondent obtained from the use of petitioners' funds during the pendency of this proceeding. Asserting that neither party has unjustly contributed to the delay in these proceedings, respondent suggests that the Court weight the two rates equally. Respondent's calculations support a request of 6.5% simple interest.

A. The Appropriate Interest Rate

Neither petitioners' nor respondent's calculations provide reliable estimates of the appropriate rate of interest. Petitioners' interest rate arguments focus on the compensatory principle. They argue that only a rate based on actual investment returns or the discount rate accepted by both parties would adequately compensate petitioners for the loss of the use of their funds. Awarding interest based on investment returns, according to petitioners, "reduces the corporation's incentive to delay the litigation" and supports

the "long standing principle of Delaware tort law that the defendant takes the plaintiff as he finds him." n71 Thus, petitioners argue that because Grimes was "involuntarily" removed from Vitalink and because the only way Grimes could continue to invest in similar companies with the funds he had invested in Vitalink was to accept the "meager amounts" offered in the merger, he should be compensated for the loss of the use of his funds at the same rate of return he achieved by investing in similar high-risk, high-return companies.

n71 Petitioners' Opening Post-Trial Br. at 32-33.

Petitioners fail to recognize that an appraisal proceeding is not akin to an action in tort. n72 The decision to enact a short-form merger is not tortious conduct Allegations of wrongdoing associated with the decision to enact the merger such as breaches of fiduciary duty may be asserted in an action for damages. They will not be recognized here. Furthermore, petitioners' election to exercise their statutory right to reject the merger amount and to pursue appraisal does not shift to the corporation all responsibility for losses they may incur as a result of their inability to use the funds retained by the corporation. Petitioners could have mitigated their losses and obtained perfect compensation for the loss of the use of their funds by borrowing the fair value of their shares. Respondent correctly notes that this Court has repeatedly rejected the use of a petitioner's investment rate of return (as a rate reflective of the compensatory principle) in favor of an objective standard. n73 Evidence of petitioner Grimes' specific investment returns is irrelevant and was excluded at trial. In the alternative, petitioners seek a rate of interest based on the rate selected by the parties to discount Vitalink's future cash flows. Petitioners have not explained how this rate, which the parties have agreed to use to discount Vitalink's future cash flows, reflects either petitioners' loss of the use of their funds or respondent's benefit obtained from the use of petitioners' funds. Thus, I find that neither of petitioners' proposed rates are reflective of a rate that would compensate them for the loss of the use of their funds or force the corporation to disgorge the benefits obtained from the use of their funds.

n72 Rapid-American Corp., 603 A.2d at 808 (1992) ("the purpose of an appraisal proceeding is not to punish the respondent corporation.").

n73 See, e.g., Chang's Holdings, Del. Ch., C.A. No. 10856, at 9.

Respondent purports to provide rates based on the principles expounded in Chang's Holdings. Respondent calculated the average cost of its (or NSC's) debt for each year since July 1991 by first determining the 1) annual amount of cash and short-term investments and 2) annual long-term debt. Respondent then determined, for each year, three different types of interest rates. The first rate reflected the average rate on available short-term investments. The second rate reflected the average rate paid on existing long-term debt. The final type of rate provides two figures for available rates on contractual commitments. For each year, respondent then selected one of the four rates as the rate most reflective of the cost of debt.

For several reasons I cannot conclude that respondent's proffered data on the cost of borrowing is accurate--as a reflection of the cost of borrowing or the cost of debt. n74 First, respondent has failed to explain adequately why some figures are actual rates and some rates are only estimates of rates available. Second, neither Dages' report, nor the briefs, nor trial testimony reveals the actual types of short-term investments held by respondent (or NSC) or the sources of the figures. n75 Third, the report fails to provide interest rates for long-term debt in 1991, 1992, 1993 or 1994. Fourth, there is no

indication of what percentage of debt was obtained pursuant to the contractual obligations. Depending on the method used to select the representative yearly rate, these omissions might not affect the result. In this case, however, respondent's method appears to have little justification. For example, any year in which respondent (or NSC) had more than $ 100,000,000 in cash and short-term investments, the selected yearly rate was not that rate which was obtained on short-term investments, but that rate at which further short-term funds allegedly could be obtained. This use of the rate required to obtain further funds rather than the return it actually achieved on its own investments, implicitly acknowledges that petitioners should not bear the risk of respondent's particular investments and that respondent's benefit may be accurately measured by its cost of obtaining further funds. There is no evidence, however, that the short-term rate provided was the rate available to respondent or NSC, rather than a blend of the rates offered on commercial paper and treasury bills. Moreover, according to respondent's methodology, for years when NSC or respondent did not have over $ 100,000,000 in cash and short-term investments, the selected rate would have been the actual rate of long-term debt, except that rate was unavailable for those years, so respondent selected the higher of the two contractual rates. I fail to understand why, when respondent or NSC had more than $ 100,000,000 in cash and short-term investments that the benefit received from the use of petitioners' funds is most appropriately reflected by the rate reflecting the cost of additional short-term funds. Why, for example, is the benefit best reflected by the "available" short-term rate for 1995, rather than the long-term "actual" rate it paid on debt when for that year respondent had $ 264,502,000 in cash and short-term investments and $ 449,222,000 in long-term debt? n76 Vitalink could have used some of its short-term investments to pay down its long-term debt. The fact that it did not may indicate that its business required the liquidity provided by the short-term investments and that further short-term funds were not available at a rate less than that available on its long-term loans. In any case, the cost of short-term debt is not an appropriate measure of the benefit obtained from the use of petitioners' funds.

n74 If the purpose of a restitutionary rate is to force the corporation to forgo the benefits obtained from the use of petitioners' funds, then perhaps the corporation's cost of debt is not the only factor this Court should consider. Respondent, like other publicly held corporations, has two sources of funds: equity and debt. Debt, backed by security and a superior claim on the firm's assets, is obtainable at a lower cost than equity, which is unsecured and carries only a residual claim on the firm's assets. But both sources provide funds for the corporation's use. Thus, the benefit obtained from the use of additional funds may be more appropriately reflected through a weighted average of the two sources.

n75 At trial, Dages revealed that the long-debt figures were obtained from Vitalink's annual forms 10 Q.

n76 See Ryan v. Tad's Enterprises; Inc., Del. Ch., 709 A.2d 682, 705, Jacobs, V.C. (1996) (responding to argument that cash-rich corporation would not need to borrow and thus derived no benefit from holding plaintiffs' funds by noting that even a cash-rich corporation derived benefit from the use of funds at no cost and concluding that the benefit should therefore, "be considered in determining a fair rate of interest during the period that the defendants had the cost-free use of plaintiffs' funds.").

With respect to a rate that would compensate petitioners for the loss of the use of their funds respondent, on one hand, argues for investments of the type accepted by this Court in Chang's Holdings. n77 On the other hand, respondent argues that petitioners, once electing to perfect their appraisal rights, assume the status of debtors to the corporation, not investors. Petitioners object to the use of a rate based on the prudent investor standard, arguing that the expected risk and return of their

investment in Vitalink is not reflected in the investments which make up the prudent investor standard. I agree that an investment in Vitalink is not likely to be considered by any Court to be an accepted investment under the prudent investor standard. Although I am sympathetic to petitioners' claim that their investment in Vitalink demonstrates that the prudent investor rate would not reflect the risk and return of their investments, respondent is correct in its assertion that petitioners' decision to reject the merger and to seek appraisal removes them from the status of shareholder and places them in the position of a creditor to the corporation. Their former status as shareholders is not relevant to the determination of interest. n78 Yet a compensatory rate of interest based on petitioners' position as a creditor must reflect the fact that petitioners are involuntary creditors to a specific corporation with its own unique risk of defaulting on the loan. Thus, the petitioners are correct when they assert that the particular risk of the party holding their funds should be considered in the selection of the proper compensatory rate. But, because I believe that petitioners' election to exercise their statutory right to reject the merger amount and to pursue appraisal does not shift to the corporation all responsibility for losses they may incur as a result of their inability to use the funds retained by the corporation, and because petitioners could have mitigated their losses and obtained perfect compensation for the loss of the use of their funds by borrowing the fair value of their shares, I believe the proper way to reflect the specific risk borne by the petitioners would be to adjust the petitioners' cost of borrowing funds to reflect the risk that, by the time the appraisal proceeding had concluded, the surviving corporation would be unable to repay the retained funds. This risk is, perhaps, best reflected by the surviving corporation's cost of borrowing for similarly secured funds. n79

n77 Respondent's selected investments are similar to those employed by this Court in Chang's Holdings in all but two of the six categories.

n78 See Southern Production Co., Inc. v. Sabath, Del. Supr., 32 Del. Ch. 497, 87 A.2d 128, 134 (1952) (The status of a petitioner who has perfected a right to appraisal "is primarily that of a monetary claimant against the consolidated or surviving corporation, and is more nearly analogous to that of a creditor than to that of a stockholder.")

n79 Cf. In the Matter of Oil Spill by the Amoco Cadiz off the Coast of France on March 16, 1978, 954 F.2d 1279, 1332 (7th Cir. 1992) (The Court noted that an involuntary tort creditor faces a risk that the defendant will not be able to meet its obligations. "The defendant may go out of business (or encounter less serious reverses), or hide assets, during the litigation. Any market interest rate reflects three things: the social return on investment (that is the amount necessary to bid money away from other productive uses), the expected change in the value of money during the term of the loan (i.e., anticipated inflation), and the risk of nonpayment. The best estimate of these three variables is the amount the defendant must pay for money, which reflects variables specific to that entity.").

Exactly which of respondent's several "available" and "actual" rates would serve this purpose is unclear. The rates offered by respondent range from 3.2% to 5.8% on short-term funds, 7.7% to 7.8% for long-term loans (although the rates for 1991 through 1994 are missing), 6.0% to 8.8% for contractual loans based on the prime rate and 3.3% to 6.5% for contractual rates based on the ninety-day LIBOR. I decline to consider the proffered short-term rates because respondent has not shown that these rates, which were based on a mixture of commercial paper, treasury bills, and treasury notes, were available to respondent. Certainly the rate that respondent would have had to pay to attract funds would have been higher than the rate available on treasury bills. Likewise, I decline to consider the contractual rates as

respondent has failed to explain whether these were rates at which it loaned money to third parties or rates at which it had the right to obtain funds from third parties. Thus, the only potentially helpful interest rate information is respondent's cost of long-term debt. Alas, that provides little guidance. The rate only represents the borrowing rate of respondent Storage Technology from 1995 to September 1996. There is no information documenting NSC's cost of debt prior to that time and thus no way in which to determine a rate reflective of the rate that creditors would have charged NSC from 1991 to 1994 to reflect the risk that NSC would be unable to repay the fair value of petitioners' shares. Concluding that neither side has provided evidence of the proper rate of interest, I award interest at the legal rate calculated as described below. n80

n80 Cf. Cooper, Del. Ch., C.A. No. 7244 ("when, as here, none of the parties establishes a value that is persuasive, the Court must make a determination based upon its own analysis."). See also Chang's Holdings, Del. Ch., C.A. No. 10856, at 6 ("The legal interest rate serves as a useful default rate when the parties have inadequately developed the record on the issue.").

B. Simple or Compound Interest?

Prior to the 1987 amendment of section 262(i), this Court held that it did not have authority to award compound interest. n81 The 1987 amendments, however, provided that "interest may be simple or compound, as the Court may direct." n82 Our Supreme Court has repeatedly confirmed that either method is within this Court's discretion. n83 Despite the clear authority to award simple or compound since 1987, this Court has elected to award compound interest only once. n84 The reasons for continuing to award simple interest since 1987 have not been fully explained. n85 Nor was the reason for awarding compound. n86 As our Supreme Court noted in 1992, "no Delaware case has ever explicitly considered the factors which determine whether a court should award either compound or simple interest." n87 To my knowledge, this Court has yet to formulate a list of factors to consider when determining whether an award of interest should be simple or compound. To be frank, I am not sure what factors might appear on such a list. Factors affecting the fair value of petitioners' shares are best addressed in the determination of the fair value. Factors affecting the ability of the Court to provide full compensation to the petitioners for the loss of the use of their funds and to ensure that the corporation does not receive unjust benefit from the use of petitioners' funds may be addressed while setting the interest rate. The extent to which one party may be relatively more responsible for a delay in the proceedings may be addressed by balancing the two rates to relieve some of the burden imposed by the other party. Regardless of the amount of value established as the fair value, the magnitude of the particular rate which best serves the compensatory and restitutionary purposes, or the extent to which one party may have delayed the proceeding, it appears to me that, in this case, only an award of compound interest may truly serve to compensate the petitioners for the loss of the use of their funds and to prevent the corporation from retaining unjust benefits from the use of petitioners' funds. n88 As Becklean explained, compound interest is "the standard form of interest in the financial market." n89 Neither Becklean nor Dages could provide an example of an investment that would not provide for compound interest. n90 Certainly respondent has earned compound interest on its investments during the pendency of this proceeding and certainly petitioners would have had to pay compound interest to borrow funds during the pendency of the proceeding. Accordingly, I am unable to conclude that an award of simple interest will adequately compensate the petitioners for the loss of the use of their funds or prevent the corporation from retaining unjust benefits from the use of petitioners' funds. n91

n81 See Charlip, Del. Ch., C.A. No. 5178, at 9-12.

n82 66 Del. Laws, Ch. 136, § 32.

n83 Cede & Co., 684 A.2d at 301; In the Matter of the Appraisal of Shell Oil Co., 607 A.2d at 1221.

n84 See, Cede & Co., Del. Ch., C.A. 7129, 1990 Del. Ch. LEXIS 259, *108 (Oct. 19, 1990); Id. Dkt. 55 (Restated Modified Order and Final Judgment).

n85 See, e.g., Gonsalves, Del. Ch., C.A No. 8474 (no discussion); Kleinwort Benson Ltd., Del. Ch., C.A. No. 11107 (no discussion); Wacht, Del. Ch., C.A. No. 7954 (no discussion); Chang's Holdings, Del. Ch., C.A. No. 10856, at 11 (Court not persuaded that it should diverge from general practice of awarding simple interest); Salomon Brothers, Inc., C.A. No. 10054 (no discussion); In the Matter of the Appraisal of Shell Oil Co., Del. Ch., Consol. C.A. No. 8080, (no discussion); Harris, Del. Ch., C.A. No. 6462, at 43; aff'd in part, rev'd in part on other grounds, Del. Supr., 603 A.2d 796 (1992) (Court chose "not to depart from [the] Court's standard practice of allowing only simple interest."); Neal, Del. Ch., C.A. No. 8282, aff'd, Del. Supr., 588 A.2d 255 (1991) (no discussion); Pinson, Del. Ch., C.A. No. 7499 (no discussion); Charlip, Del. Ch., C.A. No. 5178, at 10-11.

n86 See Cede & Co., Del. Ch., C.A. 7129, 1990 Del. Ch. LEXIS 259 (Oct. 19, 1990) (no discussion); Id. Dkt. 55 (Restated Modified Order and Final Judgment) (no discussion).

n87 Rapid-American Corp., 603 A.2d at 808.

n88 See Saulpaugh v. Monroe Community Hospital, 4 F.3d 134 (2nd Cir. 1993) (holding that district court's failure to award compound interest was an abuse of discretion because compound interest was necessary to make plaintiff whole); In re Valuation of Common Stock of McLoon Oil Co., Me., 565 A.2d 997 (1989) (referee's failure to award compound interest on fair value of appraised shares reversed as legal error because compounding interest was "the only fair and equitable way to compensate the Dissenters for the lost use of their funds").

n89 Tr. 111.

n90 Id.; Id. at 389.

n91 See Bogosian v. Woloohojian Realty Corp., 1997 WL 431885 (D.R.I.) (finding that the case presented "a situation in which it might fairly be said that failing to award compound interest would not fully compensate the plaintiff, and would therefore amount to an abuse of the court's discretion."); In re Valuation of Common Stock of McLoon Oil Co., Me., 565 A.2d at 1007 (noting that because compound interest is available to the dissenting shareholders, it may be more profitable for shareholders to invest the consideration initially offered rather than to invoke the lengthy appraisal process).

C. Compounding Interval

Petitioners have requested that interest be compounded monthly. The selection of the appropriate compounding interval, like the determination of the proper interest rate and the decision to award simple or compound interest, should be guided by the dual purposes of providing compensation to the dissenting shareholder and compelling the corporation to disgorge any unjustly retained benefit from the use of petitioners' funds. The compounding interval should, thus, reflect the interval available to the petitioners had they the use of their funds as well as, if possible, the interval actually received by the corporation. Neither side has provided evidence of such intervals. I find that the dual purposes of

compensation and restitution may only be served by a compounding interval at least as frequent as one month. n92 Petitioners, therefore, are entitled to the legal rate of interest, compounded monthly, on the fair value of their shares ($ 8.50 per share) from July 1, 1991, to the date of payment.

n92 Marfia v. T.C. Ziraat Bankasi, 968 F. Supp. 152, 153 (S.D.N.Y. 1997) (monthly compounding); Andrew Corp. v. Gabriel Electronics, Inc., 785 F. Supp. 1041, 1055 (D. Me. 1992) (monthly compounding); New Orleans Elec. Pension Fund v. Newman, 784 F. Supp. 1233, 1238 (E.D.La. 1992) (monthly compounding); T.A. Pelsue Co. v. Grand Enterprises, Inc., 782 F. Supp. 1476, 1502 (D.Colo. 1991) (monthly compounding). But see also Uniroyal, Inc. v. Rudkin-Wiley Corp., 721 F. Supp. 28, 29 (E.D.N.Y. 1989) ("Daily compounding more accurately reflects modern banking and investment practices, and thereby satisfies more fully" the goal of proving full compensation for patent infringement."); Trans-World Mfg. Corp. v. Al Nyman & Sons, 633 F. Supp. 1047, 1057 (D. Del. 1986) (Daily compounding serves goal of providing "adequate compensation" for plaintiff who had been deprived of interest that could have been earned had plaintiff received payment promptly.).

I ask counsel to confer and to agree upon a form of Order implementing this decision.

Full Text of Court Cases

Gross v. Commissioner (II)

Case name: Gross v. Commissioner (II)
Citation: 272 F.3d 333, 2001 U.S App. LEXIS 24803
Date of decision: November 19, 2001
Country: US
State or Federal: Federal
State/Jurisdiction: 6th Circuit
Court: United States Court of Appeals
Type of action: Estate and Gift Taxation
Judge: Clay
Experts: David O. McCoy, CBA (for the taxpayer)
Charles A. Wilhoite, CPA/ABV, ASA (for the taxpayer)
Mukesh Bajaj, Ph.D. (for the IRS)
SIC: 2086 Bottled and Canned Soft Drinks and Carbonated Water (except bottled water)
NAICS: 312111 Soft Drink Manufacturing
1135, 1136, 8860

Keywords: Fair market value (FMV), Gift tax , Income approach, S corporation, Tax affecting

RECOMMENDED FOR FULL-TEXT PUBLICATION

Pursuant to Sixth Circuit Rule 206

ELECTRONIC CITATION: 2001 FED App. 0405P (6th Cir.)

File Name: 01a0405p.06

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

Walter L. Gross, Jr. and Barbara H. Gross (99-2239); Calvin C. Linnemann and Patricia G. Linnemann (99-2257), Petitioners-Appellants, v. Commissioner of Internal Revenue, Respondent-Appellee.	Nos. 99-2239/2257

On Appeal from the United States Tax Court.

Nos. 97-04460; 97-04469--James S. Halpern,

Tax Court Judge.

Argued: October 27, 2000

Decided and Filed: November 19, 2001

Before: DAUGHTREY and CLAY, Circuit Judges; COHN, Senior District Judge.(*)

COUNSEL

ARGUED: Gerald J. Rapien, TAFT, STETTINIUS & HOLLISTER, Cincinnati, Ohio, for Appellants. David I. Pincus, UNITED STATES DEPARTMENT OF JUSTICE, APPELLATE SECTION, TAX DIVISION, Washington, D.C., for Appellee. ON BRIEF: Gerald J. Rapien, James J. Ryan, TAFT, STETTINIUS & HOLLISTER, Cincinnati, Ohio, for Appellants. David I. Pincus, A. Wray Muoio, UNITED STATES DEPARTMENT OF JUSTICE, APPELLATE SECTION, TAX DIVISION, Washington, D.C., for Appellee.

CLAY, J., announced the judgment of the court and delivered an opinion, in which DAUGHTREY, J., and COHN, D. J., concurred except as to Part II.B.1. COHN, D. J. (pp. 31-39), delivered a separate opinion, in which DAUGHTREY, J. concurred, which constitutes the opinion of the court on the issue addressed in Part II.B.1.

OPINION

CLAY, Circuit Judge. Taxpayers, Walter L. and Barbara H. Gross, Jr., along with Calvin C. and Patricia G. Linnemann, appeal from the order of the United States Tax Court valuing certain gifts of corporate stock at $10,910 per share. To the extent that the valuation was based upon the use of a contested valuation approach, I would find that the tax court's decision was clearly erroneous; and would therefore reverse the tax court's decision and remand for further proceedings. However, inasmuch as Judge Daughtrey and Judge Cohn find that the tax court did not clearly err in concluding that it was appropriate not to tax affect the stock in order to determine its fair market value, the tax court's decision is AFFIRMED.

FACTS

The common question presented by this consolidated appeal is the fair market value of certain shares of corporate stock transferred as gifts by Taxpayers Walter L. Gross, Jr., and Patricia G. Linnemann to their respective children. Taxpayers Barbara H. Gross and Calvin C. Linnemann, the wife and husband of the aforementioned taxpayers, are parties because they consented to having the gifts made by their respective spouses as also having been made one-half by them for federal gift tax purposes. The shares in question are shares of stock of Pepsi-Cola Bottlers, Inc. ("G&J"), an Ohio corporation that bottles and distributes various beverages in Ohio and Kentucky. G&J's business operations can be traced back to a partnership formed in the 1920s between two married couples, Isaac N. and Esther M. Jarson and Walter L. and Nell R. Gross. This business was incorporated in 1969. By the time the questioned gifts were made in 1992, the founders of the corporation were deceased and ownership of G&J had devolved to their relatives: the Gross family group (which included members of the Linnemann family) and the Jarson family group. Directly and through voting trusts, each family group owned 50% of the outstanding shares of stock of G&J.

By a written agreement dated November 1, 1982,G&J's shareholders elected to be taxed as a small business corporation ("S corporation"), pursuant to Subchapter S of the Internal Revenue Code, I.R.C. §§ 1361-1379, for at least 10 years. This subchapter was enacted to eliminate the tax disadvantages that might dissuade small businesses from adopting the corporate form and to lessen the tax burden on such businesses. The statute accomplishes these goals by means of a pass-through system under which corporate income, losses, deductions, and credits are attributed to individual shareholders in a manner akin to the tax treatment of partnerships. See I.R.C. §§ 1366-1368; Bufferd v. Commissioner, 506 U.S. 523, 524-25 (1993). In practical terms, this means that the corporation pays no state or federal income tax. See I.R.C. §§ 1361-1363; Ohio Rev. Code Ann. § 5733.09(B) (Banks-Baldwin 1995). Rather, the S corporation passes its income through to its shareholders, who report their pro rata shares of that income on their individual tax returns. See I.R.C. § 1366. G&J maintained S corporation status through July 31, 1992, at which time there were no plans to change its S corporation status.

Also in 1982, the members of the Gross/Linnemann family group entered into an agreement restricting the transferability of their G&J stock. This restrictive agreement permitted certain transfers within the Gross/Linnemann family group, but provided that if other transfers were attempted, the G&J stock would be purchased by the family group at book value.(1) More importantly, the agreement also restricted any transfers that would jeopardize G&J's S corporation status. This agreement was still in effect as of July 31, 1992.

At that time, G&J was the third largest independent bottler of Pepsi-Cola products. G&J had an exclusive franchise agreement to distribute these products within several geographic territories. These products, including the brand names Seven-Up, Dr. Pepper, and five variations of Pepsi-Cola, were distributed to over 24,000 customers including wholesale and retail outlets. G&J's operational infrastructure included plants, warehouses, over 800 vehicles, and over 11,000 soft drink vending machines. From 1988 to 1992, G&J enjoyed steady increases in its operational income, total income, and distribution to shareholders. In addition, G&J's shareholder distributions nearly totaled the company's entire income for each of these years.

On July 31, 1992 Walter Gross gave each of his three children 124.5 shares of G&J stock, and Patricia Linnemann gave each of her two children 187.5 shares of G&J stock. The gifts to each child represented less than one percent of the corporation's outstanding shares. Walter Gross and his wife Barbara each reported one-half of the asserted value of the gifts to their children on a timely filed Form 709, United States Gift (and Generation Skipping Transfer) Tax Return ("Form 709"). Patricia Linnemann and her husband Calvin did the same with respect to the gifts to their children. In reporting these gifts ro the IRS, the Grosses and Linnemanns ("Taxpayers") relied on an appraisal report prepared by Business Valuations, Inc. This report, dated July 22, 1992, valued the G&J stock at $5,680 per share as of May 31, 1992. Based upon this report, the Grosses reported a total gift value of $2,121,480 and the Linnemanns reported a total value of $2,130,000. Upon receiving the report of these gifts, the Commissioner of Internal Revenue ("Commissioner") issued notices of deficiency to Taxpayers based on his valuation of the stock at a much higher amount, $11, 738.00. The Commissioner later agreed that the shares had a value of no more than $10,910 as of the gift date. Taxpayers challenged the Commissioner's determinations in the United States Tax Court.

At trial, both parties relied on expert testimony to establish the value of the shares of G&J stock. Taxpayers relied upon the Testimony of David O. McCoy and Charles A. Wilhoite. McCoy, a business appraiser, prepared a report valuing the common shares of G&J. He was accepted as an expert witness and his report was accepted into evidence as direct testimony. McCoy also prepared an additional report rebutting the testimony of the Commissioner's lone expert witness. Wilhoite is an appraiser and valuation expert who prepared a second rebuttal report in response to the Commissioner's expert. Wilhoite was accepted as an expert on appraisal and valuation methodology and his report was also accepted into evidence as his direct testimony. The Commissioner called Mukesh Bajaj, Ph.D., as an appraisal expert. Bajaj presented two reports, one valuing minority interests in G&J as of the gift date, and one in rebuttal to McCoy's first report. Bajaj was accepted as an expert witness and his reports were accepted into evidence as his direct testimony.

The experts on either side determined the value of the G&J stock using "income approaches" in which a company's fair market value is determined by calculating the present value of its projected future income. One approach used by both parties was the "discounted future cash flow" approach. (2)Experts on both sides also agreed that the value of the shares should be discounted to reflect the fact that, as shares of a closely held S corporation, they are not readily marketable. But two basic disagreements distinguished the experts' calculations of the value of G&J stock.

The first disagreement was whether, under the discounted future cash flow approach, to reduce the corporation's projected future income by deducting hypothetical corporate income taxes even though as an S corporation G&J did not pay income taxes. This process is known as "tax affecting." McCoy testified that in 1992 various professional associations published standards governing the conduct of professional business appraisers and that professional appraisers were ethically bound to follow those standards, citing a publication entitled the Uniform Standards of Professional Appraisal Practice ("USPAP"). This document requires appraisers to be aware of, understand, and correctly employ recognized methods and techniques necessary to produce a credible appraisal (the "standards rule"). McCoy testified that in order to comply with the standards rule, and produce a credible appraisal, it was necessary for professional appraisers to "tax affect" the earnings of an S corporation. In order to "tax affect" G&J's stock, McCoy introduced a fictitious tax burden, equal to an assumed corporate tax of 40%, which he then applied to reduce the estimated future income of G&J. Both McCoy and Wilhoite testified that despite some growing controversy surrounding the issue, use of a 40% tax affect was the accepted practice at the time Taxpayers performed the transaction in question.

Bajaj also relied on the discounted free flow cash method to value the G&J stock. But, although he was informed of G&J's S corporation status, Bajaj concluded that using a 0% tax rate was appropriate to determine the future earnings of G&J that would be available for distribution. Thus, in essence, Bajaj did not tax affect the stock at all.

The second disagreement between the experts dealt with the amount of the lack of marketability discount. McCoy examined several studies discussing the lack of marketability inherent in closely held and restricted securities such as G&J stock. He testified that his research reflected that an average lack of marketability discount for shares that would eventually become freely tradable was "30%+" and ultimately found that a discount rate of 35% was required to fully compensate an owner for the lack of marketability of those shares. On behalf of the Commissioner , Bajaj also reviewed the commonly cited published studies examining lack of marketability discounts, dividing them into two groups: those that

analyzed sales of restricted stock by firms that also had publicly traded shares, and those that compared the share prices used in several successful initial public offerings ("IPO"s). According to Bajaj, the first category of studies revealed that median discounts ranged from 10%-40%. But he determined that only about 10%-15% of these discounts could be attributed to a lack of marketability. Bajaj then concluded that the studies regarding the second category of firms was not useful in evaluating discount levels for two reasons. First, he indicated that many of the pre-IPO transactions did not occur at fair market values. Second, Bajaj surmised that referring only to discounts of companies that conducted successful IPOs would create a biased sample that could artificially inflate the discount rate. In the end, Bajaj relied upon his own study in which he conducted an empirical analysis of marketability discounts, considering such factors as G&J's generous dividend policy and its restrictive transfer agreements, the latter of which he considered to be a greater marketability restriction. This study considered 157 transactions that took place from 1980 through 1996, 75 of which took place before July 31, 1992, and 79 of which took place after that date. He concluded that the highest predicted discount for G&J was 12.84%. Based on this study as well as the other studies relied upon by McCoy, Bajaj determined that the lack of marketability discount for G&J shares should be 13%. But when considering other factors unique to G&J, such as the restrictive agreements and the fact that the corporation paid out most of its earnings to its shareholders, he came to a final figure of a 25% lack of marketability discount.

Taxpayers filed a motion in limine to exclude Bajaj's testimony regarding both tax affecting and the lack of marketability discount as being based upon unproven methodology. The tax court denied these motions and admitted Bajaj's testimony and reports into evidence. After hearing evidence presented by the experts, the tax court determined that the G&J stock should be discounted using a tax affect of 0% and that the lack of marketability discount should be 25%. Using these figures the tax court ultimately determined that the G&J stock should be valued at a rate of $10,910 per share. Taxpayers now appeal from this order. Specifically, they contest (1) the admissibility of expert testimony by the IRS' expert witness based upon methods which taxpayers claim were scientifically unreliable; and (2) the validity of the court's valuation.

I. ADMISSIBILITY OF EVIDENCE

On appeal, Taxpayers allege that the tax court did not follow proper procedures in admitting certain aspects of Bajaj's testimony on behalf of the Commissioner. For the following reasons we hold that the tax court did not abuse its discretion in admitting this testimony.

A.

The tax court's decision whether to admit expert testimony, as well as its decisions regarding how to determine the reliability of that testimony, are reviewed for an abuse of discretion. See Kumho Tire Co. v. Carmichael, 526 U.S. 137, 152 (1999).

B.

Federal Rule of Evidence 702 governs the admissibility of expert testimony. That Rule provides that "[i]f scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise." Fed. R. Evid. 702. In Daubert v. Merrill Dow Pharmaceuticals, Inc., 509 U.S. 579, 597 (1993), the Supreme

Court held that Rule 702, along with Rule 104(a) (relevance), confers upon trial judges a special obligation to ensure "that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand. Pertinent evidence based on scientifically valid principles will satisfy those demands."(3)

The Daubert Court also suggested several criteria that might assist trial courts in making a preliminary evaluation of expert testimony before admitting it: (1) whether a theory or technique has been or can be tested; (2) whether the technique has been subjected to peer review and publication; (3) the known or potential rate of error; and (4) whether the technique has been accepted by the "relevant scientific community," or "has been able to attract only minimal support within the community." Daubert, 509 U.S. at 593-94. Subsequent decisions have further refined the requirements of Daubert. The Supreme Court has extended Daubert to include any testimony based on "technical" and "other specialized knowledge." See Kumho Tire Co., Ltd., 526 U.S. at 152. We have previously held that the mandates of Daubert and Kumho Tire also apply to decisions of the United States Tax Court. See Conti v. Commissioner, 39 F.3d 658, 662 (6th Cir. 1994).

The Court has stopped short of turning the Daubert test into a straightjacket. Rather, it has insisted that trial courts must enjoy "the same kind of latitude in deciding how to test an expert's reliability, and to decide whether or when special briefing or other proceedings are needed to investigate reliability, as it enjoys when it decides whether or not that expert's relevant testimony is reliable." Kumho Tire Co., Ltd., 526 U.S. at 152. Thus, though helpful, the Daubert factors are not dispositive in every case. Instead, the Supreme Court has instructed trial courts to consider the specific factors identified in Daubert where they are reasonable measures of the reliability of expert testimony. Furthermore, "[w]hether Daubert's specific factors are, or are not, reasonable measures of reliability in a particular case is a matter that the law grants the trial judge broad latitude to determine." Id. at 139. Nonetheless, this call for broad discretion cannot be interpreted as an invitation for the trial judge "to adopt an excessive level of generality in his gate-keeping inquiry." See Black v. Food Lion, 171 F.3d 08, 313 (5th Cir. 1999). With this admonition in mind, we now consider the tax court's basis for accepting Bajaj's testimony in the instant case.

1. Testimony Regarding Tax Affecting G&J's Earnings

The tax court acknowledged that Bajaj's testimony was of a "technical nature" and, therefore, determined that Daubert applied in the instant case. But Taxpayers contend that the court abused its discretion by terminating its reliability review of the expert's testimony regarding tax affecting upon determining that his methodology was appropriate. Bajaj testified that under the discounted cash flow method, considering a hypothetical corporate tax rate of 40% would be improper. Thus, he testified that his valuation of the G&J stock was based upon use of the discounted cash flow approach with a 0% tax affect.

The tax court found that when properly applied, the discounted cash flow method, which was used by both parties, is a reliable tool for financial analysis. Noting that "value is a question of fact," the court found that the "difference in opinions as to value reached by the two expert witnesses, at least to the extent it is attributable to the discounted cash-flow approach, is exclusively the result of differences between them as to the values of certain variables." (J.A. at 186.) Thus, the court concluded that Bajaj used the same discounted cash flow methodology as Taxpayers' experts and his decision not to tax affect G&J's earnings was "not a difference as to methodology." (J.A. at 186). The court determined that

a challenge to Bajaj's approach to tax affecting was "nonsensical" and declined to apply any of the other factors suggested in Daubert, including determining whether Bajaj's method had not been subjected to peer review. (J.A. at 186.)

We disagree with the tax court's characterization of the respective experts' approaches to tax affecting as a mere difference in variables. There was no spectrum of tax percentages from which the court could have selected. Rather, the choice was either a corporate tax rate of 40% or a rate of 0%, the latter meaning no tax affect at all. But while the tax court's analysis was rather cursory, we do not believe that further evaluation was necessary under the circumstances. Taxpayers argue that Bajaj's use of the discounted cash flow analysis without tax affecting is not supported by testing, peer review, publication, or acceptance by the relevant scientific community. To a large extent, Taxpayers' claim that Bajaj's testimony was inadmissible hinges upon the correctness of their assertions that tax affecting was a generally accepted practice under the discounted cash flow method as of July 31, 1992. In this respect, we believe that Taxpayers' Daubert claim is misguided, for they are attacking the correctness of that ultimate valuation more than the reliability of the expert's methods in deriving the value of the shares of stock. The evidence on the record suggested that as of 1992 there was a growing dispute as to the validity of tax affecting the earnings of closely held corporations. In fact, one of Taxpayers' own experts indicated that if charged with the task of valuing the same stock today, he would have to give further consideration to whether he would tax affect the G&J stock. Thus, we do not believe that using a 0% tax affect in calculating the value of stock under a discounted cash flow methodology is scientifically unreliable. For the same reasons we are undeterred by Taxpayers' claim that the use of a 0% tax affect has not been published or submitted for peer review. As the Court recognized in Daubert, "in some instances well-grounded but innovative theories will not have been published. . . . Some propositions, moreover, are too particular, too new, or of too limited interest to be published." Daubert, 509 U.S. at 593 (citation omitted). "The fact of publication (or lack thereof) in a peer reviewed journal thus will be a relevant, though not dispositive, consideration in assessing the scientific validity of a particular technique or methodology on which an opinion is premised." Id.

Although we could imagine challenges to Bajaj's suitability to deliver testimony on what tax affecting approach buyers and sellers would have utilized in 1992, Taxpayers do not assert those claims here. Thus, we believe that further application of the Daubert test was unnecessary as to Bajaj's testimony regarding tax affecting, and the court properly admitted Bajaj's expert testimony on this issue. We note, however, that this finding of admissibility bears no relation to the weight to be given this evidence in determining the value of the shares of G&J stock.

2.Testimony Regarding the Lack of Marketability Discount

Taxpayers also contest the admissibility of Bajaj's testimony indicating that the lack of marketability discount should be 25%. Taxpayers challenge the reliability of what they term the "novel" methodology Bajaj used in calculating this figure and the tax court's failure to fully analyze these methods using the Daubert factors. We disagree with Taxpayers' arguments and instead find that the tax court correctly considered statistics relevant to what a reasonable buyer and seller would have considered as of the valuation date. Bajaj's testimony was based upon his own empirical analysis which included a sample of 157 transactions, 79 of which were announced subsequent to the date on which Taxpayers made the transaction at issue. In their motion in limine Taxpayers claimed that the data used by Bajaj was

unavailable as of the valuation date and that a willing buyer and seller could therefore not have relied upon such data in negotiating a sale price for G&J stock. The tax court rejected this challenge, finding that it is not improper to consider subsequent events that may shed light upon the circumstances that existed as of the valuation date. We have previously held that "subsequent events may only be considered if they were reasonably known on the date of valuation and also that such could be reasonably contemplated on that date." Morris v. Commissioner, 761 F.2d 1195, 1201 (6th Cir. 1985) (citing Estate of Jephson v. Commissioner, 81 T.C. 999, 1002 (1983) (quoting Couzens v. Commissioner, 11 B.T.A. 1040, 1165 (1928)). In Morris we held that the tax court did not abuse its discretion in refusing to permit introduction of evidence concerning the state of development on decedent's property eight years after the valuation date. The tax court has interpreted our holding as a rule of relevance. See Estate of Gilford v. Commissioner, 88 T.C. 38, 53 (1987).(4) Thus, the tax court has considered relevant subsequent events that took place less than one year from the valuation date due to its relevance. See id. Inasmuch as the 79 post-valuation date transactions used in Bajaj's study could have been anticipated, their inclusion in his empirical analysis does not impede the admissibility of his testimony on this issue. Furthermore, the record indicates that Bajaj repeated his analysis using only pre-valuation date data. This re-analysis resulted in an even smaller lack of marketability discount, which would have been less favorable to Taxpayers. Based upon these facts we do not believe that Bajaj's opinion regarding the lack of marketability discount was based upon unsound or irrelevant analysis or data. We therefore hold that the tax court did not abuse its discretion in admitting this testimony.

II. VALUATION OF THE GIFTS

Taxpayers also contend on appeal that even if Bajaj's testimony was admissible, the tax court's ultimate valuation decision was clearly erroneous. Their argument is based upon a challenge to the use of a 0% tax affect and the use of a 25% lack of marketability discount. Although a majority of the factors the tax court used in calculating the valuation amount were proper, I take issue with the court's use of a 0% tax affect and would therefore hold that to the extent the valuation was based upon the use of a 0% tax affect, the court's ultimate finding that the G&J stock was worth $10,190 per share was clearly erroneous. However, Judge Daughtrey and Judge Cohn disagree with me on this point, so that our majority holding is that the tax court's use of the 0% tax affect was proper.

A.

The parties dispute the proper standard of review to be utilized by this Court. Generally, we review the tax court's findings of fact for clear error and its application of law de novo. See Friedman v. Commissioner, 216 F.3d 537, 541 (6th Cir. 2000); Ekman v. Commissioner, 184 F.3d 522, 524 (6th Cir. 1999). The Commissioner contends that the determination of "fair market value" of G&J stock is a question of fact and the tax court's determination may be reversed only if it is clearly erroneous. See Estate of Newhouse v. Commissioner, 94 T.C. 193, 217 (1990); Akers v. Commissioner, 798 F.2d 894, 897 (6th Cir. 1986) (both holding that determining the value of a gift is an issue of fact and the tax court's factual findings as to fair market value may be reversed only if the determination is clearly erroneous). Yet the question of whether the tax court used the correct standard to determine the fair market value is a legal issue. See Powers v. Commissioner, 312 U.S. 259, 260 (1941); Razavi v. Commissioner, 74 F.3d 125, 127 (6th Cir. 1996) (holding that the determination of whether the tax court used the correct standard to measure "fair rental value" is a legal issue); Ruehlmann v. Commissioner, 418 F.2d 1302, 1304 (6th Cir. 1969) (holding that the criterion to be applied in determining value is a matter of law). It is

undisputed that for federal gift tax purposes the fair market value is the price at which the stock 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. See United States v. Cartwright, 411 U.S. 546, 551 (1973); Heyen v. United States, 945 F.2d 359 (10th Cir. 1991); I.R.C. § 2512. This legal standard has come to be known as the "willing buyer/willing seller" standard. In the case at bar, the tax court clearly cited the correct legal standard (the willing buyer/willing seller standard), which was the same standard advocated by Taxpayers. But Taxpayers allege that the court deviated from this standard by not "tax affecting" the G&J stock and by considering post-valuation date data. They therefore argue that the proper standard of review is de novo because the issue is a mixed question of law and fact. See Razavi, 74 F.3d at 127.

We find that this dispute is not over the proper criteria to be used in determining fair market value, but rather over whether those criteria were properly applied. Essentially, Taxpayers are merely arguing that the tax court erred in its final valuation by failing to tax affect G&J's stock and by finding that the lack of marketability discount should be 25%. These contentions do not challenge the actual standard; rather they reflect a difference in opinion as to the methodologies used to arrive at the valuation amount. "The choice of the appropriate valuation methodology for a particular stock is, in itself, a question of fact." Estate of Newhouse, 94 T.C. at 245 (citing O'Malley v. Ames, 197 F.2d 256, 258 (8th Cir. 1952); Riss v. Commissioner, 56 T.C. 388, 430 (1971), aff'd sub nom. Commissioner v. Transport Mfg. & Equipment Co., 478 F.2d 731 (8th Cir. 1973), aff'd, cause remanded 478 F.2d 1160 (8th Cir. 1973)). Thus, we will review the tax court's valuation decision only for clear error.

A finding is clearly erroneous when, although there is evidence to support it, a review of the entire record leaves the reviewing court with the definite and firm conviction that a mistake has been made. See Commissioner v. Duberstein, 363 U.S. 278, 291 (1959); Faulconer v. Commissioner, 748 F.2d 890, 895 (4th Cir.1984). This standard of review requires that we accord great deference to the values established by the tax court, but it does not render us a mere rubber stamp. See Miami Valley Broad. Corp. v. Commissioner, 594 F.2d 556, 557 (6th Cir. 1979). This Court can only overturn the tax court's decision if it is "left with a definite and firm conviction that a mistake has been committed." Anderson v. Bessemer City, 470 U.S. 564, 573 (1985) (quoting United States v. United States Gypsum Co., 333 U.S. 364, 394095 (1948)). When reviewing for clear error, the court cannot substitute its judgment for that of the tax court but rather must uphold the tax court's account of the evidence if it is plausible in light of the record viewed in its entirety. Id. at 574. "Where there are two permissible views of the evidence, the fact finder's choice between them cannot be clearly erroneous." Id. Thus, where the tax court's findings of fact rest upon credibility determinations, the fact finder's choice must be accorded more deference. Moreover, the Commissioner's determination of a tax deficiency is presumptively correct and the taxpayer has the burden of proving that the determination is erroneous or arbitrary. See Kearns v. Commissioner, 979 F.2d 1176, 1178 (6th Cir. 1992) (citing United States v. Janis, 428 U.S. 433, 440 (1976)); see also Tx Ct. R. 142(a).(5)

B.

The Internal Revenue Code imposes a tax on the transfer of property by gift. The valuation of a gift of stock is the fair market value on the date the gift was made. See I.R.C. § 25.2512-2(a). Fair market value has been defined as 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 the relevant facts." Treas. Reg. § 25.2512-1; see also United States v. Cartwright, 411 U.S. 546, 551 (1973); cf. Razavi, 74 F.3d at 127 (defining the term "fair rental value" in a similar fashion and by reference to the term "fair market value").

Moreover, the IRS's published regulations indicate that "determination of fair market value, being a question of fact, will depend upon the circumstances in each case . . . [and a] sound evaluation . . . [requires] common sense, informed judgment and reasonableness." Rev. Rul. 59-60 § 3.01, 1959-C.B. 237, 238, modified by Rev. Rul. 65-193, 1965-2 C.B. 370. Section 4 of Revenue Ruling 59-60 provides:

> It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive are fundamental and require careful analysis in each case:
>
> (a) The nature of the business and the history of the enterprise from its inception.
>
> (b) The economic outlook in general and the condition and outlook of the specific industry in particular.
>
> (c) The book value of the stock and the financial condition of the business.
>
> (d) The earning capacity of the company.
>
> (e) The dividend-paying capacity.
>
> (f) Whether or not the enterprise has goodwill or other intangible value.
>
> (g) Sales of the stock and the size of the block of stock to be valued.
>
> (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Rev. Rul. 59-60 § 4, 1959-1 C.B. 237.

After hearing the evidence on these issues, the tax court found that the fair market value of a share of G&J stock on July 31, 1992 was $10,910. In so holding, the court noted that valuation is an issue of fact on which Taxpayers' beared the burden of proof. Taxpayers contend that the tax court lost sight of the willing buyer and willing seller standard. They assert that the tax court made no attempt to discuss or analyze any of the relevant facts which a hypothetical buyer of a minority interest in G&J stock would be legally presumed to know and act upon with respect to two key variables--the decision whether to tax affect G&J's earnings and the extent of the lack of marketability discount.

1.Tax Affecting(6) (http://pacer.ca6.uscourts.gov/cgi-bin/getopn.pl?OPINION=01a0405p.06#ft6)

Taxpayers contend that a willing buyer in 1992 would have tax affected the stock by 40% in determining a purchase price. Their main argument in support of this contention is that a hypothetical willing buyer in 1992 would be presumed to know that tax affecting earnings was the generally accepted practice of the business appraisal community in valuing a minority interest in S corporations. The Commissioner argues that tax affecting was not a generally accepted business practice at the time. At trial, both parties presented conflicting evidence on this issue. Bajaj testified to that it would be unreasonable to subtract hypothetical corporate income taxes from G&J's projected future income because the corporation did not, in fact pay any taxes. But Taxpayers largely discredited Bajaj's testimony by pointing out that by his own admission he had no first hand knowledge of what willing buyers did in 1992. In fact, Bajaj testified that he had no first hand knowledge as to what the accepted practice among tax appraisers was in 1992 regarding tax affecting S corporation stock. Conversely, both McCoy and Wilhoite testified on behalf of Taxpayers that tax affecting was the approach generally followed in 1992 by the appraisal community in evaluating S corporations. On cross-examination, McCoy did admit that there was a growing controversy in 1992 as to the propriety of the tax affecting. McCoy also agreed that the matter was still being debated as of the time of trial and that if he had to value stock of the G&J corporation as of that time, he would give further consideration as whether he would use the tax affecting method. But, as Taxpayers note, the fact that there was a growing controversy on the issue does not necessarily mean that the method was not generally relied upon in 1992. McCoy averred that despite a sprinkling of articles questioning tax affecting, it was the recognized practice for appraising S corporations at the time. In fact, McCoy testified that although there may have been other approaches to appraising the stock of S corporations, all that he had seen had tax affected.

Taxpayers attempted to justify use of tax affecting by arguing that although an S corporation does not have to pay property taxes, there are costs or trade-offs in electing S corporation status which tax affecting is intended to address. But the court found that as a "theoretical matter" and "as a matter of economic theory," that tax affecting was inappropriate to offset these concerns. In addition the court found, and the Commissioner now argues, that despite Taxpayers' contention that tax affecting was the recognized practice, it would be imprudent to tax affect the stock of an S corporation absent the existence of circumstances indicating that these trade-offs were at play with respect to G&J. One of these trade-offs was that S corporations sacrifice growth opportunities and capital appreciation in exchange for current income. Through the expert testimony of McCoy and Wilhoite, Taxpayers also claimed that S corporation shareholders were at risk that the corporation might not distribute enough of its income to through dividends to cover the shareholders' tax obligations. They argued that tax affecting

is appropriate because an S corporation is "committed" to distributing enough income to its shareholders to cover their tax liabilities and this "imbedded cost" must be recognized. The tax court rejected the notion that tax affecting was necessary to offset the possibility that G&J might not distribute enough income to cover its shareholder liabilities. The court noted that the evidence on the record indicated that G&J distributes nearly all of its income to the shareholders and found that this fact, combined with G&J's strong growth record made it unlikely that the corporation would be unable to distribute sufficient income to cover shareholder tax liabilities. But in fact, McCoy testified and Bajaj seemed to agree that in 1992, G&J had limited growth opportunities for the next several years. (J.A. at 252, 254.) Absent a strong projected growth pattern, the fact that a corporation distributes nearly all of its income to the shareholders does not guarantee that it will distribute dividends sufficient to cover all tax liabilities while leaving a desirable net profit.

McCoy also indicated that tax affecting was necessary in order to protect against the danger that an S corporation might lose its "S" status. But the tax court found that it was illogical to tax affect an S corporation's income without facts or circumstances that established the likelihood that its S corporation status would be lost. In support of this finding the court noted that G&J's majority shareholders had already signed restrictive agreements that would preempt any transfers that would jeopardize G&J's S corporation status and that there was no indication in the record that they planned to terminate this practice. But these agreements were only designed to protect the S corporation status, which the corporation entered into by written agreement, for at least ten years. The restrictive agreements governed only the transfer of stock. Although they were designed to protect the S corporation status, that status could have been shed absent a transfer of shares. Thus, the restrictive agreements were not the final authority. Although there is no indication that G&J sought to immediately shed its S corporation status, the period of agreement was to expire soon after the transactions at issue took place. Even if G&J's shareholders had no immediate plans to alter the company's S corporation status, there was no guarantee that the company would retain this status for a significant time beyond the transaction date at issue in this case. It is this prospective period which concerns buyers and sellers of stock insofar as events occurring during that time period have a bearing on the current sale price. Therefore, a willing buyer and seller anticipating the corporation's future earnings and would have to note the fact that G&J's S corporation status was not guaranteed.(7)

Aside from its attempt to distinguish the particular characteristics of G&J, the tax court's opinion focused on its theoretical belief that tax affecting was not an appropriate substitute for certain "difficult to quantify disadvantages" of S corporation status. The court believed that the principle benefit that shareholders of an S corporation expected was reduced taxes and it saw "no reason why that savings ought to be ignored . . . in valuating an S corporation." (J.A. at 192-194.) Cf. In re Radiology Assocs., Inc. Litig., 611 A.2d 485, 495 (Del. Ch. 1991) (holding that ignoring taxes altogether is the only way that the discounted cash flow analysis can reflect accurately the value of a company's cash flows to its investors). I recognize that in making this factual determination, the tax court is not bound by the opinion of any expert witness and may accept or reject that testimony in the exercise of its sound judgment. See Helverina v. Nat'l Grocery Co., 304 U.S. 282, 295 (1938). But I believe that in the instant case the tax court's judgment was less than sound in many respects, for it flies in the face of the evidence on the record.

On appeal Taxpayers assert that tax affecting was an accepted practice because it had been "specifically approved" by the tax court, citing Maris v. Commissioner, 41 T.C.M. (CCH) 127, 138 (1980) and Hall v. Commissioner, 34 T.C.M. (CCH) 648, 667 (1975). Although not specifically holding that tax affecting was an acceptable approach to valuation in every circumstance, in both of these cases the tax court did use after-tax earnings in valuing the stock of S corporations.(8)

But perhaps Taxpayers most persuasive argument is that the IRS itself has implicitly endorsed the policy of tax affecting in valuating stock of S corporations. In support of this claim, Taxpayers point to two internal IRS documents which mention making adjustments for taxes of S corporations. The IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers states at pages 7-14:

> S corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.

(J.A. at 864.) In addition, the IRS Examination Technique Handbook provides:

> If you are comparing a Subchapter S corporation to the stock of similar firms that are publicly traded, the net income of the former must be adjusted for income taxes using the corporate tax rates applicable for each year in question, and certain other items, such as salaries. These adjustments will avoid distortions when applying industry ratios such as price to earnings.

(J.A. at 865.) In rebuttal, the Commissioner argues that these documents were intended for internal IRS use only. This much is evident in the express language included on the cover of IRS Valuation Guide, which warns: "This material was designed specifically by the IRS for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position." (J.A. at 862.) Indeed, Taxpayers' own expert, McCoy, acknowledged that these documents were intended solely for the use of IRS employees. But McCoy responded to this argument by asserting that it was irrelevant because in the real world professionals still relied on the manuals and, therefore, their clients did, too. The tax court determined that Taxpayer's did not show that they had actually relied on these internal guidelines and therefore failed to show the type of detrimental reliance that would justify estopping the Commissioner from disregarding the tax affecting methodology. But I do not believe that Taxpayers must show that they actually relied on these materials in preparing their tax returns. Rather, the principles stated in these materials bear evidentiary weight in support of the notion that a willing buyer and seller would have used the same tax affecting approaches stated therein in valuating shares of G&J stock. Although I do not agree with Taxpayers' contention that the IRS is somehow estopped from now disclaiming tax affecting as a recognized practice, I recognize that these documents reflect a certain acceptance of tax affecting as a valid method of valuation.

The notion that willing buyers and sellers would have used tax affecting under the discounted cash flow methodology is further supported by the fact that the IRS had previously approved 1988 taxes paid by Taxpayers based on gifts of G&J stocks valued at $3,900 per share -- a sum determined by tax

affecting G&J stock. Taxpayers assert that the Commissioner's review and approval of these previous returns entitles them to rely upon tax affecting at a later date, claiming that the Commissioner somehow acted "retroactively" to their detriment. In support of this proposition they cite E.W. Bliss Co. v. United States, 224 F. Supp. 374 (N.D. Ohio 1963), aff'd 351 F.2d 449 (6th Cir. 1965), in which the court held that the Commissioner cannot act retroactively in a particular case where his own regulations are "broad enough to allow a taxpayer's method as one in accordance with generally accepted accounting principles or best accounting practices and one which was consistently followed." Id. at 384. In Bliss, the court stated:

> [if a taxpayer's] method of valuing its inventory of work in process is substantially in accord with the regulations, great weight must be given to its long record of consistent application of the same method . . . The Government's most vigorous objection to the taxpayer's method of valuing its inventory is to the latter's allowance of a normal margin of profit. The Government asserts that the allowance of a normal profit in evaluating inventories is not recognized by the American Accountants Association or by the Chartered Accountants of England was Wales. Such an allowance, however, is recognized by the Commissioner of Internal Revenue in Regulation 29.22(C)-8 as being applicable to retail merchants and also has the approval of the American Institute of Certified Public Accountants.

Id. at 383-84 (emphasis added). I acknowledge that the facts of the instant case do not reflect numerous returns using tax affecting. Nonetheless, I believe that given the amount of time since the 1988 tax returns, the Commissioner's decision not to allow tax affecting in the returns at issue in this case brings Taxpayers within the aegis of E.W. Bliss. Furthermore, although in the instant case the Commissioner had not adopted a specific regulation or policy (such as the allowance regulation in E.W. Bliss) that specifically approves tax affecting, the agency's regulations are broad enough to permit the practice and definitely do not ban it outright. See Rev. Ruling 59-60 (suggesting reliance upon a wide variety of factors in appraising the value of closely held corporations). Moreover, as I have already discussed, the agency's internal directives seem to permit the practice of tax affecting.

Taxpayers also contend that the Commissioner should not have discretion to treat taxpayers in a manifestly unfair and inequitable manner, especially given the fact that the IRS has not adopted uniform rules or regulations banning tax affecting S corporations. Taxpayers cite Righter v. United States, 439 F.2d 1204 (Ct. Cl. 1971), which stands for the proposition that the IRS should not treat parties who are similarly situated in a different manner. In that case, the court held that in determining the value of certain stock held by an estate the IRS's valuations of "other estates, involving the same stock" were probative for valuation of the taxpayer's estate. Righter, 439 F.2d at 112-13. In the instant case we are not confronted with two different parties, but rather the same parties. But we are dealing with two different tax returns, both of which tax affected G&J stock but only one of which was approved by the Commissioner. Thus, I do not believe that this case presents a situation so different from Righter as to require a different result. The Commissioner argues that no general rule of law exists that could permit a taxpayer to avoid paying a tax rightfully due by showing that he had escaped his obligation in the past. This much is true, but a principle of law does require that the IRS establish practices and procedures that are consistent and predictable, not subject to the whim of the Commissioner. See Estate of Bright v. United States, 658 F.2d 999, 1006 (5th Cir. 1981) (rejecting the proposed practice of family attribution

based upon "the important policy that the law should be stable and predictable" and noting that such a policy "is especially important in the tax laws, because there is widespread reliance by taxpayers upon established tax principles in planning their affairs") (citing Estate of Hattie L. McNary v. Commissioner of Internal Revenue, 47 T.C. 467 (1967)).

I must recognize that we are merely determining those factors that hypothetical parties to a sale of G&J stock would have considered as of the gift date. In this regard, I believe that past practices, which the IRS had not deemed to create a deficiency, are demonstrative of the idea that such hypothetical actors would have considered tax affecting G&J stock. This fact in conjunction with the testimony of the experts informs my conclusion that the court's decision to use a 0% tax affect in deriving the value of G&J stock was implausible.

2.Lack of Marketability Discount

With respect to the lack of marketability discount, Taxpayers contend that the court erred in using post-valuation date statistics that a reasonable buyer in 1992 could not have relied upon. We disagree and instead find that the tax court correctly considered statistics relevant to what a reasonable buyer and seller would have done in 1992.

At trial, both sets of experts agreed that because the shares of a closely held S corporation such as G&J are not readily marketable, Taxpayers were entitled to a lack of marketability discount. Taxpayer's expert McCoy cited the lack of marketability discounts listed in three independent studies. Using the average of the lack of marketability discounts in the three studies, he asserted that the "minimum" lack of marketability discount for valuating G&J stock was 30 to 35%. He also listed what he called "risk premiums" and "risk reductions" that were particular to G&J stock to account for this figure. One of these "risk premiums" was the fact that under the shareholders' restrictive agreement, a G&J shareholder could sell his stock to someone outside of the family groups only if he got someone from the other family group to offer the same number of shares to the outside buyer such that the two family groups could maintain equal ownership.(9)

Taxpayers claim that in arriving at the 35% lack of marketability figure, McCoy relied partly upon studies that have been generally accepted by the appraisal profession and partly upon an intuitive and necessarily subjective weighting of company-specific facts, one of which was that the restrictive agreements signed by the majority shareholders required balanced ownership of G&J stock between the two family groups. But McCoy acknowledged that he had not actually read many of the studies upon which he relied in coming up with the thirty to 50% figure. Rather, he merely relied upon summaries of those studies. McCoy also admitted that the studies showed a wide range of discounts and that several of them showed correlations between certain characteristics of the firms, such as quantity of sales, and the amount of the lack of marketability discount.

In his analysis, Bajaj analyzed the same commonly published studies of lack of marketability discounts that McCoy cited. But Bajaj noted some problems with these studies. He therefore conducted his own independent analysis and, rather than simply applying the average discounts listed in those studies, analyzed G&J specifically to determine the proper lack of marketability discount. Although 79 of the sample transactions used in the study occurred after the valuation date, Bajaj concluded that using post-1992 data was appropriate because there is no reason to believe that the underlying economics

would have changed after the valuation date. The tax court found that reliance on such figures was appropriate because they demonstrated more accurately than the flawed earlier studies what willing buyers and willing sellers were actually doing in 1992. On appeal, Taxpayers contend that even if the prior studies were indeed flawed, that willing buyers and sellers still relied upon them and they could not have relied on Bajaj's figures because they did not exist as of July 31, 1992. But Taxpayers fail to note that Bajaj repeated his analysis using only pre-valuation date data. This re-analysis resulted in an even smaller lack of marketability discount, which would have been less favorable to Taxpayers. Furthermore, Taxpayers do not reconcile their position with this Court's acknowledgment that subsequent events may be considered if they could be reasonably contemplated on the valuation date. See Morris v. Commissioner, 761 F.2d at 1201.

Admittedly, there is a fair amount of conflicting evidence on this issue. But we note that the tax court's determination hinged in large part upon the credence it gave to the testimony of the respective witnesses. Indeed, the court indicated that it found Bajaj's testimony regarding the lack of marketability discount "thorough and more persuasive" than McCoy's. (J.A. at 196.) As the Eighth Circuit recognized, the tax court "does not have to accept 'in toto, in part' or at all" opinions of value provided by experts," Estate of Ford v. Commissioner, 53 F.3d 924, 927 (8th Cir. 1995) (quoting Palmer v. Commissioner, 839 F.2d 1308, 1310 (8th Cir. 1975)). This holding reiterates the fact that the tax court is in the best position to make factual determinations as to the fair market value of stocks. We cannot conclude that the tax court erred in finding that Bajaj's indicated what a willing buyer and seller would have contemplated on July 31, 1992. Aside from questioning the admissibility of this testimony, a claim which we have already rejected, Taxpayers have done nothing to show that Bajaj's opinion as to the amount of the lack of marketability discount was in error. In this regard, we find that the tax court's application of a 25% lack-of marketability discount was not clearly erroneous.

III.

In considering the parties' arguments on appeal, I would find that the record does not support the tax court's ultimate valuation of G&J stock at $10,910 per share. The tax court derived this figure by considering multiple factors, only two of which Taxpayers contested in this case -- tax affecting and the lack of marketability discount. Despite the finding that the testimony of the Commissioner's expert was admissible with respect to both of these factors, this testimony was insufficient to support the court's valuation decision. Although I would conclude that the tax court's decision to apply a 25% lack of marketability discount was supported by facts on the record, I also am of the belief that the court's decision to tax affect the stock by 0% did not accurately reflect the fair market value of G&J stock as determined under the willing buyer/willing seller standard. Instead of relying upon real-world evidence, the court reverted to its own perception of the proper approach to tax affecting, thereby deviating from the time-sensitive willing buyer/willing seller standard. I therefore would hold that to the extent it was based upon the use of a 0% tax affect the court's ultimate valuation of $10,910 was clearly erroneous. However, as explained in Judge Cohn's opinion, neither he nor Judge Daughtrey believe that the tax court erred in utilizing the 0% tax affect in order to determine the stock's valuation.

CONCLUSION

For the aforementioned reasons, I would reverse the valuation decision of the tax court and remand for revaluation in a manner not inconsistent with my opinion; however, Judge Cohn's opinion constitutes the holding of the court in this case; that is, that the tax court's decision is AFFIRMED.

CONCURRING IN PART, DISSENTING IN PART

COHN, Senior District Judge.

I. Introduction

I concur with Parts I., II.A., and II.B.2 of the lead opinion. However, because I believe that the Tax Court did not clearly err in concluding that it was appropriate not to tax affect the stock in order to determine its fair market value, I respectively disagree with Part II.B.1 and therefore find that the decision of the Tax Court must be affirmed on this ground.

II. Analysis

A.

Taxpayers essentially argue that the valuations presented by their experts are more credible than Dr. Bajaj's valuation and the Tax Court erred in accepting Dr. Bajaj's valuation. This appeal really presents a battle of the experts on the question of how the stock of a closely held S Corporation, such as G&J, should be valued.

Section 2501 of the Internal Revenue Code imposes a gift tax "on the transfer of property by gift during [the] calendar year by any individual." 26 U.S.C. § 2501(a)(1) (1988). Section 2512(a) addresses the valuation of gifts, stating, "[i]f the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift." 26 U.S.C. § 2512(a) (1988). In interpreting this provision, section 25.2512-1 of the Treasury Regulations on gift tax provides, "[t]he value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." 26 C.F.R. § 25.2512-1 (1992). This is known as the willing buyer willing seller rule.

Where, as here, the gift is stock, its value for gift tax purposes is the fair market value of the stock on the date of the transfer, and "[a]ll relevant facts and elements of value as of the time of the gift shall be considered." 26 C.F.R. § 25.2512-1 (1992). For publicly traded stock, valuation can generally be based on market selling prices. See 26 C.F.R. § 25.2512-2(b) (1992). For closely held corporations, such as G&J, for which there is no public trading market, valuation of stock is therefore based on of a variety of factors.

Revenue Ruling 59-60 outlines the general approach, methods and factors to be considered in valuing the shares of stock of closely held corporations for estate and gift tax purposes, stating:

> 3.01. A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases.... A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

Rev. Rul. 59-60, 1959-1 C.B. 237, 238.

Valuing closely held stock incorporates a number of alternative methods of valuation, and the appellate courts have afforded the tax court broad discretion in determining what method of valuation most fairly represents the fair market value of the stock in light of the facts presented at trial. See Palmer v. Comm'r of Internal Rev., 523 F.2d 1308 (8th Cir. 1975). Moreover, "complex factual inquiries such as valuation require the trial judge to evaluate a number of facts: whether an expert appraiser's experience and testimony entitle his opinion to more or less weight; whether an alleged comparable sale fairly approximates the subject property's market value; and the overall cogency of each expert's analysis." Ebben v. Comm'r of Internal Rev., 783 F.2d 906, 909 (9th Cir. 1986).

B.

1.

Dr. Bajaj opined that tax affecting G&J's earnings was inappropriate because G&J does not pay corporate taxes, and given this closely held status and restriction on stock transfers, there was no reason to believe that G&J would not continue as an S Corporation. Dr. Bajaj also reasoned that based on G&J's past practice of distributing nearly all of its income to its shareholders, a zero percent corporate tax rate was appropriate to make in determining G&J's corporate earnings available for distribution. Moreover, Dr. Bajaj emphasized that because an S Corporation receives a tax benefit (no corporate taxes), such a benefit should not be ignored in valuing G&J's stock.

McCoy, on the other hand, opined that applying a fictitious 40% tax rate to reduce G&J's earnings was appropriate. McCoy testified that tax affecting is an accepted practice in valuation of an S Corporation. McCoy explained that the tradeoffs shareholders incur as a result of being part of an S Corporation must be accounted for, which is accomplished by tax affecting. McCoy indicated that if an S Corporation distributes less than all of its income to its shareholders, the distributions might not cover the shareholders' tax obligations. Thus, tax affecting offsets that potential burden.

McCoy also cited to two internal documents of the Internal Revenue Service that apparently says tax affecting an S Corporation's earnings for valuation: a valuation guide for income, estate, and gift taxes (the guide), an examination technique handbook for estate tax examiners (the handbook) (collectively, the IRS materials). The guide states in part:

> [S] corporations are treated similar to partnerships for tax purposes. S Corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.

The handbook provides in part:

> If you are comparing a Subchapter S Corporation to the stock of similar firms that are publicly traded, the net income of the former must be adjusted for income taxes using that corporate tax rates applicable for each year in question, and certain other items, such as salaries. These adjustments will avoid distortions when applying industry ratios such as price to earnings.

2.

The Tax Court found that applying a 0% corporate tax rate, effectively not tax affecting, G&J's stock was appropriate. The Tax Court discussed the competing expert's opinions, paying particular attention to Taxpayers' experts and examined their opinions in light of the facts of the case. The Tax Court first noted that the IRS materials quoted above "neither require tax affecting nor lay[] the basis for a claim of detrimental reliance" inasmuch as Taxpayers "failed to prove that they relied on [the IRS materials] in any way." (JA at 190-91). The Tax Court also rejected the Taxpayers' justification for tax affecting that it addresses the possibility that an S corporation may distribute less than all of its income, which would not be sufficient to cover the shareholder's tax obligations. The Tax Court explained that "G&J had a strong growth record and a history of making cash distributions to shareholders that nearly equaled its income [and] . . . it would not be reasonable to assume G&J would not continue this practice." (JA at 191). The Tax Court also rejected the argument that G&J might lose its Subchapter S status as a basis for tax affecting its stock because there was not sufficient evidence that G&J's status would be lost. Overall, the Tax Court was not convinced that tax affecting was an appropriate valuation method for valuing G&J's stock. The Tax Court explained that "the principle benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation." (JA at 194).

C.

1.

As noted in the lead opinion, Dr. Bajaj and McCoy disagreed over whether tax affecting was a generally accepted practice in 1992. Indeed, McCoy's testimony, when carefully reviewed, reveals that even he was not certain whether tax affecting was generally accepted, acknowledged some disagreement on this point, and was equivocal on whether he would continue to tax affect. The lead opinion, however, finds that the Tax Court clearly erred in its decision to not tax affect G&J's stock because willing buyers and willing sellers would have tax affected the stock in 1992. While I do not necessarily disagree with framing the issue in this manner, I do disagree with the way in which the lead opinion analyzes the issue. The lead opinion accuses the Tax Court of focusing on "its theoretical belief

that tax affecting was not [] appropriate." The lead opinion also states that "the tax court's judgment was less than sound" and "flies in the face of the evidence on the record." I read the record differently. The Tax Court was faced with the opinions of competing valuation experts and accepted one over the other. While the Tax Court did not explicitly state that it found Dr. Bajaj's valuation more "credible," the Tax Court certainly found as much when it declined to tax affect G&J's stock. Moreover, while the Tax Court did state that it did not believe that tax affecting was "appropriate as a matter of economic theory," (JA at 194), this statement was made in the context of deciding whether or not to tax affect, and reflects the Tax Court's opinion that McCoy's valuation including tax affecting was not appropriate. Given the disagreement on the propriety of tax affecting, and applying the proper standard of review, I do not believe that the Tax Court clearly erred in this regard.

2.

The lead opinion appears to emphasize the apparent unfairness to Taxpayers if G&J's stock is not tax affected and accuses the IRS and the Tax Court of being "hypocritical" and "arbitrary" in their valuations. Unfairness, however, is not the issue and even if it was, the Taxpayers were not unfairly treated by not tax affecting G&J's stock. First, the lead opinion disagrees with the Tax Court's finding that the IRS policy manuals do not establish that tax affecting is a necessary part of valuing an S Corporation. I do not believe that this finding is clearly erroneous and in fact is well supported in the record. Not only do the statements in the IRS manuals fail to affirmatively advocate tax affecting for all S Corporation valuation, both the guide and handbook provide that are not to be relied upon as binding authority, thus even if Taxpayers relied on these materials, their reliance was not justified.

Moreover, focusing solely on the perceived unfairness to the Taxpayers is improper because the willing buyer willing seller rule does not permit a determination of fair market value based solely on the price-lowering desires of the willing buyer. See Mandelbaum v. Comm'r of Internal Rev., 69 T.C.M. (CCH) 2852, 2866 (1995), aff'd without published opinion, 91 F.3d 124 (3d Cir. 1996)("[i]gnoring the views of a willing seller is contrary to the willing buyer/willing seller test"). Thus, determining fair market value also requires consideration of the standpoint of the willing seller.

Secondly, the lead opinion discusses the possibility of G&J losing its Subchapter S status, concluding that "a willing buyer and seller anticipating the corporation's future earnings would have to note the fact that G&J's S corporation status was not guaranteed." To the extent that the lead opinion finds that G&J's Subchapter S status "was not guaranteed," this conclusion appears to contradict the Tax Court's factual finding that "[w]e do not however, think it is reasonable to tax affect an S corporation's projected earnings with an undiscounted corporate tax rate without facts or circumstances sufficient to establish the likelihood that the election would be lost." (JA at 192). The lead opinion's conclusion that willing buyers and willing sellers might consider that G&J would lose its Subchapter S status is contrary to the evidence of record at the time the gift was made and reflects its own independent opinion of what willing buyers and sellers would consider when valuing G&J's stock.

The lead opinion also criticizes the Tax Court's decision regarding tax affecting because prior decisions permitted tax affecting, and because the IRS accepted prior returns of the Taxpayers which contained valuations that were tax affected. The lead opinion relies on E.W. Bliss Co. v. United States, 224 F. Supp. 374 (N.D. Ohio 1963), aff'd 351 F.2d 449 (6th Cir. 1965) to support its conclusion that the IRS acted arbitrarily in refusing to accept the returns at issue. Bliss, however, is inapposite. In Bliss, the district court held that the "Commissioner is without authority to act retroactively in a particular case

where his own regulations are broad enough to allow the taxpayer's method as one in accordance with generally accepted accounting principles or best accounting practices and one which was consistently followed." 224 F. Supp. at 384. First of all, as noted above, there was disagreement among the experts as to whether tax affecting was generally accepted. Second, Bliss involved an appeal from a decision of the Commissioner to the district court, not an appeal from a decision of the Tax Court. Thus, the district court presumably had more latitude in reviewing the Commissioner's decision to make the determination that the Commissioner acted arbitrarily in that case.

Most significantly, however, as the Commissioner points out, the Commissioner is not precluded from correcting an error. See Sirbo Holdings, Inc. v. Commissioner, 509 F.2d 1220, 1222 (2d Cir. 1975); Wagner v. United States, 387 F.2d 966, 968 (Ct. Cl. 1967); Kehaya v. United States, 355 F.2d 639, 641 (Ct. Cl. 1966), Ward v. Comm'r Internal Rev., 240 F.2d 184 (6th Cir. 1957). Thus, the fact that tax affecting may have been approved in other cases, and was even approved in prior returns filed by the Taxpayers, does not, and should not, preclude a different result in another case, particularly where there is disagreement over whether to tax affect in determining the value of stock in the first place.

III. Conclusion

Reviewing the conflicting experts' opinions, it appears that Dr. Bajaj's valuation was from an academic perspective, and he clearly took a scholarly approach to the valuation issue. McCoy's valuation, on the other hand, was from the perspective of a business professional, who has performed numerous valuations in his professional career. This distinction is observed not to diminish McCoy's expertise or elevate Dr. Bajaj's, but simply to point out the different ways the experts approached the valuation question to the facts at hand. Ultimately, the Tax Court found that Dr. Bajaj's method was the better reasoned one under the facts and circumstances of the case. I cannot say this was clear error.

The Taxpayers spend a good deal of time arguing that willing buyers would not know Dr. Bajaj's valuation techniques, and that Dr. Bajaj used data available after the date of the gift, and therefore the Tax Court erred in applying the willing buyer- willing seller rule. This argument is poorly conceived. First, the Tax Court is not prohibited from considering post-valuation data if relevant to shed light on facts existing on the date of the valuation. See Estate of Gilford v. Comm'r of Internal Rev., 88 T.C. 38, 52-53 (1987). Second, the purpose of valuation is to determine what a willing buyer would pay, and what a willing seller would accept, for the stock on the date of the valuation; it is not to determine what methodology the willing buyer would apply. The willing buyer-willing seller rule presupposes that the price will be the fair market value. Valuation, through the use of expert methodology, is the means, not the end, to application of the willing buyer willing seller rule.

Overall, the entire valuation process is a fiction - the purpose of which is to determine the price that the stock would change hands from a willing buyer and a willing seller. However, a court is not required to presume hypothetical, unlikely, or unreasonable facts in determining fair market value. See Estate of Watts, 823 F.2d 483, 487 n.2 (11th Cir. 1987). Valuation is a fact specific task exercise; tax affecting is but one tool in accomplishing that task. The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction. The Tax Court did that and determined that tax affecting was not appropriate in this case. I do not find its conclusions clearly erroneous.

Footnotes

[*]The Honorable Avern Cohn, Senior United States District Judge for the Eastern District of Michigan, sitting by designation.

[1] Members of the Jarson family group entered into a similar restrictive agreement regarding their G&J shares on April 1, 1983. This agreement was also in effect as of July 31, 1992.

[2] McCoy's initial report used three separate methods to determine the value of the stock shares: the market price comparison approach, the discounted future free cash-flow method, and valuation by capitalization of earnings. He determined a weighted average value of the results of these three approaches and then applied a discount for the lack of marketability, eventually arriving at a value of $5,680 per share.

Under the discounted future free cash-flow method, McCoy considered G&J to be an asset capable of producing cash flows to its owners for an infinite number of periods. He then determined the present value of G&J's stock by hypothesizing the amount of available cash for each such period, discounting each amount to reflect the delay in payment and the risk of nonpayment, and then summing the results.

[3] To this end, the Court found that "knowledge" as used in Rule 702 means "more than subjective belief or unsupported speculation" and the term "applies to any body of known facts or to any body of ideas inferred from such facts or accepted as truth on good grounds." Daubert v. Merrill Dow Pharmaceuticals, Inc., 509 U.S. 579, 590 (1993).

[4] The tax court held:

> In light of the Sixth Circuit's opinion in Morris v. Commissioner, we believe that the rule against admission of subsequent events is a rule of relevance. Rule 401, Federal Rules of Evidence, applicable in this Court pursuant to Rule 143, Tax Court Rules of Practice and Procedure, and section 7453, defines relevant evidence as "evidence having any tendency to make the existence of any [fact] that is of consequence to the determination of the action more or less probable than it would be without the evidence."

Estate of Gilford, 88 T.C. 38, 53-54 (1987) (citation omitted).

[5] Tax Court Rule 142(a) provides that "[t]he burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in the answer, it shall be upon the respondent." Tx Ct. R. 142(a); I.R.C. § 7453; see also Friedman v. Commissioner, 216 F.3d 537, 542 (6th Cir. 2000).

[6] The opinion expressed in this section, II.B.1, is solely that of Judge Clay, and not the opinion of the majority.

[7] Taxpayers also contended that tax affecting was necessary to compensate for the disadvantages G&J faced as an S corporation in raising capital. But the court dismissed this concern, finding that it was not a proper justification for tax affecting inasmuch as this disadvantage is more appropriately addressed in determining the appropriate "cost of capital." Taxpayers have not attacked this rationale on appeal.

[8] In addition, these cases noted the imprecise nature of valuing such stocks:

> We recognize that the valuation process is not an exact science . . . . [S]ince this unwelcomed onus has been placed on this Court, we have, in the exercise of our 'Solomon-like wisdom,' . . . arrived at our determination of fair market value, as reflected in our ultimate finding of fact, by weighing all of the facts and circumstances contained in the entire record.

Estate of Hall v. Commissioner, 34 T.C.M. (CCH) 648, 666 (1975) (citation omitted).

> Once again we are asked to determine the value of shares of stock in a closely-held corporation, a science which, to use Winston Churchill's words, usually results in a "gross terminal logical inexactitude". Determinations of value of closely held stock involve a melding of numerous objective criteria, prior human experience and personal judgment.

Maris v. Commissioner, 41 T.C.M. 127, 137 (1980).

[9] On cross-examination, however, McCoy admitted that the restrictive agreements between the family groups did not contain any limitation requiring balanced ownership. Rather, the Gross/Linnemann and Jarson family groups each had their own agreements restricting the transfer of stock outside of the respective family groups. Although functionally, the force of both agreements would maintain the status quo of each family group owning 50% of the outstanding shares of G&J stock, they did not explicitly require that the 50% balance be maintained.

34 T.C.M. (CCH) 648 (1975)
T.C. Memo. 1975-141.

Estate of Oakley J. Hall, Deceased, Southern California First National Bank, Executor
v.
Commissioner.

Docket No. **8611-71**.

United States Tax Court.

Filed May 15, 1975.

Jack M. Harrison, 2201 First Nat'l Bank Bldg., San Diego, Calif., and Raymond L. Heidemann, for the petitioner. Melvern Stein, for the respondent.

Memorandum Findings of Fact and Opinion

DRENNEN, Judge:

Respondent determined a deficiency in Federal estate tax due from petitioner-estate in the amount of $587,953.96. By amendment to his answer respondent seeks additional deficiencies in the amount of
649 $313,836.49. Following certain concessions by the parties, the issues remaining *649 for decision are: (1) The fair market value at the date of decedent's death of 700,000 shares of stock of San Diego Marine Construction Co., which were properly included in decedent's gross estate, exclusive of certain investment real estate owned by the corporation; and (2) the fair market value at the date of decedent's death of the investment real estate located at 201 West Broadway, San Diego, Calif., which the parties agreed should be valued separately and added to the value of the stock of the corporation.

Findings of Fact

Certain facts have been stipulated and are found accordingly.

The petitioner, Southern California First National Bank is a national banking association and is the duly appointed and qualified executor of the will of **Oakley J**. **Hall**, decedent in the present case. The decedent died a resident of San Diego, Calif., on September 24, 1967. The estate of the decedent was administered under the jurisdiction of the State of California.

On December 24, 1968, the petitioner filed an estate tax return with the district director of internal revenue at Los Angeles, Calif. The date of death was used as the date of valuation of the estate.

At the time of his death, decedent owned as his separate property 700,000 shares of common stock of San Diego Marine Construction Co. (hereinafter Marine), a California corporation. These shares represented all of the outstanding shares of stock of Marine.

Marine was incorporated under the laws of the State of California in 1938. There have never been any sales of shares of capital stock of Marine from which the fair market value of such shares could be determined as of September 24, 1967.

As of September 24, 1967, Marine operated three divisions, the Marine Division, the Boat Division, and the Investment Division.

The type of work undertaken by the Marine Division consisted principally of naval ship repair and commercial repair, primarily of tuna fishing vessels.

For the taxable year ended September 30, 1967, the Marine Division accounted for 86.7 percent of the corporation's total revenues from operations other than the investment in the property at 201 West Broadway. The Marine Division's gross receipts from government work versus nongovernment work for the fiscal years 1958 through 1967 are set forth below as follows:

	Government Work		Nongovernment Work		
Year Ended Sept. 30	Amount	Percent of Total	Amount	Percent of Total	Total Amount
1958	$1,049,665	50.3	$1,038,017	49.7	$2,087,682
1959	540,089	33.5	1,073,257	66.5	1,613,346
1960	806,670	38.2	1,306,744	61.8	2,113,414
1961	626,979	34.2	1,206,747	65.8	1,833,726
1962	612,753	30.3	1,411,888	69.7	2,024,641
1963	990,396	39.7	1,507,151	60.3	2,497,547
1964	948,485	40.7	1,381,805	59.3	2,330,290
1965	2,567,933	56.6	1,970,152	43.4	4,538,085
1966	3,999,808	66.9	1,982,361	33.1	5,982,169
1967	4,022,644	75.2	1,327,260	24.8	5,349,904

The Marine Division occupied a 19.2-acre site leased from the San Diego Unified Port District, which consisted of approximately 7.22 acres of industrial land, the remainder being tide land and harbor area seaward of the shipyard bulkheads and shoreline. In addition to this main site, the Marine Division also occupied a 12,525-square-foot area adjacent to the shipyard leased from San Diego Gas and Electric Co.
650 and two *650 parking lots located across the shipyard frontage road leased from the Atchison, Topeka and Santa Fe Railway.

Marine did not have facilities at the above location to repair naval vessels made of steel. This work was done either on the navy vessel or at U.S. Navy drydock facilities at San Diego and Coronado.

On the valuation date, Marine was operating under a lease entered into with the San Diego Unified Port District on February 1, 1944. This lease was due to expire on January 31, 1969. A new lease with the Port Authority was executed on December 3, 1968, in which Marine agreed to spend a minimum of $1,250,000 within the next 5 years to restore the yard. Between October 1, 1967 and June 30, 1972, Marine did make restoration expenditures of over $1,800,000. This new lease ran for a period of 5 years and gave Marine the option to extend it for nine additional 5-year terms.

Marine, on September 24, 1967, employed approximately 350 people of which 300 represented the Marine Division yard's work force, all of whom were union members. These union members began a strike against the Marine Division on June 30, 1967, which was not settled until September 30, 1967.

As of September 24, 1967, the directors of the corporation were **Oakley J**. **Hall**, Sr., **Oakley J**. **Hall**, Jr., and William G. Mirow.

The corporate books showed an indebtedness to O.J. **Hall**, Sr., in the following amounts:

Date	Amount
9-30-62	$465,611
9-30-63	447,611

9-30-64 273,611
9-30-65 213,611
9-30-66 253,611
9-30-67 193,611

For the years ending September 30, 1962 through September 30, 1967, the decedent did not draw a salary from the corporation nor did he receive or earn interest on the amount shown as loans on the corporate books.

The Boat Division, known as the Star and Crescent Boat Co., which was acquired on March 1, 1961, was a commercial towing and harbor excursion business with a float-pier and a gift shop located at Broadway Pier on Harbor Drive, San Diego, Calif. The assets of the Boat Division included three harbor excursion vessels, four commercial tugboats, and ten assorted barges.

Marine's profit and loss statements for the taxable years ending September 30, 1962, through September 30, 1967, are as follows:

REVENUE:	1962	1963	1964
Construction operations	$2,022,278	$2,497,241	$2,329,234
Boat operations	924,363	1,194,214	558,342
Real Estate operations	150,994	52,250	52,250
Total revenue	$3,097,635	$3,743,705	$2,939,826
COST OF OPERATIONS			
Prime costs of construction operations:			
Materials	$ 788,545	$1,068,653	$1,081,307
Labor	596,770	709,042	565,122
Boat operations	778,376	1,084,236	508,475
Real Estate operations	101,590	26,117	23,062
Plant overhead, administrative & general expenses	727,758	759,044	615,560
Total cost of operations	$2,993,039	$3,647,092	$2,793,526
PROFIT FROM OPERATIONS	104,596	96,613	146,300
OTHER INCOME (EXPENSE):			
Gain on sale of property	$ -0-	$ -0-	$ 159,440
Discounts earned	6,183	7,883	5,107
Interest—net	(407)	(285)	64,790
Miscellaneous	12,683	5,130	35,794
Other income—net	$ 18,459	$ 12,728	$ 265,131
INCOME BEFORE FEDERAL INCOME TAX	$ 123,055	$ 109,341	$ 411,431
FEDERAL INCOME TAX	58,489	45,716	176,294
NET INCOME	$ 64,566	$ 63,625	$ 235,137
RETAINED EARNINGS AT BEGINNING OF YEAR	219,613	284,179	347,804
RETAINED EARNINGS AT END OF YEAR	$ 284,179	$ 347,804	$ 582,941

651 *651

Ship & boat building & repairing	$3,499,335	$5,363,759	$5,349,903
Boat operations	534,444	793,635	823,997
Real Estate operations	52,250	52,250	49,999
Total revenue	$4,086,029	$6,209,644	$6,223,899
COST OF OPERATIONS			
Prime costs of ship & boat building & repairing:			
Materials	$1,585,628	$2,595,529	$2,590,117
Labor	1,024,083	1,185,697	1,372,706
Boat operations	415,379	578,400	669,496
Real Estate operations	20,559	18,954	9,228
Plant overhead, administrative, & general expenses	1,104,684	1,163,482	1,163,162
Total cost of operations	$4,150,333	$5,542,062	$5,804,709
PROFIT (LOSS) FROM OPERATIONS	$ (64,304)	$ 667,582	$ 419,190
GAIN ON SALE OF VESSELS CONSTRUCTED BY COMPANY	260,597	129,398	-0-
Total	$ 196,293	$ 796,980	$ 419,190
OTHER INCOME (EXPENSE):			
Interest income	$ 73,092	$ 67,143	$ 79,597

Interest expense	-0-	(1,145)	(27,502)
Discounts earned	10,600	18,446	12,595
Miscellaneous	19,317	26,878	22,132
Total other income—net	$ 103,009	$ 111,322	$ 86,812
INCOME BEFORE FEDERAL INCOME TAX	$ 299,302	$ 908,302	$ 506,002
FEDERAL INCOME TAX:			
Adjustments applicable to prior years	-0-	7,169	(685)
NET INCOME	$ 299,302	$ 915,471	$ 505,317
RETAINED EARNINGS AT BEGINNING OF YEAR	582,941	931,373	901,128
Total	$ 882,243	$1,846,844	$1,406,445
ADD—Federal income tax adjustments	49,130	-0-	-0-
DEDUCT—Adjustments for deferred			
Federal income tax	-0-	-0-	(76,000)
Distributions to shareholder	-0-	(945,716)	(536,613)
RETAINED EARNINGS AT END OF YEAR	$ 931,373	$ 901,128	$ 793,832

A comparative balance sheet for Marine for the taxable years ending September 30, 1962 through September 30, 1967, is set forth below:

In Re: Estate of **Oakley J. Hall** — Valuation Date: September 24, 1967
Comparative Balance Sheet — San Diego Marine Construction Co.

	For Years Ending September 30,					
Assets	1967	1966	1965	1964	1963	1962
Cash	$ 396,339	$ 389,177	$ 392,405	$ 694,509	$ 406,315	$ 880,254
Notes receivable—current	375,000	350,000	75,000	75,000	.....	.....
Accounts receivable—						
Trade	461,553	513,684	207,580	169,415	369,925	319,796
Affiliates	12,655	59,456	.....	.....	.....	79,557
Other	48,727	46,133	56,798	27,932	14,118	13,442
Inventories	124,013	83,824	108,013	93,768	74,755	77,584
Prepaid expenses	42,316	17,614	31,081	23,189	26,934	25,209
Income tax	.....	.....	21,396	21,396	21,396	.....
Other current assets	291,431	329,296	1,055,340	311,268	439,103	354,085
Total current assets	$1,752,034	$1,789,184	$1,947,613	$1,416,477	$1,352,546	$1,749,927
Notes receivable, less current	$1,125,000	$1,500,000	$ 975,000	$1,050,000	.....	.....
Property, plant & equipment, net	1,677,535	1,392,830	1,393,201	1,548,785	2,432,947	2,041,006
Other assets	.....	.....	.....	.....	.....	.....
Total assets	$4,554,569	$4,682,014	$4,315,814	$4,015,262	$3,785,493	$3,790,933

652 *652

Liabilities						
Notes payable, current	$ 560,000	$ 560,000	$ 60,000	$ 39,000	$ 38,614	$ 18,000
Accounts payable—						
Trade	101,079	208,799	301,840	122,694	133,963	116,175
Affiliates	27,623	.....	29,990	13,169	7,120	4,919
Accrued salaries and wages	32,856	22,229	18,988	27,700	20,065	20,058
Accrued vacation and leave pay	34,024	22,690	24,441	17,938	21,082	18,033
Income tax, current	21,500	.....	64,114	232,692	65,053	193,548
Other current liabilities	88,743	66,756	24,656	11,716	6,310	14,303
Total current liabilities	$ 865,825	$ 880,474	$ 524,029	$ 464,909	$ 292,207	$ 385,036
Notes payable, less current	$ 193,611	$ 253,611	$ 213,611	$ 273,611	$ 447,611	$ 465,611
Deferred Federal Income Tax	54,500	.....	.....	47,000	51,070	.....
Total liabilities	$1,113,936	$1,134,085	$ 737,640	$ 785,520	$ 790,888	$ 850,647
Capital Stock	$ 700,000	$ 700,000	$ 700,000	$ 700,000	$ 700,000	$ 700,000
Additional paid-in capital	1,946,801	1,946,801	1,946,801	1,946,801	1,946,801	1,956,1071
Retained earnings	793,832	901,128	931,373	582,941	347,804	284,179
Total Stockholders' Equity	$3,440,633	$3,547,929	$3,578,174	$3,229,742	$2,994,605	$2,940,286
Total Liabilities and capital	$4,554,569	$4,682,014	$4,315,814	$4,015,262	$3,785,493	$3,790,933
Working Capital Ratio	2.0-1	2.0-1	3.7-1	3.0-1	4.6-1	4.5-1

1 Acquired from stockholder — Principally land and buildings.

The following table is a comparative statement of the income of Marine for the taxable years ending September 30, 1962 through September 30, 1967. This table reflects adjustments to exclude net rental

income from the investment property of Marine and nonrecurring gain on the sale of capital assets in fiscal 1964 as an extraordinary income item. Since Marine in the fiscal years 1965 through 1967 elected to be treated as a subchapter S corporation, taxes, as estimated in the table, were computed on a standard corporate tax basis. With the one exception noted below, both parties obtained the results as shown in this table.

653 *653

SAN DIEGO MARINE CONSTRUCTION CO.

COMPARATIVE STATEMENTS OF INCOME(a)

	1962-67	Years Ended September 30				
	1962	1963	1964	1965	1966	1967
	$	$	$	$	$	$
Revenue(c)	2,946,641	3,691,455	2,887,576	4,033,779	6,157,394	6,173,900
Cost of Operations:						
Prime Cost of Ship and Boat Repairs:						
Materials	788,545	1,068,653	1,081,307	1,585,628	2,595,529	2,590,117
Labor	596,770	709,042	565,122	1,024,083	1,185,697	1,372,706
Depreciation	224,843	271,506	138,051	145,765	170,251	213,891
Other	1,281,291	1,571,774	985,984	1,374,298	1,572,776	1,618,767
Total	2,891,449	3,620,975	2,770,464	4,129,774	5,524,253	5,795,481
Balance	55,192	70,480	117,112	(95,995)	633,141	378,419
Other Income:						
Gain on sale of vessels constructed by company for sale	-	-	-	260,597	129,398	-
Miscellaneous	18,459	12,728	105,691	103,009	112,466	86,812
Net rental income - 201 West Broadway	49,404	26,133	29,188	31,691	33,296	40,771
Gain on Sale of Capital Assets:						
Vessels	-	-	159,440	-	-	-
Other	-	-	-	-	-	-
Net income	123,055	109,341	411,431	299,302	908,301	506,002
Less Nonrecurring and Investment Income:						
Gain on sale of capital assets	-	-	(159,440)	-	-	-
Net rental income - 201 West Broadway	1 (49,404)	(26,133)	(29,188)	(31,691)	(33,296)	(40,771)
Net income (adjusted) before federal income tax	73,651	83,208	222,803	267,611	875,005	465,231
Less federal income tax(b)	32,799	37,768	106,197	123,165	413,502	216,811
Net income (adjusted) after federal income tax	40,852	45,440	116,606	144,446	461,503	248,420

Notes: (a) Adjusted to eliminate net rental income from investment real property located at 201 West Broadway, San Diego, California, and for nonrecurring gain on sale of capital assets. (b)As computed by the Estate. (c)From operations - other than from 201 West Broadway investment property. Parentheses indicate red figures.

Source: Data provided by the Estate.

1 Respondent failed to exclude this item and as a result, computed the net income for FYE 9/30/62 as $64,566.

654 *654 In July 1972, Marine sold the Marine Division to Campbell Industries, Inc., a competitor shipyard company in San Diego, for total consideration of approximately $4.6 million, payable through a combination of cash of $694,130, a promissory note in the amount of $750,000, and the remainder by assumption of liabilities. During this time, Campbell had a large backlog of work and needed additional facilities. Consequently Campbell acquired the Marine Division in order to obtain its assets, primary consideration being given to the relatively new lease held by the Marine Division as a very important asset and a major factor in the price paid for the facilities of the Marine Division. Campbell was not interested in acquiring the stock of Marine as a going business.

Marine, on the date of decedent's death, also held investment real property located at 201-251 West Broadway in San Diego, Calif. This property is on the south side of Broadway between Front and Union Streets. The legal description of this property is Lots A, B, C, D, I, **J**, K, and L, Block 56, Horton's Addition. This real estate has a 200-foot frontage on Broadway and a depth of 200 feet containing 40,000 square feet.

At the valuation date, a part of the property was used as a bus depot for Continental Trailways and had a large parking garage in the rear which was separately rented. The Broadway frontages were divided into smaller store spaces used as a jewelry store, a souvenir shop, a cocktail lounge, a restaurant, and a waiting room for Continental Trailways.

Improvements on the land consisted of a one-story masonry building containing 40,000 square feet. The northerly 70 feet of the building was divided into stores catering to retail trade. The southerly or rear portion of the building was used as garage and storage space. During the period in issue, this building was approximately 50 years old.

As of the date of valuation, there had been no development of property for commercial office buildings or otherwise of any significance south of Broadway in San Diego.

The U.S. Government had under consideration the construction of a Federal office building and courthouse in San Diego since 1961 or 1962. Marine's investment property was one of several locations considered to be a suitable site for the building. However, a letter from the General Services Administration of the United States to the mayor of San Diego, dated September 8, 1967, indicates that, as of that date, no specific land in San Diego had been selected or approved by the General Services Administration as a site for the Federal buildings project. This letter contained a list of numerous sites which were deemed acceptable.

Additionally, this Federal building project was not approved by the Public Works Committees of Congress until May 9, 1968.

Eventually the Federal government, under a purchase agreement dated December 28, 1969, involving an exchange of properties, obtained this property plus additional property as the building site for a new Federal courthouse.

The Federal building site included not only the investment property which had been owned by Marine but also land owned by Mary F. Amaral, the First Gray Line West Corporation, and the City of San Diego. Amaral and First Gray Line were willing to sell their real property for cash but were not interested in trading for excess Federal land.

After the death of decedent, Marine conveyed the investment property to decedent's sons, **Oakley J**. **Hall**, Jr., and G.E. **Hall**, by a deed recorded June 7, 1968. In order to consummate a deal with the Federal government, it was necessary for the Halls to purchase the parcels owned by Amaral, First Gray Line, and the City of San Diego.[1]

The parcel owned by Amaral was purchased by the Halls on November 6, 1969, for a consideration of $75,000. On March 16, 1970, the Halls also purchased the land owned by the City of San Diego for $350,000, and the land owned by First Gray Line for $250,000.

The investment property at 201 West Broadway, and the adjoining parcels which were purchased by **Oakley J**. **Hall**, Jr., and G.E. **Hall** for a total consideration of $675,000, were subsequently transferred to the
655 United States of America in exchange for excess Federal land known as the Warren *655 Housing property. The purchase agreement covering this transfer was dated December 28, 1969. The Warren property was conveyed to **Oakley J**. **Hall**, Jr., and G.E. **Hall** by quitclaim deed dated February 27, 1970. Simultaneously, but under a purchase agreement dated November 19, 1969, the Warren property was sold by **Oakley J**. **Hall**, Jr., and G.E. **Hall** to Swan Constructors, Inc., for $2,300,000. The Halls paid a real estate commission in the amount of $200,000 to the several real estate brokers who had put the deal together.

The parties have stipulated that for estate tax purposes the value of decedent's separate property interest in a diesel yacht named the "Caronia," as of September 24, 1967, was $275,000.

Ultimate Findings of Fact

(1) The fair market value of the 700,000 shares of San Diego Marine Construction Co. on September 24, 1967, exclusive of the investment real estate at 201 West Broadway, was $1,680,000.

(2) The fair market value of the investment real estate located at 201 West Broadway, San Diego, Calif., and owned by Marine on September 24, 1967, was $850,000.

Opinion

The sole issue in this case involves the determination of the fair market value of 700,000 shares of stock in San Diego Marine Construction Co. owned by decedent, **Oakley J**. **Hall**, on September 24, 1967, the date of his death. These shares represent all of the outstanding stock of Marine.

By agreement, both parties addressed themselves to this valuation issue as follows. First, these shares of Marine were valued by each party exclusive of the investment real estate owned by Marine and located at 201 West Broadway, San Diego, Calif. Secondly, separate determinations were made of the value of this real estate. Finally each party added together the two separately computed values to arrive at his determination of the fair market value of the Marine stock. We have followed the approach taken by the parties in determining the total value of the stock in question.

On its Federal estate tax return, petitioner reported the value of the 700,000 shares of Marine to be $2,185,000. Petitioner now claims that the value of the stock, exclusive of the investment real estate, was $1,216,000 and that the value of the real estate was $800,000.

In the notice of deficiency respondent determined the value of the 700,000 shares of Marine to be $3,133,000. In his answer to an amended petition and in support of his claim for an increased deficiency, respondent claims that the value of the stock, exclusive of the investment real estate, was $2,600,000 and that the value of the real estate was $1,100,000.

Section 2001, I.R.C. 1954,[2] imposes an estate tax on the transfer of the taxable estate of a decedent, which, under section 2051, shall be determined by deducting from the value of the gross estate the exemption and deductions provided in Part IV. Sections 2031(a) and 2033 provide in general that the value of the gross estate of a decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, to the extent of decedent's interest therein.

Value of the Stock Exclusive of the Real Estate

The first question for resolution is the fair market value at the date of decedent's death of his 700,000 shares of stock in Marine, exclusive of the investment real estate. Marine's stock is not listed on a stock exchange nor have there been any sales of the stock to assist in determining its fair market value.

The long-standing and accepted definition of fair market value is contained in section 20.2031-1(b), Estate Tax Regs., which states, in pertinent part:

> The fair market value 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 to sell and both having reasonable knowledge of relevant facts. * * *

Estate of Maurice Gustave Heckscher [Dec. 33,023], 63 T.C. 485 (1975).

Since the stock of Marine was not traded on the open market, we must first follow the dictates of section 2031(b), which provides:

656 > Valuation of Unlisted Stock and Securities. — In the case of stock and securities of a corporation the value of which, by *656 reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange.

In addition, section 20.2031-2(f), Estate Tax Regs., provides that in valuing stocks and bonds where selling prices or bid and asked prices are lacking, the fair market value is established by taking the following factors into consideration:

> In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.
>
> Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: The good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. * * *

The evidence pertinent to this issue consisted primarily of the testimony and valuation reports of petitioner's expert, Thomas P. Morrissey (sometimes hereinafter Morrissey), and respondent's expert, Matthew **J**. Donohue (sometimes hereinafter Donohue).

Both experts appear to agree that around the valuation date the prospects of the economy in general were favorable. Petitioner's expert, in his report noted that shipyards, such as Marine, which engage primarily in ship repair work, tend to show somewhat erratic records. Additionally, respondent's expert concluded that the shipbuilding and repair industry is highly competitive and has a tendency to experience cycles of high and low levels of activity. The experts agreed that the industry as a whole had reached a peak of profitability in 1966-7 and that there would continue to be relatively high levels of activity within the industry as a result of the continuing needs of the military, particularly the Navy, due to the conflict in Southeast Asia. Respondent's expert added the caveat that "the industry was faced by problems and uncertainties which led many to believe that 1968 and 1969 would not match very favorable operating results achieved by industry members in 1967."

Because of the nature of the stock involved, both experts followed the guidelines enunciated in section 2031(b) and section 20.2031-2(f), Estate Tax Regs. Unfortunately the final opinions of these experts as to the fair market value of the stock of Marine on the valuation date, exclusive of the investment real property, differed dramatically with petitioner's expert valuing the stock at $1,216,000, and respondent's expert at $2,600,000. While these experts considered similar factors the vast difference in their respective appraisals of approximately $1,400,000 resulted from the different application of these factors and the emphasis they placed on each of these separate factors.

Both experts relied heavily on the capitalization of earnings of Marine to determine the value of its stock and in doing so considered the price-earnings ratios and other factors relative to prices being paid for the stock of other corporations listed on stock exchanges which they considered were comparable to Marine. In fact, they chose and analyzed a number of the same corporations in establishing the multiples they applied to the earnings of Marine to determine value. Nevertheless, the large gap between the two experts necessitates a discussion of each appraisal.

Petitioner's expert, Morrissey, in arriving at the fair market value of the stock of Marine, used three basic approaches: (1) capitalization of earnings; (2) capitalization of dividends; and (3) the application of a ratio based on the relationship of market price to book value. After Morrissey arrived at three separate valuation figures, he averaged these amounts together counting the capitalization of earnings approach three

times and the other two approaches once.

In establishing a valuation under the earnings approach, Morrissey readjusted the net income of Marine by estimating a salary for decedent at $50,000 per annum. He also estimated interest charges at a rate
657 of 6 percent on the noninterest-bearing debt which Marine owed to decedent. These additional estimated expenses lowered the *657 net income of Marine to the following amounts:

FYE Sept. 30	Adjusted net income
1962	$(23,996)
1963	3,312
1964	78,166
1965	108,013
1966	425,494
1967	212,646

Morrissey next determined price-earnings multiples for companies which he considered comparable to Marine. He established yearly price-earnings ratios for each company by dividing the yearly earnings by the *average price of the stock during that year.* The following table of price-earnings ratios was constructed by Morrissey:

658 *658

EARNINGS PER SHARE AND PRICE:EARNINGS MULTIPLES

OF FIVE COMPARABLE COMPANIES

1962-67

Company	Listed	Earnings per share 1962 $	1963 $	1964 $	1965 $	1966 $	Latest 12 Months Earnings $	Average Price Nine Months Ended September 30, 1967 $	Average Price September, 1967 $
American Ship Building Company (The)	NYSE	(0.48)	0.29	0.35	1.17	1.63	1.64 - 6 /30/67	22.13	29.81
Campbell Machine, Inc.	ASE	0.34	0.44	0.59	0.98	2.29	2.22 - 6 /30/67	21.00	19.88
Levingston Shipbuilding Company	OTC	1.53	(1.21)	0.44	3.13	5.85	4.90 - 6 /30/67	35.00	34.75
Maryland Shipbuilding & Drydock Company	OTC	0.97	(2.66)	3.07	4.03	4.48	4.48 - 12/31/66	29.38	32.50
Todd Shipyards Corporation	ASE	1.95	1.64	(0.01)	5.22	6.24	6.24 - 3 /31/67	37.94	46.38

	Price: Earnings Multiples Based on Average Annual Market Prices and Year-End Earnings Per Share 1962	1963	1964	1965	1966	Five-Year Average 1962-66	Three-Year Average 1964-66	Price: Earnings Multiples Based on Latest 12 Months Earnings and Average Price Nine Months Ended September 30, 1967	Average Price September 1967
	-Times-								
American Ship Building Company (The)	Deficit	19.2(a)	18.2(a)	9.0	8.0			13.5(a)	18.2(a)
Campbell Machine, Inc.	9.2	6.0	5.3	4.8	4.0			9.5	9.0
Levingston Shipbuilding Company	4.6	Deficit	14.8(a)	5.0	4.4			7.1	7.1
Maryland Shipbuilding & Drydock Company	18.3(a)	Deficit	5.7	5.8	5.2			6.6	7.3
Todd Shipyards Corporation	11.7	14.9(a)	Deficit	5.7	6.1		6.1	7.4	
Average, excluding atypical ratios	8.5	6.0	5.5	6.1	5.5	6.3	5.7	7.3	7.7
Average excluding atypical ratios and excluding American Ship Building and Todd	6.9	6.0	5.5	5.2	4.5	5.6	5.1	7.7	7.8

Notes: (a)Excluded from averages as atypical,
Parentheses indicate red figures.

Source: Appendix C. Computations by Standard Research Consultants.

659 *659 As stated in a footnote in the table, Morrissey excluded certain ratios which he considered atypical and he also eliminated American Ship Building Company and Todd Shipyards Corp. from consideration claiming that these firms were not comparable. Petitioner's expert was left with three comparables whose average price-earnings ratio for 1964, 1965, and 1966 were 5.5, 5.2, and 4.5, respectively. The overall average for this 3-year period was 5.1.

Morrissey concluded that based on all relevant factors, the appropriate multiple to be used in capitalizing the historical earnings of Marine should be 5.0. He also determined that the earnings for the latest 3 years and for the latest year were the most significant in view of the upward trend of earnings. Consequently, when the 5.0 multiple was applied to the latest 3-year average adjusted net income and latest year net income of Marine and the two resulting figures were then averaged together, Morrissey obtained the following fair market value based on capitalization of earnings:

Latest 3-year (1965-67)
average earnings of
$248,717 × 5 ..... = $1,243,585
Latest fiscal year (1967)
earnings of
$212,646 × 5 ..... = $1,063,230
Indicated fair market
value on earnings basis
(average) ..... = $1,153,407

Under his dividend approach to fair market value, Morrissey created the following table of dividend yields and dividend payout ratios of his five comparable companies:

DIVIDEND YIELDS AND DIVIDEND PAYOUT RATIOS

FIVE COMPARABLE COMPANIES

1962-66

Company	1962 %	1963 %	1964 %	1965 %	1966 %
Dividend Yields					
American Shipbuilding Company (The)	Nil	Nil	2.0	1.7	4.2
Campbell Machine, Inc.	3.5	5.7	6.1	4.1	3.5
Levingston Shipbuilding Company	Nil	2.0	Nil	1.6	2.9
Maryland Shipbuilding & Drydock Company	7.0	3.9	3.4	4.0	4.3
Todd Shipyards Corporation	6.1	5.7	5.2	4.7	3.7
Average(a)	5.5	4.3	4.2	3.2	3.7
Dividend Payout Ratios					
American Shipbuilding Company (The)	Nil	Nil	35.7	15.0	33.7
Campbell Machine, Inc.	32.4	34.1	32.2	19.4	14.2
Levingston Shipbuilding Company	Nil	(d)	Nil	8.0	12.8
Maryland Shipbuilding & Drydock Company	128.9(c)	(d)	19.5	23.6	22.3
Todd Shipyards Corporation	71.8(c)	85.4(c) (d)		26.8	22.4
Average(b)	32.4	34.1	29.1	18.6	21.1
San Diego Marine Construction Co.	Nil	Nil	Nil	Nil	Nil

Notes: (a)Of companies paying dividends. (b)Excluding atypical ratios.
(c)Considered as atypical. (d)Deficit earnings.

660 *660 Based on these computations, dividend yield averaged between a high of 5.5 percent in 1962 to a low of 3.2 percent in 1965. Average dividend payout ratio, excluding those which Morrissey deemed atypical, ranged from a high of 34.1 percent in 1963 to 18.6 percent in 1965. Although Marine did not pay any dividends during these years, Morrissey made the assumption that Marine had a dividend paying capacity of 25 percent on the average earnings for the last 3 years (1965-67) of $248,717, or $62,179. He also assumed a dividend yield of 5 percent thereby obtaining a fair market value under the dividend approach of $1,243,580.

Finally, in considering the question of fair market value as related to the book value of a company, Morrissey concluded that there is generally a relationship between the percent earned on common equity and the ratio of market price to book value, i.e., the more a company earns on its common equity, the higher its stock tends to sell in relationship to book value. Following this theory, petitioner's expert devised the following chart for the comparable companies and Marine:

661 *661

RELATIONSHIP OF PERCENT EARNED ON AVERAGE COMMON

STOCK EQUITY AND RATIO OF MARKET PRICE TO BOOK VALUE

COMPARABLE COMPANIES

1962-67

Company	Five-Year (1962-66) Averages: Percent Earned on Average Common Stock Equity %	Five-Year (1962-66) Averages: Ratio of Market Price to Book Value %	Three-Year (1964-66) Averages: Percent Earned on Average Common Stock Equity %	Three-Year (1964-66) Averages: Ratio of Market Price to Book Value %	Latest Available 1967 Data Related to Average Market Price Nine Months Through September, 1967: Percent Earned on Average Common Stock Equity %	Latest Available 1967 Data Related to Average Market Price Nine Months Through September, 1967: Ratio of Market Price to Book Value %
Campbell Machine, Inc.	26.3	125.6	32.7	130.0	48.1	365.9
Levingston Shipbuilding Company	9.8	58.7	15.6	74.7	19.6	131.5
American Ship Building Company (The)	5.7	81.9	10.1	93.6	13.7	177.2
Maryland Shipbuilding & Drydock Company	4.7	48.2	9.3	51.5	9.8	64.1
Todd Shipyards Corporation	4.7	44.9	5.9	48.5	9.4	54.9
San Diego Marine Construction Co.	4.0		6.9		6.3	

Sources: Appendix C, Table No. 6, Exhibit No. 8. Computations by Standard Research Consultants.

662 *662 Considering Marine's earnings rate in comparison to the alleged trends for the comparable companies, Morrissey determined a ratio of market value to book value for Marine of 40 percent would be appropriate in determining the price at which the stock would sell if it were freely traded. By applying the 40 percent to Marine's book value at September 30, 1967, of $3,442,000, petitioner's expert arrived at a

fair market value of $1,376,800.

It was Morrissey's position that although the stock in question constituted 100 percent of the outstanding stock of Marine and carried with it the authority to liquidate the entire corporation, this factor should not be controlling because there was no indication of an intention to liquidate and a substantial amount of the company's fixed assets investment was in leasehold improvements which could not be liquidated.

After arriving at the three separate fair market value figures, Morrissey averaged them together assigning three times the weight to the value obtained under the earnings approach. The following table represents Morrissey's final calculations of the fair market value of the Marine stock:

FAIR MARKET VALUE

OF

CAPITAL STOCK

OF

SAN DIEGO MARINE CONSTRUCTION CO.

SEPTEMBER 24, 1967

Valuation Approach	Indicated Value $	Weight (Times)	Total $
Earnings based on:			
Three-year (1965-67) average	1,243,585		
Fiscal 1967	1,063,230		
Average	1,153,407	3	3,460,221
Dividends	1,243,580	1	1,243,580
Book value	1,376,800	1	1,376,800
Total		5	6,080,601
Indicated fair market value ($1,216,120 rounded) ...			1,216,000

Respondent's expert, Donohue, used two approaches in reaching his determination of the fair market value of the Marine stock: (1) Capitalization of earnings, and (2) what could possibly be termed capitalization of cash flow.

Donohue first created a chart which purportedly showed for a 10-year period revenues, adjusted earnings, depreciation, and cash flow of Marine. In determining the adjusted earnings of Marine, Donohue did not further decrease this amount by either an estimated salary for decedent or estimated interest on decedent's loan to Marine. Cash flow as defined by Donohue was the addition of depreciation deductions to earnings. Donohue's table is as follows:

663 *663

Summary of Revenue, Earnings and Cash Flow
9/30/58 - 9/30/67

Fiscal Year	Revenue	Earnings (Adjusted)	Depreciation	Cash Flow
	(---------- 000 ---------)			
1967	$6,174	$248	$214	$462
1966	6,157	462	170	632
1965	4,031	144	146	290
1964	2,888	117	138	255
1963	3,691	45	272	317
1962	2,947	65	225	290
1961	2,328	80	69	149
1960	2,108	93	62	155
1959	1,608	42	60	102
1958	2,079	71	56	127
Five-year average		203	188	391
Ten-year average		137	141	278

Next, respondent's expert analyzed other companies in order to develop multiples. For comparison purposes, he chose six companies whose stocks are publicly traded:

(1) American Ship Building Co.

(2) Campbell Machine, Inc.

(3) Levingston Shipbuilding Co.

(4) Maryland Shipbuilding and Drydock Co.

(5) Todd Shipyards Corp.

(6) St. Louis Shipbuilding-Federal Barge, Inc.

Donohue concluded that of these six companies, American Ship Building Co. and Campbell Machine, Inc., were not proper comparables. Consequently, he based his analysis on the other four.[3]

To establish a valuation under the ratio of price to earnings and cash flow approach, Donohue also computed price-earnings and price-cash flow multiples for the companies which he considered comparable with Marine. Donohue developed his price-earnings and price-cash flow ratios by dividing the selling price of the stock of each corporation at date of death over a set number of years. In doing so Donohue developed the following table which he included in and referred to in his appraisal report:

664 *664

Comparative Corporations to
San Diego Marine Construction Co. In re: Estate of **Oakley J. Hall** - Valuation Date: September 24, 1967

	Net tangible asset value	-Ratios - Market Price/to - Latest year earnings	10-year average earnings	5-year average earnings	Latest year cash flow	10-year average cash flow	5-year average cash flow	Dividend yield Latest year dividends	10-year average dividends	5-year average dividends
American Shipbuilding Co.	247.62	18.64	52.24	30.23	10.78	19.55	14.38	2.0	0.7	1.1
Campbell Machine Inc.	359.27	9.01	33.98	22.25	8.38	1--	19.71	1.6	1--	0.9
Levingston Shipbuilding Co.	128.71	6.99	22.86	13.43	4.87	10.72	7.97	3.6	1.4	2.1
Maryland Shipbuilding & Drydock Co.	72.58	7.43	11.47	16.28	5.62	7.09	8.71	3.1	4.3	3.0
St. Louis Shipbuilding - Federal Barge, Inc.	160.66	6.64	1--	13.15	4.48	1--	7.45	2.5	1--	1.2
Todd Shipyards Corp.	68.37	7.57	24.46	15.69	5.17	11.61	8.61	3.0	3.1	3.0
Total	1,037.21	56.28	145.01	111.03	39.30	48.97	66.83	15.8	9.5	11.3
Averages -										
Arithmetic	172.87	9.38	29.00	18.51	6.55	12.24	11.14	2.6	2.4	1.9
Median	144.69	7.50	24.46	15.99	5.40	11.17	8.66	2.8	2.3	1.7

1 Information for 10-year averages not available.

665 *665 Donohue believed that the most significant tests of value would come from 5 years' average production of earnings. After eliminating American Ship Building and Campbell Machine, Inc., Donohue found he had price-earnings ratios for the four other companies which ranged between 13 to 16. He computed Marine's latest 5-year average income as $203,000 and when he applied the four price-earnings ratios to this figure he obtained values which ranged between $2,639,000 to $3,248,000.

Donohue also used another method of valuation which could be characterized as capitalization of cash flow. Cash flow, as used by Donohue, was the earnings plus depreciation deductions. First, respondent's expert established the cash flow for Marine and the other six companies for each year from 1958 through 1967. He then established price-cash flow ratios for the six comparative companies by dividing their respective market prices *at the date of death* by the cash flow of each company for the latest year, for a 10-year period and for a 5-year period. The following is the result of these calculations:

	Latest Year Cash Flow	10-Year Average Cash Flow	5-Year Average Cash Flow
American Shipbuilding Co.	10.78	19.55	14.38
Campbell Machine Inc.	8.38	1 --	19.71
Levingston Shipbuilding Co.	4.87	10.72	7.97
Maryland Shipbuilding & Drydock Co.	5.62	7.09	8.71
St. Louis Shipbuilding-Federal Barge, Inc.	4.48	1 --	7.45
Todd Shipyards Corp.	5.17	11.61	8.61
Total	39.30	48.97	66.83
Averages -			
Arithmetic	6.55	12.24	11.14
Median	5.40	11.17	8.66

1 Information for 10-year averages not available.

Donohue again excluded American and Campbell and chose the 5-year average cash flow as most significant. He computed Marine's 5-year average cash flow as $391,000 and applied to this figure price-cash flow ratios between 7½ and 8½ thereby obtaining values which ranged between $2,933,000 and $3,324,000.

Finally, respondent's expert listed the following factors which were instrumental in his final determination of the value of the Marine stock:

(1) The interest valued was a controlling interest;

(2) The shipbuilding industry is highly competitive, thereby attaching a higher risk to investment;

(3) The general condition of the industry was good but a down-turn was predicted;

(4) Marine's earnings peaked in 1966 and

(5) Marine's net tangible asset value exclusive of investment real estate was $3.1 million;

(6) Long-term debt was relatively small;

(7) Executive salaries were understated; and

666 *666 (8) Marine compared favorably with other industry members.

Donohue concluded that the fair market value of the stock on the valuation date was $2,600,000.

We recognize that the valuation process is not an exact science. By placing this case before us, these parties are asking us to establish a true fair market value for the property on the valuation date. As we

have stated previously, this difficult task could have been better resolved through a discussion and bargaining process involving the acknowledged experts of both the petitioner and respondent whom we believe should be better equipped to reach a proper result. See *Estate of Maurice Gustave Heckscher, supra*. Nonetheless, since this unwelcomed onus has been placed upon this Court, we have, in the exercise of our "Solomon-like wisdom," *Morris T. Messing* [Dec. 28,532], 48 T.C. 502 (1967), arrived at our determination of fair market value, as reflected in our ultimate finding of fact, by weighing all of the facts and circumstances contained in the entire record.

Since Marine was an operating company, both experts accorded primary significance to Marine's earning capacity in valuing its stock. We agree with this approach in this case but since the two experts reached such diverse results with the same approach it is obvious that we, as well as knowledgeable investors, should analyze the variables in the expert's approaches and make our own determination as to how best to use the various factual elements that enter into the computation under the existing circumstances. We must also decide what other factors should be considered, and the weight to be given them, in our search for a realistic, though hypothetical, fair market value.

It appears from a comparison of the two approaches that the single factor which causes the largest divergence in the experts' results is the price to be used in determining the price-earnings ratio of the comparable companies. Donohue used the stock exchange price on the valuation date and applied it to the average earnings over the latest 5 years of the comparable companies to arrive at a multiple of 13 to 16 to be applied to the average of the latest 5 years' earnings of Marine. Morrissey, on the other hand, determined the average price of the comparable's stock for each year taken into consideration and applied those prices to the earnings of the comparables for each of those years to develop his price-earnings ratios. He then totaled these multiples and divided the total by the number of years considered to arrive at the price-earnings ratio he determined for each of the comparables. This reflected multiples of slightly above or below 5 for the various comparables and he decided that a multiple of 5 should be applied to the average of Marine's latest 3 years' earnings, and its latest year's earnings, to determine fair market value on the earnings approach.

We prefer Morrissey's method of arriving at the multiple to be used in determining the value of this stock. In times of wide speculation and resulting fluctuations in the stock market we are extremely doubtful that the price at which a stock is traded on the stock exchange on any particular day is a true reflection of what an investor would pay for the stock if he was looking primarily to the historical earnings of the corporation to determine a fair price. We believe such an investor would give more weight to price-earnings ratio of comparable stocks during each of the years under consideration in determining a multiple that he can apply to the historical earnings of a corporation whose stock he is buying to determine the price he would pay for that stock.

However, we cannot ignore entirely the multiples arrived at by Donohue. We think they are obviously too high for use with respect to a corporation engaged in a very competitive, high-risk, and volatile business. The greater the risk, the shorter the time an investor would be willing to count on to recover his investment out of a corporation's earnings, and the smaller the multiples he would use. We conclude that Donohue's multiples are too high despite the fact that he claims support for the value produced by their uses in his cash-flow analysis. We accept the fact that a cash-flow analysis may be a useful supplementary tool to be used by an appraiser or investor to determine whether there are factors in a corporation's financial condition not revealed by an analysis of earnings that would make him hesitate to accept the indicated value, but we do not believe the cash-flow analysis used by Donohue would be used per se by investors to determine value. We find ample support for this conclusion in Exh. 48 "Cash Flow" Analysis and the Funds Statement, by Perry Mason, introduced into evidence by petitioner but relied on by both parties on brief.

667 *667 Nevertheless, giving due weight to Donohue's appraisal and to other factors which we believe should be taken into consideration, we believe the multiple of 5 developed by Morrissey is too low.

In addition to the comparable companies and their respective price-earnings ratios, we believe the following factors would also be critical in the development of a proper multiple if the fair market value of Marine's stock is to be stated in terms of price-earnings ratios:

(1) The interest being valued is a 100-percent interest. This should add to the value of decedent's stock because of the unencumbered control it gives for determining what will be done with the business.

(2) The lease from the Port Authority was one of the most important assets of Marine and the existing lease was due to expire on January 31, 1969. There was no assurance at the time of decedent's death that this lease would be renewed; and it was recognized that, if renewed, Marine would be required to spend a considerable sum to upgrade the improvements on the property;

(3) At the valuation date, Marine was experiencing a strike, which began in June 1967 and ended after decedent's death;

(4) Decedent appears to have been the guiding genius of Marine and he apparently kept such tight reins on the business that neither of his sons could develop much interest in the business;

(5) Marine's operation was relatively small in comparison with other companies in the industry and its facilities were rather limited;

(6) Marine's adjusted book value at September 30, 1967, was $3,442,000.

We have concluded that based on all the available evidence a hypothetical buyer of decedent's stock in Marine at the time of decedent's death would be willing to pay 7 times the earning capacity of Marine.

There is also a difference in the experts' opinions of the earning capacity of Marine, but the difference is not so great as to cause us much concern. By taking the average of the latest 5 years of Marine's earnings, with no adjustments for salaries or interest, Donohue arrived at a figure of $203,000 as Marine's earning power. Strangely enough, Morrissey arrived at the higher figure of $248,000 as Marine's earning power despite adjusting its reported income downward for salaries and interest. This was because he concluded that the latest 9 months' earnings and the average of the latest 3 years' earnings would better reflect Marine's potential earnings in the future. We would take a middle position on this and use Marine's earnings over the latest 4 years as a guide to prognosticate the future earnings. A turnaround in Marine's profitability appears to have occurred in 1964 and despite the falloff in Marine's profits in 1967 when compared to 1966, the prospects of continued good business activity in the industry seem well founded. Giving special emphasis to its latest 4 years' earnings, but without simply relying on the mathematical average of those years, we conclude that a reasonable earning capacity for Marine to be used in arriving at a valuation figure through the capitalization of earnings would be $240,000. As stated by the Court of Claims in *Central Trust Company v. United States* [62-2 USTC ¶ 12,092] 305 F. 2d 393, 404:

> "Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. * * *"

By applying our multiple of 7 to this earning capacity we arrive at a figure of $1,680,000 which, in our best judgment, was the fair market value of decedent's stock of Marine at the time of his death.

In reaching our conclusion we have given little weight to petitioner's theory of capitalizing assumed dividend paying capacity because we do not believe it is relevant here. Marine paid no dividends until it became a subchapter S corporation and then it distributed all of its earnings. We have not overlooked the fact that Marine had a book value of $3,442,000 at September 30, 1967, but we deem it quite unlikely that such a value could have been realized if the company had been liquidated; furthermore, there was no indication in the evidence that there was any intent to liquidate the company at the time of decedent's death. Nor have we ignored completely the fact that Marine's assets were sold to Campbell for approximately $4,600,000 in 1972. However, this sale occurred about 5 years after decedent's death after Marine had obtained a renewal lease with options to extend it to 50 years, and after Marine had spent about $1,800,000 for improvements to the property. Furthermore, not much cash was received on the sale and the
668 sale took *668 place because of Campbell's special need of the facilities at that time, so we have given little weight to this factor.

Value of the Investment Real Estate

Our next task is to determine the fair market value at the date of decedent's death of the real property owned by Marine located at 201-251 West Broadway in San Diego, Calif.

Petitioner offered as evidence in support of its position that the value of the property was $800,000 the appraisal report and testimony of its expert, Emmett **J**. McKanna. McKanna had been commissioned by the General Services Administration in 1968 to render an opinion on the fair market value of eleven parcels of real estate, in-including subject property, in connection with a study of possible sites for a Federal building project. McKanna's appraisal report and opinion reflected a value as of September 15, 1968, approximately 1 year after decedent's death. McKanna employed the following three generally accepted approaches in valuing real property:

(1) The cost approach;

(2) The income approach, and

(3) The comparative market approach.

Using these approaches he arrived at a fair market value for the subject real estate of $850,000 as of September 15, 1968.

McKanna's appraisal report appears to be a well-documented study of the subject property. McKanna defined the highest and best use of land concept, which is an important ingredient in land valuations, as the most profitable, likely, and legal use to which the property is adapted and for which there is demand. In his report McKanna stated;

> Highest and best use of the property is considered to be a combination commercial and retail usage in line with the existing [*sic*] usages of the building. This estimate is made in light of the existing improvements and is in keeping with other usages of property in the neighborhood.

We will forego a detailed analysis of McKanna's methods of analysis because respondent's primary attack on McKanna's appraisal was disagreement with his conclusion as to the highest and best use of the property. Furthermore, McKanna's evidence was the only evidence offered which we would consider to be an expert's opinion of value.

Respondent's only evidence of value offered at the trial was the testimony of Harold Pierce, an estate and gift tax agent for the Internal Revenue Service who had prepared the report on which the Commissioner determined the fair market value of this property in his notice of deficiency. We do not question Pierce's qualifications as an expert real estate appraiser, but his testimony was limited to an explanation of how he arrived at the valuation figure used in his report, which was a mathematical calculation from what we consider to be unjustified assumptions based on hindsight. Pierce's report was prepared in late 1969 or 1970. He testified that he did not appraise this real estate "in the sense of making a formal appraisal report * * *" Pierce concluded that the property had a fair market value as of the date of decedent's death of $1,100,000. While respondent argues that Pierce concluded that the highest and best use of this property was for an office building, we believe it is clear from Pierce's testimony and his method of determining the value of this property that he concluded its highest and best use was for the Federal courthouse and office building that is presently being constructed on the property. By the time Pierce made his report the site for the Federal building had become fixed and Pierce apparently thought the project had been approved prior to decedent's death. The evidence is to the contrary; the project itself was not approved by Congress until May of 1968 and the site was not actually settled until sometime after that. There was no assurance on the valuation date that subject property would be used for a Federal office building and a valuation based on the assumption that it would be used for that purpose was neither justified nor well founded.

Pierce's assumption also led him to use a method for determining the value of this property which is questionable. While Pierce testified that he took into consideration sales of comparable properties he offered no evidence about the comparables he used. It appears that Pierce relied primarily on the transactions by which the Halls acquired the remainder of the property needed by the Federal government, exchanged it and subject property for the Warren tract which was owned by the government, and then sold the Warren tract to Swan Constructors, Inc., in November of 1969.

669 *669 The Halls acquired the remainder of the land needed by the government for a total of $675,000. After the exchange they sold the Warren tract for $2,300,000. Pierce subtracted the $675,000 and a $200,000 real estate commission paid by the Halls from the $2,300,000 sales price of the Warren tract and attributed the balance of $1,425,000 to the Broadway property originally owned by Marine. He then discounted that figure by about 6 percent for each of the years between the valuation date and the date of the sale to arrive at his value of $1,100,000 for the Broadway property as of the date of decedent's death. This is not an acceptable method for determining the fair market value of subject property as of the date of decedent's death and we can give it no weight.

We are thus left with McKanna's appraisal as the only reliable evidence of fair market value. His appraisal approach was sound and in accord with generally accepted appraisal methods and we have no reason to question the validity of the comparables he used. We accept his appraisal figure of $850,000 as the fair market value of the property as of September 24, 1967. Petitioner would have us discount this figure by 6 percent for the claimed increase in value of the property between the valuation date and McKanna's appraisal date. McKanna did not testify that a 6-percent discount should be applied to his valuation figure and we have no competent evidence that would justify a 6-percent discount.

Furthermore, we believe some consideration should have been given to the possibility that the property might be used for a Federal or other office building location. The property was well located in downtown San Diego and the building on the property was a one-story structure about 50 years old. We believe there was a likelihood that in a growing city like San Diego this property would be converted to a more profitable use than the commercial and retail use for which it was being used in September of 1967. Consideration of this factor would tend to raise the value even at the date of decedent's death. So we will not apply a discount to McKanna's appraised value but will accept it as the fair market value of subject property on the valuation date.

Adding the $850,000 value of the real estate to the $1,680,000 we have found as the value of the stock exclusive of the real estate, we conclude that the total value of decedent's stock in Marine at the date of his death was $2,530,000.

Decision will be entered under Rule 155.

[1] Some of this land was encumbered by leases but they were apparently eliminated prior to the ultimate exchange between decedent's heirs and the Federal government.

[2] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise stated.

[3] Parenthetically, we note that petitioner's expert studied five of the six corporations examined by respondent's expert, the only exception being St. Louis Shipbuilding — Federal Barge, Inc.; however, petitioner's expert excluded American Shipbuilding and Todd Shipyards Corp. as comparables.

T.C. Memo. 2002-121

UNITED STATES TAX COURT

ESTATE OF MORTON B. HARPER, DECEASED, MICHAEL A. HARPER, EXECUTOR, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 19336-98. Filed May 15, 2002.

HFLP, a limited partnership, was established in 1994 and was capitalized by the contribution thereto by D of the majority of his assets. D was initially named as the sole limited partner and his children, M and L, were designated as general partners. D subsequently gave to M and L 24- and 36-percent limited partnership interests, respectively. At his death in 1995, D continued to hold a 39-percent limited partnership interest in HFLP.

Held: The property contributed by D to HFLP is includable in his gross estate pursuant to sec. 2036(a), I.R.C.

Held, further, value of the assets to be included in the gross estate determined.

Warren J. Kessler and Joan B. Kessler, for petitioner.

Donna F. Herbert and Jonathan H. Sloat, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

NIMS, Judge: Respondent determined, as a primary position, a Federal estate tax deficiency in the amount of $331,171 with respect to the estate of Morton B. Harper (the estate). In the alternative, respondent determined a Federal estate tax deficiency of $150,496 and a Federal gift tax deficiency of $180,675 for the 1994 calendar period. The principal issue for decision is the proper treatment for estate and gift tax purposes of interests in a limited partnership, some of which were transferred by Morton B. Harper (decedent) prior to his death, and another of which was held by decedent at his death.

Unless otherwise indicated, all section references are to sections of the Internal Revenue Code in effect during the relevant periods, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of the parties, with accompanying exhibits, are incorporated herein by this reference. Decedent was a resident of Palm Springs, California, when he died testate in Portland, Oregon, on February 1, 1995. No probate proceeding was ever

filed by or on behalf of the estate. Decedent is survived by his two children, Michael A. Harper (Michael) and Lynn H. Factor (Lynn). Decedent's wife, Ruth Harper, died in 1988. Michael serves as executor of the estate and provided a mailing address in Lake Oswego, Oregon, at the time the petition in this case was filed.

Decedent was born on September 1, 1908, in Cincinnati, Ohio. He later attended law school, graduating in 1931, and began practicing law in Chicago. His practice initially specialized in corporate and "political" law and subsequently expanded to include bankruptcy, tax, real estate, and wills and trusts law. After World War II, decedent and his family moved to California where decedent continued his legal practice, focusing in particular on the entertainment industry. Decedent was a member of the California bar from 1946 until his death. Decedent was diagnosed with prostate cancer in 1983 and with cancer of the rectum in 1989.

On December 18, 1990, decedent created a revocable living trust entitled the Morton B. Harper Trust (the Trust). The trust instrument designated decedent as the original trustee and as the initial primary beneficiary. The document further provided: "During the lifetime of the Trustor, the Trustee, in Trustee's sole discretion may pay or apply the net income and/or corpus, or so much as Trustee chooses, to or for the benefit of the

Trustor". Michael and Lynn were named as successor trustees and were to receive the trust assets upon decedent's death, with 60 percent thereof being distributed to Lynn and 40 percent to Michael. The percentages were based on perceived need; Michael has pursued a successful career in business as a real estate professional, while Lynn has been less consistent in fiscal matters.

At all relevant times, Lynn maintained a residence in Hawaii. On December 18, 1990, a complaint was filed by the Association of Apartment Owners of International Colony Club (AOAO) against Lynn in the Circuit Court of the Second Circuit, State of Hawaii. Lynn owned a home within the International Colony Club condominium project, and the AOAO was the condominium association overseeing that project. The complaint alleged that Lynn had engaged in unauthorized and illegal construction and renovation of her property and requested both injunctive and monetary relief. Subsequently, in November of 1992, the AOAO demanded arbitration of its claims. An arbitration award was then entered against Lynn in December of 1993 and required extensive reconstruction work as well as payment of fees, costs, and expenses.

Lynn and Michael testified that following entry of the above award, Lynn told Michael about her litigation versus the AOAO and the concomitant award, which Michael then communicated to

decedent. Thereafter, in approximately February of 1994, Michael and decedent met in California with John G. Coulter, Jr., an experienced real estate developer familiar with the Hawaii market. Michael had previously contacted Mr. Coulter, asking him to review documents relating to the Hawaii lawsuit and to offer his advice. After reviewing the documents and speaking to a gentleman involved in management of the condominium, Mr. Coulter expressed his concern that Lynn had gotten herself into "deep water"; that is, into a situation where "if she takes additional steps which could injure her further, her loss could go beyond the judgment". He also recommended that they evaluate her legal counsel and suggested that "they get involved with her in the management of her assets through a trust or some other form of involvement." Several weeks after the meeting, Michael accompanied Mr. Coulter to Hawaii for the purpose of being introduced to other potential representatives for Lynn. On March 23, 1994, the attorney who had represented Lynn in the AOAO proceeding filed a complaint against her alleging unpaid legal fees in the amount of $18,153.92.

At a time not entirely clear from the record, decedent made the decision to form a limited partnership and to contribute thereto the majority of his assets. An Agreement of Limited Partnership for Harper Financial Company, L.P. (HFLP), was prepared and sets forth the governing provisions for the entity.

The document begins with language stating that the Agreement was made "as of the 1st day of January, 1994", but later recites that the partnership shall commence its existence upon the date a certificate of limited partnership is duly filed with the California Secretary of State. The primary purpose for HFLP's formation, according to the Agreement, was as follows:

> The acquisition, including by purchase of, sale of, management of, holding, investing in and reinvesting in stocks (both common and preferred), options with respect thereto, bonds, mutual funds, debt instruments, money market funds, notes and deeds of trust and similar instruments and investments (the "Portfolio").

Michael and Lynn were named as the general partners of HFLP and the Trust as the sole limited partner, with interests of .4 percent, .6 percent, and 99 percent, respectively. Michael was also designated to serve as the managing general partner. As regards his authority, the Agreement provides:

> Subject to the provisions of Paragraph 7.3, the Managing General Partner shall have the full, exclusive and complete authority and discretion in the management and control of the business of the Partnership for the purposes stated herein and shall have the right to make any and all decisions affecting the business of the Partnership. Subject to the provisions of this Agreement, the Managing General Partner shall have full and exclusive authority with respect to the Portfolio, including rights of sale, reinvesting and voting. * * *

The referenced Paragraph 7.3 then specifies the following limitations:

> Notwithstanding the provisions of this Paragraph 7, neither General Partner shall have any right, power or authority to:

(a) Do any act in contravention of this Agreement, without first obtaining the written consent thereto of a "Majority in Interest of the Limited Partners" * * * [defined as limited partners holding more than 50 percent of the interest in the ordinary income of the partnership held by limited partners].

(b) Do any act * * * which would (i) make it impossible to carry on the ordinary business of the Partnership, or (ii) change the nature of the Partnership's business, without first obtaining the written consent thereto of a Majority in Interest of the Limited Partners.

(c) Confess a judgment against the Partnership, without first obtaining the written consent thereto of a Majority in Interest of the Limited Partners.

(d) Possess Partnership property, or assign the Partnership's right in such property, for other than a Partnership purpose without first obtaining the written consent thereto of a Majority in Interest of the Limited Partners.

(e) Admit a person as a limited partner, otherwise than as permitted by this Agreement, without first obtaining the written consent thereto of a Majority in Interest of the Limited Partners.

(f) Elect to dissolve and wind up the Partnership, without first obtaining the written consent thereto of a Majority in Interest of the Limited Partners.

(g) Sell or reinvest 5% or more of the Portfolio (based on their fair market value) in a single transaction or in a related series of transactions, other than in the ordinary course of business, without first obtaining the written consent thereto of a Majority in Interest of the Limited Partners.

(h) Issue or sell new interests in the Partnership (or admit new partners in connection therewith) or permit the contribution of new capital to

> the Partnership, without first obtaining the written consent thereto of a Majority in Interest of the Limited Partners.
>
> (i) Enter into any transactions, other than those transactions contemplated by Paragraph 7, in which a General Partner has an actual or potential conflict of interest with the Trust or the Partnership, without first obtaining the written consent thereto of a Majority in Interest of the Limited Partners.
>
> (j) Admit a person as a general partner, without first obtaining the written consent thereto, and to any related transactions with such person, of a Majority in Interest of the Limited Partners.
>
> (k) Amend this Agreement, without first obtaining the written consent thereto of a Majority in Interest of the Limited Partners.

In addition, Paragraph 12.5 provides explicitly that "The Trust is entitled to vote, prior to any such action being taken to" approve any of the above-enumerated actions.

Regarding capital accounts and contributions, the Agreement states that capital accounts were to be established and maintained in accordance with section 704(b) and the regulations promulgated pursuant thereto; namely, section 1.704-1(b)(2)(iv), Income Tax Regs. In general, Paragraph 10.2 of the document requires that profits and losses be allocated 0.6 percent, 0.4 percent, and 99 percent to the capital accounts of Lynn, Michael, and the Trust, respectively. The Agreement also sets forth the following with respect to contributions: "Concurrently with the execution of this Agreement (or as soon thereafter as is reasonably possible), the Trust shall make an initial capital

contribution to the Partnership consisting of the Portfolio. The General Partners shall have no obligation to make any contribution to the capital of the Partnership."

Although "the Portfolio" is not defined in the Agreement, there appears to be no dispute between the parties that it consisted of: (1) Securities held in a brokerage account at M.L. Stern & Co., Inc., (2) securities held in a Putnam Investments account, (3) securities held in two Franklin Fund accounts, (4) 2,500 shares of Rockefeller Center Properties, Inc., and (5) a $450,000 note receivable from Jack P. Marsh. The parties value these assets at between $1.6 and $1.7 million (rounded), an amount representing approximately 94 percent of decedent's total assets. The Trust's capital account in HFLP was credited with 99 percent of the value of the property contributed. Decedent retained, personally or through the Trust, his personal effects, a checking account, an automobile, and his Palm Springs condominium.

As regards distributions, Paragraph 11.1 of the Agreement states: "Subject to all of the provisions of this Agreement, funds of the Partnership from any source shall be distributed to the Partners at such times and in such amounts as are determined in the sole and absolute discretion of the Managing General Partner." Paragraph 11.2 then goes on to recite:

> Funds of the Partnership shall be distributed as follows:

> (a) First, to any Partner, the amount then due on any Advances [loans to the entity] * * *
>
> (b) Ordinary Net Cash Flow [revenues from dividends, interest, and other items of ordinary income in excess of ordinary and necessary operating expenses] shall be distributed 0.6% to Lynn, 0.4% to Michael and 99% to the Trust.
>
> (c) Extraordinary Net Cash Flow [revenues from capital gains in excess of capital losses, less consequent expenses] shall be distributed to the Partners with positive Capital Account balances, pro rata to the extent thereof.

The Agreement also specifies that "No distribution of funds of the Partnership shall be made until the allocations described in Paragraph 10 hereof [regarding the allocation of profits and losses to the partners' capital accounts] have first been made."

The Agreement prohibits transfer, sale, assignment, or encumbrance of a limited partnership interest without the consent of all partners. Any transfer attempted in violation of this restriction is declared by the Agreement to be null and void ab initio. Under provisions of the Agreement, the entity is to be dissolved upon the earlier of: (1) January 1, 2034; (2) the retirement, withdrawal, death, or insanity of any general partner or any other event or condition, other than removal, which results in a general partner's ceasing to be a general partner, unless (i) at the time there is at least one remaining general partner to continue the business of the partnership and such remaining general partner chooses to do so, or (ii) all partners agree in writing within 60 days thereof to continue the business

and, if necessary, to the admission of one or more general partners; (3) an election to dissolve the partnership made in writing by the general partners and the limited partners; or (4) the failure to elect a successor general partner within 60 days after the removal of the last general partner.

Although the Agreement contains no express provision regarding the removal of a general partner, it specifies that rights and duties of the partners are governed by the California Revised Limited Partnership Act except to the extent the Agreement states otherwise. This Act includes the following: "The limited partners shall have the right to vote on the removal of a general partner, and that action shall be effective without further action upon the vote or written consent of a majority in interest of all partners". Cal. Corp. Code sec. 15636(f)(2) (West 1991).

The Agreement was signed by decedent on behalf of the Trust, by Michael, and by Lynn. Although the signatures are undated, the document was executed by Michael in May or June of 1994. Lynn could not remember when she signed the Agreement and did not read it prior to signing. A certificate of limited partnership was filed on behalf of HFLP with the California Secretary of State on June 14, 1994.

From June 17 to June 20, 1994, decedent was hospitalized in Palm Springs. Medical records prepared at that time contain the explanation set forth below:

> This is one of multiple Desert Hospital admissions for this 85-year-old Caucasian who is well known to have metastatic colonic carcinoma and prostatic carcinoma and admitted at the present time for poor oral intake, poor fluid intake, dehydration and for further rehydration, close observation, nutrition support, etc.

After his release, decedent went to Oregon, where he resided until his death. He first stayed with Michael for approximately a month and then moved into a nearby Oregon retirement facility known as Carmen Oaks. Carmen Oaks served independent individuals and was not a nursing center.

Thereafter, by a document entitled Assignment of Partnership Interest and Amendment No. 1 to Agreement of Limited Partnership for Harper Financial Company, L.P., dated and made effective as of July 1, 1994, the Trust transferred to Michael and Lynn 60 percent of the Trust's partnership interest. As a result, Michael and Lynn became holders of 24- and 36-percent limited partnership interests, respectively, and were given corresponding percentages of the Trust's capital account balance. The limited partnership interests held by Michael and Lynn were designated as "Class B Limited Partnership Interest[s]" and were entitled to 60 percent of the income and loss of the entity, with 40 percent thereof going to Michael and 60 percent to Lynn.

The Amendment also reclassified the Trust's remaining 39-percent limited partnership interest as a "Class A Limited Partnership Interest" which was entitled to 39 percent of the entity's income and losses and to a "Guaranteed Payment" of "4.25% annually of its Capital Account balance on the Effective Date, payable quarterly no later than twenty (20) days after the close of any such calendar quarter (or sooner, if cash flow permits)." Decedent, as trustee of the Trust, Michael, and Lynn signed the document.

On July 26, 1994, decedent commenced the process of transferring the Trust's portfolio to the partnership, which process continued for approximately the next 4 months. On July 26, 1994, decedent executed as trustee an allonge endorsement assigning to HFLP the Trust's interest in the Marsh note. A collateral assignment of the Trust's interest in property securing the note was also signed on that date. Then, on August 28, 1994, a letter agreement confirming and/or finalizing the transfer was executed by or on behalf of Mr. Marsh, the Trust, and HFLP.

Next, a letter dated September 29, 1994, was sent by decedent to M.L. Stern & Co. confirming instructions for (1) the sale of all securities held in the Trust's account and (2) the use of the proceeds for the immediate repurchase of the same securities for an account established on behalf of the

partnership. Michael, as managing general partner, completed the requisite form opening a new account with M.L. Stern & Co. for the partnership. The form designated Michael as the "individual * * * authorized to enter orders on behalf of customer". Neil Hattem served as decedent's broker and subsequently as the broker on the HFLP account.

Letters dated September 30, 1994, were then sent by decedent to Putnam Investor Services and to Franklin Templeton requesting transfer of the respective Putnam and Franklin Fund accounts to HFLP. Lastly, by a letter dated November 22, 1994, decedent requested transfer of the Trust's stock in Rockefeller Center Properties to the partnership.

During this period, on September 23, 1994, Michael opened a checking account at Bank of America in the name of the partnership with a $200 deposit. Thereafter, the first activity in the account, other than the debiting of a monthly service charge, was a deposit on October 13, 1994, of $3,750 representing interest paid on the Marsh note. The check register maintained by Michael, in conjunction with his explanatory testimony, reflects checks written for the benefit of HFLP partners in 1994 and 1995, as follows:

Date	Lynn	Michael	Trust	Description and/or Purpose
11/9/94	$120			reimbursement of contribution to checking account opening deposit
11/9/94		$80		reimbursement of contribution to checking account opening deposit
11/9/94	4,200			distribution
11/9/94		2,800		distribution
11/9/94			$3,800	distribution
12/19/94	2,250			distribution
12/19/94		1,500		distribution
12/19/94			3,750	distribution
1/10/95	2,250			distribution
1/10/95		1,500		distribution
1/10/95			3,750	distribution
1/17/95			6,520	“additional distribution” to cover tax voucher
1/30/95			4,000	“additional distribution” to complete gift
5/30/95			5,000	“return of capital” for an estate expense
8/30/95			5,000	“return of capital” for an estate purpose
10/13/95			5,000	“capital return” for an estate expense
10/30/95			195,000	“return of capital” to cover estate taxes
11/15/95	7,200			distribution
11/15/95		4,800		distribution

The funds to make the $195,000 payment on October 30, 1995, were obtained through two deposit transactions. Proceeds in the amount of $135,000 from the liquidation of a money market account with M.L. Stern & Co. and in the amount of $60,000 from a reduction in principal on the Marsh note were placed into the bank account on October 30, 1995. Michael negotiated the $60,000 payment on the Marsh note in return for agreeing to extend the maturity date of the remaining principal balance.

Prior to establishment of the partnership account, amounts received with respect to securities contributed to HFLP were deposited in the Morton B. Harper Trust checking account.

In January of 1995, decedent entered hospice care in Oregon. Preceding that time, he had been hospitalized on three occasions, in late September, early October, and late November. He had also renewed his vehicle registration on September 23, 1994, and his driver's license was current at the time of his death. Decedent passed away on February 1, 1995.

Thereafter, in March or April of 1995, Michael engaged a certified public accountant, David S. Blankstein, to prepare financial books and tax returns for the partnership and also to prepare the income, gift, and estate tax returns due with respect to decedent. In furtherance of these objectives, Mr. Blankstein reviewed the partnership Agreement; the certificate of limited partnership; the Amendment; checking account records for the

partnership, the Trust, and decedent; M.L. Stern & Co. statements for the partnership and the Trust; Putnam Investments statements for the partnership and the Trust; Franklin Funds statements for the partnership and the Trust; the Rockefeller Center Properties stock certificate; and the Marsh note.

Mr. Blankstein set up a general ledger for HFLP to categorize and account for all transactions affecting partnership assets and income beginning June 14, 1994. Capital accounts were established for each partner, as well as ledger accounts to show distributions to partners, income received by the partnership on the various portfolio assets, proceeds from the sale of securities, and costs and charges incurred. In addition, an account labeled “Receivable from Trust” was created primarily to reflect amounts received by the Trust after June 14, 1994, that should properly have been received by the partnership. This account was presumably necessitated in large part by the delay in transferring title to the portfolio securities and in opening the partnership bank account. The balance in this account was then treated as a distribution to the Trust; no funds were actually transmitted between the two entities. Mr. Blankstein also conceded that several items which should have been attributed to the partnership were omitted.

A Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, and a Form 706, United States Estate (and

Generation-Skipping Transfer) Tax Return, were filed on behalf of decedent and were received by the Internal Revenue Service on October 16, 1995, and November 2, 1995, respectively. The gift tax return reported the .4-percent general and 24-percent limited partnership interests given to Michael and the .6-percent general and 36-percent limited partnership interests given to Lynn. The estate tax return included as part of decedent's gross estate the Trust's 39-percent limited partnership interest in HFLP.

Notices of deficiency were issued with respect to the above returns on October 21, 1998. As previously stated, respondent therein advanced a primary and an alternative position. Under the primary position, the full value of the assets held by HFLP was included in decedent's gross estate, and prior taxable gifts were reduced to $0, resulting in an estate tax deficiency of $331,171 and no deficiency in gift tax. Under the alternative position, respondent determined an estate tax deficiency of $150,496 and a gift tax deficiency of $180,675.

OPINION

I. Contentions of the Parties

The parties in this case disagree regarding how properly to treat the partnership interests transferred by decedent to his children during life and the interest included through the Trust in his estate at death. Respondent contends that the full fair market value of the assets contributed to HFLP is includable in

decedent's gross estate upon either of two alternative theories. Respondent argues that the partnership lacked economic substance and should thus be disregarded for transfer tax purposes or, alternatively, that section 2036(a) applies to include the value of the contributed property in decedent's gross estate due to decedent's retention of the economic benefit of the assets.

Furthermore, respondent maintains that even if the partnership is respected and section 2036(a) is found not to apply, the discounts claimed by the estate with respect to valuation of the subject partnership interests are excessive, unsupported, and should not be sustained. Respondent offers and relies upon the expert reports of John A. Thomson in connection with this latter argument.

Conversely, the estate emphasizes that HFLP was a duly organized and operating limited partnership established with the business purpose of protecting from Lynn's creditors the assets that Lynn would receive or inherit from decedent. Hence, according to the estate, the partnership must be recognized for tax purposes. Moreover, it is the estate's position that section 2036(a) has no application here because the Trust unconditionally transferred the portfolio assets to HFLP, the Trust received adequate and full consideration for the transfer in the form of a credit to its capital account, and there existed no express or implied agreement that decedent would retain a right to control

over or income generated by the contributed property. The estate thus contends that this controversy devolves to a valuation case where the property to be valued takes the form of partnership interests in HFLP and where the analysis provided by the estate's expert Clint Cronkite establishes a sound appraisal thereof.

II. Evidentiary Issues

As a preliminary matter, we address several evidentiary objections reserved by the parties in the stipulation of facts. The estate objected to the admission of Exhibit 27-J on grounds of authenticity, relevance, and prejudice. Exhibit 27-J is a facsimile of medical records for decedent requested by and sent to the Internal Revenue Service. The estate pointed out at trial that the lines within the document for the doctor's signature are blank. During the proceeding, respondent offered as Exhibit 53-R signed copies of key portions of the records. The estate agreed that no objection would be pressed as to the authenticity of Exhibit 53-R, at which time the document was admitted into evidence with the estate renewing objections as to relevance and prejudice. Given this posture, Exhibit 27-J is largely cumulative, and we sustain the estate's objection thereto. We also overrule any remaining objections to Exhibit 53-R.

The estate similarly objected to Exhibit 28-J on grounds of authenticity, relevance, and prejudice. This document is a letter to the Internal Revenue Service from one of decedent's

physicians, and the estate again cites concerns with the signature thereon. In light of these concerns and the fact that the letter does not appreciably add to the information reported in the admitted medical records, we sustain the estate's objection.

The estate's final objection in the stipulation was to the admission of Exhibit 29-J, a letter to Michael from decedent's doctor, on grounds of relevance and prejudice. These objections, however, were overruled at trial, and the document was taken into evidence.

Respondent in the stipulation objected to the admission of Exhibits 33-J through 37-J, which pertain to the Hawaii arbitration, on the ground of relevance. On reply brief, respondent expressly waived objection to these documents. Exhibits 33-J through 37-J are admitted into evidence.

Respondent also in the stipulation raised relevancy objections to Exhibits 41-J, 44-J, and 45-J. Since these documents (a photo of decedent taken in the 1950s and copies of various checks written for gifts and charitable contributions) all relate to periods prior to those at issue and do not bear in any meaningful way on matters considered herein, we sustain respondent's objections.

III. Inclusion in the Gross Estate--Section 2036

A. General Rules

As a general rule, section 2501 imposes a tax for each calendar year "on the transfer of property by gift" by any taxpayer, and section 2511(a) further clarifies that such tax "shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible". For purposes of determining whether a gift has been made, section 2512(b) provides: "Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift". The tax is then computed based upon the statutorily defined "taxable gifts", which term is explicated in section 2503. Section 2503(a) states generally that taxable gifts means the total amount of gifts made during the calendar year, less specified deductions.

Similarly, the Internal Revenue Code imposes a Federal tax "on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." Sec. 2001(a). Such taxable estate, in turn, is defined as "the value of the gross estate", less applicable deductions. Sec. 2051. Section 2031(a)

specifies that the gross estate comprises "all property, real or personal, tangible or intangible, wherever situated", to the extent provided in sections 2033 through 2045.

Section 2033 broadly states that "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death." Sections 2034 through 2045 then explicitly mandate inclusion of several more narrowly defined classes of assets. Among these specific sections is section 2036, which reads in pertinent part as follows:

> SEC. 2036. TRANSFERS WITH RETAINED LIFE ESTATE.
>
> (a) General Rule.--The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death--
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Regulations likewise explain that the gross estate under section 2036 includes the value of transferred property if the decedent

retained the "use, possession, right to the income, or other enjoyment of the transferred property". Sec. 20.2036-1(a)(i), Estate Tax Regs.

Given the language used in the above-quoted provisions, it has long been recognized that "The general purpose of this section is 'to include in a decedent's gross estate transfers that are essentially testamentary' in nature." Ray v. United States, 762 F.2d 1361, 1362 (9th Cir. 1985) (quoting United States v. Estate of Grace, 395 U.S. 316, 320 (1969)). Accordingly, courts have emphasized that the statute "describes a broad scheme of inclusion in the gross estate, not limited by the form of the transaction, but concerned with all inter vivos transfers where outright disposition of the property is delayed until the transferor's death." Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971).

As used in section 2036(a)(1), the term "enjoyment" has been described as "synonymous with substantial present economic benefit." Estate of McNichol v. Commissioner, 265 F.2d 667, 671 (3d Cir. 1959), affg. 29 T.C. 1179 (1958); see also Estate of Reichardt v. Commissioner, 114 T.C. 144, 151 (2000). Moreover, possession or enjoyment of transferred property is retained for purposes of section 2036(a)(1) where there is an express or implied understanding to that effect among the parties at the time of the transfer, even if the retained interest is not

legally enforceable. Estate of Maxwell v. Commissioner, 3 F.3d 591, 593 (2d Cir. 1993), affg. 98 T.C. 594 (1992); Guynn v. United States, supra at 1150; Estate of Reichardt v. Commissioner, supra at 151; Estate of Rapelje v. Commissioner, 73 T.C. 82, 86 (1979). Regulations likewise provide that "An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred." Sec. 20.2036-1(a), Estate Tax Regs.

The existence or nonexistence of such an understanding is determined from all of the facts and circumstances surrounding both the transfer itself and the subsequent use of the property. Estate of Reichardt v. Commissioner, supra at 151; Estate of Rapelje v. Commissioner, supra at 86. However, an exception to the treatment mandated by section 2036(a) exists where the facts establish "a bona fide sale for an adequate and full consideration in money or money's worth".

B. Burden of Proof

Typically, the burden of disproving the existence of an agreement regarding retained enjoyment has rested on the estate, and this burden has often been characterized as particularly onerous in intrafamily situations. Estate of Maxwell v. Commissioner, supra at 594; Estate of Reichardt v. Commissioner, supra at 151-152; Estate of Rapelje v. Commissioner, supra at 86.

With respect to the case at bar, however, respondent conceded on reply brief that the opposite burden applies here. The estate had asserted on opening brief that the burden of proof regarding nonvaluation issues shifted to respondent, to which contention respondent replied as follows:

> The respondent agrees that the lack of economic substance and I.R.C. § 2036 issues are new matters within the meaning of Tax Court Rule 142(a). As such, the petitioner correctly states that the respondent bears the burden of proof on these issues under Shea v. Commissioner, 112 T.C. 183 (1999). * * * [Fn. ref. omitted.]

For purposes of this litigation, we have accepted respondent's concession and have considered its role in our analysis. Nonetheless, after reviewing all of the evidence presented, we have found that our resolution does not depend on which party bears the burden of proof. Both parties adduced testimony and offered exhibits in support of their respective positions, and the evidence so introduced was not evenly balanced in favor of the competing alternatives. Accordingly, we have based our conclusions upon the preponderance of the evidence rather than upon an allocation of the burden of proof.

C. Existence of a Retained Interest

As previously indicated, section 2036 mandates inclusion in the gross estate of transferred property with respect to which the decedent retained, by express or implied agreement, possession, control, enjoyment, or the right to income. The

focus here is on whether there existed an implicit agreement that decedent would retain control or enjoyment, i.e., economic benefit, of the assets he transferred to HFLP.

Respondent avers that section 2036's applicability is established on these facts, emphasizing in particular actual conduct with respect to partnership funds. Respondent further maintains that this case is indistinguishable from the situations presented in Estate of Reichardt v. Commissioner, supra, and Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242. The estate, on the other hand, discounts the evidence and cases relied on by respondent, emphasizing instead the formal terms of the partnership arrangement and the accounting treatment of entity assets.

In Estate of Reichardt v. Commissioner, supra at 147-148, the decedent formed a family limited partnership, the general partner of which was a revocable trust created on the same date. The decedent and his two children were named as cotrustees, but only the decedent performed any meaningful functions as trustee. Id. at 147, 152. He was the only trustee to sign the articles of limited partnership, to open brokerage accounts, or to sign partnership checks. Id. at 152. He transferred his residence and all of his other property (except for his car, personal effects, and a small amount of cash in his checking account) to the partnership and subsequently gave his two children limited

partnership interests. Id. at 148-149, 152-153. The decedent deposited partnership income in his personal account, used the partnership checking account as his personal account, and lived at his residence without paying rent to the partnership. Id. at 152. Based on these facts, we concluded that nothing but legal title changed in the decedent's relationship to his assets after he transferred them to the partnership. Id. at 152-153.

In Estate of Schauerhamer v. Commissioner, supra, the decedent formed three limited partnerships. The decedent and one of her three children were named as the general partners of each partnership, with the decedent's being designated as the managing partner. Id. The decedent transferred business assets, including real estate, partnership interests, and notes receivable, to the partnerships in undivided one-third shares. Id. Limited partnership interests in these entities were given to family members. Id. Partnership bank accounts were opened, but the decedent deposited the income earned by the partnerships into the account she used as her personal checking account, where it was commingled with funds from other sources. Id. Checks were then written from this account to pay both personal and partnership expenses. Id. The decedent's children later acknowledged at trial that formation of the partnerships was merely a way to enable the decedent to assign interests in the partnership assets to family members, with the assets to be

managed by the decedent exactly as in the past. Id. We therefore found the assets includable under section 2036(a). Id.

We agree with respondent that the circumstances before us bear many similarities to those in Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000), and Estate of Schauerhamer v. Commissioner, supra, and are convinced that a like result should obtain. We focus particularly on the commingling of funds, the history of disproportionate distributions, and the testamentary characteristics of the arrangement in support of our conclusion that there existed an implied agreement that decedent would retain the economic benefit of the assets transferred to HFLP.

As regards commingling of funds, we note that this fact was one of the most heavily relied upon in both Estate of Reichardt v. Commissioner, supra at 152, and Estate of Schauerhamer v. Commissioner, supra. We find the disregard here for partnership form to be equally egregious. The Agreement specified: "All funds of the Partnership shall be deposited in a separate bank account or accounts". Yet no such account was even opened for HFLP until September 23, 1994, more than 3 months after the entity began its legal existence. Prior to that time, partnership income was deposited in the Trust's account, resulting in an unavoidable commingling of funds.

Michael testified concerning this delay as follows:

> Inadvertently, either my account or I failed to apply timely for any--an employee [sic] identification

> number. That is required before a checking account is open. So I just made the determination that without a checking account and I wanted the flow of cash, what we would do is use the Morton B. Harper Trust account as a holding account, and then I instructed the accountant to properly credit and account for those funds. * * *

This explanation, however, seems to beg the question. Had Michael sought promptly upon HFLP's creation to establish a bank account, he would have been immediately alerted to the need for an EIN. Hence, he either neglected to attempt opening and/or using an account or allowed the lack of an EIN to continue for several months after having been reminded of its necessity. Both reflect at best a less than orderly approach to the formal partnership structure so pressed by the estate.

Moreover, we find Michael's reliance on post mortem accounting manipulations to be especially unavailing. Michael and Mr. Blankstein, HFLP's accountant, each testified that no moneys actually changed hands in connection with the adjustments. In response to similar contentions in Estate of Reichardt v. Commissioner, supra at 154-155, we stated:

> The 1993 yearend and 1994 post mortem adjusting entries made by Hannah's firm were a belated attempt to undo decedent's commingling of partnership and personal accounts. There is no evidence that the partnership or decedent transferred any funds to the other as a result of the adjusting entries. After-the-fact paperwork by decedent's C.P.A. does not refute that decedent and his children had agreed that decedent could continue to use and control the property during his life. [Fn. ref. omitted.]

Here Michael did not even hire Mr. Blankstein until after decedent's death, strengthening the inference that the partners had little concern for establishing any precise demarcation between partnership and other funds during decedent's life.

Closely related to the delay in opening the partnership bank account and consequent commingling of income is the delay in formally transferring the underlying portfolio assets to HFLP. No attempt was made to begin the process of title transfer until July 26, 1994, when decedent executed an allonge endorsement assigning the Marsh note to HFLP. No action was taken with respect to any of the other securities until September 29 and 30, 1994, when letters addressing transfer of the M.L. Stern & Co., Putnam, and Franklin accounts were drafted and an account with M.L. Stern & Co. was opened on behalf of HFLP. A letter requesting transfer of the Rockefeller Center Properties stock was not prepared until November 22, 1994.

When Michael was asked on cross-examination to explain this delay between the effective date of the partnership and the formal transfer of assets into the entity, he replied: "Probably for different reasons, some mechanical delays and who we're dealing with, but generally, there was no rush to do it. We were just doing it in an orderly fashion." Next, in response to a further question asking why there was no rush, he continued: "There was no rush. I mean, we were just handling the business

in an orderly fashion. There wasn't any deadline or urgency to do it and get it done." The following colloquy then ensued:

> Q Now let's talk for a moment about the income from the portfolio assets. Before the title to the assets was transferred to the partnership, your father or his trust continued to receive the income from those assets. Isn't that right?
>
> A Would you restate that? I'm lost.
>
> Q Okay. At a certain point in time the assets were contributed to the partnership, correct?
>
> A Yes.
>
> Q Okay. Before that happened, your father's trust continued to receive the income from those assets, correct?
>
> A Probably.
>
> Q Well, why isn't it Yes?
>
> A Well, before he contributed it, he was in control of that. Who else would get it? I say probably.

Hence, we are again met with an example of indifference by those involved toward the formal structure of the partnership arrangement and, as a corollary, toward the degree of separation that the Agreement facially purports to establish. Moreover, until title to the assets was transferred to HFLP, decedent would not have forfeited the control over the underlying securities that he through the Trust possessed as legal holder. Thus, at the time of the June 14, 1994, creation of HFLP and for some months following, decedent's Trust retained title to the underlying assets and was issued the dividends and interest

generated thereby. In addition, according to Michael's own testimony, the partners were in no hurry to alter this state of affairs. This speaks volumes concerning how little the partners understood to have changed in decedent's relationship to his assets as a result of the entity's formation.

Turning to facts regarding distribution of partnership funds, we find equally compelling indicia of an implied understanding or agreement that the partnership arrangement would not curtail decedent's ability to enjoy the economic benefit of assets contributed to HFLP. In addition to the deemed distributions engendered by the commingling discussed above, even the distributions made by Michael from the partnership checking account are heavily weighted in favor of decedent. The check register indicates that during the period extending from September of 1994 through early November 1995, partnership funds were distributed for the benefit of Michael and Lynn in the amounts of $5,800 and $8,700, respectively. These distributions occurred on November 9, 1994, December 19, 1994, and January 10, 1995. During that same time frame, partnership checks totaling $231,820, were remitted to the Trust, with the last being written on October 30, 1995. Only then did distributions to Michael and Lynn resume with checks drawn on November 15, 1995, in the amounts of $4,800 and $7,200, respectively. Given this pattern, we would be hard pressed to conclude other than that the

partnership arrangement did little to curtail the access of decedent or his estate to the economic benefit of the contributed property.

Similarly significant is the evidence that certain of the distributions to the Trust were linked to a contemporaneous expense of decedent personally or of his estate. These amounts, variously labeled by Michael "additional distribution", "return of capital", or "capital return", totaled $220,520 and even included $4,000 to enable decedent to complete a gift 2 days before he died. This evidence buttresses the inference that decedent and his estate had ready access to partnership cash when needed.

On the issue of distributions, the estate repeatedly intones, in mantralike fashion: "The managing general partner's right to make distributions was unlimited and could be made 'at such times and in such amounts as are determined in the sole and absolute discretion of the Managing General Partner.'" Once again, however, this point begs the question. The more salient feature is not that Michael did or did not have authority to make the distributions but that he frequently used his position to place partnership funds at the Trust's disposal in response to personal or estate needs. No other partner was afforded the same luxury of "additional" distributions or capital returns.

Furthermore, the fact that the contemporaneous check register labels various disbursements to the Trust a "return of capital", regardless of whether such are proper under the Agreement and/or should be otherwise classified, also supports the clear implication that Michael understood decedent's capital could and would be made available to him if necessary. Additionally, Michael even liquidated an M.L. Stern & Co. money market account and renegotiated the Marsh note in order to obtain the requisite cash to enable the Trust to pay decedent's estate taxes. These facets, in turn, provide strong evidence of an implied agreement under which decedent did not divest himself economically of the contributed assets.

The estate also argues that the distributions to the Trust were consistent with the guaranteed payment obligation. Nonetheless, without regard once again to the veracity of this allegation, we find it of little import in our analysis. The record supports a conclusion that in making the payments Michael was motivated by concern not with meeting HFLP's guaranteed payment obligation but rather with facilitating underlying partner expenditures. Michael testified as follows on this subject:

> Q Did you regularly pay the guaranteed payments to your father during 1994?
>
> A Payments were made, yes.
>
> Q Were they made regularly?

A I don't know what you mean by "regularly."

Q Were they made as provided for in the partnership agreement?

A To the best of my ability, yes.

Q Were you aware that the partnership agreement called for them to be paid quarterly?

A Not specifically, no.

Q You recall how often you made guaranteed payments to him?

A I took the approach that I would look at receivables, and distributions were entirely within my control, and if the dollars were sitting there, I would possibly make distributions. It could have been as often as monthly; I don't recall, as I sit here.

Q How did you compute the amount of the guaranteed payments?

A I don't understand. What do you mean, how did I compute it?

Q How did--how did you compute the amounts that you paid? Did you compute them? I mean, they were 4.25 percent of the portfolio, right?

A Oh, I don't know if I did it--

Q Of the capital--I'm sorry; I stand corrected. The capital account. They were supposed to be 4.25 percent of the capital account.

A That's my--that's my understanding, yes.

Q Did you make computations when you made those guaranteed payments?

A It seems to me I did, yes.

Q Did you do them in writing?

A Well, I did them, and then I asked the accountant to double-check me on all of them--

Q When?

A --because I'm not an accountant.

Q When did you ask him to double-check you on that?

A Regularly.

The foregoing exchange solidifies our belief that moneys were not remitted to the Trust in a calculated effort to comply with the 4.25-percent entitlement. The vague nature of the testimony makes clear that the guaranteed payment averments are nothing more than an attempted after-the-fact justification for Michael's actions.

In addition, given that Mr. Blankstein was not engaged until March or April of 1995, after decedent's death, his help was unavailable to Michael for purposes of any of the 1994 or early 1995 distributions, a circumstance which apparently did not deter Michael from proceeding despite his admitted lack of accounting expertise. There are also questions with regard to whether profit and loss allocations called for by the Agreement should have been made prior to any distribution of funds. In any event, we are satisfied that respect for the Agreement was not the catalyst for the disproportionate distributions made to the Trust.

We are equally unimpressed by the estate's references to the fiduciary capacity in which Michael purportedly acted as managing general partner. The estate claims: "Michael, as the managing

general partner, is a fiduciary and must act on behalf of the Partnership and all of its partners and cannot favor any one of them over any other of them. He cannot make distributions to one partner without making distributions to all partners and did not do so." The record, on the other hand, shows a consistent pattern of acting in response to particular needs of decedent or his estate. We simply are unable to agree that Michael was acting in these instances first and foremost for the good of HFLP and not primarily as the son of his father.

Lastly, we focus on testamentary characteristics of the partnership arrangement. According to the estate:

> It is clear from the record that the organization of the Partnership and the contribution by the Trust of the Portfolio to the Partnership's capital was not "testamentary." No part of such transaction was intended to be effective at the time of Morton's death. The terms and conditions of the Partnership Agreement and the funding of the Portfolio were complete and unconditional and changed the relationship of the parties to the Portfolio assets. * * *

While we acknowledge that HFLP did come into existence prior to decedent's death and that some change ensued in the formal relationship of those involved to the assets, we are satisfied that any practical effect during decedent's life was minimal. Rather, the partnership served primarily as an alternate vehicle through which decedent would provide for his children at his death.

As previously discussed, decedent continued to be the principal economic beneficiary of the contributed property after HFLP's creation. The few minor distributions made to Michael and Lynn, which tellingly ceased throughout the entire period that funds were being disbursed for final gifts and estate expenses, hardly evidence a meaningful economic stake in the assets during decedent's life. Michael's technical control over management and distributions is likewise of little import. Although there was testimony that Michael reinvested proceeds of maturing bonds, and he presumably collected interest and dividends paid on securities held in HFLP's name, these activities are more akin to passively administrating than to actively managing the contributed portfolio. From the documents in the record, it appears that the composition of the portfolio changed little prior to decedent's death. We also note that a significant percentage of the portfolio consisted of professionally managed bond funds.

Given the above, we place little weight on averments concerning change, during decedent's life, in the partners' relationships to the contributed property. In addition, we believe that our conclusions in this regard are corroborated by the alleged reason advanced at trial and on brief for establishment of the partnership. The estate contends:

> Morton's primary reason for transferring the Portfolio to the Partnership was to create an arrangement that would protect from Lynn's creditors, the assets that Lynn would receive or inherit from Morton. * * *
>
> * * * * * * *
>
> Once Morton learned of the [arbitration] award and its seriousness, he knew that he needed to address his concerns about Lynn's handling of her finances in a different manner than that provided in the Trust. Pursuant to Article V of the Trust agreement, on Morton's death, Lynn' [sic] share would be distributed to her outright. Following such distribution, Lynn would have the responsibility to manage her assets and Lynn's creditors could reach them without restriction or limitation. This was unacceptable to Morton.
>
> * * * * * * *
>
> Therefore, by placing Michael in charge of the Partnership and providing by gift and on Morton's death that all but a fraction of Lynn's interest would be held as a limited partner, Morton addressed his concerns about Lynn. Lynn's creditors would be inhibited due to the legal limitations of collecting a judgment from a limited partner's interest. [Citations omitted.]

The emphasis of this discussion is patently post mortem as opposed to inter vivos. Hence, not only the objective evidence concerning HFLP's history but also the subjective motivation underlying the entity's creation support an inference that the arrangement was primarily testamentary in nature. The objective record belies any significant predeath change, particularly from the standpoint of economic benefit, in the partners' relationship to the assets. Likewise, the subjective impetus prompting

decedent to form HFLP centered on what would happen to his property after death. He wanted to protect what Lynn would receive from him, not what she currently possessed.

Other facets of the entity's establishment are similarly consistent with a testamentary arrangement. In particular, the largely unilateral nature of the formation, the extent and type of the assets contributed thereto, and decedent's personal situation are indicative. Michael testified that decedent made all decisions regarding the creation and structure of the partnership. During cross-examination he stated: "We really didn't discuss anything. He told me what he wanted to do and he explained why, and I accepted the assignment." Later, when asked why the guaranteed payment clause was added to the HFLP Agreement, Michael replied: "The same reason every provision was put in the agreement. * * * Specifically, because that's what he wanted." Such statements are far more consistent with a description of one man's estate plan than with any sort of arm's-length transaction or joint enterprise between partners.

The fact that the contributed property constituted the majority of decedent's assets, including nearly all of his investments, is also not at odds with what one would expect to be the prime concern of an estate plan. We additionally take note of decedent's advanced age, serious health conditions, and experience as an attorney.

In summary, we are satisfied that HFLP was created principally as an alternate testamentary vehicle to the Trust. Taking this feature in light of all that is discussed above, we conclude that decedent retained enjoyment of the contributed property within the meaning of section 2036(a).

D. Existence of Consideration

Having decided that decedent retained enjoyment of the transferred assets for purposes of section 2036(a), we turn to the question whether the statute's application may nonetheless be avoided on the basis of the parenthetical exception for "a bona fide sale for an adequate and full consideration in money or money's worth". The estate contends:

> The primary reason why I.R.C. §2036 does not apply to Petitioner is that the Trust's transfer of the Portfolio to the Partnership in exchange for a credit to its capital account for 99% of the fair market value of the Portfolio assets and a 99% interest in profits and losses is a "bona fide sale for an adequate and full consideration in money or money's worth." * * *

We, however, disagree on the ground that the estate's position fails to take into account significant aspects of the jurisprudence addressing this exclusionary language. The phrase, as used in a predecessor statute, was explained in early caselaw of this Court, as follows:

> Accordingly, the exemption from tax is limited to those transfers of property where the transferor or donor has received benefit in full consideration in a genuine arm's length transaction; and the exemption is not to be allowed in a case where there is only contractual

> consideration but not "adequate and full consideration in money or money's worth." * * * [Estate of Goetchius v. Commissioner, 17 T.C. 495, 503 (1951).]

It has similarly been stated in construing the "bona fide sale" terminology: "The word 'sale' means an exchange resulting from a bargain". Mollenberg's Estate v. Commissioner, 173 F.2d 698, 701 (2d Cir. 1949). The foregoing interpretations have subsequently been cited with approval in related contexts by both this and other Federal courts. See, e.g., Bank of N.Y. v. United States, 526 F.2d 1012, 1016-1017 & n.6 (3d Cir. 1975) (noting that "the statutory basis for requiring an arm's length bargain would seem to be the requirement of a 'bona fide' contract"); Estate of Morse v. Commissioner, 69 T.C. 408, 418 (1977) (observing that judicial decisions refer to a bona fide contract "as an arm's-length transaction or a bargained-for exchange"), affd. 625 F.2d 133 (6th Cir. 1980); Estate of Musgrove v. United States, 33 Fed. Cl. 657, 663-664 (1995). From the above language it can be inferred that applicability of the exception rests on two requirements: (1) A bona fide sale, meaning an arm's-length transaction, and (2) adequate and full consideration.

On the facts before us, HFLP's formation at a minimum falls short of meeting the bona fide sale requirement. Decedent, independently of any other anticipated interest-holder, determined how HFLP was to be structured and operated, decided

what property would be contributed to capitalize the entity, and declared what interest the Trust would receive therein. He essentially stood on both sides of the transaction and conducted the partnership's formation in absence of any bargaining or negotiating whatsoever. It would be an oxymoron to say that one can engage in an arm's-length transaction with oneself, and we simply are unable to find any other independent party involved in the creation of HFLP.

Furthermore, lack of a bona fide sale aside, we believe that to call what occurred here a transfer for consideration within the meaning of section 2036(a), much less a transfer for an adequate and full consideration, would stretch the exception far beyond its intended scope. In actuality, all decedent did was to change the form in which he held his beneficial interest in the contributed property. We see little practical difference in whether the Trust held the property directly or as a 99-percent partner (and entitled to a commensurate 99-percent share of profits) in a partnership holding the property. Essentially, the value of the partnership interest the Trust received derived solely from the assets the Trust had just contributed. Without any change whatsoever in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise, there exists nothing but a

circuitous "recycling" of value. We are satisfied that such instances of pure recycling do not rise to the level of a payment of consideration. To hold otherwise would open section 2036 to a myriad of abuses engendered by unilateral paper transformations.

We note that the foregoing interpretation is supported by our holdings in both Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000), and, by implication, Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242. In Estate of Reichardt v. Commissioner, supra at 155-156, the taxpayer contended that the parenthetical exception should apply. We, however, rejected this argument, observing that neither did the decedent's children give anything to him or to the partnership at the time he contributed his assets nor did he sell the transferred property to the entity. Id. In Estate of Schauerhamer v. Commissioner, supra, the contributed assets were included in the decedent's gross estate under section 2036(a) without discussion of the exception, leading to the inference that it would not apply in such circumstances.

We further are convinced that the cases cited by the estate do not require a contrary conclusion. The estate points in particular to Estate of Jones v. Commissioner, 116 T.C. 121 (2001); Estate of Strangi v. Commissioner, 115 T.C. 478 (2000); Shepherd v. Commissioner, 115 T.C. 376 (2000), affd. 283 F.3d 1258 (11th Cir. 2002); Estate of Harrison v. Commissioner, T.C.

Memo. 1987-8; and Church v. United States, 85 AFTR 2d 2000-804, 2000-1 USTC par. 60,369 (W.D. Tex. 2000), affd. without published opinion 268 F.3d 1063 (5th Cir. 2001). The estate apparently argues that the just-cited cases establish that a proportionate partnership interest constitutes per se adequate and full consideration for contributed assets. We believe, however, that any such global formulation would overreach what can be drawn from the decisions.

First, with respect to Estate of Jones v. Commissioner, supra, Estate of Strangi v. Commissioner, supra, and Shepherd v. Commissioner, supra, none of these opinions involved section 2036. Rather, they considered whether gifts were made at the inception of family limited partnership arrangements. Estate of Jones v. Commissioner, supra at 127-128; Estate of Strangi v. Commissioner, supra at 489-490; Shepherd v. Commissioner, supra at 384-389. The cases therefore do not control interpretation of the requirements of section 2036. Furthermore, while section 2512(b) describes a gift as a transfer of property "for less than an adequate and full consideration in money or money's worth", there exists an equally fundamental principle that a gift requires a donee--some other individual must be enriched. In this connection, we note that Estate of Jones v. Commissioner, supra at 127-128, and Estate of Strangi v. Commissioner, supra at 489-490, which find no gift at inception, say nothing explicit

about adequate and full consideration but do refer to enhancement, or lack thereof, of other partners' interests. Hence, even if relevant here, we would be unable to conclude that these rulings resolve the question of whether a proportionate entity interest, in and of itself, constitutes adequate and full consideration for contributed assets.

Second, although Estate of Harrison v. Commissioner, supra, and Church v. United States, supra, do address section 2036, there exist significant differences between these cases, on the one hand, and Estate of Reichardt v. Commissioner, supra, and Estate of Schauerhamer v. Commissioner, supra, on the other, which distinguish the two groups. In both Estate of Harrison v. Commissioner, supra, and Church v. United States, supra, the other partners made contributions at the formation of the entity which were not de minimis in nature. The partnership entity thus served as the vehicle for a genuine pooling of interests. The court in each case then went on to conclude that the partnerships had been created for a business purpose. Estate of Harrison v. Commissioner, supra; Church v. United States, supra.

Accordingly, it is not unreasonable to assume that a genuine pooling for business purposes injects something different into the adequate and full consideration calculus than does mere, unilateral value "recycling" as seen in Estate of Reichardt v. Commissioner, supra, Estate of Schauerhamer v. Commissioner,

supra, and the present matter. In the former situation, there is at least the potential that intangibles stemming from a pooling for joint enterprise might support a ruling of adequate and full consideration. We also note that section 25.2512-8, Gift Tax Regs., specifies that transfers "made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth."

We therefore hold that where a transaction involves only the genre of value "recycling" described above and does not appear to be motivated primarily by legitimate business concerns, no transfer for consideration within the meaning of section 2036(a) has taken place. Hence, the exception provided in that statute is inapplicable. Furthermore, although section 2043 can entitle taxpayers to an offset for partial consideration in cases where a transfer is otherwise subject to section 2036, this section, too, is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration.

E. Conclusion

We conclude that the property contributed by decedent to HFLP is included in his gross estate pursuant to section 2036(a). We further note that, given the foregoing conclusion, we need not reach respondent's additional argument for includability, which argument is premised on disregard of the partnership for lack of

economic substance, a judicial doctrine. Likewise, we need not address respondent's contentions with respect to gift tax liability, as those determinations were made in the alternative to full inclusion based on either section 2036(a) or the economic substance doctrine. Accordingly, we now turn to valuation of the assets to be included in the gross estate.

IV. Valuation

A. Introduction and General Rules

Given our resolution above, the valuation inquiry with which we are concerned is the value on February 1, 1995, decedent's date of death, of the property previously transferred by decedent to the partnership. In other words, we must ascertain the value of HFLP's underlying portfolio assets, without regard to any claimed discounts attributable to the partnership form.

As used in transfer tax statutes, value denotes fair market value, meaning "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 to sell and both having reasonable knowledge of relevant facts." Sec. 20.2031-1(b), Estate Tax Regs. Both parties submitted expert reports in support of their contentions regarding the fair market value of all property held by the partnership, referred to as HFLP's net asset value. Clint

Cronkite, CA, ASA, prepared reports on behalf of the estate,[1] and John A. Thomson, ASA, MAI, prepared reports on behalf of respondent. We evaluate expert testimony in light of all evidence contained in the record and may accept or reject the proffered opinions, in whole or in part, according to our own judgement. Helvering v. Natl. Grocery Co., 304 U.S. 282, 295 (1938); Shepherd v. Commissioner, 115 T.C. at 390. In particular, "'The persuasiveness of an expert's opinion depends largely upon the disclosed facts on which it is based.'" Shepherd v. Commissioner, supra at 390 (quoting Estate of Davis v. Commissioner, 110 T.C. 530, 538 (1998)).

The respective appraisals by Mr. Cronkite and Mr. Thomson of HFLP's net asset value are summarized below:

ASSET	Mr. Cronkite	Mr. Thomson
Cash	$2,517	$2,517
Marketable Securities (M.L. Stern & Co. Account)	832,299	832,299
California Tax-Free Income Fund (M.L. Stern & Co. Account)	63,817	63,817
Franklin AGE High Income Fund	69,130	69,130
Franklin California Tax-Free Fund	249,979	249,979
Putnam American Government Income Fund	71,017	71,017

[1] The report submitted on behalf of the estate valuing HFLP as of February 1, 1995, contains a certification signed by both Mr. Cronkite and Helena Nam Reich, ASA. However, because it is Mr. Cronkite who testified at trial, whom both parties refer to as petitioner's expert, and whose qualifications have been stipulated by the parties, we adopt a similar convention of referring solely to Mr. Cronkite.

Rockefeller Center Properties, Inc. - Common	14,375	14,375
Note Receivable (Marsh note)	300,000	405,000
NET ASSET VALUE	$1,603,134	$1,708,134

As can be seen from the foregoing table, the only difference reflected in the net asset value analyses of the parties' experts lies in their valuation of the Marsh note.[2] This level of agreement is logical in light of the fact that the remaining assets, in addition to cash, consisted of marketable securities and mutual funds. Before proceeding to address the Marsh note specifically, however, we deal with a question that has arisen concerning burden of proof.

B. Burden of Proof

The estate's opening brief contains the statement that "the only matter as to which Petitioner bore the burden of proof was the determination of fair market value." Respondent's opening brief refers to the estate's failing to satisfy its burden but also includes the following remark: "Even if respondent had the burden with respect to the valuation of the property, the evidence produced by respondent clearly satisfies any such burden. See Estate of Mitchell v. Commissioner, 250 F.3d 696

[2] Although one of the summary tables contained in Mr. Thomson's report states a value of $69,310 for the Franklin AGE High Income Fund, the $69,130 figure is used elsewhere in the report and is necessary to derive the oft-repeated total of $1,708,134. We conclude that the $69,310 amount should be disregarded as a transcription error.

(9th Cir. 2001) [affg. in part and vacating and remanding in part T.C. Memo. 1997-461]." The estate's reply brief then focuses on the foregoing citation to Estate of Mitchell v. Commissioner, supra, in arguing that respondent does in fact bear the burden of proof in this situation.

The Court of Appeals for the Ninth Circuit, to which appeal in this case would normally lie, has addressed the issue of burden of proof in valuation cases in a series of three recent decisions. Estate of Mitchell v. Commissioner, supra; Estate of Simplot v. Commissioner, 249 F.3d 1191 (9th Cir. 2001), revg. and remanding 112 T.C. 130 (1999); Morrissey v. Commissioner, 243 F.3d 1145 (9th Cir. 2001), revg. and remanding Estate of Kaufman v. Commissioner, T.C. Memo. 1999-119. In each of these cases, the Commissioner determined an estate tax deficiency based upon an increase in the fair market value, over that claimed on the tax return, of shares in a closely held corporation. Estate of Mitchell v. Commissioner, supra at 698-699; Estate of Simplot v. Commissioner, supra at 1193; Morrissey v. Commissioner, supra at 1147. Subsequently, the Commissioner submitted for trial expert reports opining, and/or the Commissioner conceded, that the value of the subject stock was less than that asserted in the statutory notice. Estate of Mitchell v. Commissioner, supra at 702; Estate of Simplot v. Commissioner, supra at 1193-1194; Morrissey v. Commissioner, supra at 1147. Confronting this scenario, the

Court of Appeals in each instance indicated that the deviation in the Commissioner's litigation posture from the valuation stated in the notice resulted in a forfeiture of any presumption of correctness and/or a placing of the burden of proof on the Commissioner. Estate of Mitchell v. Commissioner, supra at 702; Estate of Simplot v. Commissioner, supra at 1193; Morrissey v. Commissioner, supra at 1148-1149.

Under the rule of Golsen v. Commissioner, 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir. 1971), this Court will "follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals". We also acknowledge that the notice of deficiency issued with respect to decedent's estate tax placed a value of $1,750,000 on decedent's interest in the assets held by HFLP, while the expert report and posttrial briefs submitted by respondent advocate a value of $1,708,134. Nonetheless, the record in this case is such that our conclusion would be the same regardless of any presumption of correctness or the falling of the burden of proof. We therefore need not further probe the implications here of the above-described decisions by the Court of Appeals for the Ninth Circuit and shall base our ruling on the preponderance of the evidence.

C. Value of Marsh Note

The subject note, with principal amount of $450,000, was issued on April 15, 1991. Jack P. Marsh was the maker, and the Trust was the payee. The original due date was April 14, 1992, and the original interest rate borne by the note was 10.75 percent. As of decedent's date of death, the note had been renewed annually for 1-year extensions, the interest rate had been reduced to 10 percent, and payments of interest were current.

The Marsh note was secured by collateral in the form of a 45-percent interest in a $1 million note, which note in turn was secured by a deed of trust on Carson Harbor Village, a mobile home park. Jack P. Marsh was the payee of the $1 million note and beneficiary of the deed of trust, and Carson Harbor Village, Ltd., was the payor and trustor. Carson Harbor Village, Ltd., was a limited partnership of which Goldstein Properties, Inc., was the general partner. James F. Goldstein, as president of Goldstein Properties, signed the $1 million note and related deed of trust on behalf of Carson Harbor Village, Ltd.

i. Mr. Cronkite's Report

Mr. Cronkite, at the outset of his report, states the terms of the Marsh note and indicates that it is secured by a collateral interest in the aforementioned note secured by deed of trust. He continues: "In addition to this note, there is a

first trust deed in the amount of approximately $10-$11 million." In estimating the fair market value of the Marsh note, Mr. Cronkite utilized two approaches: (1) An income approach, discounting future interest income to present value at its required yield; and (2) a market approach, discussing the loan with Mr. Marsh, an alleged secondary loans expert.

With respect to the income approach, Mr. Cronkite explained that the higher the inherent risk in an income stream, the higher the required yield to be used in computing present value. The portion of his report concerning selection of the required yield to be employed here reads:

> The appropriate yield for an investment in this note was estimated based on a review of the May 1, 1991 Note Secured By Deed Of Trust, which stipulates that in the event of default, the unpaid amounts will bear interest at the Contract Rate plus 5% per annum. We concluded that 15% was an appropriate yield on this basis.

This 15-percent rate is then used in conjunction with a present value formula to produce a $300,000 fair market value for the subject note.

The section of Mr. Cronkite's report addressing the market approach references discussions with Mr. Marsh and then sets forth the following:

> According to Mr. Marsh, the $1,000,000 loan was intended to be interim financing only. Harbor Village intended to refinance its property, but encountered environmental issues.

> Although the loan is current, Mr. Marsh estimates that he could only get $0.70 to $0.80 on the dollar for a 100% interest, and perhaps $0.60 to $0.70 for a 45% interest (due to liquidity factors).
>
> Based on the above, we conclude that the fair market value of the Marsh note is $300,000 (approximately 65% of $450,000).

ii. Mr. Thomson's Report

Mr. Thomson in his report preceded valuation of the Marsh note with a discussion of certain factual assumptions underlying his analysis. The report refers to the $1 million note as equating to "more than 2 to 1 coverage" for the Marsh note and mentions personal guaranties by Mr. Marsh and Mr. Goldstein. Mr. Thomson also addresses several items relating to the security for the $1 million note; namely, the value of the mobile home park, the existence of any prior liens against the park, and possible environmental issues pertaining to the park.

Mr. Thomson appraised the 410-unit mobile home park and concluded that it "could command a price of $40,000 to $50,000 per unit or $16.0 to $20.0 million based on other mobile home park sales we are familiar with in Southern California." As regards potential prior liens, the report states:

> We requested any other Trust Deeds (notes), if any, against the Carson Harbor Village Mobile Home Park which may have a senior position to the $1,000,000 Deed of Trust. However, we were not provided any data on this request from the taxpayor [sic]. We did obtain a property profile from Chicago Title which showed no recorded liens as of the appraisal date.

Concerning environmental issues, Mr. Thomson reviewed Park Environmental Corporation's environmental analysis dated June 10, 1994, and requested, but was not provided, sections of a remedial action plan dated January 26, 1995, outlining procedures for removal and disposal of waste material. Cleanup was ultimately assumed to require minimal cost in comparison to the overall property value, such that it would not significantly influence refinancing or sale.

In then determining whether the Marsh note should be valued at a discount to its face value, Mr. Thomson weighed five factors. These were: (1) The collateral securing the note; (2) the existence of guaranties relating to the note and its collateral; (3) the interest rate on the note; (4) previously granted extensions of the note's maturity date and the currency of payments; and (5) environmental concerns related to the collateral. Mr. Thomson concluded that, of the foregoing factors, the first three enumerated would tend to support no discount or a slight premium while the latter two would tend to support a discount.

More specifically, Mr. Thomson opined that the following facts would tend to decrease any applicable discount: (1) The Marsh note possessed good collateral coverage in that it was secured by a $1 million note, which in turn was secured by a deed of trust on a well-located mobile home park; and (2) the $450,000

note was personally guaranteed by Mr. Marsh and the $1 million note was personally guaranteed by Mr. Goldstein. Neither increasing nor decreasing any applicable discount was the fact that the interest rate, at 10 percent, was a reasonable 87 basis points over the conventional mortgage rate of 9.13 percent for the week ended January 27, 1995. Identified as tending to increase any applicable discount were facts indicating: (1) The note had been extended several times, such that there could be no assurance it would be paid in full at the upcoming maturity date without legal action, although all interest payments were current; and (2) there could be environmental concerns relative to a small section of the mobile home property, which could delay the refinancing and/or sale of the property.

After setting forth the above factors, Mr. Thomson's report concludes:

> In our opinion, based on our experience with real property and promissory notes, we believe a range of 5 to 15 percent discount would be applicable to the subject $450,000 note. Therefore, based on the factors considered and the note itself, it is our opinion that a discount of 10.0 percent is reasonable to apply to the $450,000 note in HFCL.P., as of February 1, 1995. Accordingly, we have estimated the fair market value of the $450,000 note in HFCL.P. at $405,000, or ($450,000 x (1.0-.10)).

iii. Analysis

In our comparison of the foregoing views, we generally found those of Mr. Thomson to be better explained, better supported, and more convincing. While we conclude that certain factual assumptions described in Mr. Thomson's report were not established by a preponderance of the evidence, the level of detail in the report's treatment of individual factors considered enabled us to make adjustments within what was a reasonable framework. In contrast, Mr. Cronkite's report was highly conclusory and revealed little about the underlying analysis. As a result, we could neither perform any meaningful evaluation nor ascertain that the conclusions were supported by an appropriate foundation. We therefore found Mr. Cronkite's report unpersuasive and of minimal assistance in the valuation endeavor. Accordingly, we sustain respondent's position to the extent of the reduced valuation amount discussed below for the Marsh note.

Mr. Cronkite's Approaches: We begin by addressing the difficulties encountered with Mr. Cronkite's approaches. As previously mentioned, Mr. Cronkite included in his report an income approach discounting interest income at 15 percent. Although the report explains that the required yield should reflect inherent risk in the income stream, it fails to offer any satisfactory link between this premise and the chosen 15-percent rate. Mr. Cronkite apparently added the 5-percent default

increase specified in the $1 million note to the 10-percent contract rate of the $450,000 note.[3] Why the default provisions negotiated with a different debtor nearly 4 years earlier accurately reflect the inherent risk in the Marsh note as of decedent's date of death is not elucidated. We are afforded no information on relative conditions and circumstances that would facilitate a useful comparison. It is for these reasons that we were unable to give Mr. Cronkite's income approach any significant weight in our analysis. In addition, we observe that Mr. Cronkite testified at trial to having relied primarily on the market approach in his valuation.

As regards Mr. Cronkite's market approach, our concerns in many respects parallel those highlighted above in connection with the income approach. Again, the report is cursory, conclusory, and reveals little underlying reasoning that would enable us to evaluate the result reached. The report sets forth value estimates made by Mr. Marsh and characterizes Mr. Marsh as "a secondary loans expert". Mr. Cronkite explained at trial only that Mr. Marsh "represented to me that he was an expert in the secondary loan market." When questioned regarding Mr. Marsh's

[3] Although the estate on brief refers to 15 percent as "the default rate under the Marsh Note" and respondent similarly characterizes 15 percent as "the default rate on the note", the copy of the Marsh note itself in the record does not contain any provisions regarding a default rate. Rather, the $1 million note, which bears a contract rate of 11.25 percent, specifies a default rate of the contract rate plus 5 percent.

role in the valuation, Mr. Cronkite testified: "I relied primarily on an expert in the field to establish what the fair market value of the note was. I did some checking on that for reasonableness, determined that his analysis was reasonable." Mr. Cronkite also answered in the affirmative to an inquiry asking: "So, then, you essentially took your value of the note from Mr. Marsh, or based a good part of your conclusions on Mr. Marsh's own opinion?"

We, however, know almost nothing about the qualifications of Mr. Marsh beyond the fact that he was involved in lending the $1 million to Carson Harbor Village, Ltd., and was payee of the note for that amount and beneficiary of the related deed of trust. We are equally uninformed about the nature of the discussions that led to his appraisal. To wit, we are unaware of whether the figures were merely an offhand estimate or followed a period for study or evaluation. Mr. Marsh did not appear or testify at trial. Accordingly, we are asked to accept his opinions, as reported by Mr. Cronkite, without any opportunity to probe their foundation or any assurances that he was qualified to render them. We also note that his independence for purposes of offering a neutral opinion is not free from doubt. Furthermore, although Mr. Cronkite stated that he checked Mr. Marsh's analysis for reasonableness, he gave no indication whatsoever of the

materials or information that figured in such corroboration. His assertions therefore can do little to increase our confidence.

Another difficulty we have with the valuation produced by Mr. Cronkite's market approach is the lack of explanation concerning the factors taken into account in arriving at the discount. Environmental issues are mentioned, and Mr. Cronkite testified that this factor was very important to Mr. Marsh. When asked what studies he reviewed in making a conclusion as to the environmental problem, Mr. Cronkite responded:

> You know, I don't--I don't recall actual studies. I believe I had a lot of correspondence regarding the environmental issues. My discussion with Mr. Marsh--he was certainly well aware of them. The fact that they couldn't get, you know, refinancing due to the environmental concerns was an issue, but my understanding was, there was no dollar amount, you know, put on this, this liability.

These remarks, and the reference to environmental issues in the report, fall short not only of assuring us that Mr. Cronkite had a reliable foundation for his understanding of the seriousness of the environmental problem but also of permitting us to assess the role it played relative to any other factors. We therefore are unable to accept portions of the analysis while making adjustments in other aspects that we might find unsupported by the evidence. Nor can we usefully compare components as between the two experts. We are placed in a position of having largely to embrace or reject Mr. Cronkite's

conclusions in wholesale fashion. As a consequence, Mr. Cronkite's market approach, too, offers only a modicum of guidance in valuing the subject note.

Mr. Thomson's Approach: We now address Mr. Thomson's approach, which weighed five factors in arriving at a 10-percent discount for the Marsh note. We deal with each of these components seriatim, beginning with the factor addressing collateral coverage. Mr. Thomson opined that collateral coverage on the Marsh note was good and cited both the $1 million note secured by deed of trust and the underlying mobile home park in support of this assertion. The estate raises several points in response to Mr. Thomson's position on coverage, one of which involves the existence of a senior lien on the mobile home park.

As previously mentioned, Mr. Cronkite's report references a first trust deed in the amount of $10 to $11 million; Mr. Cronkite testified at trial that this statement was based on his discussion with Mr. Marsh and that he had seen no documents related to the encumbrance.

We pause here to note that the estate attempted at trial to introduce public records from the Los Angeles County Recorder's Office relating to the alleged first lien. Respondent's objection to these documents was sustained on the grounds that the information was requested from the estate during discovery, was not provided, and should have been stipulated and/or

exchanged prior to trial in accordance with Rule 91 and this Court's Standing Pre-Trial Order. Presumably Mr. Thomson was unaware of these documents when formulating his expert opinion, since he makes no mention of them. The Court deemed the consequent surprise significant in these circumstances. The estate then sought by requests and motions filed after trial to have judicial notice taken of the documents. Such submissions were denied as an improper attempt to augment the closed record without the concurrence of the opposing party.

Mr. Thomson relied on a property profile from Chicago Title showing no prior liens, but this document has not been made a part of the record. The record also leaves unclear the extent to which the property profile would have contained historical data reflecting encumbrances as of February 1, 1995. As a result, we are not satisfied that either expert relied on adequate information in developing his opinion.

However, even if we were to hypothesize the existence of a first lien, we do not believe that Mr. Thomson's more general reliance in valuing the Marsh note on good collateral coverage would be appreciably weakened. Because Mr. Thomson appraised the mobile home park at $16 to $20 million, generous coverage would not cease to exist merely on account of a first trust deed in the $10- to $11-million range.

Furthermore, the record contains no materials that undermine the value placed by Mr. Thomson on the park, prior to consideration of environmental issues, or offer an alternative figure. Mr. Cronkite did not inspect the mobile home park or perform a real estate appraisal, and his professional qualifications do not reveal any expertise in the real estate area. Mr. Thomson, on the other hand, is a licensed real estate appraiser and broker in the State of California. He testified to having appraised mobile home parks. We thus are confident that he would have been in a position to make an informed judgment about a general value range in comparison to other Southern California mobile home park sales. In addition, the fact that the park was refinanced in 1997, after the year in issue, for nearly $16 million also lends a degree of credence to Mr. Thomson's numbers.

Another point raised by the estate concerns references in Mr. Thomson's report to the coverage provided by the primary collateral, the $1 million note, as "more than 2 to 1". Although the actual coverage is only "1 to 1", inasmuch as the Marsh note was secured by a 45-percent interest in the $1 million note, we again do not believe that this fact, in and of itself, eviscerates the basic premise of good coverage. We are equally unconvinced that any of the various other contentions made by the estate on brief render unreasonable the conclusion that the Marsh

note was well covered by collateral. Hence, while we acknowledge that the level of coverage was not as great as Mr. Thomson may have assumed, we remain satisfied that good coverage could appropriately be considered as a positive factor enhancing the value of the subject note.

We next address the factor involving personal guaranties, about which the parties express significant differences. Mr. Cronkite indicated at trial that he was not aware of any personal guaranties at the time he prepared his report, while Mr. Thomson took guaranties into account in his valuation. The record contains no guaranty agreement or document relating to either the Marsh note or the $1 million note, and the notes themselves bear no evidence of a guarantor. Instead, guaranties are referred to in several items of correspondence which passed between Mr. Marsh and either decedent or Michael. The first is an April 15, 1991, letter from Mr. Marsh to decedent. This letter adverts to the new $450,000 promissory note and concludes with the following paragraph:

> I am proceeding with the closing of the $1,000,000.00 loan to James Goldstein that will be adequately secured by a Note secured by Deed of Trust on real property. I, of course, will have all the necessary personal guarantees, etc. on same. If, for any reason whatsoever, this loan does not close within the next fifteen days, your funds will be returned to you upon demand plus 10 3/4% interest from April 15, 1991. If the loan closes, Morton B. Harper, Trustee of the Morton B. Harper Revocable Trust Dated December 18, 1990, will be assigned, as collateral, a 45% interest

> in the $1,000,000.00 Note. Your investment will also be personally guaranteed by myself along with the personal guarantee of James Goldstein.

Then, in a second letter from Mr. Marsh to decedent, dated June 6, 1991, Mr. Marsh enumerates five enclosed documents. The first four pertain to the $1 million note and deed of trust. The fifth item is "Personal Guarantee dated May 1, 1991, executed by Jack P. Marsh."

Later, an August 15, 1994, letter from Michael to Mr. Marsh advised that the Trust's interest in the Marsh note had been assigned to the partnership and asks Mr. Marsh to acknowledge his agreement that "all preexisting assignments of the collateral Note and Deed of Trust security and also your Guarantee dated May 1, 1991 remain in full force and effect for the benefit of" HFLP. The August 28, 1994, letter agreement between Mr. Marsh and the Trust then similarly declares that security for the $450,000 investment funds is assigned to the partnership and that "Jack P. Marsh's personal guarantee for the $450,000.00 investment funds is still in effect and is transferred to" HFLP.

Lastly, a February 10, 1995, letter from Mr. Marsh to Michael states that the "$450,000.00 Note is personally guaranteed by Jack P. Marsh" and that the "$1,000,000.00 Carson Harbor Village, Ltd. Note is personally guaranteed by James Goldstein."

In assessing the import of this documentary evidence, we must also be conscious of relevant provisions of State law. Cal. Civ. Code sec. 2787 (West 1993) defines "guarantor" for purpose of the statutes relating to rights and obligations which arise out of a guaranty relationship:

> The distinction between sureties and guarantors is hereby abolished. The terms and their derivatives, wherever used in this code or in any other statute or law of this State now in force or hereafter enacted, shall have the same meaning, hereinafter in this section defined. A surety or guarantor is one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor. * * *

Against the foregoing backdrop, we first consider the existence of any guaranty by Mr. Marsh. Clearly, Mr. Marsh and the Harpers were under the impression that Mr. Marsh had executed a personal guaranty on May 1, 1991. However, to the extent that the purported guaranty existed and was of the $450,000 note, we conclude that it should be disregarded in the valuation process. The $450,000 note on its face is an unrestricted personal obligation of "Jack P. Marsh". Accordingly, any personal guaranty thereof would fail to conform to the definition of a guaranty under California law, would be no more than a redundant second promise to pay personally, and would not appreciably enhance the value of the note. Furthermore, to the extent that the context provided by certain of the above letters could support an inference that Mr. Marsh's alleged May 1, 1991,

guaranty was actually of the $1 million note, the evidence is ambiguous and fails to establish such a guaranty by a preponderance.

Concerning a possible guaranty of the $1 million note by Mr. Goldstein, we again find the record insufficient to meet respondent's burden. While the April 15, 1991, letter indicates prospectively that Mr. Marsh intended to seek a guaranty from Mr. Goldstein, the absence of any reference to a Goldstein guaranty in the June 6, 1991, letter is conspicuous. The June 6, 1991, letter specifically enumerates documents pertaining to the $1 million note, as well as a personal guaranty by Mr. Marsh. The omission of any mention of a guaranty by Mr. Goldstein could certainly imply that the anticipated assurance was not obtained. The only other item which alludes to a Goldstein guaranty is the February 10, 1995, letter written nearly 4 years later. Given this record, we are not convinced that the latter document sufficiently overcomes the inference which can be drawn from the more contemporaneous letters. In summary then, we conclude that, on the evidence before us, personal guaranties should not be considered as a factor enhancing the value of the Marsh note.

As regards the factor directed toward the interest rate on the note, Mr. Thomson found this element to be neutral. Mr. Thomson compared the 9.13-percent conventional mortgage rate for the week ended January 27, 1995, as reported in the Federal

Reserve Statistical Release, to the 10-percent rate born by the Marsh note. He concluded that the spread of 87 basis points was reasonable. Mr. Cronkite indicated that he did not research interest rates, the estate has offered no alternative evidence or position, and we have no grounds for doubt of Mr. Thomson's assumptions on this matter.

Turning to the two factors that Mr. Thomson felt would increase any applicable discount, we begin with that pertaining to maturity date and extensions. Mr. Thomson indicated that, given the repeated annual extensions of maturity, there existed a lack of assurance that the note would be paid in full at its upcoming due date. He viewed this circumstance as one which would favor an increase in discount. Again, the estate has not challenged the foregoing premise, and we note Mr. Cronkite testified with similar import. Mr. Cronkite stated: "whether there's a pending maturity date, I think is kind of moot. I believe everyone thought it wouldn't--it wouldn't be paid at the maturity date." We find Mr. Thomson's analysis of maturity issues to be logical.

The remaining factor identified by Mr. Thomson as tending to support an increased discount focuses on environmental concerns. Both parties and their experts are in agreement insofar as the notion that environmental issues relating to the mobile home park detract from the value of the Marsh note. The estate, however,

places a far greater emphasis on this factor and alleges that Mr. Thomson trivialized the seriousness of the Carson Harbor Village property's environmental condition. Mr. Cronkite, as we have previously discussed, offered generalized testimony portraying the environmental issues as very important to Mr. Marsh but conceded that he had not reviewed any environmental studies in preparing his report. He also cited the fact that refinancing for the property was not obtained until 1997 as an indication of the seriousness of the problem.

Mr. Thomson reviewed an analysis by Park Environmental Corporation and requested, but was not provided, portions of a study by McLaren/Hart addressing remedial action. Mr. Thomson testified that in reading the materials obtained he did not perceive any groundwater contamination but did see mentioned a surface tarlike substance which seemed to be confined to a relatively small, 20- to 30-foot area of the property. Mr. Thomson described his assessment of this information: "Well, as an investor wanting to buy that note, I would be concerned about the environmental, and that did--that's what really generated our discount. I would be concerned. I didn't think it was a big impact, but it was an impact that was--could delay the

refinancing." In a similar vein, his report assumes a comparatively minimal cleanup cost but does recognize the factor as a contingency detracting from the value of the note.

On this record, we believe that Mr. Thomson has taken the better supported and more convincing position on environmental issues. He reviewed objective materials and was able to offer specifics relating to the physical condition of the property. Mr. Cronkite relied almost exclusively on the generalized opinion of Mr. Marsh. While we understand that Mr. Marsh was the beneficiary of the $1 million note secured by the park, we are uninformed as to the nature, extent, or basis of his knowledge regarding the park's environmental profile. Additionally, although both sides acknowledge a delay in refinancing that could have been attributable to environmental problems, we saw before us no evidence confirming the degree to which environmental concerns figured in financing negotiations. We therefore conclude that Mr. Thomson appropriately took environmental issues into account as one of several factors affecting value and was not compelled to give greater emphasis to this feature.

The foregoing evaluation thus results in a scenario comprising one factor tending to decrease and two tending to increase any applicable discount, with the other two factors being either neutral or irrelevant. Mr. Thomson used these five factors to place the discount for the Marsh note within a 5- to

15-percent range. With two positive and two negative elements, Mr. Thompson appears to have selected the midpoint of the range, or 10 percent.

As to the range itself, Mr. Thomson's report states that the numbers are "based on our experience with real property and promissory notes". When asked at trial whether he was aware of any note transactions or published compilations of note transactions to use as comparables, Mr. Thomson responded: "Specific transactions? As a California real estate broker, I get information all the time. I'm not specifically aware of any source that necessarily tracks--are you saying trust deeds? * * * [Counsel replies affirmatively.] I get brokers sending me stuff all the time, but I don't have anything specific to track them." Mr. Thomson also indicated that he could conceive of situations where discounts would be 33 percent or greater, as where a note was unsecured or bore a below-market interest rate.

Mr. Cronkite's report states: "Mr. Marsh estimates that he could only get $0.70 to $0.80 on the dollar for a 100% interest, and perhaps $0.60 to $0.70 for a 45% interest (due to liquidity factors)." These remarks would seem to refer to discount ranges for interests in the $1 million note. Mr. Cronkite thus apparently selected a discount for the Marsh note based on what Mr. Marsh "estimate[d]" he could "perhaps" get for sales of the $1 million note. Yet Mr. Cronkite at trial neither expounded

upon the basis for Mr. Marsh's ranges nor provided any exegesis for his derivation therefrom of a 33.33-percent discount for the Marsh note.

Faced with this limited record, we observe that both sides' treatments of discount ranges leave something to be desired in terms of support and explanation. Nonetheless, we again are satisfied that Mr. Thomson has submitted the more convincing position. We know that he is a licensed real estate broker and appraiser, and his testimony tied the selected range to data regularly received from professionals in the real estate brokerage field. In contrast, we reiterate that Mr. Marsh's alleged expertise in this area is not established by the record. We additionally repeat our concern about the complete absence of information as to the underpinnings for his views. We therefore accept Mr. Thomson's 5- to 15-percent range.

Within the above-stated range, however, we seek a discount reflective of one factor tending to decrease and two tending to increase the applicable figure, rather than an even split of factors. Accordingly, we conclude that 12 percent, or two-thirds of the spread from 5 to 15 percent (rounded), is an appropriate discount. The fair market value of the Marsh note is thus held

to be $396,000 ($450,000 x (1-.12)). This results in a total value for the HFLP assets to be included in decedent's gross estate under section 2036 of $1,699,134.

To reflect the foregoing,

Decision will be entered under Rule 155.

T.C. Memo. 2002-34

UNITED STATES TAX COURT

ESTATE OF RICHIE C. HECK, DECEASED,
GARY HECK, SPECIAL ADMINISTRATOR, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 11619-99. Filed February 5, 2002.

Decedent owned 630 shares of F. Korbel & Bros., Inc. stock representing a 39.62-percent ownership interest in the corporation.

Held: Fair market value of the shares determined. Sec. 2031, I.R.C.

Richard J. Sideman, Steven M. Katz, and George I. Hoffman, for petitioner.

Marion T. Robus, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HALPERN, Judge: By notice of deficiency dated April 16, 1999, respondent determined a deficiency in Federal estate tax of $5,427,983. Of the adjustments giving rise to that determination, the only one remaining in dispute is respondent's increase in the value of certain shares of stock included in the gross estate.

Unless otherwise noted, all section references are to the Internal Revenue Code in effect at the time of decedent's death, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some facts are stipulated and are so found. The stipulation of facts, with accompanying exhibits, is incorporated herein by this reference.

Introduction

Richie C. Heck (decedent) died on February 15, 1995 (the date of death or the valuation date). Gary Heck (sometimes, petitioner) is the special administrator of decedent's estate. At the time of the petition, petitioner resided in Santa Rosa, California. Among the assets includable in decedent's gross estate are 630 shares of stock (the shares), representing 39.62 percent, of the outstanding common stock of F. Korbel & Bros., Inc. (Korbel), a California corporation. Petitioner

timely filed a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (the estate tax return) on May 15, 1996. Petitioner did not elect alternate valuation. See sec. 2032. In the estate tax return, petitioner valued the shares at $16,380,000, or $26,000 a share. In determining a deficiency in estate tax, respondent valued the shares at $30,177,000, or $47,900 a share.

Organization and Operation of Korbel

Korbel was formed in 1903. Its business began in 1860, when three Korbel brothers purchased property in Guerneville, California, for the logging of timber. A decade later, vinifera grapes were planted on the property, and, in 1882, the first bottle of champagne was produced. Korbel has produced champagne on the property, utilizing the traditional "methode champenoise",[1] ever since.

[1] Champagne or sparkling wine (although the name "champagne", technically, refers to sparkling wine produced in the Champagne region of France, the terms "champagne" and "sparkling wine" are often used interchangeably, and are so used herein) is, in essence, wine that has been subject to a second fermentation. Premium brands, such as Korbel, utilize the French "methode champenoise", pursuant to which the second fermentation and all subsequent steps such as the removal of impurities and the addition of flavoring components take place while the champagne is in the bottle that is ultimately sold to the public. That method is much more expensive and is considered far superior to methods, such as the "Charmat process" or the "transfer method", pursuant to which certain steps do not take place in the bottle.

The Heck family purchased control of Korbel in 1954, and, in 1976, Adolf Heck (decedent's husband) became the sole shareholder of the 1,900 shares of common stock outstanding. As of 1984, Adolf and decedent each owned 950 shares. In 1984, Gary Heck acquired 380 shares (190 each from Adolf and decedent). Also, in 1984, Adolf died, Korbel redeemed 310 of his remaining 760 shares from his estate, and the remaining 450 shares passed in trust for decedent's benefit. In or around 1987, Gary Heck purchased the 450 of the shares in trust, giving him 830 shares (52.2 percent of the 1,590 shares outstanding) and leaving decedent with the remaining 760 shares. In 1989, decedent transferred 130 shares in trust for the benefit of her two grandchildren. That left decedent with 630 shares, the value of which, on the date of death, is in dispute herein.

Primarily, Korbel produces economically priced premium champagne. During the 3-year period ending with 1994, champagne sales represented approximately 70 percent of Korbel's total sales, brandy represented approximately 27 percent of such sales, and still wine accounted for the approximately 3-percent balance. At the beginning of 1995, 95 percent of Korbel's gross profits were attributable to sales of champagne and just under 5 percent to sales of brandy.

As of the valuation date, Korbel's facilities were located on 1,800 acres of land, mostly in Sonoma County. Of that

acreage, 1,099 acres were not used in Korbel's business activities, and, on the valuation date, such land had a value of $2,000 an acre.

In January 1986, Korbel elected to become an S corporation (within the meaning of section 1361(a)(1)). That election was in effect on the valuation date. Korbel's financial statements and tax returns are prepared on a calendar-year basis.

Distribution Agreement Between Korbel and Brown-Forman Corp.

In 1965, Korbel signed a marketing agreement with Jack Daniel Distillery, Lem Motlow, Prop., Inc. (Jack Daniel), granting Jack Daniel worldwide rights to buy, sell, and distribute all Korbel beverage products. Thereafter, Jack Daniel was consolidated into Brown-Forman Corp. (Brown-Forman), and, in 1987, Brown-Forman contracted to be the exclusive distributor of Korbel products.

In 1991, Korbel and Brown-Forman entered into a new distribution agreement (the agreement or the Brown-Forman agreement), effective through April 30, 2003, automatically renewable on a year-to-year basis thereafter, and cancelable on or after May 1, 1998, upon 5 years' written notice by either party to the other of its intent to cancel. The agreement granted to Brown-Forman the U.S. distribution rights for Korbel's champagne and brandy products, except for Korbel's right to sell through its on-premises wine shop. The agreement was amended in

October 1994 to grant Brown-Forman worldwide distribution rights.

In addition to dealing with the distribution of Korbel's products, the agreement grants to Brown-Forman a right of first refusal with respect to offers of Korbel's stock by family members. In that respect, the agreement provides:

> RIGHT OF FIRST REFUSAL. In the event any member of the Heck family desires to sell his or her shares of stock in KORBEL to a person who is not a lineal descendant of ADOLF L. HECK, he or she shall notify BROWN-FORMAN, in writing, giving the name of the prospective purchaser, a copy of the offer to purchase, the number of shares and the price per share. BROWN-FORMAN shall have thirty (30) days from receipt of such notice to elect to purchase and pay for the said stock at the price stated for cash. If BROWN-FORMAN does not purchase such stock within said 30 day period, it may be sold to the stated person at the stated price without any further obligation to BROWN-FORMAN, meaning that BROWN-FORMAN shall not have any further right to purchase any of the KORBEL stock sold. If KORBEL has a prospective purchaser for 50% or more of KORBEL stock who is not a lineal descendant of ADOLF L. HECK and BROWN-FORMAN does not exercise its prior right to purchase said stock, then BROWN-FORMAN shall have no further first right of refusal to buy that stock of KORBEL at any time. * * *

Financial Performance

From 1985 through 1994, Korbel's sales and net income were as follows:

Year	Revenues	Net Income
1986	$76,955,000	$17,527,000
1987	85,582,000	25,317,000
1988	86,920,000	20,177,000
1989	79,294,000	12,728,000
1990	78,646,000	11,961,000
1991	75,677,000	7,735,000
1992	77,551,000	6,720,000
1993	78,569,000	7,179,000
1994	82,758,000	11,955,000

As of December 31, 1994, Korbel's audited balance sheet showed assets valued at $83,985,000, liabilities of $10,115,000 (current liabilities of $5,456,000 and long-term obligations of $4,659,000), and shareholder equity of $73,870,000. Among Korbel's assets was a $2,209,000 interest-bearing note receivable from KFTY Broadcasting (KFTY), a company owned by Gary Heck.

In 1994, although sales of Charmat process and transfer method brands declined 11 percent, sales by domestic methode champenoise producers increased by 4 percent. Korbel's sales of champagne increased by 6 percent in 1994. That year, although Korbel was responsible for only 8.8 percent of total sales of champagne in the United States, it represented 47.6 percent of the domestic market for champagne produced by the methode champenoise.

Respondent's Expert

Respondent offered Herbert T. Spiro, Ph.D. (Dr. Spiro), as an expert witness, to testify concerning the valuation of closely held companies. Dr. Spiro is president of the American Valuation Group, Inc. (AVG), and has directed and conducted valuation studies of various types of business enterprises. The Court accepted Dr. Spiro as an expert in the valuation of closely held companies and received written reports of AVG into evidence as Dr. Spiro's direct testimony and his rebuttal testimony,

respectively. In his direct testimony, Dr. Spiro reached the conclusion that the aggregate fair market value of the shares as of the valuation date was $30,300,000, or $48,100 a share, rounded.[2]

In reaching his conclusion, Dr. Spiro utilized both a market approach and an income approach, the latter of which is based upon the discounted cashflow method. He then applied to the results under both approaches a 15-percent "liquidity discount" and a 10-percent discount for "additional risks associated with S corporations" including "the potential loss of S corporation status and shareholder liability for income taxes on S corporation income, regardless of the level of distributions." He reconciled the two approaches by applying a 70-percent weighting factor to the "indicated value" of each share under the income approach ($36,150) and a 30-percent weighting factor to such value under the market approach ($65,209), resulting in a

[2] The AVG report that constitutes Dr. Spiro's direct testimony is dated Apr. 26, 2000. The parties have stipulated, and we have received into evidence, an earlier report from AVG to respondent, dated Oct. 3, 1997, in which AVG concludes that the fair market value of the shares on the valuation date was $30,177,000. That value agrees with the value used by respondent in preparing the notice of deficiency here in issue, but it is lower than the value reached in the Apr. 26, 2000, report. On brief, respondent asks us to find that, on the valuation date, the fair market value of the shares was $30,177,000. We conclude that respondent is not asking for any increased deficiency, even though the report that constitutes Dr. Spiro's direct testimony finds a slightly higher valuation of the shares.

"weighted" share value of $44,868. He explained that "[t]he market approach is weighted less at 30 percent due to the lack of perfect comparables". Lastly, he adjusted that value upward to account for certain nonoperating assets: 1,099 acres of so-called excess land with a stipulated value of $2,000 an acre (total value: $2,198,000) and $5.25 million of "excess cash". Before making that upward adjustment, however, he applied certain discounts. He applied a 25-percent "minority" discount and, sequentially, the above mentioned 25-percent "liquidity" discount to the stipulated value of the land, reducing such stipulated value to $1,236,375, or $778 a share. He applied the additional 25-percent "minority" discount in recognition of the fact that the land value "cannot be readily realized by the minority shareholder." He applied the same 25-percent minority discount (but not the liquidity discount) to the so-called excess cash, resulting in a value of $3,939,000, or $2,477 a share. He derived his share value for Korbel of $48,123 ($48,100 rounded) and total value of decedent's 630 shares (rounded) of $30,300,000 after making the aforesaid adjustments to the value of the nonoperating assets.

Petitioner's Expert

Petitioner offered Mukesh Bajaj, Ph.D (Dr. Bajaj), as an expert witness, to testify concerning the valuation of closely held companies. Dr. Bajaj is a managing director, finance and

damages practice, of LECG, Inc. Dr. Bajaj has experience as a university professor of finance and business economics, he has lectured on valuation issues, and he has performed business valuations for purposes of litigation. The Court accepted Dr. Bajaj as an expert in the valuation of closely held companies and received his written reports into evidence as his direct and rebuttal testimony, respectively. In his direct testimony, Dr. Bajaj reached the conclusion that the aggregate fair market value of the shares as of the valuation date was $18,707,000, or $29,694 a share.

Dr. Bajaj rejected the market approach and relied exclusively upon a discounted cashflow analysis. He rejected the market approach on the ground that there were no publicly traded companies that were comparable to Korbel.

Dr. Bajaj's discounted cashflow analysis resulted in a net operating asset value for Korbel of $72,041,711. To that amount he (like Dr. Spiro) added an additional amount for nonoperating assets: $5,517,000, consisting of $2,198,000 for the excess land, $1,110,000 representing the proceeds from insurance policies on decedent's life, and $2,209,000 for the note receivable from KFTY. He then subtracted $4,918,000 of interest-bearing debt, resulting in a fair market value for Korbel as of the valuation date of $72,640,711.

Dr. Bajaj then applied a 35-percent discount to the value derived under his discounted cashflow approach, which consisted of a 25-percent marketability discount and an additional 10-percent discount to reflect the negative impact of Brown-Forman's right of first refusal and what Dr. Bajaj refers to as "agency problems" (the inability of a purchaser of decedent's minority interest to influence dividend distributions, which would be at the discretion of the controlling shareholder, Gary Heck). Application of those discounts, totaling 35 percent, resulted in Dr. Bajaj's being of the opinion that the marketable minority value of Korbel's equity as of the valuation date was $47,216,462, resulting in a value of $18,707,162 for decedent's 630 shares, or $29,694 a share.

OPINION

I. Introduction

We must determine the fair market value of decedent's 630 shares of Korbel on the valuation date. The shares were included in decedent's gross estate and reported on the estate tax return at a value of $26,000 a share. Based upon the expert testimony of Dr. Bajaj, petitioner now argues that the value of each share on the valuation date was $29,694. We interpret petitioner's change in position as a concession that the estate is liable for a portion of the deficiency, and we accept that concession. In

determining the deficiency in estate tax, respondent valued the shares at $47,900 a share.

Petitioner bears the burden of proof. Rule 142(a).

II. Law

Section 2001(a) imposes a tax on "the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." Section 2031(a) provides: "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."

Fair market value is the standard for determining the value of property for Federal estate tax purposes. United States v. Cartwright, 411 U.S. 546, 550-551 (1973). Section 20.2031-1(b), Estate Tax Regs., defines fair market value as: "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." The willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the actual buyer or seller. Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990) (citing Estate of Bright v. United States, 658 F.2d 999, 1006 (5th Cir. 1981)). The hypothetical willing

buyer and seller are presumed to be dedicated to achieving the maximum economic advantage, which advantage must be achieved in the context of market conditions, the constraints of the economy, and, assuming shares of stock are to be valued, the financial and business experience of the subject corporation existing on the valuation date. Estate of Newhouse v. Commissioner, supra.

In valuing shares of stock in a corporation whose shares are not publicly traded, the factors we take into account include net worth, prospective earning power and dividend paying capacity, and other relevant factors, including the economic outlook for the particular industry, the company's position in the industry, the company's management, the degree of corporate control represented by the block of stock to be valued, and the value of publicly traded stock or securities of corporations engaged in the same or similar lines of business. See sec. 2031(b); sec. 20.2031-2(f)(2), Estate Tax Regs.; Rev. Rul 59-60, 1959-1 C.B. 237, 238-242.

III. Expert Opinions

A. Introduction

In this case, the parties rely heavily, if not exclusively, on expert testimony to establish the fair market value of the shares as of the valuation date. Indeed, respondent's only witness was Dr. Spiro. In addition to Dr. Bajaj, petitioner called Gary Heck, decedent's son and Korbel's president and

chairman of the board, and David Faris, a Korbel assistant vice president. Formerly, Mr. Faris was a partner in the tax department of Pisenti & Brinker, C.P.A.s. In that role, he oversaw the preparation of Korbel's income tax returns, the estate tax return filed on behalf of decedent's estate, and the valuation, for gift tax purposes, of the stock that, in 1989, decedent transferred in trust for the benefit of her grandchildren. Mr. Heck did not testify as to the value of the shares, and, although Mr. Faris testified that the Pisenti & Brinker gift tax valuation, in part, formed the basis for the value of the shares set forth on the estate tax return, it is the value arrived at by Dr. Bajaj, not the value on the return, that petitioner urges us to adopt.

In deciding valuation cases, courts often look to the opinions of expert witnesses. Nonetheless, we are not bound by the opinion of any expert witness, and we may accept or reject expert testimony in the exercise of our sound judgment. Helvering v. Natl. Grocery Co., 304 U.S. 282, 295 (1938); Estate of Newhouse v. Commissioner, supra at 217. Although we may accept the opinion of an expert in its entirety, see Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 452 (1980), we may be selective in determining what portions of an expert's opinion, if any, to accept, Parker v. Commissioner, 86 T.C. 547, 562 (1986). Finally, because valuation necessarily involves an

approximation, the figure at which we arrive need not be directly traceable to specific testimony if it is within the range of values that may be properly derived from consideration of all the evidence. Estate of True v. Commissioner, T.C. Memo. 2001-167 (citing Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo. 1974-285).

B. Differences Between the Experts

The major difference between Drs. Bajaj and Spiro is their disagreement as to the propriety of utilizing a market approach (i.e., the guideline company method) in valuing the shares. Also, although both experts utilized a discounted cashflow approach in valuing the shares (Dr. Bajaj, exclusively; Dr. Spiro, in part), they disagree sharply over methodology in applying that approach. We shall analyze the arguments presented by both experts in support of their respective positions.

IV. Propriety of Dr. Spiro's Application of the Guideline Company Method

A. Introduction

The guideline company method of appraisal is commonly used in valuing shares of stock in a closely held corporation. When appropriate, its usage is mandated by section 2031(b), which provides that the value of unlisted shares of stock or securities "shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of

corporations engaged in the same or a similar line of business which are listed on an exchange." See also sec. 20.2031-2(f), Estate Tax Regs.; Rev. Rul. 59-60, 1959-1 C.B. 237, 242.

The parties sharply dispute whether (1) the two guideline companies chosen by Dr. Spiro, the Robert Mondavi Corp. (Mondavi) and Canandaigua Wine Co. (Canandaigua), were comparable to Korbel for purposes of section 2031(b), (2) Dr. Spiro actually utilized only one company, Mondavi, as a guideline company, and (3) if so, the use of a single guideline company is permissible. The parties also disagree as to the propriety of the financial ratios chosen by Dr. Spiro and his adjustments to those ratios. Petitioner also claims, and respondent denies, that Dr. Spiro's 30-percent weighting of the result of his market approach was essentially arbitrary.

B. Dr. Spiro's Guideline Companies: Mondavi and Canandaigua

1. Dr. Spiro's Method

Dr. Spiro first identified 1,317 companies listed under the Standard Industrial Classification Code (SIC) 2084, wines, brandy, and brandy spirits. Of those companies he identified only 11 that were publicly traded, and he rejected 9 of the 11 as potential comparables because, for the most part, they were either too large or diverse (or both), too small, unprofitable, or conducted business in a different manner than Korbel.

Dr. Spiro considered the remaining two companies, Mondavi and Canandaigua, comparable to Korbel.

Dr. Spiro valued Korbel's stock under the guideline company method (as of the valuation date), by reference to the 1994 fiscal yearend price to earnings (P/E) and price to operating cashflow (P/OCF) ratios for Mondavi and Canandaigua. For Mondavi, those ratios, when reduced to multiples (of earnings and OCF, respectively), were 17.51 and 9.57 and, for Canandaigua, they were 22.09 and 14.54. Dr. Spiro based Korbel's corresponding multiples on Mondavi alone, but he "adjusted" them downward, to a P/E multiple of 13 and a P/OCF multiple of 8, "to account for Korbel's additional risk factors" (i.e., the differences, discussed below, between Korbel and the guideline companies in terms of size, product mix, consumption patterns, etc.). Those derived multiples were applied, and a mean value was determined, which mean, $86,945, was Dr. Spiro's valuation (before discounting) of each share of Korbel under his market approach.

2. Comparability

Dr. Spiro treated Mondavi and Canandaigua as comparable (guideline) companies despite acknowledging that, in many significant respects, they differ markedly from Korbel.

Size: In 1994, in terms of both revenue and total assets, Canandaigua was approximately 10 times as large as Korbel.

Mondavi's gross revenue for its 1994 fiscal year was more than twice that of Korbel for its 1994 calendar year ($176,236,000 versus $82,758,000), and Mondavi's total assets at yearend were approximately triple those of Korbel ($244,236,000 versus $84,043,000).

Product Lines: Although Korbel produces some brandy and an insignificant amount of still wine, it is essentially a single product company, producing economically priced premium champagne. In 1992, Canandaigua's products included table wines, dessert wines, sparkling wines, imported beer, and distilled spirits. Sparkling wines constituted only 3.79 percent of the firm's total shipments for 1993.

As of the valuation date, Korbel marketed its champagne under two labels, Armstrong Ridge and Korbel. Canandaigua marketed its products under many brand names including Paul Masson, Inglenook, Manischewitz, Almaden, and Taylor California Cellars, for wine, and Corona, for beer. Although Canandaigua also produced and marketed six different brands of sparkling wine and maintained a 32-percent share of the sparkling wine market for 1994, all of its sparkling wines were produced using the less expensive Charmat process or transfer method, whereas Korbel utilized the methode champenoise exclusively. Canandaigua produced for the low end of the champagne market, whereas Korbel was the leading producer of premium champagne, controlling almost

50 percent of the methode champenoise or high-end market and 8.8 percent of the total domestic market. For the period 1985 through 1994, the low-end and high-end champagne markets fared differently. Sales of champagne produced by means of the Charmat process or transfer method (the low-end market) fell steadily between 1985 and 1994. In 1994, sales of the lower priced domestically produced Charmat process and transfer method labels dropped 11 percent, when compared to 1993. Canandaigua's sparkling wine sales reflected that trend in 1994, declining by about 8 percent from 1993. In sharp contrast, led by Korbel's 6-percent increase in champagne sales for 1994, 1994 sales by domestic methode champenoise producers as a whole grew 4 percent, when compared to 1993.

Mondavi markets premium still wine under seven different labels, but it produces little or no sparkling wine.[3]

Other Factors: Dr. Spiro testified that, as of the valuation date, compared to Mondavi and Canandaigua, Korbel was smaller, more profitable, and growing more slowly. It also had

[3] Both Drs. Bajaj and Spiro state that Mondavi does not produce any champagne. Gary Heck testified, however, that Mondavi produces "about 1500 cases [of champagne] that they only sell through their wine shop, kind of like we do with still wines." Even if Mr. Heck is correct, the amount of champagne produced by Mondavi is negligible in comparison with its wine production, which, for 1994, was 4,274,000 cases. Thus, as a practical matter, Mondavi was a producer of still wines, whereas Korbel was a producer of high-end champagne and a small amount of brandy.

substantially lower debt to asset and debt to equity ratios than either Canandaigua or Mondavi.

Dr. Spiro summarized the totality of the differences between Korbel and both Mondavi and Canandaigua as follows:

> Whereas both comparable companies produce and/or market many products, Korbel essentially only produces two products, champagne and brandy. Korbel also has less revenue and greater revenue variability during the course of a fiscal year than the two comparables. Korbel's greater revenue variability results from the nature of champagne consumption in the U.S., which is closely linked to celebrations and parties. This results in a seasonal sales pattern with most sales coinciding with the holiday season between Thanksgiving and New Year's Eve. In contrast, wine is consumed more steadily throughout the year, often with dinner or as a social drink. Korbel's lack of product diversification and comparatively small size tend to increase investor risk, necessitating a greater investment return. * * *

Gary Heck testified to the following significant differences between the production and marketing of wine as opposed to methode champenoise champagne: The second fermentation in the bottle, which makes production of the latter more complex, expensive, and time consuming than the production of wine; the fact that sales of champagne do not benefit from the so-called "French Paradox" (i.e., reports that link the moderate daily consumption of red wine to cardiovascular health); and the fact that champagne sales are subject to higher Federal excise taxes than are sales of wine.

3. Dr. Spiro's Opinion

In Dr. Spiro's opinion, comparability is established by the fact that both Mondavi and Canandaigua, like Korbel, produce, a

form of wine ("While Korbel occupies a specialized niche, it crushes grapes, ferments the juice and bottles the product like other producers. To argue that comparables do not exist is incorrect.").[4]

C. Rejection of Mondavi and Canandaigua as Guideline Companies

Dr. Spiro discussed the similarities and differences between both Mondavi and Canandaigua and Korbel, and he computed price to earnings and price to operating cashflow multiples for both Mondavi and Canandaigua. Nevertheless, when he applied those multiples to Korbel, he referred only to Mondavi, and he adjusted downward from the Mondavi figures. We fail to see how Canandaigua influenced Dr. Spiro's guideline analysis. It appears to us that Dr. Spiro, himself, effectively disregarded Canandaigua as a guideline company. Assuming that to be the case, respondent has failed to persuade us that we should have any confidence in Dr. Spiro's guideline analysis. In Estate of Hall v. Commissioner, 92 T.C. 312 (1989), the Commissioner's expert selected only one comparable company. The proposed comparable, American Greetings Corp. (American Greetings), was selected because it, along with Hallmark Cards, Inc. (Hallmark),

[4] Dr. Spiro's oral testimony echoed that view: "Sir, we selected * * * [Mondavi and Canandaigua] as guideline companies, as the only game in town. We did not say they were exactly like Korbel. We say they have the same general production approach. They have the same general customer base. They are all in the grape processing business. In that sense they are comparable."

the company subject to valuation, were the two leaders in the greeting card industry. The Commissioner's expert concluded that American Greetings "was the only reasonably comparable company to Hallmark because it had a similar product mix and capital structure and served the same markets." Id. at 331. We rejected the valuation report submitted by the Commissioner's expert in light of his reliance on a single comparable company in employing the market approach. In so doing, we observed that "[a]ny one company may have unique individual characteristics that may distort the comparison." Id. at 340. A sample of one tells us little about what is normal for the population in question.[5] Dr. Spiro has failed to convince us of the reliability of his guideline analysis.

Even if we were to accept that Dr. Spiro relied on both Canandaigua and Mondavi as guideline companies, as respondent argues, we would still reject Dr. Spiro's use of the market approach in this case. Respondent points out that we have approved the use of the market approach based upon as few as two guideline companies. See Estate of Desmond v. Commissioner, T.C. Memo. 1999-76. But in that case, all three companies were in the same, and not just a similar, line of business (manufacture and

[5] In his rebuttal report, Dr. Bajaj states: "The superior quality of Mondavi's wines, its innovative packaging [a new bottle with a flange top that prevented dripping and used a dot of wax instead of a foil capsule as a seal] and strong advertising coupled with its reputation as an environment-friendly producer * * * [were attributes that] were largely unique to * * * [Mondavi]". (Fn. ref. omitted.) Respondent does not challenge Dr. Bajaj on that point, which point indicates that Mondavi may not be reflective of the norm.

sale of paint and coatings). Here, Mondavi and Canandaigua were, at best, involved in similar lines of business. Under section 2031(b) and section 20.2031-2(f), Estate Tax Regs., publicly held companies involved in similar lines of business may constitute guideline companies, and we have so held. See, e.g., Estate of Gallo v. Commissioner, T.C. Memo. 1985-363, where, in valuing the stock of the largest producer of wine in the United States, we approved the use by taxpayer's experts of comparables consisting of companies in the brewing, distilling, soft drink, and even food processing industries. But, in that case, the experts used at least 10 companies as guideline companies. See also Estate of Hall v. Commissioner, supra at 325, where we adopted an expert report utilizing a market approach based upon a comparison with six somewhat similar companies. As similarity to the company to be valued decreases, the number of required comparables increases in order to minimize the risk that the results will be distorted by attributes unique to each of the guideline companies. In this case, we find that Mondavi and Canandaigua were not sufficiently similar to Korbel to permit the use of a market approach based upon those two companies alone.[6]

[6] Dr. Bajaj argues that only companies that are "primarily champagne/sparkling wine producers like Korbel" constitute permissible guideline companies. Because no such publicly traded company existed, Dr. Bajaj rejected the market approach. We find Dr. Bajaj's approach to be unduly narrow (in theory), in light of the case law cited in the text. Nonetheless, we agree, albeit for different reasons, that respondent improperly applied the market approach in this case.

Our conclusion that Dr. Spiro improperly applied the guideline company approach based upon Mondavi and Canandaigua makes it unnecessary to address petitioner's other criticisms of Dr. Spiro's application of that approach: The selection of inappropriate financial ratios, the arbitrary adjustment of those ratios, and the arbitrary nature of the weight given to the result reached by Dr. Spiro under the market approach.

D. Conclusion

Dr. Spiro improperly applied the guideline company approach in valuing the stock of Korbel.

V. Utilization of the Discounted Cashflow Method in Valuing the Stock of Korbel

A. Introduction

This Court considers the discounted cashflow (DCF) method employed by both experts to be an appropriate method for use in valuing corporate stock. See, e.g., N. Trust Co. v. Commissioner, 87 T.C. 349, 379 (1986). Moreover, where we have rejected use of the market approach as unreliable, we have based the value of a closely held corporation on the DCF approach alone. See Estate of Jung v. Commissioner, 101 T.C. 412, 433 (1993). We, therefore, find that the DCF method utilized by both experts in this case is an appropriate method for valuing the stock of Korbel as of the valuation date.

B. Analysis of the Experts' Application of the Discounted Cashflow Method

1. Introduction

Recently, in Estate of True v. Commissioner, T.C. Memo. 2001-167, we described the DCF method as follows:

> The discounted cash-flow method is an income approach based on the premise that the subject company's market value is measured by the present value of future economic income it expects to realize for the benefit of its owners. This approach analyzes the subject company's revenue growth, expenses, and capital structure, as well as the industry in which it operates. The subject company's future cash-flows are estimated, and the present value of those cash-flows is determined based on an appropriate risk-adjusted rate of return.

Drs. Bajaj and Spiro are in agreement as to the elements of the DCF valuation method: The discounted present value of cashflow projections for Korbel over a 5-year (1995-1999) period, plus Korbel's residual value at the end of the fifth year (also discounted back to present value), plus the value of nonoperating assets, less long-term debt, and less appropriate discounts, e.g., for lack of marketability. They disagree, however, regarding the computation of almost every element, including projected revenues, operating costs, capital expenditures, the rate of return to be incorporated into the discount factor, the nature and amount of the nonoperating assets, the amount of long-term debt, and the nature and amount of the discounts. We find neither of the experts totally persuasive. We accept, however, portions of the testimony of each. We shall discuss and evaluate

the various elements of both experts' DCF computations in arriving at a value for the shares.

2. Projected Cashflows

a. Sales

In projecting post-1994 sales growth for Korbel, Dr. Bajaj determined that there would be 2-percent sales growth for 1995, that the growth rate would steadily increase to 4.5 percent in 1999, and that the latter rate would prevail indefinitely for post-1999 years. Dr. Bajaj considered his forecast optimistic in light of wine industry analysts' predictions of a 2.9-percent decline in champagne consumption during the 1995-1999 period. Dr. Spiro projected a 4.5-percent sales increase for 1995, increases of 4.0, 3.5, and 3.0 percent for 1996, 1997, and 1998, respectively, and 3-percent annual increases thereafter. Dr. Spiro's forecast was primarily based upon the strong growth in Korbel's sales during 1994 and the first quarter of 1995.

We find Dr. Spiro's sales growth assumptions to be the more realistic. Projected growth for 1995 is based upon Korbel's 1994 sales growth, and subsequent years' growth is assumed to gradually decrease to the 3-percent growth rate applicable to 1992-1994, which does not differ materially from the annual compound growth rate of 3.1 percent since 1984. Dr. Bajaj's more modest sales growth projections for the early years are based upon projected sales for the champagne industry as a whole, which

includes low-end Charmat and transfer process brands. Moreover, we find no evidence in Korbel's recent sales history to justify an assumed 4.5-percent sales growth for 1999 and thereafter.

b. Operating Margin

Dr. Bajaj's projected annual operating (pretax)[7] margin (total revenues less cost of goods sold, excise taxes, depreciation, officers' compensation, and selling, general, and administrative expenses (SG&A)) for 1995 and all subsequent years is 12 percent of sales revenues. He bases his projection upon the 5-year simple average of operating margins for the 1990-1994 period. Dr. Spiro's projected annual operating margin for 1995-1999 and subsequent years is 13.3 percent of sales revenues. Dr. Spiro computes each element of cost entering into his projection of operating margin separately, in some cases based upon 2-year averages, in others, based upon 5-year averages. In computing average annual SG&A for 1990-1994, Dr. Spiro fails to include $420,000 of promotional expenses incurred by Korbel in 1993, which Dr. Spiro attributes to the launching of a new product (Armstrong Ridge champagne). Dr. Spiro considers that to be a special, nonrecurring cost that, in future years, will be borne by Brown-Forman pursuant to the Brown-Forman agreement. We do not agree with Dr. Spiro's treatment of the 1993 promotional

[7] The parties agree that the only tax applicable to the income of Korbel is California's 1.5-percent income tax on S corporations.

expense as a nonrecurring cost. Mr. Heck testified that new label promotional expenditures are a recurring feature of Korbel's business. Although the Brown-Forman agreement relieves Korbel of any responsibility to pay marketing or selling expenses ("Brand Expense") for Korbel champagne or brandy, Korbel incurred the promotional expenses in question subsequent to the 1991 effective date of the agreement, and Mr. Heck testified that a similar "spike" in Korbel's promotional costs could occur at any time. Projecting the mean annual SG&A costs for a 5-year period that includes a year of extraordinary promotional expenses associated with the introduction of a new label does not seem unreasonable.

Dr. Spiro criticizes Dr. Bajaj for relying on a simple 5-year average in projecting an annual operating margin. Yet for cost of goods sold, where Dr. Spiro uses a 2-year average to make projections, he testified, in rebuttal: "The * * * [rate chosen by Dr. Bajaj] appears reasonable although we once again question the use of a simple average." Dr. Spiro, himself, uses a 5-year average in projecting officers' compensation and SG&A. Korbel's annual operating margins for the 1990-1994 period do not show a trend, and Dr. Spiro has failed to convince us that Dr. Bajaj's use of a 5-year simple average is inappropriate. At least, it has the virtue of consistency, and for that reason, we prefer it to Dr. Spiro's approach, the inconsistency of which he did not

adequately explain. We modify Dr. Bajaj's approach only to take into account small amounts of other income, which he takes into account in his rebuttal testimony. Dr. Bajaj's projected profit margin, based upon an unweighted arithmetic average of operating margins from 1990-1994, and including "other income" (interest and "Heck Cellars" revenue), is 12.3 percent. We find that to be the proper assumed operating margin for purposes of determining Korbel's value on the valuation date under the DCF method.

c. Cashflow Adjustments

To determine cashflow, it is necessary to modify after-tax income by adding back depreciation and subtracting working capital additions and capital expenditures.

Depreciation averaged 3.8 percent of sales revenues during the 1990-1994 period and 4.1 percent for 1993 and 1994. Dr. Bajaj, relying on a 5-year average, projected depreciation at 3.8 percent of gross sales and Dr. Spiro, relying on a 2-year average, projected it at 4.0 percent of gross sales. Although, for 4 out of the 5 years, total depreciation grew as a percentage of sales revenues, the question is whether the most recent 2 years is a better measure of the trend than the last 5 years. Neither expert took the other head-on with respect to this point, and, since, in general, we found Dr. Bajaj's analysis to be more thorough than Dr. Spiro's, we shall rely on his 5-year average as determinative.

Both Drs. Bajaj and Spiro project inventory expenditures to remain constant at 50 percent of sales revenue. However, Dr. Bajaj projects "other working capital" (including cash) at 5 percent of sales whereas Dr. Spiro projects noninventory working capital at 3.5 percent of sales (in both cases, based on historical data). Dr. Spiro justifies his lower figure by discounting the 1993 and 1994 average working capital level (11.7 percent) on the ground that it was largely attributable to "excess cash". As we discuss, infra (in connection with our analysis of Korbel's nonoperating assets), we do not believe Korbel retained excess cash in 1993 and 1994. We are persuaded that Dr. Bajaj's projection of working capital levels is justified based on historical performance, and we find in accordance with his calculation.

Dr. Spiro projected annual capital expenditures by Korbel equal to $4 million for 1995 and every year thereafter. Dr. Bajaj projected annual capital expenditures on the assumption that they would equal depreciation plus 30 percent of Korbel's annual sales increases. Dr. Bajaj projected that capital expenditures would increase in an amount adequate to maintain Korbel's net fixed asset to sales ratio at 30 percent, which is slightly below the average of such ratios for the 1990-1994 period. Each expert points to unreasonable aspects of the other's approach: Dr. Bajaj to the fact that Dr. Spiro's

approach will eventually lead to negative net asset value, Dr. Spiro to the fact that Dr. Bajaj's projected increases in capital expenditures more than double his projected sales increases over the 1995-1999 period.

Korbel's financial statements for the 1985-1994 period show that, whereas depreciation increased annually, capital expenditures ("property, plant and equipment purchased") have fluctuated significantly over that same period, the low of $2,315,000 occurring in 1990 and the high of $6,142,000, in 1991. Average annual capital expenditures for the 1990-1994 period were $3,817,000. Therefore, we consider Dr. Spiro's projection of $4 million in annual capital expenditures to be reasonable, and we adopt it. Conversely, we find nothing in Korbel's financial history to support Dr. Bajaj's projection of ever-increasing annual capital expenditures.

3. Rate of Return

The DCF method involves the computation of the present value of expected future cashflows. The present value of a cashflow equals the cashflow multiplied by a discount factor (less than 1). The discount factor is usually expressed as the reciprocal of 1 plus a rate of return: Discount factor (for one period) = $1/(1 + r)$.[8] Drs. Bajaj and Spiro agree that the rate of return

[8] See Brealey & Myers, Principles of Corporate Finance 16 (6th ed. 2000) ("The rate of return *r* is the reward that

(continued...)

to be used in applying the DCF method to Korbel's cashflows is Korbel's "weighted average cost of capital" (WACC).[9] Dr. Bajaj computed the WACC as 14.22 percent; Dr. Spiro computed it as 16.54 percent. Their only significant disagreement is as to one component of the WACC, the cost of equity capital.[10] Dr. Bajaj computed the cost of equity capital as 14.70 percent; Dr. Spiro computed it as 16.71 percent.

We need not engage in an extended discussion of the appropriate cost of equity capital since, in computing the WACC, other things being equal, the higher the cost of equity capital (i.e., the larger the percentage), the larger the WACC. Given the DCF method, the larger the WACC, the lower the present value of expected cashflows. The parties endorse the DCF method, differing only as the value of certain variables. Since we are

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[8](...continued)
investors demand for accepting delayed payment.").

[9] As expressed by Dr. Spiro:

$$WACC = W_d \times K_d \times (1-t) + W_e \times K_e$$

Where:

- $WACC$ = weighted average cost of capital,
- W_d = weight of debt in capital structure,
- K_d = estimated pretax cost of debt,
- t = income taxes at 1.5 percent,
- W_e = weight of equity in capital structure, and
- K_e = cost of equity capital.

[10] Dr. Spiro defined the cost of equity capital as follows: "[T]he rate of return required by an investor as sufficient compensation for committing equity funding to the business."

deconstructing each expert's DCF analysis, and assembling our own, our adopting Dr. Bajaj's cost of equity capital cannot, in isolation, be objectionable to respondent, since respondent has proposed that we find a higher, 16.71-percent cost of equity capital. Dr. Bajaj relied on the capital asset pricing model (which takes into account exclusively systematic (or market) risk) to compute the cost of equity capital, while Dr. Spiro relied on the so-called buildup method (which pays attention to the unsystematic (or individual) risk that an investor would face in investing in Korbel). Neither expert convinced us that his approach was significantly better (on the facts at hand) than the other expert's approach, and we are satisfied that 14.70 percent (the percentage reached by Dr. Bajaj) is a reasonable figure for Korbel's cost of equity capital, and we so find.[11] We find that the WACC is 14.22 percent.

[11] In recent cases, we have criticized the use of both the capital asset pricing model (CAPM) and WACC as analytical tools in valuing the stock of closely held corporations. See Furman v. Commissioner, T.C. Memo. 1998-157. See also Estate of Maggos v. Commissioner, T.C. Memo. 2000-129 and Estate of Hendrickson v. Commissioner, T.C. Memo. 1999-278, which reaffirm that view, citing Furman, and Estate of Klauss v. Commissioner, T.C. Memo. 2000-191, where we rejected an expert valuation utilizing CAPM in favor of one utilizing the buildup method. In other recent cases, however, we have adopted expert reports which valued closely held corporations utilizing CAPM to derive an appropriate cost of equity capital. See BTR Dunlop Holdings, Inc. v. Commissioner, T.C. Memo. 1999-377; Gross v. Commissioner, T.C. Memo. 1999-254, affd. 272 F.3d 333 (6th Cir. 2001)

4. Present Value Computation: Yearend Versus Mid-Year Cashflow Convention

In computing the present value of all cashflows, Dr. Bajaj adopted a yearend convention (cashflows discounted as of yearend), while Dr. Spiro adopted a midyear convention (cashflows assumed to be received at, and discounted from, midyear). Because, under the midyear convention, the cashflow for a year is deemed to have been received 6 months earlier, the discount factor for the year is slightly greater (and the dollar amount of the discount itself is slightly smaller) than if the yearend convention is adopted. Given the same cashflow but a greater discount factor, the present value of the cashflow is greater.

The parties agree that (1) approximately 60 percent of Korbel's champagne sales occur during the last quarter of the calendar year and (2) as much as 20 percent of such sales occur during the last week of December. Since Korbel's revenues are not spread evenly throughout the year, we are unconvinced that Dr. Spiro's use of the midyear convention results in a more accurate valuation than Dr. Bajaj's use of the yearend convention. We adopt the yearend convention.

5. Increase in Korbel's Value for Nonoperating Assets

a. Introduction

The question here is whether the value of certain nonoperating assets should be added to the value determined under the DCF method in determining the value of the shares.

b. Excess Land; Insurance Proceeds; KFTY Receivable

The parties agree, and we find, that the excess land constitutes a nonoperating asset to be added to the present value of Korbel's cashflows at a value of $2,198,000 and that insurance proceeds in the amount of $1,110,000 likewise are to be so added. Although they differ in exactly how a receivable from KFTY in the amount of $2,209,000 is to be taken into account, they agree that it is to be taken into account. We agree and so find. The total of the aforesaid nonoperating assets is $5,517,000

c. Excess Cash

Dr. Spiro considered $5,250,000 of cash held by Korbel on December 31, 1994, to be a nonoperating asset, which he referred to as "excess cash". Dr. Spiro reached that conclusion by examining historical cash levels in relation to gross revenue, in order to determine the appropriate "normalized" cash level, which he determined to be 6.55 percent of gross revenue. Applying that percentage to 1994 gross revenue, Dr. Spiro concluded that Korbel had excess cash in the amount stated. In determining the value of the shares, he included only a portion of the excess cash to reflect the inability of minority shareholders to force a distribution of such cash. Dr. Bajaj concluded that there was no excess cash, and, in his rebuttal testimony, he persuasively explained his basis for that conclusion. We were impressed with his interpretation of the historical data, in light of the

information he received (the need to retain funds for a number of contingencies) on interviewing Mr. Heck. On the basis of his testimony, we find that there was no nonoperating asset consisting of excess cash.

6. Decrease in Korbel's Value by Amount of Long-Term Debt

Putting aside Drs. Bajaj and Spiro's disagreement over the treatment of the KFTY receivable, see supra p. 35, the remaining disagreement is over whether the current portion of long-term bank borrowings is a component of working capital or a long-term liability. On brief, respondent states that any resulting difference in the value of the shares is immaterial, and the choice of treatment is "a valid choice of the appraiser". We shall treat such current portion as a long-term liability.

7. Discounts

a. The Expert Testimony

Dr. Bajaj determined that the shares were subject to a 25-percent basic marketability discount. Dr. Bajaj then added an additional 10 percent to his basic marketability discount, which addition was attributable to both the right of first refusal (ROFR) held by Brown-Forman and what he refers to as "agency problems", the fact that the shares represented a minority interest unable to influence the majority shareholder's control over cash distributions. The addition of those two discounts

resulted in Dr. Bajaj's determination of an overall 35-percent discount, which he treats, in total, as a marketability discount.

Dr. Spiro determined a basic 15-percent liquidity discount,[12] increased by an additional 10 percent for risks associated with Korbel's status as an S corporation. Thus, Dr. Spiro's total liquidity discount is 25 percent, which he applies to the values that he determined under his market and income approaches (i.e., values exclusive of the value of nonoperating assets). Dr. Spiro applied specific, separate discounts to nonoperating assets: A 25-percent minority discount followed by his overall 25-percent liquidity discount applicable to "excess land"[13] and a 25-percent minority discount applicable to "excess cash".

b. Marketability Versus Minority Discounts

We have recognized that there is a distinction between a discount for lack of marketability and a discount for the minority position of the interest to be valued. As we stated in Estate of Andrews v. Commissioner, 79 T.C. 938, 953 (1982):

> The minority shareholder discount is designed to reflect the decreased value of shares that do not convey control of a closely held corporation. The lack of marketability discount, on the other hand, is

[12] We interpret Dr. Bajaj's references to a "marketability" discount and Dr. Spiro's references to a "liquidity" discount as references to the same type of discount.

[13] Because Dr. Spiro applies the two discounts consecutively, the total discount is 43.75 percent: 0.25 + (0.25 x 0.75) = 0.4375.

> designed to reflect the fact that there is no ready market for shares in a closely held corporation. Although there may be some overlap between these two discounts in that lack of control may reduce marketability, it should be borne in mind that even controlling shares in a nonpublic corporation suffer from lack of marketability because of the absence of a ready private placement market and the fact that flotation costs would have to be incurred if the corporation were to publicly offer its stock. * * *

c. Basic Discount for Lack of Marketability

Dr. Bajaj's 25-percent marketability discount is based upon a number of empirical studies, his critical evaluation of those studies, and his own multiple regression analysis of the "explanatory variables". Dr. Spiro, in his rebuttal testimony, finds no fault with Dr. Bajaj's methodology.

Dr. Spiro cites many of the same empirical studies as suggesting that liquidity discounts can range from 10 to 45 percent. He states that the average discounts were "often in excess of 35 percent." Yet, Dr. Spiro concludes that the basic liquidity discount for the shares, taking into account the ROFR, is appropriately set at 15 percent. Dr. Spiro fails to make clear, in either his primary or rebuttal report, the basis for his determination that the appropriate liquidity discount is at the low end of the acceptable range of such discounts. In his oral testimony, he set forth his theory that there was a specialized group of purchasers who would value the shares on other than an investment basis (who would eye Korbel as a possible future joint venture partner). Dr. Spiro failed to

quantify or explain how he adjusted his analysis to take account of that factor. Indeed, such factor has recently been rejected by the Court of Appeals for the Ninth Circuit, the likely venue of any appeal in this case. Estate of Simplot v. Commissioner, 249 F.3d 1191, 1195 (9th Cir. 2001), revg. 112 T.C. 130 (1999). We did not find Dr. Spiro's oral testimony to be persuasive. It did not bolster what we found to be weak analysis in his written reports.

We found Dr. Bajaj's analysis in support of his 25-percent basic discount to be both thorough and convincing, and we find that a basic discount for lack of marketability in the amount of 25 percent is appropriate.

d. Additional Discounts

(1) Discount for Lack of Control

Dr. Bajaj describes his entire 35-percent discount as a discount for lack of marketability. We view his proposed discount for "agency problems", however, as a discount for minority status (or lack of control), as it is based upon the inability of the owner of the shares to force the majority shareholder, Gary Heck, to make dividend distributions. Dr. Bajaj's discount for minority status takes into account factors similar to what Dr. Spiro took into account in addressing problems associated with Korbel's S corporation status, at least to the extent that Dr. Spiro's discount relates to the same lack

of control problem.[14] Thus, we view Drs. Bajaj and Spiro in basic agreement as regards the need for a discount for lack of control, which we view as a minority status discount.

(2) Discount for Brown-Forman's ROFR

Both experts agree that some discount for the ROFR is warranted. Dr. Spiro includes the ROFR as part of his basic 15-percent liquidity discount, Dr. Bajaj as part of his additional 10-percent discount for both the ROFR and the minority interest's lack of control.

Dr. Bajaj views the ROFR as a much more serious impediment to marketability than does Dr. Spiro. He argues that, because of its ROFR, Brown-Forman is always a potential bidder for an available block of Korbel stock. He further argues that, because it had been the sole distributor of Korbel champagne and brandy for a number of years, Brown-Forman knows more about Korbel than any potential outside bidder. As a result, any other outside bidder would have to expend a great deal of effort and money to even approach Brown-Forman's knowledge level concerning Korbel, without which it may offer too little and risk losing out to Brown-Forman, or too much and risk making a bad deal. Also, because Brown-Forman has a special interest in retaining its sole

[14] Dr. Spiro also states that, as an S corporation, Korbel is subject to several restrictions impairing liquidity, including restrictions on the number and type of persons that can be shareholders. Nevertheless, he views S corporation status as a benefit and fails to quantify the relevant advantages and disadvantages.

distributor position, it will have a tendency to drive up the price beyond what a potential buyer would be willing to pay based upon the present value of anticipated cashflows. According to Dr. Bajaj, both of those factors act as a significant deterrence to would-be bidders for the shares, and, therefore, they reduce the value of the shares.

In his rebuttal testimony, Dr. Spiro responds that Korbel is not "such a complex organization that the costs of analyzing the company for bidding purposes would be prohibitively high." Dr. Spiro argues that Dr. Bajaj's concerns regarding Brown-Forman's ROFR "are more appropriately applied to * * * [complex high-tech companies] where the 'hidden' value of * * * [intellectual property] can make accurate analysis difficult and expensive, especially for an outsider." Dr. Spiro agrees, however, that some discount is warranted for the ROFR and, as noted above, has included it as part of its basic 15-percent liquidity discount.

(3) Amount of Additional Discounts

We agree with Dr. Bajaj that an additional 10-percent discount for Brown-Forman's ROFR and the purchaser's lack of control over future dividend-liquidation policy (i.e., the purchaser's minority status) is warranted. We ascribe most of that discount to the minority status issue, which both Drs. Bajaj and Spiro agree deserves recognition. Both Drs. Bajaj and Spiro

also believe that the ROFR would reduce value, but disagree both as to rationale and quantum. We are satisfied that some amount of discount is attributable to the ROFR and that 10 percent is an appropriate discount for both the ROFR and the purchaser's minority status, given Dr. Spiro's addition of a 10-percent discount for only Korbel's status as an S corporation.

(4) AVG's Discounts From the Value of Nonoperating Assets

Dr. Bajaj applied an overall 35-percent marketability discount to his total valuation of Korbel, which included nonoperating assets. Dr. Spiro applied a 25-percent liquidity discount to his valuation of Korbel, not including nonoperating assets. As noted supra p. 37, he then applied separate additional discounts to what he considered nonoperating assets. We reject Dr. Spiro's 25-percent minority discount applied to "excess cash" on the basis of our finding that Korbel retained no excess cash as of the valuation date. We also reject Dr. Spiro's 43.75-percent combination minority/liquidity discount applied by him to the excess land in favor of Dr. Bajaj's 35-percent overall discount applied to his total valuation of Korbel, including such excess land. We see no reason to limit a minority discount to particular assets of Korbel even if they are nonoperating assets and, therefore, more readily available for distribution to shareholders than are Korbel's operating assets. As we observed in Estate of Fleming v. Commissioner, T.C. Memo. 1997-484, a

minority discount generally "reflects the minority shareholder's inability to compel liquidation and thereby realize a pro rata share of the corporation's net asset value"; i.e., the minority shareholder's share of total corporate net asset value.

C. Conclusion

On the basis of the foregoing application of the DCF method, taking into account certain discounts, we find that the fair market value of the shares as of the valuation date was $20,269,736, or $32,174 a share. See Appendix.

VI. Conclusion

We shall redetermine a deficiency in Federal estate tax commensurate with our finding that the value of the shares as of the valuation date was $20,269,736.

Decision will be entered under Rule 155.

Appendix:

Valuation of 630 Shares of R. Korbel & Bros., Inc. as of 2/15/95

Projected Items	1994	1995	1996	1997	1998	1999
Sales	$82,757,920	$86,482,026	$89,941,307	$93,089,252	$95,881,929	$98,758,386
Net Income						
Pre-Tax Income (@ 12.3% op. margin)		10,637,289	11,062,780	11,449,977	11,793,477	12,147,281
Income Taxes (@ 1.5%)		(159,559)	(165,942)	(171,750)	(176,902)	(182,209)
Net Income		10,477,730	10,896,838	11,278,227	11,616,575	11,965,072
Cashflow Adjustments						
+ Depreciation (3.8% of sales)		3,286,317	3,417,770	3,537,391	3,643,513	3,752,819
(-) Working Capital Additions (55% of incremental sales)		(2,048,258)	(1,902,605)	(1,731,370)	(1,535,972)	(1,582,051)
(-) Capital Expenditures		(4,000,000)	(4,000,000)	(4,000,000)	(4,000,000)	(4,000,000)
Yearend Cashflow		7,715,789	8,412,003	9,084,248	9,724,116	10,135,840
Discount Rate (WACC)		14.22%	14.22%	14.22%	14.22%	14.22%
Present Value Interest Factor ($1/(1.1422)^n$)		.8755	.7666	.6712	.5876	.5145
Present Value of Cashflows		6,755,173	6,448,641	6,097,347	5,713,891	5,214,890
Total Present Value of Cashflows		$30,229,942				
Present Value of Reversion:						
10,135,840 ($\frac{1.03/.1422-.03}{(1+.1422)^5}$)		47,861,436				
=10,135,840 (4.722)						
Present Value of Operating Assets		78,091,378				
Value of Nonoperating Assets		5,517,000				
Long-Term Debt		(4,918,000)				
Enterprise Value of Korbel (w/o discount)		78,690,378				
Enterprise Value of Korbel with 35% Discount		51,148,745				
Value of 39.629% interest (630 shares)		20,269,736				
Value of each share		32,174				

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Heck v. Commissioner

103 Wis.2d 327 (1981)
309 N.W.2d 343

Judith B. HOLBROOK, Plaintiff-Respondent,

v.

John S. HOLBROOK, Jr., Defendant-Appellant.[†]

No. 80-1290.

Court of Appeals of Wisconsin.

Submitted on briefs April 15, 1981.
Decided June 4, 1981.

330 *330 For the defendant-appellant the cause was submitted on the briefs of *Harry F. Peck* and *Louise A. Ptacek* of *Petrie, Stocking, Meixner & Zeisig, S.C.,* of Milwaukee.

For the plaintiff-respondent the cause was submitted on the brief of *Burton A. Strnad* of *Strnad & Gossens, S.C.,* of Milwaukee.

Before Decker, C.J., Moser, P.J., and Cannon, J.

MOSER, P.J.

This is an appeal from the property division, family support and attorneys' fees awards of the amended divorce judgment dated September 5, 1980. We vacate, in part, the property division and the award of attorneys' fees and remand for further findings consistent with this opinion. We affirm the family support award.

John and Judith **Holbrook** were married on July 28, 1962, and remained married for eighteen years. At the time of their divorce they had four minor children, ages 16, 14, 11 and 3. Their youngest child is physically disabled due to cerebral palsy. Judith worked as a school teacher for the first two years of the marriage while John attended law school. After John's graduation from law school, Judith did not work outside of the home.

John is currently a partner in the law firm of Quarles & Brady, and, at the time of the divorce, was earning $112,000 per year.

The trial court divided and valued the assets of the parties, as follows:

331 *331

Judith:	Homestead	$152,300
	Household furnishings	$ 15,000
	Checking and Savings Accounts in her name[1]	
	1975 Buick Station Wagon	$ 1,000
	All securities owned by either or both of the parties except the stock in Ashbourne, Ltd.	$ 3,138
	Life insurance policies on her life[2]	
	Cash payment	$ 35,000[3]
John:	Partnership Interest in Quarles & Brady (capital account value of $23,790 plus "intangible or goodwill value" of $161,330[4])	$185,120

332 *332

1977 Plymouth Voyager Van	$ 3,000
Checking and savings accounts in his name[5]	
Household goods in his possession	$ 2,000
Stock in Ashbourne, Ltd.[6]	

Additionally, the court valued John's retirement benefits at $12,179, but determined that the benefits accrued to the date of the original decision should be equally divided when John actually receives them, after he retires.

The court found that John's gross income was $112,000. Judith was awarded custody of the children. The court ordered family support payments to Judith and the children of $60,000 per year, or $5,000 per month (in addition to the cash payment ordered as part of the property division). John was also ordered to pay $1,000 per month for seven months, and $500 in the eighth month immediately following the entry of judgment. This provision appears to have been included to cover Judith's attorneys' 333 fees. The court further ordered that *333 John pay Judith for the income taxes payable for the 1980 temporary family support and that the pay for all health care costs for the children.

John makes several claims of error on appeal regarding the valuation and distribution of the marital estate, as well as the family support and attorneys' fees awards. He contends:

1. that the trial court improperly valued:

a. the homestead, b. the automobiles, and c. the retirement benefits;

2. that sale of the homestead should have been ordered;

3. that the $60,000 annual maintenance award was excessive;

4. that he should not have been required to contribute to Judith's attorneys' fees;

5. that the trial court erred in finding that John's partnership has a goodwill or intangible value which is a marital asset to be included in the property division; and,

6. that the trial court erred in establishing a goodwill value of $161,300 because the calculation of that figure was based upon an unproven factual assumption.

VALUATIONS OF HOMESTEAD, AUTOMOBILES AND RETIREMENT BENEFITS

Homestead

The trial court found that the homestead, a large brick home on Newton Avenue in Shorewood, Wisconsin, had a value of $152,300, subject to a mortgage of $41,962. John claims that the trial court erroneously valued the homestead as of December 1979, and should have valued it as of the date of the commencement of the trial, September 26, 1979. John's expert testified that on September 26, 1979, the home had a value of $185,000. Judith's expert testified at the December 10, 1979, hearing that 334 he appraised the home in August of 1979, and *334 estimated its value to be $162,000. He testified also that between August of 1979, and December 1979, the market had changed and the value of the home had fallen by about five percent to seven percent.

[1]

Assets of the marital estate are valued as of the date the divorce is granted.[7] This court will not upset the trial court's valuations of assets unless the valuations are against the great weight and clear preponderance of the evidence.[8] Weighing the evidence and determining the credibility of witnesses are matters for the trial court and, where more than one inference can reasonably

be drawn from the evidence, we are obliged, on review, to accept the one drawn by the trier of fact.[9]

The divorce in this case was granted orally from the bench on December 10, 1979.[10] It is settled law in Wisconsin that this is the date for determining the value of assets.[11] In the absence of exceptional intervening circumstances,[12] we are not at liberty to conclude that some other date should have been used.

The valuation of assets is a difficult and imprecise obligation of a trial judge in a divorce action. The values of some assets can fluctuate markedly throughout the months of a divorce proceeding and, even on one given date, there may be several conflicting
335 opinions of the *335 value of a certain asset. As the fact finder, it is the trial judge who must draw reasonable inferences and come to reasonable, albeit disputable, conclusions as to the value of assets as of the date the divorce is granted.[13]

[2]

In this case, the trial court's valuation of the homestead was properly made as of the date the divorce was granted and is not against the great weight and clear preponderance of the evidence.

Automobiles

We do find error, however, in the valuation of the automobiles. The only testimony in the record regarding the value of the automobiles was John's testimony, based on Bluebook values, that the Buick station wagon was worth $2,795 and the Plymouth van was worth $2,675. There was no other evidence of the value of these automobiles. However, in the amended findings of fact, the trial court valued the Buick station wagon at $1,000 and the Plymouth van at $3,000.

[3]

A court is not required to adopt uncontradicted testimony if it is inherently improbable.[14] However, "[p]ositive uncontradicted testimony as to the existence of some fact, or the happening of some event, cannot be disregarded by a court or a jury in the absence of something in the case which discredits the same or renders it against reasonable probabilities."[15]

The trial court gave no explanation of its reasons for rejecting the uncontradicted valuations of the automobiles. The failure to
336 set forth its reasoning rendered its analysis of the valuations incomplete, and was an abuse *336 of discretion.[16] Accordingly, we vacate the trial court's valuation of the automobiles and instruct the court on remand to either adopt the uncontradicted values testified to at trial ($2,795 for the Buick station wagon and $2,675 for the van) or to explain what in the case discredited these valuations or rendered them improbable.

Retirement Benefits

In reference to John's retirement benefits from Quarles & Brady, the amended findings of fact and conclusions of law equivocally state: "That the pension plan of Quarles & Brady and salary continuation program pursuant to the partnership agreement have an aggregate value of $12,179. That said amount does not truly reflect the value of the program." The latter statement
337 apparently refers to the admissions by the expert who valued the plan at $12,179[17] that there were certain *337 errors made in
338 computing that amount.[18] The court then went on, not to divide the present value of the retirement *338 benefits, but to order that when they become due "[t]he proceeds shall be divided equally between the parties based upon the pension benefits accrued as of the date of the original Decision in this action."

John contends on appeal that the court was obligated to distribute the present value of the benefits at the time of the divorce and that it was error for the trial court to postpone, for at least twenty-five years, the division of the retirement benefits.

In *Bloomer v. Bloomer*[19] our supreme court recognized that the valuation and division of pension rights is a matter for the trial court's discretion.[20] The court explained that there are at least three ways that pension rights can be valued and divided:

339 *339 1. the trial court may determine the amount of the employee-spouse's contribution to the fund, plus interest, and award the other spouse an appropriate share;

2. the court may award the nonemployee-spouse a share of the present value of the employee-spouse's retirement benefits when they vest under the plan. In addition to discounting to present value, further discounting should be made to account for the probability of death before qualification for benefits and for vesting. Consideration should also be given to the employee-spouse's life expectancy as a retiree. This approach may be too speculative in some situations;[21]

3. the trial court may determine a fixed percentage of any future payments under the employee-spouse's pension plan attributable to earnings during marriage to which the nonemployee-spouse is entitled.[22] This requires no calculation of present value. This method is best where present value of a pension fund is difficult or impossible to assess.[23]

Which, if any, of these methods is appropriate is a discretionary decision dependent "upon the circumstances of the case, the status of the parties, and whether the result is a reasonable valuation of the marital asset."[24]

Although it was a discretionary matter for the trial court to determine which valuation and division method should be used, the record does not show why the court determined a present value for the pension plan[25] and then ordered a future division of the payments as they become due.

[4, 5]

340 Appellate review of discretionary decisions is virtually impossible where there is no record of the trial court's *340 reasoning in reaching a particular conclusion. Our supreme court has explained that the exercise of discretion is more than simply making a decision: it requires a reasoning process dependent upon facts in, or reasonable inferences from, the record and a conclusion based on proper legal standards.[26] "There should be evidence in the record that discretion was in fact exercised and the basis of that exercise of discretion should be set forth."[27] The failure to set forth the reasoning used to reach a decision is an abuse of discretion.[28]

[6]

In deciding which method of dividing the retirement benefits should be adopted in this case, the trial court should consider the advantages and disadvantages of the various methods. We believe that a trial court should be particularly alert to the advantages of dividing retirement benefits at the time of divorce rather than postponing the actual division for a number of years until the employee-spouse actually retires. Determining the present value of retirement benefits is admittedly speculative, but this is true of valuation of any asset. We believe that where there are sufficient assets available at the time of divorce to divide the present value of the retirement benefit without causing an undue hardship on either spouse, this method is preferred. This method is especially preferred where, as here, there is uncontradicted expert testimony on valuation.

[7]

341 Although the future division method adopted by the trial court in this case is an acceptable method of division, *341 we believe that it should only be used where the record shows that present value determinations are unacceptably speculative or where there are not enough assets to equitably require that benefits due in the future be split presently.

[8]

In this case, the method of computing the present value of the retirement benefits was undisputed (although the actual computation contained errors which are corrected in our footnote 18). The court indicated no reasons for rejecting this method and for opting for the less preferred future division method. Accordingly, on remand we instruct the trial court to either adopt the present value method or to set forth its reasoning, under the facts and circumstances of this case, for delaying the division until some undetermined future date.

SALE OF THE HOMESTEAD

[9]

John contends on appeal that in order to accomplish an equitable division of the marital estate, the homestead should be sold and the proceeds divided. We think the conclusion that Judith and the children should be permitted to remain in the home is reasonable. The amount of equity the Holbrooks have in the home, the costs and disruption of moving, the age of the children, and the current cost of financing a new home are factors which support the trial court's conclusion. There is also a statutory preference for this result.[29] How Judith allocates the funds provided by the property division and family support to cover the upkeep of the home should be left to her.

342 *342 ## FAMILY SUPPORT

[10]

Judith was awarded $60,000 per year for family support. John contends that this is excessive. We do not believe that the family support award is unreasonable under the circumstances in this case.

Family support is to be determined by assessing the family's need and the paying spouse's ability to pay.[30] We think both considerations support the award in this case.

Judith has the responsibility of feeding, clothing and generally caring for four minor children, one of whom is, at least to some extent, physically disabled by cerebral palsy. The record also shows that Judith is disabled by an ankle injury which makes her unable to work. In contrast, John is a partner in a large and reputable law firm where he is earning $112,000 a year.

The trial court indicated its reasons for awarding $60,000 in family support in its memorandum decision written in response to a motion to amend the original findings of fact and conclusions of law and the original judgment. The court indicated that it had reexamined the award and declined to change its determination that the amount was fair and reasonable. The court determined that, although two of the children were approaching the age of majority, the award should not be changed and when the childen do reach majority, John can bring a motion for reduction of family support based on the change of circumstances.

The memorandum decision and the findings of fact and conclusions of law indicate that the trial court exercised its discretion
343 based upon proper factors and set forth at least some of its reasoning in the record. We *__343__ find no abuse of discretion and therefore defer to the trial court's judgment.

ATTORNEYS' FEES

Originally, John was ordered to pay $15,000 toward Judith's attorneys' fees. On reconsideration of this issue, the court stated:

The court has again reviewed the file and determines that that would be the amount of [Judith's attorneys'] total fee and agrees with counsel for the defendant that to require defendant to pay the total fee would be unfair. Therefore the court sets as a reasonable contribution, under *Anderson v. Anderson,* 72 Wis.2d 631, the sum of $7,500 to be paid in the manner described earlier.

The court further finds that there is a demonstrated need for the plaintiff to receive this assistance by way of a contribution and further there is a demonstated ability on behalf of the defendant to pay the same, and that the sum fixed by the court is a fair and reasonable sum.

Before awarding attorney's fees, the trial court is required to make the following factual determinations:

1. the spouse receiving the award needs the contribution;

2. the spouse ordered to pay has the ability to do so; and,

3. the total fee is reasonable (this provides guidance in determining what is a reasonable contribution).[31]

John disputes the trial court's determination that Judith needed the contribution to her attorneys' fees. We do not believe that the trial court's finding of need was against the great weight and clear preponderance of the evidence.

344 *344 [11]

However, we must, nonetheless, remand the issue to the trial court for a determination of the amount of Judith's total attorneys' fees and the reasonableness of that amount. "In the absence of some indication as to what the total fee is, this court is left to surmise as to whether the proper balance was struck between the former wife's needs and the divorced husband's ability to pay."[32] This requirement is not satisfied by the trial court's determination that $7,500 was a *reasonable contribution.* It must first be determined what the total fee actually is and whether it is reasonable. Without this determination, we cannot review the reasonableness of the contribution.

INCLUSION OF GOODWILL AS AN ASSET

The major dispute in this appeal focuses on the trial court's determination that the goodwill or intangible value of John's partnership interest in Quarles & Brady is a marital asset which must be considered in the property division. John also disputes
345 the court's determination that this asset had a value of $161,300.[33] He claims *345 that the method of calculating this value was based on completely unsupported factual assumptions, specifically, the assumption of a $100 per hour billing rate.

John contends that the intangible or goodwill value of the partnership is not an asset or any kind of property. He argues that the only property interest in the partnership consists of his "capital account" of $23,790.36, the contractually determined, fixed amount payable to him upon withdrawal from the firm.

We conclude that the trial court erred in determining that the marital estate included the goodwill value of John's partnership. We therefore do not address the issue of the method of valuation.

Defining the Concept

Goodwill has been defined thusly:

[T]he advantage or benefit which is acquired by an establishment beyond the mere value of the capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partiality or prejudices.[34]

The favor which the management of a business wins from the public . . . . The fixed and favorable consideration of customers arising from established and well-conducted business . . . . The favorable consideration shown by the purchasing public to goods known to emanate from a particular source . . . . Something in business which gives reasonable expectancy of preference in race of competition.[35]

346 *346 Originally, goodwill was said to exist only in commercial business, and not in a professional business which depends upon the skill and reputation of a particular person.[36]

Because goodwill has no existence apart from the business to which it attaches, courts have determined that there can be no income tax deduction for loss of goodwill;[37] the loss of goodwill cannot be compensated for in eminent domain proceedings;[38] goodwill cannot be used to satisfy debts;[39] nor is it subject to depreciation.[40]

In an article criticizing the rather unstable and inconsistent development of the concept of professional goodwill in marital

dissolutions in California, Ira Lurvey points out that some view goodwill as something that can only be ascertained upon the actual sale of a business.[41] However, "[s]uch protection of the real marketplace is missing . . . from the *hypothetical* sale ordered on dissolution of marriage. There is neither a real buyer nor a real seller."[42] Mr. Lurvey asserts that in light of this and the other attributes of goodwill discussed above it is:

at least arguable that "goodwill," by whatever name designated, is only an entry in an accounting statement arrived at by hindsight to accommodate any amount paid or received on transfer of a going business beyond the value attributable to its tangible assets.

347 *347 Thus at best "goodwill" is intangible.

It is also amorphous, ephemeral, elusive; and, by general definition, speculative and uncertain except to the extent that it has already been established by an armslength bargaining in the open market place.[43]

Professional Goodwill as a Marital Asset in Other Jurisdictions

With an apparent lack of deliberativeness, the California courts have developed the view that the goodwill of a professional practice is an asset which must be accounted for upon dissolution of a marriage.[44] However, the cases are inconsistent in their treatment of goodwill. It is not clear whether it is truly a separate asset to be valued and divided,[45] or whether it is actually "the vehicle whereby the *established employment or earning capacity of the husband,* which often `constitutes the most valuable economic asset of the parties,' was divided as community property."[46] The California position is further obscured by the determination in one case involving the dissolution of a law partnership and not a divorce, in which it was ruled that goodwill cannot be divided between partners when a law partnership is dissolved because it had attached to the individual partners, had no monetary value, and could not be sold.[47] Subsequently, in the first California divorce case involving the issue of goodwill in
348 which the husband-professional was not a *348 sole practitioner, but a partner,[48] the court stated that the existence and value of goodwill must be determined regardless of "whether related to that of a sole practitioner, a professional partnership or a professional corporation."[49]

The California rule has been adopted in Washington.[50]

The California approach has been deservedly criticized as a "confusion of rules and methods of valuation, compounded by inconsistencies in logic and application and conceptual problems over possible duplication of spousal support and denial of equal protection."[51]

An equally criticizable and anomalous situation exists in Texas where the inclusion of professional goodwill as an asset in the marital estate is dependent upon whether the professional involved is a sole practitioner or a member of a professional partnership or corporation.

349 *Nail v. Nail*[52] involved an opthalmologist who had established a sole medical practice. The Texas Supreme *349 Court determined that the goodwill of a sole practitioner's business does not possess value or constitute an asset separate from the individual and his ability to continue practicing and would cease to exist if the individual withdrew from the business.[53] Accordingly, the supreme court determined that the wife's community interest in the medical business did not extend to the enhanced value attributable to goodwill. This enhanced value, the court said, was merely an expectancy completely contingent on the continuation of existing circumstances and therefore was not a vested property right subject to division upon divorce.[54]

However, in *Geesbreght v. Geesbreght*[55] the court of civil appeals determined that goodwill may exist as an asset of a professional partnership or corporation separate from any individual member. That case involved a multi-member medical corporation, which the court said could acquire its own reputation or goodwill, despite changes in personnel. Hence, the goodwill of the corporation should be accounted for in evaluating the practitioner's interest in the business.[56]

The inconsistencies and inequity of the distinctions of *Nail* and *Geesbreght* have been noted and criticized.[57]

Even greater problems arise when, after it has been determined that professional goodwill is a marital asset divisible upon divorce, attempts are made to place a dollar value on the goodwill that is part of the marital estate. This would be especially problematic, where, as here, the business involved has several members, all of whom have presumably contributed to the goodwill of the business. Valuation of one individual's goodwill interest in the business would be almost pure speculation.

350 *350 ***Professional Goodwill in Wisconsin***

We are not persuaded that the concept of professional goodwill as a divisible marital asset should be adopted in Wisconsin. We are not obliged nor inclined to follow the twisted and illogical path that other jurisdictions have made in dealing with this concept in the context of divorce.

The concept of professional goodwill evanesces when one attempts to distinguish it from future earning capacity. Although a professional business's good reputation, which is essentially what its goodwill consists of, is certainly a thing of value, we do not believe that it bestows on those who have an ownership interest in the business, an actual, separate property interest. The reputation of a law firm or some other professional business is valuable to its individual owners to the extent that it assures continued substantial earnings in the future. It cannot be separately sold or pledged by the individual owners. The goodwill or reputation of such a business accrues to the benefit of the owners only through increased salary.

We think this case is analogous to the situation in *DeWitt v. DeWitt*[58] in which this court determined that a professional education or the increased earning capacity that it confers upon the spouse who holds it is not a divisible marital asset, even though the acquisition of the degree is partly attributable to the earnings and efforts of the other spouse. This court quoted, with approval, the reasoning of *In re Marriage of Graham:*[59]

An educational degree . . . is simply not encompassed even by the broad views of the concept of "property." It does not have an exchange value or any objective transferable value on an open market. It is personal to the holder. It terminates on death of the
351 holder and is not inheritable. It cannot be assigned, sold, transferred, *351 conveyed, or pledged. An advanced degree is a cumulative product of many years of previous education, combined with diligence and hard work. It may not be acquired by the mere expenditure of money. It is simply an intellectual achievement that may potentially assist in the future acquisition of property. In our view, it has none of the attributes of property in the usual sense of that term.

It was further explained in *DeWitt* that valuing a professional degree as a marital asset necessarily requires division of the post-divorce earnings of the degree-holding spouse, which is inconsistent with the requirement that only assets acquired during marriage can be divided.[60]

[12]

Like an educational degree, a partner's theoretical share of a law firm's goodwill cannot be exchanged on an open market: it cannot be assigned, sold, transferred, conveyed or pledged. Although we recognize the factual distinction between a degree-holder and a partner or shareholder in a law firm, we think the similarities compel analogous treatment in a divorce setting. In both cases, the "asset" involved is not salable[61] and has computable value to the individual only to the extent that it promises increased future earnings.

There is a disturbing inequity in compelling a professional practitioner to pay a spouse a share of intangible assets at a judicially determined value that could not be realized by a sale or another method of liquidating value.[62]

352 *352 There is no dispute in this case that upon withdrawal from the partnership, John would be entitled to receive only his capital account value of $23,790. Ethically and contractually, he is prevented from otherwise disposing of his interest in Quarles & Brady. The capital account value is the only value that should have been assigned to his partnership as an asset.

As stated earlier, the goodwill or reputation of Quarles & Brady is reflected in John's substantial salary. This salary was

considered in setting the family support award. To also treat the goodwill of the law firm as a separate divisible asset, would constitute double counting.[63] The fact that John is a partner in a reputable law firm is, however, a proper factor to consider in dividing the assets, as well as determining the amount of family support.[64] If circumstances warrant future amendment of the family support award, this may be done.[65] We think that this is a more direct and reasonable way of accounting for John's professional position.

Judith's contribution to the furtherance of John's legal career is reflected in the home, furnishings and other tangible assets that the family has acquired over the years. Indeed, she was awarded a great deal of these family assets in the divorce.

Accordingly, we vacate the trial court's valuation of John's partnership to include goodwill and order on remand that the undisputed value of $23,790 be assigned to that property.

353 *353 *By the Court.* — That part of the judgment regarding the family support award is affirmed; the valuation and disposition of the homestead are also affirmed. The remainder of the property division section of the judgment is vacated and the matter remanded for further findings consistent with this opinion with regard to the following items: the valuation of the automobiles, the valuation of the retirement benefits, the valuation of the parties' individual bank accounts, the valuation of the stock in Ashbourne, Ltd., and the valuation of John's partnership interest at Quarles & Brady. The portion of the judgment granting the award of attorneys' fees is vacated and remanded for further findings consistent with this opinion. The trial court is instructed to reconsider the division of the assets after these findings are made.

[†] Petition to review denied. ABRAHAMSON, J., took no part.

[1] No value for either Judith's or John's bank accounts was determined by the trial court. The record shows that as of September 26, 1979, Judith had $650 in a checking account and $1,880 in a savings account. There is no way for this court to determine the amounts the parties had in their individual accounts as of September 5, 1980, the date of the amended judgment of divorce. This is a factual determination that should be made on remand by the trial court.

[2] The trial court did not indicate any value for any such policies.

[3] The trial court ordered that as a further division of the estate, John pay Judith $25,000 forthwith and $500 per month for twenty months with nine-percent interest on the remaining balance.

[4] This "goodwill" value was based upon the testimony by Judith's expert witness, Mr. Powers. The valuation process used by Mr. Powers is as follows:

a. "gross income from personal services" is calculated by multiplying billable hours times the hourly billing rate. Mr. Powers used John's total billable hours in 1978, 1,569 hours, and multiplied this by a billing rate of $100 per hour. (There is nothing in the record that indicates that $100 per hour was or is John's billing rate). The total arrived at was $156,900.

b. "contribution to overhead" was computed by multiplying "gross income from personal services" ($156,900) times the reciprocal of the percentage of the law firm's gross income (which is represented by the net income to partners). It was determined that 53.8% of the firm's income was distributed to partners. The overhead was therefore determined to be 46.2%. The "contribution to overhead" was calculated as $72,488. ($156,900 × 46.2%).

c. "salary earned from personal efforts" was calculated by subtracting the "contribution to overhead" from the "gross income from personal services:" $156,900 minus $72,488 equals $84,412.

d. "earnings in excess of salary" was calculated by subtracting "salary earned from personal efforts" ($84,412) from gross income for 1978 ($111,000) resulting in $26,588.

e. one-half of "earnings in excess of salary" was subtracted to allow for income taxes, with the rounded result of $13,500.

f. finally, 13,500 was capitalized over twenty years at 5½% to get a present value of $161,330.

[5] *See* note 1, *supra.*

[6] No valuation of this stock was included in the original findings of fact and conclusions of law or the original judgment nor in either the amended findings of fact and conclusions of law or the amended judgment. According to John's testimony, Ashbourne, Ltd. is a family-owned corporation and the stock has no market value.

[7] *Dean v. Dean,* 87 Wis.2d 854, 871, 275 **N.W.2d** 902, 909 (1979); *Sholund v. Sholund,* 34 Wis.2d 122, 132, 148 **N.W.2d** 726, 731 (1967).

[8] *Carty v. Carty,* 87 Wis.2d 759, 765, 275 **N.W.2d** 888, 890 (1979); *Markham v. Markham,* 65 Wis.2d 735, 741, 223 **N.W.2d** 616, 619 (1974).

[9] *Markham, supra* note 8, at 741, 223 **N.W.2d** at 619.

[10] A judgment of divorce is "granted" when it is orally pronounced from the bench. *Holschbach v. Holschbach,* 30 Wis.2d 366, 368-69, 141 **N.W.2d** 214, 216 (1966).

[11] *See* note 7, *supra.*

[12] *See Sholund, supra* note 7.

[13] *See* notes 7, 8 and 9, *supra.*

[14] *Kilgust Heating Div. of Wolff, Kubly & Hirsig, Inc. v. Kemp,* 70 Wis.2d 544, 549, 235 **N.W.2d** 292, 295 (1975).

[15] *Id.* (quoting *Thiel v. Damrau,* 268 Wis. 76, 85, 66 **N.W.2d** 747, 752 (1954)).

[16] *See Wisconsin Ass'n of Food Dealers v. City of Madison,* 97 Wis.2d 426, 434-35, 293 **N.W.2d** 540, 545 (1980).

[17] John had two forms of retirement benefits: a basic pension and a supplemental benefit for partners. The total retirement benefits were valued through the use of the following calculation process:

```
1. Accrued benefits calculated
   a. average final compensation                      $111,176.00
      × 20% (provided for in the plan)                      × .20
      × accrual fraction                                    ×  15/40
      (number of years employed divided by expected
      total number of employment years at
      retirement)
                                                      ---------------
      equals accrued basic pension benefit            $  8,338.20.

   b. average final compensation                      $111,176.00
      × 5% (provided for in the plan)                       × .05
      × accrual fraction                                    ×   8/33
      (number of years as partner divided by expected
      number of partnership years upon
      retirement)
                                                      ---------------
      equals accrued supplemental benefit             $  1,347.59.

2. Present value calculated

   a. basic pension benefit
      accrued benefit                                 $  8,338.20
      × annuity value                                      × 8.0353
      × survival factor                                    ×  .70084
      × present value discount                             ×  .23300
                                                      ---------------
      present value of basic pension benefit          $ 10,941.00.

   b. supplemental benefit
      accrued benefit                                 $  1,347.59
      × annuity value                                      × 8.0353
      × survival factor                                    ×  .70084
      × discount for withdrawal prior to retirement        ×  .70
                                                      ---------------
      present value of supplemental benefit           $  1,238.00.
```

```
Total present value of retirement benefits          $ 12,179.00.
```

[18] Two errors were made in this calculation and were disclosed in the record: first, the basic pension benefit plan contained a provision limiting the "average final compensation" amount to $100,000 (this limit does not apply to the supplemental benefits); and second, the retirement plan applicable to John excluded the first five years of employment so that the "accrual fraction" for the basic benefit would be 10/35, rather than 10/40. Correcting for both of these errors, the present value for the benefits would be:

```
basic pension
      $100,000
            × .20
            ×  15/35
      --------------
      $ 5,714.00
          × 8.0353
          ×  .70084
          ×  .23300
      --------------
      $ 7,498.00

supplemental benefits
      $111,176.00
            × .05
            × 8/33
      --------------
      $ 1,348.00 (rounded)
          × 8.0353
          ×  .70084
          ×  .2330
          ×  .70
      --------------
     $  1,238.00
Total = $8,736.
```

On remand, should the trial court decide to presently divide the pension benefits, it must adjust the present value amount of these benefits as indicated above to account for the undisputed errors in computation used to arrive at the $12,179 figure. However, the trial court is not bound by the recalculation set out above to the extent that it deems it proper to accept John's argument that the "final compensation" figure used to begin the calculations should be the actual income average for the five years preceding the divorce rather than using the then-current year's compensation or the $100,000 maximum.

[19] 84 Wis.2d 124, 267 **N.W.2d** 235 (1978).

[20] *See id.* at 134, 267 **N.W.2d** at 240.

[21] *See id.* at 135, 267 **N.W.2d** at 241.

[22] *See id.* at 136, 267 **N.W.2d** at 241.

[23] *Selchert v. Selchert,* 90 Wis.2d 1, 11-12, 280 **N.W.2d** 293, 298 (Ct. App. 1979).

[24] *Bloomer, supra* note 19, at 135, 267 **N.W.2d** at 240-41.

[25] *See notes* 17 and 18, *supra.*

[26] *McCleary v. State,* 49 Wis.2d 263, 277, 182 **N.W.2d** 512, 519 (1971); *see also D.H. v. State,* 76 Wis.2d 286, 310, 251 **N.W.2d** 196, 205 (1977); *State v. Hutnik,* 39 Wis.2d 754, 764, 159 **N.W.2d** 733, 737-38 (1968).

[27] *McCleary, supra* note 26, at 277, 182 **N.W.2d** at 519.

[28] *Id.* at 277-78, 182 **N.W.2d** at 520.

[29] Sec. 767.255(7) (formerly sec. 247.255(7)), Stats.

[30] *See Czaicki v. Czaicki,* 73 Wis.2d 9, 18, 242 **N.W.2d** 214, 218 (1976).

[31] *Selchert, supra* note 23, at 15-16, 280 **N.W.2d** at 300 (Ct. App. 1979); *see also Anderson v. Anderson,* 72 Wis.2d 631, 646, 242 **N.W.2d** 165, 172 (1976).

[32] *Anderson, supra* note 31, at 646, 242 **N.W.2d** at 173. Although the court stated in the above quoted excerpt from its memorandum decision that the original award of $15,000 would cover Judith's attorneys' total fee, we find no indication from the record of the actual amount of attorneys' fees owed. In the trial brief, Judith's attorneys state that Judith "incurred substantial expense in the litigation of this matter" due to the use of many experts, the custody dispute, various motions, depositions and conferences with doctors and experts. It was asserted that many hours were spent preparing for trial. In conclusion it was asserted that "a reasonable contribution towards attorneys' fees and expert witness fees would be $13,500.00." It is not at all clear if that was meant to be a statement of what the total fee was. If so, we are at a loss to determine where the court arrived at its original $15,000 figure.

[33] *See* note 4, *supra.*

[34] 38 Am. Jur.2d, *Goodwill* § 1 (1968); *see* J. Story, Commentaries on the Law of Partnerships § 99 at 170 (6th ed. J. Gray, ed., 1868).

[35] Black's Law Dictionary 625 (5th ed. 1979) [citations omitted.]

[36] 38 Am. Jur.2d, *Goodwill* § 8 (1968); Lurvey, *Professional Goodwill on Marital Dissolution: Is It Property or Another Name for Alimony?* Jan./Feb. 1977 Cal. State Bar J. 27, 29 (hereinafter Lurvey).

[37] Lurvey, *supra* note 36, at 29 citing *Red Wing Malting Co. v. Willcuts,* 15 F.2d 626, 633 (8th Cir. 1926).

[38] *Id.* citing *inter alia* 27 Am. Jur.2d, *Eminent Domain* § 287.

[39] *Id.* citing *Lilienthal v. Drucklieb,* 84 F. 918, 918-19 (C.C.N.Y. 1898).

[40] *Id.* citing *Red Wing Malting Co. v. Willcuts,* 15 F.2d 626, 629, 632-34 (8th Cir. 1926).

[41] *Id.* at 30.

[42] *Id.* [Footnote omitted, emphasis in original.]

[43] *Id.*

[44] *Id.* at 30, 78-83. *Golden v. Golden,* 270 Cal. App.2d 401, 404-05, 75 Cal. Rptr. 735, 737-38 (1969) is often cited as the leading case for this rule. *Golden* involved a medical practice in which the husband was a sole practitioner.

[45] *See Todd v. Todd,* 272 Cal. App2d 786, 792-93, 78 Cal. Rptr. 131, 135-36 (1969).

[46] *Lurvey, supra* note 36, at 82 [emphasis in original] quoting *In re Marriage of Rosan,* 24 Cal. App.3d 885, 898, 101 Cal. Rptr. 295, 304 (1972).

[47] *Lyon v. Lyon,* 246 Cal. App.2d 519, 54 Cal. Rptr. 829, 833 (1966).

[48] *In re Marriage of Lopez,* 38 Cal. App.3d 93, 113 Cal. Rptr. 58 (1974).

[49] *Id.* at 109, 113 Cal. Rptr. at 68; *see* Adams, *Professional Goodwill as Community Property: How Should Idaho Rule?,* 14 Idaho L. Rev. 473 (1978).

[50] *See In re Marriage of Lukens,* 16 Wash. App. 481, 558 P.2d 279 (1976). This case conflicts with the early Washington case of *Lockhart v. Lockhart,* 145 Wash. 210, 259 P. 385 (1927), in which the court, although recognizing the existence of goodwill in a professional business, ruled that upon divorce a wife is not entitled to a portion of its value because goodwill attached to the husband and could be abandoned at any time. *Id.* at 213, 259 P. at 387; Adams, *supra* note 49, at 479.

[51] Lurevy, *supra* note 36, at 85. To the extent that the recognition of goodwill in divorce is really an effort to divide "the value that had accrued during the marriage to the establishment of the husband's career, in whatever field, and his resultant income," the equal protection question arises: Is it not an arbitrary and capricious distinction to apply the doctrine only to professional spouses, individually or as partners, but not to salaried employees? *Id.* at 84.

[52] 486 S.W.2d 761 (Tex. 1972).

[53] *Id.* at 764.

[54] *Id.*

[55] 570 S.W.2d 427 (Tex. Civ. App. 1978) *writ dismissed.*

[56] *Id.* at 436.

[57] Note, 11 St. Mary's L.J. 222 (1979).

[58] 98 Wis.2d 44, 53-54, 296 **N.W.2d** 761, 766 (Ct. App. 1980).

[59] 194 Colo. 429, 574 P.2d 75, 77 (1978).

[60] *DeWitt, supra* note 58, at 54, 296 **N.W.2d** at 766.

[61] In contrast, a commercial business, including any goodwill value, is salable. We do not think the same inequities arise when the goodwill value of a commercial business is included in the assessment of the total worth of the business for purposes of property division. *See Spheeris v. Spheeris,* 37 Wis.2d 497, 504-07, 155 **N.W.2d** 130, 134-36 (1967).

[62] *See* Note, 11 St. Mary's L.J. 222, 230 (1979).

[63] *See Kronforst v. Kronforst,* 21 Wis.2d 54, 63-64, 123 **N.W.2d** 528-534 (1963) in which the supreme court found that it was error to include a profit-sharing trust as an asset for property division purposes and then also as an income source to be considered in awarding alimony. The same rule was applied in *Johnson v. Johnson,* 78 Wis.2d 137, 143, 254 **N.W.2d** 198, 201-02 (1977) to the accounts receivable of a medical business.

[64] *See* secs. 767.255(6) (previously 247.255(6)) and 767.26(5) (previously 247.26(1)(e)), Stats.

[65] *See* sec. 767.32(1) (previously 247.32(1)), Stats.

130 T.C. No. 12

UNITED STATES TAX COURT

THOMAS H. HOLMAN, JR. AND KIM D.L. HOLMAN, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 7581-04. Filed May 27, 2008.

Ps transferred D stock of substantial value to a newly formed family limited partnership and then made gifts of limited partnership units (LP units) to a custodian for one of their children and in trust for the benefit of all of their children. Ps made a large gift in 1999 and smaller gifts in 2000 and 2001. In valuing the gifts for Federal gift tax purposes, they applied substantial discounts for minority interest status and lack of marketability. With respect to the 1999 gift, R argues that the gift should be treated as an indirect gift of D shares and not as a direct gift of LP units. For all of the gifts treated as gifts of LP units, R argues that the restrictions in the partnership agreement on a limited partner's right to transfer her interest should be disregarded pursuant to I.R.C. sec. 2703(a)(2). R also disagrees with Ps' application of discounts.

1. Held: The limited partnership was formed and the shares of D stock were transferred to it almost 1 week in advance of the 1999 gift, so that, on the facts before us, the transfer cannot be viewed as an indirect gift of the shares to the donees under sec. 25.2511-1(a) and (h)(1), Gift Tax Regs.

2. Held, further, the 1999 gift may not be viewed as an indirect gift of the shares to the donees under the step transaction doctrine.

3. Held, further, in valuing the gifts, the transfer restrictions are disregarded pursuant to I.R.C. sec. 2703(a)(2).

4. Held, further, values of the gifts determined.

John W. Porter, Stephanie Loomis-Price, and J. Graham Kenney, for petitioners.

Lillian D. Brigman and Richard T. Cummings, for respondent.

HALPERN, Judge: By separate notices of deficiency (the notices), respondent determined deficiencies in each petitioner's Federal gift tax of $205,473, $8,793, and $16,009 for 1999, 2000, and 2001, respectively. In response to the notices, petitioners jointly filed a single petition. Respondent answered, and, by amendment to answer, he increased by $2,304 and $13, the deficiencies he had determined for each petitioner for 1999 and 2001, respectively.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

After concessions, the principal issues for decision are (1) whether petitioners' transfer of assets to a family limited partnership constitute an indirect gift to another member of the partnership; (2) if not, whether, in valuing the gifts of limited

partner interests that are the subject of this litigation, we must disregard certain restrictions on the donees' rights to sell those interests; and (3) assuming that we must value those interests, those values.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, with accompanying exhibits, is incorporated herein by this reference. Petitioners resided in St. Paul, Minnesota, at the time they filed the petition.

Background

Petitioners are husband and wife. They have four minor children, the initials of whose first names are L., C., V., and I. (collectively, the children).

Petitioner Thomas H. Holman, Jr. (Tom), was employed by Dell Computer Corp. (Dell) from October 1988 through November 2001. While employed by Dell, Tom received substantial stock options, some of which he has exercised. Tom and petitioner Kim D.L. Holman (Kim) have purchased additional shares of Dell stock.

In 1996 and 1997, as their net worth increased, petitioners grew more concerned with managing their wealth, particularly as their wealth might affect the children.

Texas UTMA Accounts

Beginning in 1996, when they lived in Texas, and continuing through early 1999, petitioners made annual gifts of Dell stock to three custodial accounts under the Texas Uniform Transfer to Minors Act (Texas UTMA), one for each of their then three

daughters, L., C., and V. Tom served as custodian for the three Texas UTMA accounts until August 1999, when, for estate planning reasons, he resigned and was replaced by his mother, Janelle S. Holman (Janelle). At the time of his resignation, each of the Texas UTMA accounts held 10,030 shares of Dell stock.

Move to Minnesota and Discussions with Mr. LaFave

In August 1997, the Holman family moved from Texas to St. Paul, Minnesota. At that time, petitioners had no wills.

In late 1997, petitioners met with business and estate planning attorney E. Joseph LaFave (Mr. LaFave) to discuss estate planning and wealth management issues. They continued those discussions with Mr. LaFave and with others over the next 2 years. They recognized that they were wealthy, and they anticipated transferring substantial wealth to the children. They wished to make the children feel responsible for the wealth they expected them to receive. They discussed with Mr. LaFave and others various ways simultaneously to meet their goals of transferring their wealth to the children and making the children feel responsible for that wealth. They learned from Mr. LaFave about family limited partnerships. Mr. LaFave discussed with petitioners forming a partnership, contributing property to it, and making gifts of interests in the partnership to (or for the benefit of) the children. Mr. LaFave described, and Tom understood, the gift tax savings from valuation discounts that could result if Tom made gifts of limited partner interests rather than gifts of some or all of the property contributed to

the partnership. Tom discussed those tax savings with Kim. Tom's understanding of the potential for gift tax savings played a role in his decision to form a family limited partnership and make gifts (indirectly) to the children of limited partner interests. Tom had four reasons for forming a family limited partnership: "very long-term growth", "asset preservation", "asset protection", and "education". At trial, he elaborated:

> Long-term asset growth to us means that we're looking at assets for the benefit of the family over decades. Preservation really means that we wanted a vehicle where our children would be demotivated and disincentivized to spend the assets. Protection –- we were worried that the assets that the girls would eventually come into would be sought after by third party people, friends, spouses, potential creditors. The fourth one [education] is interesting in that we wanted something that we could use to educate our daughters on business management concerns.

He further elaborated on his understanding of asset preservation: "The preservation of capital is important to us. We did not want our daughters to just go blow this money." And: "[W]e really are concerned about negatively affecting their lives with the wealth, so by creating a partnership, we can establish a vehicle that preserves the wealth and such that the kids won't go off and spend it." Asset preservation motivated Tom to include transfer restrictions in the limited partnership agreement described infra. He testified with respect to those restrictions: "Remember, the big goal of this thing is to preserve the assets and to disincentivize the girls from getting rid of these assets, spending these assets, feeling entitled to these assets."

Minnesota UTMA Account

I., the Holmans' youngest daughter, was born in June 1999. In August 1999, Tom opened an account at Dean Witter (now Morgan Stanley Dean Witter; hereafter, MSDW) for I.'s benefit. He opened the account under the Minnesota Uniform Transfers to Minors Act (Minnesota UTMA). Janelle was appointed custodian. Tom caused MSDW to transfer 30 shares of Dell stock to that account on August 16, 1999.

Wills

On November 2, 1999, petitioners executed wills prepared by Mr. LaFave.

The Trust

Mr. LaFave drafted an agreement (the trust agreement) establishing "The Holman Irrevocable Trust U/A dated September 10, 1999" (the trust). The trust agreement names petitioners as grantors, Janelle as trustee, and the children as the primary beneficiaries. Petitioners executed the trust agreement on November 2, 1999, and Janelle executed it on November 4, 1999. The trust agreement provides that it is effective as of September 10, 1999. Previously, on August 3, 1999, Tom had opened an account at MSDW for the to-be-established trust. Tom caused MSDW to transfer 100 shares of Dell stock and $10,000 to that account on August 16, 1999.

The Holman Limited Partnership

An attorney in Mr. LaFave's office drafted an agreement (the partnership agreement) to establish the Holman Limited Partnership (the partnership), a Minnesota limited partnership. The partnership agreement recites that petitioners are both general and limited partners and Janelle, as trustee of the trust (as trustee) and as custodian, separately, for each of the children, is a limited partner. Tom suggested changes to preliminary drafts of the partnership agreement to insure that his goals of long-term growth, asset preservation, asset protection, and education were reflected in the final agreement. Petitioners executed the partnership agreement on November 2, 1999. Janelle executed it thereafter.

November 2, 1999, Transfers

On November 2, 1999, Janelle, as trustee, caused MSDW to transfer 100 shares of Dell stock from the trust's account to a new MSDW account established for the partnership (the partnership's account). On that same date, Tom caused MSDW to transfer 70,000 shares of Dell stock owned one-half by him and one-half by Kim from another MSDW account to the partnership's account. In exchange for their contributions to the partnership, petitioners and Janelle, as trustee, received the following general and limited partner interests:[1]

[1] Each contributor received an interest in the partnership equal to the number of Dell shares contributed by that individual divided by the total number of Dell shares contributed by all of the individuals. In that respect, no distinction was drawn

(continued...)

Table 1

Partner	Class	Shares of Dell Stock Contributed	Partnership Units	% Owned
Tom	General	625	89.16	0.89
Kim	General	625	89.16	0.89
Tom	Limited	34,375	4,903.71	49.04
Kim	Limited	34,375	4,903.71	49.04
Trust	Limited	100	14.26	0.14
Total		70,100	10,000.00	100.00

The partnership was formed on November 3, 1999, pursuant to the partnership agreement and the laws of Minnesota, when a certificate of limited partnership for it was filed with the Minnesota secretary of state.

Since its creation, the partnership has been a validly existing Minnesota limited partnership.

Partnership Agreement

The following are among the provisions of the partnership agreement:

> 1.6 Family. "Family" means Thomas H. Holman, Jr. and Kim D.L. Holman and their descendants.
>
> 1.7 Family Assets. "Family Assets" mean all property owned by the Family, individually, in trust or in combination with others, which has been contributed to or acquired by the Partnership.
>
> * * * * * * *
>
> 3.1 Purposes. The purposes of the Partnership are to make a profit, increase wealth, and provide a means for the Family to gain knowledge of, manage, and preserve Family Assets. The Partnership is intended to accomplish the following:

---

[1](...continued)
between general and limited partner interests.

(1) maintain control of Family Assets;

(2) consolidate fractional interests in Family Assets and realize the efficiencies of coordinated investment management;

(3) increase Family wealth;

(4) establish a method by which gifts can be made without fractionalizing Family Assets;

(5) continue the ownership of Family Assets and restrict the right of non-Family persons to acquire interests in Family Assets;

(6) provide protection to Family Assets from claims of future creditors against Family members;

(7) provide flexibility in business planning not available through trusts, corporations, or other business entities;

(8) facilitate the administration and reduce the cost associated with the disability or probate of the estates of Family members; and

(9) promote the Family's knowledge of and communication about Family Assets.

* * * * * * *

6.1 Management. The General Partners shall have exclusive management and control of the business of the Partnership, and all decisions regarding the management and affairs of the Partnership shall be made by the General Partners. * * * [Specifically,] they shall have the power and authority * * * :

(1) to determine the investments and investment strategy of the Partnership;

* * * * * * *

8.4 No Withdrawal. No Limited Partner may withdraw from the Partnership except as may be expressly provided in this Agreement.

* * * * * * *

9.1 Assignment of Interest. A Limited Partner may not without the prior written consent of all

Partners assign (including by encumbrance), whether voluntarily or involuntarily, all or part of his or her Interest in the Partnership, except as permitted by this Agreement. * * *

9.2 Permitted Assignments. A Limited Partner may assign all or any portion of his or her Interest in the Partnership to a revocable trust the entire beneficial interest of which is owned by the Partner. In addition, a Limited Partner may assign all or any portion of his or her Interest in the Partnership, at any time or from time to time, during lifetime or upon death, to a Family member; to a custodian for a Family member under an applicable Uniform Transfers to Minors Act; to another Partner; or to trustees, inter vivos or testamentary, holding property in trust for Family members (notwithstanding that someone who is not a Family member may also be a beneficiary of such trust.) * * *

9.3 Acquisition of Partnership Interest in Event of Non-Permitted Assignment. If an assignment of a Partnership Interest occurs which is prohibited or rendered void by the terms of this Agreement, but the General Partners determine that such assignment is nevertheless effective according to then applicable law,[2] the Partnership shall have the option (but not the obligation) to acquire the Interest of the assignee or transferee upon the following terms and conditions:

(1) The Partnership will have the option to acquire the Interest by giving written notice of its intent to purchase to the transferee or assignee within ninety (90)days from the date the Partnership is notified in writing of the transfer or assignment.

(2) Unless the Partnership and the transferee or assignee agree otherwise, the purchase price for the Interest, or any fraction to be acquired by the Partnership, shall be its fair market value based upon the assignee's right to share in distributions from the Partnership, as determined by an appraisal performed by an independent appraiser selected by the General Partners.

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[2] As examples of assignments of a partnership interest that would be violative of the partnership agreement but still effective, petitioners suggest transfers upon death or divorce of a limited partner and a transfer to a creditor.

(3) The valuation date for the determination of the purchase price of the Interest will be the date of death in the case of an assignment due to death or, in all other cases, the first day of the month following the month in which the Partnership is notified in writing of the assignment.

(4) The closing of the purchase of the Interest shall occur no later than one hundred eighty (180) days after the valuation date, as defined in (3) above.

(5) In order to reduce the burden upon the resources of the Partnership, the Partnership will have the option, to be exercised in writing delivered at closing, to pay ten percent (10%) of the purchase price at closing and pay the balance of the purchase price in five (5) equal annual installments of principal (or equal annual installments over the remaining term of the Partnership if less than five (5) years), together with interest at the Applicable Federal Rate (as that term is defined in the Code) which is in effect for the month in which the closing occurs. The first annual installment of principal, with accrued interest, will be due and payable exactly one year after the date of closing, and subsequent annual installments of principal, with accrued interest, will be due and payable each year thereafter on the anniversary date of the closing until five (5) years after the date of closing (or shorter term, if applicable), when the remaining amount of the obligation, with unpaid accrued interest, shall be paid in full. The Partnership will have the right to prepay all or any part of the remaining obligation at any time without penalty.

(6) By consent of the Partners (other than the Partner whose interest is to be acquired), the General Partners may assign the Partnership’s option to purchase to one or more Partners and when done, any rights or obligations imposed upon the Partnership will instead become, by substitution, the rights and obligations of such Partners.

(7) If the option to purchase under this paragraph 9.3 is not exercised, the assignee

> may retain the assigned Interest provided the assignee agrees in writing to be bound by the terms and conditions of this Agreement. The assignee shall not become a Limited Partner unless all of the other Partners consent, which consent may be granted or withheld in their sole discretion, and the other conditions for admission contained in this Article IX are satisfied. The rights of an assignee who does not become a Limited Partner shall be limited to the right to receive, to the extent assigned, only the distributions to which the assignor would be entitled under this Agreement.
>
> * * * * * * *
>
> 12.1 Events Causing Dissolution. The Partnership shall be dissolved and its affairs shall be wound up upon the first to occur of the following:
>
> (1) on December 31, 2049, * * * ;
>
> * * * * * * *
>
> (4) written consent of all Partners; * * *
>
> * * * * * * *

November 8, 1999, Gift

As of November 8, 1999, petitioners made a gift of limited partner interests (LP units) in the partnership to Janelle, both as custodian for I. under the Minnesota UTMA and as trustee. Apparently, the gift to Janelle as custodian for I. was one step in petitioners' plan to equalize gifts among their daughters. Each petitioner transferred (1) 713.2667 LP units (together, 1,426.5334 LP units) to Janelle as custodian for I. and (2) 3,502.6385 LP units (together, 7,005.367 LP units) to Janelle as trustee. As a result of that gift, the partnership was owned as follows:

Table 2

Partner	Class	Partnership Units	% Owned
Tom	General	89.16	0.89
Kim	General	89.16	0.89
Tom	Limited	687.76	6.88
Kim	Limited	687.76	6.88
Trust	Limited	7,019.63	70.20
I. Custodianship	Limited	1,426.53	14.26
Total		10,000.00	100.00

Each petitioner timely filed a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for 1999, electing to split gifts (i.e., treating gifts made to third parties as being made one-half by each spouse) and reporting the fair market value of the November 8, 1999, transfer of LP units from each petitioner (one-half of the total gift) as $601,827 on the basis of an independent appraisal of the LP units transferred. The appraiser making that appraisal applied a discount of 49.25 percent to the partnership's net asset value (the value of the Dell shares) in reaching his conclusion as to the value of 1 LP unit on November 8, 1999.

December 13, 1999, Transfers

On December 13, 1999, MSDW transferred 10,030 shares of Dell stock to the partnership's account from each of three custodial accounts maintained for L., C., and V. under the Texas UTMA.

Also on December 13, 1999, MSDW transferred 30 shares of Dell stock to the partnership's account from the custodial account maintained for I. under the Minnesota UTMA.

As a result of those transfers, the partnership owned 100,220 shares of Dell stock, and the partners held interests in the partnership as follows:[3]

Table 3

Partner	Class	Partnership Units	% Owned
Tom	General	89.16	0.62
Kim	General	89.16	0.62
Tom	Limited	687.76	4.81
Kim	Limited	687.76	4.81
Trust	Limited	7,019.63	49.10
I. Custodianship	Limited	1,430.81	10.01
L. Custodianship	Limited	1,430.81	10.01
C. Custodianship	Limited	1,430.81	10.01
V. Custodianship	Limited	1,430.81	10.01
Total		14,296.71	100.00

January 4, 2000, Gift

As of January 4, 2000, petitioners transferred 469.704 LP units to Janelle as custodian, one quarter (117.426 LP units) for each of the daughters.

As a result of those transfers, interests in the partnership were held as follows:

[3] Janelle, as custodian for the various custodial accounts, received a limited partner interest in the partnership equal to the number of Dell shares contributed from each account divided by the total number of Dell shares contributed then, or before, by all of the partners.

Table 4

Partner	Class	Partnership Units	% Owned
Tom	General	89.16	0.62
Kim	General	89.16	0.62
Tom	Limited	452.91	3.17
Kim	Limited	452.91	3.17
Trust	Limited	7,019.63	49.10
I. Custodianship	Limited	1,548.24	10.83
L. Custodianship	Limited	1,548.24	10.83
C. Custodianship	Limited	1,548.24	10.83
V. Custodianship	Limited	1,548.24	10.83
Total		14,296.73	100.00

Each petitioner timely filed a Form 709 for 2000, electing to split gifts and reporting the fair market value of the January 4, 2000, transfer of LP interests from each petitioner (one-half of the total gift) as $40,000 on the basis of an independent appraisal of the LP interests transferred (which, as with the appraisal of the 1999 gift, applied a discount of 49.25 percent to the partnership's net asset value to determine the value of 1 LP unit on January 4, 2000).

January 5, 2001, Transfers

On January 5, 2001, petitioners contributed an additional 10,880 shares of Dell stock to the partnership (allocated as 5,440 from each), and each received 1,552.07 new LP units, which increased each of their limited partner interests in the partnership by 4.58 percent.

As a result of those transfers, the partnership owned 111,100 shares of Dell stock, and the partners held interests in the partnership as follows:[4]

Table 5

Partner	Class	Partnership Units	% Owned
Tom	General	89.16	0.56
Kim	General	89.16	0.56
Tom	Limited	1,229.08	7.75
Kim	Limited	1,229.08	7.75
Trust	Limited	7,019.63	44.29
I. Custodianship	Limited	1,548.24	9.77
L. Custodianship	Limited	1,548.24	9.77
C. Custodianship	Limited	1,548.24	9.77
V. Custodianship	Limited	1,548.24	9.77
Total		15,849.07	99.99

February 2, 2001, Gift

As of February 2, 2001, petitioners transferred 860.772 LP units to Janelle as custodian, one quarter (215.193 LP units) for each of the daughters.

As a result of those transfers, interests in the partnership were held as follows:

[4] Petitioners received limited partner interests equal to the number of Dell shares contributed by each divided by the total number of Dell shares contributed then, or before, by all of the partners.

Table 6

Partner	Class	Partnership Units	% Owned
Tom	General	89.16	0.56
Kim	General	89.16	0.56
Tom	General	798.70	5.04
Kim	Limited	798.70	5.04
Trust	Limited	7,019.63	44.29
I. Custodianship	Limited	1,763.43	11.13
L. Custodianship	Limited	1,763.43	11.13
C. Custodianship	Limited	1,763.43	11.13
V. Custodianship	Limited	1,763.43	11.13
Total		15,849.07	100.01

Each petitioner timely filed a Form 709 for 2001, electing to split gifts and reporting the fair market value of the February 2, 2001, transfer of LP interests from each petitioner (one-half of the total gift) as $40,000 on the basis of their estimates of the value of the transferred interests in the light of prior independent appraisals of LP interests transferred.

Assets and Operation of the Partnership

Upon formation of the partnership, Tom had no immediate plan other than that it would hold the Dell shares it had received. At no time from formation through 2001 did the partnership have a business plan.

The partnership has no employees and no telephone listing in any directory.

At formation and on each of the dates for valuing the transfers here in question, the partnership's assets consisted solely of shares of stock of Dell.

From the formation of the partnership through 2001, the partnership prepared no annual statements.

At the time Tom decided to create the partnership, he had plans to make the gifts of LP units that were made in 1999, 2000, and 2001.

The partnership had no income to report, and it filed no Federal income tax return for 1999, 2000, or 2001.

On December 5, 2001, the partnership received $67,573.84 on the sale of covered call options on some of its Dell shares. That transaction was not reportable for Federal income tax purposes until the following year, when the options expired.

Values of Dell Shares

For the dates indicated, the high, low, average, and closing prices of a share of Dell stock were as follows:

Table 7

Date	High	Low	Average	Closing
Nov. 2, 1999	$41.19	$40.13	$40.660	$41.1875
Nov. 8, 1999	40.94	39.31	41.125	40.1250
Jan. 4, 2000	49.25	46.50	47.875	46.6250
Feb. 2, 2001	27.25	25.00	26.125	25.1875

The Notices

As pertinent to the issues before us, in support of each notice, respondent made the following adjustments with respect to the gifts of LP units described above:

Table 8

Gifts of LP Units

Year	Respondent's Determined Value	Reported Value	Increase
1999	$1,184,684	$601,827	$582,857
2000	78,912	40,000	38,912
2001	78,760	40,000	38,760

Respondent explained those adjustments for 1999 as follows:

(1) It is determined that the transfer of assets to the Holman Limited Partnership, [sic] is in substance an indirect gift within the meaning of I.R.C. Section 2511 of the assets to the other partners.

(2) Alternatively, it is determined that in substance and effect the taxpayer's interest in Holman Limited Partnership is more analogous to an interest in a trust than to an interest in an operating business, and should be valued as such for federal transfer tax purposes.

(3) Alternatively, it is determined that the transferred interest in the Holman Limited Partnership should be valued without regard to any restriction on the right to sell or use the partnership interest within the meaning of I.R.C. Section 2703(a)(2).

(4) Alternatively, it is determined that certain restrictions on liquidation of the Holman Limited Partnership interests contained in the articles of organization and operating agreement should be disregarded for valuation purposes pursuant to I.R.C. Section 2704(b).

(5) Alternatively, it is determined that the fair market value of such gifts is $871,971.00, after allowance of a discount for lack of marketability or minority interest of 28%.

Respondent's explanations of his adjustments for 2000 and 2001 are the same except that, in the fifth alternative, the

determination of the fair market value of the gifts is $56,817 and $56,707 for 2000 and 2001, respectively.

OPINION

I. Introduction

Petitioners transferred Dell stock of substantial value to a newly formed family limited partnership and then made gifts of limited partnership units in the partnership (LP units) to a custodian for one of their children and in trust for the benefit of all of their children. Petitioners made a large gift in 1999 and smaller gifts in 2000 and 2001 (collectively, the gifts; individually, the 1999, 2000, or 2001 gift, respectively). In valuing the gifts for Federal gift tax purposes, they applied substantial discounts for minority interest status and lack of marketability. With respect to the 1999 gift, respondent argues that the gift should be treated as an indirect gift of Dell shares and not as a direct gift of LP units. For all of the gifts treated as gifts of LP units, respondent argues that the restrictions contained in the partnership agreement on a limited partner's right to transfer her interests in the partnership should be disregarded pursuant to section 2703(a)(2). Respondent also disagrees with petitioners' application of discounts. Respondent has abandoned his reliance on section 2704(b) ("Certain restrictions on liquidation disregarded."), and he no longer argues that the partnership should be treated as if it were a trust. We shall address respondent's remaining arguments in turn.

II. Indirect Gifts

A. Law

Section 2501(a) imposes a tax on the transfer of property by gift during the year. The tax is imposed on the values of the gifts made during the year. See sec. 2502(a). The amount of a gift of property is the value thereof on the date of transfer. See sec. 2512(a). That value of a gift of property is determined by the value of the property passing from the donor and not necessarily by the measure of enrichment resulting to the donee from the transfer. Sec. 25.2511-2(a), Gift Tax Regs. Where property is transferred for less than adequate and full consideration in money or money's worth (hereafter, simply, adequate consideration), then the excess of the value of the property transferred over the consideration received is generally deemed a gift. See sec. 2512(b). The gift tax applies whether the gift is direct or indirect. Sec. 2511(a). Section 25.2511-1(h)(1), Gift Tax Regs., illustrates an indirect gift made by a shareholder of a corporation to the other shareholders of the corporation. The shareholder transfers property to the corporation for less than adequate consideration. The regulation concludes that, generally, such a transfer represents gifts by the shareholder to the other individual shareholders to the extent of their proportionate interests in the corporation. Similarly, if a partner transfers property to a partnership for less than adequate consideration, the transfer generally will be treated as an indirect gift by the transferor to the other

partners. See, e.g., Shepherd v. Commissioner, 115 T.C. 376, 389 (2000), affd. 283 F.3d 1258 (11th Cir. 2002). Indeed, in affirming the Tax Court, the Court of Appeals said: "[G]ifts to a partnership, like gifts to a corporation, are deemed to be indirect gifts to the stakeholders 'to the extent of their proportionate interests' in the entity. See * * * [sec. 25.2511-1(h)(1), Gift Tax Regs.]." Shepherd v. Commissioner, 283 F.3d at 1261.

B. Parties' Arguments

1. Respondent's Indirect Gift Arguments

Respondent's arguments are simple and straightforward:

> The gift tax is imposed on the donor, and is based on the value of the transferred property on the date of the gift. * * * Here, the property that passed from the donors is Dell stock, not the * * * LP units. Therefore, Tom and Kim's transfers of Dell stock, not the * * * LP units, as of November 8, 1999, are taxed under the terms of § 2501(a)(1).
>
> Alternatively, the formation, funding, and gifts of * * * LP units dated as of November 8, 1999 are steps of an integrated donative transaction. Once the intermediate steps are collapsed, Tom and Kim's gifts are gifts of Dell stock in the form of * * * LP units. * * *

2. Petitioners' Responses

Petitioners' responses are equally simple and straightforward:

> First, no donative transfer occurred on formation of the Partnership because each partner contributed Dell stock to the Partnership, and each received interests in the Partnership precisely in proportion to the assets contributed by each. Further, because the Partnership was clearly and properly established under Minnesota law on November 3, 1999, Petitioners' gifts of Partnership interests on November 8, 1999, to the Trust and to the Minnesota UTMA Account cannot

constitute indirect gifts of the Dell stock owned by the Partnership on that date.

C. Discussion

1. A Gift to the Partners on Account of a Transfer to the Partnership

Respondent's first alternative indirect gift argument invokes the illustration in section 25.2511-1(h)(1), Gift Tax Regs., of an indirect gift made by a shareholder of a corporation to the other shareholders of the corporation. The regulation concludes that, generally, where a shareholder transfers property to a corporation for less than adequate consideration, the transfer represents gifts by the shareholder to the other shareholders to the extent of their proportionate interests in the corporation. Respondent asks us to compare the facts at hand to the facts in Shepherd and in Senda v. Commissioner, T.C. Memo. 2004-160, affd. 433 F.3d 1044 (8th Cir. 2006), in both of which we concluded that transfers by a partner to a partnership were indirect transfers to the other partners.

In Shepherd v. Commissioner, 115 T.C. at 380-381, the taxpayer transferred real property and shares of stock to a newly formed family partnership in which he was a 50-percent owner and his two sons were each 25-percent owners. Rather than allocating contributions to the capital account of the contributing partner, the partnership agreement provided that any contributions would be allocated pro rata to the capital accounts of each partner according to ownership. Id. at 380. Because the contributions were reflected partially in the capital accounts of the

noncontributing partners, the values of the noncontributing partners' interests were enhanced by the contributions of the taxpayer. Accordingly, we held that the transfers to the partnership were indirect gifts by the taxpayer to his sons of undivided 25-percent interests in the real property and shares of stock. Id. at 389.

In Senda v. Commissioner, supra, the Commissioner contended that the taxpayers' transfers of shares of stock to two family limited partnerships, coupled with their transfers of limited partner interests to their children, were indirect gifts of the shares to those children. In both instances, the stock transfers and the transfers of the partnership interests occurred on the same day. We said that the taxpayers' transfers of shares were similar to the transfer of property in the Shepherd case: "In both cases, the value of the children's partnership interests was enhanced by their parents' contributions to the partnership." We rejected the taxpayers' attempt to distinguish the Shepherd case on the ground that they first funded the partnership and then transferred the partnership interests to their children. We found: "At best, the transactions were integrated (as asserted by respondent) and, in effect, simultaneous." We held that the taxpayers' transfers of the shares of stock to the two partnerships were indirect gifts of the shares to their children.

The facts in the instant case are distinguishable from those of both the Shepherd and Senda cases. On November 3, 1999, the partnership was formed, petitioners transferred 70,000 Dell

shares to the partnership, and Janelle, as trustee, transferred 100 Dell shares to the partnership. On account of those transfers, petitioners and Janelle received partnership interests proportional to the number of shares each transferred to the partnership. It was not until November 8, 1999, that petitioners are deemed to have made (and, on that date, they did make)[5] a gift of LP units to Janelle, both as custodian for I. under the Minnesota UTMA and as trustee. Petitioners did not first transfer LP units to Janelle and then transfer Dell shares to the partnership, nor did they simultaneously transfer Dell shares to the partnership and LP units to Janelle. The facts of the Shepherd and Senda cases are materially different from those of the instant case, and we cannot rely on those cases to find that petitioners made an indirect gift of Dell shares to Janelle, either as custodian for I. under the Minnesota UTMA or as trustee. We shall proceed to respondent's alternative argument.

[5] On the basis of stipulated facts, we have found that, "[a]s of November 8, 1999," petitioners made a gift of LP units to Janelle, both as custodian for I. under the Minnesota UTMA and as trustee. The stipulated facts are based on undated instruments assigning the LP units "effective November 8, 1999". On the basis of a stipulated fact, we have also found that petitioners each filed a 1999 gift tax return reporting the fair market value of "the November 8, 1999," transfer of LP units. The parties have also stipulated an appraisal of that gift that recites that the gift was made on Nov. 8, 1999. Respondent's valuation expert, Francis X. Burns, assumed that the 1999 gift was made on Nov. 8, 1999, as did petitioners' valuation expert, Troy D. Ingham. While it is not free from doubt, we conclude, and find, that the 1999 gift was made on Nov. 8, 1999. For similar reasons, we conclude and find that the gifts made "as of" Jan. 4, 2000, and Jan. 5, 2001, were made on those dates, respectively.

2. Indirect Gift Under the Step Transaction Doctrine

Alternatively, respondent argues that petitioners made an indirect gift under the step transaction doctrine. As we recently summarized that doctrine in Santa Monica Pictures, L.L.C. v. Commissioner, T.C. Memo. 2005-104:

> The step transaction doctrine embodies substance over form principles; it treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987). "Where an interrelated series of steps are taken pursuant to a plan to achieve an intended result, the tax consequences are to be determined not by viewing each step in isolation, but by considering all of them as an integrated whole." Packard v. Commissioner, 85 T.C. 397, 420 (1985).
>
> There is no universally accepted test as to when and how the step transaction doctrine should be applied to a given set of facts; however, courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine in a particular situation: the "binding commitment," the "interdependence," and the "end result" tests. Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181, 198-199 (1989); Penrod v. Commissioner, supra at 1429-1430. * * *

We have considered the step transaction doctrine in transfer (gift and estate) tax cases. See, e.g., Daniels v. Commissioner, T.C. Memo. 1994-591.

Respondent does not explicitly state which of the above three tests he is relying on, although it appears he is arguing that the 'interdependence' test is applicable. In Santa Monica Pictures, we described the interdependence test as follows:

> Under the "interdependence" test, the step transaction doctrine will be invoked where the steps in a series of transactions are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. * *

> * We must determine whether the individual steps had independent significance or whether they had significance only as part of a larger transaction. * * * [Citations omitted.]

In his brief, respondent argues:

> If none of the individual events occurring between the contribution of the property to the partnership and the gifts of partnership interests had any significance independent of its status as an intermediate step in the donors' plan to transfer their assets to their donees in partnership form, the formation, funding, and transfer of partnership units pursuant to an integrated plan is treated as a gift of the assets to a partnership of which the donees are the other partners. Treas. Reg. § 25.2511-1(h)(1).

The nub of respondent's argument is that petitioners' formation and funding of the partnership should be treated as occurring simultaneously with their 1999 gift of LP units since the events were interdependent and the separation in time between the first two steps (formation and funding) and the third (the gift) served no purpose other than to avoid making an indirect gift under section 25.2511-1(h), Gift Tax Regs. While we have no doubt that petitioners' purposes in forming the partnership included making gifts of LP units indirectly to the children, we cannot say that the legal relations created by the partnership agreement would have been fruitless had petitioners not also made the 1999 gift. Indeed, respondent does not ask that we consider either the 2000 gift (made approximately 2 months after formation of the partnership) or the 2001 gift (made approximately 15 months after formation of the partnership) to be indirect gifts of Dell shares. We must determine whether the fact that less

than 1 week passed between petitioners' formation and funding of the partnership and the 1999 gift requires a different result.

Respondent relies heavily on the opinion of the Court of Appeals for the Eighth Circuit in Senda v. Commissioner, 433 F.3d 1044 (8th Cir. 2006).[6] In affirming our decision in the Senda case, the Court of Appeals concluded that we did not clearly err in finding that the taxpayers' transfers of shares of stock to two family limited partnerships, coupled with their transfers on the same days of limited partner interests to their children, were in each case integrated steps in a single transaction. Id., at 1049. The taxpayers argued that the order of transfers did not matter since, pursuant to the partnership agreements in question, their contributions of the shares of stock were credited to their partnership capital accounts before being credited to the children's accounts. Id. at 1047. Invoking the step transaction doctrine, the Court of Appeals rejected that step-dependent argument. Id. at 1048. It said: "In some situations, formally distinct steps are considered as an integrated whole, rather than in isolation, so federal tax liability is based on a realistic view of the entire transaction." Id.

This case is distinguishable from Senda because petitioners did not contribute the Dell shares to the partnership on the same day they made the 1999 gift; indeed, almost 1 week passed between

[6] The Court of Appeals for the Eighth Circuit is the court to which, barring the parties' stipulation to the contrary, any appeal in this case would lie. See sec. 7482(b).

petitioners' formation and funding of the partnership and the 1999 gift. Nevertheless, the Court of Appeals in Senda did not say that, under the step transaction doctrine, no indirect gift to a partner can occur unless, on the day property is transferred to the partnership, the partner is (or becomes) a member of the partnership. As respondent's failure to argue indirect gifts on account of the 2000 and 2001 gifts suggests, however, the passage of time may be indicative of a change in circumstances that gives independent significance to a partner's transfer of property to a partnership and the subsequent gift of an interest in that partnership to another.

Here the value of an LP unit changed over time. The parties have stipulated the high, low, average, and closing prices of a share of Dell stock on November 2, 1999, the date petitioners initially transferred Dell shares to the partnership's account, and the subsequent dates of the gifts, and we have found accordingly. See supra table 7. Beginning on November 2, 1999, and ending on the dates of the gifts, the percentage changes in the average price of a share of Dell stock were as follow:

Table 9

Percentage Changes in the Average Price of a Share of Dell Stock

Date	Percentage
11/2/1999 to 11/8/1999	-1.316
11/2/1999 to 1/4/2000	+17.745
11/2/1999 to 2/2/2001	-35.748

The value of an LP unit, based on its proportional share of the average value of the Dell shares held by the partnership, fell or rose between the dates indicated by the percentage indicated. Respondent has proposed as a finding of fact, and we have found, that, at the time Tom decided to create the partnership, he had plans to make the 1999, 2000, and 2001 gifts. Petitioners bore the risk that the value of an LP unit could change between the time they formed and funded the partnership and the times they chose to transfer LP units to Janelle. Indeed, the absolute value of the rate of change in the value of an LP unit was greater from November 2 to November 8, 1999, than it was from November 2, 1999, to February 2, 2001. Morever, the partnership held only shares of Dell stock on both November 8, 1999 (the date of the 1999 gift), and January 4, 2000 (the date of the 2000 gift), and the partnership agreement was not changed in the interim. Respondent apparently concedes that a 2-month separation is sufficient to give independent significance to the funding of the partnership and a subsequent gift of LP units. We assume that concession to be on account of respondent's recognition of the economic risk of a change in value of the partnership that petitioners bore by delaying the 2000 gift for 2 months. We draw no bright lines. Given, however, that petitioners bore a real economic risk of a change in value of the partnership for the 6 days that separated the transfer of Dell shares to the partnership's account and the date of the 1999 gift, we shall treat the 1999 gift the same way respondent

concedes the 2000 and 2001 gifts are to be treated; i.e., we shall not disregard the passage of time and treat the formation and funding of the partnership and the subsequent gifts as occurring simultaneously under the step transaction doctrine.[7]

D. Conclusion

The 1999 gift is properly treated as a direct gift of LP units and not as an indirect gift of Dell shares.

III. Section 2703

A. Introduction

In pertinent part, section 2703(a) provides that, for purposes of the gift tax, the value of any property transferred by gift is determined without regard to any right or restriction (without distinction, restriction) relating to the property. Paragraphs 9.1, 9.2, and 9.3 of the partnership agreement (paragraphs 9.1, 9.2, and 9.3, respectively), set forth supra, govern the assignment of LP units, and the parties agree that those paragraphs contain restrictions on the right of a limited partner in the partnership (a limited partner) to sell or assign her partnership interest. Section 2703(b) provides that section

[7] The real economic risk of a change in value arises from the nature of the Dell stock as a heavily traded, relatively volatile common stock. We might view the impact of a 6-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term Government bond.

2703(a) does not apply to disregard a restriction if the restriction meets each of the following three requirements:

> (1) It is a bona fide business arrangement.
>
> (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
>
> (3) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

Because we find that paragraph 9.3 fails at least the first and second restrictions, we shall disregard it in determining the values of the LP units transferred.

B. Bona Fide Business Arrangement

1. Parties' Arguments

Respondent argues that paragraph 9.3 is not part of a bona fide business arrangement since "[c]arrying on a business requires more than holding securities and keeping records." As authority for that proposition, respondent cites an income tax case, Higgins v. Commissioner, 312 U.S. 212 (1941) (taxpayer's managerial activities in connection with collecting interest and dividends on securities held for investment did not amount to carrying on a business for purposes of deducting associated expenses). Besides, respondent adds, Tom's primary purpose in forming the partnership were to preserve his Dell wealth and "disincentivize" the children from spending it, while Kim's primary purpose in forming it was to educate the children about family wealth. Those, respondent argues, "are personal, not

business[,] goals. Personal goals, with nothing more, do not create a business arrangement."

Petitioners argue:

> The restrictions on transferability, the right of first refusal, and the payout mechanism in paragraphs 9.1, 9.2, and 9.3 of the Partnership Agreement serve a bona fide business purpose * * * by preventing interests in the Partnership from passing to non-family members. * * * The creation of a mechanism to ensure family ownership and control of a family enterprise has long been held by this Court to constitute a bona fide and valid business purpose. See Estate of Stone v. Comm'r, 86 T.C.M. (CCH) 551 (2003); Estate of Bischoff v. Comm'r, 69 T.C. 32, 39-41 (1977); Estate of Reynolds v. Comm'r, 55 T.C. 172, 194 (1970), acq., 1971-2 C.B. 1; Estate of Littick v. Comm'r, 31 T.C. 181, 187 (1958), acq., 1984-2 C.B. 1; Estate of Harrison v. Comm'r, 52 T.C.M. (CCH) 1306, 1309 (1987) (holding that "[w]ith respect to business purpose, petitioner presented convincing proof that the partnership was created as a means of providing necessary and proper management of decedent's properties and that the partnership was advantageous to and in the best interests of decedent").

2. Discussion

Section 2703 contains no definition of the phrase "bona fide business arrangement". Nevertheless, we have held that the subject of the restrictive agreement need not directly involve an actively managed business. See, e.g., Estate of Amlie v. Commissioner, T.C. Memo. 2006-76 (citing Estate of Bischoff v. Commissioner, 69 T.C. 32, 40-41 (1977), a pre-section 2073 case in which we found it irrelevant that the restrictive agreements necessary to maintain continuity of management in, and control over, corporations carrying on active businesses were agreements with respect to the ownership of a holding company not actively conducting a trade or business and requiring no management). In

Estate of Amlie, the asset in question was the decedent's minority interest in a bank. Before her death the decedent voluntarily became the ward of a conservator appointed to oversee her affairs. The conservator entered into a series of agreements that, among other things, fixed the value of the decedent's bank shares for purposes of satisfying the decedent's obligations to transfer those shares to a prospective heir both in satisfaction of promised bequests and by sale upon her death. The fixed value was lower than the price obtained by the heir on his resale of the shares a month after the decedent's death. The Commissioner sought to disregard the value-fixing agreements entered into by the conservator. We found that, in securing the agreements, the conservator "was seeking to exercise prudent management of decedent's assets by mitigating the very salient risks of holding a minority interest in a closely held bank, consistent with the conservator's fiduciary obligations to decedent." We held:

> [A]n agreement that represents a fiduciary's efforts to hedge the risk of the ward's holdings may serve a business purpose within the meaning of section 2703(b)(1). In addition, planning for future liquidity needs of decedent's estate, which was also one of the objectives underlying * * * [one of the relevant agreements], constitutes a business purpose under section 2703(b)(1). * * *

In reaching that conclusion, we referred to the legislative history of section 2703, which includes an informal report of the Senate Committee on Finance, Informal Senate Report on S. 3209, 101st Cong., 2d Sess. (1990), 136 Cong. Rec. 30,488, 30,539 (1990) (the Committee on Finance report). The Committee on Finance report observes that buy-sell agreements

> are common business planning arrangements * * * that * * * generally are entered into for legitimate business reasons * * * . Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance. * * *

Indeed, we have held that buy-sell agreements serve a legitimate purpose in maintaining control of a closely held business. E.g., Estate of Bischoff v. Commissioner, supra; Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970); Estate of Fiorito v. Commissioner, 33 T.C. 440 (1959).[8]

Here, however, we do not have a closely held business. From its formation through the date of the 2001 gift, the partnership carried on little activity other than holding shares of Dell stock. Dell was not a closely held business either before or after petitioners contributed their Dell shares to the partnership. While we grant that paragraphs 9.1 through 9.3 (and paragraph 9.3 in particular) aid in control of the transfer of LP units, the stated purposes of the partnership, viewed in the light of petitioners' testimony as to their reasons for forming the partnership and including paragraphs 9.1 through 9.3 in the partnership agreement, lead us to conclude that those paragraphs do not serve bona fide business purposes. Paragraph 3.1 of the

[8] Nevertheless, the existence of a valid business purpose does not necessarily exclude the possibility that a buy-sell agreement is a tax-avoidance testamentary device to be disregarded in valuing the property interest transferred. St. Louis County Bank v. United States, 674 F.2d 1207, 1210 (8th Cir. 1982).

partnership agreement includes among the stated purposes of the partnership: "to * * * provide a means for the Family to gain knowledge of, manage, and preserve Family Assets." Tom testified at some length as to his understanding of the term "preservation" and his reasons for making asset preservation a purpose of the partnership. On the basis of that testimony, we find that his reason for making asset preservation a purpose of the partnership was to protect family assets from dissipation by the children. Tom also testified that paragraph 9.1 "lays out pretty strong limitations on what the limited partners can do in assigning or giving away their interests to other people." He viewed the buy-in provisions of paragraph 9.3 as a "safety net" if an impermissible person obtained an assignment of a limited partner interest from one of the girls. He considered the provisions of paragraphs 9.1, 9.2, and 9.3, together, as important in accomplishing his goal of keeping the partnership a closely held partnership of family members: "If there are ways for the family [the children] to wiggle out of that and bring other people in, then it will prevent us from accomplishing our goals, so we wanted a couple of levels here of restriction that would prevent that from happening." Kim testified that the purpose of organizing the partnership was to establish a tool for Tom and her "to be able to teach * * * [the] children about wealth and the responsibility of that wealth."

We believe that paragraphs 9.1 through 9.3 were designed principally to discourage dissipation by the children of the

wealth that Tom and Kim had transferred to them by way of the gifts. The meaning of the term "bona fide business arrangement" in section 2703(b)(1) is not self apparent. As discussed supra, in Estate of Amlie v. Commissioner, T.C. Memo. 2006-76, we interpreted the term "bona fide business arrangement" to encompass value-fixing arrangements made by a conservator seeking to exercise prudent management of his ward's minority stock investment in a bank consistent with his fiduciary obligations to the ward and to provide for the expected liquidity needs of her estate. Those are not the purposes of paragraphs 9.1 through 9.3. There was no closely held business here to protect, nor are the reasons set forth in the Committee on Finance report as justifying buy-sell agreements consistent with petitioners' goals of educating their children as to wealth management and "disincentivizing" them from getting rid of Dell shares, spending the wealth represented by the Dell shares, or feeling entitled to the Dell shares.

3. Conclusion

We find that paragraphs 9.1 through 9.3 do not serve bona fide business purposes. Those paragraphs do not constitute a bona fide business arrangement within the meaning of section 2703(b)(1).

C. Device Test

The second requirement of section 2703(b) is that the restriction not be a device to transfer the encumbered property to members of the decedent's family for less than full and

adequate consideration in money or money's worth (hereafter, simply adequate consideration). Sec. 2703(b)(2). The Secretary's regulations interpreting section 2703 substitute the term "the natural objects of the transferor's bounty" for the term "members of the decedent's family", apparently because he interprets section 2703 to apply to both transfers at death and inter vivos transfers. Sec. 25.2703-1(b)(1)(ii), Gift Tax Regs.[9] Clearly, the gifts of the LP units were both (1) to natural objects of petitioners' bounty and (2) for less than adequate consideration. They were not, however, a "device" to transfer the LP units to the children for less than adequate consideration. The question we must answer is whether paragraphs 9.1 through 9.3, which restrict the children's rights to enjoy the LP units, constitute such a device. We believe that they do. Those paragraphs serve the purposes of Tom and Kim to discourage the children from dissipating the wealth that Tom and Kim had transferred to them by way of the gifts. They discourage dissipation by depriving a child desirous of making an impermissible transfer of the ability to realize the difference in value between the fair market value of his LP units and the units' proportionate share of the partnership's NAV. If a child persists in making an impermissible transfer, paragraph 9.3

[9] Petitioners argue: "Of course, there is no decedent in this case, so § 2703(b)(2) appears to be satisfied on its face." They fail, however, to challenge the validity of sec. 25.2703-1(b)(1)(ii), Gift Tax Regs., upon which respondent relies. We assume that they concede the validity of the regulation in applying the device test to transfers to "the natural objects of the transferor's bounty".

allows the general partners (currently Tom and Kim) to redistribute that difference among the remaining partners. Thus, if the provisions of paragraph 9.3 are triggered and the partnership redeems the interest of an impermissible transferee for less than the share of the partnership's net asset value proportionate to the impermissible transferee's interest in the partnership (which is likely, given the agreement of the parties' valuation experts as to how the valuation discounts appropriate to an LP unit are applied; see infra section IV.A. of this report), the values of the remaining partners' interests in the partnership will increase on account of that redemption. See infra note 17 and the accompanying paragraph. The partners benefiting from the redemption could (indeed, almost certainly, would) include one or more of the children, natural objects of petitioners' bounty.

Tom participated in the drafting of the partnership agreement to ensure, in part, that "asset preservation" as he understood that term (i.e., to discourage the children from dissipating their wealth) was addressed. Tom impressed us with his intelligence and understanding of the partnership agreement, and we have no doubt that he understood the redistributive nature of paragraph 9.3. and his and Kim's authority as general partners to redistribute wealth from a child pursuing an impermissible transfer to his other children. We assume, and find, that he intended paragraph 9.3 to operate in that manner, and this intention leads us to conclude, and find, that paragraph 9.3 is a

device to transfer LP units to the natural objects of petitioners' bounty for less than adequate consideration.

D. Comparable Terms

The third requirement of section 2703(b) is that the terms of the restriction be comparable to similar arrangements entered into by persons in an arm's-length transaction. Comparability is determined at the time the restriction is created. Sec. 25.2703-1(b)(1)(iii), Gift Tax Regs. The parties rely on expert testimony to show that the elements of section 2703(b)(3) have or have not been satisfied.

Respondent called Daniel S. Kleinberger, professor of law at William Mitchell College of Law, St. Paul, Minnesota. Professor Kleinberger was accepted as an expert on arm's-length limited partnerships. In his direct testimony, he expressed the opinion that the overall circumstances of the partnership arrangement made it unlikely that a person in an arm's-length arrangement with the general partners would accept any of the "salient" restrictions on sale or use contained in the partnership agreement. He explained:

> In virtually every material respect, the * * * [partnership] agreement blocks for 50 years the limited partners' ability to sell or use their respective limited partner interests. In an arm's length transaction, a reasonable investor faced with such a prospect would ask, "What is so special about this opportunity, what do I get out of this arrangement that justified so restricting and enfeebling my rights?" The answer, in an arm's length context, is nothing.

On cross-examination, he agreed with counsel for petitioners that transfer restrictions similar to those found in paragraphs

9.1 through 9.3 are common in agreements entered into at arm's length. That, however, he concluded, was beside the point since "The owners of a closely held business at arm's length would never get into this deal with the Holmans, period, so the issue [transfer restrictions] wouldn't come up." In response to petitioner's counsel's expression of doubt as to what he meant, he answered:

> What I mean is that when you look at the overall context, when you look at the nature of the assets, when you look at the expertise or non-expertise of the general partner, when you look at the 50-year term, when you look at the inability to get out, when you look at the susceptibility of this single asset, * * * the issue [transfer restrictions] wouldn't arise, because nobody at arm's length would get into this deal."

Using a colorful expression, he summed up his view as follows:

> [B]ased on my experience and based on conversations with more than a dozen practitioners who do this stuff, I couldn't find anybody would do this deal, who would let their client into a deal like this as a limited partner without writing a very large CYA memo, saying: "We advise against this."

Petitioners called William D. Klein (Mr. Klein), a shareholder in the Minnesota law firm of Gray, Plant, Mooty, Mooty & Bennett, P.A. Mr. Klein has "practiced, written, and lectured about" partnership taxation and law for more than 20 years. He has participated in the drafting of, or reviewed drafts of, more than 300 limited partnership agreements. He was accepted as an expert with respect to the comparability of the provisions of the partnership agreement to provisions in other partnership agreements entered into by parties at arm's length. He was asked by petitioners to express his opinion as to whether

various provisions of the partnership agreement are "'comparable to similar arrangements entered into by persons in an arm's length transaction'". With respect to paragraphs 9.1 and 9.2, Mr. Klein is of the opinion that the paragraphs "are comparable to provisions one most often finds in limited partnership agreements among unrelated partners." As to paragraph 9.3, he is of the opinion that the paragraph "is not out of the mainstream of what one typically finds in arm's length limited partnership agreements."

Petitioners must show that paragraph 9.3 is "comparable to similar arrangements entered into by persons in an arm's length transaction." See sec. 2703(b)(3). The experts agree that transfer restrictions comparable to those found in paragraphs 9.1 through 9.3 are common in agreements entered into at arm's length. That would seem to be all that petitioners need to show to satisfy section 2703(b)(3). Nevertheless, respondent relies on one of his expert's, Professor Kleinberger's, testimony "that the overall circumstances of the * * * [partnership] arrangement make it unlikely that arm's length third parties would agree to any one of its restrictions on sale or use." Even were we to find that paragraph 9.3 is comparable to similar arrangements entered into by persons in arm's-length transactions (thus satisfying section 2703(b)(3)), we would still disregard it because it fails to constitute a bona fide business arrangement, as required by section 2703(b)(1), and is a prohibited device within the meaning of section 2703(b)(2). Therefore, we need not

(and do not) decide today whether respondent is correct in applying the arm's-length standard found in section 2703(b)(3) to the transaction as a whole.

IV. Valuation

A. Introduction

We must determine the values of the gifts. Although the gifts were of LP units, the parties agree that the starting point for determining those values is the net asset value (NAV) of the partnership. Since, on the dates of the gifts, the partnership held only shares of Dell stock and had no liabilities, the parties agree that the NAV on each of those dates equals the value of the Dell shares then held. The parties also agree that, in valuing the gifts of LP units, we are to look to the pro rata portion of the NAV of the partnership allocable to the LP units transferred but are to make negative adjustments to the values so determined to reflect the lack of control and lack of marketability inherent in the transferred interests. The parties disagree on the magnitude of those discounts. They also disagree on the effect of disregarding paragraph 9.3. We have set forth as appendixes A through D hereto comparisons based on materials prepared by respondent of the parties' valuation positions for each of the gifts. There appear to be no discrepancies between the information in those appendixes and petitioners' computations of like amounts.

B. Law

Pertinent to our determination of the values of the gifts is section 25.2512-1, Gift Tax Regs., which provides that the value of property for Federal gift tax purposes is "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." The willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the donor and the donee. See, e.g., Estate of Davis v. Commissioner, 110 T.C. 530, 535 (1998). The hypothetical willing buyer and the hypothetical willing seller are presumed to be dedicated to achieving the maximum economic advantage. E.g., id.

C. Expert Opinions

1. Introduction

The parties rely exclusively on expert testimony to establish the appropriate discounts to be applied in determining the fair market values of the gifts of LP units. Of course, we are not bound by the opinion of any expert witness, and we may accept or reject expert testimony in the exercise of our sound judgment. Helvering v. Natl. Grocery Co., 304 U.S. 282, 295 (1938); Estate of Newhouse v. Commissioner, 94 T.C. 193, 217 (1990). Because valuation necessarily involves an approximation, the figure at which we arrive need not be directly traceable to specific testimony if it is within the range of values that may

be properly derived from consideration of all the evidence. E.g., Peracchio v. Commissioner, T.C. Memo. 2003-280.

2. Petitioners' Expert

Petitioners called Troy D. Ingham (Mr. Ingham) as an expert witness to testify concerning the values of the gifts. Mr. Ingham is a vice president and director with Management Planning, Inc., a business valuation firm. He has been performing valuation services since 1996. He is a candidate for the American Society of Appraisers. The Court accepted Mr. Ingham as an expert on business valuation and limited partnership valuation, and we received into evidence as his direct testimony four reports he had participated in preparing. Three of those reports express his opinions as to the fair market value of an LP unit on November 8, 1999, January 4, 2000, and February 2, 2001, respectively (the dates of the 1999, 2000, and 2001 gifts, respectively). In each report, Mr. Ingham gives his opinion alternatively regarding and disregarding the effect of paragraph 9.3. Mr. Ingham's opinions are summarized in appendixes A through D. Petitioners offered Mr. Ingham's fourth report in rebuttal to respondent's valuation expert witness's testimony, and that report expresses Mr. Ingham's opinion that some of respondent's valuation expert witness's conclusions are flawed.

3. Respondent's Expert

Respondent called Francis X. Burns (Mr. Burns) as an expert witness to testify concerning the values of the gifts. Mr. Burns is a vice president of CRA International, Inc., an international

consulting firm that provides business valuation services. He is an accredited senior appraiser in business valuation within the American Society of Appraisers and a member of the Institute of Business Appraisers. He has been performing valuation services for more than 18 years, and he has testified as an expert in several valuation cases. The Court accepted Mr. Burns as an expert in the valuation of business entities and partnerships, and we received into evidence as his direct testimony the report he had prepared. In that report, he expresses his conclusions as to the fair market values of the gifts, alternatively regarding and disregarding the effect of paragraph 9.3. His opinions are summarized in appendixes A through D.

D. Discussion

1. Net Asset Value of Partnership

The parties agree on the numbers of Dell shares the partnership held on the dates of the gifts. They further agree that the value of those shares establishes the NAV of the partnership on each of those dates. They agree that the partnership's NAV was $2,812,763 (rounded) on the date of the 1999 gift. They disagree as to the partnership's NAV on each of the dates of the 2000 and 2001 gifts. Relying on Mr. Ingham's calculation of the closing values of a share of Dell stock on the dates of those gifts, petitioners argue that the partnership's NAVs on those dates were $4,672,758 and $2,798,331, respectively. Relying on Mr. Burns's calculations of the averages of the high and low prices of a share of Dell stock on those dates,

respondent argues that the partnership's NAVs on those dates were $4,798,033 and $2,902,488, respectively. Section 25.2512-2, Gift Tax Regs., deals with the valuation of stocks and bonds for purposes of the gift tax. See sec. 25.2512-2(a), Gift Tax Regs. In pertinent part, section 25.2512-2(b)(1), Gift Tax Regs., provides: "In general, if there is a market for stocks * * *, on a stock exchange, in an over-the-counter market or otherwise, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share". Petitioners argue that, because the gifts here being valued are gifts of partnership interests that do not trade in a public market, the regulation is inapplicable. Moreover, argue petitioners, in determining his discount for lack of control, Mr. Ingham relied on data showing that shares of publicly held investment companies generally trade at a discount from NAV, determined by comparing the price of the company to its end-of-day NAV.

We cannot dismiss the regulation, as petitioners would have us do. The starting point for valuing the gifts is determining the NAV of the partnership, which is defined exclusively by the value of shares of Dell stock, which Mr. Ingham opines are "traded over-the-counter". The rules for valuing marketable shares of stock found in section 25.2512-2(b)(1), Gift Tax Regs., are not gift-specific rules whose application makes no sense if it is only the value of the shares, indirectly, that is at issue, and petitioners provide no authority for disregarding the rules.

To the contrary, petitioners cite a case that supports a contrary view: Estate of Cook v. Commissioner, T.C. Memo. 2001-170 (annuity tables appropriate to value installment payoff of lottery ticket held by partnership notwithstanding marketability discount that might apply to valuation of partnership interest), affd. 349 F.3d 850 (5th Cir. 2003).

Petitioners' argument with respect to Mr. Ingham's methodology for determining a lack of control discount is equally unpersuasive. Data from the universe of trades of publicly held investment companies may well show that shares of those companies generally trade at a discount from NAV determined at the end of the day, but petitioners have failed to show that any statistical inference to be drawn from that data would be any different if an average of the highs and lows of the component securities were used to determine NAV.

We shall rely on Mr. Burns's computations of $4,798,033 and $2,902,488 as the partnership's NAVs on the dates of the 2000 and 2001 gifts, respectively.

2. Minority Interest (Lack of Control) Discount

a. Introduction

Pursuant to the partnership agreement, a hypothetical buyer of an LP unit would have limited control of his investment. For instance, such a buyer (1) would have no say in the partnership's investment strategy, and (2) could not unilaterally recoup his investment by forcing the partnership either to redeem his unit or to undergo a complete liquidation. The parties agree that the

hypothetical "willing buyer" of an LP unit would account for such lack of control by demanding a reduced price; i.e., a price that is less than the unit's pro rata share of the partnership's NAV.

b. Comparison to Closed-End Investment Funds

Both Messrs. Ingham and Burns apply minority interest discounts in valuing the gifts by reference to the prices of shares of publicly traded, closed-end investment funds, which typically trade at a discount relative to their share of fund NAV by definition.[10] The idea is that since, by definition, such shares enjoy a high degree of marketability, those discounts must be attributable, at least to some extent, to a minority shareholder's lack of control over the investment fund. The minority interest discounts applied by Messrs. Ingham and Burns in valuing the gifts are as follows:

Table 10

Valuation expert	1999 gift	2000 gift	2001 gift
Mr. Ingham	14.4%	16.3%	10%
Mr. Burns	11.2	13.4	5

In determining those discounts, both experts rely on samples of closed-end investment funds with investment portfolios comprising predominantly domestic equity securities; viz, shares

[10] We understand from the expert testimony of Messrs. Ingham and Burns that, unlike a shareholder of an open-end fund (and similar to a holder of a limited partner interest in the partnership), a shareholder of a closed-end fund cannot obtain the liquidation value of his investment (i.e., his pro rata share of the fund's net asset value (NAV)) at will by tendering his shares to the fund for repurchase.

of common stock. Each expert relies on three samples, one for the date of each gift (the valuation dates). Mr. Ingham's sample sizes are 28, 28, and 27, and Mr. Burns's are 28, 27, and 25. For the first two valuation dates, 20 of the closed-end investment funds in each of the four sets of samples are the same. For the third date, 18 are the same. Mr. Burns relies solely on general equity funds, which contain a diversified portfolio of stocks across industries. Mr. Ingham includes in his samples seven specialized equity funds with investments in the healthcare, petroleum and resources, and banking industries. Mr. Ingham computes (and relies on) only the median discount for each of his samples. Mr. Burns computes not only the median discount for each of his samples but also the mean and interquartile mean discounts for each.[11] The following table shows the results of each expert's computations.

[11] The following description of the terms "mean", "median", and "interquartile mean" is drawn from Kaye & Freedman, "Reference Guide on Statistics", in Reference Manual on Scientific Evidence, 83, 113–115 (Federal Judicial Center, 2d ed. 2000). "Mean" and "median" are common descriptive statistics used to describe the central tendency (i.e., the middle or "expected" value) of a set of numerical data. The mean (commonly, "average") is found by adding up all the numbers and dividing by how many there are. By comparison, the median is defined so that half the numbers are bigger than the median, and half are smaller. The mean takes account of all the data – it involves the total of all the numbers. Particularly with small data sets, however, a few unusually large or small observations may have too much influence on the mean. The median is resistant to such outliers. See the definition of the term "outlier" infra note 12. The interquartile mean is the mean of the 50 percent of the data points falling between the 25th and 75th percentiles. Like the median, it is resistant to outliers. Also, to remove the influence of outliers on the mean, it may be recomputed disregarding outliers.

Table 11

Valuation expert's computation	1999 gift	2000 gift	2001 gift
Mr. Ingham: Median	13.1%	14.8%	9.1%
Mr. Burns: Mean	10.8	11.7	3.4
Mr. Burns: Median	12.1	14.8	3.8
Mr. Burns: Interquartile mean	11.2	13.4	5.0

Mr. Ingham considers adjustments to his median discount figures to reflect what he describes as quantitative factors (i.e., aggregate size of the partnership's NAV, relative volatility of the partnership's portfolio, measures of return and yield) but determines that those factors had an insignificant influence. He considers qualitative factors (i.e., the lack of diversification of the partnership's portfolio, the depth and quality of the partnership's management, the partnership's income tax status), and he determines that, "[b]ased on all relevant factors, including the fact that * * * [the partnership's] portfolio is neither well diversified nor professionally managed on a daily basis", an investor or willing buyer of an LP unit would require a discount 10 percent greater than the median discount he had determined. Table 10 reflects his final determination that the appropriate minority interest discounts are 110 percent of the median discounts he determined. Mr. Burns relies on the interquartile mean discount. Although he considers a downward adjustment to reflect the large size of the limited partner interest held by Janelle as trustee (and the influence that would

give her over the general partners), he rejects any adjustment "as a point of conservatism".

We must determine (1) the composition of the appropriate samples of closed-end investment funds (i.e., whether Mr. Ingham appropriately includes specialized funds); (2) the appropriate descriptive statistic to measure the central tendency of the samples; and (3) whether Mr. Ingham's adjustments to his sample medians are justified.

c. Discussion

On cross-examination, Mr. Ingham agreed with counsel for respondent that the seven specialized equity funds that he had included in his samples of closed-end equity funds resembled the partnership only in that they were specialized in their investments. Indeed, that was his reason for including them, although he agreed that he could find no correlation between quantitative factors particular to the funds in his samples and the discounts at which those funds traded. He further agreed that he had included no explanation in his report as to why he had included the specialized funds in his samples. We have examined the data Mr. Ingham presented with respect to discounts from NAV for the seven specialized funds for the first valuation date (November 8, 1999) and have determined that the discounts for that subset of his sample range from a minimum of 9.8 percent to a maximum of 24.9 percent, with mean and median discounts of 17.1 and 17.8 percent, respectively, as compared to the range of discounts for the full sample, 1 to 24.9 percent, with mean and

median discounts of 12 and 13 percent, respectively. Both experts agree that general equity funds are sufficiently comparable to the partnership so that useful information as to an appropriate minority discount can be drawn from a sample of those funds. They disagree as to whether useful information can be obtained by considering funds specializing in industries different from Dell's computer business. Mr. Burns believes that it cannot. Given that disagreement and the significant differences we found in comparing the range, mean, and median of the subset and the sample, we are content to rely on the area of the experts' agreement; i.e., that a sample of general equity funds is reliable for purposes of determining an appropriate minority discount. We shall construct samples for each valuation date from the intersection of the experts' data sets for that date (i.e., the 20 funds selected for both the first and second valuation dates and the 18 funds selected for the third valuation date).

Mr. Ingham dealt with his concern for outliers[12] by relying on the median of each sample. He is of the opinion that the median does not put any weight on outliers as the mean would. In response to the Court's question as to whether he relied on the median because outliers caused a significant difference between the means and the medians in his samples, he answered that he did

[12] Outlier: "An observation that is far removed from the bulk of the data. Outliers may indicate faulty measurements and they may exert undue influence on summary statistics, such as the mean * * *." Kaye & Freedman, supra at 168.

not know since he had not computed the mean. Mr. Burns computed the mean, the median, and the interquartile mean for each of his samples. His approach to the problem of outliers appears to have been more thoughtful than Mr. Ingham's, and we shall follow his lead and deal with the problem of outliers by relying on the interquartile mean of each sample we construct.

We shall also follow Mr. Burns's lead and make no adjustments to the averages so obtained. Simply put, Mr. Ingham has failed to convince us that lack of portfolio diversity and professional management justify an increased adjustment on account of lack of control of 10 percent (or, indeed, any adjustment at all). In his report, Mr. Ingham concedes: "the Partnership's relatively simple investment portfolio negates [lack of professional management]". Nor can we see how lack of diversity could exacerbate lack of control since the partnership was, on the valuation dates, transparently, the vehicle for holding shares of stock of a single, well-known corporation. Mr. Ingham's 10-percent adjustment, based on "all relevant factors", is without sufficient analytical support to convince us that any adjustment should be made to the sample averages we obtain. See Casey v. Commissioner, 38 T.C. 357, 381 (1962) ("An expert's opinion is entitled to substantial weight only if it is supported by the facts.").

d. Conclusion

We determine minority interest discounts to be applied in valuing the gifts as follows:

Table 12

1999 gift	2000 gift	2001 gift
11.32%	14.34%	4.63%

3. Marketability Discount

a. Introduction

The parties agree that, to reflect the lack of a ready market for LP units (or, more pertinently, assignee interests in the partnership), an additional discount (after applying the minority interest discounts) should be applied to the partnership's NAV to determine the fair market values of the gifts. Such a discount is commonly referred to as marketability discount. The experts differ sharply on two points: (1) The existence of a market for LP units, and (2) the weight that should be given various qualitative factors.

b. Mr. Ingham's Opinion

To determine an appropriate marketability discount, Mr. Ingham looks at his and others' studies of restricted stock transactions, which compare the private-market price of restricted shares of public companies (i.e., shares that, because they have not been registered with the Securities and Exchange Commission (SEC), generally cannot be sold in the public market

for a 2-year period)[13] with their coeval public market price. Mr. Ingham combines data from the restricted stock approach with his analysis of the "investment quality" of the LP units to support a marketability discount of 35 percent.

c. Mr. Burns's Opinion

Mr. Burns's approach requires more explanation. He also considers various studies of marketability discounts with respect to restricted stock sales. He looks at studies of the mean discount (in two cases, the median discount) on sales of restricted stock during three periods: (1) before 1990; (2) from 1990 to 1997; and (3) during 1997 and 1998. In 1972, the SEC adopted rule 144, 17 C.F.R. sec. 230.144 (1972), imposing a 2-year holding period on the resale of restricted stock. In 1990, the SEC adopted rule 144A, 17 C.F.R. sec. 230.144A (1990), allowing institutional buyers to buy and sell restricted stock. In 1997, the SEC amended rule 144, 17 C.F.R. sec. 230.144 (1997), reducing the required holding period to 1 year. For the first period (pre-1990), which Mr. Burns characterizes as "lack[ing] * * * a resale market", the average of the discounts for the studies he considered is 34 percent. For the second period (1990 to 1997), the similar average is 22 percent, and, for the third period (1997 and 1998), it is 13 percent. He concludes:

> Based on the evolution of restricted stock discounts, there appear to be at least two factors that influence investors: 1) the limited access to a liquid market

[13] See 17 C.F.R. sec. 230.144(d) (1972). The required holding period was shortened to 1 year in 1997. See 62 Fed. Reg. 9242 (Feb. 28, 1997).

> and 2) the required holding period before the restricted stock can be freely traded. These factors suggest an explanation as to why average marketability discounts have decreased since the implementation of Rule 144A and the Amendment to Rule 144A [sic., Rule 144]. Rule 144A allowed for institutional trading of restricted stocks. The difference between average marketability discounts before and after Rule 144A would appear to reflect the discount investors required for having virtually no secondary market. In contrast, the difference between average discounts found prior to and after 1997 is a logical result of the reduction in holding period from two years to one year.

Mr. Burns recognizes that the partnership is very different from the operating companies that are the subject of the restricted stock studies he examined. Nevertheless, he thinks that the changes in restricted stock discounts over time evidenced by those studies are instructive with respect to the pricing decisions of investors holding securities that cannot readily be resold. He starts with the premise that, before SEC rule 144A, holders of restricted stock had virtually no access to any secondary (resale) market and, therefore, demanded a discount (34 percent being the average of the studies he examined) to account for that lack of market access. The promulgation of SEC rule 144A, he argues, opened a resale market (albeit a limited one), and the average discount of the studies he examined for the period from 1990 to 1997 is, at 22 percent, 12 percentage points lower than the average discount he observed for the prior period, before the promulgation of rule 144A. He concludes that the difference is due to the availability of a resale market after 1990. Put another way, Mr. Burns believes that 12 percent is indicative of the charge that the buyer imposed on the seller of

restricted stock before 1990 to account for the buyer's lack of access to a ready resale market. Mr. Burns concludes that the remaining 22 percentage points of the average pre-1990 discount of 34 percent are attributable to holding period restrictions and factors unrelated to marketability. He explains the effect of holding period restrictions as follows: "Legally mandated holding periods can be particularly onerous for investors when the restricted shares are subject to extreme price volatility, as is the case with many financially distressed companies." He concludes:

> For investment holding companies such as the Partnership –- those not hindered by legal holding periods, nor subject to the operating and financial risks of typical restricted shares -– the measure of discount based on restricted stock research suggests a lack of marketability adjustment closer to 12 percent.

That, he explains "is the incremental level of discounts that investors demanded before 1990, when the trading market became more liquid."

Mr. Burns next turns his attention to the circumstances of the partnership. He believes that there are factors particular to the partnership that must be considered in determining an appropriate marketability discount. Mr. Burns lists the following factors: the failure to make distributions, a nondiversified portfolio, the restrictions on transferring LP units, the dissolution provisions of the partnership agreement, and the liquidity of Dell shares. He considers the last two factors as increasing marketability. He believes that the provisions of the partnership agreement providing for the

voluntary dissolution of the partnership (and distribution of its assets on a pro rata basis to its partners) would benefit a limited partner wishing to sell her interest. He believes that a voluntary dissolution of the partnership would be of little detriment to the remaining partners, who could reconstitute the partnership less the withdrawing partner (who might agree to pay the costs attendant to dissolution and reconstitution), and the dissolution would significantly benefit the withdrawing partner, who would save the large discount to her proportional share of the partnership's NAV attendant to any assignment of her interest. He notes that, on each valuation date, the partnership's portfolio consisted of only highly liquid, marketable securities; viz, Dell shares: "These assets have an easily discernible value and can be sold quickly and easily."[14] Mr. Burns concludes that a reasonable negotiation between a buyer and seller over the price of a limited partner interest in the partnership would result in a price concession for lack of marketability in the range of 10 to 15 percent. He starts with the notion that traditional studies of unregistered shares of public companies suggest a price concession of 12 percent due to the lack of a ready market. Because of his belief that, unlike restricted stock, a limited partner interest in the partnership is not burdened by prescribed holding period limitations on

[14] He adds: "The Partnership owns a substantial block of Dell stock. However, these shares represented less than 0.28% of Dell's trading volume on the dates of valuation, which suggests that the Partnership's shares could be readily absorbed by the market."

resale, nor does it carry the business or financial risk associated with the typical issuer of private placement shares, he adds little for those factors. He settles on a marketability discount of 12.5 percent.

d. Discussion

(1) Introduction

The experts agree on the usefulness of restricted stock studies in determining appropriate marketability discount for the gifts. They further agree that (1) no secondary market exists for LP units; (2) an LP unit cannot be marketed to the public or sold on a public exchange; and (3) an LP unit can be sold only in a private transaction. They disagree principally on the likelihood of a private market among the partners for LP units.

(2) Mr. Ingham's Opinion

Mr. Ingham's approach is relatively straightforward. He believes that "restricted shares [of publicly held companies] sell at a price below their publicly traded (unrestricted) counterparts because of the lack of access to a ready market due to SEC Rule 144." He has sampled private transactions in the common stocks of actively traded companies. His sample shows median and mean discounts of 24.8 and 27.4 percent, respectively, "for equities with access to public stock market liquidity in about two years." He believes that "these private placement transactions * * * are an appropriate starting point from which to measure the diminution in valuing arising from lack of marketability." He adds: "The * * * [marketability] discounts

demanded by potential investors in privately held business interests with potentially very long holding periods should be much larger [than for restricted shares with access to a ready market in 2 years]." In particular, with respect to the partnership, he concludes that (1) the willing buyer of a limited partner interest "has no real prospects of being able to sell the interest in the public market at the full, freely traded value at any time," and (2) "there is virtually no ready market for * * * [interests in the partnership]". He appears to dismiss altogether the possibility of a private sale of LP units:

> Further, there is no market for a limited partnership unit in * * * [the partnership]. There have never been any purchases or sales of * * * [partnership] limited partnership units. Sales of partnership units are restricted by the Agreement. A buyer has no assurance, as well, of being admitted as a substitute partner, as such admission requires the consent of all the partners.

He concludes: "Considering all relevant factors, * * * [I] believe that the discount for lack of marketability should be at least 35%." (Emphasis added.) He settles for a 35-percent discount for lack of marketability in determining the value of an LP unit.

Respondent observes about Mr. Ingham's analysis: If Mr. Ingham's assumptions about the absence of a market for LP units are accepted, "then the conclusion is unavoidable that the value of limited partnership interests in the * * * [partnership] is virtually zero, or that they cannot be valued at all." Respondent criticizes Mr. Ingham for being arbitrary in stopping at 35 percent when his analysis would seem to lead to the

conclusion that, since he believes that an LP unit cannot be sold, the appropriate discount for lack of marketability should be 100 percent. Respondent has a point. Mr. Ingham's analysis is predicated on the assumption that he can extrapolate the marketability discount appropriate to an LP unit from the typical discount found by him with respect to a sample of sales of restricted stock barred from resale in a ready market for 2 years. The obstacle he must overcome is his belief that there is not now, nor will there ever be, a ready market (indeed, any market) for LP units. If we are to assume (as he would have us do) that the size of the marketability discount is a function of the length of time that a holder of an interest in a business is barred access to a ready market, then Mr. Ingham has not persuaded us that his stopping point, 35 percent, is anything but a guess. He does not build from his observed sample median and mean discounts of 24.8 and 27.4 percent, respectively, to his 35 percent conclusion by quantitative means. He considers the "investment quality" of the LP units, concluding that the lack of public information about the partnership is a detriment that is mitigated "somewhat" by the transparency of the partnership (since its only assets are shares of Dell stock). He takes into account that there is no market for LP units, and an investor wishing to acquire Dell shares could do so outside of the partnership without encountering the various restrictions attaching to a partnership interest. Without any further analysis, he concludes, as stated supra: "Considering all

relevant factors, * * * the discount for lack of marketability should be at least 35 percent."[15] Given his assumptions that (1) there is virtually no ready market for LP units, and (2) the size of any marketability discount is a function of the length of time that a holder of an interest in a business is barred access to a ready market, it would seem that he could only draw the conclusion that an LP interest is simply not salable, which is not the conclusion that he draws. We do not reject per se Mr. Ingham's reliance on restricted stock studies. We simply lack confidence in the result he reaches given the assumptions he makes. We need not rely on the unsupported opinion of an expert witness. See Casey v. Commissioner, 38 T.C. at 381.

(3) Mr. Burns's Opinion

Mr. Burns looks at the marketability discount as comprising principally two components: a market access (liquidity) component and a holding period component. We assume that petitioner's expert, Mr. Ingham, accepts that division since, in his rebuttal report, he states: "[Mr. Burns] concluded, correctly, that private placement discounts have declined because of relaxations for institutional trading and reductions in

[15] A clue to his settling on 35 percent may be contained in a reference in his direct testimony to a group of 13 restricted stock studies, which he describes as having a range of observed discounts from 13 to 45 percent and "an observed clustering of discounts between 30% and 35%." We have computed the group's mean and median discounts to be 29.36 and 31.9 percent, respectively. The data set is skewed to the left (with more extreme measurements among the lower percentages), which indicates that the median is the preferred measure of central tendency. Mr. Ingham does not explain what further significance he attaches to his clustering observation.

required holding periods under Rule 144." (Emphasis added.) Mr. Burns pegs at 12 percent the difference in private placement discounts between a period in which holders of restricted stock had no access to a ready market and could only dispose of their restricted stock in private transactions and a period in which certain holders of restricted stock were allowed limited access to a ready market.[16] He concludes: "[That] difference * * * would appear to reflect the discount investors required for having virtually no secondary market." That difference suggests to Mr. Burns the market access component of the marketability discount appropriate to an LP unit; i.e., the price concession that a buyer of an LP unit would demand to reflect that the unit could only be liquidated in a private transaction.

Mr. Burns recognizes that factors particular to the partnership (such as the restrictions on transferring LP units) might elicit an additional discount, and, on the basis of those factors and the discounts suggested by his empirical research studies, he settles on a marketability discount of 12.5 percent. He makes little, if any, adjustment on account of holding period restrictions. He notes that the partners can agree to dissolve the partnership; and, although he did not determine the likelihood of a dissolution, he testified that, so long as the

[16] In his rebuttal testimony, Mr. Ingham criticizes Mr. Burns for referring in a portion of his testimony to a reduction in "average marketability discounts" rather than a reduction in private placement discounts. It is clear to us that Mr. Burns is referring to the average of his summary of marketability discount studies based on restricted stock sales. We see no ambiguity or error.

partnership continued to hold only shares of Dell stock (which he characterizes as having "an easily discernible value"), "[he could not] envision an economic reason why * * * [the partnership] would not be willing to let somebody be bought out, because * * * [the remaining partners would] be holding the same proportion of assets, the same type of assets, after * * * [the buyout]." Indeed, given the significant minority interest and marketability discounts from an LP unit's proportional share of the partnership's NAV that each expert would apply in valuing the gifts, it would appear to be in the economic interest of both any limited partner not under the economic necessity to do so but wishing to make an impermissible assignment of LP units and the remaining partners to strike a deal at some price between the discounted value of the units and the dollar value of the units' proportional share of the partnership's NAV. The wishing-to-assign partner would get more than she would get in the admittedly "thin" market for private transactions, and the dollar value of each remaining partner's share of the partnership's NAV would increase.[17] So long as the partnership's assets remain

[17] Thus, for instance, assume that a hypothetical limited partnership organized under an agreement identical to the partnership's has one general and four limited partners, all sharing equally in profits and losses, an NAV of $100, and, because of minority interest and marketability discounts, no impermissible assignment of a limited partner interest could be made for a price greater than 60 percent of the interest's share of NAV. If a limited partner with bargaining power and wishing to dispose of her 20-percent interest and the limited partnership were to settle on a redemption price of $14 for her interest, she would receive $2 more than she could receive on an impermissible assignment, the limited partnership's remaining NAV would be $86, (continued...)

highly liquid (as they were on each of the valuation dates), the remaining partners would appear to bear little or no economic risk in agreeing to a redemption or similar transaction to accommodate a wishing-to-assign partner.

A transaction of the type described would (if petitioners' proposed discounts are to be credited) increase the wealth of the family members post hoc. While such a transaction is perhaps inconsistent with the stated purpose of the partnership to "preserve Family assets", the provision in the partnership agreement allowing for the consensual dissolution of the partnership convinces us that preservation of family assets is not an unyielding purpose. We think that Mr. Burns was correct to take into account the prospect of such a dissolution of the partnership as a significant factor in the private market for LP units, and we think that the economic self-interest of the partnership (more precisely, any remaining partners) must be considered in determining any marketability discount. We agree with Mr. Burns that the holding period component of the marketability discount is of little, if any, influence here.[18]

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[17](...continued)
and each of the four remaining partners' share of that NAV would increase by $1.50, from $20 to $21.50. Of course, we cannot say where between $12 and $20 the redemption price would settle, but, putting transaction costs aside, it would be in the economic interest of both the withdrawing partner and the remaining partners to have it settle somewhere in between.

[18] We are mindful of one of respondent's expert's, Professor Kleinberger's, testimony that "nobody at arm's length would get into this deal" (meaning the partnership), and the implication to be drawn from that testimony that it would be hard to market an interest in the partnership. Professor Kleinberger, (continued...)

(4) Conclusion

Mr. Burns has persuaded us that a hypothetical purchaser of an LP unit would demand and get a price concession to reflect the market access component of the marketability discount but would get little if any price concession to reflect the holding period component of that discount. On the record before us, and considering the expert testimony presented, we cannot determine any better estimate of an appropriate marketability discount than Mr. Burns's estimate, 12.5 percent, and we find accordingly.

(5) Paragraph 9.3

Since we have determined to disregard paragraph 9.3 in determining the values of the gifts, we need not address the parties' differences with respect to its effects on those values.[19]

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[18](...continued)
however, was not called as an expert on valuation; he did not offer any opinion as to the value of an existing LP unit, and, although we are unpersuaded by one of petitioners' expert's, Mr. Ingham's, opinion as to an appropriate marketability discount, he stopped at 35 percent.

[19] We note in passing that when asked to determine the fair market values of the gifts disregarding the impact of paragraph 9.3, the parties' experts took different approaches. Mr. Burns simply disregarded the additional discount on account of paragraph 9.3 that he had applied sequentially after applying the minority interest and marketability discounts that he thought appropriate. See infra appendixes A–D. Mr. Ingham added an amount to what he had determined to be the freely traded value of an LP unit (i.e., the unit's proportional share of the partnership's NAV) minus his calculation of the appropriate minority interest discount. See infra appendixes A–D, final portion: "Mr. Ingham's computation –- effect of par. 9.3". We fail to see the logic of Mr. Ingham's approach, since he did not take into account paragraph 9.3 in determining the freely traded value of an LP unit. He is adding back an amount to show his disregard of a provision (par. 9.3) that he had not taken into
(continued...)

V. Conclusion

On the premises stated, we calculate the fair market values of the gifts as follows:

Table 13

	Date of gift			
	11/8/1999 f/b/o I.	11/8/1999 in trust	1/4/2000 in trust	2/2/2001 in trust
Net asset value	$2,812,763	$2,812,763	$4,798,033	$2,902,488
Gift interest	14.265%	70.054%	3.285%	5.431%
Pro rata portion of net asset value	401,241	1,970,453	157,615	157,634
Discount for lack of control (11.32, 11.32, 14.34, and 4.63% respectively)	(45,420)	(223,055)	(22,602)	(7,298)
	355,820	1,747,398	135,013	150,336
Discount for lack of marketability (12.5%)	(44,478)	(218,425)	(16,877)	(18,792)
Fair market value	311,343	1,528,973	118,137	131,544

We find accordingly, except that, on the basis of respondent's position on brief that the amount of the 2001 gift is $131,033, we find that the total amount of that gift is that amount.

Decision will be entered under Rule 155.

[19](...continued)
account. If, for instance, the minority interest discount is set to zero, Mr. Ingham's approach would increase the freely traded value of an LP unit to an amount greater than its proportional share of the partnership's NAV, a result that we do not think he would support.

APPENDIX A

Comparison of Valuation Experts' Computations
Gift of 1,426.5334 Limited Partnership Units f/b/o I.-Nov. 8, 1999

Units outstanding	10,000
Units transferred	1,426.5334
Percentage of outstanding units transferred	14.265%

	Petitioners' expert Mr. Ingham		Respondent's expert Mr. Burns	
Net asset value (NAV):	Total	Per unit	Total	Per unit
100%	$2,812,763	281.28	2,812,763	281.28
NAV proportional to gift	$401,241	281.28	401,241	281.28
Computations of fair market value (FMV)--restrictions contained in paragraph 9.3 of partnership agreement (par. 9.3) taken into account				
Minority discount:				
Mr. Ingham--14.4%	(57,779)	(40.50)	--	--
Mr. Burns--11.2%	--	--	(44,939)	(31.50)
Freely traded value	343,462	240.77	356,302	249.77
Marketability discount:				
Mr. Ingham--35%	(120,212)	(84.27)	--	--
Mr. Burns--12.5%	--	--	(44,538)	(31.22)
Subtotal	$223,250	156.50	311,764	218.55
Par. 9.3 discount:				
Mr. Ingham--not separately stated	--	--	--	--
Mr. Burns--16.1%	--	--	(50,506)	(35.41)
FMV--par. 9.3 taken into account:	$223,250	156.50	261,258	183.15
Total discounts	$177,990	124.77	139,982	98.13
Total discounts as percentage of NAV	44.4%	44.4%	34.9%	34.9%
Computations of FMV--par. 9.3 disregarded				
FMV above--par. 9.3 taken into account:	$223,250	156.50	261,258	183.15
Mr. Ingham--add premium	5,581	3.91	--	--
Mr. Burns--add back 16.1% discount	--	--	50,506	35.41
FMV--par. 9.3 disregarded:	$228,832	160.41	311,764	218.55
Total discounts	$172,409	120.86	89,477	62.72
Total discounts as percentage of NAV	43.0%	43.0%	22.3%	22.3%

Mr. Ingham's computation--effect of par. 9.3

	Total	Per unit
Freely traded value	$343,462	240.77
Add 2.5% premium	8,587	6.02
Adjusted freely traded value	352,049	246.79
Subtract 35% marketability discount	123,217	86.38
FMV--par. 9.3 disregarded	228,832	160.41
FMV--par. 9.3 taken into account	223,250	156.50
Net increase in FMV--par. 9.3 disregarded	5,581	3.91

APPENDIX B

Comparison of Valuation Experts' Computations
Gift of 7,005.367 Limited Partnership Units f/b/o the children-Nov. 8, 1999

Units outstanding	10,000
Units transferred	7,005.367
Percentage of outstanding units transferred	70.054%

	Petitioners' expert Mr. Ingham		Respondent's expert Mr. Burns	
Net asset value (NAV):	Total	Per unit	Total	Per unit
100%	$2,812,763	281.28	2,812,763	281.28
NAV proportional to gift	$1,970,453	281.28	1,970,453	281.28
Computations of fair market value (FMV)--restrictions contained in paragraph 9.3 of partnership agreement (par. 9.3) taken into account				
Minority discount:				
Mr. Ingham--14.4%	(283,745)	(40.50)	--	--
Mr. Burns--11.2%	--	--	(220,691)	(31.50)
Freely traded value	1,686,708	240.77	1,749,762	249.77
Marketability discount:				
Mr. Ingham--35%	(590,348)	(84.27)	--	--
Mr. Burns--12.5%	--	--	(218,720)	(31.22)
Subtotal	$1,096,360	156.50	1,531,042	218.55
Par. 9.3 discount:				
Mr. Ingham--not separately stated	--	--	--	--
Mr. Burns--16.1%	--	--	(248,029)	(35.41)
FMV–par. 9.3 taken into account:	$1,096,360	156.50	1,283,013	183.15
Total discounts	$874,093	124.77	687,440	98.13
Total discounts as percentage of NAV	44.4%	44.4%	34.9%	34.9%
Computations of FMV--par. 9.3 disregarded				
FMV above--par. 9.3 taken into account:	$1,096,360	156.50	1,283,013	183.15
Mr. Ingham--add premium	27,409	3.91	--	--
Mr. Burns--add back 16.1% discount	--	--	248,029	35.41
FMV--par. 9.3 disregarded:	$1,123,769	160.41	1,531,042	218.55
Total discounts	$846,684	120.86	439,411	62.72
Total discounts as percentage of NAV	43.0%	43.0%	22.3%	22.3%

Mr. Ingham's computation--effect of par. 9.3

	Total	Per unit
Freely traded value	$1,686,708	240.77
Add 2.5% premium	42,168	6.02
Adjusted freely traded value	1,728,875	246.79
Subtract 35% marketability discount	605,106	86.38
FMV--par. 9.3 disregarded	1,123,769	160.41
FMV--par. 9.3 taken into account	1,096,360	156.50
Net increase in FMV--par. 9.3 disregarded	27,409	3.91

APPENDIX C

Comparison of Valuation Experts' Computations
Gift of 469.704 Limited Partnership Units f/b/o the children-Jan. 4, 2000

Units outstanding	14,296.71
Units transferred	469.704
Percentage of outstanding units transferred	3.285%

	Petitioners' expert Mr. Ingham		Respondent's expert Mr. Burns	
Net asset value (NAV):	Total	Per unit	Total	Per unit
100%	$4,672,758	326.84	4,798,033	335.60
NAV proportional to gift	$153,500	326.84	157,615	335.60
Computations of fair market value (FMV)--restrictions contained in paragraph 9.3 of partnership agreement (par. 9.3) taken into account				
Minority discount:				
Mr. Ingham--16.3%	(25,021)	(53.28)	--	--
Mr. Burns--13.4%	--	--	(21,120)	(44.97)
Freely traded value	128,480	273.57	136,495	290.63
Marketability discount:				
Mr. Ingham--35%	(44,968)	(95.75)	--	--
Mr. Burns--12.5%	--	--	(17,062)	(36.33)
Subtotal	$83,512	177.82	119,433	254.30
Par. 9.3 discount:				
Mr. Ingham--not separately stated	--	--	--	--
Mr. Burns--16.1%	--	--	(19,229)	(40.94)
FMV--para. 9.3 taken into account:	$83,512	177.82	100,204	213.36
Total discounts	$69,988	149.02	57,411	122.24
Total discounts as percentage of NAV	45.6%	45.6%	36.4%	36.4%
Computations of FMV--par. 9.3 disregarded				
FMV above--par. 9.3 taken into account:	$83,512	177.82	100,204	213.36
Mr. Ingham--add premium	2,088	4.45	--	--
Mr. Burns--add back 16.1% discount	--	--	19,229	40.94
FMV--par. 9.3 disregarded:	$85,600	182.26	119,433	254.30
Total discounts	$67,901	144.58	38,182	81.30
Total discounts as percentage of NAV	44.2%	44.2%	24.2%	24.2%

Mr. Ingham's computation--effect of par. 9.3

	Total	Per unit
Freely traded value	$128,480	273.57
Add 2.5% premium	3,212	6.84
Adjusted freely traded value	131,692	280.41
Subtract 35% marketability discount	46,092	98.14
FMV--par. 9.3 disregarded	85,600	182.26
FMV--par. 9.3 taken into account	83,512	177.82
Net increase in FMV--par. 9.3 disregarded	2,088	4.45

APPENDIX D

Comparison of Valuation Experts' Computations
Gift of 860.7708 Limited Partnership Units f/b/o the Children-Feb. 2, 2001

Units outstanding	15,849.07
Units transferred	860.7708
Percentage of outstanding units transferred	5.431%

	Petitioners' expert Mr. Ingham		Respondent's expert Mr. Burns	
Net asset value (NAV):	Total	Per unit	Total	Per unit
100%	$2,798,331	176.56	2,902,488	183.13
NAV proportional to gift	$151,977	176.56	157,634	183.13
Computations of fair market value (FMV)--restrictions contained in paragraph 9.3 of partnership agreement (par. 9.3) taken into account				
Minority discount:				
Mr. Ingham--10.0%	(15,198)	(17.66)	--	--
Mr. Burns--5.0%	--	--	(7,882)	(9.16)
Freely traded value	136,779	158.91	149,752	173.98
Marketability discount:				
Mr. Ingham--35%	(47,873)	(55.62)	--	--
Mr. Burns--12.5%	--	--	(18,719)	(21.75)
Subtotal	$88,906	103.29	131,033	152.23
Par. 9.3 discount:				
Mr. Ingham--not separately stated	--	--	--	--
Mr. Burns--17.7%	--	--	(23,193)	(26.94)
FMV--par. 9.3 taken into account:	$88,906	103.29	107,840	125.28
Total discounts	$63,070	73.27	49,793	57.85
Total discounts as percentage of NAV	41.5%	41.5%	31.6%	31.6%
Computations of FMV--par. 9.3 disregarded				
FMV above--par. 9.3 taken into account:	$88,906	103.29	107,840	125.28
Mr. Ingham--add premium	2,223	2.58	--	--
Mr. Burns--add back 16.1% discount	--	--	23,193	26.94
FMV--par. 9.3 disregarded:	$91,129	105.87	131,033	152.23
Total discounts	$60,848	70.69	26,601	30.90
Total discounts as percentage of NAV	40.0%	40.0%	16.9%	16.9%

Mr. Ingham's computation--effect of par. 9.3

	Total	Per unit
Freely traded value	$136,779	158.91
Add 2.5% premium	3,419	3.97
Adjusted freely traded value	140,199	162.88
Subtract 35% marketability discount	49,070	57.01
FMV--par. 9.3 disregarded	91,129	105.87
FMV--par. 9.3 taken into account	88,906	103.29
Net increase in FMV--par. 9.3 disregarded	2,223	2.58

United States Court of Appeals
FOR THE EIGHTH CIRCUIT

No. 08-3774

Thomas H. Holman, Jr.; Kim D.L. Holman, Donors,	*	
Appellants,	*	
	*	Appeal from the
v.	*	United States Tax Court.
Commissioner of Internal Revenue,	*	
Appellee.	*	

Submitted: September 22, 2009
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Before MELLOY, BEAM, and GRUENDER, Circuit Judges.

MELLOY, Circuit Judge.

Thomas H. Holman, Jr. and Kim D.L. Holman (the "donors") created a limited partnership, funded it with common stock of Dell, Inc., and gifted limited partnership shares to their children. In a gift-tax return, the donors asserted lack-of-marketability and minority-interest discounts to claim a value for the gifts substantially below the value of the underlying Dell stock. In doing so, the donors relied in part on transfer restrictions contained in the partnership agreement, asserting that the transfer restrictions would depress the value of the partnership shares relative to the value of the underlying assets.

The Commissioner challenged the return, characterizing the gifts as gifts of Dell stock rather than gifts of limited partnership shares. In addition, the Commissioner applied Internal Revenue Code § 2703 and disregarded the partnership agreement's transfer restrictions for valuation purposes. Finally, the Commissioner agreed that lack-of-marketability and minority-interest discounts should apply but asserted that the discounts should be smaller than claimed by the donors.

The Tax Court[1] held that the gifts were gifts of limited partnership shares. The Tax Court also held that the Commissioner correctly applied I.R.C. § 2703 and properly disregarded the partnership agreement's transfer restrictions. Finally, the Tax Court applied smaller lack-of-marketability and minority-interest discounts than claimed by the donors.

In doing so, the Tax Court adopted the lack-of-marketability discount as asserted by the Commissioner's expert based on historical studies of restricted stock sales. The Tax Court noted that the partnership held only highly liquid, easily valued assets and that the agreement contained a consensual dissolution provision and granted broad management discretion to the general partners. According to the Tax Court, because economically rational actors would take advantage of the dissolution provision to dissolve and reconstitute the partnership or otherwise buy out a departing partner, there was a natural cap on any lack-of-marketability discount.

On appeal to our court, the Commissioner does not challenge the determination that the gifts were gifts of partnership shares. The donors challenge the Tax Court's application of I.R.C. § 2703, its determination of marketability and minority-interest discounts, and its overall valuation determination. We affirm the judgment of the Tax Court.

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[1]The Honorable James S. Halpern, United States Tax Court.

I. Background

The donors amassed wealth primarily in the form of Dell stock during Thomas's tenure as a Dell employee. They sought to transfer wealth to their children, preserve wealth within their family, and prevent their children from dissipating assets. At the same time, they sought to teach their children basic investing principles and impart to their children a general understanding of responsibility attendant to wealth. As part of an overall estate-planning process seeking to achieve these goals, Thomas and Kim met with counsel and developed an estate and gifting plan that involved execution of wills, creation of the limited partnership, transfer of Dell stock into the limited partnership, and transfer of limited partnership shares to a trustee and conservator for the children. The children, who already owned some Dell stock through the trustee and conservator or in accounts under different states' versions of the Uniform Transfers to Minors Act, transferred their Dell stock into the partnership in exchange for additional partnership shares.

Several provisions of the partnership agreement are material to the issues in this appeal. Section 3.1 lists the purposes of the partnership:

> 3.1 Purposes. The purposes of the Partnership are to make a profit, increase wealth, and provide a means for the Family to gain knowledge of, manage, and preserve Family Assets. The Partnership is intended to accomplish the following:
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> > (1) maintain control of Family Assets;
> > (2) consolidate fractional interests in Family Assets and realize the efficiencies of coordinated investment management;
> > (3) increase Family wealth;
> > (4) establish a method by which gifts can be made without fractionalizing Family Assets;
> > (5) continue the ownership of Family Assets and restrict the right of non-Family persons to acquire interests in Family Assets;

> (6) provide protection to Family Assets from claims of future creditors against Family members;
> (7) provide flexibility in business planning not available through trusts, corporations, or other business entities;
> (8) facilitate the administration and reduce the cost associated with the disability or probate of the estates of Family members; and
> (9) promote the Family's knowledge of and communication about Family Assets.

Section 6.1 grants the general partners "exclusive management and control of the business of the Partnership" including "the power and authority . . . to determine the investments and investment strategy of the Partnership." Sections 8.4 and 9.1 provide that limited partners may not withdraw from the partnership or involuntarily or voluntarily assign or encumber their limited partnership interests except as permitted by the agreement. Section 9.2 describes various permitted assignments such as assignments to family members or assignments to trusts or to certain custodians where such trusts or custodians hold the partnership interests exclusively for the benefit of family members. Section 9.3, which we address in more detail below, describes conditions under which the partnership may acquire partnership interests that are lawfully assigned in a manner prohibited by the agreement. Finally, section 12.1 provides that the partnership may be dissolved by the written consent of all partners.

Section 9.3 provides that the partnership has an option to purchase at an appraised value any partnership interest assigned in a manner that is prohibited by the agreement but that is otherwise lawful. Specifically, section 9.3 provides that the partnership may purchase such an interest over a five-year period at a determined interest rate with a ten-percent down payment. Further, the partnership may assign the right to acquire such an interest to one or more current partners. Finally, the partners may consent to let the prohibited assignee become a limited partner. If the partners refuse such consent and elect not to exercise the right to acquire the assigned shares, the otherwise impermissible holder of the assigned shares does not gain the

rights of a limited partner. Rather, such a holder gains merely the limited right to receive distributions to which the assignor–partner would have been entitled.

The gifts of partnership shares occurred in 1999, 2000, and 2001. In gift tax returns for these years, the donors claimed overall discounts of slightly over 49% relative to then-prevailing market prices for the underlying Dell stock. These discounts were based on appraisal recommendations that considered minority status and lack of marketability. These discounts also took into consideration the perceived impact of sections 8.4 and 9.1–9.3 upon the value of limited-partnership shares. In notices of deficiency, the Commissioner initially asserted that it would be proper to allow an overall discount of 28% for minority status and lack of marketability. The Commissioner based this lower discount on the view that the partnership units "should be valued without regard to any restriction on the right to sell or use the partnership interest within the meaning of [I.R.C. § 2703(a)(2)]."

Ultimately, when the case progressed before the Tax Court, the Commissioner employed an appraiser and argued that an even smaller discount should apply. The donors also employed an appraiser, and the appraisers' methods were detailed and require some discussion. We describe their methods and their detailed opinions below in the section of our analysis addressing the valuation.

In testimony before the Tax Court, the donors described their purposes for creating and funding the partnership, gifting shares to their children, and including transfer restrictions in the partnership agreement. Neither donor claimed an intent to maintain Dell stock as the sole asset of the partnership nor described any particular investment strategy they intended to employ, other than a future intent to diversify the portfolio's holdings. Neither donor claimed an intent to hold anything other than passive investments in the partnership nor described any business activity related to the partnership. Between formation of the partnership and the submission of the case, the partnership held only Dell stock. The total amount of stock the partnership held

represented approximately 0.28 % of the outstanding stock of Dell, and the parties agree that the broader market could easily absorb this amount.

Mr. Holman testified as to the goal of asset preservation, and the Tax Court interpreted this to mean protection of assets from dissipation by the children. Mr. Holman explained his understanding of sections 9.1–9.3 and how these sections would preclude the children from assigning or giving away their interests. Mrs. Holman testified that the purpose of the partnership was "to be able to teach . . . [the] children about wealth and the responsibility of that wealth."

In light of the purposes stated in section 3.1 of the Agreement, and in light of the donors' testimony, the Tax Court concluded:

> We believe that paragraphs 9.1 through 9.3 were designed principally to discourage dissipation by the children of the wealth that Tom and Kim had transferred to them by way of the gifts. The meaning of the term "bona fide business arrangement" in section 2703(b)(1) is not self apparent. As discussed supra, in Estate of Amlie v. Commissioner, [91 T.C.M. (CCH) 1017], we interpreted the term "bona fide business arrangement" to encompass value-fixing arrangements made by a conservator seeking to exercise prudent management of his ward's minority stock investment in a bank consistent with his fiduciary obligations to the ward and to provide for the expected liquidity needs of her estate. Those are not the purposes of paragraphs 9.1 through 9.3. There was no closely held business here to protect, nor are the reasons set forth in the Committee on Finance report as justifying buy-sell agreements consistent with petitioners' goals of educating their children as to wealth management and "disincentivizing" them from getting rid of Dell shares, spending the wealth represented by the Dell shares, or feeling entitled to the Dell shares.

> We find that paragraphs 9.1 through 9.3 do not serve bona fide business purposes. Those paragraphs do not constitute a bona fide business arrangement within the meaning of section 2703(b)(1).

Holman v. C.I.R., 130 T.C. 170, 195 (2008).

The Tax Court also concluded that the restrictions were merely a testamentary device such that the donors failed to satisfy § 2703(b)(2). The Tax Court did not reach the arms-length transaction test of § 2703(b)(3). Having determined that the transfer restrictions of sections 9.1–9.3 were to be disregarded for valuation purposes, the Tax Court assessed the remaining aspects of the competing experts' valuation opinions. The Tax Court accepted lack-of-marketability discounts of 12.5% for each tax year and minority-interest discounts of 4.63–14.34%, all as asserted by the Commissioner's expert. The donors appeal.

II. Discussion

a. I.R.C. § 2703

Restrictions on the sale or use of property generally tend to depress the value of the property. Oftentimes, such restrictions serve legitimate business purposes, impose actual and meaningful limitations on the use or transferability of property, and are accepted by parties dealing with one another in arms-length transactions. When carefully crafted and applied in certain circumstances, however, such restrictions can minimize the tax consequences of gifts or transfers without imposing substantial additional limitations on the transferability or use of the property. This is particularly true in the context of family transfers where a donor may hold some degree of practical control over a recipient's actions, even in the absence of formal restrictions, and where transactions often do not occur at arms length. In this context and in others, Congress has expressed concern over the abusive use of such restrictions. See, e,g., Explanatory Material Concerning Committee on Finance 1990 Reconcilia-tion

Submission Pursuant to House Concurrent Resolution 310, 136 Cong. Rec. S15629-04, S15681 (1990) ("Finance Committee Report") ("[T]he committee is aware of the potential of buy-sell agreements for distorting transfer tax value. Therefore, the committee establishes rules that attempt to distinguish between agreements designed to avoid estate taxes and those with legitimate business agreements. These rules generally disregard a buy-sell agreement that would not have been entered into by unrelated parties acting at arm's length.").

In attempting to sort between permissible and impermissible uses of such restrictions, Congress repealed an earlier Code provision, I.R.C. § 2036(c) (1987) because "the committee [was] concerned that the statute's complexity, breadth, and vagueness posed an unreasonable impediment to the transfer of family businesses." Finance Committee Report, 136 Cong. Rec. S15680. In 1990, Congress enacted in its place a statute that broadly prohibits consideration of restrictions for valuation purposes, see I.R.C. § 2703(a), but allows taxpayers to prove eligibility for an exception that permits valuation based on such restrictions, see I.R.C. § 2703(b).

To be eligible for the exception and gain the benefit of having such restrictions considered for valuation purposes, the taxpayer must satisfy a three-part test: the restriction must be "a bona fide business arrangement," it must not be "a device to transfer such property to members of the decedent's family for less than full and adequate consideration," and its terms must be "comparable to similar arrangements entered into by persons in an arms' length transaction."[2] Because we conclude that

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[2]Section 2703 provides:

> (a) General rule.–For purposes of this subtitle, the value of any property shall be determined without regard to–
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> (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the

the Tax Court correctly held the present restrictions are not "a bona fide business arrangement" in accordance with § 2703(b)(1), we address only that first part of the test.

The ultimate question of whether there was a bona fide business arrangement is a question of fact to be reviewed for clear error. See Estate of True v. Comm'r, 390 F.3d 1210, 1218–19 (10th Cir. 2004) (holding that the question of whether an "agreement was entered into for bona fide business reasons and is not a testamentary substitute" is a question of fact reviewed for clear error); cf. St. Louis County Bank v. United States, 674 F.2d 1207, 1210–11 (8th Cir. 1982) (affirming a finding that stock-purchase agreement "had a bona fide business purpose" but finding an outstanding question of fact as to whether it was merely a testamentary transfer).

As noted, the Tax Court in the present case viewed the restrictions as failing the "bona fide business arrangement" test. The Tax Court emphasized Mr. Holman's testimony in which he failed to identify any current or planned activity by the partnership other than holding passive investments without a clearly articulated

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property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.

(b) Exceptions.–Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.
(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

investment strategy. In addition, he made clear that asset preservation meant preservation from dissipation by the children, not the pursuit of any particular investment strategy. Mrs. Holman emphasized the personal goals of educating the children as to financial responsibility.

In support of the opposite conclusion, the donors cite several Tax Court cases addressing the business-purpose element of § 2703(b)(1) or similar clauses in other provisions of the Tax Code. The donors argue the Tax Court in the present case applied an overly restrictive definition for the phrase "business arrangement" and effectively imposed an "operating business nexus" or requirement that the underlying partnership be an actively managed enterprise. The donors also argue that the "business arrangement" test should be applied looking solely at the taxpayer's stated intentions and at the language of the restrictions in the partnership agreement without considering the actual context of this case and the nature of the underlying assets. The donors sum up their position in their brief, asserting that "the nature of the assets of the Partnership is irrelevant for purposes of determining whether the restrictions in paragraphs 9.1 and 9.3 constitute a bona fide business arrangement. There is no dispute that the Partnership was an enterprise with the business purpose of generating profits through long-term growth."

We agree with the Tax Court's conclusion and reject the donor's attempt to characterize the Tax Court's opinion as creating an "operating business nexus." In answering the question of whether a restriction constitutes a bona fide business arrangement, context matters. Here that context shows that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions. Simply put, in the present case, there was and is no "business," active or otherwise. The donors have not presented any argument or asserted any facts to distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash. We and other courts have held that "maintenance of family ownership and control of [a] business" may be

a bona fide business purpose. St. Louis County Bank, 674 F.2d at 1207; see also Estate of Bischoff v. Comm'r, 69 T.C. 32, 39–40 (1977). We have not so held, however, in the absence of a business.[3]

That is not to say we necessarily believe it will always be easy to apply § 2703(b)(1) or that investment-related activities cannot satisfy the subsection (b)(1) test. When the restrictions at issue, however, apply to a partnership that holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy, we do not view this determination as difficult. See, e.g., Higgins v. Comm'r, 312 U.S. 212, 217–18 (1941) (holding in another context that merely keeping records and collecting interest and dividends did not amount to "carrying on a business"); Estate of Thompson v. Comm'r, 382 F.3d 367, 380 (3d Cir. 2004) ("Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this family limited partnership with no ongoing business operations.").

One case the donors cite in support of their position is Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017 (2006). There, the Tax Court found that a buy–sell

[3] In St. Louis County Bank, for example, the transferred interests were shares in a family company that had started out as a moving, storage, and parcel-delivery business and evolved into a real estate management company. St. Louis Bank, 674 F.2d at 1208–09. When engaged in the moving and storage business, the company had created a stock-purchase agreement based on a valuation formula keyed to income. Id. at 1209. Later, the family exited the moving and storage business but kept the business structure as a vehicle for renting real estate. Id. With this new activity, the formula resulted in a dramatically lower value. Id. We stated, "We have no problem with the District Court's findings that the stock-purchase agreement provided for a reasonable price at the time of its adoption, and that the agreement had a bona fide business purpose—the maintenance of family ownership and control of the business. Courts have recognized the validity of such a purpose." Id. at 1210.

agreement was a bona-fide business arrangement where a fiduciary had entered into the agreement to ensure the ability to sell stock that represented an otherwise illiquid minority interest in a closely held bank. Id. at *12. The Tax Court viewed this purpose as patently business oriented and likely necessary to ensure that the fiduciary could fulfill his duty of protecting the beneficiary by ensuring the ability to sell the underlying assets. Id.

Here, in contrast, the donors did not enhance the liquidity of an otherwise illiquid asset through their actions nor do they claim their actions were necessary as a matter of business necessity to ensure a market for the assets. The underlying Dell stock is widely held, easily valued, and highly liquid. The donors placed it into the partnership thereby burdening it with illiquidity as part of an overall estate and gift planning process. As such the donor's reliance on Amlie is misplaced.

In Estate of Bischoff v. Comm'r, 69 T.C. 32 (1977), the question was whether the price contained in a buy–sell agreement regarding limited-partnership shares was controlling for valuation purposes. In that case, the Tax Court stated, "the cases have held that the maintenance of family ownership and control constituted a legitimate business consideration." Id. at 39–40. The underlying asset in Bischoff was "a pork processing business organized, controlled, and managed by three families" who sought "to assure their continuing ability to carry on their pork processing business without outside interference, including that of a dissident limited partner." Id. at 40. In Bischoff then, there was a perceived risk of an outsider interfering with management.

There is no similarity between the facts of Bischoff and the present case because limited partners in the Holman partnership held little-to-no ability to interfere with asset management. Further, the donors have made no allegation that they, as the general partners, are skilled or savvy investment managers whose expertise is needed or whose investment philosophy needs to be conserved or protected from interference

as might justify placement of stock assets into the partnership. Finally, the assets of the partnership—passively held Dell stock—are not assets with which an outsider or dissident owner might interfere. In the quantities held by the partnership, the value of the underlying assets are largely unaffected by the individual actions of the general partners or other owners of relatively insignificant fractions of outstanding stock (unlike the actions of potentially dissenting co-owners of a pork-processing enterprise).

Arguably, the strongest cases for the donors are a line of cases involving investment entities with restrictions imposed to ensure perpetuation of an investment model or strategy. See Estate of Black v. Comm'r, 133 T.C. 15 (2009); Estate of Murphy v. United States, No. 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009); Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353 (2005). The donors cite Schutt for the proposition that relatively inactive investment trusts or shells involving restricted rights may nevertheless involve legitimate business purposes and gain favored tax treatment. In making this point, the donors again attempt to portray the present Tax Court opinion as imposing an "operating business nexus" arguably contrary to Schutt. These cases, however, are more nuanced than the donors assert, and each involves unique facts not present in our case.[4]

In Schutt, the Tax Court addressed a different code section, but one of the underlying questions at issue was similar: whether the transfer of publicly traded stock into a business trust was a bona fide sale for full and adequate consideration. Id. at *18 (discussing the "bona fide sale" exception to 26 U.S.C. § 2036(a)). Under relevant Third Circuit authority, the Tax Court viewed this requirement as having a

[4]These cases address a slightly different, albeit similar, question under I.R.C. § 2036(a), the presence of a "legitimate business purpose." We, nevertheless, feel compelled to comment on these cases because they do not stand for the apparently broad proposition the donors would have us adopt, namely, that holding investments for gain necessarily satisfies the "bona fide business arrangement" test.

good faith element and also a "legitimate business purpose" element. Id. at *19–20 (applying Estate of Thompson, 382 F.3d at 383). Regarding the legitimate business purpose, the Tax Court ultimately concluded that the maintenance and perpetuation of a specific buy-and-hold investment strategy was, in that case, a legitimate business purpose. Id. at *25. The court based its decision on an express factual finding that the transferor's primary objective was to preserve his very specific investment strategy. Id. In so holding, however, the Tax Court appeared to recognize that it was approaching an outside limit as to the meaning of legitimate business purpose and noted the "unique circumstances of this case." Id. In fact, the court noted the general position that "the mere holding of an untraded portfolio of marketable securities weighs negatively in the assessment of potential nontax benefits." Id.

The facts of Schutt did not end up being as unique as suggested, and the Tax Court and a district court subsequently reached similar results in Murphy and Black. In Estate of Erickson v. Comm'r, 93 T.C.M. (CCH) 1175 (2007), however, the Tax Court distinguished Schutt, effectively illustrating an important difference between cases like Schutt and the present case:

> We have found a significant nontax purpose where the justification for the transaction was the decedent's personal views and concerns regarding the operation of an income-producing activity and not a business exigency. There is no significant nontax purpose, however, where a family limited partnership is just a vehicle for changing the form of the investment in the assets, a mere asset container.

Id. at *10 (internal citations omitted).

Here, as in Erickson, the family partnership is "a mere asset container." Id. The donors do not purport to hold any particular investment philosophy or possess any particular investing insight. The present partnership agreement does not require that the general partners retain the Dell stock held by the partnership and the donors

apparently intend to diversify their investments, although they have articulated no time frame or strategy for doing so. The donors admit that holding Dell stock as the exclusive asset of the limited partnership is not part of an overall, long-term plan. Here, then, unlike Schutt, the family membership, educational, and tax-reduction purposes overshadow any claim of a business purpose for the restrictions.

If anything, the important rule that we believe may be taken from Schutt and cases like it is that context matters such that it is appropriate to defer to the reasoned judgment and fact-finding ability of the Tax Court. In this regard, we note that in St. Louis County Bank, our case that set forth two of the three steps that Congress subsequently adopted in § 2703(b), we clearly emphasized the importance of context in this factually intense inquiry. We emphasized that the transaction at issue had taken place in the context of a donor who was facing a present heart condition and had a history of heart conditions suggesting a predominately testamentary motive to the transactions. St. Louis County Bank, 674 F.2d at 1210. In the present case, looking at the entirety of the surrounding transactions—including the contemporaneous execution of wills, Mr. Holman's understanding of the potential tax benefits of his actions, Mrs. Holman's educational goals, and the absence of any business activity—we find ample support for the Tax Court's determination. When viewed in this context, there is little doubt that the restrictions included in the Holmans' limited partnership agreement were not a bona fide business arrangement, but rather, were predominately for purposes of estate planning, tax reduction, wealth transference, protection against dissipation by the children, and education for the children.[5]

[5]Given our resolution of the "business arrangement" issue, we need not address the additional requirements of § 2703. Our election not to address these issues, however, should not be interpreted as implicit agreement with the dissent. We note that the Tax Court elected not to decide the § 2703(b)(3) requirement regarding the comparability of terms to those found in arms-length transactions. The dissent, however recites limited agreement between the parties' experts on this issue as recognized in dicta from the Tax Court. We are compelled, therefore, to note that we do not believe the parties' experts were as aligned on this issue as suggested by the

b. Valuation

In the Tax Court, the parties disagreed as to the value of the underlying Dell stock on the dates of the gifts as well as the appropriate marketability and minority-interest (lack-of-control) discounts. On appeal, aside from the § 2703 issue, the donors challenge only the Tax Court's determination of a marketability discount. The determination of an appropriate discount is a question of fact that we review for clear error. Estate of Ford v. Comm'r, 53 F.3d 924, 926–27 (8th Cir. 1995).

The donor's expert, Mr. Ingham, and the Commissioner's expert, Mr. Burns, employed methodologies there were similar in part. They looked to studies comparing the private sales of restricted, unregistered stock in public companies with contemporaneous, unrestricted sales of registered stock in those same companies. According to the experts, although these studies were not perfect analogs for sales of partnership interests, they did serve as examples providing insight as to price discrepancies between freely transferable stock in publicly traded companies and less marketable versions of the same stock, thereby illustrating pricing discounts that could be attributed to the absence of ready market.

The Tax Court agreed with the experts that the studies were useful, and we also agree. In general, Securities and Exchange Commission (SEC) rules limit owners' ability to sell unregistered stock in public companies other than (1) sales to institutional buyers, or (2) sales subject to certain holding periods. Rule 144, adopted

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dissent. For example, the Commissioner's expert opined that "when you look at the overall context . . . the issue of [transfer restrictions] wouldn't arise, because nobody at arm's length would get into this deal." He later stated, "[B]ased on my experience . . . I couldn't find anybody who would do this deal, who would let their client into a deal like this as a limited partner without writing a very large CYA memo, saying: 'We advise against this.'" Given this disagreement and the absence of a Tax Court ruling, we believe it is prudent not to address the § 2703(b)(3) requirement on appeal.

in 1972, imposed a two-year holding period on the resale of restricted stock. 17 C.F.R. § 230.144 (1972); 37 Fed. Reg. 591 (Jan. 14, 1972). Rule 144A, adopted in 1990, permits qualified institutional buyers to buy and sell unregistered, restricted stock. 17 C.F.R. § 144A (1990); 55 Fed. Reg. 17933-01 (April 30, 1990). In 1997, the SEC amended Rule 144 to reduce the holding period from two years to one year. 17 C.F.R. § 230.144 (1997); 62 Fed. Reg. 9242-01 (Feb. 28, 1997).

The experts' opinions in the present case differed in the degree of detail with which they discussed these evolving rules and the general inferences about marketability discounts that might be drawn from sales throughout the years that these rules were in effect. Mr. Ingham studied a sample of transactions with median and mean discounts of 24.8% and 27.4%, respectively. He then concluded, without additional quantitative explanation, that qualitative differences between the restricted-stock studies and the present, limited partnership situation justified a marketability discount of 35%. Mr. Burns criticized this upward adjustment as speculative and unsupported. The Tax Court agreed with Mr. Burns and rejected Mr. Ingham's conclusion, noting that it "need not rely on the unsupported assumption of an expert witness."

Mr. Burns examined restricted-stock sales with greater detail. He looked at sales during separate windows of time corresponding to the SEC's adoption of its different regulations. Mr. Burns explained that marketability discounts as per the studies included holding-period components and liquidity components.[6] He observed that for sales of restricted stock between 1972 and 1990, when there was a two-year holding period and no institutional-buyer market, the sale price for restricted shares was, on average 34% lower than sales of corresponding unrestricted shares. He then noted that between 1990 and 1997, when a limited market was created among

[6]Mr. Ingham appears to have conceded that Mr. Burns was correct in this qualitative explanation for different components of overall marketability discounts.

institutional buyers, the average price difference between restricted stock and corresponding non-restricted stock was 22%. He opined that the 12% difference in these two periods of time was reflective of the fact that buyers demanded a 12% discount to account for the lack of a secondary market. He concluded that the remaining portion of the discounts observed in the studies were due to holding-period restrictions not applicable in the context of the Holman partnership shares. He concluded, therefore, that the 12% lack-of-market or liquidity discount was similar to what private buyers of the limited-partnership shares would demand.

Mr. Burns continued his analysis by explaining why he believed it was appropriate to accept a marketability discount in the range of 12% rather than adjusting this amount substantially upward. Looking at the terms of the Agreement, he found a natural limit or cap on any discounts. He discussed the fact that the Agreement permitted all shareholders, by unanimous agreement, to dissolve the partnership and that it permitted partners or the partnership to buy out an exiting partner. He also noted the ease with which the value of the underlying assets could be determined on any given day. He opined that if outside buyers were to demand too great a discount relative to the then-prevailing price of Dell stock, economically rational insiders would have a clear incentive to step into the void and purchase the exiting partner's shares at a lesser discount, thereby providing a cap or ceiling to any potential discount.

The donors on appeal do not vigorously defend their expert's opinion regarding a 35% discount based on studies of restricted-stock sales. They do not claim that their expert disagreed with Mr. Burns's characterization of marketability discounts as including holding-period and liquidity components. Nor do they discuss their expert's failure to address this distinction. They do note that their expert's opinion is commensurate in scope with the discounts Mr. Burns cited for restricted stock sales between 1972 and 1990. They do not point to anything in the record, however,

suggesting that Mr. Ingham based his overall recommendation on the prevailing discount from that era.

The donor's primary argument on appeal focuses on the later aspect of Mr. Burn's opinion discussing what insiders likely would do in the face of potentially large discounts in partnership share price relative to Dell stock prices. The donors argue that this line of reasoning violates the hypothetical willing buyer/willing seller test by asking what the partnership or particular family members in this case would do rather than asking what hypothetical buyers and sellers would do. See Treas. Reg. § 25.2512-1 ("The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."); id. § 2512-3 ("The fair market value of any interest in a business, whether a partnership or a proprietorship, is the net amount which a willing purchaser, whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.").

When assessing hypothetical transactions between hypothetical buyers and sellers, it is improper to ascribe motivations that are personal and reflective of the idiosyncracies of particular individuals. See Estate of Jung v. Comm'r, 101 T.C. 412, 438 (1993) (refusing to cast a family corporation as the willing buyer where the attempt to do so was based on the non-economic-based view that the family corporation would purchase an interest merely to keep ownership within the family); Propstra v. United States, 680 F.2d 1248, 1251–52 (9th Cir. 1982) (refusing to cast executor and beneficiaries as hypothetical willing sellers to avoid "delicate inquiries into the feelings, attitudes, and anticipated behavior of those holding undivided interests in . . . property."). Rather, it is necessary to view such persons as economically rational actors possessing all relevant information and seeking to maximize their gains. See Estate of Jameson v. Comm'r, 267 F.3d 366, 370 (5th Cir.

2001) ("The buyer and seller are hypothetical, not actual persons, and each is a rational economic actor, that is, each seeks to maximize his advantage in the context of the market that exists at the date of valuation."); Curry's Estate v. United States, 706 F.2d 1424, 1431 (7th Cir. 1983) ("[T]he sole relevant consideration in determining whether the company here should be valued as liquidated or as a going concern is *which alternative could be expected to yield the profit-maximizing result.* . . . [T]he subjective intention or 'idea' of this particular plaintiff corporation . . . is irrelevant . . . . To hold otherwise would be to command future juries to wade into the thicket of personal corporate idiosyncrasies and non-market motives as part of their valuation quest . . . .") (emphasis added); Estate of Newhouse v. Comm'r, 94 T.C. 193, 218 (1990) ("The hypothetical willing buyer and seller are presumed to be dedicated to achieving the maximum economic advantage.").

Here, we believe the Tax Court's approach in adopting Mr. Burns's analysis comports with this general rule of casting the potential buyer merely as a rational economic actor. A buyer possessed of all relevant information would know that (1) the underlying assets are highly liquid and easily priced; (2) the amount held by the partnership could be absorbed by the broader market and represents but a small fraction of the total outstanding market capitalization of Dell corporation; (3) the partnership agreement permits the buying out of exiting partners or dissolution upon unanimous consent of all partners; and (4) there would be little or no economic risk and likely no additional capital infusion necessary for remaining partners to buy out an exiting partner.

Against this backdrop, it is not necessary to look at the personal proclivities of any particular partner or the idiosyncratic tendencies that might drive such a specific person's decisions. Rather it is only necessary to examine what is technically permissible in accordance with the agreement and forecast what rational actors would do in the face of a pending sale at a steep discount relative to net asset value. Simply put, the Tax Court did not ascribe personal non-economic strategies or motivations to

hypothetical buyers; it merely held that, presented with the opportunity, rational actors would not leave money on the table.

We affirm the judgment of the Tax Court.

BEAM, Circuit Judge, dissenting.

Because I would reverse the Tax Court's applications of I.R.C. § 2703's property valuation rules and Treasury Regulation § 25.2512-1's willing buyer/willing seller test, I respectfully dissent.

I. I.R.C. § 2703

I.R.C. § 2703(a)(2) provides that the value of any property shall be determined without regard to "any restriction on the right to sell or use such property." As an exception to this general rule, § 2703(b) provides that a restriction is considered for property valuation purposes if it meets each of the following requirements:

> (1) It is a bona fide business arrangement.
> (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
> (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

The court majority halted its analysis after its discussion of § 2703(b)(1), holding that the Holman partnership restrictions were not bona fide business arrangements. I, however, would hold that the restrictions safely satisfy § 2703(b)(1)'s bona fide business arrangement test as well as the remaining tests in § 2703(b)(2) and (3).

A. Bona Fide Business Arrangement Test–§ 2703(b)(1)

The Holman family limited partnership was created to maintain family control over family assets, coordinate investment management, protect family assets from future creditors and other third parties, and to educate the Holman children as to wealth management. See ante at 3-4. To aid in achieving these goals, the partnership agreement includes transfer restrictions and a right of first refusal (the "restrictions"). The agreement also grants the general partners, Thomas and Kim Holman, exclusive control over the partnership's business, including the power to determine the investments and investment strategy of the partnership.

Despite conceding that the partnership agreement's restrictions "aid in control of the transfer" of partnership interests, Holman v. Commissioner, 130 T.C. 170, 194 (2008), the Tax Court concluded that the provisions did not satisfy § 2703(b)(1)'s "bona fide business arrangement" test. After reviewing case law and § 2703's legislative history, the Tax Court reasoned that partnership restrictions aimed at maintaining family control over a partnership and its assets do not serve a "bona fide business purpose" where, as here, "the partnership carried on little activity other than holding shares of [publicly-traded stock]." Id. Moreover, the Tax Court concluded that § 2703(b)(1)'s legislative history did not list educating children or preventing children from dissipating family assets as legitimate business purposes. Id. at 195.

As a preliminary matter, I disagree with the court majority's decision to review the Tax Court's application of § 2703(b)(1) for clear error based on its conclusion that "[t]he ultimate question of whether there was a bona fide business arrangement is a question of fact." Ante at 9-10. To be sure, the ultimate determination of whether restrictions are bona fide business arrangements is likely a question of fact. However, the fundamental question before us is whether the Tax Court employed the correct criteria, framework, or test to make this factual determination. This is a question of law, subject to de novo review. Cf. Estate of Palmer v. Comm'r, 839 F.2d 420, 423

(8th Cir. 1988) (while "the ultimate determination of fair market value is a finding of fact . . . [t]he question of what criteria should be used to determine value is a question of law"); IHC Health Plans, Inc. v. Comm'r, 325 F.3d 1188, 1193 (10th Cir. 2003) ("The appropriate legal standard for determining whether an organization operates for a 'charitable' purpose is a legal question, which we review de novo."). Moreover, this question requires a review of the Tax Court's interpretation of § 2703(b)(1), and we review the Tax Court's statutory interpretations de novo. Scherbart v. Comm'r, 453 F.3d 987, 989 (8th Cir. 2006). Thus, we are presented with *at least* a mixed question of law and fact, if not a pure question of law. Either way, our precedent requires de novo review. Blodgett v. Comm'r, 394 F.3d 1030, 1035 (8th Cir. 2005).

While interpreting § 2703(b)(1), our ultimate goal is to "give effect to the Congressional intent behind the statute's enactment." Estate of Farnam v. Comm'r, 583 F.3d 581, 584 (8th Cir. 2009). Where, as here, the statute's language is ambiguous,[7] it is appropriate to examine legislative history to determine legislative intent. Id. In light of § 2703(b)(1)'s legislative history, the court's interpretation and application of § 2703(b)(1) does not give effect to the statute's legislative intent.

The court, like the Tax Court, essentially holds that "maintaining family control" is a legitimate business purpose for partnership restrictions *only* when the "control" being preserved is the right to manage an operating business or an actively-managed asset. See ante at 10-11. While the court narrowly reads Estate of Bischoff v. Commissioner, 69 T.C. 32, 39-41 (1977) to bolster its holding, congressional committees cited Bischoff to support much broader propositions. First, the Joint Committee on Taxation cited Bischoff for the proposition that maintaining family control is a legitimate business purpose for buy-sell agreements, "even when the

[7]The Tax Court noted that § 2703 "contains no definition of the phrase 'bona fide business arrangement,'" Holman, 130 T.C. at 192, and acknowledged that "[t]he meaning of the term 'bona fide business arrangement' . . . is not self apparent," id. at 195. I agree.

'control' being preserved is a right to receive income from investment assets." Staff of Joint Comm. on Taxation, 101st Cong., 2d Sess., Federal Transfer Tax Consequences of Estate Freezes 14 (Comm. Print 1990). Furthermore, the parenthetical following the Committee's Bischoff citation explains that "maintenance of control is [a] business purpose even if the interest being sold is a limited partnership interest in a holding company." Id. at 14 n.44. Finally, the Senate Finance Committee cited Bischoff for the proposition that "[c]ontinuation of family ownership" is a legitimate business purpose for buy-sell agreements "even when the 'control' being preserved is only the right to participate as a limited partner." Explanatory Material Concerning Committee on Finance 1990 Reconciliation Submission Pursuant to House Concurrent Resolution 310, 136 Cong. Rec. 30,488, 30,538 (1990) [hereinafter Finance Committee Report]. Accordingly, I think the Holman partnership restrictions served the congressionally-recognized legitimate business purposes of maintaining family control over the right to participate as a limited partner and the right to receive income from the partnership's investment assets.

Next, the court attempts to distinguish the value-fixing agreement in Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017, 2006 WL 995337 (2006), from the restrictions in the present case. In Amlie, the Tax Court determined that a conservator's value-fixing agreement qualified as a bona fide business arrangement, in part, because it aided in "planning for future liquidity needs" of the ward's estate. Id. at *12. To support it's holding, the Tax Court in Amlie cited to a portion of the Finance Committee Report that provides:

> The committee believes that buy-sell agreements are common business planning arrangements and that buy-sell agreements generally are entered into for legitimate business reasons that are not related to transfer tax consequences. Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an

> unrelated party, to provide a market for the equity interest, and *to allow owners to plan for future liquidity needs in advance*.

Finance Committee Report, 136 Cong. Rec. at 30,539 (emphasis added); Amlie, 2006 WL 995337, at *12 (citing the same); see also Holman, 130 T.C. at 193-94 (quoting the same). Notably, the Tax Court recognized planning for future liquidity needs as a legitimate business purpose for the agreement despite the fact that the ward's stock "was not an actively managed business interest but merely an investment asset."[8] Amlie, 2006 WL 995337, at *12.

The court asserts that Amlie is distinguishable from the present case because the Holman partnership restrictions were not created to provide for the future liquidity needs of the partnership. This is a distinction without merit. Here, the Tax Court conceded that the Holman partnership restrictions aided in controlling the transfer of partnership interests to third parties. The court majority's attempt to distinguish the present case from Amlie ignores that the *same portion of legislative history* cited by the Tax Court in Amlie, and quoted by the Tax Court in the present case, recognizes that buy-sell agreements serve the legitimate business purpose of "prevent[ing] the transfer to an unrelated party." Finance Committee Report, 136 Cong. Rec. at 30,539. If the absence of an "actively managed business interest" was irrelevant in Amlie, it is unclear why an actively managed business interest is required in the present case to legitimize the Holman partnership restrictions.

In light of Amlie and § 2703(b)(1)'s legislative history, the Holman partnership restrictions serve the legitimate business purpose of protecting partnership assets from

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[8]In Amlie, the Commissioner argued that the agreement could not satisfy § 2703(b)(1) unless the stock was an actively managed business interest. The Tax Court explained: "We rejected such an argument in Estate of Bischoff v. Commissioner, 69 T.C. 32, 40-41, 1977 WL 3667 (1977), and find it equally unpersuasive here." Amlie, 2006 WL 995337, at *12.

unrelated parties.[9] Protecting partnership assets from creditors is surely a legitimate business purpose for transfer restrictions, regardless of whether the partnership manages an operating business or merely holds publicly-traded stock. Cf. Estate of Mundy v. Comm'r, 35 T.C.M. (CCH) 1778, 1976 Tax Ct. Memo LEXIS 8, at *46 (1976) (finding that insulating corporate assets from possible liabilities was a valid business purpose for restricting transferability of stock). Similarly, protecting partnership assets from the Holman daughters' potential future ex-spouses is a legitimate business purpose for the restrictions. Cf. Keller v. United States, No. V-02-62, 2009 WL 2601611, at *19 (S.D. Tex. Aug. 20, 2009) (recognizing protecting family assets from depletion by ex-spouses through divorce proceedings as a "legitimate business purpose" for the creation and funding of a partnership).

Additionally, the Holman partnership restrictions serve the legitimate business purpose of preserving the partners' fundamental right to choose who may become a partner.[10] See In re Schick, 235 B.R. 318, 324 (Bankr. S.D.N.Y. 1999) (recognizing that, although arguably more important in the general partnership context, the right to

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[9]The Tax Court acknowledged that the Holman partnership agreement restrictions were intended, in part, to place "strong limitations on what the limited partners can do in assigning or giving away their interests to other people" and to provide a "'safety net' if an impermissible person obtained an assignment of a limited partner interest from one of the girls." Holman, 130 T.C. at 194 (quotation omitted). Indeed, the partnership agreement provides that the Holman partnership was created to "restrict the right of non-Family persons to acquire interests in Family Assets" and to "provide protection to Family Assets from claims of future creditors against Family members." Id. at 176. Moreover, at trial, Thomas Holman testified: "[W]e were worried that the assets that the girls would eventually come into would be sought after by third-party people, friends, spouses, potential creditors."

[10]At trial, Thomas Holman explained that the partnership allowed the Holmans "to give [their] daughters a seat at the table, to become real partners in the operation of [the] business." Moreover, one of Thomas Holman's long-term goals was to have his daughters "become more and more engaged in the partnership over time."

choose partners "still provides the underlying rationale for restricting the admission of new or substitute limited partners"). As the Holmans' partnership expert explained:

> Partnership agreements contain [transfer] restrictions because persons who join together as partners generally desire a high degree of certainty as to who their partners are and will be, especially where they establish the entity with commonly-shared investment goals and the intention that the entity be closely-held. They want the ability to limit who may become their partner without their agreement that such person may take a place at the table.

Without restrictions on who may become a limited partner, Thomas and Kim Holman, as general partners, could find themselves owing obligations[11] and fiduciary duties to third parties to whom they never envisioned owing such obligations and duties–e.g., the Holman daughters' future spouses. Such obligations and duties exist regardless of whether the Holman limited partnership operates a lemonade stand or holds Dell stock. And, as the Holmans' partnership expert explained, "[h]aving an unwanted partner or assignee of a partnership interest is likely to increase the general partner's risk of personal liability."

Finally, I think the court's decision is contrary to the underlying purposes of § 2703. Section 2703 is one of several special valuation rules Congress enacted, in part, "to allow business owners who are not abusing the transfer tax system to freely engage in standard intrafamily transactions without being subject to severe transfer tax consequences." Finance Committee Report, 136 Cong. Rec. at 30,538. Congress enacted § 2703, in particular, to "distinguish between agreements designed to avoid estate taxes and those with legitimate business agreements." Id. at 30,539. This

[11]For example, section 6.1 of the Holman partnership agreement provides: "The General Partners shall use their best efforts to carry out the purposes and business of the Partnership in a prudent and businesslike manner."

legislative history suggests that the bona fide business arrangement test was designed to determine whether restrictions are created primarily to avoid transfer taxes.

Here, the Tax Court made the express factual determination that the partnership agreement restrictions were "designed *principally*" to protect family assets from dissipation by the Holman daughters. Holman, 130 T.C. at 195 (emphasis added). In other words, the Tax Court determined that the restrictions were designed primarily to serve a *non-tax* purpose. Notably, the Tax Court did *not* find that the Holmans merely paid lip service to legitimate business purposes for the restrictions while, in reality, using the restrictions for the primary purpose of avoiding taxes.[12] Additionally, the Tax Court did *not* find that the restrictions failed to match the partnership's legitimate, non-tax goals.[13] The underlying purposes of § 2703 are not served where, as here, the bona fide business arrangement test is applied in a manner that discourages partners in family partnerships from creating restrictions principally to achieve non-tax, economic goals.

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[12]While the Tax Court determined that Thomas Holman understood the tax benefits of creating a partnership, it did not determine that tax avoidance was the principal purpose of the partnership restrictions. Indeed, understanding tax benefits and using transfer restrictions for the primary purpose of avoiding taxes are two different things.

[13]The court majority states that restrictions on the sale or use of property, "[w]hen carefully crafted and applied in certain circumstances . . . can minimize the tax consequences of gifts or transfers without imposing substantial additional limitations on the transferability or use of the property." Ante at 7. Here, however, there is apparently no question that the Holman partnership restrictions imposed actual, substantial limitations on the transfer of partnership interests. Indeed, even the Commissioner's expert recognized that "[i]n virtually every material respect" the Holman partnership agreement "blocks for 50 years the limited partners' ability to sell or use their respective limited partner interests." Holman, 130 T.C. at 197.

Thus, I would hold that the Holman partnership agreement restrictions are "bona fide business arrangements" because they were not created for the primary purpose of avoiding taxes, and they served the following legitimate business purposes: (1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnership's investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners' fundamental right to choose who may become a partner.

B. Device Test–§ 2703(b)(2)

Having determined that the partnership restrictions satisfy § 2703(b)(1), I now turn to § 2703(b)(2)'s "device" test. Under this test, the Holman partnership restrictions must not be a "device to transfer such property to *members of the decedent's* family for less than full and adequate consideration in money or money's worth." I.R.C. § 2703(b)(2) (emphasis added). Treasury Regulation § 25.2703-1(b)(1)(ii) excises the phrase "members of the decedent's family" found in § 2703(b)(2) and substitutes in its place the phrase "natural objects of the transferor's bounty," apparently because the Secretary of the Treasury interprets § 2703(b)(2) to apply to both inter vivos transfers and transfers at death. Holman, 130 T.C. at 195-96. Applying this regulation, the Tax Court held that the Holman partnership restrictions operate as a device to transfer property to the natural objects of the Holmans' bounty. The Holmans argue that Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it fails to give effect to § 2703(b)(2)'s plain language. I agree.

The validity of a treasury regulation is a question of law, which we review de novo. Walshire v. United States, 288 F.3d 342, 345 (8th Cir. 2002). We afford treasury regulations interpreting the Internal Revenue Code "substantial deference." Mayo Found. for Med. Educ. & Research v. United States, 568 F.3d 675, 679 (8th Cir. 2009). That said, our first question in reviewing an agency's interpretation of a statute

is "whether Congress has directly spoken to the precise question at issue." Chevron, U.S.A., Inc. v. Natural Res. Def. Council Inc., 467 U.S. 837, 842 (1984). If so, we, "as well as the agency, must give effect to the unambiguously expressed intent of Congress." Id. at 843. If, however, "the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." Id.

The parties primarily dispute whether § 2703(b)(2) is ambiguous. The Holmans assert that the term "decedent" unambiguously refers to a deceased person and, therefore, § 2703(b)(2) asks only whether restrictions operate as a device to transfer property to family members at death. The Holmans point out that only the term "decedent," not the broader term "transferor," is used throughout § 2703(b)(2)'s legislative history. Conversely, the Commissioner argues that the term "decedent" is ambiguous due to § 2703's location in the Internal Revenue Code. Specifically, § 2703 is located in Subtitle B of the Code, which includes three transfer taxes–the estate, gift and generation-skipping transfer taxes. More precisely, § 2703 is located in Subtitle B, Chapter 14. In Chapter 14, § 2703 joins a set of special valuation rules targeting transfer tax avoidance schemes.

It is clear that the phrase "members of the decedent's family" unambiguously limits § 2703(b)(2)'s application to transfers at death. First, the term "decedent" is itself unambiguous. Black's Law Dictionary 465 (9th ed. 2009) plainly defines "decedent" as "[a] dead person." Moreover, the phrase "members of decedent's family" is not ambiguous when read in the greater context of Chapter 14. While Congress used the term "decedent" in § 2703(b)(2), it used the broader term "transferor" in Chapter 14's other valuation statutes. See I.R.C. §§ 2701(a)(1) & 2702(a)(1). And, as the Holmans point out, the term "decedent" consistently appears in § 2703(b)(2)'s legislative history. Finally, I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase "members of the decedent's family" with the Commissioner's phrase "natural

objects of the transferor's bounty." See Smith v. United States, No. C.A. 02-264 ERIE, 2004 WL 1879212, at *6 n.3 (W.D. Pa. June 30, 2004). Thus, although Congress enacted Chapter 14 to generally address transfer tax avoidance schemes, § 2703(b)(2) applies specifically to transfers at death.

Therefore, Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it does not give effect to the plain language of § 2703(b)(2). Since the Holmans are living persons, they are, by definition, not "decedents" and § 2703(b)(2)'s device test is satisfied.

C. Comparable Terms Test–§ 2703(b)(3)

Since the Holman partnership restrictions satisfy § 2703(b)(1) and (2), I now analyze the restrictions under § 2703(b)(3). Under § 2703(b)(3)'s "comparable terms" test, the Holman partnership restrictions' terms must be "comparable to similar arrangements entered into by persons in an arms' length transaction." While the Tax Court did not decide whether the restrictions satisfied the comparable terms test, it noted that both parties' experts "agree that transfer restrictions comparable to those found in [the Holman partnership agreement] are common in agreements entered into at arm's length."[14] Holman, 130 T.C. at 198-99. The Tax Court explained that this "would seem to be all that [the Holmans] need to show to satisfy section 2703(b)(3)." Id. at 199. I agree, and I would hold that the Holman partnership restrictions satisfy § 2703(b)(3)'s comparable terms test.

[14]The court in footnote 5 appears to import language from one of the Commissioner's experts to impeach the Tax Court's statements concerning the requirements of § 2703(b)(3). At best, the cited emanations of this particular witness are barely relevant to a proper interpretation of this portion of the statute.

Thus, because the partnership restrictions satisfy all three of § 2703(b)'s tests, I would reverse and remand to the Tax Court for a valuation of the limited partnership interests that does not disregard the partnership restrictions.

II. MARKETABILITY DISCOUNT CALCULATION

As a preliminary matter, I also disagree with the court's decision to review the Tax Court's marketability discount calculation for clear error. "The mathematical computation of fair market value is an issue of fact, but determination of the appropriate valuation method is an issue of law that we review de novo." Estate of Jelke v. Comm'r, 507 F.3d 1317, 1321 (11th Cir. 2007) (quotation and alteration omitted); see also Palmer, 839 F.2d at 423 (the "question of what criteria should be used to determine value is a question of law subject to de novo review"). Since the real issue here is whether the Tax Court used a proper valuation method–i.e., properly applied the willing buyer/willing seller test to calculate an appropriate marketability discount, I would review this legal issue de novo.

Under Treasury Regulation § 25.2512-1, the value of property for gift tax purposes is "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." While the hypothetical willing seller and willing buyer "are presumed to be dedicated to achieving the maximum economic advantage," Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990), "the Commissioner cannot tailor 'hypothetical' so that the willing seller and willing buyer [are] seen as the particular persons who would most likely undertake the transaction." Morrissey v. Comm'r, 243 F.3d 1145, 1148 (9th Cir. 2001) (internal quotation omitted).

While assessing the partnership interests' marketability for valuation purposes, the Tax Court conceded that the private market for such interests was "thin." Holman,

130 T.C. at 214. However, the Tax Court adopted the opinion of the Commissioner's expert that this "thin" market did not justify a substantial marketability discount because the wishing-to-assign partner could convince the remaining partners to voluntarily dissolve the partnership and buy him out. Specifically, the Tax Court reasoned:

> [G]iven the significant minority interest and marketability discounts from an LP unit's proportional share of the partnership's [net asset value] that each expert would apply in valuing the gifts, it would appear to be in the economic interest of both any limited partner not under the economic necessity to do so but wishing to make an impermissible assignment of LP units and the remaining partners to strike a deal at some price between the discounted value of the units and the dollar value of the units' proportional share of the partnership's [net asset value]. The wishing-to-assign partner would get more than she would get in the admittedly 'thin' market for private transactions, and the dollar value of each remaining partner's share of the partnership's [net asset value] would increase.

Id. at 214.

The Tax Court's analysis violates the hypothetical willing buyer/willing seller test because it assumes the *hypothetical* buyers own Holman limited partnership interests. See Estate of Jung v. Comm'r, 101 T.C. 412, 438 (1993). The court majority asserts that the Tax Court properly cast the hypothetical willing buyer "*merely* as a rational economic actor," but the Tax Court did more than that. Ante at 20 (emphasis added). The Tax Court effectively plucked rational economic actors out of the existing "thin" private market,[15] placed Holman limited partnership shares in their pockets, and asked them what they would pay for a wishing-to-assign partner's

[15]A rational actor "seeks to maximize his advantage in the context of the *market* that exists at the date of valuation." Estate of Jameson v. Comm'r, 267 F.3d 366, 370 (5th Cir. 2001) (emphasis added).

interest in light of the partnership's dissolution provisions. In fact, the Tax Court's analysis is essentially based on the idea that a *mere* rational economic actor in the existing market would pay *less* than rational actors who already hold Holman limited partnership interests.[16] Courts commit legal error where, as here, they substitute hypothetical buyers for "particular possible purchasers" based on "imaginary scenarios as to who a purchaser might be." Estate of Simplot v. Comm'r, 249 F.3d 1191, 1195 (9th Cir. 2001).

That is not to say that courts err whenever they consider partnership agreements' dissolution provisions while calculating an appropriate marketability discount. For example, if the Holman limited partnership had a significant history of dissolving and buying out wishing-to-assign partners, a hypothetical willing buyer would consider this fact while assessing the partnership interests' marketability. See, e.g., Estate of Neff v. Comm'r, 57 T.C.M. (CCH) 669, 1989 Tax Ct. Memo LEXIS 278, at *27 (1989) (determining that "the hypothetical willing buyer would certainly take into account the [corporation's history of] stock repurchases, at premium prices, in valuing the stock"). Indeed, hypothetical willing buyers and willing sellers are considered to have "reasonable knowledge of relevant facts" surrounding the hypothetical sale. Treas. Reg. § 25.2512-1.

Here, the Commissioner's expert never determined the actual likelihood of the Holman limited partnership executing a dissolution and buy-out scheme. Holman, 130 T.C. at 214. The expert merely opined that he could not "envision an economic reason why" the partnership would not engage in such a scheme. Id. (quotation

[16]The Tax Court reasoned that the remaining partners and the wishing-to-assign partner could "strike a deal *at some price between the discounted value of the units* and the dollar value of the unit's proportional share of the partnership's [net asset value]" and, as a result, "[t]he wishing-to-assign partner *would get more than she would get in the admittedly 'thin' market for private transactions*." Holman, 130 T.C. at 214 (emphasis added).

omitted). This analysis is not helpful because it does not consider the fact that the Holman limited partnership has never engaged in such a scheme, see Jung, 101 T.C. at 437 n.9, or whether the Holman limited partnership or limited partnership owners do or do not have sufficient liquidity to buy out a wishing-to-assign partner. The expert's analysis also does not consider that dissolving and buying out a wishing-to-assign partner may be contrary to the partnership's stated goals–maintaining control of family assets, continuing ownership of family assets, and restricting the ability of unrelated parties to acquire interests in family assets. Against this factual backdrop, the hypothetical willing buyer may find that the actual probability of the remaining partners unanimously consenting to a dissolution and buy-out scheme is quite low.

Thus, the Tax Court's misapplication of the willing buyer/willing seller test constitutes reversible error. Accordingly, I would also reverse and remand to the Tax Court for a new marketability discount determination.

For the foregoing reasons, I respectfully dissent.

Full Text of Court Cases

Howell v. Howell

Case name: Howell v. Howell
Citation: 31 Va. App. 332, 523 S.E. 2d 514, 2000 Va. App. LEXIS 24
Date of decision: January 27, 2000
Country: US
State or Federal: State
State/Jurisdiction: Virginia
Court: Court of Appeals
Type of action: Marital Dissolution
Judge: Bumgardner
Experts: Robert R. Raymond (for wife)
Williams Stephens (for husband)
SIC: 8111 Legal Services
NAICS: 541110 Offices of Lawyers
1806, 1826, 767

Keywords: Intrinsic value, Marital dissolution, Partnership interest, Peer group, Practice goodwill

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Judges: Judges Coleman, Willis and Bumgardner

Opinion by: Bumgardner

George C. Howell, III appeals from the final decree divorcing Margaret H. Howell and him and distributing their marital estate. He complains primarily that the trial court erred in valuing his interest in his law firm, but he also asserts it erred in classifying a money market account, in allocating marital debt, and in setting spousal support. The trial court referred all issues to a commissioner in chancery and adopted nearly all of the commissioner's findings in its final decree. Concluding that the trial court did not err, we affirm.

The parties married in 1982 after the husband graduated from law school but before he began practicing law with Hunton & Williams, a large firm based in Richmond. The husband specialized in tax law, established a successful practice with the firm, became a partner in 1989, and earned an income of more than $ 400,000 by 1998. After the first of their two children was born in 1984, the wife no longer worked outside the home. She took care of their two children and maintained the household. When the parties separated November 17, 1995, she maintained custody of the children, and when they divorced November 4, 1998, she received sole physical custody of the children with the husband's consent.

The husband conceded that his partnership interest was marital property because he acquired it during the marriage. The partnership agreement at Hunton & Williams defined the value of the partnership interest upon termination or death. It entitled the partner to receive only the balance of his capital account and his share of the net income. As applied to this case, those two items amounted to $ 85,614. The husband maintains that the agreement fixed the value of his partnership interest for equitable distribution purposes and that it precluded consideration of whether his interest had goodwill. He argues that Kaufman v. Kaufman, 7 Va. App. 488, 375 S.E.2d 374 (1988), ruled that restrictive agreements control the valuation of business interests and limit the value to that established by the agreement. The husband argues that the trial court erred in finding that his partnership interest had goodwill because the Hunton & Williams agreement made no provision for goodwill.

Code § 20-107.3(A) directs that the trial court value all property of the parties, but it does not define the term, "value," for equitable distribution purposes. The statute does not set the standard of value, that is, the measure of property's worth for equitable distribution. "Value" is a mercurial term; the term has numerous, distinct meanings. The various meanings are not interchangeable. The meaning of the term, "value," depends on what is being valued, who is interested, and why it is being valued. A piece of property may have different values for different purposes. The purpose for which it is being valued determines which definition, which standard of value, is proper. Purpose determines the standard of value; that, in turn, determines the appropriate methods of valuation.

Bosserman v. Bosserman, 9 Va. App. 1, 384 S.E.2d 104 (1989), defined "value" for equitable distribution purposes; it set intrinsic value as the standard of value. "Trial courts valuing marital property for the purpose of making a monetary award must determine from the evidence that value which represents the property's intrinsic worth to the parties ...." Id. at 6, 384 S.E.2d at 107. The value of an item of marital property is its intrinsic worth to the parties: the worth to the husband and wife, the parties; the value to the marital partnership that the court is dissolving.

Intrinsic value is a very subjective concept that looks to the worth of the property to the parties. The methods of valuation must take into consideration the parties themselves and the different situations in which they exist. The item may have no established market value, and neither party may contemplate selling the item; indeed, sale may be restricted or forbidden. Commonly, one party will continue to enjoy the benefits of the property while the other must relinquish all future benefits. Still, its intrinsic value must be translated into a monetary amount. The parties must rely on accepted methods of valuation, but the particular method of valuing and the precise application of that method to the singular facts of the case must vary with the myriad situations that exist among married couples.

Because intrinsic value must depend on the facts of the case, we give great weight to the findings of the trial court. We affirm if the evidence supports the findings and if the trial court finds a reasonable evaluation based on proven methodology and on the application of it to the particular facts of the case. See Russell v. Russell, 11 Va. App. 411, 415-16, 399 S.E.2d 166, 168 (1990). "The trial court's valuation of goodwill will not be disturbed if it appears that the court made a reasonable approximation of the goodwill value, if any, of the professional practice based on competent evidence and the use of a sound method supported by that evidence." Id. at 417, 399 S.E.2d at 169 (citation omitted).

In Kaufman, the husband purchased a one-third interest in a medical practice six months after the parties separated. The purchase contract required stockholders to resell their interest to the corporation at a value excluding any provision for accounts receivable or work in progress. The trial court held that

the value set by the contract controlled because the terms were made at arm's length and were devoid of fraud. This Court affirmed that valuation and ruled it was bound by the finding because there was evidence to support it. See 7 Va. App. at 502, 375 S.E.2d at 381 (citing Code § 8.01-680).

In Bosserman, the wife asked the court to value the husband's interest in a family-owned, closely-held corporation. A restrictive agreement required a shareholder to offer the stock first to the corporation at "true book value." The husband argued that the restriction defined the value. See 9 Va. App. at 3, 384 S.E.2d at 106. This Court recognized that the value set by such agreements "is often artificial and does not always reflect true value," even though the agreements may be binding on business partners. Id. at 6, 384 S.E.2d at 108. "The sale price set by restrictive provisions on transfer is not conclusive as to the value of the stock." Id. at 7, 384 S.E.2d at 108. A restriction on transfer does not control its value, "but the restriction on transfer is a factor which affects the value of the stock for purposes of equitable distribution." Id. (citations omitted). Interestingly, Bosserman relied upon an article discussing goodwill valuation in law firms to conclude restrictive provisions are not conclusive of value.

Russell established that a psychiatric practice could have goodwill that had value. "If the trial court determines from the greater weight of the evidence that a professional practice has goodwill value, that amount must be subject to valuation as part of the marital property. To hold otherwise would result in a windfall to the professional spouse." 11 Va. App. at 416, 399 S.E.2d 168. Goodwill may be an asset of a professional practice, and if it is, it is subject to valuation for equitable distribution purposes.

All three decisions turned upon the particular findings made from the precise evidence presented to the trial court. The holdings establish that the value of property is an issue of fact, not of law. Goodwill may exist, or may not; an agreement may restrict its value, or may not. The existence of goodwill must be proven, and if it exists, its value must be proven. The evidence presented at trial determines the result, and the result may vary from case to case as the evidence differs. If conflicting, competent evidence is presented, that found more credible will determine whether goodwill exists and its value if it does exist. The existence is not fixed as a matter of law, nor is the method of valuation; both are functions of the fact finding process.

In this case, the commissioner found that the husband's partnership interest had intangible value, goodwill, and that the partnership agreement did not reflect its true worth to the parties, its intrinsic value. After hearing extensive expert testimony, the commissioner accepted the opinion of the wife's expert and valued the partnership interest at $ 319,569. The trial court accepted the commissioner's findings.

The wife's certified public accountant testified that the husband's interest in his law firm had value in the nature of goodwill. The husband's expert witness, also a certified public accountant, disagreed and testified that the partnership agreement controlled. Both opinions were made by qualified and experienced experts, were reasoned and based on accepted principles, and either might have been found credible by the trial court. In resolving the conflicting opinions, the commissioner gave greater weight to the wife's expert, and the trial court accepted that finding.

The trial court has discretion to resolve conflicting expert testimony to determine an asset's value. See Rowe v. Rowe, 24 Va. App. 123, 140, 480 S.E.2d 760, 768 (1997); McDavid v. McDavid, 19 Va. App. 406, 413, 451 S.E.2d 713, 718 (1994). Where the court accepts the commissioner's findings of fact, "the findings are presumed to be correct when reviewed on appeal and are to be given 'great weight' by this

Court." Rowe, 24 Va. App. at 140, 480 S.E.2d at 768 (citation omitted). The court's decision will not be disturbed on appeal unless plainly wrong or without evidence to support it. See Blank v. Blank, 10 Va. App. 1, 9, 389 S.E.2d 723, 727 (1990).

The standard of value has a critical impact on the effect of a restrictive agreement. The standard in equitable distribution, intrinsic value, looks to the value to the parties to the divorce action. When the parties do not contemplate sale and one of the two is going to enjoy the benefits of the property with no likelihood of leaving the business, a restrictive agreement may have less bearing on the value to the parties. The agreement should be considered but it is not conclusive. "The reason for rejecting the value set by buyout provisions is that they do not necessarily represent the intrinsic worth of the stock to the parties." Bosserman, 9 Va. App. at 6, 384 S.E.2d at 107.

The commissioner considered the restrictive agreement as one factor in determining whether goodwill existed, but he did not find it to be the sole, controlling factor. Credible evidence supported the finding that the partnership agreement was but one factor to consider in determining the intrinsic value of the husband's partnership interest. The trial court did not err in finding that the Hunton & Williams partnership agreement did not control the existence of goodwill in the husband's interest in the firm.

The husband contends that even if the trial court did not err in rejecting the partnership agreement valuation, it did err in the method and application used to value the interest. Both sides presented expert testimony valuing the goodwill of the partnership interest. The commissioner found that the wife's expert was persuasive and accepted his evaluation. The trial court affirmed those findings fixing the value at $ 319,569.

The wife's expert used the excess earnings method to value the practice goodwill, a method acknowledged by the husband's expert as the most popular method for evaluating professional goodwill. The wife's expert began by comparing the husband's average income for three years to that of a peer group. The difference between the two was the excess earnings due to the husband's association with the firm, but not the earnings due to his personal efforts. It was the additional income he received from being associated with his law firm. The wife's expert projected those excess earnings over the husband's expected career with Hunton & Williams. Using the discounted future earnings method, he then calculated the present value of the husband's total future excess earnings.

The wife's expert began by comparing the husband's earnings to those of a peer group. The husband argues that this method, described as working from the "bottom up," is incorrect. He contends that the peer group selected by the wife's expert compared him to merely average attorneys, did not reflect his special reputation and expertise, and failed to distinguish his personal credentials from those of Hunton & Williams. He also contends that the discounted future earnings method is an improper method of valuation because it is based on future earnings projections. Finally, he argues he can have no excess earnings due to his association with Hunton & Williams because he had received offers from other firms for 150-175% more income.

The wife's expert carefully explained why he selected the methodology that he used. A major reason was the unavailability of partnership financial data. Before getting the appraisal, the wife attempted to discover the partnership's financial records. Hunton & Williams successfully had the request quashed

and did not make any partnership financial data available. The wife's expert felt the "bottom up" method was more accurate under those circumstances. The trial court accepted that opinion and analysis. We cannot say that the opinion was unworthy of belief as a matter of law.

The wife's expert selected the husband's peer group based on factors that included comparable geographic location, population, firm size, specialization, and years of practice. The husband argued that the group did not reflect his special talents and that the appropriate peer group was the one selected by his expert. The trial court carefully examined these conflicting opinions and rejected the one offered by the husband. The trial court found the peer group suggested by the husband's expert was flawed because the group only included firms located in very large cities, such as New York or San Francisco, and it was a selection provided by the husband.

The wife's expert valued the husband's excess earnings due solely to his association with his firm at $ 38,269. He then projected this figure to the husband's expected retirement year, 2021. After adding the terminal value of the husband's capital account, he applied a discount rate of 6.9%. The result was the present value of the husband's partnership interest, $ 319,569. The court accepted the wife's expert's use of a discount rate of only 6.9%. The expert justified that rate, one applicable to nearly risk-free investments, and the record does not suggest that it was incredible. As presented, the proper discount rate was an expert opinion that could be accepted if the trier of fact found it persuasive and believable.

Discounting future earnings is not an inherently flawed method of valuation because it is based on projected future earnings. The value of goodwill can have two components. Professional goodwill (also designated as individual, personal, or separate goodwill) is attributable to the individual and is categorized as separate property in a divorce action. Practice goodwill (also designated as business or commercial goodwill) is attributable to the business entity, the professional firm, and may be marital property. The commissioner and the trial court carefully distinguished between these two components and selected a value that was solely attributable to the husband being a partner in Hunton & Williams. It represented the premium due to the husband's association with Hunton & Williams, the economic advantage he enjoyed because he was a partner in that firm. It included no value attributable to him personally, and it did not rely upon any earnings due to the husband's own expertise, reputation, experience, skill, knowledge, or personality. As applied, the discounted future earnings method was not a flawed method of valuation.

In valuing the goodwill of the partnership interest, courts must take special care not to confuse the owner spouse's personal future earning capacity with practice goodwill attributable to the law firm in order to avoid double counting. "Further, particular care must be given that future earnings capacity and reputation not be confused with professional goodwill." Russell, 11 Va. App. at 417, 399 S.E.2d at 168.

Though the husband's expert first stated that in his opinion the partnership interest could have no goodwill value, he offered an alternative opinion that recognized the husband's interest did have goodwill value. The trial court found that the alternative opinions offered by the husband, that his interest did and did not have goodwill value, were contradictory and confusing. The husband's expert used the capitalized historic earning method. His method required comparison of earnings to those of a peer group. The trial court found the husband's peer group inherently flawed, and it noted the group data was for the wrong year and compared group data to a single year of the husband's income.

The husband's expert calculated the value of a theoretical, marketable, controlling partnership interest in Hunton & Williams. To that figure, the expert applied a discount of 40% for lack of marketability and 30% for minority status. That reduced the market value of the husband's interest to $ 105,177. The trial court rejected the husband's reasoning for discounting for minority status and marketability. It found the discounts inappropriate because no transfer of the partnership interest was foreseeable and no one in the firm, nor any group within it, exercised majority control. See Bosserman, 9 Va. App. at 7-9, 384 S.E.2d at 108-09 (discussing restriction on marketability and minority shareholder status as affecting value to owning spouse). The trial court also rejected the argument that offers of employment at substantially higher compensation meant all goodwill was personal. The trial court would not accept the conclusion, suggested by that argument, that Hunton & Williams had no practice goodwill.

The experts disagreed on which of two accepted methods of valuation to use and on the application of those methods. They differed on the following: whether to value the individual interest first; whether to capitalize historic earnings or to discount future earnings; the proper peer group; the proper income data; and the application of discounts. The opinions of the experts conflicted, but neither was erroneous as a matter of law. "Depending on the circumstance of each case, different methods of valuation may reflect more accurately the actual value of the stock to the shareholder." Id. at 7, 384 S.E.2d at 108. No single method for determining the value of professional goodwill is preferred. See Russell, 11 Va. App. at 417, 399 S.E.2d at 169. We conclude that the trial court did not err in selecting the method of valuation or in the application of it to the facts presented in this case. The wife's valuation of the husband's interest in his law firm was supported by substantial and competent evidence.

The husband argues that the trial court erred in classifying a portion of a $ 203,288.46 money market account as marital property. The trial court designated $ 38,355 of the fund as marital property and $ 164,933 as the husband's separate property. The husband established the account in his name alone after the parties separated. He made the first deposit in March 1996 when he received his annual partnership earnings distribution.

Hunton & Williams operated on a fiscal year that ended in March, and it paid the partners the balance of their earnings in March of each year. The husband had to report his entire partnership income on his individual tax return for the calendar year in which the fiscal year ended. For example, he had to report all income earned from April 1, 1995 to March 31, 1996 on his individual income tax return for the calendar year 1996. That would throw nine months' worth of earnings, the portion earned in 1995, into the next individual income tax year, 1996.

The receipt of annual earnings in a lump at the end of the partnership's fiscal year created an irregular cash flow. The couple's income trailed their expenditure of it. To balance expenditures with receipts of income, the parties borrowed temporarily. They established an equity line of credit when they first purchased the marital home. Throughout the marriage, they had used that as a source of funds to pay expenses that came due before the partnership distributed its earnings. When they received the distribution at the end of the fiscal year, they would pay the credit line down. They used the distribution to repay the temporary financing incurred over the preceding twelve months.

At the time the parties separated, the balance due on the equity line was $ 126,801. The husband borrowed an additional $ 70,000 after the separation, but the wife froze the account when she learned of these draws. He then borrowed on two additional accounts and used the proceeds to pay taxes and tuition. The husband claimed that the funds borrowed after separation were used for marital purposes.

From July 1995 the husband only paid interest on the equity line account, and after separation, he did not curtail the account except to apply $ 71,652.71 from the portion of the March 1996 distribution that he considered to be marital property.

The fiscal year-end distribution that husband received in March 1996 was for work done both before and after the date of separation, November 1995. The husband calculated that $ 72,795 was marital property. He applied $ 71,652.71 of that to the balance due on the equity line of credit. The remaining portion of the March 1996 distribution became the initial deposit to his new separate money market account. In June 1996, he received a $ 50,000 bonus that also represented work done before and after the separation. The husband calculated that $ 31,350 of that bonus was earned before separation and thus was marital property. He applied $ 27,000 of the marital portion toward payment of his 1996 estimated income tax and the balance to what he claimed were joint expenses. He deposited the portion that he considered separate property, $ 18,470, to his separate money market account.

The trial court classified $ 38,355 of the money market fund as marital property because it disallowed as marital expenses the estimated tax payment of $ 27,000 and $ 11,355 claimed as expenses for maintaining the marital residence. The husband argues that the use of his separate money market fund to make the wife whole is inappropriate. The husband contends these funds paid taxes, tuition, and household expenses of the marital residence. He argues that the marital share of the June 1996 bonus paid the joint 1996 tax liability and not simply the taxes due on the bonus.

The trial court disallowed $ 38,355 of his claimed marital expenditures finding that the payment of $ 27,000 toward estimated 1996 taxes was not reasonable and that $ 11,355 of household expenses were not adequately proven. The court held that the use of a substantial portion of the marital share of the June 1996 bonus to pay taxes under the guise of a joint obligation was not a valid marital purpose. The court also held the husband's evidence was insufficient to satisfy his burden to prove that the expenditures of $ 11,355 were for valid marital purposes. The husband did not provide a detailed explanation of these expenses, but the trial court still found that $ 54,955 was expended for marital purposes.

The husband had the burden to establish by a preponderance of the evidence that post-separation withdrawals of marital funds were used for a legitimate marital purpose. See Alphin v. Alphin, 15 Va. App. 395, 402, 424 S.E.2d 572, 576 (1992) (court satisfied that husband's expenses, for which detailed accounting was provided, were for valid marital purpose); Amburn v. Amburn, 13 Va. App. 661, 666-67, 414 S.E.2d 847, 850-51 (1992) (wife did not squander away marital funds by paying for living expenses husband failed to pay). We conclude that the decision to classify a portion of the money market account to make up for the husband's non-legitimate marital expenditures was supported by the evidence and not plainly wrong when considering the way the parties normally managed their finances and used the credit line in tandem with their income.

The trial court ordered the husband to pay the balance due on the equity line loan, on two additional bank loans, and on a credit card account used by the wife. The equity line balance was $ 122,129.50. The husband incurred the two loans of $ 54,344.75 and $ 22,461 after the separation to pay tuition and estimated taxes. The wife possessed only one major credit card after the separation, but the husband stopped paying the balance, began paying only the required minimum, and reduced the limit to $ 2,500. The balance on the account was $ 2,191. The husband contends that the trial court erred in allocating the entire marital debt to him.

Throughout the marriage the parties used the equity credit line as a source of available funds until they received the partnership income distribution. After the separation, the husband stopped using his income to pay recurring family expenses. He prorated receipts, and he segregated the portion he designated as separate property into the money market account where it accumulated as a separate asset. He paid marital expenses or debts incurred to pay such expenses with the portion he designated as marital property. The husband used the date of separation to divert arbitrarily his income from its established allocation to reducing debt incurred over the previous year for ordinary living expenses. The husband's action of not reducing the equity line permitted the joint debt to rise while he diverted the offsetting income to accumulate as his separate asset. This turned marital expenses into marital liabilities of the couple and reduced the marital wealth available for distribution. At the same time, any income earned after separation was diverted and not available for continuing family obligations. The combined effect permitted the husband to decrease the marital estate while increasing his personal estate, to distort their financial condition to his advantage.

The trial court recognized the distorting effect upon obtaining a correct understanding of the marital debts of the parties. The trial court found that the equity line and credit card account were marital debts and found the other two debts, while incurred for marital expenses, would not have been incurred under normal circumstances. It allocated payment of all the debts, with the exception of the first deed of trust, to the husband. The court carefully noted that wife could not receive a double benefit from the equity in the home increasing if the husband paid that debt because it excluded the equity line debt from the calculation of the value of the marital residence. The trial court allocated the marital debt to the husband because the debt would never have been incurred if the cycle of incurring and discharging debt, established during the marriage, had been allowed to complete its final circuit.

Code § 20-107.3(E) empowers trial courts to distribute marital debt. Because making an equitable distribution award is often a difficult task, '"we rely heavily on the discretion of the trial judge in weighing the many considerations and circumstances that are presented in each case."' Moran v. Moran, 29 Va. App. 408, 417, 512 S.E.2d 834, 838 (1999) (distribution of marital debt) (quoting Klein v. Klein, 11 Va. App. 155, 161, 396 S.E.2d 866, 870 (1990)). Absent an abuse of discretion, "the trial judge's determination will not be reversed on appeal." Id.

The allocation of the debt to the husband is proper given the manner in which this couple managed their finances. To prevent an inequity, the trial court properly ordered the husband to pay the debt, and it considered all the statutory factors of Code § 20-107.3. We find no abuse of discretion.

Finally, we consider the court's award of spousal support to the wife. The court ordered the husband to pay $ 7,500 per month in spousal support and awarded child support of $ 2,181 based on the statutory guidelines. On appeal, he claims the wife's expenses include some non-recurring expenses; the wife's award should be reduced by the payment on the first deed of trust; and that some expenses, such as mortgage payment, automobile, utilities, and household expenses, should be reduced by two-thirds because they include expenses factored into the child support guidelines.

The wife had no independent source of income. She submitted two exhibits to substantiate her claim for spousal support. One listed her average monthly expenses during the marriage ($ 8,746.92), and the other listed post-separation expenses ($ 8,013.76). She also presented two exhibits showing the corresponding child expenses of $3,017.23 and of $ 3,116.07. The wife's post-separation expenses included non-recurring expenses for legal bills and car rental which the court excluded from the support

award. The court declined to reduce the support award by the amount of the mortgage payment because it found that the wife was entitled to a reasonable housing allowance and, when taxes on the support award were considered, she would not have sufficient funds to cover her monthly expenses. The court also found the husband's request to reduce the wife's living expenses by two-thirds unreasonable in view of her demonstrable needs. If so reduced, the wife would not be able to meet her demonstrated financial needs, and the support award would leave her below the standard of living to which she was accustomed during the marriage.

The husband cites Rein v. Rein, 1994 Va. App. LEXIS 699, Record No. 1120-93-1 (unpublished, Va. Ct. App. Nov. 29, 1994), as authority for reducing these items. However, that case did not mandate such a reduction. At most it directed that the trial court consider whether there might have been double consideration of items such as housing and utilities.

The husband is obligated to maintain the wife, within the limits of his ability to pay, "according to the station in life in which [she] was accustomed during the marriage." Gamble v. Gamble, 14 Va. App. 558, 574, 421 S.E.2d 635, 644 (1992). A spousal support award is subject to the trial court's discretion and will not be disturbed on appeal unless plainly wrong or without evidence to support it. See Moreno v. Moreno, 24 Va. App. 190, 194-95, 480 S.E.2d 792, 794 (1997). Based on all the evidence and appropriate factors, we conclude that the record supports the spousal support award of $ 7,500 per month.

For the foregoing reasons, we affirm the trial court's ruling.

Affirmed.

Full Text of Court Cases

Estate of Huntsman v. Commissioner

Case name: Estate of Huntsman v. Commissioner
Citation: 66 T.C. 861
Date of decision: August 17, 1976
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Simpson
SIC: 3441 Fabricated Structural Metal
NAICS: 332312 Fabricated Structural Metal Manufacturing

Keywords: Estate tax

COUNSEL:

Leon L. Rice, Jr., and R. Stephen Camp, for the petitioner.

Gary F. Walker, for the respondent.

JUDGES:

Simpson, Judge.

OPINIONBY:

SIMPSON

OPINION:

In his notice of deficiency, the Commissioner determined a deficiency in the Federal estate tax of the Estate of John L. Huntsman in the amount of $97,991.40. In his second amendment to the answer, he determined such deficiency to be $107,470.13. The primary issue involves determining the fair market value of the decedent's stock in Asheville Steel Co. and Asheville Industrial Supply Co., including determining how certain life insurance proceeds payable to such corporations by reason of the death of the decedent, are to be taken into consideration. We must also decide whether the Commissioner properly raised a new issue in his second amendment to the answer.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

John L. Huntsman (the decedent) died testate, a resident of North Carolina, on February 5, 1971. His will was probated in Buncombe County, N.C. Anthony Redmond and Wachovia Bank & Trust Co., N.A., the executors, had their legal address in Asheville, N.C., at the time of filing the petition herein. A

Federal estate tax return for the estate was filed with the District Director of Internal Revenue, Greensboro, N.C.

Asheville Steel Co. (Steel), which is located in Asheville, N.C., was chartered as a North Carolina corporation in 1944 and was originally named Asheville Steel & Salvage Co., Inc. (Salvage), but its name was changed to Steel on March 1, 1965. The decedent was originally one of the four equal shareholders in Steel, but by 1959, he had become its sole shareholder. From its creation, the decedent was the dominating force that operated the company.

Asheville Industrial Supply Co. (Supply) was originally organized as a division of Salvage in 1949. It was chartered as a North Carolina corporation on March 1, 1965, and pursuant to a plan of reorganization, it acquired all the assets and liabilities of Steel allocable to the Supply division. The decedent then acquired all the outstanding stock of Supply, and at the time of his death, he owned all the outstanding stock, 25,000 shares, of each of the corporations, Steel and Supply.

Asheville Machine & Foundry Co. (Machine & Foundry) was organized as a North Carolina corporation in 1950 by the decedent and three others, who each owned one-fourth of its stock. Beacon Manufacturing Co. (Beacon), one of the larger industries in the Asheville area, had requested the decedent to start this company as a workshop to service its textile machinery. Prior to October 1, 1970, the decedent's proportionate interest in the stock of Machine & Foundry had been increased to one-third, and Beacon had become the owner of the other two-thirds. On October 1, 1970, the decedent contributed his stock in Machine & Foundry to Steel, which purchased a portion of Beacon's stock in Machine & Foundry; the remainder of Beacon's stock in Machine & Foundry was redeemed. Machine & Foundry thereupon became a wholly owned subsidiary of Steel.

Steel was engaged in the business of fabricating and erecting structural steel for industrial and commercial buildings, with about 70 percent of its business consisting of fabrication and 30 percent consisting of erection and millwright work. To perform a typical job, steel, which had been received by rail, normally in 60-foot lengths, was cut to the desired length and brought into the shop. Using blueprints made in the drafting room, holes were pierced in the steel and clip angles added to allow the steel beam to be attached to a column or another steel beam. Any other changes necessary to make the steel beam fit into the building to be constructed were also made. The steel beams were then cleaned, painted, and shipped to the construction site, where they were erected by the use of a mobile crane. The steel was then bolted together to make the skeletal framework of the building. Because of its limited crane capacity, Steel did not handle heavy jobs for large buildings or highway bridges; nor did it engage appreciably in operating a warehouse or service center for its customers.

Steel's customers were primarily general contractors in the construction business. At the time of the decedent's death, Steel's principal sales area was western North Carolina, extending to a radius of about 100 miles from Asheville. Although occasionally a project was secured outside this area, it was usually not feasible to do so because of the transportation costs involved. Approximately 70 percent of Steel's business was obtained by negotiations, rather than competitive bidding. The margin of profit on a negotiated contract was much greater than on a bid contract. Prior to the decedent's death, he was the chief negotiator, and Steel did not have a sales force as such. Following his death, the bid work increased, and salesmen were used. Steel's principal competitor in Asheville was Dave Steel Co.,

although Dave usually handled the bigger and heavier jobs, while Steel handled the smaller ones. Outside the immediate Asheville area, it had competitors in Bristol, Tenn., Knoxville, Tenn., Hickory, N.C., and Greenville, S.C.

Steel's plant and office facilities were located on an 11-acre tract of land. The facilities included a main shop building, 120 feet by 300 feet; an office building, 54 feet by 90 feet; a warehouse, 100 feet by 70 feet; and a garage. It had about 50,000 square feet of production area. At the time of the decedent's death, the company had 67 production employees and 27 office employees. Among the larger pieces of production equipment were 6 overhead cranes in the shop having a capacity of 3 tons each. Some of the equipment was purchased used and was getting quite old, requiring considerable maintenance. Steel's production capacity was about 20 tons per week, or 1,000 tons per year.

Prior to the decedent's death, Steel began to modernize and renovate its equipment. In the fiscal year ending January 31, 1971, it purchased a 45-ton mobile crane for $ 105,000 and spent approximately $ 35,000 improving existing equipment. It borrowed $ 100,000 to purchase the crane. At a board of directors meeting shortly after the decedent's death, a preliminary schedule of capital needs, with estimated costs of $ 333,000, was presented for acquisition over a 5-year period. Of this amount, equipment costing about $ 262,000 had been purchased by November 1975, and other equipment costing over $ 280,000 had been purchased between February 1, 1971, and January 31, 1975. By November 1975, Steel's production capacity had been increased to almost 80 tons per week.

Supply was a wholesale business which sold supplies such as bolts, nuts, fasteners, tools, ladders, and paint to industrial and manufacturing plants. It did not deal in heavy equipment or high-priced items, and not more than 10 percent of its business related to the construction business. It had several competitors in the Asheville area. Its customers were located in generally the same area as Steel, but the two companies did not have the same customers and did not feed each other business. Before the decedent's death, about 60 percent of Supply's business involved bidding or quoting prices. About 90 percent of the business was outside sales, and 10 percent was over-the-counter sales. It was not the exclusive agent for any of the products which it sold, and no single customer made up more than 10 percent of its sales. The decedent negotiated many of the sales to the industrial plants, and the company also employed four salesmen. Less than 10 percent of Supply's sales were to Steel, and such sales were strictly at arm's length.

Supply was located about 1 mile from Steel's plant on 1 acre of land. It had a building, 120 feet by 180 feet, and had about 25 employees at the time of the decedent's death.

Machine & Foundry operated a custom machine shop, doing small, miscellaneous job work, utilizing equipment such as lathes and grinders, but it did no foundry work. Its shop was a building, 100 feet by 200 feet, located on a 2-acre lot about 1 mile from Steel's plant. At the time of the decedent's death, it had about 20 employees. Its business was negotiated, and it had no sales force.

The decedent was the president and treasurer of Steel, Supply, and Machine & Foundry and was on the payroll of each corporation. He was closely identified by the public with these three corporations and was the one person that came to mind when one of the companies was mentioned. He was in complete control of all three corporations and made all decisions of any importance, keeping in close contact with each business. He negotiated practically all of the important contracts and sales of the companies up to

the time of his death. During the fiscal year ended January 31, 1971, Steel obtained some unusually large one-time contracts involving sales of more than $ 500,000, which were negotiated in large part by the decedent.

The decedent worked 5 days per week, from 7 a.m. to at least 5 p.m. For many years, he took a vacation in Florida during January and February, which was a slack period for the companies. While in Florida, he was in daily contact with the companies and received sales and cash flow reports. He returned from Florida if he was needed in Asheville. The decedent always attended the meetings of the boards of directors. He had very good relations with the employees of the three companies and was friendly with them.

The decedent's general health up to the time of his death was very good. He died unexpectedly of a heart attack at the age of 62 while on vacation in Florida. His death gave rise to concern as to what was going to happen to the companies. The boards of directors and others connected with the corporations were apprehensive about the loss to the companies caused by the decedent's death. There was special concern about the loss of the decedent's ability to acquire negotiated business.

Steel and Supply owned several life insurance policies (or interests therein) issued on the life of the decedent. Upon the decedent's death, Steel received $ 250,371.03, and Supply received $ 153,174.81. Most of such insurance policies were "keyman" insurance policies while two were "split-dollar" policies. The parties have stipulated that the decedent had no interest in, ownership of, or control of such insurance policies (other than the split-dollar policies) except and to the extent, if any, he is considered to have had such interest, ownership, or control by virtue of his ownership of all the outstanding stock of Steel and Supply.

The keyman life insurance policies were acquired "to tide the company over in case that anything did happen" to the decedent. The last policy obtained was in the face amount of $ 200,000; $ 130,000 was payable to Steel, and $ 70,000 was payable to Supply. The board of directors of each company ratified the purchase of the policy at meetings on May 27, 1969. At such meetings, the decedent presented a letter to the boards which requested each company to redeem enough of his stock to pay his estate's administration costs and death taxes. The letters provided that the price to be paid for the stock so redeemed was to be 11 times the 5-year average earnings of each company. The board of directors of each company adopted a resolution agreeing to the request in the decedent's letters. Each resolution stated that the corporation would be bound to carry out the redemption when the corporation's executive vice president drafted and signed a reply to the decedent's letter. A copy of the corporation's acceptance was to be annexed to the corporate minutes, but there was no acceptance in the corporate records of either Steel or Supply.

Prior to the decedent's death, Steel and Supply paid the premiums on the keyman insurance in the proportions that the proceeds were payable to them. Neither corporation claimed an income tax deduction for such premiums. Prior to the decedent's death, the cash surrender value of each policy was carried as an asset on the balance sheet of the corporation maintaining the policy, to the extent of its interest in the policy. Upon the death of the decedent, the difference between the cash surrender value of each policy and the amount of the proceeds of the policy was reflected as an extraordinary credit to income of the corporation for accounting purposes but was not reported as taxable income for income tax purposes.

Steel paid the annual premium on the two split-dollar policies to the extent of the increase in the cash surrender value of each policy and was the beneficiary of each policy to the extent of the cash surrender value at the decedent's death. The balance of the proceeds was paid to the decedent's estate, which reported them on its Federal estate tax return. The cash surrender values of these policies were carried as an asset on Steel's balance sheets.

Except for the policies on the life of the decedent, the only corporate life insurance owned by Steel from January 1, 1965, to October 29, 1975, were two policies totaling $ 31,000 on the lives of two former officers and one policy for $ 200,000 on the life of its executive vice president. Neither Supply nor Machine & Foundry maintained any such policies during this period. On January 31, 1971, the total cash surrender value of all the life insurance policies on the decedent's life owned by Steel and Supply was $ 95,903 and $ 42,127, respectively. The cash surrender value of Steel's policies included $ 15,080, which represented the cash surrender value of the two split-dollar policies.

On November 22, 1971, the boards of directors of Steel and Supply each agreed to redeem 7,300 shares of its stock held by the decedent's estate pursuant to section 303 of the Internal Revenue Code of 1954. n1 The redemption price was $ 18.4025 per share for the Steel stock and $ 5.5845 per share for the Supply stock. The resolution providing for each redemption included a provision to the effect that if it should be finally determined for Federal estate tax purposes that the value per share of the stock redeemed was different from the value reported for estate tax purposes, the number of shares to be redeemed should be adjusted to accord with such final determination of value, either by the payment of additional cash or by adjusting the number of shares redeemed, or a combination of both. As a result of the redemptions, the decedent's estate received payment of $ 134,338.25 from Steel and $ 40,766.85 from Supply.

n1 All statutory references are to the Internal Revenue Code of 1954 as in effect for the year in issue.

Of the approximately $ 403,000 in insurance proceeds received by Steel and Supply, approximately $ 175,000 was used to redeem stock from the decedent's estate, $ 128,000 was taken into working capital, and $ 100,000 was held in reserve for possible additional redemptions from the decedent's estate. Of the amounts added to the working capital of Steel, $ 100,000 was paid toward the cost of capital additions made from February 1, 1971, to January 31, 1975.

Due to the close relationship between the general construction business and the steel fabrication industry, both businesses generally experience the same business cycles. Such industries do not operate on a constant basis, and their business cycles involve sharp rises and declines. Therefore, in order to evaluate a business in the steel fabrication industry, an investor should view the business over a 5- to 10-year period.

The net sales and the earnings per share (based upon 25,000 shares outstanding) of Steel and Supply were as follows:

	Steel n1	Supply
	Earnings	Earnings

FYE	Sales	per share	Sales	per share
1/31/67	$ 1,533,517	$ 4.12	$ 1,284,660	$ .95
1/31/68	1,641,280	3.60	1,310,101	1.28
1/31/69	1,782,279	3.19	1,539,769	1.09
1/31/70	1,870,121	1.13	1,633,690	.29
1/31/71	2,340,947	4.65	1,531,478	1.21
1/31/72	2,302,979	n2 2.78	1,654,063	n2 2.33

n1 The table does not include the net sales and earnings of Machine & Foundry, which was acquired on Oct. 1, 1970.

n2 The extraordinary credit for the life insurance proceeds is not included.

Neither company paid a dividend for the fiscal years 1967 through 1971. Steel's earnings for the fiscal year 1971 were unusually high due to some extraordinary contracts acquired that year, the use of first-in-first-out inventory accounting during a period of substantially rising costs, and a change in inventory auditing procedures. The net result was to make the earnings for the fiscal year 1971 unusually high, while making the earnings for 1970 unusually low.

The book values per share of Steel and Supply were as follows:

FYE	Steel	Supply
1/31/67	$ 23.72	$ 15.74
1/31/68	27.33	17.02
1/31/69	30.55	18.12
1/31/70	31.04	17.72
1/31/71	n1 39.06	18.93

n1 The book value of the assets of Machine & Foundry, acquired Oct. 1, 1970, is included.

If the life insurance proceeds received by the two companies were taken into account at the end of the fiscal year 1971, the book value per share of Steel and Supply would be $ 45.24 and $ 23.37, respectively. Steel's current assets less current liabilities would be $ 762,945, and it would have $ 562,043 cash on hand. Supply's current assets less current liabilities would be $ 492,967, and it would have $ 214,805 cash on hand.

The net sales and profits of Machine & Foundry were as follows:

FYE	Net sales n1	Profits
6/30/67	$ 302,000	Unknown
6/30/68	354,000	Unknown
6/30/69	352,000	Unknown
6/30/70	310,000	Unknown
1/31/71 n2	162,137	$ 11,182

1/31/72	333,964	22,836
1/31/73	382,087	34,758

n1 For the fiscal years 1967 through 1970, only the approximate sales are known.

n2 Machine & Foundry changed its fiscal year to correspond to that of its parent, Steel, when it was acquired on Oct. 1, 1970.

If Steel had acquired Machine & Foundry prior to February 1, 1969, its earnings per share would have been increased by 93 cents in fiscal 1970 and by 66 cents in fiscal 1971. Since Machine & Foundry was actually acquired on October 1, 1970, its earnings actually increased Steel's earnings per share by 26 cents for the fiscal year ending January 31, 1971.

On the Federal estate tax return for the Estate of John L. Hunstman, the decedent's stock in Steel and Supply was valued at $ 18.40 per share and $ 5.58 per share, respectively, at the date of the decedent's death. In his notice of deficiency, the Commissioner determined that the proceeds of the life insurance received by Steel and Supply were includable in the decedent's gross estate since the decedent possessed the incidents of ownership over the insurance policies at his death within the meaning of section 2042. He further determined that the fair market value of the decedent's stock in Steel and Supply was $ 26.64 and $ 7.44 per share, respectively. In his amendment to the answer, filed prior to the trial of this case, the Commissioner specifically abandoned his position that the life insurance proceeds, payable to the corporations, were included in the decedent's gross estate. However, he alleged that the insurance proceeds must be considered in determining the value of the stock of the two corporations and that the fair market values of the Steel and Supply stock were $ 36.64 and $ 13.56 per share, respectively.

At the trial of this case, the petitioner and the Commissioner each presented expert testimony as to the fair market value of the stock. The petitioner's expert stated that in his opinion, on February 5, 1971, the fair market value of the Steel stock was $ 23.83 per share and the fair market value of the Supply stock was $ 8.50 per share. The Commissioner's expert stated that the fair market value of the Steel stock was $ 30 per share without the insurance proceeds and $ 40 per share with such proceeds. He also stated that the fair market value of the Supply stock was $ 6.60 without the insurance proceeds and $ 12.72 with such proceeds. At the close of the trial, the Commissioner's counsel orally advised the Court that he would move to amend the answer to conform the allegations concerning the value of the stock in the two corporations to the opinion of his expert. Thereafter, the Commissioner moved to file a second amendment to the answer, and such motion was granted. In his second amendment to the answer, the Commissioner alleged that the evidence at the trial showed that, although the life insurance proceeds were paid to the corporations in the first instance, most of them were eventually used for the benefit of the decedent's estate and therefore are includable as a separate asset in such estate under sections 2033 and 2042. In a reply to the second amendment to the answer, the petitioner stated that the Commissioner's new allegations were contrary to the stipulated facts and were not established during the trial of this case.

OPINION

The first matter to be decided is whether the issue set forth in the Commissioner's second amendment to the answer is properly before us. Rule 41(b)(1) of the Tax Court Rules of Practice and Procedure provides:

(1) Issues Tried by Consent: When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings. The Court, upon motion of any party at any time, may allow such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issues; but failure to amend does not affect the result of the trial of these issues.

The Commissioner asserts that the issue set forth in his second amendment to the answer was tried with the consent of the petitioner. The petitioner, on the other hand, argues that in no way was such issue raised by the evidence admitted at the trial and that, in fact, it was unaware of the Commissioner's new theory until the second amendment to the answer was received, long after the trial of this case. We agree with the petitioner.

In his first amended answer and his counsel's opening statement at trial, the Commissioner unequivocally stated that the only issue in this case was the proper valuation of the stock owned by the decedent in Steel and Supply. Now, the Commissioner asserts that the petitioner was put on notice of the new issue by the cross-examination of one of its witnesses concerning the stock redemption, without objection from the petitioner. However, such testimony appeared to be offered merely to explain a corporate resolution which was included in the records of the corporations to which the parties had stipulated, and the admission of such testimony was not sufficient to indicate that the Commissioner was shifting his position or presenting the alternative position that the life insurance proceeds were in fact used for the benefit of the estate. Indeed, when at the close of the trial, the Commissioner's counsel orally requested leave to amend his answer to conform to the evidence, he did not, even then, express any intention to present such new position. The only reason given by him for the amendment to his answer was to reflect the higher valuations testified to by his expert.

Under these circumstances, we find that the position set forth in the Commissioner's second amendment to his answer was not raised by the evidence admitted at the trial and that such issue was not tried by the implied consent of the parties. Edwin E. Markwardt, 64 T.C. 989, 998 (1975). Moreover, at no time did the Commissioner put the petitioner on notice that he would argue that the insurance proceeds were paid for the benefit of the estate because the corporations redeemed some of the estate's stock, and since the Commissioner was fully aware of the redemption and the surrounding facts prior to the trial, there is no excuse for his failure to timely raise the issue. In view of the fact that the petitioner was not given timely notice of such issue, it was deprived of any opportunity to present relevant evidence concerning such matter. Daniel D. Palmer, 62 T.C. 684, 698 (1974), affd. 523 F.2d 1308 (8th Cir. 1975). Accordingly, we hold that the issue as to whether the life insurance proceeds are includable in the estate of the decedent because some of them were used to redeem the stock held by him is not properly before us, and that the only issue raised by the pleadings is the fair market value of the decedent's stock in Steel and Supply. We express no views concerning the claim set forth in the Commissioner's second amendment to his answer.

The principal issue to be decided in valuing the stock of Steel and Supply is the effect of the life insurance proceeds received by them. The petitioner argues that such proceeds are simply another corporate asset which must be considered in valuing the stock. Whereas, the Commissioner argues that the value of the stock is ascertained by first finding the value of such stock without the life insurance

proceeds and by then adding such proceeds to such value. The resolution of this issue turns upon the proper interpretation of two recently amended regulations: sections 20.2042-1(c) and 20.2031-2(f) of the Estate Tax Regulations.

The estate tax regulations concerning the treatment of corporate-owned life insurance, when the insured is the sole or controlling shareholder, have recently undergone substantial change. From 1943 until April 1974, the regulations provided that the sole shareholder of a corporation was considered to possess all of the incidents of ownership retained by the corporation in corporate-owned life insurance on his life. Sec. 20.2042-1(c)(2), Estate Tax Regs. (1958); sec. 81.27, Regs. 105 (1943). Thus, under such regulations, the sole shareholder's estate was required to include the full amount of any life insurance proceeds paid to the corporation, if the corporation had any incidents of ownership in the insurance policies. Sec. 2042(2). The regulations were apparently based upon an example contained in the legislative history of the predecessor of section 2042. See H. Rept. No. 2333, 77th Cong., 1st Sess. (1942), 1942-2 C.B. 372, 491; S. Rept. No. 1631, 77th Cong., 2d Sess. (1942), 1942-2 C.B. 504, 677. The validity of such regulations has never been specifically challenged. See Cockrill v. O'Hara, 302 F. Supp. 1365 (M.D. Tenn. 1969) (validity of regulations assumed); cf. Landorf v. United States, 408 F.2d 461, 471 (Ct. Cl. 1969) (in dicta, referred to the rule of the regulations); but see Osborn, "Corporate-Owned Life Insurance: Recent Developments in Estate Planning," 32d Ann. N.Y.U. Tax Inst. 293, 296-302 (1974).

In Rev. Rul. 71-463, 1971-2 C.B. 333, the IRS ruled that although section 20.2042-1(c)(2) of the Estate Tax Regulations expressly attributed the corporation's incidents of ownership only to a sole shareholder, it was also applicable to situations where the corporation owned life insurance on the life of a shareholder who had voting control of the corporation. This ruling was the subject of much criticism and was subsequently withdrawn, and it was announced that the regulations concerning corporate-owned life insurance were being reconsidered. Rev. Rul. 72-167, 1972-1 C.B. 307; see Walker, "What will effect of Proposed Regulations on corporate-owned life insurance be?", 39 J. Tax. 206 (1973).

In April 1974, new regulations concerning the estate tax treatment of corporate-owned life insurance where the decedent was a shareholder were adopted. T.D. 7312, 1974-1 C.B. 277. Both parties agree that the new regulations govern this case.

The new regulations deleted the statement concerning a sole shareholder in section 20.2042-1(c)(2), Estate Tax Regs., and substituted a cross-reference to a new paragraph (c)(6) of such section, which provides in pertinent part:

(6) In the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling stockholder, the corporation's incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation. * * * See § 20.2031-2(f) for a rule providing that the proceeds of certain life insurance policies shall be considered in determining the value of the decedent's stock. * * *

The Commissioner maintains the position that since the former regulations carried out the legislative purpose, and since those regulations had been approved by the courts, no change was intended in the treatment of life insurance proceeds when a sole shareholder is involved, and that therefore the life insurance proceeds should be added to the value of the stock otherwise determined under section

20.2031-2(f), Estate Tax Regs. He argues that the only effect of the change is to prorate the life insurance proceeds over the shares of stock when the life insurance is on a controlling shareholder who does not own all the stock. However, his proposed interpretation of the new regulations is not supported by the language contained therein.

Prior to the adoption of the new regulations, the entire proceeds of corporate-owned life insurance were includable in the gross estate of the sole shareholder pursuant to section 2042 because the shareholder was considered to retain the incidents of ownership of the policy. However, the new regulations provide that the mere ownership of stock in a corporation is not sufficient to attribute the incidents of ownership of corporate-owned insurance policies to the sole or controlling shareholder, but such policies shall be considered in valuing the decedent's interest in the stock. Consequently, section 2042 does not apply to any of the life insurance proceeds received by the two corporations on account of the decedent's death. n2

n2 Since the Commissioner did not timely raise the issue, we have not considered whether the use of the insurance proceeds by the two corporations to redeem some of the petitioner's stock pursuant to sec. 303 would result in the proceeds not being paid for the benefit of the corporations so that the incidents of ownership would be attributable to the decedent. See sec. 20.2042-1(c)(6), Estate Tax Regs. The Commissioner does not contend that the proceeds of the split-dollar insurance received by Steel are to be treated differently from the proceeds of the keyman insurance. See Rev. Rul. 76-274, 1976-29 I.R.B. 13.

Section 20.2031-2(f), Estate Tax Regs., as amended by the new regulations, merely provides that in addition to the normal factors considered in determining the value of stock in a closely held corporation, life insurance policies payable to or for the benefit of the corporation shall be considered in the same manner as other nonoperating assets. The purpose of the rules contained in such section is to determine the fair market value of stock, which is defined as:

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 to sell and both having reasonable knowledge of relevant facts. * * * [Sec. 20.2031-1(b), Estate Tax Regs.]

In determining the price a willing buyer would pay, it is obvious that life insurance proceeds must be given "consideration," but it is equally obvious that the price paid by a willing buyer would not necessarily be increased by the amount of the life insurance proceeds. A buyer would take into consideration such proceeds in the same manner as he would consider other liquid assets of the corporation. If the corporation is operating a going business, the willing buyer will be influenced by the prospective earning power and dividend-earning capacity of the business, as well as its net worth, including any life insurance proceeds. See Hamm v. Commissioner, 325 F.2d 934, 941 (8th Cir. 1963), affg. a Memorandum Opinion of this Court, cert. denied 377 U.S. 993 (1964); Central Trust Co. v. United States, 305 F.2d 393, 408 (Ct. Cl. 1962); see also Rev. Rul. 59-60, 1959-1 C.B. 237. Even if the value of the stock is based on the net worth of the corporation, such value may not be increased concomitantly by the amount of life insurance proceeds payable to the corporation. For example, if a corporation has liabilities of $ 100, and if its only asset consists of a life insurance policy providing for the payment of $

75, a willing buyer would not pay $ 75 for the stock of such corporation. Thus, the treatment of the life insurance proceeds urged by the Commissioner is contrary to the regulations and contrary to well-established principles of valuation.

Moreover, section 20.2031-2(f), Estate Tax Regs., calls for life insurance proceeds to be treated in the same manner as other nonoperating assets of the corporation in determining the value of the stock, and our proposed treatment of the life insurance proceeds accomplishes that result. However, the interpretation urged by the Commissioner would treat the life insurance proceeds differently than other nonoperating assets. For example, at the time of the decedent's death, Steel had on hand over $ 300,000 of cash, some or all of which may be considered a nonoperating asset; yet, the Commissioner does not propose that such $ 300,000, or any part of it, be added to the value of the stock of Steel otherwise determined.

The Commissioner argues that our interpretation of section 20.2031-2(f), Estate Tax Regs., frustrates the clear intent of Congress to include corporate-owned life insurance in the estate of its sole shareholder. See H. Rept. No. 2333, 77th Cong., 1st Sess. (1942), 1942-2 C.B. 372, 491; S. Rept. No. 1631, 77th Cong., 2d Sess. (1942), 1942-2 C.B. 504, 677. However, the statements in the legislative history relied upon by the Commissioner indicate only that Congress believed that a sole shareholder was deemed to have the incidents of ownership possessed by his corporation on insurance policies on his life. The regulations now provide that the incidents of ownership held by a corporation are not to be attributed to its shareholder, and no indication is included in the committee reports that Congress intended property owned by a decedent to be includable in his gross estate at other than its fair market value. Consequently, our interpretation of such section does not frustrate a congressional intent. In accordance with section 20.2031-2(f), Estate Tax Regs., we must determine the fair market value of the decedent's stock in the two corporations by applying the customary principles of valuation and by giving "consideration" to the insurance proceeds.

Where there is an ongoing business, such as Steel or Supply, and where there are no sales near the valuation date, neither the asset value nor the earning power is generally used as the sole criteria in determining stock value. See Hamm v. Commissioner, 325 F.2d at 941; Portland Manufacturing Co., 56 T.C. 58, 80 (1971), affd. in an unreported case (9th Cir. 1975); Trianon Hotel Co., 30 T.C. 156, 181 (1958). However, in the case of an operating business, primary consideration is given to earning power. Levenson's Estate v. Commissioner, 282 F.2d 581 (3d Cir. 1960), affg. on this issue a Memorandum Opinion of this Court; see Rev. Rul. 59-60, 1959-1 C.B. at 242.

The petitioner's expert witness was a bank vice president in charge of the bank's closely held business service, a valuation service offered to clients throughout the Southeast United States. In preparing his valuation of the stock of Steel and Supply, he interviewed the principal management of the companies, toured the production facilities, reviewed the books and records of the companies, and made a general review of the economic data of the industry. After acquiring such information, he consulted various financial publications in order to compare Steel and Supply with publicly traded companies in comparable businesses. The Commissioner's expert witness, a financial analyst for the Internal Revenue Service, used only information supplied by the IRS, did not interview the corporate officers, and made no independent investigation of the two companies. As a result, his valuation report contained several material factual errors.

The petitioner's expert determined that Steel was comparable to two publicly traded companies. Using the 5-year average earnings, he found that the price-earnings ratios of the two comparable companies were 6.1 and 5.9 at the date of the decedent's death. He also found that a much larger and more diversified company, partially engaged in the same business as Steel, had a price-earnings ratio of 10.9 on the date of the decedent's death. He thus concluded that based on these comparables, a price-earnings ratio of 7 should be used in valuing Steel's stock. He also determined that there was no publicly traded company comparable to Supply. Based upon the general market conditions and his opinion that the business was somewhat risky, he concluded that a price-earnings ratio of 5 was appropriate for Supply.

The Commissioner's expert treated the two companies as if they were one business. Due to the factual errors in his report, he mistakenly found that Steel and Supply were comparable to businesses which were in fact significantly different. Furthermore, the Commissioner's expert used only a 3-year weighted average of earnings, even though at trial, he admitted that a 5-year average was preferable in this case. Consequently, we find that his determination of a price-earnings ratio of 10 for each company to be erroneous.

The Commissioner also relies upon the stock acquisition of Hickory Steel & Iron Co. (Hickory) by Carolina Steel Corp. (Carolina) in November 1968 to support his expert's determination. Hickory was also in the steel fabrication business but did not do steel erection work. He argues that the value of the Carolina stock exchanged for the Hickory stock indicates that the price-earnings ratio of the Hickory stock was in excess of 15. However, the evidence does not support the Commissioner's argument. The earnings which the Commissioner used to calculate his price-earnings ratio were but part of 1 year's earnings. Obviously, to be meaningful, a price-earnings ratio must be based upon an entire year's earnings. Furthermore, due to the cyclical nature of the steel fabrication business, even 1 year's earnings do not give a true indication of a corporation's earning potential. In addition, the petitioner's expert testified that there were substantial economic differences between the time of the acquisition of the Hickory stock in 1968 and the time of the decedent's death in 1971 which were not fully considered by the Commissioner's expert. Finally, there were apparently some restrictions on the marketability of the Carolina stock received in exchange for the Hickory stock that may have reduced its value. Consequently, when the necessary adjustments are made to reflect these differences, the price paid for the Hickory stock does not support the determination of the Commissioner's expert.

In valuing the stock of the two companies based upon earnings, the petitioner's expert determined the 5-year average earnings and multiplied that amount times the appropriate price-earnings ratio. We believe that the price-earnings ratios used by him were generally reasonable, but in computing the earnings of Steel, he neglected to account for the acquisition of Machine & Foundry in 1970. To reflect the amount a purchaser would have paid for the Steel stock, the average earnings of Machine & Foundry must be taken into account. Although there is only evidence of Machine & Foundry's earnings for 2 of the 5 years prior to the decedent's death, the petitioner's expert should have made an adjustment to the 5-year average earnings of Steel to reflect the average earnings of Machine & Foundry over such period. Using our best judgment, we find that based solely upon earnings, the value of the stock in Steel and Supply at the date of the decedent's death was $ 29 and $ 5 per share, respectively.

The petitioner's expert determined that valuing the stock of the two corporations solely on their earnings would be unwarranted in view of the high book value n3 of the stocks. In valuing the Steel stock, he applied a formula giving four times as much weight to the earnings value as the net asset value. In the case of the Supply stock, he gave the earnings value three times the weight of the net asset value. While we agree generally with the approach of the petitioner's expert, we find that he did not give sufficient weight to the strong cash position of the two corporations, due in part to the insurance proceeds. It is true that Steel needed capital for the major purchases it was planning, but we are convinced that a potential purchaser of the stock of each company would give greater consideration to the net asset value of the corporations than did the petitioner's expert. Using our best judgment, we find that the value of the stock in Steel and Supply, on the date of the decedent's death, based upon both their earnings and net asset values, giving consideration to the insurance proceeds received by each, was $ 33 and $ 11 per share, respectively.

n3 Both experts used book value rather than net asset value. Since neither party has raised the issue, we will treat the book value as if it were the net asset value.

One final adjustment is necessary to determine the actual price a willing buyer would pay for the stock of these two companies. The decedent was the dominant force in both businesses, and his untimely death obviously reduced the value of the stock in the two corporations. However, both corporations had competent officers who were able to assume successfully the decedent's duties. Both experts agreed that some discount must be made to reflect the loss of the decedent. Using our best judgment, we find that after discounting the value of the stock to reflect the loss of the decedent, the fair market value of the Steel and Supply stock at the date of the decedent's death was $ 29 and $ 10 per share, respectively.

Decision will be entered under Rule 155.

[PUBLISH]

IN THE UNITED STATES COURT OF APPEALS

FOR THE ELEVENTH CIRCUIT

FILED
U.S. COURT OF APPEALS
ELEVENTH CIRCUIT
NOV 15, 2007
THOMAS K. KAHN
CLERK

No. 05-15549

Tax Court No. 3512-03

ESTATE OF FRAZIER JELKE, III,
Deceased,
WACHOVIA BANK, N.A.,
f.k.a. First Union National Bank, Personal Representative,

Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from a Decision of the
United States Tax Court

(November 15, 2007)

Before TJOFLAT, CARNES and HILL, Circuit Judges.

HILL, Circuit Judge:

This estate tax case presents on appeal an issue of first impression in this circuit.[1] It involves the proper valuation for estate tax purposes of a 6.44% stock interest, or 3,000 shares, owned by the decedent, Frazier Jelke III (Jelke or decedent or estate),[2] in a closely-held, investment holding company, Commercial Chemical Company (CCC), owning appreciated, marketable securities.[3]

The issue is whether or not the Tax Court used the appropriate valuation methodology in computing the net asset value of CCC to determine the value of Jelke's interest in CCC for estate tax purposes on the date of death. The Tax Court, adopting the Commissioner's expert witness appraiser's approach, allowed the estate only a partial $21 million discount for CCC's built-in capital gains tax liability, indexed to reflect present value on the date of Jelke's death, using projections based upon the court's findings as to when the assets would likely be

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[1] The issue has been previously addressed by the Second Circuit in 1998, the Sixth Circuit in 2000, and the Fifth Circuit in 2001 and 2002. See IV.C.2 & 3, infra.

[2] The 3,000 shares were held in a revocable trust of which Jelke was the primary beneficiary. The revocable trust terminated at Jelke's death, and its assets were distributed to his issue.

[3] At all times, CCC was a C corporation for tax purposes. From 1922 to 1974, CCC was a successfully operating chemical manufacturing business, producing chemicals such as arsenic acid and calcium arsenate. In 1974, CCC sold its manufacturing assets to an unrelated third party, yet maintained its name, CCC, as a holding company investing the sales proceeds. At the date of Jelke's death, CCC's stock portfolio was comprised of 92% blue-chip domestic equities and 8% international equities, the market values of which were readily and easily available.

sold and when the tax liability would likely be incurred, i.e., in this case, over a sixteen-year period. Using what could be termed an economic market reality theory, the estate argued, under the rationale set forth by the Fifth Circuit Court of Appeals in Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002), that a 100% dollar-for-dollar discount was mandated for CCC's entire contingent $51 million capital gains tax liability. Under this theory, it is assumed that CCC is liquidated on the date of Jelke's death, the valuation date, and all assets of CCC are sold, regardless of the parties' intent to liquidate or not, or restrictions on CCC's liquidation in general.

Based upon the following historical overview, discussion, and precedential authority, we are in accord with the simple yet logical analysis of the tax discount valuation issue set forth by the Fifth Circuit in Estate of Dunn, 301 F.3d at 350-55, providing practical certainty to tax practitioners, appraisers and financial planners alike. Under a de novo review, as a matter of law, we vacate the judgment of the Tax Court and remand with instructions that it recalculate the net asset value of CCC on the date of Jelke's death, and his 6.44% interest therein, using a dollar-for-dollar reduction of the entire $51 million built-in capital gains tax liability of CCC, under the arbitrary assumption that CCC is liquidated on the date of death

and all assets sold.[4]

I. FACTUAL BACKGROUND[5]

Jelke died testate on March 4, 1999, in Miami, Florida. On the date of his death, CCC's marketable securities had a fair market value of $178 million, plus a built-in contingent capital gains tax liability of $51 million on those securities. Combined with $10 million in other CCC assets, without regard to the tax liability, CCC's net asset value totaled $188 million.[6]

On the estate's federal estate tax return filed December 6, 1999, Jelke's 6.44% interest in CCC, held through his revocable trust, was included in his gross estate under Section 2031 at a value of $4,588,155. I.R.C. § 2031. The estate

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[4] Upon our thorough review of the record, we are satisfied that the Tax Court did not clearly err when it determined and discounted the value of Jelke's 6.44% interest in CCC for lack of control by 10%, and for lack of marketability by 15%. These two issues are affirmed without further discussion.

[5] Many of the facts were stipulated to by the parties and set forth in the Tax Court's findings of fact. Estate of Jelke v. Comm'r, 89 T.C.M. (CCH) 1397 (2005). Only facts pertinent to this appeal will be recited here.

[6] All parties agree that CCC is well managed by experienced individuals. Its board of directors is elected by CCC shareholders. Under CCC's articles of incorporation, shareholders are not allowed to participate in the operation or management of the investment holding company, nor do they show any interest to do so. CCC's primary investment goal is long-term capital stock growth. CCC had a relatively high annual rate of return, or 23%, for the five-year period [1994-1998] prior to death, lagging just behind the S & P 500's historical average for the same time period. CCC paid steady annual dividends. Its long-term investment goals produced a low asset annual turnover rate of 6%, and $51 million in unrealized capital gains. During the five years prior to death, there was no intent to liquidate CCC.

calculated this figure by reducing CCC's $188 million net asset value by $51 million, or 100% of the built-in capital gains tax liability. It then applied a 20% discount for lack of control and a 35% discount for lack of marketability.

In his December 2, 2002, notice of deficiency issued to the estate, the Commissioner determined that Jelke's estate owed a deficiency in estate tax of $2,564,772, resulting from an undervaluation of Jelke's 6.44% interest in CCC.[7] The Commissioner determined that the value of Jelke's 6.44% interest in CCC was $9,111,000, not the $4,588,155, claimed by the estate. Unlike the estate's 100% discount, he calculated the $9,111,000 using a zero discount for built-in capital gains taxes, and what he described as "reasonable" discounts for lack of control and lack of marketability.

II. PROCEDURAL BACKGROUND

The estate filed a petition in Tax Court in March 2003, contesting the Commissioner's $9,111,000 fair market value of Jelke's 6.44% interest in CCC stock on the date of death. It claimed that the Commissioner had based his value on an incorrect net asset value of CCC, by declining to discount CCC's net asset

[7] The other CCC shareholders are irrevocable trusts, holding interests in CCC ranging from 6.18% to 23.668%, the beneficiaries of which are all related Jelke family members. From 1988 to the date of trial, there were no sales of CCC stock. There are no restrictions on the sale or transfer of CCC stock under the terms of any of the Jelke family trusts. One trust does not terminate before the year 2019.

value of $188 million, by the $51 million in contingent built-in capital gains tax liability, accrued as of the date of death. The estate also claimed that the Commissioner undervalued the two additional discounts available to the estate, one for lack of marketability and one for lack of control.[8]

After a two-day bench trial, the Tax Court rejected the estate's position that CCC's net asset value must be reduced dollar-for-dollar by the entire amount of the built-in capital gains tax liability under Estate of Dunn, 301 F.3d at 351-53, as the Estate of Dunn was a Fifth Circuit, not an Eleventh Circuit, case. It determined that a discount was available, but not one for 100%.

The Tax Court noted that a hypothetical buyer of 6.44% of CCC stock single-handedly would be unable to cause or force a liquidation of CCC. It stated that CCC's long-term history of dividends and appreciation, with no immediate plans to liquidate (one trust continues until 2019), together with its low annual turnover of securities in the portfolio, belied the Estate of Dunn's threshold, arbitrary assumption of complete liquidation on the valuation date. Further, the Tax Court distinguished Estate of Dunn on the fact that the Fifth Circuit in Estate of Dunn was valuing a majority, not a minority, shareholder interest as was present here. Also the company valued in the Estate of Dunn was primarily (85%) an

[8] See supra note 4.

operating company, unlike CCC, a 100% investment holding company.

Under the net asset valuation approach, the Tax Court adopted the Commissioner's argument that the capital gains tax discount should be reduced to present value, as computed on an annualized, indexed basis, over the sixteen-year period it was expected to be incurred as the assets turned over.[9] Instead of a $51 million reduction, the Tax Court's present value application to net asset value resulted in a $21 million tax discount reduction, and a net deficiency in estate tax of $1 million.[10]

This appeal follows.

III. STANDARD OF REVIEW

The question of whether the Tax Court used the correct standard to determine fair market value is a legal issue. See Powers v. Comm'r, 312 U.S. 259, 260 (1941). We review de novo the Tax Court's rulings on the interpretation and application of the tax code. See Estate of Blount v. Comm'r, 428 F.3d 1338, 1342

[9] The estate attacks this approach on the basis that it is incomplete and inconsistent, as over this sixteen-year period, CCC's securities could appreciate in value, increasing tax payments and obviating the need to reduce built-in capital gains by present value principles. The same could be true if the assets were to depreciate in value over the projected period.

[10] In addition, the Tax Court applied a 10% discount for lack of control and a 15% discount for lack of marketability. As stated, supra note 4, we find no clear error in the Tax Court's analysis and calculation of the other two discounts available to the estate. These two issues need no further discussion.

(11th Cir. 2005) (citation omitted). The Tax Court's findings of fact are reviewed for clear error. Id. Where a question of fact, such as valuation, requires legal conclusions, we review those underlying legal conclusions de novo. See Adams v. United States, 218 F.3d 383, 386 (5th Cir. 2000). A determination of fair market value is a mixed question of fact and law: the factual premises are subject to a clearly erroneous standard while the legal conclusions are subject to de novo review. See Estate of Dunn, 301 F.3d at 348 (citations omitted). "The mathematical computation of fair market value is an issue of fact, but determination of the appropriate valuation method is an issue of law that we review de novo." Id.

IV. DISCUSSION

A. Introduction

The issue in this case is, for estate tax purposes, the proper calculation of the magnitude of the discount for built-in capital gains taxes in valuing stock in a closely-held corporation on the date of death. A general overview of the applicable tax statutes, regulations and revenue rulings is appropriate.

1. The Tax Code and Treasury Regulations

Section 2031(a) provides that the value of a decedent's gross estate shall be determined by including the value at the time of death of all property, real or

personal, tangible or intangible, wherever situated. I.R.C. § 2031(a). Section 20.2031-1(b) provides that the value of every item of property includable in a decedent's gross estate . . . is its fair market value at the time of the decedent's death. Treas. Reg. § 20.2031-1(b). The fair market value 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 to sell and both having reasonable knowledge of relevant facts.[11] Id. All relevant facts and elements of value as of the applicable valuation date shall be considered. Id.

2. Internal Revenue Service Guidelines

Revenue Ruling 59-60 provides the foundation for undertaking an analysis of a closely-held stock's value. Rev. Rul. 59-60, 1959-1 C.B. 237.[12] Although it has been modified and amplified over the years, Revenue Ruling 59-60 still remains the focal point for the proper method of valuing closely-held securities.[13]

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[11] The buyer and seller are hypothetical, not actual persons, and each is a rational economic actor; that is, each seeks to maximize his advantage in the context of the market that exists on the valuation date. See Estate of Newhouse v. Comm'r, 94 T.C. 193, 218 (1990).

[12] While Revenue Ruling 59-60 sets forth the basic approach for valuing closely-held securities, it recognizes that there is no one correct method. Rev. Rul. 59-60, 1959-1 C.B. 237. All of the facts and circumstances of each individual case must be analyzed by the appraiser who is expected to use common sense and informed judgment and maintain "a reasonable attitude in recognition of the fact that valuation is not an exact science." Id. at § 3.01.

[13] Rev. Rul. 59-60, 1959-1 C.B. 237, modified by Rev. Rul. 65-193, 1965-2 C.B. 370, amplified by Rev. Rul. 77-287, 1977-2 C.B. 319, amplified by Rev. Rul. 80–214, 1980-2 C.B. 101, amplified by Rev. Rul. 83-120, 1983-2 C.B. 170.

Closely-held corporations, are, by definition, corporations of which the shares are owned by a relatively limited number of shareholders. Id. at § 2.03. Their shares are traded little, if any, in the marketplace so there are usually no asked prices or third-party sales that would represent an ascertainable basis for determining the fair market value of the stock under the rules generally applicable to publicly traded stock. Id.

The fair market value of closely-held securities also clearly depends upon the potential buying public's estimate of the worth of the securities. Id. at § 3.02. The level of risk that a buyer will be willing to accept in purchasing stock of a closely-held company will directly impact the value of that stock. Id.

Revenue Ruling 59-60 states that "[t]he value of the stock of a closely-held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock." Id. at § 5(b). The net asset value method of valuation, which assumes that the value of the corporation is based upon the fair market value of its underlying assets, is in turn determined by applying the venerable willing buyer-willing seller test. Id. The net asset value method is the best method to use in valuing corporations that are essentially holding companies, while an earnings-based method applies to

operating companies. Id.[14]

B. Historical Overview of the Issue Presented on Appeal

1. The Law Prior to the Tax Reform Act of 1986

In General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), the Supreme Court held that a C corporation did not recognize taxable income at the corporate level on a distribution of appreciated property to its shareholders. Id. at 206. Congress responded to this holding, later to become known as "the General Utilities doctrine," by enacting Section § 311(a).[15] From 1935 to 1986, the fair market value of the distributed corporate property became the shareholders' adjusted stepped-up basis in the property received. It was therefore possible for a corporation to distribute its appreciated assets to its shareholders without incurring any income tax liability at the corporate level. Id.; see also I.R.C. § 301(d).

With one exception during this fifty-one year period, case law did not allow a discount for built-in capital gains tax liability when a sale or liquidation was

[14] The Tax Court agrees. See, e.g., Estate of Smith v. Comm'r, 78 T.C.M. (CCH) 745, *5 (1999) (where the net asset valuation approach given greatest weight in valuing corporation engaged in farming operation, as the underlying value of the real property is the greatest contributor to the corporation's worth); Estate of Ford v. Comm'r, 66 T.C.M. (CCH) 1507 (1993), aff'd, 53 F.3d 924 (8th Cir. 1995); Estate of Andrews v. Comm'r, 79 T.C. 938 (1982).

[15] This new tax code statute provided in part: "[N]o gain or loss shall be recognized to a corporation on the distribution (not in complete liquidation) with respect to . . . (1) its stock (or rights to acquire its stock), or (2) property." I.R.C. § 311(a).

neither planned nor imminent, as it was deemed by the courts to be too uncertain, remote or speculative.[16] See Estate of Andrews v. Comm'r, 79 T.C. 938, 942 (1982) (projected capital gains taxes do not reduce the value of closely-held stock when liquidation is only speculative as it is unlikely taxes will ever be incurred); Estate of Piper v. Comm'r, 72 T.C. 1062, 1086-87 (1979) (in gift tax case, capital gains discount unwarranted under net asset value method where there is no evidence that a liquidation of the investment companies was planned); Estate of Cruikshank v. Comm'r, 9 T.C. 162, 165 (1947) (no sale of portfolio securities projected in closely-held family investment corporation).

The pre-1986 cases do not announce a rule of law that such taxes may never affect the value of stock, but that taxes will create an impact only when the taxpayers can prove that the assets will in fact be sold in the foreseeable short-term future, rather than held for long-term investment return. See Obermer v. United States, 238 F.Supp. 29, 35-36 (D.Haw. 1964). The pre-1986 cases are now, however superceded by statute. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085.

[16] The exception was Obermer v. United States, 238 F.Supp. 29 (D. Haw. 1964), where a capital gains discount was permitted when the taxpayer established that the assets were required to be sold by the corporation to meet the terms of a restrictive agreement. Therefore, liquidation was proved by the taxpayer to be imminent and not speculative. Id. at 35-36.

2. The Tax Reform Act of 1986

The Tax Reform Act of 1986 (TRA 1986) made dramatic tax law changes. New rules were enacted to require the recognition of corporate-level gains on the distributions of appreciated property under Section § 311(b), thereby repealing the General Utilities doctrine and I.R.C. §§ 336 and 337. See I.R.C. § 311(b).

Prior to the repeal of the General Utilities doctrine by TRA 1986, no corporate tax would have been required to be paid and no discount would have been allowed. TRA 1986 required recognition of corporate-level gains and losses on liquidating sales and on distributions of corporate property.

With the repeal of the doctrine, courts began to recognize the possibility that a discount related to the capital gains taxes incurred should be allowable. Due to the taxpayer's inability to receive a step-up in basis to fair market value on the valuation date after TRA 1986, it now became more important than ever for a taxpayer to be able to quantify his or her loss in value of the stock due to inherent capital gains tax liability in the corporation.[17]

[17] At a decedent's death, appreciated property included in the decedent's gross estate generally receives a Section 1014 "step-up" in basis so that the fair market value of the property is equal to its basis. I.R.C. § 1014. However, if the decedent's property is stock in a corporation and that corporation owns appreciated capital gains property, then, as a result of the repeal of the General Utilities doctrine, the corporation would have to pay tax on such gain on its liquidation, reducing the value of the corporation. See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶¶ 8.20, 8.21 (Warren, Gorham & Lamont, 7th ed. 2000).

3. Post-TRA 1986 until Estate of Davis in 1998

Although subject to the 1986 legislation, as late as 1991, the Commissioner continued to adhere to his pre-1986 position that no capital gains discount was permitted on distributions of closely-held corporate stock, ignoring the fact that a corporate-level income tax now would be incurred upon its liquidation. See I.R.S. Tech. Adv. Mem. 91-50-001 (1991) (the Commissioner will continue to adhere to his historical rule against allowing a capital gains tax discount).[18] During this twelve-year period, the Commissioner, while agreeing that a capital gains discount is allowable in theory, and as a matter of law, uniformly denied the discount unless the taxpayer could prove that payment was imminent. See Estate of Gray v. Comm'r, 73 T.C.M. (CCH) 1940, *9 (1997) (no capital gains tax discount for stock in corporation that held installment note because payment of the note depended upon sale of land by the maker, making the risk of capital gains too speculative to be a factor in valuation).

From 1986 to 1998, taxpayers were unsuccessful in their arguments that the repeal of the General Utilities doctrine made it difficult to avoid capital gains at

[18] See also AOD 1999-001 (Jan. 29, 1999) (the Commissioner will take potential capital gains taxes into account when determining the appropriate discounts for a C corporation, but the amount of the discount and the cases in which it will be allowed will be determined on a case-by-case basis).

the corporate level, and that, therefore, ipso facto a discount for built-in capital gains should be allowed. See Estate of Bennett v. Comm'r, 65 T.C.M. (CCH) 1816, *12 (1993); Estate of Ward v. Comm'r, 87 T.C. 78, 104 (1986) (no discount as there was no evidence that liquidation is imminent or even contemplated). The courts continued to adhere to the rigid position that the highly speculative nature of the tax mandated that its present value be zero. See Estate of Luton v. Comm'r, 68 T.C.M. (CCH) 1044, *8 (1994).

C. Historical Evolution of Precedential Case Law on the Issue on Appeal

1. Estate of Davis - The Tax Court Case

Then, in 1998, twelve years after the TRA 1986 was enacted, the Tax Court began to relax its historical stance in keeping with the "new" statute.[19] In Estate of Davis v. Comm'r, 110 T.C. 530 (1998), the donor gave two blocks of the common stock of a closely-held holding company to his sons. The holding company owned shares of a publicly traded corporation. Id. at ___.

No liquidation of the holding company or sale of its assets was planned or contemplated on the valuation date. No tax was due and owing on the valuation date. Estate of Davis, 110 T.C. at ___. Nevertheless, citing section 5(b) of Rev.

[19] It could be speculated that the Tax Court's reversal of position in 1998 was a fait accompli, forced by the Commissioner's own expert appraiser witness's testimony that he included within his calculations a discount for capital gains taxes. Estate of Davis, 110 T.C. ___.

Rul. 59-60, 1959-1 C.B. at 242-43, the Tax Court determined, under an economic reality theory, that a hypothetical buyer and seller would *not* have agreed on that date on a stock price that took *no* account of the corporation's built-in capital gains tax.[20] Id. at ___.[21]

The Tax Court permitted discounts in Estate of Davis, both for a lack of marketability and for a lack of control of the shares. It did not permit a separate discount for contingent tax liability. Id. at ___. The Tax Court concluded that approximately $9 million of the permitted $28 million lack of marketability discount could be attributed to the built-in capital gains of the public corporation's

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[20] "The value of the stock of a closely-held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. . . ." Rev. Rul. 59-60, 1959-1 C.B. at 242; see also IV.A.2., supra.

[21] The court stated:

> We are convinced on the record in this case, and we find, that, even though no liquidation of [the corporation] or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of [the corporation's] built in capital gains tax. We are also persuaded on that record, and we find, that such a willing seller and such a willing buyer of each of the two blocks of [the corporation's] stock at issue would have agreed on a price on the valuation date at which each such block would have changed hands that was less than the price that they would have agreed upon if there had been no . . . built-in capital gains tax as of that date . . . . We have found nothing in the . . . cases on which respondent relies that requires us, as a matter of law, to alter our view . . . .

Estate of Davis, 110 T.C. at ___.

stock.[22] Id. at ___. By so doing, the Tax Court conceded that built-in capital gains could now be considered, not separately, but as one of the components of the marketability discount. Id.

The Commissioner's position was beginning to erode. The stage was set for other courts to become involved.[23]

2. Estate of Eisenberg and Estate of Welch - The Circuit Courts of Appeal Cases

In Estate of Eisenberg v. Comm'r, 74 T.C.M (CCH) 1046 (1997), the donor gave away shares of stock in her closely-held corporation. She owned all 1,000 shares in a corporation whose only asset was a commercial office building. Id. at *1. The corporation's only activity was renting office space in the building to clients. There were no plans to sell the building or liquidate the corporation. Id.

Nevertheless, the donor sought to reduce the value of the gifted shares of the closely-held corporation to account for the fact that, if its asset was sold, the

[22] Accord Estate of Borgatello v. Comm'r, 80 T.C.M. (CCH) 260, 264 (2000) (where, consistent with the Estate of Davis, the Tax Court allowed a 24% valuation discount for future corporate income taxes, but treated it as part of the aggregate 33% discount for lack of marketability); Estate of Dailey v. Comm'r, 82 T.C.M. (CCH) 710 (2001) (where a discount for unrealized capital gains was allowed as part of the lack of marketability discount).

[23] See however Estate of Rodgers v. Comm'r, 77 T.C.M. 1931 (CCH) (1999) (although the taxpayer relied upon the Estate of Davis, the Tax Court refused to allow a discount, also citing the Estate of Davis, this time for the proposition that valuation is necessarily an approximation and a matter of judgment, rather than one of mathematics).

sale would trigger a tax gain to the corporation. Estate of Eisenberg, 74 T.C.M. at *2. The Tax Court, notwithstanding the repeal of the General Utilities doctrine, and still citing its pre-1986 cases, declined to allow the tax discount to the donor on the basis that it was unlikely that a hypothetical buyer would want to liquidate the corporation or sell its underlying assets on the transfer date. Id. at *4. "[T]he primary reason for disallowing a discount for capital gains taxes in this situation is that the tax liability itself is deemed to be speculative," therefore, its discount value should be zero. Id.

The Second Circuit Court of Appeals disagreed. Estate of Eisenberg v. Comm'r, 155 F.3d 50, 57 (2d Cir. 1998). Buoyed by the Tax Court's own recent decision in Estate of Davis, the Second Circuit concluded that, although no liquidation of the corporation or sale of corporate assets was imminent or contemplated at the time of the gift, the requirement of an imminent sale was unnecessary. Id. It was the opinion of the court that a willing buyer would demand a discount to take account of the fact that, sooner or later, the tax would have to be paid.[24] Id.

[24] The Second Circuit cited a (then) recent study surveying CPA valuation experts, attorneys involved in business transactions, and business brokers. The survey illustrated that a large majority of buyers of closely-held stock demanded a discount for contingent capital gains tax liability. See John Gilbert, "After the Repeal of General Utilities: Business Valuations and Contingent Income Taxes on Appreciated Assets," Montana L.Rev. 5 (Nov. 1995).

For the first time since the enactment of TRA 1986, the mandate by the Commissioner and the Tax Court of an imminent sale or liquidation, *notwithstanding* the revocation of the General Utilities doctrine, was addressed directly by a circuit court of appeal:

> The issue is not what a hypothetical willing buyer plans to do with the property, but what considerations affect the fair market value of the property he considers buying. While prior to the [TRA 1986] any buyer of a corporation's stock could avoid potential built-in capital gains tax, there is simply no evidence to dispute that a hypothetical willing buyer today would likely pay less for the shares of a corporation because of a buyer's inability to eliminate the contingent tax liability.

Estate of Eisenberg, 155 F.3d at 57.

"Further, we believe, contrary to the opinion of the Tax Court, since the General Utilities doctrine has been revoked by statute, a tax liability upon liquidation or sale for built-in gains is not too speculative in this case." Id. at 58. The Second Circuit vacated and remanded the Tax Court decision for recalculation.[25]

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[25] The Second Circuit used an example from tax treatise, Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 10.41[4] n.11 (Warren, Gorham & Lamont, 6th ed. 1998), to illustrate that a hypothetical buyer and seller would allow a discount for built in capital gains tax:

> In the example, A owns 100% of the stock of X corporation, which owns one asset, a machine with a value of $1,000, and a basis of $200. Bittker assumes a 25% tax rate and points out that if X sells the machine to Z for $1,000, X will pay tax of $200 on the $800 gain. Bittker adds that if Z buys the stock for $1,000 'on

There is dicta in Estate of Eisenberg to suggest, however, that it would be incorrect to conclude that the full amount of the potential capital gains tax should be used. Id. at 58 n.15.[26] After the Estate of Eisenberg, disputes between the taxpayers and the Commissioner focused upon the magnitude of the discount allowable, not the legal right of the taxpayers to claim them.[27]

In 2000, the trend continued and moved to a different circuit. See Estate of Welch v. Comm'r, (unpublished) 208 F.3d 213 (6th Cir. 2000).[28] In Estate of Welch, the decedent was a minority shareholder of two closely-held corporations. The primary assets of both corporations consisted of real property, i.e.,

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> the mistaken theory that the stock is worth the value of the corporate assets,' Z will have lost $200 economically 'because it paid too much for the stock, failing to account for the built-in tax liability (which can be viewed as the potential tax on disposition of the machine, or as the potential loss from lock of depreciation on $800 [of] basis that Z will not enjoy.' Because of Z's loss, Bittker concludes, 'Z will want to pay only $800 for the stock, in which even A will have effectively 'paid' the $200 built-in gains tax.'

Estate of Eisenberg, 155 F.3d at 58 n.15.

[26] Based upon the Bittker example, the Second Circuit stated that "[o]ne might conclude . . . that the full amount of the capital gains tax should be subtracted from what would otherwise be the fair market value of the real estate. This would not be a correct conclusion. In this case, we are only addressing how potential tax consequences - the capital gains tax may affect the fair market value of the share of stock appellant gifted to her relatives in contrast to the fair market value of the estate." Estate of Eisenberg, 155 F.3d at 58 n.15.

[27] The Commissioner acquiesced in Estate of Eisenberg, 74 T.C.M. (CCH) 1046 (1997), acq. in result, 1999-4 I.R.B. 4.

[28] While we are aware that this case is unpublished, it is integral to our discussion and has long been included in other analyses of the issue before us.

commercial buildings rented to various tenants. The assets were subject to condemnation and sale after the decedent's death. Id. at *1.

The Tax Court denied the decedent's estate a tax discount on the basis that the estate failed to prove that liquidation of the corporations' assets was likely to occur on the valuation date. Id. at *3. The court so held even though the condemnation and subsequent sale were clearly foreseeable and imminent on the valuation date. Id.

Relying upon the rationale of the Second Circuit in Estate of Eisenberg, the Sixth Circuit found the Tax Court's judgment disallowing any discount in any amount erroneous as a matter of law and remanded to the Tax Court for a hearing. Id. at *5. The court was instructed to determine what a hypothetical, willing buyer would likely pay for the Estate of Welch stock on the valuation date, considering all the facts and circumstances at the time, including the built-in capital gains tax on the corporation's real estate.[29] Id. Similarly to the Second Circuit in the Estate of Eisenberg, there is language to suggest that the Sixth Circuit did not think it appropriate that the discount be on a dollar-for-dollar basis either.[30] Id.

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[29] The Tax Court had made no previous attempt to undertake this valuation discount. Estate of Welch, 208 F.3d at *6.

[30] See also Martin Bros. Container & Timber Prods. Corp. v Martin, et al., 241 F.Supp.2d 815 (N.D.Ohio 2003), aff'd without opinion, 112 Fed.Appx. 395 (6th Cir. 2004) (unpublished).

While neither the Second Circuit in Estate of Eisenberg, nor the Sixth Circuit in the Estate of Welch, seemed keen on granting a 100% discount, neither court prescribed a specific alternative approach either as to the amount of the reduction or a method by which to calculate it. Now that taxpayers have historically prevailed on this issue and are entitled to a discount as a matter of law, the issue shifts to the amount of the discount to be allowed.

3. The Fifth Circuit In Estate of Jameson and Estate of Dunn - A Further Shift in Emerging Case Law

By 2001, the issue presented itself squarely in the Fifth Circuit. In Estate of Jameson v. Comm'r, 267 F.3d 366 (5th Cir. 2001), the decedent owned 98% of the stock of her predeceased husband's closely-held operating company. Id. at 367. The company was both an operating timber company and an investment company. Id. at 367-69.

The Tax Court, based on its recent decision in Estate of Davis, concluded that some discount for built-in capital gains should be acknowledged. Estate of Jameson, 267 F.3d at 371. Using a net asset valuation approach, the Tax Court allowed a partial discount based upon the court's estimate of the net present value for the capital gains tax liability on the timber property that would be incurred as

the timber was cut, over a nine-year period.[31] Id. As to the investment property, the Tax Court refused to allow any capital gains discount for that property. Id. at 370.

Relying on the Second Circuit case of Estate of Eisenberg, the Fifth Circuit in the Estate of Jameson concluded that the Tax Court had clearly erred in crafting its own valuation method. Id. at 371. The method was flawed because it was based upon the Tax Court's conclusive assumption that a strategic, not a hypothetical, buyer would continue to operate the company for timber production. Id. at 371-72.

The Fifth Circuit determined that the first, or economically rational, purchaser of the stock *cannot* be presumed to operate the company. Estate of Jameson, 267 F.3d at 371-72. The rational economic actor or willing buyer would *have to take into account* the consequences of the unavoidable, substantial built-in tax liability on the property. Id. The economic reality was that any reasonable willing buyer would consider the company's low basis in the investment property in determining a purchase price. Id.

[31] This nine-year period was calculated based upon assumptions furnished by the estate, i.e., a 10% annual growth to harvest rate of the timber; a 4% annual inflation rate in the value of the harvest; a 34% capital gains tax rate; and a 20% discount rate. Estate of Jameson, 267 F.3d at 370.

Citing internally inconsistent assumptions within the Tax Court opinion, the Fifth Circuit vacated the judgment and remanded the case back to the Tax Court. The instructions given were that the Tax Court reconsider the amount of capital gains on the operating timber property, and, to consider and allow a discount for the built-in capital gains on the investment property. Estate of Jameson, 267 F.3d at 372.

A year later, the Fifth Circuit went one step further in Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002). At the time of her death, Mrs. Dunn owned a majority 62.96% of the stock of a family-owned corporation engaged in the rental of heavy equipment. The family company also managed certain commercial property as an investment. Id. at 347.

As Texas corporate law required a 66.66% interest in the voting shares to affect a liquidation, with 62.9%, Mrs. Dunn did not own a "supermajority," or 66.6%, that could force a liquidation. Id. The facts further indicated that the family company planned to remain viable and in operation for some time.[32] Id.

Using a willing buyer-willing seller fair market value test, the Tax Court in the Estate of Dunn, while agreeing with the Commissioner's argument that the tax

[32] The Commissioner, continuing to adhere to his historical pre-1986 stance, took the position that the tax was "too speculative" to consider and disallowed any discount. Estate of Dunn, 301 F.3d at 346.

was certainly speculative, still agreed to discount the stock price by 5% of the built-in capital gains as a matter of law. Id. at 347. This holding was in response to the existence of a very small possibility that a hypothetical buyer would liquidate the company. The 5% discount was in lieu of the 34% reduction sought by the taxpayers. Id. The Tax Court concluded that it was much more likely that a hypothetical buyer would continue to operate the company. Id.

The Fifth Circuit disagreed emphatically with the Tax Court. In the Estate of Dunn, under a net asset valuation approach, the Fifth Circuit determined value by totaling the corporation's assets and subtracting its liabilities. It held that a hypothetical willing buyer-willing seller ***must always be assumed*** to immediately liquidate the corporation, triggering a tax on the built-in gains.[33] Id. at 354. Thereby substantially altering the Tax Court's fair market value test, the Fifth Circuit held, as a matter of law, that, ***as a threshold assumption***, liquidation must always be assumed when calculating an asset under the net asset value approach.[34] Id. The Fifth Circuit labeled as a 'red herring' the fact that no liquidation was

[33] See also Stephens, Maxfield, Lind et al., Federal Estate and Gift Taxation ¶ 4.02 (Warren, Gorham & Lamont, 8th ed. 2002).

[34] "[T]he 'likelihood' is 100%." Estate of Dunn, 301 F.3d at 350.

imminent or even likely.[35] Id.

Turning to the proper amount of the discount, the Fifth Circuit concluded that the value of the assets must be reduced by a discount equal to 100% of the capital gains liability, dollar for dollar.[36] Id. at 352. The court relied upon the assumption that, in a net asset valuation context, the hypothetical buyer is predisposed to buy stock to gain control of the company for the sole purpose of acquiring its underlying assets. Id. This, in turn, triggers a tax on the built-in gains.[37] Id. Hence, the discount should be 100%, dollar-for-dollar. An era of

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[35] It involves the "quintessential mixing of apples and oranges." Estate of Dunn, 301 F.3d at 353.

[36] The Fifth Circuit held that:

> We are satisfied that the hypothetical willing buyer of the Decedent's block of Dunn Equipment stock would demand a reduction in price for the built-in gains tax liability of the Corporation's assets at essentially 100 cents on the dollar, regardless of his subjective desires or intentions regarding use or disposition of the assets. Here, that reduction would be 34%. This is true "in spades" when, for purposes of computing the ***asset***-based value of the Corporation, we assume (as we must) that the willing buyer is purchasing the stock to get the assets, whether in or out of corporate solution. We hold as a matter of law that the built-in gains tax liability of this particular business's assets must be considered as a dollar-for-dollar reduction when calculating the ***asset***-based value of the Corporation, just as, conversely, built-in gains tax liability would have no place in the calculation of the Corporation's ***earnings***-based value.

Estate of Dunn, 301 F.3d at 352-53 (emphasis in original). Perhaps by so doing, the court was sending a strong message to the Commissioner about capitalizing on valuation uncertainties to force enhanced compromise tax settlements for the government.

[37] The Fifth Circuit illustrated the dollar-for-dollar reduction by the following example:

> Buyer B wants an assemblage of assets identical to Corporation C's assets. Those

valuation certainty had begun.[38]

4. Cases After the Estate of Dunn

In 2004, the Fifth Circuit in Estate of Smith v. Comm'r, 391 F.3d 621 (5th Cir. 2004), was asked to decide the issue of whether or not, for estate tax purposes, the value of a decedent's individual retirement accounts (IRAs), containing marketable stocks and bonds, should be reduced by the amount of potential income tax liability of the beneficiaries upon distribution from the accounts. Estate of Smith, 391 F.3d at 626. While acknowledging the recent trend of considering potential tax liability in valuation cases, the Fifth Circuit declined to extend Estate of Davis and its progeny, including the Estate of Dunn, to the

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> assets are worth $1 million on the open market but are depreciated on C's books to a tax basis of $500,000. B has two options: (1) He can buy the assets from C for $1 million and depreciate them to zero over, e.g., seven years (or buy them on the open market and have the same cash flow and tax experience), leaving C to pay its own 34% tax ($170,000) on its gain; or (2) he can buy C's stock, get no depreciation deductions other than, at the corporate level, to the extent the asset are further depreciable, and have a 34% built-in corporate tax liability at sale of the assets. Surely a buyer of the stock rather than the asset would insist on a price reduction to account for the full amount of the built-in gain tax and the loss of the depreciation opportunity.

Estate of Dunn, 301 F.3d at 353 n.23; see also n.42 infra.

[38] In at least one case, the Commissioner has taken an inconsistent position as to dollar-for-dollar recognition. In Simplot v. Comm'r, 112 T.C. 130, 166 n.22 (1999), rev'd on other grounds 249 F.3d 1191 (9th Cir. 2001), the Commissioner presented testimony of an expert witness who concluded that, when valuing a closely-held corporation's interest in publicly traded stock, full recognition of built-in capital gains was appropriate.

valuation of IRAs held by a decedent.[39] Id.

Most recently, in Estate of McCord v. Comm'r, 461 F.3d 614 (5th Cir. 2006), another Fifth Circuit case, the "trend" continues. The case presented an issue of first impression regarding a donee's contingent liability for additional estate taxes after receipt of the gift. Id. at 630-32.

In Estate of McCord, the Commissioner asserted in a notice of deficiency that donor taxpayers had understated the fair market value of their gifted partnership interests on their gift tax returns. Id. at 621. The Commissioner claimed that this error resulted from the donor taxpayers' discounting the fair market value of those gifted interests by the mortality-based, actuarially-calculated present value of the donees' assumed obligations for additional estate taxes. Id.

Finding no error in undervaluation, the Fifth Circuit in Estate of McCord, citing Estate of Dunn, stated:

> For purposes of our willing buyer/willing seller analysis, we perceive no distinguishable difference between the nature of the capital gains tax and its rates on the one hand and the nature of the estate tax and its rates on the other hand. Rates and particular features of both the

[39] The value of an IRA should not reflect the potential income tax liability of the beneficiaries upon distribution from the accounts, as an IRA is a different asset, with different tax consequences. See also Estate of Kahn v. Comm'r, 125 T.C. 11 (2005) (where the Tax Court declined to extend Estate of Davis and its progeny, including Estate of Dunn, to IRAs). With IRAs, the tax does not survive the transfer to an unrelated third party, unlike capital gains tax potential which does survive the transfer. See Estate of Smith, 391 F.3d at 629.

> capital gains tax and the estate tax have changed and likely will continue to change with irregular frequency; likewise, despite considerable and repeated outcries and many aborted attempts, neither tax has been repealed. Even though the final amount owed by the Taxpayer as *gift* tax on their January 1996 gifts to non-exempt donees has yet to be finally determined (depending, as it does, on the final results of this case), we are satisfied that the transfer tax law and its rates that were in effect when the gifts were made are the ones that willing buyer would insist on in applying in determining whether to insist on, and calculate a discount for § 2035 estate tax liability.

Estate of McCord, 461 F.3d at 630.

The Fifth Circuit thereby extended the rationale of Estate of Davis to a gift tax case involving contingent estate taxes.[40]

D. Applying the Fifth Circuit Estate of Dunn Rationale to the Present Appeal

Juxtaposed against the backdrop of this emerging case law, the question before the Tax Court in this case, and now before us, is what was the value of Jelke's 6.44% interest in CCC on March 4, 1999? Which dollar figure do we use to discount the fair market value of CCC's securities for built-in capital gains on March 4, 1999? Is it dollar-for-dollar, as the estate contends, under the rationale set forth in 2002 by the Fifth Circuit in the Estate of Dunn, or $51 million? Or is

[40] The Fifth Circuit, in the Estate of McCord, was never asked to decide whether or not the dollar-for-dollar analysis of the Estate of Dunn applied in the context of contingent estate taxes generated by a gift, as the maximum amount that the donor taxpayers had claimed on their gift tax returns was a discount only for the present value of the date-of-gift of the contingent estate tax obligations assumed by the donees. See Estate of McCord, 461 F.3d at 631.

it the present value of the capital gains indexed over a sixteen-year period, as the Commissioner contends, or $21 million?

Is the Commissioner's present value approach incomplete and inconsistent, as the estate contends, as CCC's securities will very likely appreciate over this time period, thereby increasing capital gains tax liabilities and undermining the rationality of a present value approach? What if the value of CCC's securities were to decline over this sixteen-year period, and, concomitantly, the capital gains tax also declined?

Is the Commissioner correct in contending that the Estate of Dunn's threshold "assumption of liquidation" is unreasonable and unrealistic in the present case as CCC is precluded from liquidation until 2019? Does such a minority interest such as we have here, with no power to "force" CCC's liquidation, render the Estate of Dunn distinguishable, as it concerned a majority interest? Does it matter that the corporation in the Estate of Dunn was primarily an operating company, while CCC is exclusively an investment holding company?

Recently, on other issues and other facts, in Estate of Blount v. Comm'r, 428 F.3d 1338 (11th Cir. 2005), we were also asked to determine the fair market value of shares of stock in a closely-held corporation owned by a decedent for

estate tax purposes.[41] Id. An economic reality approach to valuation, in its dicta, is referenced: "To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value." Id. at 1346. To properly reflect the economic realities of the transaction, in other words, it is important to take liability costs into account when negotiating a market-supported price for a share of a company's stock, such as CCC, for example.

In our case, why would a hypothetical willing buyer of CCC shares not adjust his or her purchase price to reflect the entire $51 million amount of CCC's built-in capital gains tax liability? The buyer could just as easily venture into the open marketplace and acquire an identical portfolio of blue chip domestic and international securities as those held by CCC. Yet the buyer could accomplish this without any risk exposure to the underlying tax liability lurking within CCC due to its low cost basis in the securities.[42]

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[41] Insurance proceeds paid to a company upon a shareholder's death are not to be included in calculating the company's fair market value due to the company's contractual obligation to buy the decedent's shares. Estate of Blount, 428 F.3d at 1345.

[42] Consider the following example:

> [T]wo corporations each owning a portfolio of publicly traded securities having the same aggregate fair market value. Where these two companies differ concerns the purchase price each had to pay to amass the respective portfolios. The higher investment cost for one of the corporations will produce a lower corporate income tax liability in comparison to the other corporation even though each corporation,

Here, the Tax Court distinguished the majority interest held by the decedent in the Estate of Dunn from our case on the basis that the Jelke estate's minority interest was single-handedly insufficient to "force" a liquidation on its own. The Tax Court chose a sixteen-year period to reflect when the corporation would reasonably incur the tax. This distinction is not persuasive to us. We are dealing with hypothetical, not strategic, willing buyers and willing sellers. As a threshold assumption, we are to proceed under the arbitrary assumption that a liquidation takes place on the date of death. Assets and liabilities are deemed frozen in value on the date of death and a "snap shot" of value taken. Whether or not a majority or a minority interest is present is of no moment in an assumption of liquidation setting.

The Commissioner also argues that the Estate of Dunn is distinguishable on its facts as the company being valued was primarily an operating company and CCC is an investment holding company. As the company in the Estate of Dunn was both an operating company and an investment company, the Fifth Circuit was

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> should it decide to, sells the portfolio for the same price. In choosing which corporation to acquire, little doubt exists that a prospective purchaser of the stock of either of these corporations would be unwilling to pay the same price for each corporation knowing full well the potential for a greater income tax bite for the corporation with the lower investment cost in its assets.

Mark R. Siegel, "Recognizing Asset Value and Tax Basis Disparities to Value Closely-held Stock," 58 Baylor L.Rev. 861, 862-63 (Fall 2006); see also supra note 37.

forced to use two different methods of valuation, an earnings-based valuation method for the operating side of the company, and a net asset valuation method for the investment side. It assigned a percentage weight to them of 85% and 15%, respectively. Estate of Dunn, 301 F.3d at 358-59.

Here, CCC was solely an investment holding company. We need examine only the Estate of Dunn analysis as it applies to the net asset valuation method used in valuing investment holding companies; there is no need for weighting. The Commissioner's argument on this point is without merit.

It is only recently that, the Tax Court in the Estate of Davis, the Second Circuit in the Estate of Eisenberg and the Sixth Circuit in the Estate of Welch, courts are receptive to the concept that some sort of discount for capital gains tax liability exists.[43] Yet, in the more than twenty years since the TRA 1986 was enacted, none of these three cases provide any precise rules for calculating the downward adjustment with any specificity, nor give guidance to tax practitioners in future cases.

The Fifth Circuit in the Estate of Dunn is the first court to emerge with a precise valuation approach as to the amount of the reduction and how to calculate

[43] We are aware that dicta in the courts of appeal cases indicates a discount of less than 100%.

it. As a threshold matter, the court creates the arbitrary assumption that all assets are sold in liquidation on the valuation date, and 100% of the built-in capital gains tax liability is offset against the fair market value of the stock, dollar-for-dollar.[44] Estate of Dunn, 301 F.3d at 352-54.

Cases prior to the Estate of Dunn, prophesying as to when the assets will be sold and reducing the tax liability to present value, depending upon the length of time discerned by the court over which these taxes shall be paid, require a crystal ball. The longer the time, the lower the discount. The shorter the time, the higher the discount.

The downside of this approach is that, not only is it fluidly ethereal, it requires a type of hunt-and-peck forecasting by the courts. In reality, this method could cause the Commissioner to revive his "too speculative a tax" contentions made prior to the Estate of Davis in 1998. This methodology requires us to either gaze into a crystal ball, flip a coin, or, at the very least, split the difference between the present value calculation projections of the taxpayers on the one hand, and the present value calculation projections of the Commissioner, on the other.

[44] Even the Commissioner in this case agrees that the fair market value of CCC's assets and liabilities must be frozen on the valuation date. See Red Brief, at 41. Other than to describe the Fifth Circuit's methodology in Estate of Dunn as "unreasonable" and "unrealistic," the Commissioner provides no authority in support of his position.

We think the approach set forth by the Fifth Circuit in the Estate of Dunn is the better of the two. The estate tax owed is calculated based upon a "snap shot of valuation" frozen on the date of Jelke's death, taking into account only those facts known on that date. It is more logical and appropriate to value the shares of CCC stock on the date of death based upon an assumption that a liquidation has occurred, without resort to present values or prophesies.

The rationale of the Fifth Circuit in the Estate of Dunn eliminates the crystal ball and the coin flip and provides certainty and finality to valuation as best it can, already a vague and shadowy undertaking. It is a welcome road map for those in the judiciary, not formally trained in the art of valuation.

The Estate of Dunn dollar-for-dollar approach also bypasses the unnecessary expenditure of judicial resources being used to wade through a myriad of divergent expert witness testimony, based upon subjective conjecture, and divergent opinions. The Estate of Dunn has the virtue of simplicity and its methodology provides a practical and theoretically sound foundation as to how to address the discount issue.

The Fifth Circuit preempted its critics by stating: "As the methodology we employ today may well be viewed by some (valuation) professionals as unsophisticated, dogmatic, overly simplistic, or just plain wrong, we consciously

assume the risk of incurring such criticism from the business appraisal community. . . In this regard, we observe that on the end of the methodology spectrum opposite *oversimplification* lies *over-engineering*." Estate of Dunn, 301 F.3d at 358 n.36 (emphasis in original).

This type of "economic reality approach" mimics the marketplace and places a practical, transactional overlay upon the proverbial willing buyer-willing seller analysis. It allows the issue to conform to the reality of the depressing economic effect that the lurking taxes have on the market selling price. The hypothetical willing buyer is a rational, economic actor. Common sense tells us that he or she would not pay the same price for identical blocks of stock, one purchased outright in the marketplace with no tax consequences, and one acquired through the purchase of shares in a closely-held corporation, with significant, built-in tax consequences.

This 100% approach settles the issue as a matter of law, and provides certainty that is typically missing in the valuation arena. We thereby follow the rationale of the Fifth Circuit in the Estate of Dunn, that allows a dollar-for-dollar, $51 million discount for contingent capital gains taxes in valuing CCC on the date of Jelke's death, and his 6.44% interest therein. This result prevents grossly inequitable results from occurring and also prevents us, the federal judiciary, from

assuming the role of arbitrary business consultants.[45]

V. CONCLUSION

Based upon the foregoing discussion, as a matter of law, under a de novo review, we vacate the judgment of the Tax Court and remand with instructions that the Tax Court recalculate the net asset value of CCC on the date of Jelke's death, and his 6.44% interest therein, using a dollar-for-dollar reduction of the entire $51 million in built-in capital gains tax liability, under the assumption that CCC is liquidated on the date of death and all assets sold.

VACATED and REMANDED with INSTRUCTIONS.

[45] Given the maximum capital gains tax rate at this writing of 15% for future cases, one can only speculate that the maximum capital gains tax rate will not again approach the 34% range seen in previous cases.

CARNES, Circuit Judge, dissenting:

The tax code is nowhere near the center of my intellectual life, and generally I find estate tax law about as exciting as Hegel's metaphysical theory of the identity of opposites. There is, however, more involved in this case than just the estate tax issue presented, which is how to determine the fair market value of the decedent's distinctly minority interest in CCC, a closely held corporation whose assets consist primarily of marketable securities with a built-in capital gains tax liability.

The broader principles implicated by the majority opinion are timeless. They were discussed by Teddy Roosevelt at the close of the century before last:

> I wish to preach not the doctrine of ignoble ease but the doctrine of the strenuous life; the life of toil and effort; of labor and strife; to preach that highest form of success which comes not to the man who desires mere easy peace but to the man who does not shrink from danger, from hardship, or from bitter toil, and who out of these wins the splendid ultimate triumph.

Vice President Theodore Roosevelt, The Strenuous Life, Address before the Hamilton Club in Chicago, Illinois (April 10, 1899), in The Penguin Book of Twentieth-Century Speeches 1 (Brian MacArthur ed., 1992). By adopting and extending the arbitrary assumption rule of least effort from Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002), the majority gives in to the judicial

equivalent of the doctrine of ignoble ease. To avoid the effort, labor, and toil that is required for a more accurate calculation of the estate tax due, the majority simply assumes a result that we all know is wrong. We can do better than that. The tax court did.

The corporation whose assets are being valued in this case is a holding company with a portfolio of widely traded securities whose value can be readily determined. Estate of Jelke v. Comm'r, No. 3512-03, 2005 WL 1277407, at *1, 3 (T.C. May 31, 2005). The rate at which the company had liquidated the securities it held in the five years before the decedent's death is also known to one one-hundredth of a percent. Id. at *2, 8. The parties agreed that the value of the company's net assets at the time of death is what counts, and they agreed that the market value of the securities it held at the time of death should be reduced by some amount for the capital gains tax liability attached to the securities. Id. at *3. That is what the law provides. See 26 C.F.R. § 20.2031-1(b) ("The value of every item of property includible in a decedent's gross estate . . . 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 to sell and both having reasonable knowledge of relevant facts."); Estate of Blount v. Comm'r, 428 F.3d 1338, 1346 (11th Cir. 2005). The disagreement is over how to calculate that reduction in

value. Jelke, 2005 WL 1277407, at *3 ("[T]he parties differ as to the amount of the reduction from the value for the potential capital gain tax liability that would arise upon sale of the marketable securities held by the corporation.").

The estate contends that the full amount of the capital gains tax liability should be deducted from the value of the securities as though they had been sold at the time of death, even though they were not. Id. The IRS wants the capital gains reduction calculated based on projecting the average rate of past liquidation forward and then discounting the taxes that will come due in the future back to present value at the time of death. Id.

The Tax Court summarized the estate's contention, which was put forward by its expert, Mr. Frazier, as follows:

> After discussing several methods, Mr. Frazier used what he described as a combination of the market and asset approaches. Mr. Frazier used the market approach to value CCC's securities. Purporting to rely on the asset approach to valuation, Mr. Frazier then reduced the total of the market prices for CCC's securities by the liabilities shown on CCC's books and the tax liability that would have been incurred if all of CCC's securities had been sold on decedent's date of death. Mr. Frazier did not make adjustments to the tax liability for the possibility that sales of CCC's securities would have occurred after decedent's date of death. In other words, Mr. Frazier relied on the net asset method to employ an assumption of liquidation as of the valuation date, an event which would trigger recognition of $51,626,884 in capital gain tax. This method produced a $137,008,949 [] value for CCC. Mr. Frazier then computed an undiscounted value of $8,823,062 for decedent's 6.44-percent interest

(3,000 of 46,585.51 shares) held in trust.

Id. at *8.

The Tax Court summarized the IRS's contention, put forward by its expert, Mr. Shaked, as follows:

> Respondent's expert, Mr. Shaked, started with the same market value of CCC's securities. Mr. Shaked then reduced the assets by liabilities, but he used a different approach from Mr. Frazier's in arriving at a reduction for the built-in capital gain tax liability. First, he computed CCC's average securities turnover by reference to the most recent data (1994–98). Using that data, Mr. Shaked computed a 5.95-percent average annual turnover derived from the parties' stipulated asset turnover rates for 1994–98. Mr. Shaked believed that the 5.95-percent rate was conservative, because the turnover trend was generally decreasing. The use of the 5.95-percent turnover rate results in the capital gain tax's being incurred over a 16.8-year period (100 percent divided by 5.95 percent).
>
> Mr. Shaked then divided the $51,626,884 tax liability by 16 years to arrive at the average annual capital gain tax liability that would have been incurred each year over this 16-year period – $3,226,680.25 ($51,626,884 divided by 16). Next, he selected a 13.2-percent discount rate based on the average annual rate of return for large-cap stocks in the period from 1926 to 1998, as described in Ibbotson Associates Stocks, Bonds, Bills & Inflation, 1999 Yearbook (Ibbotson 1999). He then computed the present value of the $3,226,680.25 annual tax liability discounted over 16 years using a 13.2-percent interest rate to arrive at a present value for the total capital gain tax liability of $21,082,226. By reducing the $188,635,833 net asset value by the $21,082,226 future tax liability, Mr. Shaked arrived at a $167,553,607 value for CCC. Finally, Mr. Shaked concluded that the undiscounted value for decedent's 6.44-percent interest in CCC was $10,789,164 in contrast to Mr. Frazier's undiscounted value of $8,823,062. This difference reflects

> numerically the parties' differing approaches to the amount of capital gain tax that should be used to reduce the net asset value of CCC.

Id. at *8–9 (footnote omitted).

The Tax Court adopted the IRS's real value approach, even though it is more complicated than the estate's simple but arbitrary assumption that all of the assets were sold at the time of death. Id. at *11–12. The court chose the real value approach because it produces a result closer to the actual value of the company's assets, which in turn leads to a more accurate determination of the sales price a willing buyer and seller would agree on for the shares of the holding company that Jelke owned on the date of his death. Id.

While the real value approach is not perfect and itself makes some assumptions—such as the past rate of liquidation continuing in the future—it produces a more accurate result than the arbitrary assumption method because it more closely reflects the economic interests of those who control the company. The death of one who holds only 6.44 percent of the shares of a holding company, id. at *2, that has been producing an average annual rate of return of more than 23 percent on securities, id., and that has substantial built-in capital gains taxes, id. at *3, is not going to prompt the liquidation of all of the company's assets. It would be economically foolish for the majority shareholders to gut the golden goose and

bring down on their heads the embedded capital gains tax liability simply because of the death of a minority shareholder, an event of no relevance to their economic interests.

The majority's approach assumes that the holding company was liquidated on the date of Jelke's death, and therefore all of its built-in capital gains were incurred (and therefore passed on to its shareholders) immediately. Maj. Op. at 36–37. The majority makes that assumption despite the fact that: historically the company has sold only 5.95 percent of its investments and therefore precipitated only that small portion of the total built-in capital gains liability per year, Jelke, 2005 WL 1277407, at *8; the company is earning an annual return of more than 23 percent on its portfolio investments, id. at *2; and, "[a]s of the date of decedent's death, CCC's board of directors had no plans to liquidate an appreciable portion of CCC's portfolio, and they intended to operate CCC as a going concern," id. Under these circumstances, the notion that the company would suddenly dispose of its highly profitable portfolio, ending the enviable earnings stream, and inflicting a substantial capital gains tax on its shareholders is preposterous. The fact that Jelke died does not make it any less so.

The death of a human being is profoundly important to the person who dies, but it matters not one whit to the laws of economics, which dictate the self-interest

of the living. Because the interests of the majority shareholders did not change when Jelke died, the only reasonable expectation is that the holding company will continue to be run as it was before that immaterial event occurred. Yet, the majority insists on pretending that contrary to the economic interests of its shareholders, and contrary to everything that has come before, the company must be assumed to have sold all of its securities on the date of Jelke's death.

The majority suggests that subtracting the entire $51 million in embedded capital gains liability from the $188.6 million value of the company's portfolio is the best approach, because "why would a hypothetical willing buyer of CCC shares not adjust his or her purchase price to reflect the entire $51 million amount of CCC's built-in capital gains tax liability?" Maj. Op. at 31. The answer, of course, is that the buyer would adjust downward the price he was willing to pay in order to reflect that liability, but the buyer could not reasonably expect the seller to agree to a price that ignored completely the time value of money. No rational seller would accept a price that subtracted the entire amount of the future tax liability as though it were due immediately, when that liability will almost certainly be spread out over future years instead—the next 16.8 years if existing practices continue. Jelke, 2005 WL 1277407, at *8. Assets with liabilities that will not come due until future years are worth more than those with the same

amount of liabilities that are due immediately.

Any rational being would prefer to pay $51 million in taxes spread out over the next 16.8 years, which is how long it would take for the embedded tax liability to come fully due under the company's historical rate of liquidation, instead of paying the entire $51 million immediately. Ask yourself: If you had the choice would you prefer to pay the taxes you are going to owe over the next 16 or so years in advance, right now, or would you choose to pay those taxes only when they come due in the future? The majority would assume, because it makes the calculations easier, that you would choose to pay all of your future taxes now.

When tax liabilities and payments are spread out over future years a taxpayer is able to use the unpaid funds to earn more money until the taxes actually do come due. When the amount involved is $51 million and the portion of it that can be invested declines at a rate of only 5.95 percent per year, the interest, dividends, and capital gains that can be earned using that slowly declining balance (and the accumulated earnings that flow from it) are enormous. Ask yourself: Would you put any value on the earnings you could get from investing a declining balance of $51 million, which diminishes at the rate of only 5.95 percent per year, or would you think that all of the money you could earn with the use of that declining principal over the next 16 years would be negligible? The

majority's assumption makes sense only to those who would place no value on the earnings that could be made with the use of $51 million in investment principal as it declines at a rate of 5.95 percent each year for the next 16.8 years.

The majority asserts that a buyer "would not pay the same price for identical blocks of stock, one purchased outright in the marketplace with no tax consequences, and one acquired through the purchase of shares in a closely-held corporation." Maj. Op. at 36. Of course not. But we are not talking about the same price. We are talking about a price between two extremes. One extreme is the majority's approach, which assumes that tax consequences that are likely to come due gradually, over a period of 16.8 future years, have the same effect on price as those that are due immediately. The other extreme, which is the straw man the majority erects, assumes that tax consequences have no effect at all on price. But that is not the position the Tax Court took. Instead, the Tax Court position recognizes that the embedded tax liability will affect price and calculates how much effect it will have, taking into account the size of the tax liability and when it is likely to become due. The Tax Court's calculation, which is based on the facts, produces a result that is closer to reality than the majority's assumption of instant liquidation.

To its credit, the majority concedes that its approach is arbitrary. The

majority describes its operating premise that a holding company would instantly liquidate its entire investment portfolio on the date of a minority shareholder's death as an "arbitrary assumption." Maj. Op. at 34. Seeking to justify its approach, the majority argues that being arbitrary "provides certainty and finality" and "bypasses the unnecessary expenditure of judicial resources" that is required to make a more realistic calculation. Id. at 35. Indeed, it does. Of course, the same could be said about any arbitrary assumption, including one that the securities had no value at all or that the capital gains tax liability would never actually be paid for some unknown reason. Either of those arbitrary assumptions would also avoid the unnecessary expenditure of judicial resources while providing certainty and finality. Once the doctrine of ignoble ease and seductive simplicity is allowed to reign, there is no end to the shortcuts that can be taken.

If the majority's approach is good, the good it provides should not be confined to estate tax law. It should be shared with all areas of the law. To take one example of how the majority's approach can work its magic, consider the daunting task of calculating the lost future earnings award in the case of one who has been disabled or killed by a tortfeasor. In Culver v. Slater Boat Co., 722 F.2d 114 (Former 5th Cir. 1983) (en banc), our predecessor Court held that: "The calculation of damages suffered either by a person whose personal injuries will

result in extended future disability or by the representatives of a deceased person involves four steps: estimating the loss of work life resulting from the injury or death, calculating the lost income stream, computing the total damage, and discounting that amount to its present value." Id. at 117. Doing all of that requires a lot of judicial effort as even a cursory reading of the Culver opinion shows.

But no longer is all that bother necessary. The parties need not quarrel over, and courts need not concern themselves with, all the variables that go into calculating a fair award for lost future earnings. After all, the quest for a best estimate of economic reality in such a case is, in the majority's view: "fluidly etheral," it involves "hunt-and-peck forecasting," it is like "flip[ping] a coin," and it is no better than "gaz[ing] into a crystal ball." Maj. Op. at 34.

The alternative to its arbitrary assumption, the majority says, is having courts "prophesying." Id. So it is, and so it has been throughout the history of our judicial system, because sometimes prophesying is necessary. As is so often the case, the words of Justice Holmes are instructive. In Ithaca Trust Co. v. United States, 279 U.S. 151, 49 S. Ct. 291 (1929), he wrote for the Court, holding that for the purposes of calculating an estate's charitable deduction for bequeathing the remainder interest in a trust, the value of the trust assets given to the charity had to

be discounted by the decedent's widow's life estate in the trust. The value of the life estate, in turn, had to be calculated based on the statistically probable (or as our majority would say, "prophesied") length of the widow's life. Holmes explained:

> [T]he value of property at a given time depends upon the relative intensity of the social desire for it at that time, expressed in the money that it would bring in the market. Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out false than when it comes out true.

Id. at 155, 49 S. Ct. at 292 (citations omitted); accord Rev. Rul. 59-60 § 3.03, 1959-1 C.B. 237 ("Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal."); see also Culver, 722 F.2d at 123 ("Courts are not prophets and juries are not seers. In making awards to compensate injured plaintiffs or the dependents of deceased workers for loss of future earnings, however, these fact-finders must attempt, in some degree, to gauge future events.").

From now on, the majority opinion indicates, there are to be no more prophesies. For example, in cases like Culver we can just arbitrarily assume that whenever someone dies or is injured the value of the future earnings they have lost is $1 million dollars, or $10 million, or zero dollars. Or we can take the

decedent's previous year's earnings, if it is not too much trouble to figure them out, and multiply that amount by some arbitrary number (perhaps the number of years the dead man's father or grandfather lived), and we can forget about discounting future losses to present value. Which dollar figure or multiple of the last year of earnings that we arbitrarily assume will not matter, except of course to the parties themselves and to those who believe that the law ought to strive for results that seek to approximate reality, even when it requires a little prophesy.

The advantages of the majority's method flow from the simplicity that comes from being arbitrary. The more arbitrary the assumption the less that application of it will be hindered by the reality of bothersome facts which are burdensome to find. Adopting this method will "provide[] certainty and finality" and "bypass[] the unnecessary expenditure of judicial resources," relieving courts of the burden of doing what courts are designed to do, which is find facts and apply the law to them. Maj. Op. at 35. Writing the doctrine of ignoble ease into the law will have its advantages.

Of course, we are going to have to overrule some precedent, or perhaps in keeping with the majority's decisional motif we can just arbitrarily assume that the conflicting precedent does not exist. The precedent established by the en banc Court in the Culver case nearly a quarter of a century ago will have to be thrown

overboard, but it is just an admiralty decision anyway.

We will also have to get rid of the Meader ex rel. Long v. United States, 881 F.2d 1056 (11th Cir. 1989), precedent and decisions like it. The Meader case arose under the Federal Tort Claims Act and involved the calculation of an award for future medical expenses and lost future earnings. We held, among other things, that "[i]t is a settled principle of law that [such] an award . . . must be adjusted to its present value to account for two factors: first, the interest the award will earn before it is used to pay for medical expenses or to replace earnings; second, the depreciation the award will suffer over time on account of inflation." Meader, 881 F.2d at 1057–58; see also Dempsey ex rel. Dempsey v. United States, 32 F.3d 1490, 1492 (11th Cir. 1994) (FTCA medical malpractice case stemming from injuries to a newborn, required not only calculating an award for future medical expenses but also calculating a dollar value for the parent's "loss of society and affection of the child" and their loss of the child's services in the future).

Then there is our decision of just a few months ago in Advanced Telecommunications Network, Inc. v. Allen (In re Advanced Telecommunications Network, Inc.), 490 F.3d 1325 (11th Cir. 2007). There the bankruptcy court had been faced with the difficulty of valuing a company's contingent liability arising

from pending litigation against it in state court. Not sure how the result of that litigation against the company could have been predicted, the bankruptcy court took the easy way out and arbitrarily assumed that the value of the contingent liability was zero. Id. at 1335–36. In reversing, we explained:

> Although it may be true, as the bankruptcy court put it, that "no one could have predicted this result with any reasonable certainty," such a precise prediction was not required. The court was instead required to calculate the present value of the liability—the expected cost of the liability times the estimated chance of it ever occurring. Unless either the expected cost or the chances of it occurring are equal to zero (that is, the liability is costless, or the chances of it happening are negligible), the estimated value should be more than zero.

Id. at 1335 (emphasis omitted).

The majority approach in the present case cannot be reconciled with our holding in the Advanced Telecommunications case. Requiring a district court to predict the amount of damages that may be awarded in a pending lawsuit and then to discount that amount by its estimate of the chance of a liability verdict is, the majority here would say, equivalent to "flip[ping] a coin" and is no better than "gaz[ing] into a crystal ball." Maj. Op. at 34. So, the Advanced Telecommunications decision, like so many others of ours that require estimating present value based on predictions about future events, will have to go. All of those prior precedents will have to yield to the easy arbitrary assumption method

of valuation, to the judicial equivalent of the doctrine of ignoble ease.

Teddy Roosevelt is not the only one who extolled the virtue of toil and effort. Henry James once advised a young friend that, "I have in my own fashion learned the lesson that life is effort, unremittingly repeated, and . . . I feel somehow as if real pity were for those who had been beguiled into the perilous delusion that it isn't." Letter from Henry James to Charles Eliot Norton (May 6, 1872), in 1 Henry James Letters,1843–1875, at 276 (Leon Edel ed., 1974). I dissent from the majority's perilous delusion.

T.C. Memo. 2010-182

UNITED STATES TAX COURT

ESTATE OF MARIE J. JENSEN, DECEASED,
VIRGINIA E. MAURER, EXECUTRIX, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 25681-08. Filed August 10, 2010.

Jack Mitnick and Mindy K. Smolevitz, for petitioner.

Michelle L. Maniscalco, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

VASQUEZ, Judge: Respondent determined a $333,244.59 deficiency in the Federal estate tax of the Estate of Marie J. Jensen (decedent). The issue for decision is the amount of the discount for built-in long-term capital gains tax (LTCG tax) that is allowable in computing the fair market value of the estate's

interest in Wa-Klo, Inc (Wa-Klo). The parties agree that: (1) Wa-Klo's net asset value is $3,772,176[1] before reductions for lack of marketability and built-in LTCG tax discounts; (2) the estimated Federal built-in LTCG tax liability is $965,000; and (3) the estate is entitled to a 5-percent reduction for lack of marketability discount. Unless otherwise indicated, all section references are to the Internal Revenue Code (Code) in effect for the date of decedent's death, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. We incorporate by this reference the stipulation of facts and the attached exhibits.

Decedent was a resident of New York when she died on July 31, 2005. When the petition was filed, Virginia E. Maurer (executrix) resided in New York.

In February 2003 decedent created the Marie J. Jensen Revocable Trust, a revocable trust (the trust), and appointed herself trustee. As of decedent's death, the corpus of the trust

[1] The parties stipulated pursuant to Rule 91 that Wa-Klo's net asset value was $4,243,969. Respondent's expert, Klaris, Thomson, & Schroeder, Inc. (KTS), discovered that the estate's expert, Margolin, Winer, & Evens LLP (MWE), overstated Wa-Klo's net asset value by $471,793. The parties on brief agree that $3,772,176 is the correct value, which we accept.

included 164 shares of common stock in Wa-Klo,[2] a closely held C corporation incorporated in 1956 under New Hampshire law.

As of the date of decedent's death Wa-Klo's principal asset was a 94-acre waterfront parcel of real estate that extended across the city lines of Jaffrey and Dublin, New Hampshire. The improvements to the real estate include state-of-the-art facilities such as playing fields, an indoor gymnasium, a horse stable, a dining hall, cottages, and bunkhouses. Wa-Klo operates a summer camp for girls, Camp Wa-Klo, on the real estate.

The estate hired MWE, see supra note 1, to value the estate's 82-percent interest in Wa-Klo as of the date of decedent's death. MWE used the adjusted book value method[3] and attributed to Wa-Klo a net asset value of $4,243,969 (before

[2] The shares of Wa-Klo were held as follows: (1) The trust--164 shares (82-percent interest); (2) Ina Fletcher--18 shares (9-percent interest); and (3) Kathleen Cocoman--18 shares (9-percent interest).

[3] Generally, three kinds of valuation methods are used to determine the fair market value (FMV) of stock in a closely held corporation: (1) The market method; (2) the income method; and (3) the cost method. See Estate of Noble v. Commissioner, T.C. Memo. 2005-2; Estate of Borgatello v. Commissioner, T.C. Memo. 2000-264. The adjusted book value method is a variation of the cost method that restates the assets and liabilities of a company to their FMV as of the valuation date and reduces the restated FMV of the assets by the restated value of the liabilities in order to determine the company's net worth. See Julian v. Julian, No. 1892-VCP, slip op. at 5 n.13 (Del Ch. Mar. 22, 2010); Shooltz v. Shooltz, 498 S.E.2d 437, 443 (Va. Ct. App. 1998).

discounts for lack of marketability and built-in LTCG tax).[4] MWE estimated a built-in LTCG tax of $965,000.[5] MWE subtracted the $965,000 built-in LTCG tax from the $4,243,969 net asset value and calculated a $3,278,969 after-tax net asset value for Wa-Klo,

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[4] MWE based its valuation on the following:

Assets	Book value	Restated value
Cash	$934,973	$934,973
Salary advances	22,932	22,932
Federal prepaid tax	27,032	27,032
State prepaid tax	10,047	10,047
Real estate, buildings, and other depreciable assets	471,793	[1]3,776,793
Total	1,466,777	4,771,777
Liabilities		
Payroll tax payable	$2,808	$2,808
Accrued liabilities	-0-	525,000
Total	2,808	527,808
Equity	$1,463,969	$4,243,969

[1] $3,300,000 (restated FMV of the real estate and improvements based on appraisal by Whitney Associates) + $5,000 (estimated salvage value of equipment) + $471,793 (MWE math error, see supra note 1). MWE relied on Whitney Associates' appraisal of the real estate and its improvements. Whitney Associates is a residential and commercial real estate appraiser. The estate hired Whitney Associates to appraise the real estate and its improvements. Whitney Associates employed a cost method and a market method. Under the cost method it calculated a value of $3,600,000; under the market method it calculated a value of $3 million. Whitney Associates reconciled the two values on the basis of a number of factors and calculated a final value of $3,300,000. Whitney Associates did not use an income method because it concluded that it was unreliable and not an applicable method for the purpose of the appraisal.

[5] $3,300,000 (FMV real estate) - $500,000 (estimated tax basis) x 34% (tax rate) + $13,000 (tax increase for income over $100,000). The estate on brief now asserts that it is entitled to a discount of $1,133,283 for State and Federal tax.

of which $2,688,755 was attributable to the estate's 82-percent interest (before discount for lack of marketability). MWE concluded that a dollar-for-dollar discount for the built-in LTCG tax was appropriate because:

> The adjusted book value method is based on the inherent assumption that the assets will be liquidated, which automatically gives rise to a tax liability predicated upon the built-in capital gains that result from appreciation in the assets. This was clearly recognized in the decision of the United States Court of Appeals for the Fifth Circuit in the case of the Estate of Dunn v. Commissioner, * * * [which allowed a 34-percent discount]. [Citation omitted.]

MWE did not use any income methods to value the estate's interest in Wa-Klo because it concluded that: (1) Wa-Klo did not generate substantial cashflows from its operation of Camp Wa-Klo; (2) the best use of Wa-Klo could be derived from a sale of its assets because its operating performance declined in fiscal years 2004 and 2005 and because the "profitability benchmark" for summer camps with revenues below $1 million was only 5.3 percent; (3) Wa-Klo's value was driven by the appreciated value of its assets; and (4) the estate's 82-percent interest in Wa-Klo was a controlling interest.

MWE did not use any market methods to value the estate's 82-percent interest in Wa-Klo because it concluded that: (1) Wa-Klo owned a specific asset, appreciated real estate, that had a

specific appraised value; and (2) the market method was incorporated into Whitney Associates' appraisal of the real estate.

As of the date of decedent's death, neither a sale or liquidation of Wa-Klo nor a sale of its assets was imminent or planned. There is no evidence in the record of any arm's-length sale of Wa-Klo's common stock near the date of decedent's death.

The executrix filed a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. The executrix initially reported a value of $2,600,000 for the estate's 82-percent interest in Wa-Klo (after discounts for lack of marketability and built-in LTCG tax) based on MWE's appraisal. The executrix filed an amended Form 706 and reduced the value of the estate's interest in Wa-Klo to $2,554,317, reporting a total taxable estate of $4,296,449 and a Federal estate tax liability of $1,306,736.

Respondent examined the amended Form 706 and determined a value of $3,268,465 for the estate's interest in Wa-Klo (after a discount for lack of marketability of 5 percent and a discount of $250,042[6] for built-in LTCG tax). He determined the estate tax deficiency of $333,244.59 and sent the executrix a notice of deficiency.

[6] There is no evidence in the record as to how respondent determined the $250,042 discount for built-in LTCG tax.

Respondent's expert, KTS, like the estate's expert, used a cost method to value the estate's interest in Wa-Klo. Using the financial statements prepared by MWE, KTS also calculated Wa-Klo's net asset value at $4,243,969 (before discounts for lack of marketability and built-in LTCG tax).

KTS then analyzed data for other investments that have exposure to built-in capital gains to determine the discount for the built-in LTCG tax. Specifically, KTS undertook to measure the amount by which the built-in LTCG tax exposure of each of six closed-end funds[7] depressed the value of the closed-end funds in relation to their net asset values. As shown in the table infra note 8, KTS found that the built-in capital gains exposure for those six closed-end funds ranged from 10.7 to 41.5 percent. KTS also found that two of the closed-end funds with high built-in capital gains exposure, Royce Value Trust and Gabelli Equity Trust, were selling at a premium to net asset value, while the closed-end fund with the least built-in capital gains exposure, Tri-Continental Corp., was selling at the highest discount from net asset value. On the basis of those findings, KTS concluded that it was "unable to find a direct correlation, at least up to

[7] A closed-end fund is a type of investment company with the following characteristics: (1) Not continuously offered; (2) secondary market pricing; (3) not redeemable; (4) trading during the day; and (5) greater illiquidity. See Moriarty & McNeily, Closed-End Mutual Funds, 19 Reg. Fin. Pl. § 3:422 (May 2010).

41.5 percent of net asset value, between higher exposure to built-in capital gains tax and discounts from net asset value" among the six closed-end funds that it examined.[8]

KTS also compared closed-end funds that primarily hold real estate investments with those that hold non-real-estate financial securities. As shown in the table infra note 9, KTS found, as between those two categories of funds, that the discounts from net asset value were generally larger for closed-end funds that primarily held real estate investments.[9]

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[8] KTS' analysis was based on the following six closed-end funds:

Fund	Net asset value	Stock price	Percent difference	Percent unrealized investment appreciation
Adams Express	15.49	13.29	-14.20	25.8
Gabelli Equity Trust	8.83	9.07	.72	26.2
General American Investors	39.32	34.18	-13.10	41.5
Liberty All-Star Equities	9.06	9.5	4.90	13.8
Royce Value Trust	19.02	20.15	5.90	36.7
Tri-Continental Corp.	22.02	18.46	-16.20	10.7

[9] KTS calculated the following range of values:

(continued...)

KTS divided the $2,800,000 value of Wa-Klo's real estate and its improvements (net of basis) by Wa-Klo's $4,243,969 net asset value and concluded that 66 percent of that net asset value was subject to tax at the corporate and shareholder levels. KTS concluded that with a built-in capital gain equal to 66 percent of Wa-Klo's net asset value, a discount would be considered by a prudent willing buyer. KTS opined that since it could not find, from its examination of the closed-end funds listed supra note 8, any direct correlation between exposure to built-in capital gains tax and discounts from net asset value at levels of exposure of 41.5 percent or less, KTS could not conclude that any consideration should be given for Wa-Klo's built-in LTCG tax exposure up to 41.5 percent of its net asset value. But KTS opined that full consideration (i.e., a dollar-for-dollar discount) should be given for Wa-Klo's built-in LTCG tax exposure above 41.5 percent.

KTS found that the portion of Wa-Klo's exposure to built-in LTCG tax in excess of 41.5 percent of net asset value was 24.5

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[9](...continued)

Percent discount from net asset value	Specialized equity funds	Specialized equity funds holding real estate
Minimum	-16.0	-16.8
Mean	-6.1	-14.8
Median	-8.9	-15.2
Maximum	32.5	-10.8
Fund count	30	11

percent (66% - 41.5%). KTS multiplied 24.5 percent by Wa-Klo's $4,243,969 net asset value for a total of $1,039,772. KTS applied a combined State and Federal tax rate of 40 percent and calculated a combined tax liability of $415,909 (40% x $1,039,772), which it concluded was 9.8 percent of Wa-Klo's $4,243,969 net asset value ($415,909 ÷ $4,243,969).

KTS concluded that the estate was entitled to a discount of 10 percent (i.e., $424,397, about 45 percent of the built-in LTCG tax). KTS reasoned that a 10-percent discount was supported by the fact that the difference in the mean or average discount between closed-end funds with investments in real estate and those with investments in marketable securities was 8.7 percent (14.8% - 6.1%) or 9 percent rounded. See supra note 9.

KTS also opined in its report that generally there are methods to avoid paying the built-in LTCG tax by engaging in a section 1031 like-kind exchange or by converting a C corporation to an S corporation. It also acknowledged that there are certain limits to avoidance. For example, a like-kind exchange "limits the properties which may be acquired to those whose owner also [wished] to make" an exchange, and conversion to S corporation status requires a 10-year holding period before the potential tax liability would be eliminated. KTS did not, however, discuss in its report whether a like-kind exchange or conversion to S

corporation status was a viable method for a hypothetical purchaser of the estate's Wa-Klo stock.

At trial, KTS discovered that the adjusted balance sheet prepared by MWE incorrectly listed the restated value for the land, buildings, and salvage value of the equipment as $3,776,793 whereas the correct value was $3,305,000. See supra note 1. Accordingly, KTS opined that Wa-Klo's correct net asset value was $3,772,176 and calculated a revised discount of 13 percent for the built-in LTCG tax (i.e., $490,382.88 (about 50 percent of the built-in LTCG tax)). Respondent on brief asserts the correct discount for the built-in LTCG tax attributable to the estate's 82-percent interest in Wa-Klo is about $402,114 ($490,383 x 82%).

OPINION

I. Burden of Proof

As a general rule, a notice of deficiency is entitled to a presumption of correctness, and the taxpayer bears the burden of proving the Commissioner's deficiency determinations incorrect. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933). Section 7491(a), however, provides that if a taxpayer introduces credible evidence and meets certain other prerequisites, the Commissioner shall bear the burden of proof with respect to

factual issues[10] relating to the taxpayer's liability for a tax imposed under subtitle A or B of the Code.

Our conclusions are based on a preponderance of the evidence, and thus the allocation of the burden of proof is immaterial. See Estate of Bongard v. Commissioner, 124 T.C. 95, 111 (2005).

II. FMV of the Estate's 82-Percent Interest in Wa-Klo

A. General Principles

Property includable in the value of a decedent's gross estate is to be valued as of the date of the decedent's death. Sec. 2031(a). For purposes of the estate tax, property value is determined by finding 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 to sell, and both having reasonable knowledge of relevant facts. Sec. 20.2031-1(b), Estate Tax Regs. The willing buyer and willing seller are hypothetical persons. Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990) (citing Estate of Bright v. United States, 658 F.2d 999, 1006 (5th Cir. 1981)). The hypothetical buyer and seller are presumed to be dedicated to

[10] Valuation is a factual determination, and the trier of fact must weigh all relevant evidence and draw appropriate inferences. Estate of Deputy v. Commissioner, T.C. Memo. 2003-176.

achieving the maximum economic advantage. Id. (citing Estate of Curry v. United States, 706 F.2d 1424, 1429 (7th Cir. 1983)).

B. Expert Opinions Generally

Each party relies on an expert opinion to determine the discount for built-in LTCG tax that the estate is entitled to. In deciding valuation cases, courts often look to the opinions of expert witnesses. We evaluate expert opinions in the light of all the evidence in the record, and we are not bound by the opinion of any expert witness. Helvering v. Natl. Grocery Co., 304 U.S. 282, 295 (1938); Shepherd v. Commissioner, 115 T.C. 376, 390 (2000), affd. 283 F.3d 1258 (11th Cir. 2002). The persuasiveness of an expert's opinion depends largely upon the disclosed facts on which it is based. Estate of Davis v. Commissioner, 110 T.C. 530, 538 (1998). We may reject, in whole or in part, any expert opinion. See id. Because valuation necessarily involves an approximation, the figure at which we arrive need not be directly traceable to specific testimony or a specific expert opinion if it is within the range of values that may be properly derived from consideration of all the evidence. Estate of True v. Commissioner, T.C. Memo. 2001-167, affd. 390 F.3d 1210 (10th Cir. 2004) (citing Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo. 1974-285).

C. The Estate's Arguments

The estate raises the following arguments against respondent's valuation. First, the estate argues that it is entitled to a 100-percent discount (i.e., $1,133,283), or something very close thereto, for the built-in LTCG tax pursuant to the Court of Appeals for the Second Circuit's decision in Eisenberg v. Commissioner, 155 F.3d 50 (2d Cir. 1998), vacating T.C. Memo. 1997-483.[11] Second, according to the estate, if given the opportunity to review the discount for built-in capital gains tax issue again, that court would consider the recent decisions in Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002), revg. T.C. Memo. 2000-12, and Estate of Jelke v. Commissioner, 507 F.3d 1317 (11th Cir. 2007), vacating T.C. Memo. 2005-131, which allowed discounts for the built-in LTCG tax in full, and might adopt the approach of those courts. Third, the estate argues that respondent's expert's reliance on closed-end funds to determine the discount for the built-in LTCG tax is misplaced. Finally, the estate argues that respondent's reliance on alternate methods, such as a section 1031 like-kind exchange, to avoid or defer payment of the built-in LTCG tax is also

[11] Under the Golsen rule, we follow the law of the circuit in which the case is appealable, here the Second Circuit. See Golsen v. Commissioner, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971).

misplaced. Naturally, respondent has asserted arguments to the contrary. We now turn to analyzing the parties' contentions.

1. Built-In LTCG Tax Generally

The General Utilities doctrine,[12] as codified in former sections 336 and 337, allowed the tax-free liquidation of a corporation, and thus, the complete avoidance of corporate-level capital gains. See Eisenberg v. Commissioner, supra at 54-55. Before the General Utilities doctrine was repealed in the Tax Reform Act of 1986, Pub. L. 99-514, sec. 631, 100 Stat. 2269, we consistently rejected taxpayers' attempts to discount a corporation's value on the basis of any inherent capital gain tax liability. We noted that the liability could be avoided at the corporate level by employing that doctrine. See, e.g., Estate of Piper v. Commissioner, 72 T.C. 1062, 1087 n.27 (1979). In Estate of Davis v. Commissioner, supra, however, we allowed a discount for the built-in LTCG tax liability on the basis of the facts and circumstances.[13]

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[12] The General Utilities doctrine originated in General Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935).

[13] Since Estate of Davis v. Commissioner, 110 T.C. 530 (1998), we have frequently applied a present-value approach based on all the facts and circumstances in subsequent valuation cases to determine the taxpayer's discount for the built-in LTCG tax liability. See Estate of Litchfield v. Commissioner, T.C. Memo. 2009-21; Estate of Jelke v. Commissioner, T.C. Memo. 2005-131, vacated 507 F.3d 1317 (11th Cir. 2007); Estate of Borgatello v. Commissioner, T.C. Memo. 2000-264; Estate of Dunn v. Commissioner, T.C. Memo. 2000-12, revd. 301 F.3d 339 (5th Cir.

(continued...)

Subsequently, the Court of Appeals for the Second Circuit held that a discount for built-in capital gains tax was allowable. See Eisenberg v. Commissioner, supra at 57-59 (citing Estate of Davis v. Commissioner, supra). The court reasoned that since the General Utilities doctrine was repealed, a hypothetical willing buyer would likely pay less for the shares of a corporation because of the contingent capital gains tax liability. Id. It also reasoned that the contingent liability was not too speculative to preclude a discount. Id. The court opined:

> Where there is a relatively sizable number of potential buyers who can avoid or defer the tax, the fair market value of the shares might well approach the pre-tax market value of the real estate. Potential buyers who could avoid or defer the tax would compete to purchase the shares, albeit in a market that would include similar real estate that was not owned by a corporation. However, where the number of potential buyers who can avoid or defer the tax is small, the fair market value of the shares might be only slightly above the value of the real estate net of taxes. In any event, all of these circumstances should be determined as a question of valuation * * * [Emphasis added.[14]]

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[13](...continued)
2002); Estate of Jameson v. Commissioner, T.C. Memo. 1999-43, vacated 267 F.3d 366 (5th Cir. 2001). In the latter cases, we have projected the tax liability into future years, in some cases allowing for appreciation of the assets, and discounted the built-in LTCG tax liability to its present value as of the valuation date.

[14] The Court of Appeals for the Second Circuit, however, did not prescribe the method to calculate the discount.

Id. at 59 n.16. The court did not determine the amount of the discount and remanded the matter to our Court.

As stated supra, the estate asks us to embrace the dollar-for-dollar approach for valuations adopted by the Court of Appeals for the Eleventh Circuit in Estate of Jelke v. Commissioner, supra, and applied by the Court of Appeals for the Fifth Circuit in Estate of Dunn v. Commissioner, supra, and to speculate as to how the Court of Appeals for the Second Circuit might now rule in view of those decisions.

Respondent, on the other hand, asserts that the estate's position is inconsistent with Eisenberg and, citing Golsen v. Commissioner, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), asserts that the Court must follow the rule of the Second Circuit.

We decline to speculate as to how the Court of Appeals for the Second Circuit may hold in the future. See Estate of Charania v. Commissioner, 608 F.3d 67, 75 (1st Cir. 2010) (and cases cited thereat), affg. in part and revg. in part 133 T.C. 122 (2009). But we shall consider the parties' positions in view of Eisenberg and this Court's prior decisions.

2. Use of Closed-End Funds To Value the Estate's Interest

As stated supra, the estate argues that KTS' calculation of a $490,382.88 discount for Wa-Klo's built-in LTCG tax using data collected for certain closed-end funds is erroneous.

Under the facts of this case, we agree and do not believe that the closed-end funds are comparable to the estate's interest in Wa-Klo. First, Wa-Klo operates a summer day camp, and its assets consist mainly of the single parcel of real estate, its related improvements, and equipment. See sec. 2031(b); Rev. Rul. 59-60, sec. 4.02(h), 1959-1 C.B. 237, 242 (stock of a closely held corporation should be valued by taking into consideration, in addition to other factors, the value of stock of publicly traded corporations engaged in the same or similar lines of business). Closed-end funds, on the other hand, typically invest in various sectors (e.g., utilities and healthcare) and in various asset classes (e.g., securities, real estate, and fixed income).[15] See Schonfeld & Kerwin, "Organization of a Mutual Fund", 49 Bus. Law. 107, 113 (1993).[16] Moreover, closed-end funds invest indirectly in real estate through real estate investment trusts and typically hold multiple investments in

[15] Indeed, the closed-end funds that KTS selected invested in various business sectors including energy, healthcare, and utilities.

[16] For information about closed-end funds generally see "The Closed-End Fund Market, 2009", ICI Research Fundamentals, Vol. 19, No. 4 (2010), available at http://www.ici.org/pdf/fm-v19n4.pdf; Closed-End Fund Types and Strategies, CEFConnect.com, available at http://www.cefconnect.com/Education/TypesStrategiesCEF.aspx, and Charles, Wortz, & Kemler, "Closed-End Funds 101", Equity Research, June 30, 2009, available at http://www.closed-endfunds.com/_/docs/content/Learn/ResearchArticles/CEF101_0630.pdf?time=20100707100637.

various types of real estate such as office complexes, apartment buildings, and shopping centers.[17] Second, discounts from a closed-end fund's net asset value are attributable to several factors including supply and demand, manager or fund performance, investor confidence, or liquidity. See Kraakman, "Taking Discounts Seriously: The Implications of 'Discounted' Share Prices as an Acquisition Motive", 88 Colum. L. Rev. 891, 902-905 (1988); Smith, "A Capital Markets Approach to Mass Tort Bankruptcy", 104 Yale L.J. 367, 412-413 (1994). Moreover, studies on the effects of unrealized capital gains on the discounts from a closed-end fund's net asset value are inconclusive. See Kraakman, supra at 904; Smith, supra at 413. Consequently, we do not accord KTS' valuation much weight.

3. Alternate Methods To Avoid Payment of the Built-In LTCG Tax

Respondent, on the basis of his expert's report and testimony, argues that the discount for Wa-Klo's built-in LTCG tax is significantly less than $1,133,283 (or 100 percent) since there are, according to respondent, numerous methods by which potential buyers of the estate's Wa-Klo stock could avoid or defer the tax.

The suggested methods can at best only defer the recognition of the built-in LTCG tax, which we think a hypothetical seller

[17] For the definition of a real estate investment trust see sec. 856.

and buyer would consider in their negotiations. See Estate of Davis v. Commissioner, 110 T.C. at 550; Estate of Litchfield v. Commissioner, T.C. Memo. 2009-21; cf. Estate of Jones v. Commissioner, 116 T.C. 121, 136-138 (2001) (the hypothetical buyer and seller of certain partnership interests would negotiate with the understanding that a section 754 election, which would eliminate any gains for the purchaser, would be made and the price would not reflect a discount for built-in capital gains). Moreover, each method has its limitations, which a hypothetical seller and buyer would also consider in their negotiations.[18] Eisenberg v. Commissioner, 155 F.3d at 56; Estate of Jameson v. Commissioner, T.C. Memo. 1999-43, vacated 267 F.3d 366 (5th Cir. 2001).

In short, we are not convinced that any viable method for avoidance of the built-in LTCG tax exists for a hypothetical buyer of the estate's Wa-Klo stock. Thus, we do not think that

[18] For example, electing S corporation status would require the unanimous consent of Wa-Klo's shareholders, and the impact of sec. 469 or 1374 might affect the decision to convert Wa-Klo from C to S corporation status. See Eisenberg v. Commissioner, 155 F.3d 50, 56 (2d Cir. 1988), vacating T.C. Memo. 1997-483; Estate of Jameson v. Commissioner, T.C. Memo. 1999-43. Sec. 1031 would require both a willing exchanger and availability of property of the same nature and character. See Fredericks v. Commissioner, T.C. Memo. 1994-27; Greene v. Commissioner, T.C. Memo. 1991-403; sec. 1.1031(a)-1(b), Income Tax Regs.; see also C. Bean Lumber Transp., Inc. v. United States, 68 F. Supp. 2d 1055, 1058-1059 (W.D. Ark. 1999).

the discount for the built-in LTCG tax is significantly reduced as respondent argues.

D. The Estate's Discount for the Built-In LTCG Tax

As stated supra, the estate argues that it is entitled to a 100-percent discount (i.e., $1,133,283), or something very close thereto, for the built-in LTCG tax.

As also stated supra, we do not give much weight to respondent's expert's valuations. Aside from the flaws discussed supra, respondent's expert did not account for the likelihood that Wa-Klo's assets would appreciate (and that concomitantly the built-in LTCG tax would increase) nor take into account time value of money concepts. See Estate of Litchfield v. Commissioner, T.C. Memo. 2009-21; Estate of Borgatello v. Commissioner, T.C. Memo. 2000-264. We may assume arguendo, on the evidence in the record, that a present-value approach is applicable to determine the estate's discount for the built-in LTCG tax. Taking into account all the facts and circumstances, we have determined a range of values as follows.[19] We have

[19] We agree with both experts that a cost method rather than an income method or a market method should be used to determine the value of the estate's interest in Wa-Klo. See Rev. Rul. 59-60, sec. 5, 1959-1 C.B. 237, 242-243 ("The value of the stock of a closely held investment or real estate holding company * * * is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company.").

calculated future values of the $3,300,000[20] fair market value of the land and the related improvements using interest (or appreciation) rates of 5[21] and 7.725[22] percent compounded annually over 17 years as follows: $7,563,660.44 and $11,692,152.92, respectively.[23] See Estate of Litchfield v. Commissioner, supra;

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[20] This amount is based on the formula $FV = P(1+r)^y$ where P is the principal, r is the rate of interest, and y is the compound period in years. See, e.g., Hall v. Birchfield, 718 S.W.2d 313, 340 (Tex. App. 1986).

We also note that neither expert discussed the amount of the built-in LTCG tax, if any, attributable to the $5,000 of equipment; thus, we do not do so either.

[21] Whitney Associates applied a 5-percent appreciation rate in its sale comparison analysis.

[22] We have calculated an average 7.725-percent pretax return of income based on the data provided by MWE using the following: 7.8% (2001) + 9.3% (2002) + 8.8% (2003) + 5.0% (2004). We did not include as outliers the 1.6- and the 63.3-percent figures for 2005.

[23] We have calculated an average useful or depreciable life remaining in the real estate and its related improvements of 16.6 years, which we have rounded up to 17 years, using the depreciation figures estimated by Whitney Associates in its cost method and allowing zero as the depreciation allowance for the real estate. See Estate of Borgatello v. Commissioner, T.C. Memo. 2000-264 (applying a 1.75-percent capitalization rate and a 24-percent discount rate based on the evidence in the record). Neither party introduced evidence of a turnover period. We therefore use 17 years as a proxy for the turnover rate on the theory that an asset would be retired once its useful life is exhausted. See Estate of Litchfield v. Commissioner, T.C. Memo. 2009-21 (accepting expert's estimated annual turnover or sale rates for the assets); Estate of Borgatello v. Commissioner, supra n.10 (assuming a 10-year holding period). We apply it to the real estate and its related improvements because neither party has provided evidence allocating the $3,300,000 value among the real estate and its related improvements, evidence allocating

(continued...)

[23](...continued)
the estimated tax basis of $500,000 among the real estate and its related improvements, or evidence allocating the built-in LTCG tax among the real estate and its related improvements. Cf. Gates v. Commissioner, 135 T.C. __, __ n.18 (2010) (slip op. at 23 (Court would not allocate gain among the real estate and the house because the parties did not provide evidence to allow for an allocation).

Property/improvement	Depreciable years
Grandpa's House	15
Boy's Dorm	20
Maintenance Garage	15
All Inn	15
Chatter Box	20
Cracker Barrel	25
Sleepy Hollow	15
Round Up	25
Pill Box	25
Chez	15
Chez Chenet	2
Candy Shack	25
Archery	25
Rifle Range	25
Stables	25
Mouse Trap	15
Danson	15
Hilltop	15
Tippit	15
Bobbin	15
Arrowhead	15
Shower House	25
Somewhere	15
All Out	15
Pop Out	15
Wayside	15
Jenn-Klo	15
Sideout	15
Wayout	20
Far Out	20
Driftwood	20
Roy's Kitchen	3
Bike Barn	20
Work Out	3

(continued...)

Estate of Borgatello v. Commissioner, supra.

After taking into account the future values of $7,563,660.44 and $11,692,152.92 and the estimated tax basis of $500,000, we have calculated long-term capital gains of $7,063,660.44 and $11,192,152.92, respectively. See sec. 1001(a).

The parties have represented that the combined Federal and State tax rate is 40 percent. Applying a 40-percent tax rate to the long-term capital gains of $7,063,660.44 and $11,192,152.92, we have determined tax liabilities of $2,825,464.18, and $4,476,861.17, respectively.

Applying discount rates of 5 and 7.725 percent compounded annually over 17 years to the built-in LTCG tax liabilities of $2,825,464.18 and $4,476,861.17, we have determined present values[24] (or discounts) for those built-in LTCG tax liabilities of $1,232,740.66 and $1,263,551.88, respectively.[25] See Estate of Litchfield v. Commissioner, supra; Estate of Borgatello v. Commissioner, supra.

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[23](...continued)

Real estate	-0-
Total	583

583 (total depreciable years) ÷ 35 (total properties) = 16.7.

[24] These values are based on the formula Present Value = Future Value ÷ $(1 + r)^n$ where n is the compound period in years and r is the interest rate.

[25] We note that the estate's share of that discount is 82 percent.

As stated supra, KTS calculated a discount of $490,382.88 for the built-in LTCG tax. The estate, on the other hand, now asserts that it is entitled to a discount of $1,133,283 for State and Federal taxes. See supra note 5.

On the basis of the range of values we and the parties have calculated, we accept the estate's value for the built-in LTCG tax discount of $1,133,283 because although not precise, it is within the range of values that may be derived from the evidence (and the estate did not argue for a greater amount).[26] See Estate of Davis v. Commissioner, 110 T.C. at 537; see also Estate of Litchfield v. Commissioner, supra; Estate of Borgatello v. Commissioner, supra. We do not give much weight to the $490,382.88 discount that KTS calculated. The estate's share of that $1,133,283 discount is $929,292.06 (82 percent x $1,133,283).

To reflect the foregoing,

Decision will be entered under Rule 155.

[26] Applying a compound period of zero (assuming an immediate sale of the assets), with either interest rate the present value of the built-in LTCG is $1,200,000.

116 T.C. No. 11

UNITED STATES TAX COURT

ESTATE OF W.W. JONES II, DECEASED, A.C. JONES IV, INDEPENDENT EXECUTOR, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13926-98. Filed March 6, 2001.

D formed a family limited partnership (JBLP) with his son and transferred assets including real property, to JBLP in exchange for a 95.5389-percent limited partnership interest. D also formed a family limited partnership (AVLP) with his four daughters and transferred real property to AVLP in exchange for an 88.178-percent limited partnership interest. D's son contributed real property in exchange for general and limited partnership interests in JBLP, and the daughters contributed real property in exchange for general and limited partnership interests in AVLP. All of the contributions were properly reflected in the capital accounts of the contributing partners. Immediately after formation of the partnerships, D transferred by gift an 83.08-percent limited partnership interest in JBLP to his son and a 16.915-percent limited partnership interest in AVLP to each of his daughters.

Held: The transfers of property to the partnerships were not taxable gifts. See Estate of Strangi v. Commissioner, 115 T.C. 478 (2000).

Held, further, sec. 2704(b), I.R.C., does not apply to this transaction. See Kerr v. Commissioner, 113 T.C. 449 (1999).

Held, further, the value of D's gift to his son was 83.08-percent of the value of the underlying assets of JBLP, reduced by a lack-of-marketability (8%) discount. The value of D's gift to each of his daughters was 16.915 percent of the value of the underlying assets of AVLP, reduced by secondary market (40%) and lack-of-marketability (8%) discounts.

Held, further, the gifts of limited partnership interests are not subject to additional lack-of-marketability discounts for built-in capital gains. Estate of Davis v. Commissioner, 110 T.C. 530 (1998), distinguished.

William R. Cousins III, Robert Don Collier, Robert M. Bolton, and Todd A. Kraft, for petitioner.

Deborah H. Delgado and Gerald L. Brantley, for respondent.

COHEN, Judge: Respondent determined a deficiency of $4,412,527 in the 1995 Federal gift tax of W.W. Jones II. The issues for decision are (alternatively): (1) Whether the transfers of assets on formation of Jones Borregos Limited Partnership (JBLP) and Alta Vista Limited Partnership (AVLP) (collectively, "the partnerships") were taxable gifts pursuant to section 2512(b); (2) whether the period of limitations for assessment of gift tax deficiency arising from gifts on formation

is closed; (3) whether restrictions on liquidation of the partnerships should be disregarded for gift tax valuation purposes pursuant to section 2704(b); and (4) the fair market value of interests in the partnerships transferred by gift after formation. Unless otherwise indicated, all section references are to the Internal Revenue Code in effect on the date of the transfers, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulated facts are incorporated in our findings by this reference. W.W. Jones II (decedent), resided in Corpus Christi, Texas, at the time the petition in this case was filed. Decedent subsequently died on December 17, 1998, and a motion to substitute the estate of W.W. Jones II, deceased, A.C. Jones IV, independent executor, as petitioner was granted. The place of probate of decedent's estate is Nueces County, Texas. At the time of his appointment as executor, A.C. Jones IV (A.C. Jones), also resided in Nueces County, Texas.

For most of his life, decedent worked as a cattle rancher in southwest Texas. Decedent had one son, A.C. Jones, and four daughters, Elizabeth Jones, Susan Jones Miller, Kathleen Jones Avery, and Lorine Jones Booth.

During his lifetime, decedent acquired, by gift or bequest, the surface rights to several large ranches, including the Jones Borregos Ranch, consisting of 25,669.49 acres, and the Jones Alta Vista Ranch, consisting of 44,586.35 acres. These ranches were originally acquired by decedent's grandfather and have been held by decedent's family for several generations. The land on these ranches is arid natural brushland, and commercial uses include raising cattle and hunting.

Motivated by his desire to keep the ranches in the family, decedent became involved in estate planning matters beginning in 1987. In 1994, decedent's certified public accountant suggested that decedent use partnerships as estate and business planning tools. Following up on this suggestion, A.C. Jones prepared various projections for decedent concerning a hypothetical transfer of the ranches to partnerships and the discounted values that would attach to the partnership interests for gift tax purposes.

A.C. Jones, Elizabeth Jones, Susan Jones Miller, Kathleen Jones Avery, and Lorine Jones Booth each owned a one-fifth interest in the surface rights of the Jones El Norte Ranch. They acquired this ranch by bequest from decedent's aunt in 1979. The Jones El Norte Ranch was also originally owned by decedent's grandfather and has also been owned by decedent's extended family for several generations.

Effective January 1, 1995, decedent and A.C Jones formed JBLP under Texas law. Decedent contributed the surface estate of the Jones Borregos Ranch, livestock, and certain personal property in exchange for a 95.5389-percent limited partnership interest. The entire contribution was reflected in the capital account of decedent. A.C. Jones contributed his one-fifth interest in the Jones El Norte Ranch in exchange for a 1-percent general partnership interest and a 3.4611-percent limited partnership interest.

On January 1, 1995, the same day that the partnership was effectively formed, decedent gave to A.C. Jones an 83.08-percent interest in JBLP, leaving decedent with a 12.4589-percent limited partnership interest. Decedent used a document entitled "Gift Assignment of Limited Partnership Interest" to carry out the transfer. The document stated that decedent intends that A.C. Jones receive the gift as a limited partnership interest.

Federal income tax returns for 1995, 1996, 1997, and 1998 were filed for JBLP and signed by A.C. Jones as tax matters partner. Attached to each return were separate Schedules K-1 for each general partnership interest and each limited partnership interest. The Schedules K-1 for the limited partnership interest of A.C. Jones included the interest in partnership received by gift from decedent.

Also effective January 1, 1995, decedent and his four daughters formed AVLP under Texas law. Decedent contributed the surface estate of the Jones Alta Vista Ranch in exchange for an 88.178-percent limited partnership interest. The contribution was reflected in decedent's capital account. Susan Jones Miller and Elizabeth Jones each contributed their one-fifth interests in the Jones El Norte Ranch in exchange for 1-percent general partnership interests and 1.9555-percent limited partnership interests, and Kathleen Jones Avery and Lorine Jones Booth each contributed their one-fifth interest in the Jones El Norte Ranch in exchange for 2.9555-percent limited partnership interests. The following chart summarizes the ownership structure of AVLP immediately after formation:

Partner	Percentage	Interest
Elizabeth Jones	1.0	General
	1.9555	Limited
Susan Jones Miller	1.0	General
	1.9555	Limited
Kathleen Jones Avery	2.9555	Limited
Lorine Jones Booth	2.9555	Limited
Decedent	88.178	Limited

On January 1, 1995, the same day that the partnership was effectively formed, decedent gave to each of his four daughters a 16.915-percent interest in AVLP, leaving decedent with a 20.518-percent limited partnership interest. Decedent used four separate documents, one for each daughter, entitled "Gift Assignment of Limited Partnership Interest" to carry out the

transfers. Each document stated that decedent intended for his daughters to receive the gifts as limited partnership interests.

Federal income tax returns for 1995, 1996, 1997, and 1998 were filed for AVLP and signed by Elizabeth Jones as tax matters partner. Attached to each return were separate Schedules K-1 for each general partnership interest and each limited partnership interest. The Schedules K-1 for each daughter's limited partnership interest included the partnership interest received by gift from decedent.

Decedent's attorney drafted the partnership agreements of both JBLP and AVLP with the intention of creating substantial discounts for the partnership interests that were transferred by gift. Both partnership agreements set forth conditions for when an interest that is transferred by gift or by other methods may convert to a limited partnership interest. Section 8.3 of the JBLP agreement provides that the general partner and 100 percent of the limited partners must approve the conversion to a limited partnership interest in writing, and section 8.3 of the AVLP agreement provides that the general partners and 75 percent of the remaining limited partners must approve the conversion in writing. Both agreements also require that an assignee execute a writing that gives assurances to the other partners that the assignee has acquired such interest without the intention to distribute such interest, and the assignee must execute a

counterpart to the partnership agreement adopting the conditions therein.

Sections 8.4 and 8.5 of the partnership agreements provide that, before a partner may transfer an interest in the partnerships to anyone other than decedent or any lineal descendant of decedent, the partnership or remaining partners shall have the option to purchase the partnership interest for the lesser of the agreed upon sales price or appraisal value. The partnership may elect to pay the purchase price in 10 annual installments with interest set at the minimum rate allowed by the rules and regulations of the Internal Revenue Service.

Section 9.2 of the agreements provides that the partnerships will continue for a period of 35 years. Section 9.3 provides that a limited partner will not be permitted to withdraw from the partnership, receive a return of contribution to capital, receive distributions in liquidation, or redemption of interest except upon dissolution, winding up, and termination of the partnership.

Section 9.4 of the partnership agreements provides for the removal of a general partner and the dissolution of the partnership. The AVLP agreement provides that a general partner may be removed at any time by the act of partners owning an aggregated 75-percent interest in the partnership. The JBLP agreement provides that a general partner may be removed at any time by the act of the partners owning an aggregated 51-percent

interest in the partnership. After removal, if there is no remaining general partner, the remaining limited partners shall designate a successor general partner. If the limited partners fail to designate a successor general partner within 90 days, the partnership will dissolve, affairs will be wound up, and the partnership will terminate. Except upon dissolution, windup, and termination, both partnership agreements prohibit a limited partner from withdrawing and receiving a return of capital contribution, distribution in liquidation, or a redemption of interest.

Section 5.4 of the AVLP agreement originally provided that the general partners could not sell any real property interest that was owned by the partnership without first obtaining the consent of partners owning a majority interest in the partnership. This section was later amended so that partners owning 85 percent of the partnership must consent to a sale of real property.

On January 1, 1995, the Jones Alta Vista Ranch had a fair market value of $10,254,860, and the Jones Borregos Ranch, livestock, and personal property that were contributed by decedent to JBLP had a fair market value of $7,360,997. Neither partnership ever made a section 754 election. At the time that decedent transferred interests in the partnerships by gift to his children, the net asset values (NAV) of the underlying

partnership assets that were held by AVLP and JBLP were $11,629,728 and $7,704,714, respectively. JBLP and AVLP had bases in their assets of $562,840 and $1,818,708, respectively.

Attached to his 1995 Federal gift tax return, decedent included a valuation report prepared by Charles L. Elliott, Jr. (Elliott), who also testified as the estate's expert at trial. The partnerships were valued on the return and by Elliott at trial using the NAV method on a "minority interest, nonmarketable" basis. Nowhere in his report did Elliott purport to be valuing assignee interests in the partnership. The valuation report arrived at an NAV for the partnerships and then applied secondary market, lack-of-marketability, and built-in capital gains discounts. The expert report concluded that a 66-percent discount from NAV is applicable to the interest in JBLP and that a 58-percent discount is applicable to the interest in AVLP. On the return, decedent reported gifts of "an 83.08 percent limited partnership interest" in JBLP valued at $2,176,864 and a "16.915 percent limited partnership interest" in AVLP to each of his four daughters, valued at $821,413 per interest.

In an affidavit executed on January 12, 1999, A.C. Jones stated that the gifts that he and his sisters received from decedent were "limited partnership interests". The sole activity

of AVLP is the rental of its real property. AVLP produces an average annual yield of 3.3 percent of NAV.

OPINION

Gift at the Inception of the Partnerships

In an amendment to the answer, respondent contends that decedent made taxable gifts upon contributing his property to the partnerships. Using the value reported by decedent on his gift tax return, respondent argues that, if decedent gave up property worth $17,615,857 and received back limited partnership interests worth only $6,675,156, decedent made taxable gifts upon the formation of the partnerships equal to the difference in value.

In Estate of Strangi v. Commissioner, 115 T.C. 478, 489-490 (2000), a decedent formed a family limited partnership with his children and transferred assets to the partnership in return for a 99-percent limited partnership interest. After his death, his estate claimed that, due to lack-of-control and lack-of-marketability discounts, the value of the limited partnership interest was substantially lower than the value of the property that was contributed by the decedent. The Commissioner argued that the decedent had made a gift when he transferred property to the partnership and received in return a limited partnership interest of lesser value. The Court held that, because the taxpayer received a continuing interest in the family limited partnership and his contribution was allocated to his own capital

account, the taxpayer had not made a gift at the time of contribution.

In Shepherd v. Commissioner, 115 T.C. 376, 379-381 (2000), the taxpayer transferred real property and stock to a newly formed family partnership in which he was a 50-percent owner and his two sons were each 25-percent owners. Rather than allocating contributions to the capital account of the contributing partner, the partnership agreement provided that any contributions would be allocated pro rata to the capital accounts of each partner according to ownership. Because the contributions were reflected partially in the capital accounts of the noncontributing partners, the value of the noncontributing partners' interests was enhanced by the contributions of the taxpayer. Therefore, the Court held that the transfers to the partnership were indirect gifts by the taxpayer to his sons of undivided 25-percent interests in the real property and stock. See id. at 389.

The contributions of property in the case at hand are similar to the contributions in Estate of Strangi and are distinguishable from the gifts in Shepherd. Decedent contributed property to the partnerships and received continuing limited partnership interests in return. All of the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interests was not

enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts.

Because the contributions do not reflect taxable gifts, we need not decide whether the period of limitations for assessment of a deficiency due to a gift on formation has expired.

Section 2704(b)

Respondent determined in the statutory notice, and argues in the alternative, that provisions in the partnership agreements constitute applicable restrictions under section 2704(b) and must be disregarded when determining the value of the partnership interests that were transferred by gift.

Section 2704(b) generally states that, where a transferor and his family control a partnership, a restriction on the right to liquidate the partnership shall be disregarded when determining the value of the partnership interest that has been transferred by gift or bequest if, after the transfer, the restriction on liquidation either lapses or can be removed by the family. Section 25.2704-2(b), Gift Tax Regs., provides that an applicable restriction is a restriction on "the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."

Respondent argues that both partnership agreements contain provisions limiting the ability of a partner to liquidate that are more restrictive than the default Texas partnership provisions. Specifically, respondent points to section 9.2 of the partnership agreements, which provides that each partnership shall continue for a period of 35 years. Respondent also points to section 9.3 of the partnership agreements, which prohibits a limited partner from withdrawing from the partnership or from demanding the return of any part of a partner's capital account except upon termination of the partnership.

Respondent compares sections 9.2 and 9.3 of the partnership agreements with section 6.03 of the Texas Revised Limited Partnership Act (TRLPA). TRLPA section 6.03 provides:

> A limited partner may withdraw from a limited partnership at the time or on the occurrence of events specified in a written partnership agreement and in accordance with that written partnership agreement. If the partnership agreement does not specify such a time or event or a definite time for the dissolution and winding up of the limited partnership, a limited partner may withdraw on giving written notice not less than six months before the date of withdrawal to each general partner * * *.

Tex. Rev. Civ. Stat. Ann. art. 6132a-1, sec. 6.03 (West Supp. 1993).

Respondent's argument is essentially the same as the argument we rejected in Kerr v. Commissioner, 113 T.C. 449, 469-474 (1999). In Kerr, the taxpayers and their children formed two

family limited partnerships with identical liquidation restrictions. Shortly after formation, the taxpayers transferred limited partnership interests to their children by gift. On their Federal gift tax return, the taxpayers claimed substantial discounts in the value of the interests compared to the value of the underlying assets due to lack of control and lack of marketability. The partnership agreements provided that the partnerships would continue for 50 years.

The Court held:

> Respondent's reliance on TRLPA section 6.03 is misplaced. TRLPA section 6.03 governs the withdrawal of a limited partner from the partnership--not the liquidation of the partnership. TRLPA section 6.03 sets forth limitations on a limited partner's withdrawal from a partnership. However, a limited partner may withdraw from a partnership without requiring the dissolution and liquidation of the partnership. In this regard, we conclude that TRLPA section 6.03 is not a "limitation on the ability to liquidate the entity" within the meaning of section 25.2704-2(b), Gift Tax Regs.

Id. at 473. In sum, the Court concluded that the partnership agreements in Kerr were not more restrictive than the limitations that generally would apply to the partnerships under Texas law. See id. at 472-474. Respondent acknowledges that Kerr is applicable to this issue but argues that Kerr was incorrectly decided. However, we find no reason to reach a result that is different than the result in Kerr. Thus, section 2704(b) does

not apply here. See also Knight v. Commissioner, 115 T.C. 506, 519-520 (2000); Harper v. Commissioner, T.C. Memo. 2000-202.

Valuation of Decedent's Gifts of Limited Partnership Interests

A gift of property is valued as of the date of the transfer. See sec. 2512(a). The gift is measured by the value of the property passing from the donor, rather than by the property received by the donee or upon the measure of enrichment to the donee. See sec. 25.2511-2(a), Gift Tax Regs. The fair market value of the transferred property is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. See United States v. Cartwright, 411 U.S. 546, 551 (1973); sec. 25.2512-1, Gift Tax Regs. The hypothetical willing buyer and the hypothetical willing seller are presumed to be dedicated to achieving the maximum economic advantage. See Estate of Davis v. Commissioner, 110 T.C. 530, 535 (1998). Transactions that are unlikely and plainly contrary to the economic interests of a hypothetical willing buyer or a hypothetical willing seller are not reflective of fair market value. See Estate of Strangi v. Commissioner, 115 T.C. 478, 491 (2000); Estate of Newhouse v. Commissioner, 94 T.C. 193, 232 (1990); Estate of Hall v. Commissioner, 92 T.C. 312, 337 (1989).

As is customary for valuation issues, the parties rely extensively on the opinions of their respective experts to support their differing views about the fair market value of the gifts of partnership interests. The estate relies on Elliott, a senior member of the American Society of Appraisers and a principal in the business valuation firm of Howard Frazier Barker Elliott, Inc. Respondent relies on Francis X. Burns (Burns), a candidate member of the American Society of Appraisers and a principal in the business valuation firm of IPC Group, Inc. Each expert prepared a report.

We evaluate the opinions of the experts in light of the demonstrated qualifications of each expert and all other evidence in the record. See Estate of Davis v. Commissioner, supra at 536. We are not bound by the formulae and opinions proffered by expert witnesses, especially when they are contrary to our judgment. Instead, we may reach a determination of value based on our own examination of the evidence in the record. Where experts offer contradicting estimates of fair market value, we decide what weight to give those estimates by examining the factors used by the experts in arriving at their conclusions. See id. Moreover, because valuation is necessarily an approximation, it is not required that the value that we determine be one as to which there is specific testimony, provided that it is within the range of figures that properly may

be deduced from the evidence. See Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo. 1974-285. The experts in this case agree that, in ascertaining the fair market value of each gift of interest in the partnerships, one starts with the fair market value of the underlying assets of each partnership and then applies discounts for factors that limit the value of the partnership interests.

A. Nature of Interests Transferred

The first argument of the estate is that the partnership interests that were transferred by decedent were assignee interests rather than limited partnership interests. The estate claims that decedent and the recipients of the gifts did not fulfill the necessary requirements set forth in the partnership agreements for transferring limited partnership interests. The JBLP agreement provides that, upon an exchange of an interest in the partnership, the general partner and 100 percent of the remaining limited partners must approve, in writing, of a transferred interest becoming a limited partnership interest. The AVLP agreement provides that the general partners and 75 percent of the limited partners must approve, in writing, of a transferred interest's becoming a limited partnership interest. Because these written approvals were not carried out, the estate contends that the recipients of the gifts are entitled only to the rights of assignees.

In Kerr v. Commissioner, 113 T.C. 449, 464 (1999), the taxpayers held greater than 99 percent of the partnership interests of two family limited partnerships as general and limited partners. The taxpayers' children held the remaining partnership interests, totaling less than 1 percent of overall ownership, as general partners. The partnership agreements provided that no person would be admitted as a limited partner without the consent of all general partners. In 1994, the taxpayers transferred a large portion of their limited partnership interests to trusts for which they served as trustees. At trial, the taxpayers argued that, although they made these transfers to themselves as trustees, pursuant to the family limited partnership agreement, their children as general partners had to consent to the admission of the trustees as limited partners. The taxpayers argued that the interests held by the trusts should be valued as assignee interests. The Court looked at all of the surrounding facts and circumstances in holding that the interests that were transferred by the taxpayers were limited partnership interests. See id. at 464.

On review of the facts and circumstances of the case at hand, decedent, like the taxpayers in Kerr, transferred limited partnership interests to his children rather than assignee interests. The evidence shows that decedent intended for the transfers to include limited partnership interests and that the

children consented to the transfer of limited partnership interests, having waived the requirement of a writing.

Pursuant to the AVLP agreement, Susan Jones Miller and Elizabeth Jones as general partners would have had to consent in writing to the transfer of the interests as limited partnership interests. Also, 75 percent of the remaining limited partners, i.e., Elizabeth Jones, Susan Jones Miller, Kathleen Jones Avery, Lorine Jones Booth, and decedent, would have had to consent in writing. Pursuant to the JBLP agreement, A.C. Jones as general partner would have had to consent in writing to the transfer as a limited partnership interest. Also, all of the remaining limited partners, i.e., A.C. Jones and decedent, would have had to consent in writing.

Although the estate argues that the absence of written consents leads to the conclusion that the interests transferred were assignee interests, it is difficult to reconcile that position with the language that decedent, his children, and Elliott used to document and characterize the transfers. First, the documents entitled “Gift Assignment of Limited Partnership Interest”, created by decedent to carry out the transfers, state that, after the transfers are complete, each child will hold his or her newly acquired interest as a “limited partnership interest”. Second, in his 1995 Federal gift tax return, decedent describes the gifts as “limited partnership interests” rather

than assignee interests. Third, in an affidavit executed on January 12, 1999, A.C. Jones states that the gifts that he and his sisters received from decedent were "limited partnership interests". Fourth, the 1995, 1996, 1997, and 1998 Federal income tax returns for JBLP and AVLP, signed by A.C. Jones and Elizabeth Jones, respectively, designate the interests as limited partnership interests on the Schedules K-1. Fifth, although he claimed at trial that he was valuing assignee interests, Elliott's written report referred only to limited partnership interests. These factors lead to the conclusion that the estate's argument, that decedent transferred assignee interests, was an afterthought in the later stages of litigation.

Also, after giving the gifts to his daughters, decedent was left with a 20.518-percent limited partnership interest. Section 5.4 of the AVLP agreement was modified so that consent of 85 percent of the partners was required in order for a general partner to sell a real estate interest belonging to the partnership. With this modification, decedent could retain the power to block unilaterally a sale of a real estate interest even after giving the gifts. This amendment would not have been necessary if the daughters had received only assignee interests.

This case is distinguishable from Estate of Nowell v. Commissioner, T.C. Memo. 1999-15, relied on by petitioner. In Estate of Nowell, the partnership agreements specified that the

recipient of limited partnership interests would become an assignee and not a substitute limited partner unless the general partners consented to the assignee's admission as a limited partner. The Court there decided that interests in the partnerships should be valued for estate tax purposes as assignee interests rather than as limited partnership interests.

The transactions in Estate of Nowell differ from the gifts in the case at hand in that the beneficiaries, the estate, and the decedent in Estate of Nowell never treated the passing interests in the partnerships as limited partnership interests. The record was void of evidence that showed that a limited partnership interest was in fact transferred. Here, the conduct of decedent, A.C. Jones, and the daughters reflects that limited partnership interests were actually transferred by decedent.

B. Value of the Transferred Interest in JBLP

Having concluded that decedent transferred an 83.08-percent limited partnership interest in JBLP to A.C. Jones, the next issue for decision is the value of the limited partnership interest. The estate relies on the conclusions of Elliott, who opined that the value of the interest in JBLP is subject to a secondary market discount of 55 percent, a lack-of-marketability discount of 20 percent, and an additional discount for built-in capital gains. Respondent relies on the valuation of Burns, who opined that no discounts apply.

Section 9.4 of the JBLP agreement provides that a general partner may be removed at any time by the act of the partners owning an aggregate 51-percent interest in the partnership. After removal, if no general partners remain, the limited partners shall designate a successor general partner. If the limited partners fail to designate a successor general partner within 90 days, the partnership will dissolve, affairs will be wound up, and the partnership will terminate.

Section 9.4 effectively gives ultimate decision-making authority to the owner of the 83.08-percent limited partnership interest. Under the threat of removal of the general partner, the 83.08-percent limited partner would have the power to control management, to compel a sale of partnership property, and to compel partnership distributions. If the general partner refused, the 83.08-percent limited partner could force liquidation within 90 days. Having the ability to force liquidation also gives the 83.08-percent limited partner the right to force a sale of the partnership assets and to receive a pro rata share of the NAV. Because the 83.08-percent limited partner has the power to control the general partner or to force a liquidation, the discounts proffered by Elliott are unreasonable and unpersuasive. The size of the interest to be valued and the nature of the underlying assets make the secondary market an improbable analogy for determining fair market value.

We do not believe that a seller of the 83.08-percent limited partnership interest would part with that interest for substantially less than the proportionate share of the NAV.

Burns opined that no discount for lack of control should apply for the reasons stated above. We agree. He also concluded that "the size and the associated rights of the interest would preclude the need for a marketability discount." He recognized that section 8.4 of the partnership agreement purported to give family members the power to prevent a third-party buyer from obtaining an interest in the JBLP, but he maintained that "to adhere to the fair market value standard, an appraiser must assume that a market exists and that a willing buyer would be admitted into the partnership." We believe that there is merit to this position. Self-imposed limitations on the interest, created with the purpose of minimizing value for transfer tax purposes, are likely to be waived or disregarded when the owner of the interest becomes a hypothetical willing seller, seeking the highest price that the interest will bring from a willing buyer. The owner of the 83.08-percent interest has the ability to persuade or coerce other partners into cooperating with the proposed sale. Nonetheless, liquidation of a partnership and sale of its assets, the most likely threat by which the owner of such a controlling interest would persuade or coerce, would involve costs and delays. The possibility of litigation over a

forced liquidation would reduce the amount that a hypothetical buyer would be willing to pay for the interest. See Adams v. United States, 218 F.3d 383 (5th Cir. 2000); Estate of Newhouse v. Commissioner, 94 T.C. 193, 235 (1990). A marketability discount would apply, but we believe that, under the circumstances of this case, an 8-percent discount more accurately reflects reality. This amount approximates the discount for lack of marketability proposed by Burns with respect to AVLP, as discussed below.

The experts also disagree about whether a discount attributable to built-in capital gains to be realized on liquidation of the partnership should apply. The parties and the experts agree that tax on the built-in gains could be avoided by a section 754 election in effect at the time of sale of partnership assets. If such an election is in effect, and the property is sold, the basis of the partnership's assets (the inside basis) is raised to match the cost basis of the transferee in the transferred partnership interest (the outside basis) for the benefit of the transferee. See sec. 743(b). Otherwise, a hypothetical buyer who forces a liquidation could be subject to capital gains tax on the buyer's pro rata share of the amount realized on the sale of the underlying assets of the partnership over the buyer's pro rata share of the partnership's adjusted basis in the underlying assets. See sec. 1001. Because the JBLP

agreement does not give the limited partners the ability to effect a section 754 election, in this case the election would have to be made by the general partner.

Elliott opined that a hypothetical buyer would demand a discount for built-in gains. He acknowledged in his report a 75- to 80-percent chance that an election would be made and that the election would not create any adverse consequences or burdens on the partnership. His opinion that the election was not certain to be made was based solely on the position of A.C. Jones, asserted in his trial testimony, that, as general partner, he might refuse to cooperate with an unrelated buyer of the 83.08-percent limited partnership interest (i.e., the interest he received as a gift from his father). We view A.C. Jones' testimony as an attempt to bootstrap the facts to justify a discount that is not reasonable under the circumstances.

Burns, on the other hand, opined, and respondent contends, that a hypothetical willing seller of the 83.08-percent interest would not accept a price based on a reduction for built-in capital gains. The owner of that interest has effective control, as discussed above, and would influence the general partner to make a section 754 election, eliminating any gains for the purchaser and getting the highest price for the seller. Such an election would have no material or adverse impact on the preexisting partners. We agree with Burns.

Petitioner relies on Eisenberg v. Commissioner, 155 F.3d 50 (2d Cir. 1998), revg. T.C. Memo. 1997-483, and Estate of Davis v. Commissioner, 110 T.C. 530, 546-547 (1998). Those cases, however, are distinguishable. In the contexts of those cases, the hypothetical buyer and seller would have considered a factor for built-in capital gains in determining a price for closely held stock in a corporation. In Eisenberg, the Court of Appeals emphasized that earlier Tax Court cases declining to recognize a discount for unrealized capital gains were based on the ability of the corporation, under the doctrine of General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), to liquidate and distribute property to its shareholders without recognizing built-in gain or loss and thus circumvent double taxation. The Court of Appeals went on to explain that the tax-favorable options ended with the Tax Reform Act of 1986, Pub. L. 99-514, sec. 631, 100 Stat. 2085, 2269. In reversing our grant of summary judgment on this issue and remanding the case for determination of gift tax liability, the Court of Appeals cited and quoted from Estate of Davis v. Commissioner, supra, in support of its reasoning.

In Estate of Davis, the Court rejected the Government's argument that no discount for built-in capital gains should apply because of the possibility that the corporation could convert to an S corporation and avoid recognition of gains on assets

retained for 10 years. Applying the hypothetical buyer and seller test, the Court, based on the record presented, including the testimony of experts for both parties, concluded that a discount for tax on built-in gains would be applied.

In the cases in which the discount was allowed, there was no readily available means by which the tax on built-in gains would be avoided. By contrast, disregarding the bootstrapping testimony of A.C. Jones in this case, the only situation identified in the record where a section 754 election would not be made by a partnership is an example by Elliott of a publicly syndicated partnership with "lots of partners * * * and a lot of assets" where the administrative burden would be great if an election were made. We do not believe that this scenario has application to the facts regarding the partnerships in issue in this case. We are persuaded that, in this case, the buyer and seller of the partnership interest would negotiate with the understanding that an election would be made and the price agreed upon would not reflect a discount for built-in gains.

C. Value of Interests in AVLP

The estate relies on the conclusions of Elliott, who opined that the value of each transferred interest in AVLP is subject to a secondary market discount of 45 percent, a discount for lack of marketability equal to 20 percent, and an additional discount for built-in capital gains. Burns opined that the transferred

interests are entitled to a secondary market discount of 38 percent, a discount for lack of marketability equal to 7.5 percent, and no discount for built-in capital gains.

An owner of a 16.915-percent limited partnership interest in AVLP does not have the ability to remove a general partner. As such, a hypothetical buyer would have minimal control over the management and business operations. Also, a 16.915-percent limited partnership interest in AVLP is not readily marketable, and any hypothetical purchaser would demand a significant discount. In calculating the overall discount for the AVLP interests, both experts use data from different issues of the same publication regarding sales of limited partnership interests on the secondary market. The publication was the primary tool used by both experts.

Burns, using the May/June 1995 issue, opined that interests in real estate-oriented partnerships with characteristics similar to AVLP traded at discounts due to lack of control equal to 38 percent on January 1, 1995. The May/June 1995 issue contained data regarding the sale of limited partnership interests during the 60-day period ended May 31, 1995. Burns classified AVLP as a low-debt partnership making current distributions.

Elliott, using the May/June 1994 issue, opined that similar partnerships traded at a secondary market discount of 45 percent. The secondary market discount is an overall discount encompassing

discounts for both lack of control and lack of marketability for minority interests in syndicated limited partnerships. The May/June 1994 issue contained data regarding the sale of limited partnership interests during the 60-day period ended May 31, 1994.

The estate argues that Burns' conclusion, which is based on data found in the May/June 1995 issue, is flawed because such information was not available on January 1, 1995, the date the gift was made. The estate contends that, since a gift of property is valued, pursuant to section 2512(a), as of the date of the transfer, posttransfer data cannot affect our decision. However, Burns does not use the posttransfer data to prove directly the value of the transferred interests. Instead, he uses the May/June 1995 issue to show what value would have been calculated if, on January 1, 1995, decedent had looked at transactions involving the sale of interests in similarly situated partnerships occurring at that point in time. Data regarding such transactions involving similarly situated partnerships were available on the valuation date. Therefore, the data available in the May/June 1995 issue are relevant as they provide insight into what information would have been found if, on January 1, 1995, decedent had looked at transactions occurring on or near the valuation date.

The data on which Burns relied show that interests in similarly situated partnerships were trading at a 38-percent discount from April 2 to May 31, 1995. The data on which Elliott relied show that interests in similarly situated partnerships were trading at a 45-percent discount from April 2 to May 31, 1994. Therefore, transfers of interests on or around January 1, 1995, would have been trading at a discount somewhere between 38 and 45 percent. Because the data on which Burns relied are closer in time to the transfer date of the 16.915-percent AVLP interests, we give greater weight to his determination. Recognizing that the valuation process is always imprecise, a 40-percent discount is reasonable. This discount is a reduction in value for an interest trading on the secondary market and encompasses discounts for lack of control and lack of marketability.

Elliott opines that an additional 20-percent discount for lack of marketability is applicable because the partnerships that are the subject of the data in the publication are syndicated limited partnerships. He believes that, although there is a viable market for syndicated limited partnership interests, a market for nonsyndicated, family limited partnership interests does not exist. The additional 20-percent discount opined by Elliot is also attributable to sections 8.4 and 8.5 of the AVLP agreement, which attempt to limit the transferability of

interests in AVLP. In calculating the additional discount, Elliott relied on data found in various restricted stock and initial public offering studies.

Elliott acknowledges that the secondary market for syndicated partnerships is not a strong market and that a large discount for lack of marketability is already built into the secondary market discount. Although Elliott adjusts his analysis of the data found in the restricted stock and initial public offering studies to take into consideration the lack-of-marketability discount already allowed, his adjustment is inadequate. His cumulation of discounts does not survive a sanity check.

Sections 8.4 and 8.5 of the AVLP agreement do not justify an additional 20-percent discount. An option of the partnership or the other partners to purchase an interest for fair market value before it is transferred to a third party, standing alone, would not significantly reduce the value of the partnership interest. Nevertheless, the right of the partnership to elect to pay the purchase price in 10 annual installments with interest set at the minimum rate allowed by the rules and regulations of the Internal Revenue Service would increase the discount for lack of marketability. Texas courts have been willing to disregard option clauses that unreasonably restrain alienation. See Procter v. Foxmeyer Drug Co., 884 S.W.2d 853, 859 (Tex. App.

1994). We express no opinion whether this election is enforceable under Texas law. Because this clause would cause uncertainty as to the rights of an owner to receive fair market value for an interest in AVLP, a hypothetical buyer would pay less for the partnership interest. See Estate of Newhouse v. Commissioner, 94 T.C. 193, 232-233 (1990); Estate of Moore v. Commissioner, T.C. Memo. 1991-546. We believe that an additional discount equal to 8 percent for lack of marketability, to the NAV previously discounted by 40 percent, is justified.

For the reasons set forth in the built-in capital gains analysis for JBLP, an additional discount for lack of marketability due to built-in gains in AVLP is not justified. Although the owner of the percentage interests to be valued with respect to AVLP would not exercise effective control, there is no reason why a section 754 election would not be made. Elliott admits that, because AVLP has relatively few assets, a section 754 election would not cause any detriment or hardship to the partnership or the other partners. Thus, we agree with Burns that the hypothetical seller and buyer would negotiate with the understanding that an election would be made. Elliott's assumption that Elizabeth Jones and Susan Jones Miller, as general partners, might refuse to cooperate with a third-party purchaser is disregarded as an attempt to bootstrap the facts to justify a discount that is not reasonable under the

circumstances. Therefore, a further discount for built-in capital gains is not appropriate in this case.

D. Conclusion

The schedules below summarize our conclusions as to fair market value for the transferred JBLP and AVLP limited partnership interests:

83.08-Percent Interest in JBLP

NAV of limited partnership	$ 7,704,714
	83.08%
Pro rata NAV	6,401,076
Lack of marketability (8%)	(512,086)
Fair market value	$ 5,888,990

16.915-Percent Interest in AVLP

NAV of limited partnership	$11,629,728
	16.915%
Pro rata NAV	1,967,168
Secondary market (40%)	(786,867)
	1,180,301
Lack of marketability (8%)	(94,424)
Fair market value	$ 1,085,877

We have considered all remaining arguments made by both parties for a result contrary to those expressed herein, and, to the extent not discussed above, they are irrelevant or without merit.

To reflect the foregoing,

Decision will be entered under Rule 155.

Full Text of Court Cases

Estate of Jung v. Commissioner

Case name: Estate of Jung v. Commissioner
Citation: 101 T.C. 412, 101 T.C. No. 28
Date of decision: November 10, 1993
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Chabot
SIC: 6719 Offices of Holding Companies, NEC
NAICS: 551112 Offices of Other Holding Companies
8488, 9485

Keywords: Estate tax

COUNSEL:

Michael E. Neiheisel, James M. Moore, Paul D. Ratterman, and Thomas H. Clark, for petitioner.

Joseph P. Grant, for respondent.

JUDGES:

Chabot, Judge.

OPINIONBY:

CHABOT

OPINION:

CHABOT, Judge: Respondent determined a deficiency in Federal estate tax against petitioner in the amount of $ 2,396,902.92. By amendment to answer, respondent asserts an addition to tax of $ 719,070.90 under section 6660 n1 (valuation understatement).

n1 Unless indicated otherwise, all section references are to sections of the Internal Revenue Code of 1954 as in effect for the date of decedent's death.

After concessions by both sides, the issues are as follows:

(1) What the fair market value of decedent's 168,600 shares of Jung Corp. stock was on the date of her death (Oct. 9, 1984); and

(2) whether petitioner is liable for an addition to tax under section 6660.

FINDINGS OF FACT n2

n2 Rule 151(e)(3) provides, in pertinent part, as follows:

RULE 151. BRIEFS

(e) Form and Content: All briefs shall contain the following in the order indicated:

* * *

(3) * * * In an answering or reply brief, the party shall set forth any objections, together with the reasons therefor, to any proposed findings of any other party, showing the numbers of the statements to which the objections are directed; in addition, the party may set forth alternative proposed findings of fact.

In the instant case, the parties filed simultaneous briefs. Petitioner's answering brief does not include responses to respondent's proposed findings of fact. Under the circumstances, we have assumed that petitioner does not object to respondent's proposed findings of fact except to the extent that petitioner's proposed findings of fact are clearly inconsistent therewith.

Unless indicated otherwise, all Rule references are to the Tax Court Rules of Practice and Procedure.

Some of the facts have been stipulated; the stipulation and the stipulated exhibits are incorporated herein by this reference.

When the petition was filed in the instant case, petitioner was an Ohio estate with a legal residence in Cincinnati, Ohio. Decedent died a resident of Ohio on October 9, 1984. Decedent's estate was probated in Hamilton County, Ohio.

At her death decedent owned 168,600 voting shares of Jung Corp., which represented 20.83 percent of the outstanding voting shares and 20.74 percent of all the outstanding shares of Jung Corp. n3

n3 On Oct. 9, 1984, 900,000 voting shares were authorized and 809,560 were outstanding; 100,000 nonvoting shares were authorized and 3,360 were outstanding. Neither the parties nor the expert witnesses appear to attribute different values to the voting and nonvoting shares.

In the early 1900's decedent's husband cofounded Jung Arch Brace Co., the predecessor to Jung Corp. In 1949, a year after decedent's husband died, Jung Corp. was incorporated in Ohio as Jung Products, Inc. As of January 1, 1982, the name was changed to Jung Corp. Jung Corp.'s principal place of business was in Cincinnati, Ohio.

On October 9, 1984, Jung Corp. owned all of the outstanding stock of the following companies: Jung International, Inc. (hereinafter sometimes referred to as JII), J.R.A. Industries, Inc. (hereinafter sometimes referred to as JRA), Rampon Products (hereinafter sometimes referred to as Rampon), Ione Realty (hereinafter sometimes referred to as Ione), and Calley & Currier; Jung Corp. also owned 96.3 percent of the stock of Theradyne.

Jung Corp and its subsidiaries were primarily operating companies, except that Ione was a holding company for the real estate occupied by the operating companies. Jung Corp. consisted of two divisions -- (1) the corporate division, which provided management services to the Jung Corp. subsidiaries, and (2) the Futuro division (hereinafter sometimes referred to as Futuro), which manufactured and marketed health care products and other products, including the products of Jung Corp. subsidiaries. n4 Jung Corp. and its subsidiaries together comprised an integrated manufacturer and distributor of elastic textile goods and products, including elastic braces and supports, support stockings, and thermo comforters (elastic gloves and braces knitted with wool, which provide warmth and compression to swollen joints).

n4 So stipulated. Apparently Jung Corp. also had an MIS division, which coordinated all the management information services activities within Jung Corp.

Futuro marketed health supports (such as elastic braces, athletic supporters, support socks and stockings, and hernia belts), patient aids (such as wheelchairs, canes, crutches, walkers, bed pans, and sitz baths), and thermo comforters. Futuro products were marketed almost entirely through drugstores, both nationally and internationally. About 95 percent of the health supports and 70-75 percent of the patient aids that Futuro marketed were manufactured by Jung Corp. and its subsidiaries. Futuro also marketed sporting goods through its All American and Grid lines. Futuro was Jung Corp.'s most profitable business. Futuro's health supports products were number one or number two in drug stores.

JII, incorporated in 1968, was the export sales agent for Jung Corp. products. JII bought goods for resale only from Jung Corp. or its subsidiaries. JII was a domestic international sales corporation (DISC) until December 31, 1984, at which time the DISC was liquidated and its successor was incorporated as a foreign sales corporation (FSC).

JRA, incorporated in 1969, primarily produced coarse yarns for sale to other Jung Corp. subsidiaries and to third parties. JRA also used the yarns to make elastic webbing, and it made fine elastic yarn from which Rampon (acquired by Jung Corp. in 1965) and third parties made stockings. In 1983 JRA acquired the property, plant, and equipment of a yarn covering operation in Raeford, North Carolina, and the Raeford operations became part of JRA. The industry in which JRA competed is very capital-intensive and has very low profit margins. JRA had a low profit margin in 1984.

Rampon produced knitted products including hosiery.

Theradyne manufactured wheelchairs for sale to Jung Corp. subsidiaries and to third parties. Jung Corp. acquired 70 percent of Theradyne's stock in 1973. Most of the remaining stock was held by Jung family members. In 1983 Jung Corp. acquired most of the rest of Theradyne in a stock-for-stock transaction. On October 9, 1984, Jung Corp. held 96.3 percent of Theradyne's stock. In 1984 Theradyne was either marginally profitable or losing money.

Jung Corp. acquired Calley & Currier in March 1984. Calley & Currier principally manufactured wooden crutches; it was the second largest wooden crutch manufacturer, with about one-third of the domestic market.

Ione was incorporated in 1949 by Jung family members and was transferred to Jung Corp. in 1973. Its primary purpose was to hold real and personal property which was used by Jung Corp.'s operating subsidiaries. Ione owned the manufacturing facility that Futuro occupied, the plant that Theradyne occupied, and the Richard Grey plant (which was a part of Rampon). Ione also owned a condominium in Florida. Ione charged rent for the facilities it owned, but the rent charged was not market value.

Jung Corp. had industrial revenue bond (hereinafter referred to as IRB) financing for Futuro's manufacturing site. As of October 9, 1984, the outstanding balance of Jung Corp.'s IRB loan for Futuro was $ 970,000. JRA also had IRB financing. As of October 9, 1984, the outstanding balance of JRA'S IRB loan was $ 3,030,000. The interest rate on JRA'S IRB loan was computed at 69 percent of the current prime rate at the time of payment.

Jung Corp. kept its books and records on a calendar year basis. Jung Corp. and its subsidiaries filed consolidated tax returns. The net income after taxes of Jung Corp. and its subsidiaries for 1970 through 1979 is shown in table 1:

Table 1

Year	Net income
1970	$ 1,039,000
1971	379,000
1972	755,000
1973	1,009,000
1974	720,000
1975	805,000
1976	973,000
1977	1,477,000
1978	1,205,000
1979	1,344,000

The audited financial statements for 1980 through 1986 show net sales and net income after taxes for the consolidated operations of Jung Corp. in the rounded amounts set forth in table 2:

Table 2

Year	Net sales	Net income
1980	$ 41,939,000	$ 1,233,000
1981	46,352,000	944,000
1982	48,800,000	1,739,000
1983	62,757,000	1,889,000
1984	67,918,000	3,123,000
1985	71,606,000	2,098,000
1986	54,679,000	1,991,000

The unaudited interim financial statement for September 30, 1984 (9 days before decedent's death), shows year-to-date net sales (rounded) of $ 52,271,000, and year-to-date net income after taxes (rounded) of $ 2,192,000. A portion of Jung Corp.'s unaudited interim consolidated balance sheet for September 30, 1984, is attached as the appendix. Complete information concerning 1984 yearend adjusting entries is not available. However, for 1984 Jung Corp. made at least three yearend adjustments as follows: (1) The inventory of Theradyne was decreased by $ 426,677, most of which was because of the discontinuance of the Titann wheelchair line, (2) the inventory of Futuro was increased by an unknown amount to account for the increased costing of freight, and (3) deferred Federal income tax was decreased by $ 541,000.

Jung Corp. paid dividends of 4 cents per share from 1979 through 1983; in 1984 it paid dividends of 25 cents per share.

In November 1984 Jung Corp. employed 1,025 people.

In the early 1980s, Jung Corp. developed and installed computer programs which controlled its manufacturing and operating systems and produced financial statements, invoices, etc.

In the 1980s, governmental policies were introduced which were designed to reduce Medicare costs by discouraging hospital stays and encouraging home health care. Because Jung Corp. marketed its products primarily through drugstores rather than through hospitals, Jung Corp. stood to benefit from this trend. Almost all the products in Jung Corp.'s product lines would benefit from an increase in home health care expenditures.

Jung Corp. had formulated 5-year business forecast plans since 1975, but the emphasis was only on sales projections. In 1984 Jung Corp. began an in-depth analysis of its strengths, weaknesses, and opportunities, and it began to formulate specific business strategies. By mid-1984 Jung Corp. began to implement these strategies. Also, in 1984 Jung Corp. began involving employees in the planning and forecasting process. In mid-1984, to help with financial planning, Jung Corp. hired Jim Cox, a partner from Ernst & Whinney, and retained the services of an accounting firm. Jung Corp. decided to actively promote future growth through expanded domestic sales, and through acquisitions of other companies. It decided that Jung Corp. would become global in both sales and purchases, and it began searching for European companies to acquire. During 1984 Jung Corp. introduced additional products into the home health care market, and improved its then-current products. Beginning in 1984, each of Jung Corp.'s subsidiaries added a medical-surgical distribution service in order to provide products to surgical supply dealers, hospitals, and professionals. The year 1984 was the best sales and profit year in the history of Jung Corp.

Jung Corp. also experienced growth from October 1984 through 1986. During this time Futuro became number one in the drugstore market. During 1985 or 1985, Jung Corp. introduced neoprene athletic products, which increased sales in Futuro's Grid line by 3 to 5 percent. In 1985 and 1986 Jung Corp. upgraded its equipment, installed new computer programs to manage inventory, and trained personnel to use the computers. Jung Corp. bought two English companies, Solport and Lastonet. It began sending managers to management training schools at Harvard, Stanford, and Massachusetts Institute of Technology. The planning and forecasting procedures which Jung Corp. had begun in 1984 helped it to identify both weaknesses and opportunities, and helped to give it needed impetus for growth in 1985 and 1986. Jung Corp.'s net sales in 1985 were higher than 1984 net sales; however, Jung Corp.'s profits

for 1985 and 1986 were lower than 1984 profits. See supra table 2. The decline in profits in 1985 and 1986 was due to the above-mentioned increased expenditures, which ultimately helped Jung Corp. Also, in 1985 and 1986 JRA and Calley & Currier changed from profitable companies to unprofitable companies. Because of the foregoing activities, and changes in the market, Jung Corp. increased in value substantially between 1984 and 1986.

Since at least 1979, Jung Corp. had received letters inquiring about the possibility of acquiring Jung Corp. The standard response to these letters was that Jung Corp. was not for sale. In 1984 Jung Corp. was not for sale. From 1979 through 1986 there were not any arm's-length sales of the stock of Jung Corp. Jung Corp. stock was not publicly traded.

On October 9, 1984, Ruth J. Conway, decedent's daughter, was treasurer of Jung Corp., and Ruth J. Conway's husband, Robert A. Conway (hereinafter sometimes referred to as Conway), was chairman of the board of directors. Thomas H. Clark (hereinafter sometimes referred to as Clark), decedent's nephew, was legal counsel and secretary for Jung Corp. Mary Lois Jung, also a daughter of decedent, was a member of the board of directors of Jung Corp. and was one of two doctors who reviewed and approved the new product development literature that Jung Corp. distributed. No other members of decedent's family were employed by, or involved in, the management of Jung Corp. After a series of strokes in the period 1975-77, decedent had not been involved in the management of Jung Corp. Decedent's death had no impact on the running of Jung Corp. The Conways had eight children, none of whom was involved in the business. As of October 1984, Conway (then 57 years old) was not considering retirement; however, he was concerned about who his successor would be because none of his children was involved in the business.

The holders of voting common shares of record on the date of decedent's death were as shown in table 3:

Table 3

Decedent	168,600	Robert A. Conway, Trustee	
Mildred H. Jung Trust	24,000	u.a.d. 11/9/76 Ruth A.	
Mary Lois Jung	57,920	Conway, Grantor	24,000
Thomas H. Clark	3,120	Robert A. Conway, Jr.	4,520
Ruth J. Conway	194,720	Joseph A. Conway	4,520
Robert A. Conway	94,320	Kathleen Conway	4,520
Ruth J. Conway, Trust	25,440	Timothy J. Conway	4,520
Ruth J. Conway, Trust	25,440	Mary Ruth Conway	4,520
Ruth J. Conway, Trust	144,000	Sheila M. Conway	4,520
Edward R. Askew	6,200	Robert A. Conway, Cust.	
Joyce A. Russell	400	for Mary Lois Conway	4,520
Karl V. Davis	800	Robert A. Conway, Cust.	
Paul Schwartz	800	for Sean Conway	4,520
Carmen M. Newhaus	1,080	Edgar J. Mack III	800

Jean Dick	200Paul Gamm	800
Walter Dimond	80Geraldine Massie	160
	Alvin C. Drury	520

In May 1986, Kendall Co. (hereinafter sometimes referred to as Kendall) contacted Jung Corp. in regard to an acquisition of Jung Corp. Conway told Kendall's representatives that he was not interested in selling. In the summer of 1986, Conway was invited to meet with Kendall's representatives in Boston, Massachusetts. Conway then consulted with Ruth Conway and Mary Lois Jung. Conway raised the matter at a meeting of Jung Corp.'s board of directors in September 1986. The board of directors advised that, if Conway did not plan to have family succession at Jung Corp., then he should treat Jung Corp. as any other asset, to be held or sold when he thought appropriate.

Jung Corp. began negotiations with Kendall concerning the sale of certain assets of Jung Corp. The board of directors of Jung Corp. recommended that any sale be completed by December 31, 1986, because of changes in the tax law enacted by the Tax Reform Act of 1986. On December 29, 1986, Kendall bought certain assets of Jung Corp. for about $ 59.5 million. On the date of decedent's death this sale was not foreseeable.

The remaining assets of Jung Corp. were sold in transactions separate from the sale to Kendall. On July 7, 1986, Jung Corp. sold Theradyne to Surgical Appliances Industries, Inc., for $ 1 million. On December 1, 1986, Jung Corp. sold assets of Futuro's Grid line to CDC Liquidators for $ 552,705. On December 23, 1986, Jung Corp. sold certain assets of JRA to Spanco Co. for $ 5,076,200. On December 29, 1986, Calley & Currier was sold for $ 750,000.

In 1986 Jung Corp. did not discuss the possible sale of Jung Corp. assets with any entities other than those to which sales actually took place.

On December 15, 1986, the shareholders of Jung Corp. adopted a plan of liquidation. According to the plan of liquidation, Jung Corp. was to be liquidated upon the sale to Kendall, which was to be on December 29, 1986, and dissolved by December 31, 1986. In order to accommodate the liquidation, the Jung-Conway Trust was established to serve as a conduit for transferring assets from Jung Corp. to its shareholders. The total trust equity of about $ 64 million is net of liquidation expenses, and after the buyout of the voting and nonvoting stock and stock options. The buyout price was $ 75 per share. On the date of decedent's death, this liquidation was not foreseeable.

In connection with the preparation of the estate tax return, decedent's executrix relied on Clark's law firm to find an appraiser for decedent's stock in the Jung Corp. Clark's law firm retained Edwin T. Robinson (hereinafter sometimes referred to as Robinson) to prepare an appraisal report. On April 8, 1985, Robinson submitted his written valuation report to Clark, in which he valued decedent's Jung Corp. stock at $ 2,671,973 as of October 9, 1984. This valuation report was the basis for the estate's estate tax return's use of that amount as the reported value of decedent's Jung Corp. stock. Petitioner's estate tax return was filed timely, on July 9, 1985.

On the estate tax return, petitioner elected under section 6166 to pay the appropriate portion of the estate tax in installments. In the course of making this election, petitioner represented that the $ 2,671,973 reported value of decedent's Jung Corp. stock is 88.1 percent of the value of the adjusted

gross estate. On the estate tax return, petitioner reported the value of the gross estate as $ 3,418,971.52. The reported value of decedent's Jung Corp. stock is 78.2 percent of the value of the gross estate.

Robinson is a certified public accountant and an attorney. Robinson does not have formal training or accreditation in valuation. In 1966, after being graduated from law school, Robinson spent 6 years working for the Arthur Andersen accounting firm; his work there involved some valuation questions. In 1972 Robinson joined a law firm as a tax specialist. His work at the law firm included some valuation issues. From 1979 to 1984 Robinson worked for SHV North America Corp. (hereinafter sometimes referred to as SHV), which is a U.S. holding company for a privately owned Dutch company. Robinson was vice president of acquisitions, and president of the SHV Investment Fund (hereinafter sometimes referred to as the fund), a venture capital fund. His job was to make investments for the fund in privately held businesses. Although Robinson did not prepare formal appraisal reports while he was employed by SHV, his job involved valuing companies for potential acquisition, or valuing a company held by SHV for purposes of selling it.

In July 1984 Robinson joined Mayfield & Co., Inc. (hereinafter sometimes referred to as Mayfield). Mayfield provides consultation services for clients who wish to acquire businesses. Robinson's work for Mayfield involved valuing companies, and helping clients to negotiate price, contracts, and financing. Although Robinson was not in the business of issuing written appraisals until he began working for Mayfield in 1984, he already had extensive experience for several years in valuing businesses.

In preparing the appraisal report for petitioner, Robinson visited Jung Corp.'s facilities in Cincinnati and interviewed officers of Jung Corp. In his appraisal report, Robinson considered the history, economic outlook, products, and financial condition of Jung Corp. He valued Jung Corp. by (1) calculating its return on equity and its return on capital employed, and (2) using a price/earnings multiple based on market comparables and applying the multiple to Jung Corp.'s weighted earnings for 1980 through 1984. Robinson concluded that Jung Corp. should be valued at less than book value.

Table 4 shows the positions of the parties, of their expert witnesses, and of the Court as to the fair market value of decedent's 168,600 shares of Jung Corp. stock on October 9, 1984.

Table 4

	Total value
Petitioner:	
Estate tax return	$ 2,671,973
Petition	2,671,973
Expert -- Robinson	2,671,973
Expert -- McCoy	n1 2,529,000
Expert -- McCoy (revised) n2	n1 2,950,500
Expert -- Grabowski	2,585,000
Expert -- Grabowski (revised)	n1 3,372,000
Briefs	2,997,708

Respondent:	
Notice of deficiency	8,330,448
Experts -- Hanan, Mitchell	5,469,000
Experts -- Hanan, Mitchell (revised)	5,597,520
Briefs	8,000,000
Court:	
Ultimate finding of fact	4,400,000

n1 The indicated expert witness reports provided only per-share values. The total value numbers set forth in this table are the product of the respective per-share value and decedent's 168,600 shares.

n2 At trial, McCoy revised several of his numbers. Petitioner evaluated these changes as increasing McCoy's estimate of per-share value from $ 15 (rounded) to $ 17.50 (rounded).

On October 9, 1984, Jung Corp. was worth about $ 32-34 million; decedent's shares amounted to 20.74 percent of the total and were worth about $ 6.7 to $ 7 million, without regard to discounts; the value of decedent's shares should be discounted 35 percent for lack of marketability and should not be further discounted for lack of control; and the fair market value of decedent's shares was $ 4,400,000.

When Robinson prepared the appraisal report for petitioner, he was an experienced expert appraiser. Petitioner acted in good faith in claiming the valuation reported on the estate tax return. There was a reasonable basis for the valuation claimed on the estate tax return.

Respondent's refusal to waive the addition to tax under section 6660 was an abuse of discretion.

OPINION

I. Value of Decedent's Stock

The value of decedent's gross estate includes the fair market value of the stock in Jung Corp. that decedent owned at her death. Sec. 2031(a); n5 United States v. Cartwright, 411 U.S. 546, 551 (1973); sec. 20.2031-1(b), Estate Tax Regs. Because Jung Corp.'s stock was not listed on an exchange and cannot be valued with reference to bid and asked prices or historical sales prices, the statute requires us to consider the value of stock in comparable corporations engaged in the same or a similar line of business. Sec. 2031(b).

n5 Sec. 2031 provides, in pertinent part, as follows:

SEC. 2031. DEFINITION OF GROSS ESTATE.

(a) GENERAL. -- The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.

(b) VALUATION OF UNLISTED STOCK AND SECURITIES. -- In the case of stock and securities of a corporation the value of which, by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference

to sales prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange.

The parties have not agreed on the fair market value of decedent's stock, and so we will have to find the fair market value. Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 451-452 (1980).

Generally, the fair market value of property is the price at which a willing buyer will purchase the property from a willing seller, when neither is acting under compulsion and both are fully informed of the relevant facts and circumstances. E.g., Palmer v. Commissioner, 523 F.2d 1308, 1310 (8th Cir. 1975), affg. 62 T.C. 684, 696 (1974); McShain v. Commissioner, 71 T.C. 998, 1004 (1979). Respondent's determination in the notice of deficiency as to the fair market value of the subject property is presumptively correct, and petitioner bears the burden of proving that the fair market value is lower. Rule 142; Welch v. Helvering, 290 U.S. 111 (1933).

At trial, both sides presented the testimony of expert witnesses to establish the fair market value of the Jung Corp. stock. It would serve no useful purpose to make a detailed analysis of the testimony of these experts to explain item by item the extent to which we agree or disagree with their analysis. Valuation is a not precise science, and the determination of the fair market value of property on a given date is a question of fact (Kaplan v. Commissioner, 43 T.C. 663, 665 (1965)), to be resolved on the basis of the entire record (McShain v. Commissioner, 71 T.C. at 1004), and without necessarily being bound by the opinions of the expert witness, Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), and cases there cited, affg. T.C. Memo. 1974-285; Palmer v. Commissioner, 523 F.2d at 1310. However, we will note considerations that we have taken into account in our determination and explain how we reach our conclusions. See Akers v. Commissioner, 798 F.2d 894, 897 (6th Cir. 1986), revg. and remanding T.C. Memo. 1984-208.

Petitioner contends that the value of decedent's stock on October 9, 1984, was $ 2,997,708 (after applying discounts). Petitioner averages the per-share amounts determined by its three experts and multiplies this average ($ 17.78) by the number of shares (168,600) to arrive at its position. This position is about 12 percent greater than the amount shown on the estate tax return. On brief, in regard to the prediscount value of Jung Corp., petitioner does not offer substantive criticism of respondent's expert witness reports.

In contrast, respondent finds error in all of the expert witness reports, including those of her own expert witnesses. Respondent contends that all the experts undervalued Jung Corp. Respondent criticizes each report on various grounds, and urges this Court to determine a value for Jung Corp. by determining each element used in the discounted cash-flow (hereinafter sometimes referred to as DCF) approach, n6 and by recomputing value based on that approach. Respondent contends that the DCF approach gives decedent's shares a prediscount value of $ 46.20 per share. Respondent contends that if we choose to rely in whole or in part on the comparable market approach, then we should refer to ratios of companies selected by both parties' expert witnesses, as compiled by respondent. Respondent contends that Jung Corp. is two-thirds health care operations and one-third elastic textile operations. Respondent contends that the Court would need only to determine the appropriate normalized income to be used in the market comparable analysis, and the emphasis to be given to the home health care and elastic textile segments of Jung Corp. Respondent contends that under the comparable market approach the prediscount value of decedent's shares is $ 56.11 per share. Respondent contends that

the Court should give the comparable market approach twice the weight as the DCF approach, so that the prediscount value of decedent's shares is $ 52.81 per share. As to discounts, respondent contends that a minority discount should not be applied, and that a marketability discount of 10 percent should be applied, giving decedent's stock a value after discounts of $ 47.53 per share, which results in a total that respondent rounds to $ 8 million. Respondent also contends that in valuing decedent's stock, proceeds of the 1986 sale and liquidation of Jung Corp. should be considered. Respondent's position on brief is about 4 percent less than the amount shown on the notice of deficiency and about 43 percent greater than the revised amount presented by her own expert witnesses.

n6 The DCF approach computes the present value of the estimated future cash-flow. First, the available cash-flow of the business is determined for a certain projection period. Second, a discount rate is applied to determine the present value of the cash-flow. Third, the residual value of the business at the end of the projection period is determined. Fourth, the present value of the residual value is computed. Fifth, the present value of the projected cash-flow is added to the present value of the residual value. The sum is the value of the business.

We agree with petitioner in part, and we agree with respondent in part.

First, we briefly summarize the approaches and conclusions of the experts. Then we analyze the value of Jung Corp. as of October 9, 1984. Then we consider the appropriateness and magnitude of discounts for marketability and minority interests. Finally, we reach our conclusion as to the fair market value of the property (i.e., decedent's 168,600 shares of Jung Corp.).

A. Expert Witnesses

Both sides submitted expert witness reports and presented expert witness testimony in regard to the value of decedent's stock at the date of death. Three expert witnesses testified for petitioner, and two expert witnesses testified for respondent.

Petitioner -- Robinson

Robinson is a 50-percent owner of Mayfield. He is an attorney and an accountant, and has had extensive experience in valuing businesses. Robinson submitted his report to petitioner on April 8, 1985, before the estate tax return was filed, and his valuation was the amount used on the tax return -- $ 2,671,973.

Robinson concluded that the best measure of value for Jung Corp. was by reference to Jung Corp.'s earning capacity. Robinson did not use the comparable sales method of valuation because he concluded that there were no public companies whose business was reasonably comparable to Jung Corp.'s. In particular, although there were publicly traded hosiery companies about the size of Jung Corp., "they are not significant participants in the health care or sports business in the [same] sense that Jung is. Competitors * * * in the sports and health care market are typically so large overall that comparisons are meaningless." Robinson concluded that Jung Corp. should be valued at less than book value, which he determined to have been $ 19,857,000, as adjusted to the first in, first out, method of inventory valuation. Robinson also valued Jung Corp. using a price earnings multiple of 9, which

produced a value for Jung Corp. of $ 18,405,000 at the date of death, and which Robinson concluded was the value of Jung Corp. This led to his determination of a prediscount value of $ 3,817,104, or $ 22.64 per share for decedent's stock. Robinson then discounted this value by 30 percent to account for both lack of control and lack of marketability. Robinson did not assign separate discount rates to the control and marketability factors. This resulted in a value for decedent's stock of $ 2,671,973.

Petitioner -- McCoy

David O. McCoy (hereinafter sometimes referred to as McCoy) has more than 20 years of experience in business valuation. McCoy used three approaches in his appraisal: A market comparable approach, a discounted cash-flow approach, and a capitalization of earnings approach. The amounts McCoy obtained for the value of Jung Corp. are shown in table 5.

Table 5

Market comparable method:	
Earnings	$ 20,942,000
Capital	18,510,000
Sales	18,889,000
Assets	18,249,000
DCF method:	
Growth rate 3%	18,247,000
Growth rate 5%	18,945,000
Growth rate 7%	19,722,000
Capitalization of earnings method	18,213,000

McCoy averaged the eight amounts, and rounded the result, obtaining a prediscount value of Jung Corp. of $ 18,966,000, and a prediscount value for decedent's stock of $ 23.34 per share. McCoy then applied a discount of 35 percent for lack of marketability, but no minority discount, giving decedent's stock a value of $ 15 (rounded) per share. This comes to a total of $ 2,529,000 for the 168,600 shares.

At trial, McCoy conceded a number of errors, and estimated the effects of correcting certain of these errors. As a result, petitioner evaluates McCoy's revised valuation estimate as $ 17.50 per share, which comes to a total of $ 2,950,500 for the 168,600 shares.

Petitioner -- Grabowski

Roger J. Grabowski (hereinafter sometimes referred to as Grabowski) is a principal and director of Price Waterhouse Valuation Services, and he has had extensive experience in valuing businesses. In valuing Jung Corp., Grabowski divided the various subsidiary companies of Jung Corp. into three separate groups. The health care product operations group comprises Futuro, JII, Theradyne, and Calley & Currier. The elastic textile operations group comprises JRA, Rampon, and the activities of the Richard Grey Co. (which was a part of Rampon). The third group comprises the real estate assets and machinery and equipment assets of Ione. Grabowski used the market comparable approach and the DCF approach, see supra note 6, in valuing the first two groups.

In Grabowski's revised report, his market comparable approach gave the following values shown in table 6.

Table 6

Health care operations	$ 17,910,150
Elastic textile operations	7,520,300
Book value of Ione	621,143
Prediscount value of Jung Corp.	26,051,593
Decedent's proportionate share	n1 5,373,483
Less: Marketability discount (35%)	1,880,719
Postdiscount value of decedent's share	3,492,764

n1 Before calculating decedent's proportionate share, Grabowski reduced the book value of Ione by 25 percent as a minority discount. In calculating decedent's proportionate share, Grabowski used 20.75 percent, rather than the 20.74 percent we have found.

Grabowski also used the DCF approach in valuing the health care products operations and the elastic textile operations.

In Grabowski's revised report, his DCF approach gives the values shown in table 7.

Table 7

Health care product operations	$ 21,931,000
Elastic textile operations	10,302,000
Book value of Ione Realty	621,143
Prediscount value of Jung Corp.	32,854,143
Decedent's proportionate share	n1 6,817,235
Less: Minority discounts	
Health care product operations (24%)	1,092,164
Elastic textile operation (26%)	555,973
Ione Realty (25%)	32,222
Decedent's share before marketability	5,137,056
Less: Marketability discount (35%)	1,797,970
Fair market value of decedent's stock	3,339,086

n1 In calculating decedent's proportionate share, Grabowski used 20.75 percent, rather than the 20.74 percent we have found.

Grabowski concluded that the average of the two approaches was the value of decedent's stock. He concluded that decedents's Jung. Corp. stock was worth $ 20 per share (rounded). This comes to a total of $ 3,372,000 for the 168,600 shares.

Respondent -- Hanan and Mitchell

Martin D. Hanan (hereinafter sometimes referred to as Hanan) and Mark L. Mitchell (hereinafter sometimes referred to as Mitchell) prepared a joint expert witness report, and both of them testified. Hanan is the founder and president of Business Valuation Services and Mitchell manages the financial valuation services for Business Valuation Services. Both Hanan and Mitchell have extensive experience in valuing businesses. Hanan and Mitchell computed value by using the market comparable approach and the DCF approach. Hanan and Mitchell did not rely on the market comparable approach because they had difficulty in developing a reliable sample of comparable firms.

In Hanan and Mitchell's revised report, their DCF approach gives the values shown in table 8.

Table 8

Value of operating assets (marketable, minority interest basis)	$ 33,413,952
Plus nonoperating assets	344,000
Prediscount value of Jung Corp.	33,757,952
Less 20% marketability discount (operating assets)	6,682,790
Less 25% minority discount (nonoperating assets)	86,000
Postdiscount value of Jung Corp.	26,989,162
Postdiscount value of decedent's stock	5,597,520

Summary

The conclusions of the expert witnesses and the Court may be summarized as shown in table 9.

Table 9

		Discounts (percentage)		
	Value of			
Expert	Jung Corp.	Minority	Marketability	Combined
Robinson	$ 18,405,000			n1 30
McCoy	18,966,000	-0-	35	35
McCoy (revised)	n2 22,127,000	-0-	35	35
Grabowski:				
Market comparable	18,071,500	n3 -0-	35	35
Market comparable				

(revised)	26,051,593	n3 -0-	35	35
DCF	26,355,143	n4 25	35	n5 51.25
DCF (revised)	32,854,143	n4 25	35	n5 51.25
Hanan, Mitchell	32,989,000	n6 -0-	20	20
Hanan, Mitchell (revised)	33,757,952	n6 -0-	20	20
Court	32-34 million	-0-	35	35

n1 Robinson's 30-percent discount is intended to take into account both marketability and minority holding consideration.

n2 As noted supra, petitioner understands the effect of McCoy's trial testimony as increasing his valuation of decedent's shares from $ 15 per share to $ 17.50. This table shows what would be the result if McCoy were to apply the same proportionate increase (i.e., one-sixth) to his estimate of fair market value for the Jung Corp.

n3 As may be seen from table 6 note 1, supra, Grabowski (in his market comparable approach) does not apply a minority discount to Jung Corp.'s operating assets, but does apply a 25-percent minority discount to Jung Corp.'s nonoperating assets only. Because the operating assets, in Grabowski's analysis, are about 97.5 percent of the total, this is the equivalent of applying a minority discount of about 0.6 percent across the board. After applying the method of calculating combined discounts, described infra note 7, this increases the combined discount to about 35.4 percent.

n4 This is the average of the minority discount rates that Grabowski applies to the different parts of Jung Corp.

n5 See infra note 7 for the method of calculating the combined discount.

n6 As may be seen from table 8, supra, Hanan and Mitchell apply a 20-percent marketability discount to Jung Corp.'s operating assets only, and a 25-percent minority discount to Jung Corp.'s nonoperating assets only. Because the operating assets, in Hanan's and Mitchell's analysis, are almost 99 percent of the total, this is the equivalent of applying one 20.05-percent discount across the board.

B. Value of Jung Corp.

1. Later-Occurring Events

Respondent contends that, in valuing Jung Corp. stock, this Court should consider the sale to Kendall, the other sales, and the ensuing liquidation of Jung Corp. Petitioner contends the 1986 sales and the liquidation are irrelevant because the sales and liquidation were unforeseeable at the valuation date.

We agree in part with respondent and in part with petitioner.

A distinction may usefully be drawn between later-occurring events which affect fair market value as of the valuation date, and later-occurring events which may be taken into account as evidence of fair market value as of the valuation date.

If a prospective October 9, 1984, buyer and seller were likely to have foreseen the 1986 sale to Kendall, and the other activities leading to the liquidation, then those later-occurring events could affect what a willing buyer would pay and what a willing seller would demand as of October 9, 1984. We conclude, and we have found that, on October 9, 1984, Jung Corp. was not for sale, the sale to Kendall was not foreseeable, and the liquidation was not foreseeable. Accordingly, we conclude that those later-occurring events did not affect the October 9, 1984, fair market of decedent's stock. Estate of Gilford v. Commissioner, 88 T.C. 38, 51-55 (1987).

However, we have stated that "for purposes of determining fair market value, we believe it appropriate to consider sales of properties occurring subsequent to the valuation date if the properties involved are indeed comparable to the subject properties." Estate of Thompson v. Commissioner, 89 T.C. 619, 628-629 n.7 (1987), revd. on other grounds 864 F.2d 1128 (4th Cir. 1989). To the same effect are, e.g., Krapf v. United States, 977 F.2d 1454, 1458-1460 (Fed. Cir. 1992); Estate of Kaplin v. Commissioner, 748 F.2d 1109, 1111 (6th Cir. 1984), revg. T.C. Memo. 1982-440; Estate of Brown v. Commissioner, 425 F.2d 1406, 1407 (5th Cir. 1970), affg. T.C. Memo. 1969-91. See Estate of Jung v. Commissioner, T.C. Memo. 1990-5, and cases cited therein.

Of course, appropriate adjustments must be made to take account of differences between the valuation date and the dates of the later-occurring events. For example, there may have been changes in general inflation, people's expectations with respect to that industry, performances of the various components of the business, technology, and the provisions of tax law that might affect fair market values between October 9, 1984, and the sales and liquidation some 2 years later. Although any such changes must be accounted for in determining the evidentiary weight to be given to the later-occurring events, those changes ordinarily are not justification for ignoring the later-occurring events (unless other comparables offer significantly better matches to the property being valued).

When viewed in this light -- as evidence of value rather than as something that affects value -- later-occurring events are no more to be ignored than earlier-occurring events.

Accordingly, we do not consider the sales and eventual liquidation as affecting the October 9, 1984, value of Jung Corp., but we do consider these events as evidence of the October 9, 1984, value.

2. Treatment by Expert Witnesses

Robinson did not consider the 1986 events in his expert witness report. This is to be expected -- his report was submitted to petitioner on April 8, 1985, and was the foundation for the valuation on the estate tax return, which was filed on July 9, 1985.

At trial, on re-cross-examination, Robinson was asked if he considered Jung Corp. to be an acquisition candidate, and whether, if a company were about to be acquired at a premium, that would affect its value. Robinson agreed that one would take that into account. However, he went on to emphasize that he was not aware of that potential, and that he did not think that Jung Corp. was an attractive acquisition candidate on October 9, 1984.

McCoy did not consider the 1986 events in his expert witness report. At trial, on direct examination, he stated that he was aware of the sale, but did not know any details about it. He testified that he considered whether he should take into account the liquidation values, and made a decision that he

should not take them into account. He said that the reasons the liquidation values are not relevant were (1) in 1984 there was no intention to sell Jung Corp., and (2) a minority interest holder has no power to force a liquidation or sale.

Hanan and Mitchell considered the liquidation proceeds in their appraisal. After taking into account the changes in the market and the changes in Jung Corp. between October 9, 1984, and the 1986 sales and liquidation, they concluded that the proceeds obtained in the 1986 liquidation supported their date of death valuation.

Grabowski did not consider the liquidation proceeds in his initial report. In his rebuttal report Grabowski contended that Hanan and Mitchell made errors in their calculations. Nevertheless, after taking into account his view of how the intervening events should be accounted for, he concluded that the proceeds obtained by the shareholders in liquidation were consistent with his date of death valuation.

Thus, Grabowski and Hanan and Mitchell evaluated the 1986 events in the manner we described supra as being appropriate (i.e., as evidence of fair market value as of the valuation date, and not as events affecting fair market value as of the valuation date) and concluded that this evidence was consistent with the results they derived from using the DCF approach.

3. Analysis

Respondent urges us "to determine the appropriate rate or amount for each DCF element." Respondent also urges us to give twice the weight to the comparable market approach as to the DCF approach. Respondent concludes that Jung Corp. was worth $ 52.81 per share, which amounts to a total of about $ 43 million.

In the instant case, we believe the DCF approach to valuing Jung Corp. is more reliable than the market comparable approach. The market comparable approach does not work well in the instant case because the comparable corporations do not have the same product mix (health and elastic textile) as Jung Corp. None of the experts relied exclusively on the market comparable approach, and Hanan and Mitchell and Robinson rejected the market comparable approach because they had difficulty finding companies which were similar to Jung Corp. At trial, Grabowski also stated that he did not rely on the market comparable approach.

Finally, the 1986 sales of parts of Jung Corp. have been shown by Grabowski and by Hanan and Mitchell to be consistent with their conclusions of an October 9, 1984, value of $ 32-34 million for Jung Corp. See supra table 9. The lower valuations by Robinson and McCoy (about $ 18.4 and $ 22.1 million, respectively) were not reconciled with the 1986 events, and we doubt that they could be so reconciled.

We conclude that Hanan and Mitchell and Grabowski accurately valued Jung Corp. using the DCF approach. We conclude (and we have found) that the prediscount value of Jung Corp. was about $ 32-34 million. Decedent's shares amounted to 20.74 percent of the total and were worth about $ 6.7 to $ 7.0 million, without giving effect to discounts.

C. Discounts

The parties agree that the date-of-death value to be assigned to decedent's shares should be discounted in some manner. Cases involving the valuation of minority holdings in close corporations ordinarily consider a discount or discounts because the stock is a minority holding and is not publicly

traded. Conceptually, (1) a minority discount reflects a minority shareholder's inability to compel liquidation and thus inability to realize a pro rata portion of the corporation's net assets value, while (2) a marketability discount reflects the hypothetical buyer's concern that there will not be a ready market when that buyer decides to sell the stock. Each of these prospects (lack of control and lack of ready market) is likely to depress the price that a hypothetical buyer is likely to be willing to pay for the stock. Although we analyze them separately, it is likely that there is a significant real-world overlap between these two discounts. Estate of Andrews v. Commissioner, 79 T.C. 938, 952-953 (1982).

Respondent does not dispute that a marketability discount should be applied. The only dispute is the amount of the discount. Respondent contends that a marketability discount of 10 percent is appropriate. Petitioner contends that decedent's stock should be discounted 35 percent for lack of marketability.

Petitioner contends that decedent's stock also should be discounted 25 percent because it is a minority interest in Jung Corp. Respondent acknowledges that a minority discount often is appropriate, but contends that under the DCF approach to valuation used in the instant case, no minority discount should be applied because the DCF approach used in the expert witness reports values the stock by reference to minority positions, so that the value obtained in the instant case is inherently the value of a minority interest.

Under petitioner's approach, the combined discounts amount to a 51.25-percent reduction n7 from the undiscounted value of decedent's shares. Respondent's approach would allow an overall 10-percent discount. The experts' views, and the Court's conclusions, are shown supra, in table 9.

n7 The discounts are calculated in series in Grabowski's report. Thus, the 35-percent marketability discount would reduce the value to 65 percent of the undiscounted value. The 25-percent minority discount would be applied to the remaining value and would reduce it by another 16.25 percent of the undiscounted value. (25 percent times 65 percent equals 16.25 percent.) Thus, application of the two discounts would result in an aggregate reduction of 51.25 percent. (35 percent plus 16.25 percent.) The commutative laws of mathematics cause the result to be the same, even if the multiplications are made in the reverse order.

We agree with petitioner as to the marketability discount and with respondent as to the minority discount. Thus, we apply a 35-percent reduction from the undiscounted value of decedent's shares.

1. Marketability

Grabowski reviewed six studies of transactions involving restricted stock. Grabowski's report indicated that these studies showed marketability discounts as follows:

	Percentage
Securities and Exchange Commission (hereinafter some-	
times referred to as SEC) Institutional Investor Study	25.8
Gelman study	33.0
Trout study	33.5
Maher study	35.4

Moroney study	35.6
Standard research consultants study	45.0

Based on these studies, Grabowski concluded that a 35-percent discount for lack of marketability was appropriate. Grabowski's rebuttal report considered two additional studies, the Baird and Willamette studies. These studies compared initial public offerings to private transactions before the public offering. The Baird and Willamette studies showed median discounts in the private transactions of 66 percent and 74 percent, respectively.

McCoy consulted a trade magazine that publishes information about private placements of common stock. The stocks are securities of companies that have other common shares that are registered with the SEC and are publicly traded in an active market. These securities are typically bought under an "investment letter" agreement. He reviewed all the private placements shown to have occurred in the 6 years from January 1, 1979, through December 31, 1984. After excluding certain categories of placements, he found 75 private transactions in the common stock of actively traded companies. Of the 75, 11 occurred at small premiums over the freely traded market price, 1 occurred at that market price, and 63 occurred at discounts (ranging up to 90 percent) from that market price. The average of these private placements was a discount of 27 percent. Under SEC rule 144(b), n8 17 C.F.R. sec. 230.144 (1984), such restricted securities will eventually become freely tradable through either registration or the passage of time. McCoy reasoned that, if such stocks with a temporary market restriction sold at an average discount of 27 percent, then Jung Corp. stock with a permanent market restriction should sell at a discount greater than 27 percent; he chose 35 percent. McCoy's rebuttal report added comments about a Maher study and a Solberg study that supported average and modal discounts of 35 percent. In his rebuttal, he also indicated that Hanan's and Mitchell's discussions about the marketability of Jung Corp. are irrelevant to the question of marketability of a minority interest in Jung Corp.

n8 The language of SEC rule 144(b) was unchanged during 1979-84 (the years from which the statistics were taken). The definition of "restricted securities" was revised during 1979-84, but we doubt that these changes affected the results of the statistics upon which McCoy based his marketability discount.

Robinson merely stated in his report: "We believe that a discount of 30% should apply to an interest such as Mrs. Jung's to account for the lack of control and lack of marketability." Robinson's report did not favor us with an explanation of his conclusion.

Hanan and Mitchell concluded that a 20-percent marketability discount was appropriate. They based this conclusion on the SEC Institutional Investor Study for 1966 through 1969. This was a study of publicly traded stock which was restricted from trading on the open market for a certain period of time. The study shows average discounts of about 25 percent for companies with earnings similar to Jung Corp. Hanan and Mitchell concluded that because a majority of Jung Corp. stock was controlled by the Jung family, the sale of Jung Corp. could be easily accomplished. Hanan and Mitchell also concluded that Jung Corp.'s size, history of profitability, and relatively strong position in the market, and the quality of its management, indicated that the marketability discount should be less than the average marketability discount in the SEC Institutional Investor Study. Hanan and Mitchell determined the appropriate discount to be 20 percent.

Here, too, respondent disagrees in part with her expert witnesses. Respondent contends that a 10-percent marketability discount is appropriate because Jung Corp. was an attractive acquisition candidate in 1984. Respondent states "that, without consideration of the acquisition potential, the marketability discount appropriate for Jung is between 15% and 20%, as was opined by BVS" (i.e., Hanan and Mitchell).

We are persuaded by the materials and analyses presented by McCoy and Grabowski. We believe that respondent, and to a lesser extent Hanan and Mitchell, gave too much weight to acquisition potential, or ease of sale, of Jung Corp. as a whole. We have found that, on October 9, 1984, Jung Corp. was not for sale, the sale to Kendall was not foreseeable, and the liquidation was not foreseeable. Also, as McCoy pointed out, we are concerned with the marketability of decedent's interest. We try to evaluate a market for decedent's 20.74-percent interest, not a market for Jung Corp. We assume a hypothetical willing seller of decedent's interest, not a hypothetical willing seller of Jung Corp. The hypothetical willing seller of decedent's shares would have to contend with an actual absence of interest in selling the entire corporation.

Neither respondent nor Hanan and Mitchell presented an explanation of why the inquiries about acquiring Jung Corp. would translate into a significant market for decedent's shares, and we decline to speculate on this point.

We conclude, and we have found, that a 35-percent marketability discount should be allowed.

Respondent contends that a small marketability discount should be applied because Jung Corp. itself would have repurchased decedent's shares in order to keep ownership in the family. n9 Respondent supports this argument by noting that in 1972 Jung Corp. bought a 20-percent block of stock from a shareholder who was not a family member. This argument is not persuasive. Firstly, although Conway testified that he would rather decedent's stock did not fall into the hands of a third party, he also testified that Jung Corp. could tolerate a 20-percent shareholder who was not a family member. Further, the fair market value test under section 20.2031-1(b), Estate Tax Regs., contemplates a hypothetical willing buyer and a hypothetical willing seller. Propstra v. United States, 680 F.2d 1248, 1251-1252 (9th Cir. 1982); Estate of Bright v. United States, 658 F.2d 999, 1005-1006 (5th Cir. 1981); Minahan v. Commissioner, 88 T.C. 492, 499 (1987); Estate of Andrews v. Commissioner, 79 T.C. at 952-956. We will not cast Jung Corp. in the role of the hypothetical willing buyer.

n9 Respondent relies on Estate of Neff v. Commissioner, T.C. Memo. 1989-278, where this Court considered the willingness of a corporation to repurchase its shares in determining the amount of a marketability discount. In Estate of Neff, Rand McNally repurchased stock because of its self-avowed commitment to maintain its status as a closely held corporation with a limited number of shareholders. Further, in repurchasing the stock, Rand McNally was willing to pay full or premium value. This Court considered Rand McNally's history of repurchases in determining the proper marketability discount. The instant case is distinguishable because (1) in the instant case there is a showing of one repurchase 12 years before the valuation date, while in Estate of Neff, the corporation "repurchased shares on numerous occasions" and made a major repurchase in the same year as the valuation date; and (2) in the instant case there was no evidence of a willingness to pay full value or premiums for repurchased

shares, while in Estate of Neff, there was a general offer to repurchase shares (which expired about 1 month before the first valuation date) at a price about 40 percent above what we determined to be a fair market value without any discount.

We hold, for petitioner, that a 35-percent marketability discount shall be applied.

2. Minority

As may be seen from table 9, supra, Grabowski did not provide for a minority discount under his market comparables approach (except for the minor matter discussed supra in table 9 note 3); McCoy did not provide for minority discount under any of the approaches he considered (see supra table 5; three-eighths of his final figures depend on a DCF approach); and Robinson's 30-percent discount was intended to take care of both marketability and minority considerations. Hanan and Mitchell provided for a 25-percent minority discount, but only for about 1 percent of the overall value, and so that minority discount had practically no effect on their conclusion. See supra table 9 note 6.

Only Grabowski, among the expert witnesses, argues for a minority discount, and then only if we accept the DCF approach to valuation of decedent's interest in Jung Corp. As noted supra, (1) we accept the DCF approach to valuation of decedent's interest in Jung Corp., and (2) we accept the general concept of a minority discount in appropriate circumstances.

The matter now before us is whether we should allow a minority discount in addition to the 35-percent marketability discount we have already determined to allow, and, if so, then in what amount. The resolution of this issue depends on the workings of the DCF approach as used by the expert witnesses before us and explained on the record in the instant case.

Grabowski contends that his DCF approach was designed to produce a control value, but concedes that a DCF approach could be used to produce a minority interest value (i.e., a value as to which a minority discount would not be appropriate). Hanan and Mitchell contend that their DCF approach embodies a minority interest value.

Grabowski contends that his DCF approach leads to a control value because (a) his cash-flow assumptions for Jung Corp. were based on what a controlling interest could do to Jung Corp. to make it run better, (b) the discount rate he used did not reflect minority interest evaluation, and (c) his equity risk premium assumed large company financing synergies. We consider these contentions seriatim.

(a) Grabowski's initial expert witness report states that a minority discount is needed because his DCF valuation was done on a controlling interest basis. The expert witness report states: "We presume that an investor is able to take the steps necessary to realize the projected results; therefore, a controlling interest is implicit." In his rebuttal expert witness report, Grabowski states as follows:

Third, we have included one, quantifiable major synergy into our calculation which causes the formulation of the discounted cash flow approach to be a control value. Premiums for control are paid in buying entire businesses. That is, the controlling shareholders of Jung could realize a higher price if they could sell the business to a buyer who could affect [effect?] savings or synergies. (Such synergies are oftentimes categorized as operating, financial and tax synergies.)

Operating savings on [or?] synergies result from increased sales or reduced costs by operating the business differently or combining businesses with a specific acquiring company.

Financial synergy results form [from?] lower costs of funds because the acquiring firm or combined firms are perceived as less risky. Tax synergy results from tax savings peculiar to combining with a specific buyer (i.e., operating loss carryforwards to a specific buyer).

We did not discover any major operating savings that a control-buyer of Jung could realize from changing the operations of Jung as a stand-along [alone?] company. Operating synergies and tax synergies are unique to each potential purchaser and could not be measured by the controlling shareholders of Jung. However, we did account for financing synergies which could only be realized if the existing controlling shareholders of Jung were to take action and sell their shares.

In his oral testimony, Grabowski explained as follows:

So we have measured available cash flow based on what we observe to be a reasonable way Jung Corp. was being run. We did not make, I grant you, any operating changes to Jung Corp. in the calculations of the cash flow. Sometimes, Your Honor, when you are doing a control basis, you will find that the controlling shareholder is taking $ 5 million of salary out. And if you are valuing on a control basis, you will add back the excess salary; he may or may not be worth $ 5 million. But if you determine that he is not, you would add that back. Because if I controlled the business, I would not run it that way.

But there was no excessive amounts of compensation that we determined, excessive items that required extensive adjustments, et cetera, in valuing the control interest.

In neither his expert witness reports nor his oral testimony did Grabowski suggest any other element of his calculation of the amount of the available cash-flow that would make his DCF approach a valuation of a controlling interest.

From the foregoing, we gather that the only element of Grabowski's calculation of the amount of the available cash-flow that would make his DCF approach a valuation of a controlling interest is the financing synergy, which we discuss infra. As far as we can tell, in all other respects Grabowski's calculation of the amount of the available cash-flow was done on a basis which, by itself, would not result in a control premium, or minority discount.

(b) The second area of dispute is whether the discount rate applied by the expert witnesses puts the DCF approach valuations on a minority basis. In their initial expert witness report, Hanan and Mitchell stated that no minority discount was needed in their DCF valuation because their discount rate was derived by using equity return data from the trading of minority interests in publicly traded companies.

As explained previously, supra note 6, the DCF approach involves calculating the sum of the present value of the available cash-flow and the present value of the terminal value. A discount rate, which represents the required rate of return of an investor in an alternate investment opportunity, is used in this calculation. The discount rate is the weighted average of the required rate of return on equity capital and the required rate of return on debt capital. Both Grabowski and Hanan and Mitchell determined the required rate of return on equity capital by using the capital asset pricing model (hereinafter sometimes referred to as CAPM). The CAPM is the risk-free rate plus the product of the beta n10 for the specific company and an equity risk premium.

n10 Hanan and Mitchell define and illustrate beta as follows in their expert witness report:

Systematic risk is measured by beta * * *, and is the risk associated with those economic factors that threaten all businesses. Such factors are the reason that stocks have a tendency to move together. Beta provides a measure of the tendency of a security's return to move with the overall market's return (e.g., the return on the S&P 500). For example, a stock with a beta of 1.0 tends to rise and fall by the same percentage as the market (i.e., S&P 500 index). Thus, "[beta] = 1.0" indicates an average level of systematic risk. Stocks with a beta greater than 1.0 tend, on average, to rise and fall by a greater percentage than the market. Likewise, a stock with a beta less than 1.0 has a low level of systematic risk and is therefore less sensitive to changes in the market.

Grabowski's use of this term is essentially the same.

The risk-free rate is the yield to maturity on 20-year (Grabowski) or 30-year (Hanan and Mitchell) U.S. Treasury bonds on the valuation date. This yield is available to investors in the market, without regard to control or minority status. Accordingly, this element of the discount rate does not affect the question of whether the DCF approach results in a controlling interest value or a minority interest value.

Although the establishment of a beta for Jung Corp. involves consideration of many matters (e.g., selecting comparable companies the securities of which are commonly traded on stock exchanges, "unlevering" and "relevering"), it is enough for our purposes to observe that Grabowski and Hanan and Mitchell agree that the Jung Corp. beta was a little under 1. Also, because the betas for the companies and industries that these expert witnesses used are derived from reported stock exchange trading data, which is almost entirely the data of trading in minority interests, this element of the discount rate suggests that ordinarily the DCF approach results in a minority interest value.

Grabowski and Hanan and Mitchell based their equity risk premiums on Ibbotson and Associates' publication, "Stocks, Bonds, Bills, and Inflation". Grabowski based his calculations --

on the arithmetic mean of actual investor returns over the period of 1950-1984 and consists of an overall excess return for the stock market as a whole of 7.34% (the additional return common stock investors earned in excess of the return on long-term government bonds).

Hanan and Mitchell used the same source and --

concluded that the market risk premium [a different term for equity risk premium] equals 6.9%, the average annualized total return on equity investments (defined as the S&P 500) in excess of the average annualized bond yield (income) return on long-term government bonds over the period January 1926 to December 1983.

The modest difference between Grabowski's equity risk premium and that used by Hanan and Mitchell is one of many differences between them that were largely balanced out so that their bottom-line values for Jung Corp. differed by less than 3 percent. See supra table 9. What is important for purposes of the minority discount question is that the basic data these experts used are the data of stock market trading, which is almost entirely the data of trading in minority interests. Thus, this element of the discount rate also suggests that ordinarily the DCF approach results in a minority interest value.

In his rebuttal expert witness report Grabowski contends that the discount rate represents the minimum rate of return which the corporation must earn on its investments, including acquisitions of controlling interests. He notes that the prospective controlling investor will control the total available cash-flow of

the acquired corporation. However, this explanation does not persuade us that the discount rate in Grabowski's DCF calculation implies control, because this rate of return is developed from data that reflect the actions of minority investors and generally not the actions of controlling investors.

We agree with respondent that the discount rates used by the expert witnesses in the instant case reflect the minority position. n11

n11 See Zukin & Mavredakis, Financial Valuation: Businesses and Business Interests, par. 6.9[2], at 6-39 (1990).

[2] Discount for Minority Interest

In many valuation situations, the block of stock to be appraised represents minority ownership interests in the company. Minority blocks of stock, by themselves, generally do not have the power to effect change in the bylaws of a corporation, effect any significant corporate change, sellout, recapitalization or other conversion of assets, determine dividend policies and employee shareholder salaries, or effect any other significant change in corporate policy. A minority stockholder without a ready market for his stock would also find it difficult to dispose of his stock and realize a capital gain.

The fair market value of a marketable minority interest is the price at which the securities trade in a free and active market. In essence, the prices quoted in the Wall Street Journal for public companies whose shares trade on any of the various exchanges or in the over-the-counter market represent the per-share value of marketable minority interests. It therefore follows that a discount is inapplicable in instances where the value of the subject company minority position is predicated upon indices derived from prices of securities of publicly traded companies.

On the other hand, where indications of value are predicated upon control or complete ownership, a discount must be applied to provide indications of value for a minority or less-than-controlling interest. In short, discounts for the subject minority interest are appropriate for some methodologies but inappropriate for others.

To the same effect, see Pratt, Valuing a Business: The Analysis and Appraisal of Closely-Held Companies 118-119 (2d ed. 1989).

(c) Grabowski's main argument is his third argument. He contends that his equity risk premium assumed large company financing synergies. He contends that his equity risk premium of 7.34 percent is appropriate only if Jung Corp. were to be acquired by a large company which could incorporate financing synergies into Jung Corp. He contends that Hanan and Mitchell also assumed financing synergies in determining their equity risk premium of 6.9 percent. In his rebuttal expert witness report Grabowski contends that taking into account Jung Corp.'s small size, the equity risk premium should be 16.73 percent rather than 7.34 percent. Grabowski asserts that a premium of 16.73 percent is appropriate based on the equity risk premiums of the smallest companies traded on the New York Stock Exchange. Stated otherwise, Grabowski is contending that a "small stock" premium of 16.73 percent should have been applied in the DCF valuation, and that because he did not apply a small stock premium, a minority discount is needed to make up for his error. Grabowski did not make this contention

in his initial expert witness report. He made this contention only when his minority discount was challenged. We do not agree that a small stock premium is appropriate in the instant case, and we do not agree that a minority discount is appropriate in the instant case.

Firstly, if Grabowski had applied the small stock premium in his DCF approach to Jung Corp.'s value, then his prediscount value would be only about $ 20 million. n12 That number is even less than McCoy's revised estimate. See supra table 9. Grabowski has not shown us how a $ 20 million October 9, 1984, valuation (or any valuation calculated with Grabowski's small stock premium) could be reconciled with the 1986 sales and liquidation proceeds. We rejected McCoy's $ 22 million valuation in part because of McCoy's failure to so reconcile, and accepted Grabowski's $ 33 million valuation because it could be reconciled with the 1986 events.

n12 In his rebuttal expert witness report, Grabowski explains that his small stock premium calculations would result in reducing by 35 percent the value of Jung Corp.'s health care component and by 55 percent the value of Jung Corp.'s elastic textiles component. He does not indicate any change in the value for Ione. Thus, he would reduce his original prediscount valuation for Jung Corp. from under $ 26.5 million, see supra table 9, to under $ 16 million, an overall reduction of about 40 percent. When Grabowski revised his calculations, increasing his original $ 26.5 million to $ 33 million, see supra table 9, he did not also recalculate the effect of his small stock premium calculations. We have assumed, for purposes of our analysis, that his revised valuation also would be reduced by 40 percent, thus reducing his prediscount valuation for Jung Corp. from under $ 33 million to under $ 20 million.

Accordingly, we reject Grabowski's contention that he had erred by failing to use a small stock premium in his initial expert witness report calculation in the instant case. Because a small stock premium would not have been appropriate in the instant case (whatever may be the general validity of the small stock premium concept), there is no force to Grabowski's contention that a minority discount is appropriate in order to make up for Grabowski's failure to use a small stock premium.

Secondly, Mitchell testified that small companies tend to be more risky because they tend to be in risky industries. Thus, the apparently greater equity risk premiums for small companies, on which Grabowski relies, are merely a reflection of the risk involved in the type of activity and not a greater risk arising merely or primarily because of corporate size. As a result, it is not at all clear that there is any general validity in the small stock premium concept, except as a substitute for a beta rating. See Pratt, Valuing a Business: The Analysis and Appraisal of Closely-Held Companies 76-77 (2d ed. 1989).

Thirdly, at trial when Grabowski was asked to explain the differences in risk and rates of return in regard to an investment in a small company like Jung Corp., and an investment in a large publicly traded company, Grabowski discussed lack of control and lack of marketability, factors which are taken into account by the DCF approach and a discount for lack of marketability. Grabowski did not provide the Court with any evidence that Jung Corp. is a riskier investment simply because of its small size. In addition, Grabowski did not provide any explanation of why the size of the corporation affects the appropriateness of a discount for a minority interest in the corporation.

We conclude that in the instant case financing synergies do not justify a minority discount, on top of the 35-percent marketability discount that we have already determined to allow.

At trial, the Court raised the question of whether some amount of minority discount is appropriate to account for the difference between a minority shareholder in a publicly traded corporation and a minority shareholder in a closely held corporation. On brief petitioner contends that there is a difference between minority shareholders in private and publicly traded companies, but petitioner provides neither authority nor persuasive reasoning to support the contention. Respondent contends that although there may be differences, the differences generally do not affect the value of the stock, and in any event do not affect the value of decedent's stock in the instant case. The Court has not found any authority for using the public-private distinction as a basis for applying a minority discount. Accordingly, in the instant case we do not apply a minority discount based on the differences between public and private minority shareholders.

We conclude that the DCF calculations by Grabowski and by Hanan and Mitchell in the instant case were on a minority basis, and we have found that in the instant case no minority discount should be applied to the values determined using the DCF approach.

Petitioner contends that in Northern Trust Co., Transferee v. Commissioner, 87 T.C. 349, 383 (1986), affd. sub nom. Citizens Bank & Trust Co. v. Commissioner, 839 F.2d 1249 (7th Cir. 1988), this Court approved the use of a minority discount when the DCF approach is used in valuation. Respondent tells us that the instant case provides us "with an opportunity to reconsider issues" in Northern Trust Co., Transferee.

In Northern Trust Co., Transferee, stock of a closely held corporation was valued. Grabowski submitted an expert witness report and testified in that case. Grabowski used the DCF approach, and he used the CAPM to determine the discount rate. After deciding on a value for the corporation, he applied a minority discount. 87 T.C. at 369. This Court concluded that the DCF approach correctly determined the value of the stock. We also allowed both minority and marketability discounts. Id. However, in Northern Trust Co., Transferee, respondent did not contend that no minority discount was appropriate. Rather, respondent merely argued for a lower minority discount than the discount for which the taxpayer contended. Id. Because the parties in Northern Trust Co., Transferee did not present to the Court the question of whether a minority discount could be allowed in conjunction with the DCF approach, the opinion in that case did not explore whether the DCF approach that Grabowski used in that case was calculated on a control basis rather than on a minority basis. See Estate of Fusz v. Commissioner, 46 T.C. 214, 215 n.2 (1966).

Thus, we do not accept respondent's invitation to reconsider our opinion in Northern Trust Co., Transferee v. Commissioner, supra, and we also conclude that that opinion does not require us to allow a minority discount in the instant case.

We hold, for respondent, that no minority discount shall be applied.

D. Conclusion

In determining the date-of-death value of decedent's shares in Jung Corp., we have concluded that the value of Jung Corp. was $ 32-34 million. We have concluded that the prediscount value of decedent's shares was $ 6.7 to $ 7 million, and that this must be discounted by 35 percent.

We are obligated to set a specific number on the value of decedent's interest. We are not so presumptuous as the parties, who claimed the wisdom in the estate tax return and in the notice of deficiency to determine the value to seven significant figures ($ 2,671,973 and $ 8,330,448, respectively). Taking into account the "inherently imprecise" nature of this issue, Messing v. Commissioner, 48 T.C. 502, 512 (1967), we determine this value to two significant figures -- $ 4,400,000. We have so found.

We hold for neither party on this issue, although we note that our conclusion is significantly closer to petitioner's position than it is to respondent's position.

II. Section 6660

In her amendment to answer, respondent asserts an addition to tax under section 6660. See sec. 6214(a). Respondent asserts that the value claimed on the tax return is less than 40 percent of the correct value, and so the addition to tax should amount to 30 percent of the underpayment attributable to the valuation understatement. On brief, respondent does not specifically ask for the 30-percent rate, but rather asks for an addition to tax "in an amount to be computed based upon the value of the decedent's interest in Jung as determined by the Court." Respondent contends that petitioner did not have a reasonable basis for the valuation claimed on its tax return and that respondent did not abuse her discretion in refusing to waive the addition.

Petitioner contends that there should be no addition to tax because (1) there is no valuation understatement, and (2) even if there is a valuation understatement, the addition to tax should be waived because (a) there was a reasonable basis for the estate tax return value, (b) petitioner claimed this value in good faith, and (c) respondent "wrongfully refused to waive the addition to tax".

Respondent relies on our opinion in Mailman v. Commissioner, 91 T.C. 1079 (1988). Petitioner seeks to distinguish that case because (1) it is based on a different Code section (sec. 6661, not sec. 6660, as is the instant case), (2) in Mailman we relied on regulations under section 6661 while there are no regulations under section 6660, and (3) in Mailman there was no expert evidence or evidence of the taxpayer's efforts to determine proper tax liability, while in the instant case there is substantial evidence in both categories.

We agree with respondent that there is a valuation understatement, but we agree with petitioner that the resulting addition to tax should be waived.

Section 6660 n13 provides for an addition to tax if there is an underpayment of tax of at least $ 1,000 attributable to a valuation understatement for purposes of estate or gift tax. There is a valuation understatement if the value stated on the tax return is 66 2/3 percent (or less) of the correct value. Respondent may waive all or part of this addition to tax if there was a reasonable basis for the valuation claimed on the return and the claim was made in good faith.

n13 SEC. 6660. ADDITION TO TAX IN THE CASE OF VALUATION UNDERSTATEMENT FOR PURPOSES OF ESTATE OR GIFT TAXES.

(a) ADDITION TO THE TAX. -- In the case of any underpayment of a tax imposed by subtitle B (relating to estate and gift taxes) which is attributable to a valuation understatement, there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributed.

(b) APPLICABLE PERCENTAGE. -- For purposes of subsection (a), the applicable percentage shall be determined under the following table:

If the valuation claimed is the following percent of the correct valuation --	The applicable percentage is:
50 percent or more but not more than 66 2/3 percent	10
40 percent or more but less than 50 percent	20
Less than 40 percent	30

(c) VALUATION UNDERSTATEMENT DEFINED. -- For purposes of this section, there is a valuation understatement if the value of any property claimed on any return is 66 2/3 percent or less of the amount determined to be the correct amount of such valuation.

(d) UNDERPAYMENT MUST BE AT LEAST $ 1,000. -- This section shall not apply if the underpayment is less than $ 1,000 for any taxable period (or, in the case of the tax imposed by chapter 11, with respect to the estate of the decedent).

(e) AUTHORITY TO WAIVE. -- The Secretary may waive all or any part of the addition to the tax provided by this section on a showing by the taxpayer that there was a reasonable basis for the valuation claimed on the return and that such claim was made in good faith.

(f) UNDERPAYMENT DEFINED. -- For purposes of this section, the term "underpayment" has the meaning given to such term by section 6653(c)(1).

[Subsec. (f) was added by sec. 1811(d), Tax Reform Act of 1986 (TRA 86), Pub. L. 99-514, 100 Stat. 2085, 2833, retroactively as if included in sec. 6660 when sec. 6660 was enacted, TRA 86 sec. 1881, 100 Stat. 2914. The subsequent amendments of this provision by TRA 86 sec. 1899A(57), 100 Stat. 2961; and by sec. 7721(c)(2) of the Omnibus Budget Reconciliation Act of 1989 (OBRA 89), Pub. L. 101-239, 103 Stat. 2106, 2399 (which repealed sec. 6660), do not affect the instant case.]

[As a result of OBRA 89, the substance of sec. 6660 may now be found in subsecs. (g) and (h)(2)(C) of sec. 6662.]

[The waiver provision has been replaced by a reasonable cause exception (which now appears as sec. 6664(c)(1)) which is similar to the circumstances which, under pre-OBRA 89 law, could have been the basis for consideration of a waiver.]

Because respondent did not determine the addition to tax in the notice of deficiency, but asserted it in the amendment to answer, respondent has the burden of proof on all of the elements of section 6660. Rule 142(a); see Reiff v. Commissioner, 77 T.C. 1169, 1173 (1981); Achiro v. Commissioner, 77 T.C. 881, 889-891 (1981).

We consider first whether there is a valuation understatement and, if so, then whether the addition to tax should be waived.

A. Valuation Understatement

As shown supra in table 4, we hold that the correct value of decedent's interest in Jung Corp. is $ 4,400,000, and petitioner claimed on its estate tax return that the value is $ 2,671,973. The claimed value thus is about 60.7 percent of the correct value. It follows that there is a valuation understatement, sec. 6660(c), and that the applicable percentage is 10 percent, sec. 6660(b). It is apparent that the underpayment of estate tax attributable to the valuation understatement is at least $ 1,000. Sec. 6660(d).

As a result, an addition to tax of 10 percent of the attributable underpayment is to be imposed on account of the valuation understatement, unless the addition to tax is waived.

B. Waiver

Section 6660(e) provides that the Secretary may waive all or part of the addition to tax under section 6660 if the taxpayer shows both (1) that there was a reasonable basis for the valuation claimed on the tax return, and (2) that the taxpayer acted in good faith in claiming that valuation. The denial of a waiver by the Secretary is reviewable by this Court on an abuse-of-discretion basis. Mailman v. Commissioner, 91 T.C. at 1082-1084. n14 In other words, for petitioner to win on this issue it is not enough for us to conclude that we would have waived the addition to tax -- we would have to conclude that, in refusing to waive the addition to tax, respondent has exercised this discretion "arbitrarily, capriciously, or without sound basis in fact." Mailman v. Commissioner, 91 T.C. at 1084; n15 see Capitol Fed. Sav. & Loan v. Commissioner, 96 T.C. 204, 213, 223 (1991).

n14 Although, as petitioner notes, Mailman v. Commissioner, 91 T.C. 1079 (1988), was a sec. 6661 case, the abuse of discretion standards there set forth have been used in other areas where the Internal Revenue Code has specifically given discretion to respondent. E.g., Citrus Valley Estates, Inc. v. Commissioner, 99 T.C. 379, 464 (1992), on appeal (9th Cir., May 19, 1993); Capitol Fed. Sav. & Loan v. Commissioner, 96 T.C. 204, 213 (1991). The use of the Mailman standard in the instant case is specifically appropriate because the language of sec. 6660(e) that we interpret is essentially similar to the language of sec. 6661(c) interpreted in Mailman. See, e.g., Zuanich v. Commissioner, 77 T.C. 428, 442-443 (1981).

n15 We conclude that respondent had adequate opportunity to exercise her discretion under sec. 6660(e). See Mailman v. Commissioner, 91 T.C. at 1084 n.5. Petitioner objected to the addition to tax in the reply to respondent's amended answer, stating as an "affirmative defense" the allegation that petitioner had a reasonable basis for the valuation and that the valuation was made in good faith. The waiver issue was discussed at trial. Further, respondent does not contend that she did not have adequate opportunity to exercise her discretion. Compare Estes v. Commissioner, T.C. Memo. 1992-531 with Klieger v. Commissioner, T.C. Memo. 1992-734 and Sotiros v. Commissioner, T.C. Memo. 1991-95.

In the instant case, respondent has the burden of proof on the section 6660 addition to tax. If respondent were to prove that either (1) there was not a reasonable basis for the valuation claimed on the tax return, or (2) the valuation claim was not made in good faith, then respondent would have proven that petitioner failed to meet the statutory predicate for consideration of a waiver. Failing that, respondent could prevail if she were to prove that her refusal to waive the addition to tax (1) was not arbitrary, (2) was not capricious, and (3) had a sound basis in fact.

We consider first whether the valuation claim was made in good faith, then whether there was a reasonable basis for the valuation, and finally whether respondent abused her discretion in failing to waive the addition to tax.

1. Good Faith

It was clear that decedent's interest in the Jung Corp. constituted substantially all of decedent's estate. The executrix proceeded promptly to retain the services of Robinson, an experienced appraiser. Robinson examined financial records and interviewed officials of Jung Corp. On April 8, 1985, he submitted a report which provided some explanation of his conclusions. Petitioner's estate tax return, incorporating Robinson's valuation, was filed timely, on July 9, 1985. Respondent does not direct our attention to any evidence pointing to lack of good faith.

We conclude (and we have found) that petitioner acted in good faith in claiming the valuation reported on the estate tax return.

2. Reasonable Basis

It is a close question whether there was a reasonable basis for the valuation claimed on the return.

On the one hand, Robinson undervalued decedent's stock by about $ 1.7 million -- an undervaluation of about 39 percent of what we have determined to be the correct value. Robinson's report is short, it is deficient in providing data and support for its conclusions, and the Court has given little weight to it in valuing the stock. n16

n16 See 15 Mertens, Law of Federal Income Taxation, sec. 59.08, at 26 (1992).

A common fallacy in offering opinion evidence is to assume that the opinion is more important than the facts. To have any persuasive force, the opinion should be expressed by a person qualified in background, experience, and intelligence, and having familiarity with the property and the valuation problem involved. It should also refer to all the underlying facts upon which an intelligent judgment of valuation should be based. The facts must corroborate the opinion, or the opinion will be discounted. [Fn. refs. omitted; emphasis added.]

On the other hand, Robinson's analysis does have some validity, and his conclusions were based on his extensive experience as an appraiser. Robinson's report, although poor for purposes of assisting the Court in determining the value of decedent's interest, does give some explanation of Robinson's conclusion, analysis, and process. Also, it is evident that valuing decedent's interest is a difficult task. After all, in the notice of deficiency respondent overvalued decedent's interest by about 89 percent. Even on brief, after having access to all the expert witness reports and other evidence of record (more

than 3 1/2 linear feet of exhibits and almost 1,000 pages of transcript), respondent overvalued decedent's interest by about 82 percent. Thus, petitioner's valuation was much closer to the mark than was respondent's valuation.

Petitioner does not contend that Robinson's value for Jung Corp. ($ 18,405,000) can be reconciled with the proceeds which were obtained by the shareholders through the sale of Jung Corp.'s subsidiaries and assets; however, this does not negate our finding of a reasonable basis. When the appraisal report was prepared and the estate tax return was filed, neither Robinson nor the executrix of the estate knew that Jung Corp.'s subsidiaries and assets would be sold, and what the liquidation proceeds would amount to.

Under the circumstances, we conclude (and we have found) that there was a reasonable basis for the valuation claimed on the estate tax return.

3. Abuse of Discretion

If our role were to determine whether petitioner had reasonable cause and acted in good faith, then our determinations under items 1 and 2, supra, would be enough, and petitioner would prevail. However, for the years before the Court our role is much more limited. See supra the last paragraph of note 13. As we stated in Mailman v. Commissioner, 91 T.C. 1079, 1084 (1988) --

Unlike other additions to tax such as for failure to timely file (sec. 6651(a)(1)), the statute does not provide that the taxpayer's proof of reasonable cause will excuse the taxpayer's misfeasance.

To put it another way, under the statute's language petitioner's showing of reasonable basis and good faith serve only to bring petitioner to the point where respondent "may waive all or any part of the addition to the tax". Sec. 6660(e) (emphasis added). That is, such a showing gets petitioner into the game; in order for petitioner to win the game, we must consider whether respondent's refusal to waive is an abuse of discretion. In the instant case we have to determine whether respondent has carried her burden of persuading us that her discretion was not exercised "arbitrarily, capriciously, or without sound basis in fact." Mailman v. Commissioner, 91 T.C. at 1084.

On the one hand, petitioner's actions have satisfied the good faith and reasonable basis requirements, but not so clearly as to make respondent's refusal to waive arbitrary or capricious. On the other hand, it is evident that respondent's view of the situation was affected by a view of the facts that was far from the view that we took.

As we have noted, respondent overvalued the property by $ 3.6 million on brief, while petitioner undervalued the property by a little more than $ 1.7 on the tax return. From respondent's position on brief, petitioner's tax return undervaluation was enormous. From our view of the facts, the amount of petitioner's tax return undervaluation was less than one-half the amount of respondent's overvaluation on brief. We conclude that respondent's discretion was exercised "without sound basis in fact." Mailman v. Commissioner, 91 T.C. at 1084.

We conclude, and we have found, that respondent's refusal to waive the addition to tax under section 6660 was an abuse of discretion.

In Estate of Berg v. Commissioner, T.C. Memo. 1991-279, affd. in part and revd. in part 976 F.2d 1163 (8th Cir. 1992), we held that respondent's discretion had not been abused in refusing to waive the section 6660 addition to tax. The Court of Appeals reversed on that issue. The record in the instant case

is far more favorable to petitioner than the record presented by the taxpayer in Estate of Berg.

In Estate of Berg, the taxpayer did not commission an appraisal until more than 4 years after the decedent's death; in the instant case petitioner did commission an appraisal promptly, and the value on the timely filed estate tax return was based on that appraisal. In Estate of Berg, the estate tax return did not provide support for the claimed valuation, except for a reference to another opinion of this Court; in the instant case, Robinson's appraisal was deficient in terms of evidentiary standards, but provided some substantive support for the claimed valuation. In Estate of Berg, we agreed with respondent's determination of value; in the instant case, respondent overvalued the property by more than twice as much as petitioner undervalued it. Thus, our conclusion in the instant case that respondent's discretion was abused is consistent with our conclusion in Estate of Berg that respondent's discretion was not abused.

In Estate of Berg, the Court of Appeals held that respondent's discretion was abused. This is the same result that we reach in the instant case.

We conclude that, under these circumstances, the instant case is not an appropriate vehicle for determining whether we agree with the analysis presented by the Court of Appeals for the Eighth Circuit in Estate of Berg v. Commissioner, 976 F.2d at 1166-1167.

We hold for petitioner on this issue.

To take account of the foregoing and concessions on other matters,

Decision will be entered under Rule 155.

APPENDIX

Jung Corp. -- Consolidated as of September 30, 1984

Assets	
Current assets:	
Cash	$ 1,582,396
Short-term investments and cer-	
tificates of deposit	591,804
Dividends receivable	-0-
Accounts receivable:	
Trade	9,613,349
Other	1,711,458
Allowance for doubtful	
accounts	168,167CR
Total accounts receivable	11,156,640
Inventories	9,188,984
Prepaid expenses	84,113

Prepaid employee benefit plan	1,091,709
Advances & receivables from affiliates	2,583,493
Deferred income taxes	241,649CR
Total current assets	26,037,490
Investment and advance to subsidiaries	-0-
Property, plant & equipment:	
Land	466,484
Building	4,920,540
Leasehold improvements	338,494
Machinery & equipment	12,603,710
Construction work in progress	217,050
Total	18,546,278
Less allowance for depreciation	9,402,491CR
Total property plant & equipment	9,143,787
Other assets:	
Cash surrender value of life insurance, net	403,899
Due from officers	267,174
Sundry	121,373
Total other assets	792,446
Excess of cost over equity in subsidiary at date of acquisition	393,419
Total assets	36,367,142
Liabilities	
Current liabilities:	
Notes payable to banks	$ 1,700,000
Current portion of capital lease obligations and long-term debt	178,996

Trade accounts payable	3,438,694
Advances and payable to affiliates	2,673,689
Other accounts payable and accrued expenses	1,920,586
Accrued profit sharing	895,061
Accrued employee benefit plan	1,095,028
Dividend payable	-0-
Federal and State income tax	267,201
Total current liabilities	12,169,255
Capital lease obligations	900,000
Long-term debt	3,277,568
Deferred Federal income taxes	1,040,281
Accrued executive retirement net of deferred taxes	135,622
Minority interest in subsidiaries	14,556
Total liabilities	17,537,282
Shareholders' equity:	
Capital stock -- class B	33,600
Common stock	1,216,241
Additional paid-in capital	1
Retained earnings	17,580,018
Total stockholders' equity	18,829,860
Total liabilities & equity	36,367,142

Kaczkowski v. Bolubasz

491 Pa. 561 (1980)

421 A.2d 1027

Theodore KACZKOWSKI, Administrator of the Estate of Eric K. Kaczkowski, Deceased, on behalf of the Estate of Eric K. Kaczkowski, Deceased, Appellant, v. John J. BOLUBASZ, Appellee.

Supreme Court of Pennsylvania.

Argued March 10, 1980.

Decided September 22, 1980.

Seymour Sikov, Sikov & Love, Pittsburgh, for appellant.

Cosmos J. Reale, Warren D. Ferry, Pittsburgh, for appellee.

Stephen M. Feldman, Feldman & Feldman, Philadelphia, for amicus curiae Pa. Trial Lawyers.

EAGEN, C.J., and O'BRIEN, ROBERTS, NIX, LARSEN, FLAHERTY and KAUFFMAN, JJ.

OPINION

NIX, Justice.

Appellant instituted a complaint in trespass in Allegheny County Court of Common Pleas. The suit arose from an automobile accident in which the decedent, Eric K. Kaczkowski, was riding as a passenger in a vehicle operated by appellee. At the original trial of this matter, the jury established the liability of the appellee. Upon appellant's Motion For a New Trial, the case was returned to the trial court for a retrial on the issue of damages.

During the retrial of the question of damages, the jury was presented with the following facts: the decedent was a white male, twenty years of age at the time of his death; he attended Alliance College, Cambridge Springs, Pennsylvania for two years; and at the time of his death, he was attending the Institute of Computer Management, a division of Litton Industries. Decedent's close friends and relatives testified that decedent was in good health, industrious, and interested in his course of study in computer operations.

The Director of Placement at the Institute for Computer Management testified to his familiarity with the decedent, that his progress was good for a beginning student, and that the decedent evidenced motivation and willingness to learn. Based upon his professional contact with employers and experience in placing graduates, the Placement Director testified to the range of salaries for which the decedent would have been qualified. He stated that in the private sector, the average salaries ranged from $538.36 to $585.77 per month, and in the public sector, the average salaries ranged from $600 to $900 per month.

During an in-chambers discussion, appellant's counsel offered to call as an expert witness, Doctor Reuben E. Slesinger, an Economics Professor at the University of Pittsburgh. By the testimony of Doctor Slesinger, counsel offered to prove a projection of the potential earning capacity of the decedent.[1] Although the trial court did not prohibit Dr. Slesinger from testifying as to his projection of future lost earnings reduced to present value, the court refused to allow Dr. Slesinger to use a four percent (4%) annual increment to the victim's base salary to represent the combined impact of inflation and productivity gains on the future increases in the victim's earnings. The trial court's refusal was based upon the recently decided case of *Havens v. Tonner,* 243 Pa.Super. 371, 365 A.2d 1271 (1976),[2] which the trial court interpreted to mandate that "an annual increment percentage whether called a productivity factor or inflation factor is not permitted to be used by a witness projecting future loss of earnings reduced to present worth." *Kaczkowski v. Bolubasz,* No. 1246 April Term, 1978, Court of Common Pleas of Allegheny County, at 3 (February 22, 1978).

Rather than have Dr. Slesinger project the future loss of earnings without the four percent (4%) annual increment, the plaintiff chose not to use any of Dr. Slesinger's testimony. Instead, the plaintiff relied upon the trial court's charge of impairment of future earning power for the guidance of the jury. The lower court charged the jury to consider the decedent's personal characteristics to: calculate the potential gross earnings of the decedent for the period of decedent's work life expectancy; to determine the maintenance costs of the decedent for the period of decedent's work life expectancy; to deduct the personal maintenance costs from the gross earnings to produce net earnings; and to discount the net earnings to present value by six percent (6%) simple interest. Based upon the judge's instructions, the jury returned a verdict of $30,000. on behalf of the estate of Eric K. Kaczowski. The appellant's Motion for a New Trial was denied. The appellant appealed to the Superior Court which per curiam affirmed the lower court based upon the Superior Court's prior decision in *Havens v. Tonner. Kaczkowski v. Bolubasz,* No. 755 April Term, 1978 (Superior Court of Pa., May

[1] The projection took into consideration factors which had previously been testified to by various witnesses called on behalf of appellant. Counsel for appellant advised the Court that Dr. Slesinger would have testified as to the effects of productivity increases and inflation on the potential earning capacity of the decedent. The proffered projection did not take into consideration pensions, social security benefits, fringe benefits, or the like, and this appeal is not concerned with these items.

[2] See discussion of *Havens v. Tonner,* 243 Pa.Super. 371, 365 A.2d 1271 (1976), beginning at page 1031, infra.

4, 1979). Appellant filed a Petition for Allowance of Appeal with this Court and we granted allocatur.[3]

The issue raised by appellant is whether the trial court erred in excluding reliable economic testimony showing the impact of inflation[4] and increased productivity[5] on decedent's future earning power.[6] In order to address this issue, we must consider current Pennsylvania law and reassess its effectiveness in light of the purported objective of awarding full compensatory damages for loss of future earnings. To the victims of negligence or their survivors, the law of damages is of at least the same concern as the substantive law of torts. We have been quick to change substantive tort law where it has been determined that the needs of a changing society so dictated. See e.g., *Sinn v. Burd,* 486 Pa. 146, 404 A.2d 672 (1979); *Azzarello v. Black Bros. Inc.,* 480 Pa. 547, 391 A.2d 1020 (1978); *Mayle v. Pa. Dept. of Hwy.,* 479 Pa. 384, 388 A.2d 709 (1978); *Fadgen v. Lenker,* 469 Pa. 272, 365 A.2d 147 (1976); *Ayala v. Phila. Bd. of Education,* 453 Pa. 584, 305 A.2d 877 (1973). We are now called upon to determine whether the law of damages is in need of similar adjustments due to changes of circumstances occasioned by the passage of time and conclude that both a productivity factor and inflation should be reflected in an award of lost future earnings.

I. Current Law

In this Commonwealth, we have consistently held that damages are to be compensatory to the full extent of the injury sustained. *Incollingo v. Ewing,* 444 Pa. 299, 307, 282 A.2d 206, 210 (1971); *McLane v. Pittsburgh Rys. Co.,* 230 Pa. 29, 79 A. 237 (1911); *Montgomery Bank v. Reese,* 26 Pa. 143, 146 (1850). The rule "is to give actual compensation, by graduating the amount of damages exactly to the extent of the loss."

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[3] Jurisdiction over this appeal is pursuant to 42 Pa.C.S.A. § 724.

[4] Inflation is "the increase in the volume of money and credit relative to available goods resulting in a substantial and continuing rise in the general price level." Websters, Third International Dictionary (1965). Inflation gains are measured in terms of what the average person refers to as "cost of living increases." An example of inflation evidencing an increase in prices unrelated to an increase in intrinsic value is that the juice content of oranges has not increased in years, but their price continues to rise.

The presence of inflation plays two distinct roles in an award for prospective damages. The first role is determining the impact of inflation on the future earnings of the victim. The second place in which inflation plays a part is in determining the appropriate interest rate to discount the future damage award to its present value.

[5] Economist's recognize that there are at least four major elements which influence the rate of increase of an employee's income. These factors are: (1) the educational attainment of the participant prior to his entry into the labor marker; (2) the influence of age upon the earnings of participants over their life cycle; (3) the significance of productivity and growth; and (4) the impact of inflation. Henderson, The Consideration of Increased Productivity and Discounting of Future Earnings to Present Value, 20 S.D.L.Rev. 307 (1976). In our analysis, we will isolate the inflation element from the other three factors, collectively called "merit" increases, which are consumed in productivity. We recognize that merit increases are controlled by different variables than the inflationary factor, and deserve separate consideration.

[6] Since damages in personal injury and wrongful death actions involve the lost earning capacity of the victim, the proper period to calculate a loss is based upon work-life expectancy.

Forsyth v. Palmer, 14 Pa. 96, 97 (1850). Loss of future earnings is a distinct item of damages, which if properly proved, may result in recovery for the plaintiff.[7]

Inflation and productivity increasingly demand judicial attention, particularly with respect to personal injury action damages for lost future earnings. Traditionally, evidence of future inflation and productivity increases have been deemed too speculative to be included in calculating future damages even though inflation and productivity increases may drastically reduce an initially generous award. 18 *Washburn L.J.* 499 (1979). However, today, in light of clear scientific evidence of the fact that inflation and productivity have become an established part of our economy, it becomes necessary that these factors be considered in such awards.

The "law does not require that proof in support of claims for damages or in support of compensation must conform to the standard of mathematical exactness." *Lach v. Fleth,* 361 Pa. 340, 352, 64 A.2d 821, 827 (1949). All that the law requires is that "(a) claim for damages must be supported by a reasonable basis for calculation; mere guess or speculation is not enough." *Stevenson v. Economy Bank of Ambridge,* 413 Pa. 442, 453-54, 197 A.2d 721, 727 (1964). See also, *Small v. Flock,* 407 Pa. 148, 180 A.2d 59 (1962); *Getz v. Freed,* 377 Pa. 480, 105 A.2d 102 (1954). "If the facts afford a reasonably fair basis for calculating how much plaintiff's entitled to, such evidence cannot be regarded as legally insufficient to support a claim for compensation." *Western Show Co., Inc. v. Mix,* 308 Pa. 215, 162 A. 667 (1932).

Personal injury awards are usually lump-sum payments, and are not paid in weekly or monthly installments.[8] Thus, all damages for personal injuries, including damages expected to accrue in the future,[9] must be proved and calculated at trial. D. Dobbs, Remedies, § 8.1 (1973). The loss of future wages is discounted to its present value by using the six percent (6%) simple interest figure.[10]

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[7] When an injury is a permanent one, one which will cause a loss or lessening of future earning power, a recovery may be had for the probable loss of future earnings. McCormick, Damages, 299 (20th reprint 1975). If the injured party survives, he should receive undiminished, his total estimated future earnings, but if he dies, the proper measure of damages includes a deduction based upon decedent's cost of personal maintenance. *Incollingo v. Ewing,* 444 Pa. 263, 307, 282 A.2d 206, 228 (1971). Today's opinion does not disturb our requirement for personal maintenance deductions.

[8] The Workmen's Compensation Act is the most notable exception, Act of February 28, 1956, P.L. 1120 § 1 et seq., (1955) as amended, 77 P.S. § 1 et seq. See also No-Fault Motor Vehicle Insurance Act, Act of July 19, 1974, P.L. No. 176, § 106(a)(7), 40 P.S. § 1009.106(a)(1).

[9] In order for the factfinder to assess the precise measure of damages, expert testimony is admissiblie if "the subject matter of the inquiry is one involving special skills and training beyond the ken of ordinary laymen." *Reardon v. Meehan,* 424 Pa. 460, 465, 227 A.2d 667, 670 (1967).

[10] The rationale for reducing a lump-sum award to its present value is that:

> it is assumed that the plaintiff will invest the sum awarded and receive interest thereon. That interest accumulated over the number of relevant years will be available, in addition to the capital, to provide the plaintiff with his future support until the total is exhausted at the end of the period. The projected interest must therefore be allowed in reduction of capital lest it be claimed that the plaintiff is overcompensated.

Specifically, the principles relating to the limitation of the proof and consideration of the economic factors affecting lost future earnings have been articulated recently in *Havens v. Tonner,* 243 Pa.Super. 371, 365 A.2d 1271 (1976). In Havens, the appellant and the appellee were involved in an automobile accident. The appellee suffered whiplash, as well as a weakness in his right arm and leg. After his employer's reorganization of the corporate sales office, appellee's employment was terminated. As of his termination date, appellee claimed a total and permanent disability.

In the common pleas court, the jury returned a verdict in favor of the appellee. On appeal to the Superior Court, the appellant objected to the admissibility of an economist's testimony on appellee's lost future earnings. During trial, the economist calculated lost future earnings based upon a projected work life of 20.69 years. He assumed that if appellee continued as an employee he would have earned $12,780. annually, plus fringe benefits. A 3½ percent productivity factor was added to this figure.

The economist explained his calculation of the productivity factor as follows:

> What I have taken into account here is the fact of productivity increases in the future, to try and allow for future increases in wages which would come about due to the fact that the economy over a long period of time has had a tendency to exhibit an increase in the propensity to produce goods and services at a faster more efficient rate. Namely, due to better technology. This, over the longrun [sic] is the principal cause or the principal reason why a person's wages rise; if he can

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Fleming, Inflation and Tort Compensation, 26 *Am.J.Comp.Law* 51, 66 (1977).

"The measure of the lump-sum award for future pecuniary losses arising from a tort is the present worth of the full amount of what would have been received at a later time." Restatement of Torts (Second) § 913A, Wilkinson v. Northeast Borough, 215 Pa. 486, 74 A. 734 (1906). In Pennsylvania, since 1922 our courts have mandated that when discounting future damages to present worth "the interest must be computed at the lawful rate of six percent…." *Windle v. Davis*, 275 Pa. 23, 118 A. 503 (1922). The rationale for the mandatory six percent simple interest rule was explained by this Court in *Gregorius v. Safeway Steel Scaffolds Co.,* 409 Pa. 578, 585, 187 A.2d 646, 649 (1963):

> "We are all aware that present interest rates are different than as of the year this [fixed six per cent] rule was first written. In fact, they presently vary from day to day, place to place, and under different conditions in the same area. There must be a fixed rule to aid juries in calculating the present worth of such elements of damage and to guide the jury in resolving such difficult questions. It is our conclusion that a change in the rule would lead only to confusion and chaos and add greater difficulty in the trial of such cases."

The origin of this principle *is Chesapeake & Ohio RW Co. v. Kelly,* 241 U.S. 485 [36 S. Ct. 630, 60 L. Ed. 1117] (1916), in which the Supreme Court announced that awards for future damages had to be discounted to present value at some appropriate discount rate. Research reveals that the discounting theory is grounded in economic history of the latter part of the nineteenth century. "Between 1867 and 1896, for example, it is estimated that the price level dropped by about forty percent. At the turn of the century, one needed only approximately sixty percent of the dollars required at the end of the Civil War to purchase the same basket of goods." 20 *S.D.L.Rev.* at 309. When future prices are expected to decline or remain constant, there is no economic disagreement with the discounting theory. However, an economic lag of judicial practice occurs when courts perpetuate a 1916 rationale to the economic realities of the 1900's. Id.

> produce twice as much in an hour after learning to do his job better, his employer can afford to pay him more because the employer has more goods that this individual produced that he can now offer for sale and, in fact, in the longrun [sic] in the American economy, productivity has increased or the ability of American workers to produce more goods and services in an hour somewhere around three and a half per cent, therefore, I have allowed the wage increase here approximately of about three and a half percent perannum [sic] for the remaining period of his work-life expectancy. 243 Pa.Super. at 385, 365 A.2d at 277-78.

The Superior Court refused to accept the economist's testimony concerning a 3½% productivity factor. It reasoned that the productivity factor "was based upon nothing but the economist's assertion that experience demonstrated that industrial productivity increased annually by at least that much due to improved technology and that this improvement was normally passed along in the form of increased wages." Id., 243 Pa.Super. at 378, 365 A.2d at 1274. The Superior Court rationalized its holding as follows:

> Steadily rising wage rates over the next twenty years, whatever the cause, are simply one face of the coin of inflation. It may be that inflation will become so much an established pattern of our economy that it should be recognized in estimating loss of future earnings. Certainly the erratic behavior of the economy over the past half dozen years, plagued by war and other unusual circumstances, is not a sufficient demonstration that inflation at any predictable rate will continue for another twenty years. Furthermore, even if inflation is a part of the pattern of the future, one certain consequence is that interest rates on money will reflect that fact. Consequently, a sum representing the present worth of future earnings will earn more in dollars in an inflationary period than would otherwise be the case. This may not wholly compensate for the effect of inflation over the next twenty years. We view the "productivity factor" as simply a substitute for inflation and equally speculative and inadmissible in a calculation of future earnings. Id.

Thus, it appears that the Haven's Court misunderstood that inflation and productivity were separate and distinct phenomena and the court failed to distinguish between the two in its blanket rejection of the productivity factor that was offered in evidence. Therefore, under the teaching of Havens, a tort victim in Pennsylvania who institutes an action to recover lost future earnings only receives compensation based upon his or her salary as of the date of the debilitating event. The current earning amount is multiplied by the number of years remaining in the victim's worklife span. The total figure is then reduced to its alleged present value. There is no allowance made in the lost future earning formula for consideration of either potential productivity or inflation.

II. Fallacy of Havens

Ideally, a damage award computation should achieve the tripartite goals of accuracy, efficiency, and predictability. *Freeport Sulphur Co. v. S.S. Hermosa,* 526 F.2d 300, 308-12 (5th Cir. 1976). Commentators note that the Pennsylvania method of calculating lost

future earnings achieves the efficiency goal by precluding expert testimony on inflation and productivity while confining the relevant inquiry to determining wages at the date of the debilitating event. Comment, Inflation and Damages, 63 *Va.L.Rev.* 105, 108 (1977); Note, Considering Inflation in Calculating Lost Future Earnings, 18 *Wash.L.J.* 499, 500 (1979), Fleming, Inflation and Tort Compensation, 26 *Am.J.C.L.* 51, 65 (1977). Since the inflation and productivity variables are removed from consideration in calculating the damage award, the award is more predictable and the possibility of settlement out of court is enhanced. However, even assuming the premise that simplification is synonymous with efficiency and predictability, the Pennsylvania method sacrifices accuracy to the prejudice of the victim by failing to compensate the victim to the full extent of the injury sustained. By an obstinate refusal to give any recognition to inflation and productivity, we ignore our responsibility to attempt to "graduate the amount of the damage award exactly to the extent of the loss." *Forsyth v. Palmer,* 2 Harris 96, 97 (1850).

We are aware that "[T]he orderly development of the law must be responsive to new conditions and to the persuasion of superior reasoning." *Griffith v. United Air Lines,* 416 Pa. 1, 23, 203 A.2d 796, 806 (1964).

[W]hen a rule, after it has been duly tested by experience, has been found to be inconsistent with the sense of justice or with the social welfare, there should be less hesitation in frank avowal and full abandonment…. There should be greater readiness to abandon an untenable position when the rule to be discarded may not reasonably be supposed to have determined the conduct of the litigants, and particularly when in its origin it was the product of institutions or conditions which have gained a new significance or development with the progress of the years." Cardozo, The Nature of the Judicial Process, 150-51 (1921).

Despite the uninformed belief of the Haven's court, inflation and productivity factors are not speculative and are capable of definition and prediction by economic experts. For decades, economists have been refining tools to forecast economic growth and have used these tools with proven accuracy. Sophisticated economic forecasts are relied upon by every major government agency, corporation, and financial institution. These forecasts are based upon all that is known in the American economy and despite small tolerances of error, these projections have been accurate in the past. See, District of *Columbia v. Barriteau, D.C.App.,* 399 A.2d 563, 566 (1979). Thus, there exists a reasonable basis in fact for this court to consider the impact of inflation and productivity on lost future earnings. A court has a responsibility to the citizenry to keep abreast of changes in our society. In light of the recognized acceptance of the science of economics, the courts of this Commonwealth can no longer maintain their ostrich-like stance and deny the admissibility and relevancy of reliable economic data concerning the impact of productivity and inflation on lost future earnings. Indeed, to ignore economic realities and presume that there will be no changes in an individual's future earnings because of such factors is further removed from reality than any variance that may result from our efforts to predict these factors.

a. Inflation

It would be ludicrous for this Court to cling to the Haven Court's conclusion that the presence of inflation in our economy is a temporary and passing phenomenon, influenced by "war and other unusual circumstances."[11] Information gathered by the United States Bureau of Labor Statistics demonstrates that the American economy has been experiencing a steady increase in the cost of living over its history. Even though the rate of inflation has not been numerically the same for the past 40 years, the presence of inflation as a factor in our economy has been constant.[12] Purchasing Power of the Dollar: 1940-78, U.S. Bureau of the Census, Statistical Abstract of the United States: 1978 (99th Edit.).[13] Thus, while the rate of inflation may vary during any given period, its long term presence as a fact of life in our economic picture is certain.

b. Productivity

Moreover, the assertion that productivity factors are too speculative to consider in computing lost future earnings is also fallacious.[14] An individual's future earning capacity is capable of estimation based upon objective factors of age, maturity, education and skill.[15] Henderson, Consideration of Increased Productivity and

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[11] From 1940 to 1972, the consumer price index, the government's measure of inflation, rose 185 percent. In terms of purchasing power, it took almost $3.00 in 1972 to purchase what $1.00 would have purchased in 1940. The compounded rate of advances over this period is approximately 3.5% annually. Purchasing Power of the Dollar: 1940-78, U.S. Bureau of the Census, Statistical Abstract of the United States: 1978 (99th Edit.) Washington, D.C.

[12] Since 1972, the Consumer Price Index (CPI) has not declined in any month. From 1967 through 1978 the CPI has risen 102%.

1972 - 3.4% 1976 - 4.8%
1973 - 8.8% 1977 - 6.8%
1974 - 12.2% 1978 - 9.0%
1975 - 7.0% 1979 - 13.3%

Bureau of Labor Statistics, U.S. Dept. of Labor, CPI Detailed Report 1 (Dec. 1972-1979). From June 1979 through June 1980 the CPI increased 14.3%.

[13] Judge Friendly noted in *McWeeney v. New York, New Haven and Hartford Railroad Co.,* 282 F.2d 34, 38 (2d Cir. 1960):

> "There are few who do not regard some degree of continuing inflation as here to stay and would be willing to translate their own earning power into a fixed annuity, and it is scarcely to be expected that the average personal injury plaintiff will have acumen to find investments that are proof against both inflation and depression-a task formidable for the most expert investor." (Footnote omitted.)

[14] From 1947 to 1973 there was a 5.6% compound rate of increase in the average compensation of all persons in the private non-farm sector, or an overall increase of approximately 4½ times. United States Dept. of Labor, Bureau of Labor Statistics, Handbook of Labor Statistics 175 (1973).

[15] Normally, in the beginning years of participation in the labor force, the aging process or the acquiring of knowledge is the most significant influence upon earnings. During the middle years, ages 35-44, productivity and growth dominate. In the last decade of one's work-life, inflation is largely responsible for most advances. Henderson, Income Over the Life Cycle, Some Problems of Estimation and Measurement, 25 *Fed.Ins.Coun.Q.* 15, 28-29 (1974).

Discounting of Future Earnings to Present Value, 20 *S.D.L.Rev.* 307, 312 (1976). A determination of an individual's future earning capacity based on objective criteria is far less speculative than most other estimates made by the trier of fact. See e.g., *Hamil v. Bashline,* 481 Pa. 256, 392 A.2d 1280 (1978) (what might have happened to the decedent had he received proper medical care); *Wallace v. Pa. R.R.,* 222 Pa. 556, 561, 71 A. 1086 (1909) (future pain and suffering is recoverable if it is likely or probable to ensue); *Yost v. West Penn Railways Co.,* 336 Pa. 407, 410, 9 A.2d 368 (1939) (future medical expense can be recovered if they can be estimated).[16] Admittedly, predicting lost future earnings entails some degree of speculation. However, that alone does not justify excluding reliable economic evidence since imprecision is inherent in any computation of lost future benefits. In view of our acceptance of the reliability of the science of economics, the victim's lost future earning capacity should be treated like any other question of fact[17] and should be submitted to the trier of fact after a proper foundation and expert testimony.

This Commonwealth now joins the growing number of jurisdictions which consider inflation and productivity as integral factors to be included in computing lost future earnings. See *Beaulieu v. Elliott,* 434 P.2d 665 (Alaska 1967); *Richmond Gas Corporation v. Reeves,* 302 N.E.2d 795 (Ind.App. 1973); *Resner v. Northern Pacific Railway,* 161 Mont. 177, 505 P.2d 86 (1973); *Plourd v. Southern Pacific Transportation Co.,* 266 Or. 666, 513 P.2d 1140 (1973); *Willmore v. Hertz Corp.,* 437 F.2d 357, 359-60 (6th Cir. 1974); *Schnebly v. Baker,* 217 N.W.2d 708 (Iowa 1974). See also *Bach v. Penn Central Transportation Co.,* 502 F.2d 1117 (6th Cir. 1974); *Weakley v. Fishbach & Moore, Inc.,* 515 F.2d 1260 (5th Cir. 1975) (interpreting Texas law); *United States v. English,* 521 F.2d 63 (9th Cir. 1975); *Tenore v. Nu Car Carriers, Inc.,* 67 N.J. 466, 341 A.2d 613 (1975); *Seaboard Coast Line R.R. Company v. Garrison,* Fla.App., 336 So. 2d 423 (1976); *Markham v. Cross Transportation, Inc.,* 376 A.2d 1359, 1364 (R.I. 1977); *Ossenfort v. Associated Milk Producers, Inc.,* 254 N.W.2d 672, 683-84 (Minn. 1977); *Lumber Terminals, Inc. v. Nowakowski,* 36 Md.App. 82, 373 A.2d 282, 290-91 (1977).

III. Formulas Suggested By Other Jurisdictions

There are three significant approaches, traditional, middle ground, and evidentiary which the judiciary has adopted in considering the impact of future inflation and productivity on lost future earning capacity. 63 *Va.L.Rev.* at 128 n.155. The traditional approach ignores altogether the effects of future productivity and future inflation as being "too speculative." This view was previously adhered to by this Commonwealth, but for reasons stated above, it is hereby rejected.

[16] "[R]egardless of the pattern of the increase in income over the life-cycle, the probability that one's money income will not rise, on an annual basis, approaches zero. There is little or no reason for disputing the fact that money earnings rise, the only problem is by how much, or at what rate, an issue which largely depends upon the segment of the labor market being investigated." 20 *S.D.L.Rev.* at 312.

[17] In this Commonwealth, we allow the use of tables of present worth calculations prepared by qualified experts in order to provide a precise analytical calculation which will enhance the possibility of correct and just results. We also accept the reliability of mortality tables to calculate the victim's life expectancy. *Brodie v. Philadelphia Transport Co.,* 415 Pa. 296, 203 A.2d 657 (1959).

The middle ground approach is anomalous in that it permits the factfinder to consider the effects of productivity and inflation on lost future earning capacity, but prohibits expert testimony on either of these issues. The proponents of this approach argue that expert testimony on future economic trends is "speculative," yet acknowledge that such facts are within the "common experience" of all jurors and, therefore, jurors should not be prohibited from applying their common knowledge in reaching a verdict. *Bach v. Penn Central Transportation Co.,* 502 F.2d 1117 (6th Cir. 1974), overruled by *Morvant v. Construction Aggregates Corp.,* 570 F.2d 626 (6th Cir. 1978); and, *Riha v. Jasper Blackburn Corp.,* 516 F.2d 840 (8th Cir. 1975). However, it has been consistently demonstrated that expert evidence is essential to accurate economic forecasting. Since it is apparent that the middle-ground approach contributes little to the accuracy or predictability of lost future earnings, and paradoxically allows a judge or jury to determine what an acknowledge expert cannot, we decline to adopt it.

The evidentiary approach in its several variants allows the factfinder to consider productivity and inflation in awarding damages. Since we believe that there is a reasonable basis in fact to consider the impact of inflation and productivity on lost future earnings, we conclude that the evidentiary concept is the most valid method to compute lost future earnings. However, courts employing the evidentiary method differ on the factors to be considered in assessing lost productivity on the one hand and the method to calculate the inflation component in the final lost future earning award on the other. Recognizing that there are myriad of ways to incorporate such economic data[18] we find that there are two versions appropriate for our consideration.

The first of these two variants of the evidentiary approach was developed by the court in *Feldman v. Allegheny Airlines,* 382 F. Supp. 1271 (D.Conn. 1974), aff'd, 524 F.2d 384 (1st Cir. 1975). In *Feldman*, a surviving husband brought a wrongful death action as the administrator of his wife's estate. The defendant airline stipulated as to its liability and the trial was confined to the issue of damages. The court assumed that recovery for lost future earnings included the victim's lost earning capacity. In order to demonstrate the bases for the court's conclusions relative to what course the deceased's life probably would have taken, the court extrapolated the evolving pattern of Mrs. Feldman's life. The court detailed the deceased's college grades, her employment history, the opinion of the deceased held by her fellow workers, the expressed employment goals of the deceased and the potential jobs for which the deceased was qualified. The court also examined the employment history of another individual who had remarkably similar credentials as the deceased. The defendant produced one witness who testified as to the decedent's employment prospects. Based upon the above factors, the court

[18] See e.g., *Turcotte v. Ford Motor Co.,* 494 F.2d 173 (1st Cir. 1974) (independent incorporation method); *Platis v. United States,* 288 F. Supp. 254, 277-78 (D. Utah), aff'd, 409 F.2d 1009 (10th Cir. 1969) (allowing a constant increase of $500 per year to account for future wage increases); *Brooks v. United States,* 273 F. Supp. 619, 635 (D.S.C. 1967) (increased decedents last annual salary by 15% and spread this constant salary over decedents work expectancy).

predicted the incremental salary (productivity) increases of the decedent over her work-life expectancy.[19]

The court was then faced with the inflation component and the task of discounting the award to its present value. The court developed a formula known as the "offset present value method" in which it subtracted the estimated inflation rate from the discount rate to calculate the inflation adjusted or "real" rate of interest. Each year's earnings were then discounted to present value by this "real" discount rate. The "real" discount rate employed by the court was 1.5%. The court rationalized its formula:

> … on the basis of the evidence adduced at trial, the evidence judicially noticed and collated at the Appendix, and judicial notice of the continuing erratically inflationary behavior of the American economy, that 1.5 per cent per year is an appropriate figure by which to discount an award of damages based on the destruction of future earning capacity when that award has itself been computed without consideration of inflation affecting that amount subsequent to the date of the injury upon which the award is premised. Id. at 1294-1295[20]

The second variant of the evidentiary method was adopted by the Alaska Supreme Court in *Beaulieu v. Elliott,* 434 P.2d 665 (1967), and refined in *State v. Guinn,* 555 P.2d 530 (1976). Pursuant to this formula, the Alaska courts first calculate lost future earning

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[19] Based upon expert testimony that the decedent had an estimated 40 years remaining in her work-life and would probably retire at age 65, the court assigned dollar value to decedent's lost future earnings for each of the forty years. The court accomplished this task by utilizing the federal government GS pay scales, since this salary schedule was reflective of the potential earnings throughout the Washington metropolitan area.

"According to this valuation process, the value of the decedent's earning capacity for `fiscal 1972,' the fiscal year beginning July 1, 1971, is the 1971 salary for the first step in GS-12, $15,040. This increases over the next four years, so that for fiscal 1976 the decedent's earning capacity is $17,044, the 1971 salary for the fifth step in GS-12. The decedent's earning capacity then remains unchanged over the next nine years-eight years of child rearing and the decedent's first year of employment thereafter. In 1986 the decedent's earning capacity goes up to the sixth step in GS-12, $17,545, and continues to rise thereafter one step at a time, with each change of grade being from the tenth step in one grade to the fifth step in the next higher grade. In the fortieth year, fiscal 2111, the decedent is at the seventh step of GS-16, with a 1971 salary of $33,757. See generally Table I, infra, p. 1298.

382 F. Supp. at 1287.

[20] The appellate court summarized the district court's process as follows:

> "In calculating the discount rate, the appellee's expert, relied on by the district court, used an average earnings of 4.14% (from mutual savings bank investments) as representative of a prudent, non-sophisticated investment and subtracted 2.87% as the average yearly inflation rate revealed in the Department of Labor's Consumer Price Index over an 18-year period, yielding a 1.27% difference which was rounded up to 1.5%. Judge Blumenfeld corroborated this `inflation-adjusted discount rate' of 1.5% by calculating the real yields of investments since 1940 in federal government securities (with inflation factored out) from the 1974 Economic Report of the President, a source referred to by appellant Allegheny's expert."

Feldman v. Allegheny Airlines, Inc., 524 F.2d 384, 387 (2nd Cir. 1974).

capacity of the victim over his or her work-life expectancy. As to productivity, the Alaska court has stated: "Automatic step increases keyed to the length of service are by their very nature certain and predictable at the time of trial" and the court takes them into account when estimating the lost future earnings. *State v. Guinn,* 555 P.2d at 546. However, the court excluded as speculative evidence the "non-scheduled salary increases and bonuses that are granted as one progresses in his chosen occupation in terms of skill, experience and value to the employer." Id.

In order to account for the inflationary component's impact on lost future earnings and the effect of future interest rates on lump-sum payment, the Alaska court applied that "total offset method." Under the total offset method, a court does not discount the award to its present value but assumes that the effect of the future inflation rate will completely offset the interest rate, thereby eliminating any need to discount the award to its present value.

IV. Discussion

Mindful of our goal that a damage award formula should strive to be efficient, predictable as well as accurate, in computing lost future earning capacity this Commonwealth adopts the Feldman court's approach to calculating lost productivity and the Alaska court's total offset approach to inflation and discounting to present value.[21] We believe that this eclectic method best computes a damage award which will fairly compensate a victim to the full extent of his or her injuries and avoids unnecessary complexities likely to produce confusion although in reality contributing little to the degree of accuracy to be obtained. Although judges and juries are not fortune tellers equipped with crystal balls, the Feldman approach to determining productivity as a factor in awarding future lost earning best approximates the soothsayers by presenting the triers of fact with all relevant evidence. After laying a proper foundation, expert and lay witnesses are called upon to testify as to the victim's past and future employment possibilities. The defense may cross-examine the plaintiff's witnesses and present evidence on their own behalf. Upon a thorough evaluation of all the evidence presented, the factfinder makes an informed estimation of the victim's lost earning capacity.[22] Although this approach may be time consuming, and like all estimations of future events may be subject to a degree of speculation, it is exceedingly more accurate to assume that the future will not remain stagnant with the past.

We cannot embrace the Alaska court's restrictive method of computing productivity as a component of lost future earnings since the Alaska court limits its inquiry to those step

[21] This Commonwealth now requires that a damage award be discounted to its present value by using six percent simple interest figure. We do not wish to disturb this requirement in calculating future damages in other contexts. We refrain "from attempting to fashion broad general rules as a panacea. The obviously wiser course is to resolve disputes on a case-by-case basis until we develop, through experiences in [an] area, a sound basis for developing overall principles." *Pa.L.R.Bd. v. State College Area School District,* 461 Pa. 494, 500, 337 A.2d 262, 265 (1975).

[22] This tailor-made approach to lost earing capacity is accepted by many jurisdictions, even those jurisdictions which do not admit evidence of inflation on the grounds that it is speculative. See *Higginbotham v. Mobil Oil Corp.,* 545 F.2d 422 (5th Cir. 1977).

advances keyed to the length of service. The Alaska court's refusal to consider the possibility of merit based increases, unfairly discriminates against those victims whose salary is dependent on their skill, experience, and value to their employer. Moreover, it appears that the Alaska court's conception that merit based increases are "speculative" is a throwback to the previously rejected traditional approach.

In support of our adoption of the "total offset method" in allowing for the inflationary factor, we note that it is no longer legitimate to assume the availability of future interest rates by discounting to present value without also assuming the necessary concomitant of future inflation. We recognize that inflation has been and probably always will be an inherent part of our economy. Although the specific rate of inflation during any given period may vary, we accept the fact that inflation plays an integral part in effectuating increases in an employee's salary, and we choose to adopt a damage formula which will allow for that factor without actually requiring the factfinder to consider it as an independent element of the award.

Current economic theory demonstrates the accuracy of the total offset approach to inflation. As previously noted, the total offset method assumes that in the long run, future inflation and the discount rate will offset each other. "At first blush the rough and ready approach seems too obviously to invite the objection that it is far less precise than Judge Blumenfeld's (Feldman approach) and over-compensates the plaintiffs." Fleming, 26 *Am.J.Comp.L.* at 69. However, critics of the total offset approach fail to realize that future inflation rates and future interest rates do not exist in a vacuum, but co-vary significantly. Inflation: A Survey, 85 *Econ.J.* 741, 788 (1975). It can be stated with assurance that present interest rates depend at least in part upon expectations of future inflation. The mechanism for the adjustment was explained by economist W.E. Gibson:

> "When inflation becomes expected, lenders expect the real value of their principal and interest payments to be depreciated and borrowers expect to be able to repay loans with money for which less real value must be sacrificed than before expectations changed. Thus at any level of market interest rates the quantity of loans supplied decreases while the quantity demanded increases. Both forces increase nominal interest rates." Gibson, Interest Rates and Inflationary Expectations: New Evidence, 62 *Am.Econ.Rev.* 854, 855 (1972).

Modern interest theory commends the accuracy of the total-offset method:

> "[W]hen prices are rising, the rate of interest tends to be high but not so high as it should be to compensate for the rise; and when prices are falling, the rate of interest tends to be low, but not so low as it should be to compensate for the fall."

I. Fisher, The Theory of Interest 43 (1930).

Since over the long run interest rates, and, therefore, the discount rates, will rise and fall with inflation, we shall exploit this natural adjustment by offsetting the two factors in computing lost future earning capacity. Accord, *Freeport Sulphur Co. v. S.S. Hermosa,*

526 F.2d 300, 310 (5th Cir. 1976) (concurring opinion). We are satisfied that the total offset method provides at least as much, if not greater, accuracy than an attempt to assign a factor that would reflect the varying changes in the rate of inflation over the years. Our experiences with the use of the six percent discount rate suggest the difficulties inherent in such an approach. As to the concomitant goals of efficiency and predictability, the desirability of the total offset method is obvious. There is no method that can assure absolute accuracy. An additional feature of the total offset method is that where there is a variance, it will be in favor of the innocent victim and not the tortfeasor who caused the loss.

The superiority of the total offset approach becomes apparent upon comparison with the offset present value method. In Feldman, rather than forecasting the impact of inflation on future earnings, through the use of an inflation adjusted interest rate, Judge Blumenfeld discounted future earnings based upon 1971 dollars. However, from an analysis of the formula involved, it appears that predicting prospective interest rates is as difficult as forecasting future inflation. *Freeport Sulphur Co. v. S.S. Hermosa,* 526 F.2d 300, 310 (5th Cir. 1976) (concurring opinion). Notably, the merit of discounting to present value upon an inflation adjusted interest rate was questioned by the very court which originally proposed it.

"… [S]ince Connecticut law requires the discounting to present value of damages for the destruction of future earning capacity, and since such discounting demands assessment of the future earning power of money, the Court is compelled to engage in economic forecasting despite the inexactitude of the dismal science's soothsaying. It is not open to this Court to decide that the ascertainment of a discount rate has become too speculative to be fair, and that the statutory mandate of awarding `just damages' for wrongful death would be better served by dispensing with the discounting process altogether.

382 F. Supp. at 1293 n.30

Moreover, the complexities inherent in factoring the inflation out of the market rate of interest moved Judge Blumenfeld to observe that: "Nothing is more conclusively established by the instant memorandum of decision than the difficulty of ascertaining the amount of damages due in this case….." 382 F. Supp. at 1295.[23]

[23] One critic of the independent offset method explained that:

> "Feldman also is flawed from a practical standpoint. According to the court's own calculations, sudden changes in the price level have caused the real rate of interest to vary from -2.9 percent to +2.0 percent on short term Treasury bills, and from -8.9 percent to +3.7 percent on long term federal notes. Faced with these variations in the real rate of interest, the trial judge should have been wary of selecting an inflation adjusted discount rate. Instead, the judge simply assumed a stable rate of inflation, a condition historically associated with a real yield of two percent, and arbitrarily lowered the real rate of interest to one-and-a-half percent to allow for unforeseeable fluctuations. The Feldman approach clearly required strong assumptions about both future rates of inflation and future rates of real interest."

An additional virtue of the total offset method is its contribution to judicial efficiency. Litigators are freed from introducing and verifying complex economic data. Judge and juries are not burdened with complicated, time consuming economic testimony. Finally, by eliminating the variables of inflation and future interest rates from the damage calculation, the ultimate award is more predictable.

V. Conclusion

Henceforth, in this Commonwealth, damages will be awarded for lost future earnings that compensate the victim to the full extent of the injury sustained. Upon proper foundation, the court shall consider the victim's lost future productivity. Moreover, we find as a matter of law that future inflation shall be presumed equal to future interest rates with these factors offsetting. Thus, the courts of this Commonwealth are instructed to abandon the practice of discounting lost future earnings. By this method, we are able to reflect the impact of inflation in these cases without specifically submitting this question to the jury.

In view of the trial court's refusal to permit appellant to introduce evidence relating to a future productivity factor and our formulation of a new standard to be used for accommodating inflation in these cases, we reverse the judgment below and remand the cause for a new trial as to the damage question.

ROBERTS, J., filed a concurring opinion.

FLAHERTY, J., filed a concurring and dissenting opinion.

ROBERTS, Justice, concurring.

I agree with the majority that the practice of reducing to present value the lost future earnings component of personal injury awards should be abrogated and the "total offset" rule adopted in its stead. The practice of reducing to present value is unrealistic in its failure to take into account either future inflation or deflation. See generally Restatement (Second) of Torts § 913A Comment at p. 492 (1979). Though perhaps somewhat imprecise, the total offset rule will fairly accommodate parties in both inflationary and deflationary times. So too, the total offset rule "has administrative simplicity to recommend it, since it avoids rather complex calculations involved in reducing to present value." D. Dobbs, Remedies § 8.7 at p. 575 (1973). Indeed, any person who has heard a court's "present value" charge will attest to the wisdom of abrogating the practice. See *Brodie v. Philadelphia Transportation Co.,* 415 Pa. 296, 203 A.2d 657 (1964).

I also agree with the majority that a jury may consider evidence of a victim's lost future earning increases. It is my understanding, however, that Pennsylvania law has long permitted jury consideration both of earning decreases and of earning increases. For example, Proposed Jury Instruction 6.22 (Civil) on "Earnings Fluctuations" provides:

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63 *Va.L.Rev.* at 105.

> "If you find that the plaintiff will suffer an impairment or loss of earning power as the result of this accident …, you may take into consideration possible fluctuations with respect to such losses. In other words, if you find that the plaintiff's … wages would have increased or decreased over the years, you will take that factor into consideration so that proper compensation can be made."

Pennsylvania Supreme Court Committee for Proposed Standard Jury Instructions Subcommittee Draft-October 14, 1973. See also e.g., *McCaffrey v. Schwartz,* 285 Pa. 561, 132 A. 810 (1926), overruled on other grounds, *Brodie v. Philadelphia Transportation Co.,* supra; Robert M. Bernstein, "Damages in Personal Injury and Death Cases in Pennsylvania," 23 *Pa. Bar Ass'n Q.* 9 (1951).

It should also be observed that today's result does not mandate jury verdicts reflecting only earning increases. Within accepted rules of evidence, both sides are free to offer competent and relevant proof to establish their respective positions as well as to challenge the evidence offered in opposition.

Finally, today's result does not represent the exclusive means of taking future economic factors into account in cases of larger damage awards covering losses over future years. For example, special findings of fact may be helpful in making certain that neither the tortfeasor not the injured is unduly prejudiced or benefited by future economic conditions. Also, at least thirteen states, including California, Delaware, Florida, and Maryland, have enacted laws allowing for some form of periodic payments in medical malpractice actions. See T. Elligett, "The Periodic Payment of Judgments," 46 *Ins. Counsel J.* 130, 134 n.49 (1979). Very recently the National Conference of Commissioners on Uniform State Laws adopted an approved draft of a "Uniform Periodic Payment of Judgments Act" which authorizes installment payment of awards in personal injury cases. See generally Roger C. Henderson, "Periodic Payments of Bodily Injury Awards," 66 *A.B.A.J.* 734 (1980). Installment payment provisions of the uniform act

> "eliminate[] the guesswork and speculation involved in the lump-sum system when the jury is asked to discount awards of future damages to present value and, in an increasing number of jurisdictions, predict future rates of inflation. Since damages will be paid as losses accrue, there is no need to discount to present value. With regard to inflation, the act provides for adjustments in the unpaid installments so that the damages award is not eroded by inflation."

Id. at 736. Appropriate common-law approaches, including special findings, installment payments, and the like, may, of course, be fashioned to assure that full and real effect is given to the adjudication of liability and damages. See e.g., *Ellenbogen v. County of Allegheny,* 479 Pa. 429, 438, 388 A.2d 730, 734-35 (1978); W. Schaefer, "Precedent and Policy," 34 *U.Chi.L.Rev.* 3 (1966).

FLAHERTY, Justice, concurring and dissenting.

While I fully concur in the view that *Havens v. Tonner,* 243 Pa.Super. 371, 365 A.2d 1271 (1976), should be unceremoniously eliminated from the law of this Commonwealth as unrealistic, I must dissent to the majority's adoption of what it calls the "total offset method", a "per se rule" of doubtful validity. True, such an approach is a simple one, but it does not achieve justice, and, has only been adopted in one jurisdiction, i.e., Alaska. We should simply permit expert testimony on the issues of inflation and productivity. Such testimony, on both sides of the issue, is, of course, subject to cross-examination and argument as to its validity and weight. Thus, the jury is free to weigh the evidence before it and render its verdict. This is also simple, and provides justice in accordance with our time honored principles.

113 T.C. No. 30

UNITED STATES TAX COURT

BAINE P. AND MILDRED C. KERR, DONORS, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 14449-98. Filed December 23, 1999.

In 1993, Ps and their children formed two family limited partnerships (KFLP and KILP). The KFLP and KILP partnership agreements contain identical restrictions on liquidation of the partnerships. In June 1994, Ps transferred limited partnership interests in KFLP and KILP to the University of Texas (the university).

On Dec. 28, 1994, Ps created separate grantor retained annuity trusts (GRAT's). Ps each transferred a 44.535-percent class B limited partnership interest in KFLP to their GRAT's. The GRAT's remainder interests were intended to benefit Ps grandchildren through generation-skipping trusts.

On Dec. 30, 1994, the university was admitted as a limited partner of KILP. On Dec. 31, 1994 and 1995, Ps transferred limited partnership interests in KILP to their children.

Ps filed Federal gift tax returns for 1994 and 1995. Ps computed the value of the limited partnership interests in KFLP that they transferred to the GRAT's by applying discounts for lack of liquidity and minority interest. Ps computed the value of the limited partnership interests in KILP that they transferred to their children by applying a discount for lack of liquidity. R determined that sec. 2704(b), I.R.C., bars Ps from applying a discount for lack of liquidity in computing the value of the partnership interests that Ps transferred to the GRAT's and to their children.

Ps filed a motion for partial summary judgment arguing that sec. 2704(b), I.R.C. is not applicable alternatively because: (1) The GRAT's trustees received only assignee interests, as opposed to limited partnership interests; (2) the disputed transfers must be valued as assignee interests under sec. 25.2512-1, Gift Tax Regs.; and (3) the restrictions on liquidation set forth in the partnership agreements do not constitute "applicable restrictions" within the meaning of sec. 2704(b), I.R.C.

Held: Ps transferred limited partnership interests to the GRAT's in both form and substance.

Held further: Pursuant to sec. 25.2512-1, Gift Tax Regs., the value of the limited partnership interests is equal to the price that a hypothetical willing buyer would pay to a willing seller for the limited partnership interests.

Held further: The restrictions on liquidation in dispute do not constitute "applicable restrictions" within the meaning of sec. 2704(b), I.R.C.

John W. Porter, for petitioners.

Lillian D. Brigman and John D. Maceachen, for respondent.

OPINION

JACOBS, Judge: This matter is before the Court on petitioners' motion for partial summary judgment, filed pursuant to Rule 121.[1] Petitioners contend that they are entitled to partial summary judgment that section 2704(b) is not applicable in valuing the limited partnership interests that they transferred to their grantor retained annuity trusts and to their children during 1994 and 1995.[2] For the reasons set forth below, we will grant petitioners' motion.

Background[3]

Baine P. Kerr and Mildred C. Kerr were married in 1942 and have four adult children, Baine P. Kerr, Jr., John Caldwell Kerr, James Robinson Kerr, and Mary Kerr Winters (the Kerr children). The

[1] All Rule references are to the Tax Court Rules of Practice and Procedure. Unless otherwise indicated, all section references are to the Internal Revenue Code, as amended.

[2] Petitioners also moved for partial summary judgment that their interests in the grantor retained annuity trusts were "qualified interests" within the meaning of sec. 2702(b). Respondent subsequently conceded the point, and we issued an order granting so much of petitioners' motion for partial summary judgment as pertained to that issue.

[3] The following summary of the relevant facts is based on the parties' stipulations with attached exhibits and other pertinent materials in the record. They are stated solely for the purpose of deciding the pending motion and are not findings of fact for this case. See Rule 1(a); Fed. R. Civ. P. 52(a).

Kerr children are financially independent. Petitioners have 13 grandchildren.

Petitioners both graduated from the University of Texas. Baine P. Kerr (petitioner) also graduated from the University of Texas Law School.

After serving in World War II, petitioner joined the law firm of Baker & Botts in Houston, Texas, subsequently was admitted as a partner, and ultimately managed the firm's corporate law department.

Petitioner left Baker & Botts to serve in various executive positions at Pennzoil Co. Between 1964 and 1994, petitioner served on Pennzoil's board of directors and as president. In 1989, he received a $10 million bonus for work that he had performed in a lawsuit that Pennzoil had filed against Texaco.

S. Stacey Eastland (Eastland), an attorney at Baker & Botts, advised petitioners on estate planning matters for many years. Eastland has written extensively on the use of family limited partnerships (and particularly transfers of assignee interests) as an estate planning tool.[4] In September 1993, Eastland proposed that petitioners create two limited partnerships. Eastland advised petitioners that the limited partnerships could be used as a source

[4] See Eastland, Family Limited Partnerships: Non-Transfer Tax Benefits, 10 Probate and Property (Mar./Apr. 1993); Eastland, "The Art of Making Uncle Sam Your Assignee Instead Of Your Senior Partner: The Use of Partnerships In Estate Planning", SD 63 ALI-ABA 1153 (May 1999).

for making gifts to their children. Eastland further advised petitioners that the partnerships should include a charity as a partner in light of the recent enactment of section 2704 and to "make sure that traditional valuation rules apply to the partnerships."[5]

Kerr Issue GST Trust

On December 29, 1993, petitioners, as grantors, and their children, as trustees, executed a document entitled "Agreement Creating the Kerr Issue GST Trusts". The agreement provided that each of the Kerr children would act as the trustee of a separate trust under which he or she would be the primary beneficiary. The agreement further provided that each trust would terminate upon the death of the primary beneficiary and that any remaining trust property would pass to the living issue of the primary beneficiary; i.e., the Kerr grandchildren. On December 29, 1993, petitioners executed separate wills, which included "pour over" provisions to the Kerr Issue GST Trusts in an amount equal to the available generation-skipping tax exemption.

[5] Sec. 2704(b), quoted infra pp. 20-21, generally provides that restrictions on the liquidation of a family partnership will not be considered in valuing a gift of a partnership interest from one family member to another if the family has control of the partnership before the transfer and the family can remove the restriction on liquidation after the transfer.

Kerr Family Limited Partnership

On December 31, 1993, petitioners and the Kerr children executed an agreement forming the Kerr Family Limited Partnership (KFLP) under the Texas Revised Limited Partnership Act (TRLPA), Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (West Supp. 1993). Petitioners made all capital contributions to KFLP in the form of three life insurance policies on their lives with a face amount totaling approximately $7 million. The Kerr children did not make any capital contributions to KFLP.

At the time KFLP was formed, petitioners were the sole general partners. However, petitioners immediately assigned a portion of their general partnership interest to each of the Kerr children. In particular, each of the Kerr children received a .2325-percent KFLP general partnership interest. There is no evidence in the record that petitioners executed a written consent admitting the Kerr children as general partners of KFLP.

Following the transfers described above, petitioners retained the following partnership interests in KFLP: (1) A combined 100-percent class A limited partnership interest;[6] (2) a combined 2-

[6] Pursuant to sec. 5.01 of the KFLP partnership agreement, class A limited partners were entitled to an annual guaranteed payment.

percent general partnership interest; and (3) a combined 97.07-percent class B limited partnership interest.

Kerr Interests Limited Partnership

On December 31, 1993, petitioners, their children, and KFLP executed an agreement forming the Kerr Interests Limited Partnership (KILP) under TRLPA. Petitioners made all capital contributions to KILP in the form of stocks, bonds, and real estate with an aggregate fair market value of approximately $11 million. The Kerr children did not make any capital contributions to KILP.

At the time KILP was formed, petitioners were the sole general partners. However, petitioners immediately assigned all of their general partnership interest in KILP to KFLP and a portion of their class B limited partnership interest in KILP to KFLP and the Kerr children. In particular, KFLP received a 2-percent general partnership interest and an 18-percent class B limited partnership interest in KILP, while the Kerr children each received a .0785-percent class B limited partnership interest in KILP. There is no evidence in the record that petitioners executed a written consent admitting KFLP as a general partner of KILP.

Following the transfers described above, petitioners retained a combined 100-percent class A limited partnership interest in KILP[7] and a combined 76.686-percent class B limited partnership interest.

[7] Pursuant to sec. 5.01 of the KILP partnership agreement, class A limited partners were entitled to an annual guaranteed payment.

In 1995, petitioners transferred additional assets to KILP with an aggregate fair market value of approximately $9.9 million.

Partnership Agreements

The KFLP and KILP partnership agreements are identical in all material respects. They include a number of provisions pertinent to the pending motion.

Section 3.03 of the partnership agreements states that the general partners shall appoint petitioners to serve jointly as the managing partner, that if either petitioner fails or ceases to serve as managing partner, then the other shall continue to serve as managing partner, and, if both petitioners cease or fail to serve as managing partner, then Mary Kerr Winters shall serve as managing partner. Section 3.10(b) states the general rule that no limited partner shall have any control over the management of the partnerships. However, section 3.09(e) states that the partnership shall not take action with respect to certain enumerated "Major Decisions" without prior written consent of a majority of the limited partners. Section 3.10(e) identifies "Major Decisions" as extraordinary events such as the partnership's filing a petition in bankruptcy, any act that would make it impossible to carry on the partnership's business, and any act in contravention of the partnership agreement.

Section 3.06 states that no person shall be admitted as a general or limited partner without the consent of all general partners, except as provided in article VIII of the agreements.[8] Section 3.10(a) states that no other person may become a limited partner of the partnerships except by way of a transfer permitted under and effected in compliance with the partnership agreements.

Section 3.10(c) states that limited partners shall not be entitled to the withdrawal or return of their contributions to the partnerships except to the extent, if any, that distributions are made pursuant to the partnership agreements or upon termination of the partnerships.

Section 8.01 states the general rule that no limited partner or spouse of a limited partner shall make a "disposition" of an interest in the partnership owned or held by him except with the consent of the partnership and all other partners. The term "disposition" is defined in section 8.02 as any sale, assignment, gift, exchange, transfer, change in beneficial interest of any trust or estate, distribution from any trust or estate, change in ownership of a corporate or partnership partner, or any other disposition of a limited partnership interest, whether voluntary or involuntary, direct or indirect. However, section 8.02 states that

[8] The pertinent sections of article VIII of the partnership agreements are summarized infra pp. 9-10.

a "disposition" does not include a transfer to a "permitted assignee". The term "permitted assignee" is defined in section 8.03 to include, among others, each existing partner, any person who is a lineal descendant of both petitioners, a trustee of any trust that is more than 75 percent actuarially held for permitted assignees, any partnership owned exclusively by permitted assignees, or a charity.

Section 8.04 states that any limited partner desiring to make a disposition of all or any part of his or her limited partnership interest shall first submit a written offer to sell the limited partnership interest to the partnership and the remaining partners. Sections 8.11 and 8.12 set forth a formula for determining the amount that the partnership or partners will pay for such limited partnership interests.

Section 8.19 states that any disposition of a limited partnership interest shall be effective only to give the assignee the right to receive the share of profits to which his assignor would otherwise be entitled. Section 8.20 states, in pertinent part, that upon the transfer of a general partnership interest to a permitted assignee, the general partners shall admit the transferee into the partnership as a class B limited partner.

Section 8.21 states that no person not already a partner shall become a partner or acquire any rights to participate in the

management of the partnership except with the unanimous consent of the partners. However, the provision further states that the terms of article VIII shall apply to an assignee as if he were a substituted partner.

Section 9.02 states that no limited partner shall have the right to withdraw from the partnerships before the partnerships dissolve and liquidate. However, class B limited partners have a "put right"; i.e., the right to require the partnership to purchase part or all of a class B limited partnership interest at "fair market value" as defined in section 8.12. The latter section defines fair market value under the so-called willing buyer/willing seller standard, with the caveat that the hypothetical willing buyer of the limited partnership interest will have no withdrawal or put rights.

Section 10.01 sets forth the liquidation provisions at the center of the present controversy. Section 10.01 states that the partnerships will dissolve and liquidate on the earlier of (1) December 31, 2043, (2) by agreement of all the partners, or (3) on the occurrence of certain narrowly defined acts of dissolution.

Transfers to University of Texas

Petitioners donated approximately $750,000 to the university of Texas (the university) between 1975 and 1999. Between 1981 and 1983, petitioners donated $100,000 to the university to establish

the Mildred Caldwell and Baine Perkins Kerr Centennial Professorship in English History and Culture. In 1988, petitioners donated Pennzoil Co. stock valued at $433,687 to the university to enhance the aforementioned endowment and to redesignate the professorship as a chair--the Mildred Caldwell and Baine Perkins Kerr Centennial Chair in English History and Culture.

On June 24, 1994, petitioners and a representative of the university executed two documents entitled "Assignment of Partnership Interest", which state that petitioners were transferring to the university one value unit of a class A limited partnership interest in KFLP and nine value units of a class A limited partnership interest in KILP. The assignments state that petitioners desired to assign a portion of their interests in KFLP and KILP as more particularly described in schedule I thereto. Schedule I to the assignments states in pertinent part: "The Assigned Partnership Interest constituted a Class A Limited Partnership Interest in * * * [the partnerships] when owned by Assignors, and when owned by Assignee shall constitute a Class A Limited Partnership Interest in said partnership."

On December 30, 1994, the KILP partnership agreement was amended to state that the university would be admitted as a class A limited partner.

Transfers to Grantor Retained Annuity Trusts

On December 28, 1994, petitioner Baine P. Kerr created the Baine P. Kerr 1994 Retained Annuity Trust under which he served as

the sole initial trustee. On the same date, petitioner Mildred C. Kerr created the Mildred Caldwell Kerr 1994 Retained Annuity Trust under which she served as the sole initial trustee. (The above-described trusts will hereinafter be referred to as the GRAT's.) The GRAT's were structured to provide petitioners with two annuity payments--the first payment was due December 29, 1994, and the second payment was due December 30, 1995. The GRAT's were each set to terminate on the earlier of December 30, 1995, or the date of the grantor's death.

On December 28, 1994, petitioners each executed a document entitled "Assignment of Partnership Interest", stating that they were each transferring to the GRAT's trustees a 44.535-percent class B limited partnership interest in KFLP as more particularly described in Schedule I thereto. The parties agree that the GRAT's trustees were permitted assignees within the meaning of section 8.03 of the KFLP partnership agreement. Schedule I to the assignments states in pertinent part: "The Assigned Partnership Interest constituted a Class B Limited Partnership Interest in [KFLP] when owned by Assignor and, when owned by Assignee, shall constitute a Class B Limited Partnership Interest in said partnership."

On December 29, 1994, and December 30, 1995, petitioners each executed documents entitled "Assignment of Annuity" in which they sold the rights to their annual GRAT's annuity payments in exchange for promissory notes from the GRAT's. On December 29, 1994, and

December 30, 1995, the GRAT's transferred demand notes to petitioners as required under the assignments described above. The original principal amounts due on the December 30, 1995, GRAT's demand notes held by petitioners Baine P. Kerr and Mildred C. Kerr were $795,148.76 and $795,716.99, respectively.

On December 29, 1994, petitioners (in their individual capacities and as GRAT's trustees) executed documents entitled "Security Agreement-Assignment of Partnership Interest" under which the GRAT's assigned to petitioners, as security for the GRAT's demand notes, the GRAT's class B limited partnership interests in KFLP.

During 1995, petitioners received interest payments on the GRAT's demand notes totaling $18,792.47. The GRAT's were terminated on December 30, 1995, and the remaining assets and liabilities of the GRAT's were transferred to the Kerr Issue GST Trusts.

By separate agreements dated February 28, 1998, petitioners agreed that the remaining principal and interest payments due on the December 30, 1995, GRAT's demand notes--then the liabilities of the various Kerr Issue GST Trusts--would be forgiven subject to the condition that the trustees agree to pay any Federal and State gift, estate, inheritance, transfer, succession, and generation-skipping transfer tax associated with the transfer.

Additional Transfers to the Kerr Children

On December 31, 1994, petitioners each transferred a .085-percent class B limited partnership interest in KILP to each of the Kerr children. On December 31, 1995, petitioners each transferred a .09375-percent class B limited partnership interest in KILP to each of the Kerr children.

Petitioners' Federal Gift Tax Returns

Petitioners filed Federal gifts tax returns for 1994 in which they reported gift tax liabilities attributable to the transfers that they made to the GRAT's trustees and to their children. In an appraisal report (attached to the returns) prepared by Howard Frazier Barker Elliott, Inc., petitioners determined the fair market value of the KFLP class B limited partnership interests that they transferred to the GRAT's trustees by applying a 25-percent discount for lack of liquidity or marketability to the value of the KILP interests held by KFLP, and a 17.5-percent minority-interest discount and a 35-percent discount for lack of liquidity or marketability on the net asset value of KFLP's assets. Petitioners computed the fair market value of a 44.535-percent limited partnership interest in KFLP as follows:

Total net asset value (KFLP)		$3,196,366
Less class A capital account		10,000
		3,186,366
Limited partnership percentage	44.535%	
NAV of the interest		1,419,048
Minority-interest discount	17.5%	248,333
Marketable minority interest value		1,170,715
Discount for lack of marketability	35.0%	409,750
Fair market value		760,965

Petitioners further reported that 95 percent of the fair market value of the KFLP class B limited partnership interests that they transferred to the GRAT's trustees was attributable to their retained annuities, while the remaining 5 percent (or $38,050 (rounded)) represented the amount of their taxable gifts to the remainder beneficiaries of the GRAT's.

Petitioners computed the fair market value of the KILP class B limited partnership interests that they transferred to their children in 1994 and 1995 by applying a 25-percent discount for lack of liquidity or marketability.

Respondent's Determinations

Respondent issued a notice of deficiency to petitioner Baine P. Kerr determining deficiencies of $698,401 and $10,024 in his Federal gift taxes for 1994 and 1995, respectively. Respondent issued a notice of deficiency to petitioner Mildred C. Kerr determining deficiencies of $698,401 and $10,024 in her Federal gift taxes for 1994 and 1995, respectively. Respondent determined, among other things, that petitioners had understated the values of both the KFLP interests that they had transferred to the GRAT's trustees in 1994 and the values of the KILP interests that they had transferred to their children in 1994 and 1995, as follows:

Year	Partnership Interest	Reported Value	Respondent's Determination
1994	KFLP	$38,050	[1]$1,636,420
1994	KILP	12,411	16,547
1995	KILP	17,440	13,080

[1] A substantial portion of the difference between the value that petitioners reported for this item and the value that respondent determined is attributable to the sec. 2702(b) issue that respondent subsequently conceded.

Respondent determined in pertinent part that the restrictions on liquidation set forth in section 10.01 of the KFLP and KILP partnership agreements constitute "applicable restrictions" within the meaning of section 2704(b), and that these restrictions should have been disregarded in valuing the limited partnership interests.

Procedural History

After petitioners filed a timely joint petition for redetermination, and respondent filed an answer to the petition, petitioners filed the motion for partial summary judgment currently pending before the Court. Petitioners raise several alternative arguments in support of their position that respondent erred in applying section 2704(b) in this case. Petitioners' primary contention is that the interests that they transferred to the GRAT's trustees were merely assignee interests. In connection with this argument, petitioners maintain that section 2704(b) does not apply to the valuation of the transferred interests because the limited rights of assignees under the partnership agreements are no

more restrictive than the restrictions imposed on assignees under TRLPA. See sec. 2704(b)(3)(B).

Respondent filed an objection to petitioners' motion for partial summary judgment asserting in part that petitioners had not properly raised the assignment issue in their petition.

Petitioners filed a response to respondent's objection and a motion for leave to file an amendment to petition and lodged an amendment to petition with the Court raising the assignee issue. The Court granted petitioners' motion for leave and filed petitioners' amendment to petition.

Respondent subsequently filed an amended answer to the amendment to petition. Respondent also filed a supplemental objection to petitioners' motion asserting that facts remained in dispute regarding petitioners' intent in making the disputed transfers.

Initially, this matter was called for hearing in Washington, D.C. During the hearing, counsel for petitioners conceded that, because the Kerr children were already limited partners of KILP when petitioners transferred additional KILP interests to them in 1994 and 1995, the Kerr children received limited partnership interests, as opposed to assignee interests. However, petitioners argued that these property interests should be valued for Federal gift tax purposes as assignee interests under the willing buyer/willing seller standard set forth in section 25.2512-1, Gift

Tax Regs. While accepting petitioners' concession regarding the transfers to the Kerr children, counsel for respondent argued that additional discovery was needed to determine the nature of the property interests that petitioners transferred to the GRAT's trustees. In response to these developments, the Court informed the parties that it intended to define the property interests that petitioners had transferred to the GRAT's trustees, and decide the legal question of the applicability of section 2704(b) before conducting a trial on valuation issues. In this regard, the Court directed the parties to proceed with informal discovery, submit a stipulation of facts to the Court, and prepare for a partial trial, if necessary, on the issue of the nature of the property interests that petitioners had transferred to the GRAT's trustees.

This matter was subsequently called for a partial trial in Houston, Texas. The parties filed a stipulation of facts, and the Court received testimony from Eastland, petitioner, Mary Kerr Winters, and James Robinson Kerr. Following the aforementioned hearings, the parties filed additional memoranda.

Discussion

Summary judgment is intended to expedite litigation and avoid unnecessary and expensive trials. See Florida Peach Corp. v. Commissioner, 90 T.C. 678, 681 (1988). Summary judgment may be granted with respect to all or any part of the legal issues in controversy "if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." Rule 121(b). The party opposing the motion cannot rest upon the allegations or denials in the pleadings but must "set forth specific facts showing that there is a genuine issue for trial." Rule 121(d). The moving party, however, bears the burden of proving that there is no genuine issue of material fact, and factual inferences will be read in a manner most favorable to the party opposing summary judgment. See Marshall v. Commissioner, 85 T.C. 267, 271 (1985).

On the basis of the record presented, we are satisfied that there are no material facts in dispute with regard to the issues raised in petitioners' motion for partial summary judgment.

Section 2501 imposes a tax for each calendar year on the transfer of property by gift by any individual. Section 2512 provides that if a gift is made in property, "the value thereof at the date of the gift shall be considered the amount of the gift."

Pursuant to section 25.2512-1, Gift Tax Regs., the value of the gift is the price at which such 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. See United States v. Cartwright, 411 U.S. 546, 551 (1973).

In the Omnibus Budget Reconciliation Act of 1990 (OBRA 1990), Pub. L. 101-508, sec. 11602(a), 104 Stat. 1388-491, Congress enacted a series of special valuation rules applicable to transfers of interests in corporations, partnerships, and trusts. One of these provisions, section 2704(b), provides:

SEC. 2704(b). Certain Restrictions on Liquidation Disregarded.--

(1) In general.--For purposes of this subtitle, if–

(A) there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and

(B) the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity,

any applicable restriction shall be disregarded in determining the value of the transferred interest.

(2) Applicable restriction.--For purposes of this subsection, the term “applicable restriction” means any restriction–-

(A) which effectively limits the ability of the corporation or partnership to liquidate; and

> (B) with respect to which either of the following applies:
>
> (i) The restriction lapses, in whole or in part, after the transfer referred to in paragraph (1).
>
> (ii) The transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.
>
> (3) Exceptions.--The term "applicable restriction" shall not include--
>
> * * * * * * *
>
> (B) any restriction imposed, or required to be imposed, by any Federal or State law.

Section 25.2704-2(b), Gift Tax Regs., provides that an applicable restriction is a restriction on "the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."

In sum, section 2704(b) generally provides that, where a transferor and his family control a corporation or partnership, a restriction on the right to liquidate the corporation or partnership shall be disregarded in determining the value of an interest that has been transferred from the transferor to a family member if, after the transfer, the restriction on liquidation either lapses or can be removed by the family.

Section 2704(b)(4) grants the Secretary the authority to promulgate regulations providing that restrictions other than restrictions on liquidation shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership among family members if the restriction has the effect of reducing the value of the transferred interest for transfer tax purposes but does not ultimately reduce the value of the interest to the transferee. To date, the Secretary has promulgated regulations concerning only restrictions on the liquidation of partnerships.

As previously mentioned, respondent determined that section 10.01 of the KFLP and KILP partnership agreements, which states that the partnerships shall liquidate upon the earlier of December 31, 2043, or the consent of all the partners, contains restrictions on the liquidation of the partnerships that constitute "applicable restrictions" within the meaning of section 2704(b). Respondent maintains that these restrictions must be disregarded in valuing the interests petitioners transferred to the GRAT's trustees and to their children. Petitioners contend that section 2704(b) is not applicable on a number of alternative grounds.

I. Petitioners' Argument That Interests Transferred to GRAT's Trustees Were Assignee Interests

Petitioners contend that section 2704(b) does not apply to the KFLP interests that they transferred to the GRAT's trustees because

those interests were merely assignee interests under State law. TRLPA section 7.02(a)(2) provides that an assignment of a partnership interest does not dissolve a limited partnership or entitle the assignee to become or exercise the rights or powers of a partner. TRLPA section 7.02(a)(3) and (4) provides that an assignee is allocated the income, gain, loss, deduction, or credit to which the assignor was entitled, and, until the assignee becomes a partner, the assignor continues to be a partner and to have the power to exercise any rights or powers of a partner. TRLPA section 7.04(a) provides that an assignee of a partnership interest may become a limited partner if and to the extent that the partnership agreement provides for such a transition or on the consent of all partners. Relying on the definition of an applicable restriction contained in section 25.2704-2(b), Gift Tax Regs., petitioners maintain that an assignee's inability to force KFLP to liquidate under the KFLP partnership agreement imposes no greater restriction than those imposed upon assignees under TRLPA.

Petitioners' contention that the partnership interests they transferred to the GRAT's trustees were assignee interests as opposed to limited partnership interests is based on a strict construction of the KFLP partnership agreement. In particular, although petitioners made the transfers to themselves as GRAT's trustees, petitioners nonetheless maintain that their children, as KFLP general partners, had to consent to the admission of the

GRAT's trustees as limited partners pursuant to section 3.06 of the KFLP partnership agreement.

Taxpayers generally are free to structure a business transaction as they please, even if motivated by tax avoidance considerations. See Gregory v. Helvering, 293 U.S. 465, 469 (1935); Yosha v. Commissioner, 861 F.2d 494, 497 (7th Cir. 1988), affg. Glass v. Commissioner, 87 T.C. 1087 (1986); Johnson v. Commissioner 86 F.2d 710, 712 (2d Cir. 1936), affg. 33 B.T.A. 1003 (1936). However, the tax effects of a particular transaction are informed by the substance of the transaction rather than its form. In Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978), the Supreme Court has articulated the principle as follows:

> In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," Commissioner v. Tower, 327 U.S. 280, 291 (1946), as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." Helvering v. Lazarus & Co., 308 U.S. [252, 255 (1939).] * * *

The doctrine that the substance of a transaction will prevail over its form has been applied in Federal estate and gift tax cases. See Heyen v. United States, 945 F.2d 359, 363 (10th Cir. 1991); Estate of Murphy v. Commissioner, T.C. Memo. 1990-472; see

also Schultz v. United States, 493 F.2d 1225 (4th Cir. 1974); Johnson v. Commissioner, supra.

On the basis of our review of the record, we are persuaded by a number of factors that petitioners, in substance, as in form, transferred limited partnership interests to the GRAT's trustees. As discussed below, the factors that we have relied upon in support of our holding on this point include petitioners' failure to respect the literal terms of the partnership agreement, the form of the transfers, and the economic realities and tax motivation underlying the transfers.

A. Failure To Comply With The Partnership Agreement

Petitioners failed to adhere strictly to the literal terms of the KFLP partnership agreement governing transfers of general partnership interests. Specifically, when KFLP was formed, petitioners transferred three life insurance policies on their lives to the partnership. The Kerr children did not contribute any assets to the partnership. Consistent with the terms of the partnership agreement, petitioners admit that they initially were the sole general partners of KFLP. Pursuant to section 4.01 of the partnership agreement, petitioners subsequently assigned a portion of their general partnership interests in KFLP to each of their children.

Significantly, under the plain language of section 8.20 of the KFLP partnership agreement, petitioners' inter vivos transfers of

general partnership interests to their children, who were permitted assignees within the meaning of section 8.03, should have resulted in the admission of the Kerr children as class B limited partners of KFLP. Petitioners were free, of course, to override section 8.20 of the partnership agreement and admit the Kerr children as general partners of KFLP. Nevertheless, considering the unambiguous terms of section 8.20, it would have been reasonable to expect that petitioners would clearly document the admission of the Kerr children as general partners of KFLP by way of written consents. Given the lack of formality surrounding the admission of the Kerr children as general partners of KFLP, we are left with the impression that petitioners either did not fully appreciate the terms of the KFLP partnership agreement or deemed formal consents to the admission of the Kerr children as general partners to be unnecessary. In either case, petitioners' failure to take any formal steps in regard to the admission of the Kerr children as general partners of KFLP belies petitioners' contention that the Kerr childrens' formal consent was necessary to admit the GRAT's trustees as limited partners of KFLP.

B. The Form of the Transfers

Petitioners transferred limited partnership interests to themselves as GRAT's trustees. Although it is agreed that the GRAT's trustees were permitted assignees under section 8.03 of the KFLP partnership agreement, petitioners contend that the GRAT's

trustees could not be admitted to the partnership as limited partners without the consent of all the KFLP general partners, including the Kerr children. Petitioner testified that he never considered whether he was transferring a limited partnership interest or an assignee interest to himself as a GRAT's trustee. Further, two of petitioners' children testified that they were never asked to consent to the admission of the GRAT's trustees as limited partners.

Although petitioners argue that the absence of formal consents by the Kerr children to the admission of the GRAT's trustees as limited partners suggests that petitioners technically transferred assignee interests to themselves as the GRAT's trustees, it is difficult to reconcile that position with the language petitioners used to document the transfers. As noted earlier, petitioners each signed a document entitled "Assignment of Partnership Interest" stating that "Assignor and Assignee desire that Assignor assign to Assignee a portion of the Partnership Interest of Assignor in [KFLP] * * * such assigned partnership interest being more particularly described in Schedule I hereto." In each case, the "Assignment of Partnership Interest" further stated that "all consents required to effect the conveyance of the Assigned Partnership Interest have been duly obtained." Further, Schedule I, which identified the transferred interests as a "44.535% Class B Limited Partnership Interest", stated that "The Assigned

Partnership Interest constituted a Class B Limited Partnership Interest in [KFLP] when owned by Assignor, and when owned by Assignee, shall constitute a Class B Limited Partnership Interest in said partnership."

Read as a whole, the language used in the "Assignment of Partnership Interest" establishes that petitioners transferred limited partnership interests to themselves as the GRAT's trustees. Although the documents refer to the GRAT's trustees as assignees, the description of the assigned interests contained in Schedule I clearly states that the assignees will hold class B limited partnership interests in KFLP. Equally important, the "Assignment of Partnership Interest" states that petitioners had obtained all necessary consents to effect the conveyance. Because the GRAT's trustees qualified as permitted assignees within the meaning of section 8.03 of the partnership agreement, and petitioners were not required to obtain any consents to transfer an assignee interest to a permitted assignee, the inclusion of the statement that all necessary consents had been obtained also indicates that petitioners were transferring limited partnership interests to the GRAT's trustees. Further, the statement that all necessary consents had been obtained contradicts the testimony of the Kerr children that petitioners never requested that they consent to the transfers to the GRAT's trustees.

C. Objective Economic Analysis

The objective economic realities underlying the transfers to the GRAT's trustees do not support petitioners' position that the transferred interests should be considered assignee interests. First, and perhaps most importantly, there were no significant differences under the KFLP partnership agreement between the rights of limited partners and assignees. Petitioners were vested with managerial responsibilities for KFLP; neither limited partners nor assignees had any managerial rights. In addition, limited partners and assignees enjoyed equivalent rights to information concerning the partnership's business affairs, and they shared the same interests in the partnership's distributable cash. Finally, while limited partners were permitted to put or sell their interests to the partnership under section 9.02 of the partnership agreement, assignees were given a substantially equivalent right to offer their interests to the partnership under sections 8.04 and 8.21 of the partnership agreement.

The only relevant difference between the rights of limited partners and assignees relates to a limited partner's right to vote on major decisions--a right not extended to assignees. However, given the rare and extraordinary nature of the matters qualifying as a major decision, such as the filing of a bankruptcy petition or approving an act in contravention of the partnership agreement, we

do not consider a limited partner's right to vote on such matters to be significant for purposes of deciding the question presented.

We further note that petitioners retained the right to vote the limited partnership interests and petitioners and the Kerr children had the ability to convert the purported assignee interests to full limited partnership interests or liquidate the partnership at will. To characterize the interests that petitioners transferred to the GRAT's trustees as assignee interests ignores the objective economic reality that there was no meaningful difference between the transfer of an assignee interest as opposed to a limited partnership interest.

D. Tax Motivation

The record shows that Eastland structured petitioners' transfers to the GRAT's trustees primarily to avoid the special valuation rules set forth in section 2704(b). Eastland's writings on the subject of family limited partnerships disclose his belief that the transfer of an assignee interest from one family member to another would serve to circumvent section 2704(b). Accepting petitioner's testimony that he did not consider whether he was transferring a limited partnership interest as opposed to an assignee interest to his GRAT's, it appears that Eastland made a conscious decision not to raise the subject with his clients.

Consistent with the foregoing, we conclude that petitioners transferred limited partnership interests to the GRAT's trustees in substance as in form.

II. Petitioners' Argument That the Disputed Transfers Must Be Valued as Assignee Interests Under Section 25.2512-1, Gift Tax Regs.

Petitioners contend, in the alternative, that the limited partnership interests in KFLP they transferred to the GRAT's trustees and the limited partnership interests in KILP they transferred to the Kerr children must be valued as assignee interests under the willing buyer/willing seller standard prescribed in section 25.2512-1, Gift Tax Regs. Specifically, petitioners contend that the hypothetical willing buyer is assumed to be an outsider who would approach the purchase of a KFLP or KILP limited partnership interest with the understanding that he could buy only an assignee interest and that there would be no guaranty of admission as a limited partner.

Petitioners' position is based on a misunderstanding of the proper application of the willing buyer/willing seller standard. The nature of the property interest to be valued for Federal gift tax purposes generally is determined under State law. See Morgan v. Commissioner, 309 U.S. 78, 80 (1940); Estate of Bright v. United States, 658 F.2d 999, 1001 (5th Cir. 1981). Once the Court has determined the nature or character of the property interest in

question, Federal law applies to determine how the property interest will be taxed. See United States v. Bess, 357 U.S. 51, 55 (1958).

The valuation standard under section 25.2512-1, Gift Tax Regs., is objective--the standard is based on a purely hypothetical willing buyer and willing seller, each of whom seeks to maximize his or her profit from any transaction involving the property. See Estate of Simplot v. Commissioner, 112 T.C. 130, 151-152 (1999), and cases cited thereat. The hypothetical willing buyer and willing seller are not specific individuals or entities, and their characteristics are not necessarily the same as the personal characteristics of the actual seller or a particular buyer. See Estate of Bright v. United States, supra at 1005-1006; Estate of Simplot v. Commissioner, supra at 152.

Petitioners attempt to expand section 25.2512-1, Gift Tax Regs., beyond its intended scope by using the provision to redefine the character of the property interests in question as assignee interests. See, e.g., Estate of Nowell v. Commissioner, T.C. Memo. 1999-15. However, as explained above, we have already determined that petitioners transferred limited partnership interests to the GRAT's trustees. Further, petitioners admit that they transferred limited partnership interests to their children. Accordingly, section 25.2512-1, Gift Tax Regs., is properly applied by determining the price that a hypothetical willing buyer would pay

a willing seller for limited partnership interests in KFLP and KILP.

III. Section 2704(b)--Applicable Restriction

Petitioners contend that section 2704(b) is not applicable in this case even if the Court concludes (as we have) that petitioners transferred limited partnership interests to the GRAT's and to their children. Petitioners argue that the provisions of section 10.01 of the partnership agreements do not constitute "applicable restrictions" because: (1) The provisions do not restrict liquidation of the partnerships within the meaning of section 2704(b)(2)(A); and (2) the university's interests in KFLP and KILP demonstrate that the Kerr family did not have the ability unilaterally to lift any restrictions on liquidation within the meaning of section 2704(b)(2)(B)(ii). In the alternative, petitioners assert that any restrictions on liquidation in the partnership agreements are excepted from the definition of an "applicable restriction" pursuant to section 2704(b)(3)(B) and section 25.2704-2(b), Gift Tax Regs. Because we agree with petitioners' contention that restrictions on liquidation in the partnership agreements are excepted from the definition of an "applicable restriction" pursuant to section 2704(b)(3)(B) and section 25.2704-2(b), Gift Tax Regs., we need not consider petitioners' remaining arguments.

Before proceeding with our analysis, we will briefly review the legislative history underlying section 2704. The special valuation rules, of which section 2704 is a part, were enacted in OBRA 1990 section 11602(a), in conjunction with the repeal of section 2036(c).[9] The latter provision, enacted as part of the Omnibus Budget Reconciliation Act of 1987, Pub. L. 100-203, sec. 10402(a), 101 Stat. 1330, 1330-431, represented Congress' attempt to discourage taxpayers' use of "estate freeze" transactions for the purpose of reducing or avoiding Federal transfer taxes. See H. Conf. Rept. 100-495, at 994 (1987), 1987-3 C.B. 193, 274. By 1990, Congress felt compelled to repeal section 2036(c) on the ground that "the statute's complexity, breadth, and vagueness posed an unreasonable impediment to the transfer of family businesses." Informal S. Rept. on S. 3209, 136 Cong. Rec. S15629, S15679-S15680 (daily ed. Oct. 18, 1990).

Although the special valuation rules were enacted as a more targeted substitute for section 2036(c), there is little in the way of direct legislative history relating to the enactment of section 2704. In particular, there was no provision for the special

[9] Sec. 2036(c) generally provided that if a person transferred property having a disproportionately large share of the potential appreciation in an enterprise while retaining an interest or right in the enterprise, then the transferred property would be included in the transferor's gross estate, or upon the disposition of either the transferred property or the retained interest, the transferor would be deemed to have made a gift.

valuation rules in H.R. 5835, 101st Cong., 2d Sess. (1990)--the House bill underlying OBRA 1990. Provisions for special valuation rules first appeared in S. 3209, 101st Cong., 2d Sess. (1990)--the text of which the Senate adopted in lieu of the language passed by the House in H.R. 5835. S. 3209, section 7210(a), included new section 2704, which provided in pertinent part as follows:

> Treatment of Certain Restrictions and Lapsing Rights.–-
>
> For purposes of this subtitle, the value of any property shall be determined–-
>
> (1) without regard to any restriction other than a restriction which by its terms will never lapse * * *

The broad language of the Senate version of section 2704 did not survive the ensuing conference between the House and Senate managers of the legislation. Unfortunately, there is no meaningful explanation of the detailed language or concepts that were made a part of section 2704 as finally enacted. H. Conf. Rept. 101-964, at 1137 (1990), 1991-2 C.B. 560, 606, states in pertinent part:

> Treatment of certain restrictions and lapsing rights
>
> In general
>
> The conference agreement modifies the provision in the Senate amendment regarding the effect of certain restrictions and lapsing rights upon the value of an interest in a partnership or corporation. These rules are intended to prevent results similar to that of Estate of Harrison v. Commissioner, 52 T.C.M. (CCH) 1306 (1987). These rules do not affect minority discounts or other discounts available under present law. The conferees intend that no inference be drawn regarding the transfer tax effect of restrictions and lapsing rights under present law.

* * * * * * *

Restrictions

Under the conference agreement, any restriction that effectively limits the ability of a corporation or partnership to liquidate is ignored in valuing a transfer among family members if (1) the transferor and family members control the corporation or partnership, and (2) the restriction either lapses after the transfer or can be removed by the transferor or members of his family, either alone or collectively.

Example 8.--Mother and Son are partners in a two-person partnership. The partnership agreement provides that the partnership cannot be terminated. Mother dies and leaves her partnership interest to Daughter. As the sole partners, Daughter and Son acting together could remove the restriction on partnership termination. Under the conference agreement, the value of Mother's partnership interest in her estate is determined without regard to the restriction. Such value would be adjusted to reflect any appropriate fragmentation discount.

This rule does not apply to a commercially reasonable restriction which arises as part of a financing with an unrelated party or a restriction required under State or Federal law. The provision also grants to the Treasury Secretary regulatory authority to disregard other restrictions which reduce the value of the transferred interest for transfer tax purposes but which do not ultimately reduce the value of the interest to the transferee.

With the foregoing as background, we return to our analysis.

Section 2704(b)(2)(A) broadly defines an applicable restriction as "any restriction which effectively limits the ability of the corporation or partnership to liquidate". However, section 2704(b)(3)(B) excepts from the definition of an applicable restriction "any restriction on liquidation imposed, or required to be imposed, by any Federal or State law".

In what we view as an expansion of the exception contained in section 2704(b)(3)(B), the Secretary promulgated section 25.2704-2(b), Gift Tax Regs., which states in pertinent part: "An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." Thus, the question arises whether the partnership agreements involved herein impose greater restrictions on the liquidation of KFLP and KILP than the limitations that generally would apply to the partnerships under State law.

Section 10.01 of the partnership agreements states in pertinent part that the partnerships shall dissolve and liquidate upon the earlier of December 31, 2043, or by agreement of all the partners. Petitioners direct our attention to TRLPA section 8.01, which provides that a Texas limited partnership shall be dissolved on the earlier of: (1) The occurrence of events specified in the partnership agreement to cause dissolution; (2) the written consent of all partners to dissolution; (3) the withdrawal of a general partner; or (4) entry of a decree of judicial dissolution. TRLPA section 8.04 provides that, following the dissolution of a limited partnership, the partnership's affairs shall be wound up (including the liquidation of partnership assets) as soon as reasonably practicable.

On the basis of a comparison of section 10.01 of the partnership agreements and TRLPA section 8.01, we conclude that section 10.01 of the partnership agreements does not contain restrictions on liquidation that constitute applicable restrictions within the meaning of section 2704(b). We reach this conclusion because Texas law provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the partnership agreement or upon the written consent of all the partners, and the restrictions contained in section 10.01 of the partnership agreements are no more restrictive than the limitations that generally would apply to the partnerships under Texas law. Consequently, these provisions are excepted from the definition of an applicable restriction pursuant to section 2704(b)(3)(B) and section 25.2704-2(b), Gift Tax Regs.

Respondent counters that we should compare the restrictions contained in section 10.01 of the partnership agreements with TRLPA section 6.03, which provides:

> A limited partner may withdraw from a limited partnership at the time or on the occurrence of events specified in a written partnership agreement and in accordance with that written partnership agreement. If the partnership agreement does not specify such a time or event or a definite time for the dissolution and winding up of the limited partnership, a limited partner may withdraw on giving written notice not less than six months before the date of withdrawal to each general partner * * *.

Respondent's reliance on TRLPA section 6.03 is misplaced. TRLPA section 6.03 governs the withdrawal of a limited partner from the

partnership--not the liquidation of the partnership. TRLPA section 6.03 sets forth limitations on a limited partner's withdrawal from a partnership. However, a limited partner may withdraw from a partnership without requiring the dissolution and liquidation of the partnership. In this regard, we conclude that TRLPA section 6.03 is not a "limitation on the ability to liquidate the entity" within the meaning of section 25.2704-2(b), Gift Tax Regs.

Respondent's position herein is inconsistent with section 25.2704-2(d) (Example 1), Gift Tax Regs., which states in pertinent part:

> D owns a 76 percent interest and each of D's children, A and B, owns a 12 percent interest in General Partnership X. The partnership agreement requires the consent of all the partners to liquidate the partnership. Under the State law that would apply in the absence of the restriction in the partnership agreement, the consent of partners owning 70 percent of the total partnership interests would be required to liquidate X. * * * The requirement that all the partners consent to the liquidation is an applicable restriction. * * *

Significantly, the restriction on liquidation in the partnership agreement described in the example was not compared with a State law provision (such as TRLPA section 6.03) pertaining to withdrawal from a partnership. Rather, the terms of the partnership agreement are compared with a partnership liquidation provision similar to TRLPA section 8.01. With these points in mind, we reject respondent's argument regarding TRLPA section 6.03.

We are mindful that the Secretary has been vested with broad regulatory authority under section 2704(b)(4). However, the

regulations in place do not support a conclusion that the disputed provisions in the KFLP and KILP partnership agreements constitute applicable restrictions.

Conclusion

In sum, we hold that petitioners transferred limited partnership interests to the GRAT's trustees. However, consistent with the preceding discussion, we conclude that section 10.01 of the partnership agreements does not contain "an applicable restriction" within the meaning of section 2704(b). Accordingly, we will grant petitioners' motion for partial summary judgment as it pertains to this issue.

To reflect the foregoing,

An order granting petitioners' Motion for Partial Summary Judgment will be issued as it relates to the section 2704(b) issue.

244 F. Supp. 2d 700 (2003)

David A KIMBELL, Sr., Independent Executor under the Will of Ruth A. Kimbell, Deceased, Plaintiff,
v.
UNITED STATES OF AMERICA, Defendant.
No. Civ.A. 7:01-CV-0218-R.

United States District Court, N.D. Texas, Wichita Falls Division.
January 14, 2003.
As Amended April 16, 2003.

Michael Allen Denham, Robert Don Collier, William R. Cousins, Meadows Owens Collier Reed Cousins & Blau, Dallas, TX, for Plaintiff.

Louise P. Hytken, U.S. Department of Justice, Dallas, TX, for Defendant.

MEMORANDUM OPINION AND ORDER

BUCHMEYER, District Judge.

Now before this Court are DEFEDANT'S MOTION FOR PARTIAL SUMMARY JUDGMENT and PLAINTIFF'S CROSS MOTION FOR PARTIAL SUMMARY JUDGMENT (jointly filed October 15, 2002). Oral argument was held on November 6, 2002, and the parties submitted supplemental briefs on November 16 and 26, 2002. For the reasons discussed below, Defendant's Motion for Partial Summary Judgment is GRANTED, and Plaintiffs Cross Motion for Partial Summary Judgment is DENIED.

I. BACKGROUND

Ruth A. Kimbell (the "Decedent") died March 25, 1998 at the age of 96. The Plaintiff, David A. Kimbell, is the Decedent's son and executor of her estate.

At the time of Decedent's death, she held interests in three entities relevant to this case: 1) the R.A. Kimbell Living Trust (the "Trust"), 2) the R.A. Kimbell Management Co., LLC (the "LLC"), and 3) the R.A. Kimbell Property Co., Ltd. (the "Partnership"). The Trust is a living trust created by Decedent in 1991 and fully revocable by her prior to her death. Thus, it is not in dispute that the interests of the Trust and those of Decedent are to be treated as one for the purposes of analysis under the Internal Revenue Code (the "Code"). Decedent and Plaintiff were cotrustees of the Trust, and Plaintiff was paid a

monthly fee to manage the trust. The LLC is a Texas limited liability company which was established on January 7, 1998 and is owned 50% by the Trust, 25% by Plaintiff and 25% by Plaintiffs wife (Decedent's daughter-in-law). Plaintiff was the manager of the LLC. The Partnership is a Texas limited partnership created on January 29, 1998 (two months before Decedent's death) by the Trust and the LLC. The LLC contributed *1% of the capital* of the Partnership and was its *general partner,* while the Trust contributed *99% of the capital* yet was only a *limited partner.* The Partnership is for a term of 40 years (i.e. until Decedent would have been 136 years old). As Decedent had a 50% interest in LLC and a 99% interest in the Trust, Decedent's real interest in the Partnership was 99.5%.

After Decedent died, Plaintiff, as executor of Decedent's estate, filed estate tax returns with the IRS. The IRS audited the returns and found that the value of Decedent's 99% interest in the Partnership was $2,463 million not $1,257 million as stated in the return. Accordingly, the IRS increased the amount of estate tax due. Plaintiff paid the increased taxes and subsequently, on November 15, 2001, brought this action seeking a refund of $837,089 for the IRS's alleged overvaluation of the estate.

II. ANALYSIS

A. SUMMARY JUDGMENT STANDARD

Rule 56(c) of the Federal Rules of Civil Procedure allows summary judgment when there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. FED. R. Civ. P. 56(c); *Celotex Corp. v. Catrett,* 477 U.S. 317, 322, 106 S. Ct. 2548, 91 L. Ed. 2d 265 (1986); *Melton v. Teachers his. & Annuity Ass'n of Am.,* 114 F.3d 557, 559 (5th Cir. 1997). The court must decide all reasonable doubts and inferences in the light most favorable to the party opposing the motion. *Lemelle v. Universal. Mfg. Corp.,* 18 F.3d 1268, 1272 (5th Cir.1994); *Walker v. Sears, Roebuck & Co.,*853 F.2d 355, 358 (5th Cir.1988). As long as there appears to be some support for the disputed allegations such that "reasonable minds could differ as to the import of the evidence," the motion must be denied. *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 250, 106 S. Ct. 2505, 91 L. Ed. 2d 202 (1986).

The party moving for summary judgment bears the initial burden of identifying those portions of the pleadings, depositions, answers to interrogatories, and admissions on file, together with affidavits, if any, which it believes demonstrate the absence of a genuine issue of material fact. *Celotex,* 477 U.S. at 323, 106 S. Ct. 2548; *Lynch Properties, Inc. v. Potomac Ins. Co.,* 140 F.3d 622, 625 (5th Cir.1998). Where the non-moving party bears the burden of proof on a claim upon which summary judgment is

sought, the moving party may discharge its summary judgment burden by showing that there is an absence of evidence to support the nonmoving party's ease. *Celotex,* 477 U.S. at 325, 106 S. Ct. 2548. Once the moving party has satisfied this burden, the nonmoving party must go beyond the pleadings and by its own affidavits or depositions, answers to interrogatories, and admissions on file set forth specific facts showing a genuine issue for trial. *Matsushita Elec, Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574, 587, 106 S. Ct. 1348, 89 L. Ed. 2d 538 (1986); *Edwards v. Your Credit, Inc.,* 148 F.3d 427, 431-32 (5th Cir.1998). Summary judgment will be granted "against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial." *Celotex,* 477 U.S. at 322, 106 S. Ct. 2548.

B. SECTION 2036(A) OF THE INTERNAL REVENUE CODE

The question before the Court in these cross-motions for partial summary judgment is how the transfer of assets made by Decedent into the Partnership should be treated under section 2036(a) of the Internal Revenue Code (the "Code").[1] Section 2036(a) seeks to prevent individuals from avoiding estate tax by transferring their assets to others prior to death. *Harper v. Commissioner of Internal Revenue,* 2002 WL 992347, T.C.M. (RIA) 2002-121, *15 (U.S.Tax Ct. 2002). (noting that "[t]he general purpose of this section is to `include in a decedent's gross estate transfers that are essentially testamentary' in nature.") (citations omitted). The provision states:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

26 U.S.C § 2036(a). Decedent died before the expiry of the Partnership. Thus, under the plain language of § 2036(a), "all property to the extent of any interest therein" which Decedent had "at any time" transferred is part of the estate unless the property interest

[1] The parties have also briefed the issue of whether the interest formerly held by Decedent in the Partnership is to be considered, for the purpose of valuation, as a limited partnership interest or an assignee interest. The parties agree that this is a subsidiary issue which does not affect the question of the applicability of 26 U.S.C. § 2036(a).

qualifies for an exception to the general rule of inclusion. The two exceptions provided by § 2036(a) are (1) transfers which are "bona fide salefs] for an adequate and full consideration" (the "Bona Fide Sale Exception"), and (2) transfers after which the decedent retains neither the "possession or enjoyment of, or the right to income from the property" nor "the right, either alone or in conjunction with any other person, to designate the persons who shall benefit or enjoy the property" (the "Retained Income or Rights Exception"). For the granting of partial summary judgment to be appropriate, Plaintiff must establish, as a matter of law, that Decedent's transfer of property to the Partnership qualifies for one of the exceptions. Conversely, Defendant must demonstrate, as a matter of law, that the transfers fail to qualify for both exceptions. Each exception will be considered in turn.

1. The Bona Fide Sale Exception

Plaintiff argues that Decedent's transfer of assets to the Partnership was a bona fide sale for an adequate and full consideration in money or money's worth.[2] The Tax Court has explained, and this Court agrees, that "applicability of the [bona fide sale] exception rests on two requirements: (1) [a] bona fide sale, meaning an arm's-length transaction, and (2) adequate and full consideration." *Harper,* 2002 WL 992347, T.C.M. (RIA) 2002-121, *21.

In the instant case, Decedent's transfer fails both requirements. Plaintiff has produced no credible evidence that the formation of the Partnership was the product of an arm's length transaction, i.e. a transaction "between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power." *Black's Law Dictionary* 103 (7th ed.1999). Indeed, one cannot even find two parties, much less two parties conducting an arm's length negotiation leading to a "bona fide sale". *See Mollenberg's Estate v. Commissioner,* 173 F.2d 698, 701 (2d Cir.1949) (quoted in *Harper,* 2002 WL 992347, T.C.M. (RIA) 2002-121, *21) (defining a `sale' as "an exchange resulting from a bargain"). Ownership interests in the Partnership are held by two entities: 99% by the Trust which was wholly-owned by Decedent, and 1% by the LLC which was 50% owned by the Trust. Therefore, Decedent not only "stood on both sides of the transaction," but, for all intensive purposes, was both sides of the transaction. *Harper,* 2002 WL 992347, T.C.M. (RIA) 2002-121, *21 (noting that "it would be an oxymoron to say that one can engage in an arm's length transaction with oneself).

Moreover, even if one assumes the Partnership was the result of "a bona fide sale," Plaintiff has failed to establish that the Decedent received "adequate and full consideration" for the sale. While "adequate and full consideration" is not defined in the Code, *Wheeler v. U.S.,* 116 F.3d 749, 754-55 (5th Cir.1997), this Court agrees with the Tax Court that the meaning of "adequate and full consideration" does not include paper transactions such as the one at issue in the current case. The Decedent, through the

[2] See *Plaintiff's Brief in Support of Cross Motion for Partial Summary Judgment,* at 12-17.

Trust, contributed 99% of the capital for the Partnership and in return received a 99% interest in the partnership. Decedent received no consideration other than the interest in the Partnership. Plaintiff, before becoming the general partner of the Partnership, was already managing both the Trust, from where 99% of the assets of the Partnership came and the LLC from where the other 1% came (of which 0.5% were from the Trust). Nothing appears to have changed. In *Harper,* the Tax Court recently rejected a similar claim for applicability of the exceptions to § 2036(a) in a case in which the decedent had contributed 99% of the capital, by means of a trust, to a partnership. In words that are equally applicable to Decedent's transfers to the Partnership, the Tax Court stated:

> all decedent did was change the form in which he held his beneficial interest in the contributed property.... Essentially the value of the partnership interest the [t]rust received derived solely from the assets the [t]rust had just contributed. Without any change whatsoever in the underlying pool of assets or prospect for profit ... there exists nothing but a circuitious "recycling" of value. We are satisfied that such instances of pure recycling do not rise to the level of a payment of consideration. To hold otherwise would open section 2036 to a myriad of abuses engendered by unilateral paper transformations. *Harper,* 2002 WL 992347, T.C.M (RIA) 2002-121, *21-22. The same is true in this case; there has been "only a recycling of value and not a transfer of consideration." *Harper,* 2002 WL 992347, T.C.M (RIA) 2002-121, *23. The facts here stand in sharp contrast to *Wheeler* in which IRS actuarial tables were used to value the remainder interest transferred by decedent to his two sons. *Wheeler,* 116 F.3d at 752, 767, Decedent's transfer fails to qualify for the bona fide sale exception.

2. The Retained Income or Rights Exception

For the purposes of 2036(a), "[a] transferor retains the enjoyment of property," if:

> there is an express or implied agreement at the time of the transfer that the transferor will retain the present economic benefits of the property, even if the retained right is not legally enforceable.

Reichardt v. Commissioner of Internal Revenue, 114 T.C. 144, 151-52, 2000 WL 230358 (2000). In this case, there is no need to search for an implied agreement, as the Partnership Agreement (the "Agreement") itself qualifies. The Decedent (through the revocable Trust), although formally a limited partner, owned 99% of the Partnership, and an additional 0.5% of the Partnership through her 50% interest in the LLC. Section 2.4 of the Partnership Agreement (the "Agreement") provides that:

70 Percent in Interest of the Limited Partners will have the right to remove the General Partner.[3]

Therefore, Decedent, as a limited partner with a 99% interest in the partnership, could, at any time, remove the General Partner, and either appoint herself or someone else of her choosing to be the new General Partner. Similarly, section 9.34 of the Agreement provides that:

> If the General Partner ceases to serve for any reason, a Majority in Interest of Limited Partners shall ... elect one or more new General Partners from among the Limited Partners or any Persons not already Limited Partners.[4] The General Partner, in turn, has "sole discretion" to decide on distributions of income from the Partnership.[5] By retaining the power to designate the General Partner, Decedent retained the power to either personally benefit from the income of the partnership or to designate the persons who would benefit from the income of the partnership, and thus runs afoul of both §§ 2036(a) (1) and (2). *Cf W.W. Jones II v. Commissioner of Internal Revenue,* 116 T.C. 121, 134-35, 2001 WL 233964 (2001) (finding that the owner of an 83% partnership interest was "effectively give[n] ultimate decision-making authority").

Plaintiff contends that Decedent did not have the power to take over the partnership because she had fiduciary duties. Plaintiff makes much of a Supreme Court case, *U.S. v. Byrum,* 408 U.S. 125, 92 S. Ct. 2382, 33 L. Ed. 2d 238 (1972), in which the Court held that § 2036 did not apply to a decedent who retained voting interest in several corporations. However, *Byrum,* is not only distinguishable on its facts from our case, but was expressly overruled by Congressional enactment of § 2036(b) which states that "the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of the transferred property." Moreover, section 2.95 of the Partnership Agreement states: "The General Partner wall not owe a fiduciary duty to the Partnership or to any Partner."[6] If Decedent, at any time, could remove the general partner and herself become general partner, then, by the terms of the Agreement, she would not owe a fiduciary duty to the other Partners, who, in any case, own only a minuscule share of the Partnership. Assuming such fiduciary duties exist, to whom does a party which owns 99% of the Partnership owe them? The fiduciary argument falls flat.

Plaintiff argues that Decedent had "irrevocably" transferred her assets to the partnership. Such a statement flies in the face of the ability Decedent retained to select a new general partner who could then distribute the income, at her "sole discretion" back to Decedent. Plaintiff also relies on *Church v. U.S.,* 2000 WL 206374

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[3] *Joint Appendix,* at 56.
[4] *Joint Appendix,* at 79.
[5] *Agreement* § 5.1, *Joint Appendix,* at 70. Section 5.5 places certain restrictions on distributions by the General Partner.
[6] *Joint Appendix,* at 60.

(W.D.Tex.2000) to argue that the Partnership was a legitimate business venture. Although the validity of the Partnership under Texas law can be presumed for the purposes of this Opinion, the facts of this case are clearly distinguishable from *Church.* In *Church* three family members pooled their interests *for the first time* into a 57% stake in a ranch, with the remaining 43% still being held by members of another family. Thus, "the character of the interests owning a majority of the Ranch changed dramatically as a result of the [partnership." *Church,* 2000 WL 206374, *4. In the instant case, the 99% interest transferred by Decedent from the Trust to the Partnership was already pooled in the Trust and was already being managed by Plaintiff as cotrustee. Plaintiff also was already the manager of the LLC which contributed the other 1% of the assets of the Partnership.

Finally Plaintiff argues that issues of material fact exist as to whether there was an express or implied agreement between Decedent and her son to make a testamentary transfer. This is a red herring. An award of partial summary judgment for Defendant need not be based on any facts other than those contained in the documents submitted to the Court documents which speak for themselves and whose validity is not in dispute.

Plaintiffs arguments are without merit and have been cogently addressed by Defendant. This Court finds that the transfer of assets to the Partnership is governed by the default provision of 26 U.S.C. § 2036(a), rather than by any exception thereto. The Court also holds that § 2036 is applicable to the Decedent's 50% interest in R.A. Kimball Management Co., LLC (the LLC), including Decedent's indirect 0.5% interest in the partnership assets resulting from the LLC's ownership of the 1% general interest in the partnership.

III. CONCLUSION

For the foregoing reasons, Defendant's Motion for Partial Summary Judgment is GRANTED, and Plaintiffs' Cross Motion for Partial Summary Judgment is DENIED.

It is so ORDERED.

United States Court of Appeals
Fifth Circuit
F I L E D
May 20, 2004
Charles R. Fulbruge III
Clerk

UNITED STATES COURT OF APPEALS
For the Fifth Circuit

No. 03-10529

DAVID A. KIMBELL,SR., INDEPENDENT EXECUTOR
UNDER THE WILL OF RUTH A. KIMBELL, DECEASED,
Plaintiff-Appellant,

versus

UNITED STATES OF AMERICA,
Defendant-Appellee.

Appeal from the United States District Court
for the Northern District of Texas

Before DAVIS, BARKSDALE and PRADO, Circuit Judges.

W. EUGENE DAVIS, Circuit Judge:

In this estate tax case, David A. Kimbell, the executor of the estate of his mother Ruth A. Kimbell, appeals the judgment of the district court denying his request for a refund of estate taxes and interest paid by the estate. The district court decided on cross-motions for partial summary judgment that the value of assets the decedent transferred to the R.A. Kimbell Property Co., Ltd (Partnership) was includible in her gross estate under I.R.C. § 2036 because the transfer was not a bona fide sale for full and adequate consideration. We conclude that the district court erred in finding as a matter of law that (1) family members can not enter into a bona fide transaction, and (2) a transfer of assets in return for a pro rata partnership interest is not a transfer for full and adequate consideration. The district court also erred in failing to consider uncontroverted record evidence to support the taxpayer's position that the transfer was a bona fide sale. We therefore

vacate and remand.

I.

Ruth A. Kimbell ("Mrs. Kimbell" or the "Decedent") died testate on March 25, 1998. She was 96 years old. The Plaintiff, David A. Kimbell, is the Decedent's son and the executor of her estate. In the years prior to her death, the Decedent transferred a large portion of her estate in a series of transactions to three entities. In 1991, Mrs. Kimbell created the R.A. Kimbell Living Trust (the "Trust"), which was a revocable living trust administered by Mrs. Kimbell and her son as co-trustees. In January 1998, the Trust, David Kimbell and his wife formed a limited liability company, the R.A. Kimbell Management Co., L.L.C. (the "LLC"). The Trust contributed $20,000 for a 50% interest. David Kimbell and his wife each contributed $10,000 for 25% interests each. David Kimbell was the sole manager of the LLC.

Later in January 1998, the Trust and the LLC formed the R.A. Kimbell Property Co., Ltd., a limited partnership under Texas law (the "Partnership"). The Trust contributed approximately $2.5 million in cash, oil and gas working interests and royalty interests, securities, notes and other assets for a 99% pro-rata limited partner interest. The oil and gas properties were a continuation of an oil and gas business that the Decedent's late husband had founded in the 1920's. The LLC contributed approximately $25,000 in cash for a 1% pro-rata general partner interest. At inception, approximately 15% of the assets of the Partnership were oil and gas working (11%) and royalty (4%) interests. As a result of these transfers, Mrs. Kimbell, through the Trust and the LLC, owned 99.5% of the Partnership. David Kimbell managed Mrs. Kimbell's business interest before and after the creation of the LLC and the Partnership. Not all of Mrs. Kimbell's assets were conveyed to the LLC and the Partnership. She retained over $450,000 in assets outside of

the LLC and the Partnership for her personal expenses. The primary focus of this appeal is on this transfer from the LLC and the Trust to the Partnership. Because of Mrs. Kimbell's control of the Trust assets, the transfer by the Trust is viewed as a transfer by Mrs. Kimbell.

Under the stated terms of the Partnership Agreement, the purposes of the Partnership were to "increase Family wealth; establish a method by which annual gifts can be made without fractionalizing Family Assets; continue the ownership and collective operation of Family Assets and restrict the right of non-Family members to acquire interests in Family Assets; provide protection to Family Assets from claims of future creditors against Family members; prevent transfer of a Family member's interest in the Partnership as a result of a failed marriage; provide flexibility and continuity in business planning for the Family not available through trusts, corporations or other business entities; facilitate the administration and reduce the cost associated with the disability or probate of the estate of Family members; promote the Family's knowledge of and communication about Family Assets; provide resolution of any disputes which may arise among the Family in order to preserve Family harmony and avoid the expense and problems of litigation; and consolidate fractional interests in Family Assets." (Paragraph numbers omitted.) These purposes were supported by the deposition testimony of David Kimbell and Micheal Elyea, Mrs. Kimbell's business advisor. The term of the Partnership was 40 years.

The LLC, as general partner, managed the Partnership and had exclusive authority to make distributions. The Partnership Agreement provided that the general partner owed no fiduciary duty to the Partnership or to any Partner but owed a duty of loyalty and a duty of care to the Partnership. The Trust, as limited partner, had no right to withdraw from the Partnership or receive a return of contributions until the Partnership was terminated, which could occur only by

unanimous consent of the partners. The Partnership Agreement provided that 70% in interest of the limited partners had the right to remove the general partner. A majority in interest of the limited partners had the right to elect a new general partner.

The estate filed its federal estate tax return in December 1998. At the time of Mrs. Kimbell's death, the value of the Partnership assets was approximately $2.4 million. On the return, the estate claimed a 49% discount on the value of Mrs. Kimbell's interest in the Partnership and her interest in the LLC for lack of control and lack of marketability of the partnership interest. It reported her 99% interest in the Partnership as having a fair market value of approximately $1.2 million and her 50% interest in the LLC as having a fair market value of approximately $17,000.

The IRS audited the estate. It found that the value of the assets transferred to the Partnership and the LLC, rather than Mrs. Kimbell's interest in these entities, was includible in the gross estate under § 2036(a) of the Internal Revenue Code and increased the tax due accordingly. The estate paid the additional tax and then filed for a refund, claiming that the IRS overvalued Mrs. Kimbell's interests in the Partnership and the LLC.

On cross-motions for summary judgment, the district court found that the government had demonstrated, as a matter of law, that Mrs. Kimbell's transfers of assets to the Partnership and the LLC were subject to I.R.C. § 2036(a), which recaptures certain assets transferred prior to death in the gross estate. Therefore, the district court found that the IRS correctly included the value of the assets Mrs. Kimbell transferred to the Partnership and the LLC in the estate and granted partial summary judgment to the government. The estate appeals.

II.

This court reviews a grant of summary judgment *de novo*. Browning v. Odessa, 990 F.2d 842, 844 (5th Cir. 1993).

III.

Whether the assets Mrs. Kimbell transferred to the Partnership must be recaptured into her estate for estate tax purposes depends on the application of Internal Revenue Code section 2036(a). Internal Revenue Code section 2036(a) provides:

> (a) General rule. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death--
> (1) the possession or enjoyment of, or the right to the income from, the property, or
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

26 U.S.C. § 2036(a).

The statute recognizes that some assets transferred prior to death must be recaptured into the estate. By recapturing these transfers into the estate, this section of the code prevents the circumvention of federal estate tax by the use of inter vivos transactions which do not remove the lifetime enjoyment of property purportedly transferred by a decedent. Estate of Wyly v. Commissioner, 610 F.2d 1282, 1290 (5th Cir. 1980). Regarding this provision, this court has stated:

> [Section 2036 is] part of a Congressional scheme to tax the value of property transferred at death, whether the defendant accomplishes the transfer by will, by intestacy, or by allowing his substantial control over the property to remain unexercised until death so that the shifting of its economic benefits to the beneficiary only then becomes complete.

Estate of Lumpkin v. Commissioner, 474 F.2d 1092, 1097 (5th Cir. 1973).

The statute provides two exceptions that will allow a transfer to escape the operation of § 2036(a). First, if the transfer is a bona fide sale for full and adequate consideration, then § 2036(a) does not apply. See Treas. Reg. §§ 20.2036-1(a), 20.2043-1(1)(as amended in 1960). If the transfer is not a bona fide sale for full and adequate consideration, then the transfer may still be excluded from the estate of the decedent under the second exception, if the decedent did not retain either the (1) possession, enjoyment or rights to the transferred property, or (2) the right to designate the persons who would possess or enjoy the transferred property. Estate of Stone v. Comm'r, 86 T.C.M. (CCH) 551, 578 (T.C. 2003); 26 U.S.C. § 2036(a).

IV.

Bona Fide Sale for Adequate and Full Consideration.

The first exception allows a transfer to escape the reach of § 2036(a) if it is a bona fide sale for adequate and full consideration for money or money's worth. 26 U.S.C. § 2036(a). The district court found that Mrs. Kimbell's transfer of assets to the Partnership did not qualify for this exception. Relying on Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641 (T.C. 2002), the district court stated that the "applicability of the [bona fide sale] exception rests on two requirements: (1) [a] bona fide sale, meaning an arm's length transaction, and (2) adequate and full consideration." The court defined an arm's length transaction as one involving "two parties who are not related or not on close terms," citing BLACK'S LAW DICTIONARY 103 (7th ed. 1999). Because Mrs. Kimbell, or at least family members, were present on both sides of the transfer to the Partnership, the district court found that the transfer was not at arm's length and therefore not a "bona fide sale."

The district court also found that, even if one could assume that the transfer of assets to the Partnership was the result of a bona fide sale, the pro rata interest in the Partnership that Mrs. Kimbell received was not adequate consideration for the assets she transferred to the Partnership. The district court viewed the transaction as a paper transaction resulting in a mere "recycling of value." In coming to this determination, the district court again relied on Harper and distinguished this court's decision in Wheeler v. United States, 116 F.3d 749 (5th Cir. 1997).

The only case addressing the exception for a bona fide sale for full and adequate consideration in this circuit, and indeed the only appellate level case cited to us on this point, is Wheeler v. United States, 116 F.3d 749 (5th Cir. 1997). In Wheeler, the decedent sold a remainder interest in his ranch to his adopted sons. The sale was in return for a price based on the ranch's actuarial value from the tables established in Treasury Regulations for valuing future interests in property where the measuring life was that of a person of the seller's age. Id. at 752. Applying the bona fide sale exception of § 2036(a), the executor of the decedent's estate did not include the ranch in the gross estate. Id. at 752-53. The Internal Revenue Service disagreed and assessed a deficiency which the estate paid and then challenged. Id. at 753. The government's position in Wheeler was that the sale of the remainder interest in the ranch to the decedent's sons was part of a testamentary plan designed to reduce estate taxes. Id. It argued that, although the price paid for the remainder interest was equal to the then fair market value of the ranch multiplied by the present value factor from the Treasury Regulations for a person of the decedent's age, this price was not adequate and full consideration because it was less than the value of the full fee interest. Id.

Addressing the question of what constitutes "adequate and full consideration," the

Wheeler court noted the reason the term presents such persistent conceptual difficulty is the lack of a statutory definition for the term combined with the competing interests of tax litigants. Id. at 755. After synthesizing prior estate and gift tax cases, the court concluded that adequate and full consideration under § 2036(a) "requires only that the sale not deplete the gross estate." Id. at 759.

> The following rule emerges: unless a transfer that depletes the transferor's estate is joined with a transfer that augments the estate by a commensurate (monetary) amount, there is no "adequate and full consideration" for the purposes of either the estate or gift tax. We thus come full circle to the "equilibrium rule" set forth in United States v. Allen and cited in Gradow.

Id. at 762. In other words, the asset the estate receives must be roughly equivalent to the asset it gave up.

Wheeler also makes it clear that whether a transaction was made for adequate and full consideration is an objective inquiry. Addressing the government's argument that transactions between family members should be necessarily treated differently for estate tax purposes, this court stated:

> [t]he present transfer tax scheme eschews subjective intent determinations in favor of the objective requirements of the statute. Therefore, section 2036(a) permits the *conclusion* that a split-interest transfer was testamentary when, and if, the objective requirement that the transfer be for an adequate and full consideration is not met. Section 2036(a) does not, however, permit a perceived testamentary intent, *ipse dixit*, to determine what amount constitutes an adequate and full consideration.

Id. at 766. The court pointed out that before its amendment in 1976, the estate tax contained a provision recapturing into the gross estate transfers "intended to take effect in possession or enjoyment" at or after the decedent's death and those made "in contemplation of death." Id. at 765. After experience showed that this rule resulted in inordinate litigation by taxpayers

attempting to establish life motives for transfers, the rule was eventually changed to its present form to eliminate the requirement for difficult fact findings designed to determine subjective motive. Id. Thus, in this circuit, since Wheeler, a taxpayer's testamentary or tax saving motive for a transfer alone does not trigger § 2036(a) recapture if objective facts demonstrate that the transfer was made for a full and adequate consideration.

Wheeler also defines the requirements of a bona fide sale. After concluding that the actuarial value paid for the remainder interest was adequate and full consideration, the court stated that, once the appropriate value is paid for the property transferred, "the only possible grounds for challenging the legitimacy of the transaction are whether the transferor actually parted with the . . . interest and the transferee actually parted with the requisite adequate and full consideration." Id. at 764.

In Wheeler, the government argued that the requirement that a sale be "bona fide" takes on heightened significance in intrafamily transfers and this court agreed. Id. at 763. Based on this heightened scrutiny, we concluded that a court should inquire beyond the form of a transaction between family members to determine whether the substance justified the claimed tax treatment. Id. However, we made it clear that just because a transaction takes place between family members does not impose an additional requirement not set forth in the statute to establish that it is bona fide. Id. at 764. A transaction that is a bona fide sale between strangers must also be bona fide between members of the same family. In addition, the absence of negotiations between family members over price or terms is not a compelling factor in the determination as to whether a sale is bona fide, particularly when the exchange value is set by objective factors. Id. at 769. In summary, the Wheeler case directs us to examine whether "the sale . . . was, in fact a bona fide

sale or was instead a disguised gift or a sham transaction." Id. at 767.

This definition is consistent with the language of the statute and regulations. According to Treasury Regulations, a transaction is a bona fide sale if it is made in good faith. Treas. Reg. § § 20.2036-1(a), 20.2043-1(a). Black's Law Dictionary defines a "bona fide sale" as "A completed transaction in which seller makes sale in good faith, for a valuable consideration without notice of any reason against the sale." BLACK'S LAW DICTIONARY 161 (5th ed. 1979). "Bona fide" is defined as "in or with good faith; honestly, openly, and sincerely; without deceit or fraud" and "Real, actual, genuine, and not feigned." Id. at 160.

When examining a transaction to determine if it is "real, actual, genuine and not feigned," we are again constrained to objective factors. As stated previously, Congress eliminated the decedent's subjective intent from direct consideration under § 2036(a). A transaction motivated solely by tax planning with no business or corporate purpose is nothing more than a contrivance without substance that is rightly ignored for purposes of the tax computation. See Gregory v. Helvering, 293 U.S. 465, 469 (1935). However, tax planning motives do not prevent a sale from being "bona fide" if the transaction is otherwise real, actual or genuine. Wheeler, 116 F.3d at 769-70.

In Church v. United States, 85 A.F.T.R. 2d (RIA) 804 (W.D. Tex. 2000), aff'd without published opinion, 268 F.3d 1063 (5th Cir. 2001)(per curiam)(table), unpublished opinion available at 88 A.F.T.R. 2d 2001-5352 (5th Cir. 2001), a mother and her children formed a Texas limited partnership to consolidate their undivided interests in a family ranch. Id. at 805. The mother and the children were limited partners and a limited liability company was the general partner. Id. All parties contributed their undivided interests in the ranch to the partnership. Id.

The mother also contributed approximately $1 million in securities to finance ranch operations and the purchase of interests in the ranch owned by non-partners. Id. at 805-07. Each partner received a pro-rata interest in the partnership. Id. at 805-06. Under these circumstances, the court found that the character of the assets transferred to the partnership changed dramatically:

> Prior to its formation . . . [the several family members] owned undivided interests in the Ranch, with each interest carrying the right to use and enjoy the property, or force partition or possible sale. The Partnership eliminated these individual rights and placed ownership of a majority of the Ranch in a Partnership that was not controlled by any single person.

Id. at 2000-807. The court also found that the partnership was created for a genuine business purpose. "[P]reserving the family ranching business for themselves and their descendants" was a valid motivating reason to form the partnership. Id. at 2000-807. Preservation of their interests in the ranch was effectively accomplished by placing the property in the Partnership which allowed division of ownership to be recognized by ownership of partnership interests rather than by direct ownership of undivided interests in the ranch. This structure also permanently consolidated operating decisions and management of the property. The court held that the property transferred to the partnership was a bona fide sale to exclude it from application of § 2036.

Another case in which the transfer qualified as a bona fide sale is Estate of Stone v. Comm'r, 86 T.C. M. (CCH) at 578. In Stone, the assets transferred to the several family limited partnerships were going concern businesses operated for a profit. The partnerships were formed for two main reasons: as a means to currently transfer management of the parents' estates to the children, who as general managers of the partnerships, began to actively manage the partnerships; and to settle disputes among the children related to the operation of the businesses. The

decedents retained enough assets to maintain their standard of living. Id. at 580. The court concluded that these transfers were bona fide sales for adequate and full consideration.

Other cases relied on by the government, have as a common element the conclusion that "[w]hen a family partnership is only a vehicle for changing the form in which the decedent held his property – a mere 'recycling of value' -- the decedent's receipt of a partnership interest in exchange for his testamentary assets" does not qualify as a bona fide sale for adequate and full consideration because the transfer was only a paper transaction and without substance. Estate of Thompson v. Comm'r, 84 T.C.M. 374, 388 (2002). See also Estate of Harper, 83 T.C.M. (CCH) 1641 (T.C. 2002); Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331 (T.C. 2003). However, even these cases recognize that family partnerships can qualify for this exception if the transaction includes elements that indicate that the exchange was more than a sham or a disguised gift. See Harper, 83 T.C.M. at 1654 (This "transaction involves only the genre of value 'recycling' . . . and does not appear to be motivated primarily by legitimate business concerns."); Thompson, 84 T.C.M at 388-89 ("[N]one of the individual partners . . . was involved in the conduct of an active business. . . . None of the parties involved in the partnerships joined together with the intent to either form business enterprises or otherwise to conduct any trade or business. . . . [The activities of the partnership were] not for business purposes."); Strangi, 85 T.C.M. at 1344 (The partnership "patently fails to qualify as the sort of functioning business enterprise that could potentially inject intangibles that would lift the situation beyond mere recycling.").

In summary, what is required for the transfer by Mrs. Kimbell to the Partnership to qualify as a bona fide sale is that it be a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership

interest issued in exchange. In order for the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition, when the transaction is between family members, it is subject to heightened scrutiny to insure that the sale is not a sham transaction or disguised gift. The scrutiny is limited to the examination of objective facts that would confirm or deny the taxpayer's assertion that the transaction is bona fide or genuine. We now turn to the application of these principles to today's case.

A.

The district court found that the exchange of a limited partnership interest for the assets Mrs. Kimbell transferred to the Partnership was not a bona fide sale for adequate and full consideration. It did not separately analyze the two requirements. Rather it concluded that Mrs. Kimbell's contribution of more than 99% of the assets into the Partnership to be managed (as they were before the transfer) by her son was nothing more than a recycling of value and the interest in the Partnership Mrs. Kimbell received not a transfer of consideration. The government adopted that position and argues in addition that it is inconsistent for the estate to assert, on one hand, that the value of Mrs. Kimbell's interest in the Partnership is worth only 50% of the assets she transferred (as discounted for lack of control and marketability), and on the other hand claim that the Partnership interest Mrs. Kimbell received in exchange for the assets transferred was adequate and full consideration for the transfer.

The Tax Court has expressly rejected the argument that a discounted valuation of a pro rata partnership interest precludes a finding that the interest is adequate consideration for the assets transferred. In Estate of Stone v. Comm'r, 86 T.C.M. (CCH) 551, 578, the Tax Court held

that this argument:

> in effect reads out of section 2036(a) the exception for a "bona fide sale for an adequate and full consideration in money or money's worth" in any case where there is a bona fide, arm's length transfer of property to a business entity (e.g. a partnership or a corporation) for which the transferor receives an interest in such entity (e.g. a partnership interest or stock) that is proportionate to the fair market value of the property transferred to such entity and the determination of the value of such interest takes into account appropriate discounts.

Id.

We would only add to the Tax Court's rejection of the government's inconsistency argument that it is a classic mixing of apples and oranges: The government is attempting to equate the venerable "willing buyer-willing seller" test of fair market value (which applies when calculating gift or estate tax) with the proper test for adequate and full consideration under § 2036(a). This conflation misses the mark: The business decision to exchange cash or other assets for a transfer-restricted, non-managerial interest in a limited partnership involves financial considerations other than the purchaser's ability to turn right around and sell the newly acquired limited partnership interest for 100 cents on the dollar. Investors who acquire such interests do so with the expectation of realizing benefits such as management expertise, security and preservation of assets, capital appreciation and avoidance of personal liability. Thus there is nothing inconsistent in acknowledging, on the one hand, that the investor's dollars have acquired a limited partnership interest at arm's length for adequate and full consideration and, on the other hand, that the asset thus acquired has a present fair market value, i.e., immediate sale potential, of substantially less than the dollars just paid —— a classic informed trade-off.

As this principle applies to wholly unrelated buyers and sellers of interests in limited partnerships, it must be equally true of buyers and sellers of such interests who happen to be

related by blood or affinity, unless (1) the evidence demonstrates the absence of good faith, i.e., a sham transaction motivated solely by tax avoidance, or (2) Congress or the courts are ready to change long-held positions and establish a per se rule that related parties can never enter into arms-length transactions for adequate and full consideration — positions that none has shown any inclination to assume. Certainly, close scrutiny must be applied when the parties are related, but close scrutiny is not synonymous with automatic proscription or impossibility vel non.

The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts. Id. at 580. The answer to each of these questions in this case is yes. Mrs. Kimbell received a partnership interest that was proportionate to the assets she contributed to the Partnership. There is no question raised as to whether her partnership account was properly credited with the assets she contributed. Also, on termination and liquidation of the Partnership, the Partnership Agreement requires distribution to the Partners according to their capital account balances.

Accordingly, we conclude that this transaction was for adequate and full consideration. The district court's concern that Mrs. Kimbell's transfer of assets to the partnership in exchange for a pro-rata partnership interest is a mere paper transaction resulting in "recycling of value" is better addressed under the "bona fide sale" prong of this exception.

B.

As stated previously, the district court found that the transfer by Mrs. Kimbell of assets to the Partnership in exchange for pro-rata partnership interest was not a bona fide sale. Ignoring circuit precedent established in Wheeler, the district court's conclusion was based on its erroneous assumption that an arm's length transaction, defined as one between persons who are not related, was a requirement of this exception. The district court also concluded that the transaction resulted only in a change in form, a recycling of value, which would also preclude a conclusion that this transaction was a bona fide sale. However, its analysis ignored record evidence in support of the estate's position that the transaction was entered into for substantial business and other non-tax reasons.

Our review of the record reveals that the taxpayer established the following objective facts (uncontroverted by the government) that would support their position that the transfer to the Partnership was a bona fide sale:

(1) Mrs. Kimbell retained sufficient assets outside the Partnership for her own support and there was no commingling of Partnership and her personal assets. See Estate of Strangi, 85 T.C.M. at 1338-39; Estate of Harper, 83 T.C.M. at 1650.

(2) Partnership formalities were satisfied and the assets contributed to the Partnership were actually assigned to the Partnership. Id.

(3) The assets contributed to the Partnership included working interests in oil and gas properties which do require active management. A working interest in an oil and gas lease is a cost-bearing operating interest in the property. Lowe, Oil and Gas Law in a Nutshell 40 (2003). The owners of the working interest have the

exclusive right to exploit the minerals on the land. Williams & Meyers, Manual of Oil and Gas Terms 1207, 11th edition (2000). Nonoperating working interest owners are called upon to pay their share of operating expenses and to make elections whether to participate in drilling operations or various phases thereof. Lowe at 387-92. A royalty interest, in contrast, is a passive right to receive a share of production, if and when there is production, free of costs. Manual of Oil & Gas Terms at 964. At formation, $438,000 of approximately $2.5 million in assets were oil and gas properties. Approximately 71% of the oil and gas interests were working interests. Strangi, 85 T.C.M. at 1344; Thompson, 84 T.C.M at 388.

(4) David Kimbell and Michael Elyea advanced several credible and unchallenged non-tax business reasons for the formation of the Partnership that could not be accomplished via Mrs. Kimbell's Trust. Harper, 83 T.C.M. at 1654; Thompson, 84 T.C.M. at 389.

Michael Elyea, Mrs. Kimbell's business advisor, testified as follows regarding the business strategy for forming the Partnership. He stated that he and Mrs. Kimbell first discussed placing the assets in a limited partnership around the same time the living trust was formed in the early 1990's. Although some business strategies were accomplished by the trust, others were not. Specifically, a living trust did not provide legal protection from creditors as a limited partnership would. That protection was viewed as essential by Mr. Elyea and Mrs. Kimbell because she was investing as a working interest owner in oil and gas properties and could be personally liable for any environmental issues that arose in the operation of those properties. Mr. Elyea also stated that Mrs. Kimbell wanted the oil and gas operations to continue beyond her lifetime and they felt

that by putting the assets in a limited partnership, they could keep the pool of capital together in one entity that would be enhanced over time rather than subdivided by distributions to subsequent generations. Keeping the assets in one pool, under one management would reduce administrative costs by keeping all accounting functions together. The partnership would also avoid costs of recording transfers of oil and gas properties as the property was passed from generation to generation. Mrs. Kimbell wanted to keep the asset in an entity that would preserve the property as separate property of her descendants. The family had faced that issue during the divorce of one of Mrs. Kimbell's grandsons. The partnership also served the purpose of setting up the management of the assets if something should happen to her son, which was a concern as he had experienced some heart problems and had undergone a serious surgery. The partnership agreement provided that all disputes be resolved through mediation or arbitration to avoid interfamily litigation if disputes should arise. This statement of reasons is supported by the recitation of purposes in the formation documents of the Partnership (which the government and the district court selectively excerpt) and the deposition testimony of Mrs. Kimbell's son. More to the point, the stated reasons for the formation of the Partnership are confirmed by objective facts, many of which relate to the rights and responsibilities associated with investments in oil and gas investments.

The government contends that one fact pointing toward a conclusion that Mrs. Kimbell's transfer to the Partnership was not a bona fide sale is the de minimis contribution to the partnership made by the other partners. Mrs. Kimbell's son and his wife contributed approximately $20,000 of the $2.4 million in assets in the Partnership. This argument amounts to a restatement of the government's recycling of value argument and does not justify treating the

transaction as a sham. In addition, we know of no principle of partnership law that would require the minority partner to own a minimum percentage interest in the partnership for the entity to be legitimate and its transfers bona fide. The government also points out that the management of the Partnership assets did not change as a result of the transaction. Prior to the formation of the Partnership, David Kimbell managed Mrs. Kimbell's assets in the Trust. He continued to manage the assets once they were transferred to the Partnership. However, the important fact is that David Kimbell contributed his management expertise to the Partnership after its formation. Given the business reasons established above for the change in business form, the fact that David Kimbell performed the same services for the assets in the Trust is irrelevant.

This case was decided on cross-motions for summary judgment. The burden of proof on this issue is on the taxpayer. Estate of Maxwell v. Commissioner, 3 F.3d 591, 594 (2d Cir. 1993). The government raised no issues of material fact in its motion for summary judgment and challenged none of the taxpayer's facts. The taxpayer argued that genuine issues of material fact precluded a grant of summary judgment in favor of the government. We conclude that the district court erred in granting the government's motion for summary judgment and denying the taxpayer's motion for summary judgment on the issue of whether Mrs. Kimbell's transfer to the Partnership was a bona fide sale for full and adequate consideration so as to remove the transaction from the application of § 2036. First, as stated previously, the pro rata Partnership interest Mrs. Kimbell received was adequate and full consideration for the assets she transferred to the Partnership. Second, there is no contention that the transfer did not actually take place. The assets were formally assigned to the Partnership and Mrs. Kimbell was actually credited with a pro rata partnership interest. There is no evidence that partnership formalities were ignored or

that Mrs. Kimbell used Partnership assets for personal expenses. Finally, applying the heightened scrutiny applicable to transactions between family members, we are satisfied that the taxpayer has established through objective evidence recited above that the transaction was not a disguised gift or sham transaction. The government raised no material issues of fact to counter the taxpayer's evidence that the Partnership was entered into for substantial business reasons. These reasons were strongly supported by the nature of the business assets (divided working interests in oil and gas properties) conveyed, and the deposition testimony of Michael Elyea and David Kimbell.

Accordingly, we vacate the district court's judgment granting the government's motion for summary judgment and denying the taxpayer's motion for summary judgment because we conclude on this summary judgment record that the transfer to the Partnership qualifies as a bona fide sale for adequate and full consideration so as to remove the assets transferred to the Partnership from the estate of Mrs. Kimbell.

V.

Retained Interest

As stated previously there are two exceptions from the application of § 2036. The second exception allows a transfer to escape the reach of § 2036(a) if the transferor did not retain an interest in the asset transferred. Under § 2036(a)(1) and (2), transfers are recaptured into the estate of a decedent who retained the possession, enjoyment or right to income from the transferred property or retained the right to designate who could possess, enjoy or receive income therefrom. 28 U.S.C. § 2036(a)(1)-(2). A transferor retains the right of enjoyment of property if, at the time of transfer, there was an express or implied agreement that the interest or right would later be conferred. Estate of Reichardt v. Commissioner, 114 T.C. 144, 151-52 (T.C. 2000). A

retained interest can be present in the form of control over the entity that is the recipient of the assets transferred. Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331 (T.C. 2003).

Because we conclude that the Partnership assets qualify for exclusion from Mrs. Kimbell's estate under the exception for bona fide sales, we need not address the second exception as to that transfer. However, the second exception must be examined in reference to Mrs. Kimbell's transfer to the LLC. In an order amending its memorandum opinion and order, the district court summarily concluded that § 2036(a) was applicable to Mrs. Kimbell's 50% interest in the LLC, including her indirect 0.5% interest in the Partnership assets resulting from the LLC's ownership of the 1% general partner interest in the Partnership.

The district court's application of § 2036(a) to the LLC transfer was erroneous. Even if the transfer did not constitute a bona fide sale for full and adequate consideration, Mrs. Kimbell did not retain sufficient control of the assets transferred to the LLC to make her transfer subject to § 2036(a). Mrs. Kimbell's interest in the LLC was only a 50% interest, and her son had sole management powers over the LLC. Thus, Mrs. Kimbell did not retain the right to enjoy or designate who would enjoy the LLC property. Accordingly, we vacate the ruling of the district court on this issue.

VI.

In the district court, the parties briefed the issue whether Mrs. Kimbell's interest in the Partnership was an assignee interest or a limited partner interest for purposes of placing a value on the decedent's partnership interest for estate tax purposes. The district court did not reach this issue because of its ruling that § 2036(a) applied to Mrs. Kimbell's transfer to the Partnership. The Estate now asks this Court to make a determination on this issue, even though it was never

addressed in the court below. We decline to do so, leaving that issue to be first decided by the district court.

VII.

In summary, we conclude that the district court erred in granting summary judgment to the government and denying summary judgment to the taxpayer on the issue of whether the Decedent's transfer to the Partnership was a bona fide sale for full and adequate consideration as a matter of law. We therefore vacate that judgement. We also vacate the district court' grant of partial summary judgment on the issue of whether the Decedent retained an interest in property transferred to the LLC and remand for determination of whether Mrs. Kimbell's interest in the Partnership was an assignee interest or limited partnership interest and for any other proceedings consistent with this opinion.

VACATED; REMANDED.

Estate of Kirkpatrick v. Commissioner

34 T.C.M. (CCH) 1490 (1975)
T.C. Memo. 1975-344.

Estate of Ernest E. Kirkpatrick, Deceased, L.R. French, Jr. and Rita Bettis, Executors
v.
Commissioner.

Docket No. 1976-73.

United States Tax Court.

Filed November 25, 1975.

1491 *1491 Brooks L. Harman, 112 W. 5th Odessa, Tex., for the petitioners. John W. Dierker, for the respondent.

Memorandum Findings of Fact and Opinion

FORRESTER, Judge:

Respondent has determined a deficiency of $117,286.40 in petitioner's **estate** tax. A concession having been made by petitioner, the two remaining issues presented for our decision concern the respective fair market values of closely-held stock owned by Ernest E. **Kirkpatrick** in French Tool & Supply Company, Inc., and French Oil Company on April 17, 1968, the date of his death.

Findings of Fact

Some of the facts have been stipulated and are so found.

Ernest E. **Kirkpatrick** (decedent) died April 17, 1968, and L.R. French, Jr., and Rita Bettis qualified as executors of his **estate**. The executors' address was the American Bank of Commerce Building, Odessa, Texas, at the time the petition herein was filed. The executors timely filed a Federal **estate** tax return with the District Director of Internal Revenue, Dallas, Texas.

On the date of his death, decedent owned 1,091 shares of stock in French Tool & Supply Company, Inc. (French Tool), which represented 43.43 percent of that company's 2,512 issued and outstanding shares. Rita Bettis, decedent's daughter, owned 545.5 shares (21.71 percent) and Lloyd French, Jr., Bettis' son, owned the remaining 875.5 shares (34.85 percent).

French Tool is a Texas corporation, chartered in 1947. From 1947 until 1954 the company operated an International truck dealership and an oilfield supply house. In 1950, it entered the oil business. In 1954, it ceased its oilfield supply operations but continued to operate the International truck dealership. The company began a ranching business in 1955 and, in 1956, started a Chrysler-Plymouth dealership.

On April 17, 1968, the date of decedent's death, French Tool operated an International truck dealership (and a related rig-up shop), a Chrysler-Plymouth dealership, and was engaged in the oil production and ranching business. The company sold products and services to the public in all phases of its business.

The company's oil business consisted of certain producing and nonproducing properties situated primarily in the Permian Basin area of West Texas and Southeastern New Mexico.

Its ranching operations consisted of a 50-percent, undivided ownership in two cattle and sheep ranches, the South Fork Ranch and Rancho Real, located, respectively, in Kerr County and Real County, Texas.

A comparative balance sheet statement of French Tool for fiscal years ending June 30, 1966 through 1968 is as follows:

1492 *1492

	1968	1967	1966
Current assets	$1,332,050	$1,534,638	$1,719,645
Investment in capital stock	1,000	1,000	1,000
Fixed assets			
Auto and truck operations	460,050	517,230	500,010
Oil operations	492,474	316,835	477,100
Ranch operations	1,235,694	1,250,719	1,315,579
Other assets	526,022	403,550	464,237
Total assets	$4,047,290	$4,023,972	$4,477,571
Current liabilities	$1,249,084	$1,302,107	$1,542,813
Long-term debt	1,194,456	1,273,759	1,498,580

Deferred taxes and other liabilities	65,404	55,125	40,650
Total liabilities	2,508,944	2,630,991	3,082,043
Capital stock	300,000	300,000	300,000
Earned surplus	1,303,971	1,158,606	1,161,153
	1,603,971	1,458,606	1,461,153
Less: Treasury stock, at cost	65,625	65,625	65,625
Total net worth	1,538,346	1,392,981	1,395,528
Total liabilities and net worth	$4,047,290	$4,023,972	$4,477,571
Distributions:			
Total assets: Truck and auto operation	$2,049,391	$2,121,192	$2,318,885
Oil operations	492,474	316,835	477,100
Ranch operations	1,505,425	1,585,945	1,681,586
	$4,047,290	$4,023,972	$4,477,571
Book value or net worth:			
Truck and auto operations	$ 632,390	$ 867,194	$1,025,608
Oil operations	492,474	109,490	(57,271)
Ranch operations	413,482	416,297	427,191
	$1,538,346	$1,392,981	$1,395,528
Ratio of current assets to current liabilities	1 to .94	1 to .85	1 to .90

A comparative statement of income and earned surplus of French Tool for the same fiscal years is as follows:

1493 *1493

	1968		1967		1966	
	Amount	Percent	Amount	Percent	Amount	Percent
Trucks and Auto Operations						
Net Sales	$5,337,710	100.00	$4,440,235	100.00	$5,565,745	100.00
Cost of sales	4,535,082	84.96	3,772,080	84.95	4,730,814	85.00
Gross profit on sales	802,628	15.04	668,155	15.05	834,931	15.00
Operating expense	658,968	12.35	662,703	14.92	729,768	13.11
	143,660	2.69	5,452	.13	105,163	1.89
Other income	35,109	.66	29,097	.66	40,119	.72
	178,769	3.35	34,549	.79	145,282	2.61
Other expense	60,435	1.13	(54,833)	(1.23)	(48,056)	(.86)
Income (loss) from truck and auto operations	118,334	2.22	(20,284)	(.44)	97,226	1.75
Oil Operations						
Oil and gas revenues	265,513		308,932		321,422	
Operating expense, depreciation, depletion, dry holes, etc.	142,054		202,722		267,173	
Operating income (loss) from oil operations	123,459		106,210		54,249	
Ranch Operations						
Revenues	118,141		69,102		83,947	
Expenses	194,508		137,831		164,972	
Operating income (loss) from ranch	(76,367)		(68,729)		(81,025)	

Total income before taxes	165,426	17,197	70,450
Federal Income Taxes			
Current	(9,782)	5,269	
Deferred	(10,279)	14,475	825
Net income (loss) after taxes	145,365	(2,547)	69,625
Earned surplus beginning of year	1,158,606	1,161,153	1,091,528
Earned surplus, end of year	$1,303,971	$1,158,606	$1,161,153

1494 *1494 L.R. French, Jr. (French) had been the company's president and chief executive officer since February 1952. The three directors of French Tool at decedent's death were decedent, French, and Ralph Hamilton. Decedent also served as the company vice president and Hamilton served as the secretary, treasurer, and general manager of the Automotive Division.

On the date of his death, decedent also owned 130 shares of stock in French Oil Company (French Oil), which represented 6.5 percent of that company's 2,000 issued and outstanding shares. French owned 1,805 shares (90.25 percent), and the remaining 65 shares (3.25 percent) were owned by Bettis.

French Oil is a Texas corporation, which was incorporated in 1935 as Rodman Supply Company (Rodman) to conduct an oilfield supply business in the Permian Basin area of West Texas and Southeastern New Mexico.

In September 1954, French and decedent purchased 87 percent and 13 percent, respectively, of Rodman's outstanding stock. In the year of the purchase, Rodman operated an oilfield supply business in the Permian Basin, an oil and gas development and production business, and a ranching business. From 1954 until the date of decedent's death, French served as the president and chief executive officer of French Oil.

In 1963, Rodman sold the oilfield supply store assets and the name of the corporation was changed to French Oil Company.

The new company, French Oil, retained certain accounts receivable, most of which had been charged off as bad debts. In the four succeeding years, it collected from those receivables the following amounts:

1964 ..... $319,413.50
1965 ..... 103,676.00
1966 .....   41,867.00
1967 ..... 154,447.00

After the sale of the oilfield supply store assets, the company continued in the oil, gas and ranching business and dealt some in the sale of tubular goods.

During fiscal years ending August 31, 1965 through 1967, French Oil sold some of its oil and gas leases at an aggregate profit of $220,000 net after applicable taxes. At the start of its 1967-1968 fiscal year, the company owned 22 producing leases in the Permian Basin area. All 22 producing leases continued to produce throughout the fiscal year except the so-called University 30 lease, which was sold on May 31, 1968 — about six weeks after the date of decedent's death.

University 30 had been the company's most productive lease and, for the nine-month period ending May 31, 1968, it produced approximately 66 percent of the total gross revenues from all 22 leases for that period. The idea to sell the University 30 lease came up after April 17, 1968, and a prospective purchaser of decedent's 6.5 shares of French Oil stock on that date would not have known that the University 30 lease would be sold six weeks later.

On the date of decedent's death, French Oil produced and sold oil in the Permian Basin area, owned a 50-percent, undivided interest in the South Fork Ranch and Rancho Real,[1] and sold oilfield tubular goods.

A comparative balance sheet statement of French Oil for fiscal years ending August 31, 1965 through 1967 is as follows:

1495 *1495

			August 31,
	1967	1966	1965
Current assets	$ 574,677	$ 619,507	$ 255,372
Fixed assets			
Oil operations	246,961	335,509	387,830
Ranch operations	1,346,401	1,402,750	1,397,080
Other	85,338	67,621	98,934
Other assets	727,063	498,108	706,105
Total assets	$2,980,440	$2,923,495	$2,845,321
Current liabilities	$ 404,885	$ 588,312	$ 600,997
Long-term debt	1,145,947	1,170,316	1,206,969

Total liabilities	1,550,832	1,758,628	1,807,966
Capital stock	200,000	200,000	200,000
Capital in excess of par	3,796	3,796	3,796
Earned surplus	1,225,812	961,071	833,559
Total net worth	1,429,608	1,164,867	1,037,355
Total liabilities and net worth	$2,980,440	$2,923,495	$2,345,321
Distribution: Assets			
Oil operations	$ 693,800	$ 547,052	$ 737,450
Ranch operations	1,671,141	1,799,720	1,752,766
Other	615,499	576,715	355,095
Total assets	$2,980,440	$2,923,495	$2,845,321
Book value or net worth			
Oil operations	$ 371,994	$ 90,246	$ 303,154
Ranch operations	500,825	537,532	463,952
Other	556,789	537,089	270,249
Total	$1,429,608	$1,164,867	$1,037,355
Ratio of current assets to current liabilities	1 to .70	1 to .95	.42 to 1

A comparative statement of income and earned surplus for the same period is as follows:

1496 *1496

	Year ended August 31,					
	1967		1966		1965	
	Amount	Percent	Amount	Percent	Amount	Percent
Oil and gas operations						
Oil and gas sales	$408,773	100	$592,757	100	$458,675	100
Lease operating expense	89,880		116,080		121,375	
Intangible development cost and dry hole cost	24,281		224,794		284,232	
Depreciation and depletion	50,380		83,994		89,452	
General and administrative	37,958		42,364		46,245	
	202,499	49	467,232	79	541,304	118
Income (loss) of oil and gas operations	206,274	51	125,525	21	(82,629)	(18)
Ranch Operations						
Ranch income	91,152	100	83,512	100	74,893	100
Ranch operating expenses and depreciation	181,661	199	187,853	224	126,799	169
Income (loss) on ranch operations	(90,509)	(99)	(104,341)	(124)	(51,906)	(69)
Other						
Sales - oil equipment	295,167	100	207,849	100	292,950	100
Expenses	146,190	50	157,796	76	187,820	64
Income (loss) on other operations	148,977	50	50,053	24	105,130	36
Federal income taxes						
Refunds, reductions and other changes	56,274		32,327			
Net income or loss after taxes	264,742		127,511		2,922	
Earned surplus beginning of year	961,070		833,559		830,637	
Earned surplus end of year	$1,225,812		$961,070		$833,559	

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1497 *1497 Neither French Oil nor French Tool had ever paid any dividends. There had never been any outside sale of their stock[2] nor had their stock been listed on any public exchanges.

On its return, petitioner valued decedent's 1,091 shares of French Tool stock at $353.63 per share. Respondent, in his deficiency notice, determined the fair market value of decedent's French tool stock to be its book value, or $600.34 per share. At trial, however, petitioner claimed the stock was worth $216 per share and respondent contended the stock to be worth no more than $500 per share.

On the return, petitioner valued decedent's 130 shares of French Oil stock at $287.36 per share. In his deficiency notice, respondent again valued the stock at its book value, or $882.73 per share. At trial, however, petitioner claimed the stock to be worth $171 per share and respondent argued that the stock was properly valued at $650 per share.

On the date of decedent's death, French Tool and French Oil each owned a 50-percent undivided interest in two cattle and sheep ranches; the South Fork Ranch and Rancho Real.[3]

At the date of decedent's death, the South Fork Ranch (Ranch) consisted of approximately 32,914 acres of land located in the southwest corner of Kerr County, Texas,[4] about 75 miles northwest of San Antonio, Texas, and 25 miles west of Kerrville, Texas.

The Ranch is situated in an area of Texas known as "The Hill Country." This area is characterized by high, rolling hills and an unusually abundant amount of surface water. These factors, combined with a relatively mild summer climate, make the area extremely popular for recreational purposes.

The Ranch contains a number of improvements such as frame dwellings, barns, storage sheds, etc. It has a good water supply with the wells and waterings spaced at about one for each of the 32 or 33 pastures.

The major portion of the Ranch (approximately 28,165 acres) was purchased by French in July 1963, for $70 per acre. In January 1965, French purchased approximately 3,065 additional acres for $75 per acre, and in March 1966, he bought the remaining 1,684 acres for $75 per acre.[5]

On November 13, 1968, approximately seven months after the date of decedent's death, a pipeline company, Lo-Vaca Gathering Company, acquired by condemnation a pipeline right-of-way easement through a portion of the Ranch. In a subsequent condemnation suit, heard November 3, 1969, a jury composed of six residents of Kerr County returned a verdict in the County Court of Kerr County, Texas, that the fair market value of the Ranch, as of the date of condemnation, was $150 per acre. At these proceedings, R. Floyd Price, Jr. (petitioner's expert witness in the instant case), testified that, in his opinion, the Ranch was worth $125 per acre on November 13, 1968.

As ultimate findings of fact, we find that:

1. The fair market value of the Ranch on April 17, 1968, was $94 per acre;

2. The fair market value of decedent's 1,091 shares of French Tool stock was $300 per share on April 17, 1968;

3. The fair market value of decedent's 130 shares of French Oil stock was $250 per share on April 17, 1968.

Opinion

For purposes of determining the value of decedent's gross **estate** under section 2031,[6] we must find the respective fair market values of the shares of stock decedent owned in French Tool and French Oil on the date of his death.

Determining the fair market value of closely-held stock is often a difficult task, and the instant case presents no exception. Among the factors courts have found relevant in making this determination are: (1) the value of the corporation's underlying assets; (2) the fact that less than a controlling interest is involved; (3) trends
1498 in the corporation's earnings; (4) the dividend paying capacity of the corporation; (5) the capitalized value of the corporation's *1498 past earnings; and (6) the corporation's management. *Richard R. Riss, Sr.* [Dec. 31,200], 56 T.C. 388, 430 (1971); ***Estate** of Harry Stoll Leyman* [Dec. 26,081], 40 T.C. 100, 119 (1963).

In applying these factors to the facts of a particular case, no single formula is universally applicable, *O'Malley v. Ames* [52-1 USTC ¶ 9361], 197 F. 2d 256, 258 (8th Cir. 1952), and the ultimate fair market value determination is basically a question of judgment rather than mathematics. *Hamm v. Commissioner* [64-1 USTC ¶ 12,206], 325 F. 2d 934, 940 (8th Cir. 1963).

As we have noted, in attempting to determine the fair market value of closely-held stock, the value of the company's underlying assets can be an important consideration. In the instant case, the sole dispute between the parties regarding the value of French Tool's and French Oil's underlying assets involves the fair market value of the South Fork Ranch, in which each corporation owned a 50-percent, undivided interest. Thus, we must first find the fair market value of the Ranch before we can proceed to determine the respective values of decedent's shares of French Tool and French Oil stock.

In making our fair market value determinations in the instant case, we are guided by section 20.2031-1(b), **Estate** Tax Regs., which defines "fair market value" as —

> 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 to sell and both having reasonable knowledge of the relevant facts. * * *

Although we are of the opinion that petitioner has carried its burden of proof regarding the correctness of respondent's fair market value determinations, Rule 142, Tax Court Rules of Practice and Procedure, we cannot wholly accept petitioner's valuations of the Ranch and the stock. After examining all of the relevant facts

presented in the record before us, we find that, on April 17, 1968, the fair market value of the Ranch was $94 per acre and decedent's shares of French Tool and French Oil stock were worth $300 and $250 per share, respectively.

Petitioner contends that the fair market value of the Ranch on April 17, 1968, was $80 per acre and bases its position on an appraisal prepared by R. Floyd Price, Jr. (Price), a real **estate** appraiser and dealer in the Kerr County area.[7] Respondent, in determining that the Ranch was worth $140 per acre, relies on an appraisal prepared by Joe T. Gilbert (Gilbert), a valuation expert employed by the Internal Revenue Service.

Using the so-called comparable sale method of valuation, Price examined 18 different land sale transactions in the Kerr County area. He stated that, in estimating the Ranch's fair market value from these comparable sales, he gave primary consideration to four such sales because of their proximity to the valuation date and because the land involved bore a greater similarity to the Ranch with respect to size, location, and physical characteristics.

Gilbert examined nine comparable sales and also took into account his estimation as to the amount the Ranch had appreciated in value between the dates of purchase[8] and the valuation date. He stated that he relied primarily on three of the comparable sales and appreciated value of the Ranch in making his valuation.

Under the facts of the instant case, we think the most accurate estimation of the Ranch's fair market value on April 17, 1968, can be determined by finding, and giving equal weight to, (1) the estimated appreciated value of the Ranch land and (2) the Ranch's approximate value determined by the comparable sale method of valuation. Both such determinations, and especially the former, necessitate our having a fairly accurate estimate of the rate of land appreciation in the Kerr County area. On this point, however, Price and Gilbert were in sharp disagreement.

Petitioner's witness, Price, testified that, based on his 20 years of experience as a real **estate** appraiser and dealer in the Kerr County area, he was of the opinion that land in that area had appreciated at an annual rate of 5 percent from 1963 through 1966 and 15 percent from 1967 until 1974. On the other hand, Gilbert
1499 *1499 estimated that land in that area had appreciated at an annual rate of 25 percent from 1963 until 1974, and he presented three "land appreciation trend" graphs to support his position.

We were more persuaded by Price's personal and professional familiarity with land appreciation rates in the Kerr County area than we were by Gilbert's graphs. In these graphs, Gilbert relied, in large part, on fair market value estimations derived from offers to buy and sell land as well as from the 1969 condemnation award in which a jury found the Ranch to have been worth $150 per acre in November 1968. Our determination of the rate at which land appreciated in the Kerr County area bears quite heavily on our ultimate valuation of the Ranch and, in making this determination, we are extremely reluctant to place much reliance on such inaccurate benchmarks of fair market value as offers to buy and sell and jury condemnation awards. Thus, we found Price's determination as to the Kerr County area land appreciation rate to be the more realistic.

The extremely large size of the Ranch (almost three times the size of any comparable sale used by either Price or Gilbert) combined with the unique geographical and climactic conditions in the immediate Kerr County area makes valuation by the comparable sale method in the instant case most difficult. The only sale we found that sheds real light on the Ranch's valuation is the so-called Smith to Ault sale. This is also the only sale that both Price and Gilbert agreed should be given primary consideration in determining the Ranch's value.

The Smith to Ault sale involved a 10,526 acre piece of property located in Kerr County adjacent to the eastern boundary of the Ranch. The land was sold for $75 per acre on March 18, 1966, approximately two years prior to the date of decedent's death. The property appears to have been similar to the Ranch as regards location and physical characteristics. After adjusting for the two-year time differential between the date of sale and the valuation date and after allowing for the greater size of the Ranch, we found the Ranch to have been worth $90 per acre when analyzed in terms of the Smith to Ault sale.

In determining the Ranch's fair market value, however, we need not rely solely on the comparable sale method of valuation. We note that French purchased 28,165 of the Ranch's 32,914 acres in July 1963 for $70 per acre. He purchased 3,065 acres in January 1965 for $75 per acre and, in March 1966, he purchased the remaining 1,684 acres for $75 per acre. We also note that no significant improvements were made to the land between the dates of these purchases and the valuation date.

Using Price's annual land appreciation rate, i.e., 5 percent from 1963 through 1966 and 15 percent from 1967 until 1974, we find that, on April 17, 1968, the average appreciation of these three parcels of land resulted in the Ranch being worth approximately $98 per acre, when viewed strictly from an appreciation standpoint.[9]

Accordingly, after giving equal weight to the approximate values of the Ranch determined from these two methods of valuation, we find that the fair market value of the Ranch on April 17, 1968, was $94 per acre.

Having determined the value of the Ranch, we now turn to our primary task of determining the fair market value of decedent's shares of French Tool and French Oil stock.

Petitioner's expert witness, Robert E. Moroney (Moroney), in determining the fair market value of decedent's shares of French Tool stock, relied primarily on the capitalization of earnings method of valuation. He estimated that, based on numerous publicly-owned companies with financial prospects similar to French Tool's, decedent's stock, if it had been marketable, would have sold at eight times the company's earnings for the 12-month period ending March 31, 1968, or $432 per share. He then applied a 50-percent discount to this figure to reflect the nonmarketability of the stock, the lack of dividends, and the fact that a purchaser of decedent's interest would have no effective voice in the company's management. Thus, he concluded that, on April 17, 1968, decedent's 1,091 shares of French Tool stock had a fair market value of $216 per share.

1500 Respondent's expert witness, George S. Krug, a valuation expert employed by the Internal Revenue Service, gave primary *1500 consideration to the value of French Tool's underlying assets in determining that decedent's shares of stock were worth $500 per share. He adjusted the book value of the company's assets upward to reflect respondent's $140 per acre valuation of the Ranch and then applied a 50-percent discount to reflect the stock's lack of marketability and decedent's minority interest.

Of the two methods of valuation, we found Moroney's to be the more persuasive. On the date of decedent's death, French Tool was actively engaged in three separate lines of business. Although it owned interests in large amounts of real **estate**, its land holdings constituted an integral part of its ongoing ranching business. Thus, since French Tool was clearly an operating company actively engaged in selling products and services to the general public, we think that primary consideration should be given to its earnings and prospects for future profits as opposed to the value of its underlying assets. See *Levenson's **Estate** v. Commissioner* [60-2 USTC ¶ 969], 282 F. 2d 581, 586 (3d Cir. 1960); Rev. Rul. 59-60, sec. 5(b), 1959-1 C.B. 237.

From this perspective, we think that a prospective purchaser of decedent's French Tool stock, in examining the company's financial position on April 17, 1968, would discover a number of factors that would have had a depressing influence on the value of decedent's shares.

Such an examination would reveal that, for a number of years, French Tool's ratio of current assets to current liabilities had been about one-to-one. The company's net earnings had fluctuated widely for the past several years and, in fiscal year ending June 30, 1967, the company showed a net loss of approximately $3,000. It had a significant amount of long-term debt that approximately equaled stockholder's equity. The company had never paid any dividends and had not been in a financial position to do so. Finally, the stock was not marketable, and a purchaser of decedent's 43.43-percent interest in French Tool would probably have had little or no voice in the company's management due to the fact that the majority interest was held by decedent's daughter and grandson.

However, we think these negative factors would be offset somewhat by the fact that the company's fiscal year ending June 30, 1968, was quite profitable in relation to past years.[10] Also, although the company's net earnings had been quite low for the past several years, its cash flow position (net income plus depreciation) had been much more favorable. Finally, even though the chances on April 17, 1968, were minimal that French Tool would be liquidated in the foreseeable future, we think the rather high adjusted book value of the company's underlying assets would have been an attractive feature to a prospective purchaser of decedent's stock.

After taking all of these factors into consideration and after adjusting the value of the underlying assets to reflect the $94 per acre value of the Ranch,[11] we find decedent's 1,091 shares of French Tool stock to have been worth $300 per share on April 17, 1968.

Valuations prepared by Moroney and Krug also formed the basis for the parties' respective positions with regard to the fair market value of decedent's 130 shares of French Oil stock. Petitioner contends that such stock was worth $171 per share, while respondent argues that such shares should be valued at $650 per share.

Moroney, after noting that French Oil's peculiar financial position negated the more normal methods of valuation, utilized a rather unique approach in making his fair market value determination. He first calculated French Oil's liquidating value at $821 per share. Then, after taking into account the fact that such liquidating value would be of little benefit to a purchaser of decedent's 6.5-percent interest, he attempted to determine how much discount from the liquidating value of $821
1501 per share would be required to compensate a purchaser for the exceptional risks involved. He determined that a fair bargain to both buyer and seller would *1501
be reached if the selling price were such as to give a buyer a potential profit of four-to-one (before taxes) on the money he invested.

Thus, he valued decedent's shares of French Oil stock at $171 per share since, if a purchaser invested this amount, he would make about a four-to-one profit if the company were later liquidated at $821 per share.

In making his valuation of decedent's French Oil stock, Krug again gave primary consideration to the book value of the company's underlying assets. He adjusted such value upward to reflect respondent's $140 per acre valuation of the Ranch and then applied a 50-percent discount because of the stock's nonmarketability and decedent's minority interest.

In making our determination that decedent's 130 shares of French Oil stock were worth $250 per share on the date of his death, we did not feel comfortable with either expert's method of valuation. We found Moroney's hypothetical amount that a purchaser would "gamble" in order to obtain a certain return on his investment to be too speculative to warrant our total reliance. With respect to the method utilized by Krug, we think the facts presented clearly show that French Oil, like French Tool, was an operating company on the date of decedent's death. Thus, we think Krug gave excessive consideration to the value of the company's underlying assets in making his valuation.

We think that a prospective investor would view French Oil primarily from the standpoint of its history and prospects as a profit-making corporation.

An examination of its financial position as of April 17, 1968, reveals that the company was in rather poor shape. Its ratio of current assets to current liabilities had been about one-to-one for a number of years, and its long-term debt was quite high in relation to stockholder's equity. Its ranching business consistently operated at a loss and, although the company showed modest profits for its fiscal years ending August 31, 1965, 1966, and 1967,[12] had it not been for the items of extraordinary income (collection of bad debts and sale of certain oil leases), the company would have lost money in each of these years.

Surely a prospective purchaser would have taken into account the fact that, as of April 17, 1968, all of French Oil's bad debts had been collected and would have realized that the company could not continue to sell its oil and gas leases indefinitely.[13]

Moreover, French Oil had never paid any dividends in its 33 years of existence. Decedent's 130 shares were nonmarketable and represented a mere 6.5 percent of the company's issued and outstanding stock. A purchaser of decedent's interest would have had no voice in the company's management since the company was run by French who owned approximately 90 percent of its stock and served as its president and chief executive officer.

As we found with French Tool, however, French Oil's cash flow position was more favorable than its net earnings position. Also, notwithstanding the minimal chances that the company would be liquidated, we think a prospective purchaser would place some importance on the rather high adjusted book value of the underlying assets.

After taking all of these factors into account, we find that $250 per share would have been a fair price for decedent's 130 shares of French Oil stock.

Decision will be entered under Rule 155.

[1] French Oil also owned 100-percent interest in a 1,280 acre ranch in Dimmit County, Texas, southwest of San Antonio, which it occasionally used for grazing purposes.

[2] The only sale of either company's stock occurred in 1960 when, as part of a property settlement connected with a divorce, French bought 870 shares of French Oil stock from his former wife for approximately $287 per share.

[3] The parties have stipulated that the fair market value of Rancho Real was $80 per acre on April 17, 1968.

[4] A small portion of the Ranch extends across the western boundary of Kerr County into Real County.

[5] French purchased these three parcels of land in his own name but was apparently acting as an agent for French Tool and French Oil, who were undisclosed principals in the transactions.

[6] Unless otherwise specified, all statutory references are to the Internal Revenue Code of 1954.

[7] Respondent argues on brief that Price's testimony that the Ranch was worth $80 per acre on April 17, 1968, should have no probative value since, in the 1969 condemnation suit involving the same property, he testified that the Ranch was worth $125 per acre on November 13, 1968. We disagree with respondent and accept Price's explanation at trial that he only had one week to prepare an appraisal for the condemnation suit and was therefore limited as to the number of comparable sales he could analyze for purposes of that litigation.

[8] Acting as the corporations' agent, French purchased 28,165 acres in 1963, 3,065 acres in 1965, and 1,684 acres in 1966.

[9] Gilbert testified that, using Price's annual land appreciation rate, the Ranch would be valued at $108 per acre. He apparently made these calculations by using an appreciation rate of 15 percent for 1966 and misunderstood that Price was of the opinion that land in that area had appreciated at an annual rate of 5 percent from 1963 *through* 1966.

[10] Although French Tool's June 30, 1968, financial data would not have been available to a prospective purchaser of decedent's stock on April 17, 1968, the company maintained monthly balance sheets and earnings statements. The financial data for the nine-month period ending March 31, 1968, would have been available and clearly forecasted the profitability of the 1967-1968 fiscal year.

[11] We cannot accept Moroney's contention that the value of decedent's French Tool stock would not be increased if we found the Ranch to be worth more than $80 per acre. While we think that little weight should be given to the value of the company's underlying assets, to adopt Moroney's position is, in effect, to ignore their value altogether. This we cannot do. See *Est. of Lida R. Tompkins* [Dec. 25,182(M)], T.C. Memo. 1961-338.

[12] Unlike French Tool, French Oil did not keep its financial data on a monthly basis. Thus, the financial information for fiscal year ending August 31, 1967, would have been the most recent information available to a prospective purchaser of decedent's stock.

[13] However, a prospective purchaser would not have known or anticipated on April 17, 1968, that the company's most productive oil lease, Universal 30, would be sold some six weeks later.

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115 T.C. No. 36

UNITED STATES TAX COURT

INA F. KNIGHT, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

HERBERT D. KNIGHT, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 11955-98, 12032-98.[1] Filed November 30, 2000.

On Dec. 28, 1994, Ps established a trust of which P-H was trustee (the management trust), a family limited partnership (the partnership) of which the management trust was the general partner, and trusts for the benefit of each of Ps' two adult children (the children's trusts). Ps transferred three parcels of real property used by Ps and their children and some financial assets to the partnership. Each P transferred a 22.3-percent interest in the partnership to each of their children's trusts.

The parties stipulated that the steps to create the partnership satisfied all requirements under Texas

[1] These cases were consolidated for trial, briefing, and opinion.

law, and that the partnership has been a limited partnership under Texas law since it was created.

Held: We recognize the partnership for Federal gift tax purposes.

Held, further, the value of each of Ps' gifts to their children's trusts in 1994 was $394,515; i.e., 22.3 percent of the value of the real property and financial assets Ps transferred to the partnership, reduced by minority and lack of marketability discounts totaling 15 percent.

Held, further, sec. 2704(b), I.R.C., does not apply to this transaction. See Kerr v. Commissioner, 113 T.C. 449 (1999).

William R. Cousins III, Robyn A. Frohlin, Todd Allen Kraft, Robert M. Bolton, Robert Don Collier, and John E. Banks, Jr., for petitioners.

Deborah H. Delgado, Gerald Brantley, and James G. MacDonald, for respondent.

COLVIN, Judge: In separate notices of deficiency sent to each petitioner, respondent determined that each petitioner has a gift tax deficiency of $120,866 for 1994.

Petitioners formed a family limited partnership called the Herbert D. Knight Limited Partnership (the partnership), and gave interests in it to trusts they established for their children. After concessions, the issues for decision are:

1. Whether, as respondent contends, the partnership is disregarded for Federal gift tax purposes. We hold that it is not.

2. Whether, as petitioners contend, the fair market value of petitioners' gifts is the value of the assets in the partnership reduced by portfolio, minority interest, and lack of marketability discounts totaling 44 percent. We hold that discounts totaling 15 percent apply.

3. Whether the fair market value of each of petitioners' gifts to each children's trust on December 28, 1994, is $263,165 as petitioners contend, $450,086 as respondent contends, or some other amount. We hold that it is $394,515.

4. Whether section 2704(b) applies. We hold that it does not.

Unless otherwise indicated, section references are to the Internal Revenue Code. Rule references are to the Tax Court Rules of Practice and Procedure. References to petitioner are to Herbert D. Knight. References to Mrs. Knight are to petitioner Ina F. Knight.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

A. Petitioners

1. Petitioners' Family

Petitioners were married and lived in San Antonio, Texas, when they filed their petitions and at the time of trial. They have two adult children, Mary Faye Knight (Mary Knight) and Douglas Dale Knight (Douglas Knight). Petitioners' children were

not married, and petitioners had no grandchildren at the time of trial. Petitioner worked for Luby's Cafeterias for 49 years and retired at age 65 on December 31, 1992, as a senior vice president. In 1992, Douglas Knight was 40, and Mary Knight was 33. By December 1994, petitioners owned assets worth about $10 million, most of which was Luby's Cafeterias stock. Petitioners were both in excellent health at the time of trial.

2. Petitioners' Real Property

In 1861, petitioner's great-grandfather bought a 290-acre ranch (the ranch) in Freestone County, Texas, about 120 acres of which is pasture. Knight family members are buried in a cemetery on the ranch. Petitioner was raised on the ranch. By 1959, parts of the ranch were owned by several members of petitioner's family. In 1959, petitioner began to buy parts of the ranch for sentimental reasons. Petitioner generally has 55 to 75 cattle on the ranch. The ranch has never been profitable while petitioner owned it.

Petitioners bought their family residence at 6219 Dilbeck in Dallas, Texas, on June 1, 1973. Petitioners moved to San Antonio in 1981. Douglas Knight lived at 6219 Dilbeck rent-free from 1984 to the date of trial. Petitioners bought a residence at 14827 Chancey in Addison, Texas, on May 12, 1993. Mary Knight has lived there rent-free from 1993 to the date of trial except from November 1995 to September 1997.

Petitioner managed the ranch and the houses before December 28, 1994. Petitioner paid the real estate taxes and insurance on those properties before December 28, 1994.

B. The Partnership

1. Initial Discussions

Robert Gilliam (Gilliam), a certified public accountant, met petitioner in the 1970's while Gilliam was auditing Luby's Cafeterias. Petitioners became Gilliam's tax clients in 1992 or 1993. Gilliam and petitioner discussed estate planning in 1993 and 1994.

Gilliam knew that petitioners had about $10 million in assets. Gilliam and petitioner discussed the fact that, if petitioners did no estate planning, Federal transfer taxes would equal 50 to 55 percent of their estate. Gilliam and petitioner discussed the tax benefits of estate planning. Gilliam told petitioners that they could claim discounts for transferred limited partnership interests if supported by a professional appraisal. Gilliam believed that petitioners could form a trust to help protect their assets from creditors and that a limited partnership would add another layer of protection for those assets.

Petitioner sought estate planning advice from John Banks, Jr. (Banks), in 1993 or 1994. Banks had been petitioners' attorney since 1981. Petitioners met with Gilliam or Banks

several times in November and December 1994. Late in 1994, Gilliam and Banks devised and helped to implement an estate plan for petitioners using a family limited partnership and related trusts.

2. Implementing the Plan

On December 6, 1994, petitioner opened an investment account at Broadway National Bank in the name of petitioners' family limited partnership, the Herbert D. Knight limited partnership (created on December 28, 1994, as described below), and transferred Treasury notes to it. On December 12, 1994, petitioners opened a checking account for their partnership at Broadway National Bank and transferred $10,000 to it from their personal account. On December 15, 1994, petitioners transferred $558,939.43 worth of a USAA municipal bond fund from their personal investment account to the partnership.

On December 28, 1994, the following occurred:

a. Petitioners signed documents which created the partnership, consisting of 100 units of ownership. The steps followed in the creation of the partnership satisfied all requirements under Texas law to create a limited partnership.

b. Petitioners conveyed the ranch and the real property at 6219 Dilbeck and 14827 Chancey to the partnership.

c. Petitioners created the Knight Management Trust (management trust). The steps followed in the creation of the

management trust satisfied all requirements under Texas law to create a trust. The management trust was the partnership's general partner.

d. Petitioners each transferred a one-half unit of the partnership to the management trust. That unit is the only asset held by the management trust. Petitioners each owned a 49.5-percent interest in the partnership as limited partners.

e. Petitioners created trusts for Mary Knight and Douglas Knight (the children's trusts). The documents petitioners executed were sufficient under Texas law to create the children's trusts. Douglas Knight and Mary Knight were each the beneficiary and trustee of the children's trust bearing their name.

f. Petitioners each signed codicils to their wills in which they changed the bequests to their children to bequests to the children's trusts.

g. Petitioners each transferred a 22.3-percent interest in the partnership to each of the children's trusts. After those transfers, petitioners each retained a 4.9-percent interest in the partnership as limited partners.

3. The Partnership Agreement

The partnership has been a limited partnership under Texas law since it was created. Article 9 of the partnership agreement prohibits any partner from withdrawing from the partnership or demanding the return of any of his or her capital contribution or

the balance in that partner's capital account. Article 14 provides that the partnership will continue for 50 years, unless all partners consent to a dissolution. Under the partnership agreement, petitioner, as trustee of the management trust, could sell any asset or part of any asset at any time.

The fair market values (before any discounts) of partnership assets on December 28, 1994, were as follows:

Freestone County Ranch (with mineral rights)	$182,251
Residential property (6219 Dilbeck)	166,880
Residential property (14827 Chancey)	145,070
USAA municipal bond fund	553,653
Dreyfus municipal bond fund	510,239
Treasury notes	461,345
Insurance policies	51,885
Cash	10,000
Total	2,081,323

Petitioners transferred the bond funds and Treasury notes to brokerage accounts in the name of the partnership. The partnership had no liabilities and no assets other than those listed above. All of these assets were petitioners' community property before being transferred to the partnership.

C. Operation of the Management Trust and Partnership

1. Operation of the Management Trust

Petitioner has been the only trustee of the management trust. Petitioner decides which assets to buy and sell, pays all partnership expenses, handles and keeps records of all partnership transactions, and explains the transactions to the partnership's accountants. The management trust has never had a

checking account. The partnership paid the management trust expenses, such as preparation of the trust tax returns.

2. Operation of the Partnership

Petitioner signed all of the checks drawn on the partnership checking account. The partnership kept no records, prepared no annual reports, and had no employees. The children and their trusts did not participate in managing the partnership. The partners or their representatives have not exchanged any correspondence, meeting notes, or e-mail about the partnership's operations. The partners never met and never discussed conducting any business activity. All assets and know-how came from petitioners.

The partnership has never borrowed or lent money, and never conducted any business activity. It has not bought, otherwise acquired, or sold any notes or obligations of any entity other than Government-backed securities. The partnership did not prepare annual financial statements or reports.

3. Partnership Assets

Petitioner did not trade the partnership's bond funds. He reinvested the partnership's Treasury notes when they matured. He managed these investments the same way before and after he transferred them to the trust. The partnership did not rent real property to third parties.

A substantial portion of the partnership assets (the two houses and the ranch) was used for personal purposes before and after petitioners formed the partnership. Petitioners' children did not sign a lease or pay rent to the partnership in exchange for living at 6219 Dilbeck and 14827 Chancey. Petitioners' children paid the utilities while they lived at 6219 Dilbeck and 14827 Chancey. The partnership paid the utilities at 14827 Chancey while Mary Knight was absent from November 1995 to September 1997. Petitioners paid real property taxes for 1994 for the ranch, 6219 Dilbeck, and 14827 Chancey, and the partnership paid them thereafter. Petitioners paid property insurance premiums for 1994 for 6219 Dilbeck and 14827 Chancey, and the partnership paid them thereafter. The expenses of 6219 Dilbeck and 14827 Chancey were more than 70 percent of the partnership's annual expenses.

Petitioner continued to operate the ranch after he contributed it to the partnership. He paid no rent to the partnership until December 1998, after the petitions in these cases were filed. The parties stipulated that, in December 1998, petitioner entered into an oral pasture lease on the ranch between himself as an individual and himself as trustee. On December 31, 1998, petitioner paid $1,500 to the partnership as rent under the oral pasture lease.

D. Federal Tax Returns

Petitioners filed Federal gift and generation-skipping transfer tax returns for 1994. Both petitioners reported that they had given a 22.3-percent interest in the partnership to each of the children's trusts.

The partnership filed Forms 1065, U.S. Partnership Return of Income, for 1995, 1996, and 1997. The management trust and each of the children's trusts filed Forms 1041, U.S. Income Tax Return for Estates and Trusts, for 1995, 1996, and 1997.

OPINION

A. Contentions of the Parties

The parties agree that the starting point for valuing petitioners' gifts to their children's trusts is the fair market value of the assets petitioners transferred to the partnership (i.e., $2,081,323), but they disagree about which discounts apply.

Respondent contends that petitioners' family limited partnership should be disregarded for gift tax valuation purposes. Thus, respondent contends that the fair market value of each of the gifts is $450,086; i.e., 22.3 percent of the fair market value of the real property and financial assets given by petitioners, discounted for selling expenses and built-in capital gains.

Petitioners contend that the partnership must be recognized for Federal gift tax purposes,[2] and that portfolio, minority, and lack of marketability discounts totaling 44 percent apply, reducing the value of each of the gifts to $263,165. Alternatively, petitioners contend that, if we do not recognize the partnership for Federal gift tax purposes, the value of each of the four gifts is between $429,781 and $435,291 after application of fractional interest and transactional costs discounts.

B. Whether To Disregard the Partnership for Gift Tax Purposes

Respondent contends that the partnership lacks economic substance and fails to qualify as a partnership under Federal law. See, e.g., Commissioner v. Culbertson, 337 U.S. 733, 740 (1949); Commissioner v. Tower, 327 U.S. 280, 286 (1946); Merryman v. Commissioner, 873 F.2d 879, 882-883 (5th Cir. 1989), affg. T.C. Memo. 1988-72.[3] Petitioners contend that their rights and legal relationships and those of their children changed significantly when petitioners formed the partnership,

[2] Petitioners contend that respondent bears the burden of proving that the partnership should be disregarded for lack of economic substance. We need not decide petitioners' contention because our findings and analysis on that issue do not depend on which party bears the burden of proof.

[3] Respondent does not contend that we should apply an indirect gift analysis. See Kincaid v. United States, 682 F.2d 1220 (5th Cir. 1982); Shepherd v. Commissioner, 115 T.C. ____ (2000); sec. 25.2511-1(h)(1), Gift Tax Regs. Thus, we do not consider that analysis here.

transferred assets to it, and transferred interests in the partnership to their children's trusts, and that we must recognize the partnership for Federal gift tax valuation purposes. We agree with petitioners.

State law determines the nature of property rights, and Federal law determines the appropriate tax treatment of those rights. See United States v. National Bank of Commerce, 472 U.S. 713, 722 (1985); United States v. Rodgers, 461 U.S. 677, 683 (1983); Aquilino v. United States, 363 U.S. 509, 513 (1960). The parties stipulated that the steps followed in the creation of the partnership satisfied all requirements under Texas law, and that the partnership has been a limited partnership under Texas law since it was created. Thus, the transferred interests are interests in a partnership under Texas law. Petitioners have burdened the partnership with restrictions that apparently are valid and enforceable under Texas law. The amount of tax for Federal estate and gift tax purposes is based on the fair market value of the property transferred. See secs. 2502, 2503. The fair market value of property is "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." See sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512-1, Gift Tax Regs. We apply the willing buyer, willing seller test to value the

interests in the partnership that petitioners transferred under Texas law. We do not disregard the partnership because we have no reason to conclude from this record that a hypothetical buyer or seller would disregard it.

Respondent relies on several income tax economic substance cases. See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561, 583-584 (1978); Knetsch v. United States, 364 U.S. 361, 366 (1960); ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 511-516 (D.C. Cir. 2000), affg. T.C. Memo. 1998-305; ACM Partnership v. Commissioner, 157 F.3d 231, 248 (3d Cir. 1998), affg. in part and revg. in part T.C. Memo. 1997-115; Merryman v. Commissioner, supra; Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 278 (1999). We disagree that those cases require that we disregard the partnership here because the issue here is what is the value of the gift. See secs. 2501, 2503; sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512-1, Gift Tax Regs.

Respondent points out that in several transfer tax cases we and other courts have valued a transfer based on its substance instead of its form. See, e.g., Heyen v. United States, 945 F.2d 359, 363 (10th Cir. 1991); Schultz v. United States, 493 F.2d 1225 (4th Cir. 1974); Estate of Murphy v. Commissioner, T.C. Memo. 1990-472; Griffin v. United States, 42 F. Supp. 2d 700, 704 (W.D. Tex. 1998). Our holding is in accord with those cases because we believe the form of the transaction here (the creation

of the partnership) would be taken into account by a willing buyer; thus the substance and form of the transaction are not at odds for gift tax valuation purposes. Respondent agrees that petitioners created and operated a partnership as required under Texas law and gave interests in that partnership to their children's trusts. Those rights are apparently enforceable under Texas law.

C. Whether the Value of Petitioners' Four Gifts Is Limited to $300,000 Each

The transfer document through which petitioners made the gifts at issue states that each petitioner transferred to each of their children's trusts the number of limited partnership units which equals $300,000 in value.[4] Petitioners contend that this bars respondent from asserting that the value of each partnership interest exceeds $300,000.

Respondent contends that the transfer document makes a formula gift that is void as against public policy. Respondent relies on Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), and Ward v. Commissioner, 87 T.C. 78, 109-116 (1986). In Procter, the transfer document provided that, if a court decided

[4] The transfer document identifies petitioners as transferors and states:

> Transferor irrevocably transfers and assigns to each Transferee above identified, as a gift, that number of limited partnership units in Herbert D. Knight Limited Partnership which is equal in value, on the effective date of this transfer, to $600,000.

a value that would cause a part of the transfer to be taxable, that part of the transfer would revert to the donor. The U.S. Court of Appeals for the Fourth Circuit described this provision as a condition subsequent, and held that it was void as against public policy. See Commissioner v. Procter, supra at 827.

We need not decide whether Procter and Ward control here because we disregard the stated $300,000 gift value for other reasons. First, petitioners reported on their gift tax returns that they each gave two 22.3-percent interests in the partnership. Contrary to the transfer document, they did not report that they had given partnership interests worth $300,000. We believe this shows their disregard for the transfer document, and that they intended to give 22.3-percent interests in the partnership.[5]

Second, even though petitioners contend that respondent is limited to the $300,000 amount, i.e., that the gifts were for $300,000 and thus cannot be worth more than $300,000, petitioners contend that the gifts are each worth less than $300,000. In fact, petitioners offered expert testimony to show that each gift was worth only $263,165. We find petitioners' contentions to be at best inconsistent. We treat petitioners' contention and offer

[5] Gifts of 22.3-percent partnership interests are at odds with the appraisal which valued a 22.22222-percent interest at the $300,000 amount specified in the transfer document. Petitioners do not explain this discrepancy between the transfer document and their returns.

of evidence that the gifts were worth less than $300,000 as opening the door to our consideration of respondent's argument that the gifts were worth more than $300,000.

D. Petitioners' Contention That a Portfolio Discount and Minority and Lack of Marketability Discounts Totaling 44 Percent Apply

Petitioners' expert, Robert K. Conklin (Conklin), estimated that, if we recognize the partnership for Federal tax purposes, a 10-percent portfolio discount and discounts of 10 percent for minority interest and 30 percent for lack of marketability apply, for an aggregate discount of 44 percent.[6]

1. Portfolio Discount

Conklin concluded that a 10-percent portfolio discount applies based on the assumption that it is unlikely that a buyer could be found who would want to buy all of the Knight family partnership's assets. He provided no evidence to support that assumption, see Rule 143(f)(1); Rose v. Commissioner, 88 T.C. 386, 401 (1987), affd. 868 F.2d 851 (6th Cir. 1989); Compaq Computer Corp. v. Commissioner, T.C. Memo. 1999-220.

To estimate the amount of the portfolio discount, Conklin relied on a report stating that conglomerate public companies tend to sell at a discount of about 10 to 15 percent from their

[6] Respondent's expert, Francis X. Burns, testified about the "fair value" but not the "fair market value" of the partnership interests at issue in these cases. We have not considered his testimony in deciding the fair market value of the gifts.

breakup value. However, the Knight family partnership is not a conglomerate public company.

Conklin cites Shannon Pratt's definition of a portfolio discount[7] in estimating the portfolio discount to apply to the assets of the partnership. A portfolio discount applies to a company that owns two or more operations or assets, the combination of which would not be particularly attractive to a buyer. See Estate of Piper v. Commissioner, 72 T.C. 1062, 1082 (1979). The partnership held real estate and marketable securities. Conklin gave no convincing reason why the partnership's mix of assets would be unattractive to a buyer. We apply no portfolio discount to the assets of the partnership.

2. Lack of Control and Marketability Discounts

Conklin concluded that a lack of control discount applies. He speculated that, because the partnership invested a large part

[7] Pratt et al., Valuing a Business, The Analysis and Appraisal of Closely Held Companies 325 (3d ed. 1996):

> The concept of a 'portfolio' discount is a discount for a company that owns anywhere from two to several dissimilar operations and/or assets that do not necessarily fit well together. Many private companies have accumulated such a package of disparate operations and/or assets over the years, the combination of which probably would not be particularly attractive to a buyer seeking a position in any one of the industries, necessitating a discount to sell the entire company as a package. Research indicates that conglomerate public companies tend to sell at a discount of about 10 to 15 percent from their breakup value, although the relationship is not consistent from company to company or necessarily over time.

of its assets in bonds, and investors in the bond fund could not influence investment policy, the partnership "could be similar to a closed-end bond fund".[8] He estimated that a lack of control discount of 10 percent applies by evaluating the difference between the trading value and the net asset values on October 21, 1994, of 10 publicly traded closed-end bond funds. The 10 funds that Conklin chose are not comparable to the Knight family partnership.[9] We find unconvincing his use of data from noncomparable entities to increase the discount. However, on

[8] A publicly traded closed-end bond fund owns a fixed number of bonds. The net asset value of those bonds held by a closed-end fund is published. The value of an interest in a closed-end fund may trade at a premium (i.e., above the net asset value per share) or at a discount (i.e., below the net asset value per share).

[9] Only the Nuveen Municipal Value Fund had assets that were comparable to the partnership. No hard and fast rule dictates the number of comparables required, but courts have rejected use of one comparable, see Estate of Hall v. Commissioner, 92 T.C. 312 (1989); Estate of Rodgers v. Commissioner, T.C. Memo. 1999-129; Klukwan, Inc. v. Commissioner, T.C. Memo. 1994-402; Crowley v. Commissioner, T.C. Memo. 1990-636, affd. on other grounds 962 F.2d 1077 (1st Cir. 1992); Higgins v. Commissioner, T.C. Memo. 1990-103; Dennis v. United States, 70 AFTR 2d 92-5946, 92-5949, 92-2 USTC par. 50,498 (E.D. Va. 1992), unless it is compelling, see also 885 Inv. Co. v. Commissioner, 95 T.C. 156, 167-168 (1990); Estate of Fawcett v. Commissioner, 64 T.C. 889, 899-900 (1975); Clark v. Commissioner, T.C. Memo. 1978-402. The comparability is not compelling here. First, the value of the partnership's interest in the two bond funds was about $1.1 million; the value of the assets in the Nuveen Municipal Value Fund was nearly $1.9 billion. Second, 51 percent of the partnership assets were invested in two tax-exempt municipal bond funds; the Nuveen Municipal Value Fund held no real property.

this record, we believe some discount is appropriate based on an analogy to a closed-end fund.

Conklin cited seven studies of sales of restricted stocks from 1969 to 1984 to support his estimate that a 30-percent discount for lack of marketability applies. He used a table summarizing initial public offerings of common stock from 1985 to 1993. However, he did not show that the companies in the studies or the table were comparable to the partnership, or explain how he used this data to estimate the discount for lack of marketability. See Tripp v. Commissioner, 337 F.2d 432, 434-435 (7th Cir. 1964), affg. T.C. Memo. 1963-244; Rose v. Commissioner, supra; Chiu v. Commissioner, 84 T.C. 722, 734-735 (1985). He also listed seven reasons why a discount for lack of marketability applies, but he did not explain how those reasons affect the amount of the discount for lack of marketability.

3. Conklin's Factual Assumptions

Conklin listed 19 purported business reasons for which he said the partnership was formed. Petitioners claimed to have had only 5 of those 19 reasons.[10] Conklin also said: "The

[10] Petitioners' five reasons are: (a) Centralize control of family investments; (b) avoid fragmentation of interests; (c) consolidate family interests into one entity; and protect the children's assets (d) from creditors and (e) in the event of a divorce.

The 14 reasons Conklin gave but petitioners did not are: (a) Obtain better rates of return; (b) reduce administrative costs; (c) provide for competent management in case of death or

(continued...)

compensation and reimbursement paid to the general partner reduce the income available to limited partners or assignees." His statement is inapplicable because the general partner received no compensation and incurred no expenses.

We have rejected expert opinion based on conclusions which are unexplained or contrary to the evidence. See Rose v. Commissioner, supra; Compaq Computer Corp. v. Commissioner, supra. An expert fails to assist the trier of fact if he or she assumes the position of advocate. See Estate of Halas v. Commissioner, 94 T.C. 570, 577 (1990); Laureys v. Commissioner, 92 T.C. 101, 122-129 (1989). Conklin's erroneous factual assumptions cast doubt on his objectivity.

4. Conclusion

The parties stipulated that the net asset value of the partnership was $2,081,323 on December 28, 1994. Each petitioner gave each trust a 22.3-percent interest in the partnership; 44.6 percent of $2,081,323 is $928,270.

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[10](...continued)
disability; (d) avoid cumbersome and expensive guardianships; (e) avoid or minimize probate delay and expenses; (f) minimize franchise tax liability; (g) provide business flexibility because the agreement can be amended; (h) eliminate ancillary probate proceedings; (i) provide a convenient mechanism for making annual gifts; (j) provide a vehicle to educate descendants about family assets to increase their value; (k) provide a mechanism to resolve family disputes; (l) avoid adverse tax consequences that may occur by dissolving a corporation; (m) provide better income tax treatment than would apply to a corporation or trust; and (n) provide more flexibility in making investments than a trust because of the fiduciary standard.

We conclude that Conklin was acting as an advocate and that his testimony was not objective. However, despite the flaws in petitioners' expert's testimony, we believe that some discount is proper, in part to take into account material in the record relating to closed-end bond funds. We hold that the fair market value of an interest in the Knight family partnership is the pro rata net asset value of the partnership less a discount totaling 15 percent for minority interest and lack of marketability. Thus, on December 28, 1994, each petitioner made taxable gifts of $789,030 (44.6 percent of $2,081,323, reduced by 15 percent).

E. Whether Section 2704(b) Applies

Respondent contends that Article 14 (the 50-year term or dissolution by agreement of all partners) and Article 9 (the lack of withdrawal rights for limited partners) of the partnership agreement are applicable restrictions under section 2704(b) because sections 8.01 and 6.03 of Texas Revised Limited Partnership Act (TRLPA), Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (West Supp. 1993), are less restrictive. We disagree. See Kerr v. Commissioner, 113 T.C. 449 (1999).

If a transferor conveys to a family member an interest in a partnership or a corporation which is subject to an "applicable restriction", and the transferor and transferor's family members control the entity immediately before the transfer, the restriction in valuing the interest shall be disregarded. See

sec. 2704(b)(1). An "applicable restriction" is a provision that limits the ability of the partnership or corporation to liquidate if (1) the restriction lapses after the transfer, or (2) the transferor or any member of the transferor's family, collectively or alone, can remove or reduce the restriction after the transfer. See sec. 2704(b)(2); sec. 25.2704-2(b), Gift Tax Regs. However, a restriction on liquidation is not an applicable restriction if it is not more restrictive than limitations on liquidation under Federal or State law. See sec. 2704(b)(3).

In Kerr, the Commissioner contended that the provisions in the partnership agreement (50-year term or dissolution by agreement of all partners and the lack of withdrawal rights for limited partners) were applicable restrictions under section 2704(b) because TRLPA sections 8.01 and 6.03 were less restrictive. We rejected those arguments in Kerr and noted that, under Texas law, a limited partner may withdraw from a partnership without requiring the dissolution and liquidation of the partnership. See id. at 473. We concluded that the partnership agreements in Kerr were not more restrictive than the limitations that generally would apply to the partnerships under Texas law. See id. at 472-474. Similarly, we conclude that section 2704(b) does not apply here.

To reflect the foregoing,

Decisions will be entered under Rule 155.

Reviewed by the Court.

CHABOT, COHEN, PARR, RUWE, WHALEN, HALPERN, CHIECHI, GALE, and THORNTON, JJ., agree with this majority opinion.

LARO and MARVEL, JJ., concur in result only.

FOLEY, J., concurring in result: Family limited partnerships are proliferating as an estate planning device, taxpayers are planning amid great uncertainty, and respondent is asserting numerous theories (i.e., economic substance, Chapter 14, section 2036, immediate gift upon formation, etc.) in an attempt to address these transactions. It is important that we clarify the law in this area with a careful statement of the applicable principles. While I agree with the majority that the partnership must be respected, I write separately to emphasize two points.

I. The "Willing Buyer, Willing Seller" Test Is Not a Relevant Consideration in Determining Whether a Partnership Is To Be Respected Under State Law

I disagree with some of the reasoning set forth in the majority opinion. Specifically, the rationale set forth for respecting the partnership is as follows:

> We do not disregard the partnership because we have no reason to conclude from this record that a hypothetical buyer or seller would disregard it.
>
> * * * * * * *
>
> * * * we believe the form of the transaction here (the creation of the partnership) would be taken into account by a willing buyer; thus the substance and form of the transaction are not at odds for gift tax valuation purposes. * * * [Majority op. pp. 14-15.]

The Knight family limited partnership is a valid legal entity under Texas law. Even if a hypothetical buyer and seller were to determine that the value of the partnership interest was

equal, or approximately equal, to the value of the corresponding underlying assets,[1] that would not be legal justification for applying the economic substance doctrine and disregarding the partnership. Whether "the form of the transaction here (the creation of the partnership) would be taken into account by a willing buyer" is not a relevant consideration in determining whether the entity must be respected for transfer tax purposes. Our assessment of the property rights transferred is a State law determination not affected by the "willing buyer, willing seller" valuation analysis. Sec. 20.2031-1(b), Estate Tax Regs. (stating that the fair market value of property is "the price at which the property would change hands between a willing buyer and a willing seller"). In essence, that analysis assists the Court in determining the value of partnership interest after the Court establishes whether the entity is recognized under State law.

The determination of whether or not the partnership should be respected is independent of the value of the partnership interest. The logical inference from the majority's statements, however, is that a partnership could be disregarded for lack of economic substance if a hypothetical willing buyer would not respect the partnership form. This language may mislead

[1] The value of the partnership interest and its corresponding underlying assets will not be equal because virtually any binding legal restriction will make such partnership interest less than the value of its corresponding underlying assets.

respondent and encourage him to proffer expert testimony in a fruitless attempt to establish that a partnership should be disregarded because the value of a partnership interest is equal, or approximately equal, to the value of the corresponding underlying assets. The "willing buyer, willing seller" analysis merely establishes the value of a partnership interest, not whether the economic substance doctrine is applicable.

II. The Economic Substance Doctrine Should Not Be Employed in the Transfer Tax Regime To Disregard Entities

A fundamental premise of transfer taxation is that State law defines and Federal tax law then determines the tax treatment of property rights and interests. See Drye v. United States, 528 U.S. 49 (1999); Morgan v. Commissioner, 309 U.S. 78 (1940). As a result, the courts have not employed the economic substance doctrine to disregard an entity (i.e., one recognized as bona fide under State law) for the purpose of disallowing a purported valuation discount.

The application of the economic substance doctrine in the transfer tax context generally has been limited to cases where a taxpayer attempts to disguise the transferor or transferees. The courts in these cases occasionally mention, but do not explicitly incorporate, a business purpose inquiry in their analysis. See Heyen v. United States, 945 F.2d 359 (10th Cir. 1991)(applying only substance over form analysis to a gift of stock to disregard

intermediate transferees); Schultz v. United States, 493 F.2d 1225 (4th Cir. 1974)(applying essentially a substance over form analysis to reciprocal gifts); Griffin v. United States, 42 F. Supp. 2d 700 (W.D. Tex. 1998)(discussing the lack of business purpose inherent in gifts, and then applying economic substance analysis to a gift of stock).

Generally, the economic substance doctrine, with its emphasis on business purpose, is not a good fit in a tax regime dealing with typically donative transfers. Business purpose will oftentimes be suspect in these transactions because estate planning usually focuses on tax minimization and involves the transfer of assets to family members. If taxpayers, however, are willing to burden their property with binding legal restrictions that, in fact, reduce the value of such property, we cannot disregard such restrictions. To do so would be to disregard economic reality.

WELLS, C.J., agrees with this concurring opinion.

BEGHE, J., dissenting: Using the estate depletion approach set forth in my dissenting opinion in Shepherd v. Commissioner, 115 T.C. ___ (2000) (slip opinion pp. 63-67), as supplemented by my dissenting opinion in Estate of Strangi v. Commissioner, 115 T.C. ___ (2000) (slip opinion pp. 39-48), I respectfully suggest that the valuation focus in this case should have been on the assets transferred by the donors, rather than on the partnership interests received by the donees. I would have valued the gifts at 100 percent of the values of the assets transferred to the partnership by Mr. and Mrs. Knight, reducing the values so arrived at by the values of the partnership interests Mr. and Mrs. Knight received and retained.

Full Text of Court Cases

Kumho Tire Company v. Carmichael

Case name: Kumho Tire Co. v. Carmichael
Citation: 119 S. Ct. 1167,1999 U.S. LEXIS 2189
Date of decision: March 23, 1999
Country: US
State or Federal: Federal
Court: Supreme Court
Type of action: Evidence
Judge: Breyer
Experts: Dennis Carlson, Jr (for plaintiff)
SIC: 3011 Tires and Inner Tubes
NAICS: 326211 Tire Manufacturing (except Retreading)
993

Keywords: Expert testimony

COUNSEL:

Joseph H. Babington argued the cause for petitioners.

Jeffrey P. Minear argued the cause for the United States, as amicus curiae, by special leave of court.

Sidney W. Jackson argued the cause for respondents.

JUDGES:

BREYER, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and O'CONNOR, SCALIA, KENNEDY, SOUTER, THOMAS, and GINSBURG, JJ., joined, and in which STEVENS, J., joined as to Parts I and II. SCALIA, J., filed a concurring opinion, in which O'CONNOR and THOMAS, JJ., joined. STEVENS, J., filed an opinion concurring in part and dissenting in part.

OPINIONBY:

BREYER

OPINION:

JUSTICE BREYER delivered the opinion of the Court.

In Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579, 125 L. Ed. 2d 469, 113 S. Ct. 2786 (1993), this Court focused upon the admissibility of scientific expert testimony. It pointed out that such testimony is admissible only if it is both relevant and reliable. And it held that the Federal Rules of Evidence "assign to the trial judge the task of ensuring that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand." Id. at 597. The Court also discussed certain more

specific factors, such as testing, peer review, error rates, and "acceptability" in the relevant scientific community, some or all of which might prove helpful in determining the reliability of a particular scientific "theory or technique." Id. at 593-594.

This case requires us to decide how Daubert applies to the testimony of engineers and other experts who are not scientists. We conclude that Daubert's general holding -- setting forth the trial judge's general "gatekeeping" obligation -- applies not only to testimony based on "scientific" knowledge, but also to testimony based on "technical" and "other specialized" knowledge. See Fed. Rule Evid. 702. We also conclude that a trial court may consider one or more of the more specific factors that Daubert mentioned when doing so will help determine that testimony's reliability. But, as the Court stated in Daubert, the test of reliability is "flexible," and Daubert's list of specific factors neither necessarily nor exclusively applies to all experts or in every case. Rather, the law grants a district court the same broad latitude when it decides how to determine reliability as it enjoys in respect to its ultimate reliability determination. See General Electric Co. v. Joiner, 522 U.S. 136, 143, 139 L. Ed. 2d 508, 118 S. Ct. 512 (1997) (courts of appeals are to apply "abuse of discretion" standard when reviewing district court's reliability determination). Applying these standards, we determine that the District Court's decision in this case -- not to admit certain expert testimony -- was within its discretion and therefore lawful.

I

On July 6, 1993, the right rear tire of a minivan driven by Patrick Carmichael blew out. In the accident that followed, one of the passengers died, and others were severely injured. In October 1993, the Carmichaels brought this diversity suit against the tire's maker and its distributor, whom we refer to collectively as Kumho Tire, claiming that the tire was defective. The plaintiffs rested their case in significant part upon deposition testimony provided by an expert in tire failure analysis, Dennis Carlson, Jr., who intended to testify in support of their conclusion.

Carlson's depositions relied upon certain features of tire technology that are not in dispute. A steel-belted radial tire like the Carmichaels' is made up of a "carcass" containing many layers of flexible cords, called "plies," along which (between the cords and the outer tread) are laid steel strips called "belts." Steel wire loops, called "beads," hold the cords together at the plies' bottom edges. An outer layer, called the "tread," encases the carcass, and the entire tire is bound together in rubber, through the application of heat and various chemicals. See generally, e.g., J. Dixon, Tires, Suspension and Handling 68-72 (2d ed. 1996). The bead of the tire sits upon a "bead seat," which is part of the wheel assembly. That assembly contains a "rim flange," which extends over the bead and rests against the side of the tire. See M. Mavrigian, Performance Wheels & Tires 81, 83 (1998) (illustrations).

[Graphic omitted; see printed opinion.]

A. Markovich, How To Buy and Care For Tires 4 (1994).

Carlson's testimony also accepted certain background facts about the tire in question. He assumed that before the blowout the tire had traveled far. (The tire was made in 1988 and had been installed some time before the Carmichaels bought the used minivan in March 1993; the Carmichaels had driven the van approximately 7,000 additional miles in the two months they had owned it.) Carlson noted that the tire's tread depth, which was 11/32 of an inch when new, App. 242, had been worn down to depths that

ranged from 3/32 of an inch along some parts of the tire, to nothing at all along others. Id. at 287. He conceded that the tire tread had at least two punctures which had been inadequately repaired. Id. at 258-261, 322.

Despite the tire's age and history, Carlson concluded that a defect in its manufacture or design caused the blow-out. He rested this conclusion in part upon three premises which, for present purposes, we must assume are not in dispute: First, a tire's carcass should stay bound to the inner side of the tread for a significant period of time after its tread depth has worn away. Id. at 208-209. Second, the tread of the tire at issue had separated from its inner steel-belted carcass prior to the accident. Id. at 336. Third, this "separation" caused the blowout. Ibid.

Carlson's conclusion that a defect caused the separation, however, rested upon certain other propositions, several of which the defendants strongly dispute. First, Carlson said that if a separation is not caused by a certain kind of tire misuse called "overdeflection" (which consists of underinflating the tire or causing it to carry too much weight, thereby generating heat that can undo the chemical tread/carcass bond), then, ordinarily, its cause is a tire defect. Id. at 193-195, 277-278. Second, he said that if a tire has been subject to sufficient overdeflection to cause a separation, it should reveal certain physical symptoms. These symptoms include (a) tread wear on the tire's shoulder that is greater than the tread wear along the tire's center, id. at 211; (b) signs of a "bead groove," where the beads have been pushed too hard against the bead seat on the inside of the tire's rim, id. at 196-197; (c) sidewalls of the tirewith physical signs of deterioration, such as discoloration, id. at 212; and/or (d) marks on the tire's rim flange, id. at 219-220. Third, Carlson said that where he does not find at least two of the four physical signs just mentioned (and presumably where there is no reason to suspect a less common cause of separation), he concludes that a manufacturing or design defect caused the separation. Id. at 223-224.

Carlson added that he had inspected the tire in question. He conceded that the tire to a limited degree showed greater wear on the shoulder than in the center, some signs of "bead groove," some discoloration, a few marks on the rim flange, and inadequately filled puncture holes (which can also cause heat that might lead to separation). Id. at 256-257, 258-261, 277, 303-304, 308. But, in each instance, he testified that the symptoms were not significant, and he explained why he believed that they did not reveal overdeflection. For example, the extra shoulder wear, he said, appeared primarily on one shoulder, whereas an overdeflected tire would reveal equally abnormal wear on both shoulders. Id. at 277. Carlson concluded that the tire did not bear at least two of the four overdeflection symptoms, nor was there any less obvious cause of separation; and since neither overdeflection nor the punctures caused the blowout, a defect must have done so.

Kumho Tire moved the District Court to exclude Carlson's testimony on the ground that his methodology failed Rule 702's reliability requirement. The court agreed with Kumho that it should act as a Daubert-type reliability "gatekeeper," even though one might consider Carlson's testimony as "technical," rather than "scientific." See Carmichael v. Samyang Tires, Inc., 923 F. Supp. 1514, 1521-1522 (SD Ala. 1996). The court then examined Carlson's methodology in light of the reliability-related factors that Daubert mentioned, such as a theory's testability, whether it "has been a subject of peer review or publication," the "known or potential rate of error," and the "degree of acceptance . . . within the relevant scientific

community." 923 F. Supp. at 1520 (citing Daubert, 509 U.S. 579 at 592-594). The District Court found that all those factors argued against the reliability of Carlson's methods, and it granted the motion to exclude the testimony (as well as the defendants' accompanying motion for summary judgment).

The plaintiffs, arguing that the court's application of the Daubert factors was too "inflexible," asked for reconsideration. And the Court granted that motion. Carmichael v. Samyang Tires, Inc., Civ. Action No. 93-0860-CB-S (SD Ala., June 5, 1996), App. to Pet. for Cert. 1c. After reconsidering the matter, the court agreed with the plaintiffs that Daubert should be applied flexibly, that its four factors were simply illustrative, and that other factors could argue in favor of admissibility. It conceded that there may be widespread acceptance of a "visual-inspection method" for some relevant purposes. But the court found insufficient indications of the reliability of

"the component of Carlson's tire failure analysis which most concerned the Court, namely, the methodology employed by the expert in analyzing the data obtained in the visual inspection, and the scientific basis, if any, for such an analysis." Id. at 6c.

It consequently affirmed its earlier order declaring Carlson's testimony inadmissable and granting the defendants' motion for summary judgment.

The EleventhCircuit reversed. See Carmichael v. Samyang Tire, Inc., 131 F.3d 1433 (1997). It "reviewed . . . de novo" the "district court's legal decision to apply Daubert." 131 F.3d at 1435. It noted that "the Supreme Court in Daubert explicitly limited its holding to cover only the 'scientific context,'" adding that "a Daubert analysis" applies only where an expert relies "on the application of scientific principles," rather than "on skill- or experience-based observation." Id. at 1435-1436. It concluded that Carlson's testimony, which it viewed as relying on experience, "falls outside the scope of Daubert," that "the district court erred as a matter of law by applying Daubert in this case," and that the case must be remanded for further (non-Daubert-type) consideration under Rule 702. Id. at 1436.

Kumho Tire petitioned for certiorari, asking us to determine whether a trial court "may" consider Daubert's specific "factors" when determining the "admissibility of an engineering expert's testimony." Pet. for Cert. i. We granted certiorari in light of uncertainty among the lower courts about whether, or how, Daubert applies to expert testimony that might be characterized as based not upon "scientific" knowledge, but rather upon "technical" or "other specialized" knowledge. Fed. Rule Evid. 702; compare, e.g., Watkins v. Telsmith, Inc., 121 F.3d 984, 990-991 (CA5 1997), with, e.g., Compton v. Subaru of America, Inc., 82 F.3d 1513, 1518-1519 (CA10), cert. denied, 519 U.S. 1042, 136 L. Ed. 2d 536, 117 S. Ct. 611 (1996).

II

A

In Daubert, this Court held that Federal Rule of Evidence 702 imposes a special obligation upon a trial judge to "ensure that any and all scientific testimony . . . is not only relevant, but reliable." 509 U.S. at 589. The initial question before us is whether this basic gatekeeping obligation applies only to "scientific" testimony or to all expert testimony. We, like the parties, believe that it applies to all expert testimony. See Brief for Petitioners 19; Brief for Respondents 17.

For one thing, Rule 702 itself says:

"If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise."

This language makes no relevant distinction between "scientific" knowledge and "technical" or "other specialized" knowledge. It makes clear that any such knowledge might become the subject of expert testimony. In Daubert, the Court specified that it is the Rule's word "knowledge," not the words (like "scientific") that modify that word, that "establishes a standard of evidentiary reliability." 509 U.S. at 589-590. Hence, as a matter of language, the Rule applies its reliability standard to all "scientific," "technical," or "other specialized" matters within its scope. We concede that the Court in Daubert referred only to "scientific" knowledge. But as the Court there said, it referred to "scientific" testimony "because that was the nature of the expertise" at issue. Id. at 590, n. 8.

Neither is the evidentiary rationale that underlay the Court's basic Daubert "gatekeeping" determination limited to "scientific" knowledge. Daubert pointed out that Federal Rules 702 and 703 grant expert witnesses testimonial latitude unavailable to other witnesses on the "assumption that the expert's opinion will have a reliable basis in the knowledge and experience of his discipline." Id. at 592 (pointing out that experts may testify to opinions, including those that are not based on firsthand knowledge or observation). The Rules grant that latitude to all experts, not just to "scientific" ones.

Finally, it would prove difficult, if not impossible, for judges to administer evidentiary rules under which a gatekeeping obligation depended upon a distinction between "scientific" knowledge and "technical" or "other specialized" knowledge. There is no clear line that divides the one from the others. Disciplines such as engineering rest upon scientific knowledge. Pure scientific theory itself may depend for its development upon observation and properly engineered machinery. And conceptual efforts to distinguish the two are unlikely to produce clear legal lines capable of application in particular cases. Cf. Brief for National Academy of Engineering as Amicus Curiae 9 (scientist seeks to understand nature while the engineer seeks nature's modification); Brief for Rubber Manufacturers Association as Amicus Curiae 14-16 (engineering, as an "applied science," relies on "scientific reasoning and methodology"); Brief for John Allen et al. as Amici Curiae 6 (engineering relies upon "scientific knowledge and methods").

Neither is there a convincing need to make such distinctions. Experts of all kinds tie observations to conclusions through the use of what Judge Learned Hand called "general truths derived from . . . specialized experience." Hand, Historical and Practical Considerations Regarding Expert Testimony, 15 Harv. L. Rev. 40, 54 (1901). And whether the specific expert testimony focuses upon specialized observations, the specialized translation of those observations into theory, a specialized theory itself, or the application of such a theory in a particular case, the expert's testimony often will rest "upon an experience confessedly foreign in kind to [the jury's] own." Ibid. The trial judge's effort to assure that the specialized testimony is reliable and relevant can help the jury evaluate that foreign experience, whether the testimony reflects scientific, technical, or other specialized knowledge.

We conclude that Daubert's general principles apply to the expert matters described in Rule 702. The Rule, in respect to all such matters, "establishes a standard of evidentiary reliability." 509 U.S. at 590. It "requires a valid . . . connection to the pertinent inquiry as a precondition to admissibility." Id. at 592. And

where such testimony's factual basis, data, principles, methods, or their application are called sufficiently into question, see Part III, infra, the trial judge must determine whether the testimony has "a reliable basis in the knowledge and experience of [the relevant] discipline." 509 U.S. at 592.

B

The petitioners ask more specifically whether a trial judge determining the "admissibility of an engineering expert's testimony" may consider several more specific factors that Daubert said might "bear on" a judge's gate-keeping determination. These factors include:

-- Whether a "theory or technique . . . can be (and has been) tested";

-- Whether it "has been subjected to peer review and publication";

-- Whether, in respect to a particular technique, there is a high "known or potential rate of error" and whether there are "standards controlling the technique's operation"; and

-- Whether the theory or technique enjoys "general acceptance" within a "relevant scientific community." 509 U.S. at 592-594.

Emphasizing the word "may" in the question, we answer that question yes.

Engineering testimony rests upon scientific foundations, the reliability of which will be at issue in some cases. See, e.g., Brief for Stephen Bobo et al. as Amici Curiae 23 (stressing the scientific bases of engineering disciplines). In other cases, the relevant reliability concerns may focus upon personal knowledge or experience. As the Solicitor General points out, there are many different kinds of experts, and many different kinds of expertise. See Brief for United States as Amicus Curiae 18-19, and n. 5 (citing cases involving experts in drug terms, handwriting analysis, criminal modus operandi, land valuation, agricultural practices, railroad procedures, attorney's fee valuation, and others). Our emphasis on the word "may" thus reflects Daubert's description of the Rule 702 inquiry as "a flexible one." 509 U.S. at 594. Daubert makes clear that the factors it mentions do not constitute a "definitive checklist or test." Id. at 593. And Daubert adds that the gatekeeping inquiry must be "'tied to the facts'" of a particular "case." Id. at 591 (quoting United States v. Downing, 753 F.2d 1224, 1242 (CA3 1985)). We agree with the Solicitor General that "the factors identified in Daubert may or may not be pertinent in assessing reliability, depending on the nature of the issue, the expert's particular expertise, and the subject of his testimony." Brief for United States as Amicus Curiae 19. The conclusion, in our view, is that we can neither rule out, nor rule in, for all cases and for all time the applicability of the factors mentioned in Daubert, nor can we now do so for subsets of cases categorized by category of expert or by kind of evidence. Too much depends upon the particular circumstances of the particular case at issue.

Daubert itself is not to the contrary. It made clear that its list of factors was meant to be helpful, not definitive. Indeed, those factors do not all necessarily apply even in every instance in which the reliability of scientific testimony is challenged. It might not be surprising in a particular case, for example, that a claim made by a scientific witness has never been the subject of peer review, for the particular application at issue may never previously have interested any scientist. Nor, on the other hand, does the presence of Daubert's general acceptance factor help show that an expert's testimony is reliable where the discipline itself lacks reliability, as, for example, do theories grounded in any so-called generally accepted principles of astrology or necromancy.

At the same time, and contrary to the Court of Appeals' view, some of Daubert's questions can help to evaluate the reliability even of experience-based testimony. In certain cases, it will be appropriate for the trial judge to ask, for example, how often an engineering expert's experience-based methodology has produced erroneous results, or whether such a method is generally accepted in the relevant engineering community. Likewise, it will at times be useful to ask even of a witness whose expertise is based purely on experience, say, a perfume tester able to distinguish among 140 odors at a sniff, whether his preparation is of a kind that others in the field would recognize as acceptable.

We must therefore disagree with the Eleventh Circuit's holding that a trial judge may ask questions of the sort Daubert mentioned only where an expert "relies on the application of scientific principles," but not where an expert relies "on skill- or experience-based observation." 131 F.3d at 1435. We do not believe that Rule 702 creates a schematism that segregates expertise by type while mapping certain kinds of questions to certain kinds of experts. Life and the legal cases that it generates are too complex to warrant so definitive a match.

To say this is not to deny the importance of Daubert's gatekeeping requirement. The objective of that requirement is to ensure the reliability and relevancy of expert testimony. It is to make certain that an expert, whether basing testimony upon professional studies or personal experience, employs in the courtroom the same level of intellectual rigor that characterizes the practice of an expert in the relevant field. Nor do we deny that, as stated in Daubert, the particular questions that it mentioned will often be appropriate for use in determining the reliability of challenged expert testimony. Rather, we conclude that the trial judge must have considerable leeway in deciding in a particular case how to go about determining whether particular expert testimony is reliable. That is to say, a trial court should consider the specific factors identified in Daubert where they are reasonable measures of the reliability of expert testimony.

C

The trial court must have the same kind of latitude in deciding how to test an expert's reliability, and to decide whether or when special briefing or other proceedings are needed to investigate reliability, as it enjoys when it decides whether that expert's relevant testimony is reliable. Our opinion in Joiner makes clear that a court of appeals is to apply an abuse-of-discretion standard when it "reviews a trial court's decision to admit or exclude expert testimony." 522 U.S. at 138-139. That standard applies as much to the trial court's decisions about how to determine reliability as to its ultimate conclusion. Otherwise, the trial judge would lack the discretionary authority needed both to avoid unnecessary "reliability" proceedings in ordinary cases where the reliability of an expert's methods is properly taken for granted, and to require appropriate proceedings in the less usual or more complex cases where cause for questioning the expert's reliability arises. Indeed, the Rules seek to avoid "unjustifiable expense and delay" as part of their search for "truth" and the "just determination" of proceedings. Fed. Rule Evid. 102. Thus, whether Daubert's specific factors are, or are not, reasonable measures of reliability in a particular case is a matter that the law grants the trial judge broad latitude to determine. See Joiner, supra, at 143. And the Eleventh Circuit erred insofar as it held to the contrary.

III

We further explain the way in which a trial judge "may" consider Daubert's factors by applying these considerations to the case at hand, a matter that has been briefed exhaustively by the parties and their 19 amici. The District Court did not doubt Carlson's qualifications, which included a masters degree in mechanical engineering, 10 years' work at Michelin America, Inc., and testimony as a tire failure consultant in other tort cases. Rather, it excluded the testimony because, despite those qualifications, it initially doubted, and then found unreliable, "the methodology employed by the expert in analyzing the data obtained in the visual inspection, and the scientific basis, if any, for such an analysis." Civ. Action No. 93-0860-CB-S (SD Ala., June 5, 1996), App. to Pet. for Cert. 6c. After examining the transcript in "some detail," 923 F. Supp. at 1518-519, n. 4, and after considering respondents' defense of Carlson's methodology, the District Court determined that Carlson's testimony was not reliable. It fell outside the range where experts might reasonably differ, and where the jury must decide among the conflicting views of different experts, even though the evidence is "shaky." Daubert, 509 U.S. at 596. In our view, the doubts that triggered the District Court's initial inquiry here were reasonable, as was the court's ultimate conclusion.

For one thing, and contrary to respondents' suggestion, the specific issue before the court was not the reasonableness in general of a tire expert's use of a visual and tactile inspection to determine whether overdeflection had caused the tire's tread to separate from its steel-belted carcass. Rather, it was the reasonableness of using such an approach, along with Carlson's particular method of analyzing the data thereby obtained, to draw a conclusion regarding the particular matter to which the expert testimony was directly relevant. That matter concerned the likelihood that a defect in the tire at issue caused its tread to separate from its carcass. The tire in question, the expert conceded, had traveled far enough so that some of the tread had been worn bald; it should have been taken out of service; it had been repaired (inadequately) for punctures; and it bore some of the very marks that the expert said indicated, not a defect, but abuse through overdeflection. See supra, at 3-5; App. 293-294. The relevant issue was whether the expert could reliably determine the cause of this tire's separation. Nor was the basis for Carlson's conclusion simply the general theory that, in the absence of evidence of abuse, a defect will normally have caused a tire's separation. Rather, the expert employed a more specific theory to establish the existence (or absence) of such abuse. Carlson testified precisely that in the absence of at least two of four signs of abuse (proportionately greater tread wear on the shoulder; signs of grooves caused by the beads; discolored sidewalls; marks on the rim flange) he concludes that a defect caused the separation. And his analysis depended upon acceptance of a further implicit proposition, namely, that his visual and tactile inspection could determine that the tire before him had not been abused despite some evidence of the presence of the very signs for which he looked (and two punctures).

For another thing, the transcripts of Carlson's depositions support both the trial court's initial uncertainty and its final conclusion. Those transcripts cast considerable doubt upon the reliability of both the explicit theory (about the need for two signs of abuse) and the implicit proposition (about the significance of visual inspection in this case). Among other things, the expert could not say whether the tire had traveled more than 10, or 20, or 30, or 40, or 50 thousand miles, adding that 6,000 miles was "about how far" he could "say with any certainty." Id. at 265. The court could reasonably have wondered about the reliability of a method of visual and tactile inspection sufficiently precise to ascertain with some certainty the abuse-related significance of minute shoulder/center relative tread wear differences, but insufficiently precise to tell "with any certainty" from the tread wear whether a tire had traveled less than 10,000 or more than 50,000 miles. And these concerns might have been augmented by Carlson's

repeated reliance on the "subjectiveness" of his mode of analysis in response to questions seeking specific information regarding how he could differentiate between a tire that actually had been overdeflected and a tire that merely looked as though it had been. Id. at 222, 224-225, 285-286. They would have been further augmented by the fact that Carlson said he had inspected the tire itself for the first time the morning of his first deposition, and then only for a few hours. (His initial conclusions were based on photographs.) Id. at 180.

Moreover, prior to his first deposition, Carlson had issued a signed report in which he concluded that the tire had "not been . . . overloaded or underinflated," not because of the absence of "two of four" signs of abuse, but simply because "the rim flange impressions . . . were normal." Id. at 335-336. That report also said that the "tread depth remaining was 3/32 inch," id. at 336, though the opposing expert's (apparently undisputed) measurements indicate that the tread depth taken at various positions around the tire actually ranged from .5/32 of an inch to 4/32 of an inch, with the tire apparently showing greater wear along both shoulders than along the center, id. at 432-433.

Further, in respect to one sign of abuse, bead grooving, the expert seemed to deny the sufficiency of his own simple visual-inspection methodology. He testified that most tires have some bead groove pattern, that where there is reason to suspect an abnormal bead groove he would ideally "look at a lot of [similar] tires" to know the grooving's significance, and that he had not looked at many tires similar to the one at issue. Id. at 212-213, 214, 217.

Finally, the court, after looking for a defense of Carlson's methodology as applied in these circumstances, found no convincing defense. Rather, it found (1) that "none" of the Daubert factors, including that of "general acceptance" in the relevant expert community, indicated that Carlson's testimony was reliable, 923 F. Supp. at 1521; (2) that its own analysis "revealed no countervailing factors operating in favor of admissibility which could outweigh those identified in Daubert," App. to Pet. for Cert. 4c; and (3) that the "parties identified no such factors in their briefs," ibid. For these three reasons taken together, it concluded that Carlson's testimony was unreliable.

Respondents now argue to us, as they did to the District Court, that a method of tire failure analysis that employs a visual/tactile inspection is a reliable method, and they point both to its use by other experts and to Carlson's long experience working for Michelin as sufficient indication that that is so. But no one denies that an expert might draw a conclusion from a set of observations based on extensive and specialized experience. Nor does anyone deny that, as a general matter, tire abuse may often be identified by qualified experts through visual or tactile inspection of the tire. See Affidavit of H. R. Baumgardner 1-2, cited in Brief for National Academy of Forensic Engineers as Amici Curiae 16 (Tire engineers rely on visual examination and process of elimination to analyze experimental test tires). As we said before, supra, at 14, the question before the trial court was specific, not general. The trial court had to decide whether this particular expert had sufficient specialized knowledge to assist the jurors "in deciding the particular issues in the case." 4 J. McLaughlin, Weinstein's Federal Evidence P702.05[1], p. 702-33 (2d ed. 1998); see also Advisory Committee's Note on Proposed Fed. Rule Evid. 702, Preliminary Draft of Proposed Amendments to the Federal Rules of Civil Procedure and Evidence: Request for Comment 126 (1998) (stressing that district courts must "scrutinize" whether the "principles and methods" employed by an expert "have been properly applied to the facts of the case").

The particular issue in this case concerned the use of Carlson's two-factor test and his related use of visual/tactile inspection to draw conclusions on the basis of what seemed small observational differences. We have found no indication in the record that other experts in the industry use Carlson's two-factor test or that tire experts such as Carlson normally make the very fine distinctions about, say, the symmetry of comparatively greater shoulder tread wear that were necessary, on Carlson's own theory, to support his conclusions. Nor, despite the prevalence of tire testing, does anyone refer to any articles or papers that validate Carlson's approach. Compare Bobo, Tire Flaws and Separations, in Mechanics of Pneumatic Tires 636-637 (S. Clark ed. 1981); C. Schnuth et al., Compression Grooving and Rim Flange Abrasion as Indicators of Over-Deflected Operating Conditions in Tires, presented to Rubber Division of the American Chemical Society, Oct. 21-24, 1997; J. Walter & R. Kiminecz, Bead Contact Pressure Measurements at the Tire-Rim Interface, presented to Society of Automotive Engineers, Feb. 24-28, 1975. Indeed, no one has argued that Carlson himself, were he still working for Michelin, would have concluded in a report to his employer that a similar tire was similarly defective on grounds identical to those upon which he rested his conclusion here. Of course, Carlson himself claimed that his method was accurate, but, as we pointed out in Joiner, "nothing in either Daubert or the Federal Rules of Evidence requires a district court to admit opinion evidence that is connected to existing data only by the ipse dixit of the expert." 522 U.S. at 146.

Respondents additionally argue that the District Court too rigidly applied Daubert's criteria. They read its opinion to hold that a failure to satisfy any one of those criteria automatically renders expert testimony inadmissible. The District Court's initial opinion might have been vulnerable to a form of this argument. There, the court, after rejecting respondents' claim that Carlson's testimony was "exempted from Daubert-style scrutiny" because it was "technical analysis" rather than "scientific evidence," simply added that "none of the four admissibility criteria outlined by the Daubert court are satisfied." 923 F. Supp. at 1522. Subsequently, however, the court granted respondents' motion for reconsideration. It then explicitly recognized that the relevant reliability inquiry "should be 'flexible,'" that its "'overarching subject [should be] . . . validity' and reliability," and that "Daubert was intended neither to be exhaustive nor to apply in every case." App. to Pet. for Cert. 4c (quoting Daubert, 509 U.S. at 594-595). And the court ultimately based its decision upon Carlson's failure to satisfy either Daubert's factors or any other set of reasonable reliability criteria. In light of the record as developed by the parties, that conclusion was within the District Court's lawful discretion.

In sum, Rule 702 grants the district judge the discretionary authority, reviewable for its abuse, to determine reliability in light of the particular facts and circumstances of the particular case. The District Court did not abuse its discretionary authority in this case. Hence, the judgment of the Court of Appeals is

Reversed.

CONCURBY:

SCALIA

CONCUR:

JUSTICE SCALIA, with whom JUSTICE O'CONNOR and JUSTICE THOMAS join, concurring.

I join the opinion of the Court, which makes clear that the discretion it endorses- trial-court discretion in choosing the manner of testing expert reliability- is not discretion to abandon the gatekeeping function. I think it worth adding that it is not discretion to perform the function inadequately. Rather, it is discretion to choose among reasonable means of excluding expertise that is fausse and science that is junky. Though, as the Court makes clear today, the Daubert factors are not holy writ, in a particular case the failure to apply one or another of them may be unreasonable, and hence an abuse of discretion.

DISSENTBY:

STEVENS (In Part)

DISSENT:

JUSTICE STEVENS, concurring in part and dissenting in part.

The only question that we granted certiorari to decide is whether a trial judge "may . . . consider the four factors set out by this Court in Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579, 125 L. Ed. 2d 469, 113 S. Ct. 2786 (1993), in a Rule 702 analysis of admissibility of an engineering expert's testimony." Pet. for Cert. i. That question is fully and correctly answered in Parts I and II of the Court's opinion, which I join.

Part III answers the quite different question whether the trial judge abused his discretion when he excluded the testimony of Dennis Carlson. Because a proper answer to that question requires a study of the record that can be performed more efficiently by the Court of Appeals than by the nine Members of this Court, I would remand the case to the Eleventh Circuit to perform that task. There are, of course, exceptions to most rules, but I firmly believe that it is neither fair to litigants nor good practice for this Court to reach out to decide questions not raised by the certiorari petition. See General Electric Co. v. Joiner, 522 U.S. 136, 150-151, 139 L. Ed. 2d 508, 118 S. Ct. 512 (1997) (STEVENS, J., concurring in part and dissenting in part).

Accordingly, while I do not feel qualified to disagree with the well-reasoned factual analysis in Part III of the Court's opinion, I do not join that Part, and I respectfully dissent from the Court's disposition of the case.

638 F.Supp.2d 1277 (2009)

William A. LINTON and Stacy A. Linton, Plaintiffs,
v.
UNITED STATES of America, Defendant.

No. C08-227Z.

United States District Court, W.D. Washington, at Seattle.

July 1, 2009.

Cory L. Johnson, Darrell D. Hallett, John Mark Colvin, Cori E. Flanders-Palmer, Chicoine & Hallett, Seattle, WA, for Plaintiffs.

Jennifer D. Auchterlonie, Michael P. Hatzimichalis, U.S. Department of Justice, Washington, DC, for Defendant.

ORDER

THOMAS S. ZILLY, District Judge.

THIS MATTER comes before the Court on cross-motions for summary judgment. Having reviewed all papers filed in support of and in opposition to each motion, and having heard the arguments of counsel, the Court GRANTS the Government's motion for summary judgment, docket no. 19, DENIES plaintiffs' cross-motion for partial summary judgment, docket no. 21, and DIRECTS the Clerk to enter judgment consistent with this Order.

Background

Plaintiffs William and Stacy Linton seek a partial refund of gift taxes paid for the year 2003. For that year, William Linton reported taxable gifts of $725,548, while Stacy Linton reported taxable gifts of $724,000. *See* Exh. I to Linton Decl. (docket no. 23-10). The Internal Revenue Service ("IRS") examined both gift tax returns and concluded that, during the year 2003, William and Stacy Linton actually made taxable gifts of $1,587,988 and $1,520,440, respectively. *See* Exhs. A & B to Complaint (docket no. 1-2 at 29 & docket no. 1-3 at 29). The Lintons timely paid the additional gift taxes computed by the IRS, in the aggregate amount of $518,331.41, including interest, and in this action, they seek a refund of this additional amount, together with costs and attorney fees.

The gift taxes at issue relate to interests in a limited liability company given by William and Stacy Linton to trusts established for the benefit of their children. In November 2002, William Linton formed WLFB Investments, LLC ("WLFB LLC"). Certification of Formation, Exh. A to Linton Decl. (docket no. 23-2 at 20); *see*Limited Liability Company Agreement dated Nov. 7, 2002 [hereinafter "LLC Agreement"] at 1, 18, Exh. A to Linton Decl. (docket

no. 23-2 at 2, 19). At the time of formation, WLFB LLC had only one member, namely William Linton. LLC Agreement at 18, Exh. A to Linton Decl. (docket no. 23-2 at 19).

On January 22, 2003, William Linton gave to his wife Stacy Linton 50% of his percentage interests in WLFB LLC. Gift of Percentage Interest in WLFB Investments, LLC (docket no. 42).[1] [1] Also on January 22, 2003, William and/or Stacy Linton executed and dated the following documents, which contributed property to WLFB LLC:

- A Quit Claim Deed signed by William Linton, conveying undeveloped real property in Snohomish County, which was his separate property, to WLFB LLC; *see* Exh. D to Linton Decl. (docket no. 23-5);
- Letters signed by William Linton, authorizing transfers of securities, including municipal bonds, and cash to WLFB LLC; *see* Exh. D to Auchterlonie Decl. (docket no. 20-5); Exh. E to Linton Decl. (docket no. 23-6); and
- An Assignment of Assets signed by William Linton as Assignor and by both William and Stacy Linton as Managers of Assignee WLFB LLC; *see* Exh. F to Linton Decl. (docket no. 23-7); *see also* LLC Agreement at ¶ 6 (identifying William and Stacy Linton as Managers of WLFB LLC).

In addition, on January 22, 2003, William and Stacy Linton, as well as James Linton, William Linton's brother, signed a number of other documents, which they left undated. These executed, but contemporaneously undated, documents consist of:

- Four separate Trust Agreements signed by both William and Stacy Linton as Grantors, and by James Linton as Trustee, one Trust Agreement for each of the Lintons' four children, who are identified by initials as J.M.L., J.R.L., S.J.L., and T.W.L.; *see* Exh. E to Auchterlonie Decl. (docket no. 20-6);
- Four separate documents titled "Gift of Percentage Interest in WLFB Investments, LLC" signed by William Linton as Assignor and James Linton, Trustee, on behalf of Assignee, one document for each of the four Trusts; *see* Exh. G to Linton Decl. (docket no. 23-8); and
- Four separate documents titled "Gift of Percentage interest in WLFB Investments, LLC" signed by Stacy Linton as Assignor and James Linton, Trustee, on behalf of Assignee, one document for each of the four Trusts; *see,* Exh. G to Linton Decl. (docket no. 23-8).

Each of the Trust Agreements indicates that the Trust is irrevocable and that the Trust Agreement is "entered into effective upon contribution of property to the Trust." Exh. E to Auchterlonie Decl. (docket no. 20-6). The Trust Agreements further state that "[a]t the time of signing of this Agreement, the Grantors have transferred percentage interests in the WLFB Investments, LLC … to the Trustee of the Trust for the benefit of the Grantor's [sic] child." *Id.* Finally, the Trust Agreements reflect that the Trustee, James Linton, "acknowledges receipt of such property and agrees to administer all contributed property pursuant to the terms" of the Agreements. *Id.*

[1] This gift had no gift tax implications. *See* 26 U.S.C. § 2523(a).

The documents titled "Gift of Percentage Interest in WLFB Investments, LLC" (the "Gift Documents") contain the following language: Assignor "hereby gifts to the … Trust, dated the same date hereof, (the "Assignee") a total of 11.25 of the percentage interests in WLFB Investments, LLC … standing in his respective name on the books of the Company." Exh. G to Linton Decl. (docket no. 23-8). Based on this language, each of the four Trusts received 11.25% from each parent, for a total of 22.5 of the percentage interests in WLFB LLC for each Trust.

According to Richard Hack, the attorney who prepared the various documents, a few months after the transactions at issue, when he was preparing the minute book for WLFB LLC, he filled in the missing dates on the Trust Agreements and Gift Documents. Hack Dep. at 13:12-17:1, Exh. B to Colvin Decl. (docket no. 22-3 at 4-8). He put the date of January 22, 2003, on these documents, but he now believes that he made a "mistake" in doing so and that the intended date for the creation of the Trusts and the transfers of percentage interests in WLFB LLC to the Trusts was January 31, 2003. Hack Dep. at 20:18-23:12, Exh. B to Colvin Decl. (docket no. 22-3 at 9-12).

Mr. Hack's deposition testimony is consistent with that of Caryl Thorp, who provided estate planning and tax compliance services for the Lintons. *See* Thorp Dep. at 18:23-19:5, Exh. C to Colvin Decl. (docket no. 22-4 at 6-7). According to Ms. Thorp, the intended order of the transactions was as follows: "To form the LLC, transfer the assets into the LLC, and then determine the amount of any gifts they wanted to make of LLC units for the benefit of their children and do those after that." Thorp Dep. at 20:6-9, Exh. C to Colvin Decl. (docket no. 22-4 at 8). Ms. Thorp explained that this sequence was required "[b]ecause you have to get the assets into the LLC first so it's the owner of the assets before you start making transfers of units in the LLC." Thorp Dep. at 20:12-14, Exh. C to Colvin Decl. (docket no. 22-4 at 8).

When asked in his deposition how he decided on the amount of assets he would transfer to WLFB LLC, William Linton testified as follows:

> Well, it started out Stacy and I were using our lifetime exemptions, and somewhere along the way, with my team of experts, they came up with this thing that people do in my situation and they discount it because as managers, we control it, and what a willing buyer will pay to a willing seller, who is going to buy a hundred percent of someone's share if they can't touch it or feel it or control it, so there's some proven way that they go out and they discount this stuff. Well, it was news to me…. They said somewhere between 40 and 49 percent discounting based on the blend of assets that you're proposing. So, based on that, I just did some back math to figure out how much money to put into the LLC.

Linton Dep. at 26:6-23, Exh. B to Auchterlonie Decl. (docket no. 20-3).

The tax return filed on behalf of WLFB LLC for the calendar year 2003 provided the following information about the capital accounts of the LLC members:

member	capital contributed	income	withdrawals	capital balance

1	$1,792,386	$ 5,793	$1,613,148	$185,031
2	$1,792,386	$ 5,793	$1,613,148	$185,031
3	$ 806,574	$26,070		$832,644
4	$ 806,574	$26,071		$832,645
5	$ 806,574	$26,067		$832,641
6	$ 806,574	$26,070		$832,644

See Schedule L to Form 1065 for 2003, Exh. J-1 to Linton Decl. (docket no. 23-11 at 15). Members 1 and 2 are William and Stacy Linton, while Members 3, 4, 5, and 6 are the Trusts for the Linton children. Schedule L reflects contributions of assets in the aggregate amount of $3,584,772, and transfers of capital in the aggregate amount of $3,226,296, divided evenly among the four Trusts, with each Trust receiving $806,574. The capital account balances shown in Schedule L appear consistent with the percentage interests held by each member after the gifts at issue, namely 5% for William Linton, 5% for Stacy Linton, and 22.5% for each of the Trusts.[2]

The LLC Agreement places certain restrictions on the transfer of percentage interests to persons who are not family members, and it limits the involvement of members in the day-to-day business of the LLC, reserving to the Managers (William and Stacy Linton) all "authority or power to act" for WLFB LLC. LLC Agreement at ¶¶ 6.5, 9.1, 9.2, 9.2.1., 9.2.2., & 9.2.3 (docket no. 23-2 at 4-5, 8-10). In light of these provisions, in computing their gift taxes for the year 2003, plaintiffs applied a discount of 47% based on the theory that the limitations on alienability and non-controlling status rendered the percentage interests in WLFB LLC unmarketable. *See* Exh. 5 to Moss Adams Advisory Services Appraisal Report for WLFB LLC, Exh. H to Linton Decl. (docket no. 23-9 at 39) [hereinafter "Moss Adams Report"]. The Government contends that any discounting is improper.

Discussion

A. *Standard for Summary Judgment*

The Court should grant summary judgment if no genuine issue of material fact exists and the moving party is entitled to judgment as a matter of law. Fed. R.Civ.P. 56(c). The moving

[2] The tax return for WLFB LLC indicates that the business started on January 31, 2003. *See* Exh. J-1 to Linton Decl. (docket no. 23-11). This date is inconsistent with the Certificate of Formation for WLFB LLC, which was filed by the Washington Secretary of State on November 7, 2002, *see* Exh. A to Linton Decl. (docket no. 23-2 at 21); *see also* RCW 25.15.070(2)(a) ("a limited liability company is formed when its certificate of formation is filed by the secretary of state"), as well as with the Assignment of Assets signed by William Linton and Stacy Linton as Managers of WLFB LLC, which is dated January 22, 2003, and thereby manifests the conducting of business before the date indicated on the tax return, *see* Exh. F to Linton Decl. (docket no. 23-7). The tax return itself, which was prepared by Moss Adams LLP, is dated March 29, 2004, and it does not constitute contemporaneously prepared evidence as to the sequence of the transactions resulting in the capital account balances disclosed in Schedule L.

party bears the initial burden of demonstrating the absence of a genuine issue of material fact. *Celotex Corp. v. Catrett,* 477 U.S. 317, 323, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). A fact is material if it might affect the outcome of the suit under the governing law. *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). When a properly supported motion for summary judgment has been presented, the adverse party "may not rely merely on allegations or denials in its own pleading." Fed.R.Civ.P. 56(e). Rather, the non-moving party must set forth "specific facts" demonstrating the existence of a genuine issue for trial. *Id.; Anderson,* 477 U.S. at 256, 106 S.Ct. 2505. All "justifiable inferences" are to be drawn in favor of the non-moving party. *Anderson,* 477 U.S. at 255, 106 S.Ct. 2505. When the record, however, taken as a whole, could not lead a rational trier of fact to find for the non-moving party, summary judgment is warranted. *See Miller v. Glenn Miller Prod. Inc.,* 454 F.3d 975, 988 (9th Cir. 2006).

B. *Federal Gift Tax Analysis*

A tax is imposed "for each calendar year on the transfer of property by gift during such calendar year by any individual." 26 U.S.C. § 2501(a)(1). If property is transferred for less than adequate and full consideration, then "the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift." 26 U.S.C. § 2512(b). The value of gifted property is determined as of the date of the gift. 26 U.S.C. § 2512(a). A gift is measured "by the value of the property passing from the donor, rather than by the [value of the] property received by the donee," and the amount of a gift is generally an issue of fact. *Shepherd v. Comm'r,* 115 T.C. 376, 383, 2000 WL 1595698 (2000). A gift is complete when the donor "has so parted with dominion and control as to leave in him no power to change its disposition." 26 C.F.R. § 25.2511-2(b). Although federal revenue acts identify the property interests and rights that are taxed, state law governs the creation of those property interests and rights. *Morgan v. Comm'r,* 309 U.S. 78, 80, 60 S.Ct. 424, 84 L.Ed. 585, 1035 (1940).

The gift tax applies "whether the transfer is in trust or otherwise" and "whether the gift is direct or indirect." 26 U.S.C. § 2511(a). An example of an indirect gift is a transfer of property for less than adequate consideration to a corporation, which constitutes an indirect gift of the property to each shareholder of the corporation to the extent of his or her proportionate interest in the corporation. *Shepherd,* 115 T.C. at 388 (citing 26 C.F.R. § 25.2511-1(h)(1)). Because the corporate structure differs from a partnership relationship, the question whether a contribution of property to a partnership is an indirect gift to the partners requires further analysis. In situations in which property has been transferred for less than adequate consideration to a partnership, the distinguishing factor for gift tax purposes is whether the donating partner's contribution of property was apportioned among the other partners or was attributed only to the donor's own capital account. In the former circumstance, the contribution of property has been deemed an indirect gift to the other partners, *see Shepherd,* 115 T.C. at 388-89, while in the latter situation, the transfer has been held not to constitute an indirect gift, *see Estate of Jones v. Comm'r,* 116 T.C. 121, 2001 WL 233964 (2001) (citing *Estate of Strangi v. Comm'r,* 115 T.C. 478, 2000 WL 1755274 (2000)); *see also Gross v. Comm'r,* 96 T.C.M. (CCH) 187, 2008 WL 4388277 (2008).

1. *Indirect Gift to Partners (Shepherd)*

In *Shepherd,* the taxpayer and his wife executed deeds purporting to transfer certain leased land to a partnership, the partnership agreement for which the taxpayer signed on the same day. 115 T.C. at 379, 382. The following day, the taxpayer's two adult sons executed the partnership agreement. *Id.* at 379. The Tax Court concluded that, under the law of the state in which the partnership was created, the partnership came into existence on the second day, when the sons signed the partnership agreement. *Id.* at 384-85. As a result, the Tax Court held that the conveyance of land occurred on the second day, not on the first day. *Id.* at 385 (on the first day, "there was no completed gift, because there was no donee, and petitioner had not parted with dominion and control over the property"). On a subsequent day, the taxpayer contributed bank stock to the partnership. *Id.* at 381. The Tax Court ultimately held that the taxpayer's transfers of both land and bank stock represented indirect gifts to each of his sons to the extent of their respective percentage interests in the partnership. *Id.* at 389. The Tax Court reasoned that, because the contributions of property were allocated, pursuant to the partnership agreement, to the taxpayer's and his sons' capital accounts according to their respective partnership shares, and because each son would be entitled upon dissolution of the partnership to receive payment of the balance in his capital account, the taxpayer had made indirect gifts to the sons. *Id.*

2. *Contributions to Own Capital Account (Jones and Gross)*

In contrast, in both *Estate of Jones* and *Gross,* one partner's contributions were not treated as indirect gifts to the other partners. In *Estate of Jones,* the decedent formed two different partnerships under Texas law. 116 T.C. at 123-24. The first partnership, Jones Borregos Limited Partnership ("JBLP"), was with his son, and the second partnership, Alta Vista Limited Partnership ("AVLP"), was with his four daughters. *Id.* Both decedent and his son transferred certain property to JBLP, with the contributions reflected in their respective capital accounts. *Id.* at 123. Decedent and each of his daughters transferred certain property to AVLP, with the contributions reflected in their respective capital accounts. *Id.* at 124.

On the same day the partnerships were formed and property was contributed, decedent gave his son an 83.08% limited interest in JBLP, and he gave each of his daughters a 16.915% limited interest in AVLP. *Id.* at 123-25. Decedent filed a federal gift tax return in which he applied a 66% percent discount to the limited interests in JBLP and a 58% discount to the limited interests in AVLP, pursuant to a "minority interest, nonmarketable" theory. *Id.* at 127. The Tax Court concluded that, in making contributions to each of the partnerships, decedent had not made indirect gifts to his children because he had received continuing limited partnership interests in exchange for the property at issue, his contributions had been properly reflected in his respective capital accounts, and the value of the other partners' interests had not been enhanced by his contributions. *Id.* at 128.

In *Gross,* the Tax Court found that the contributions of property were "similar in form to the contributions in *Estate of Jones*" and were "distinguishable in form from the gifts in *Shepherd.*" 2008 WL 4388277 at *7. The Tax Court concluded that the taxpayer, who had

formed a partnership with her two daughters, "made a series of contributions of securities to Dimar [Holdings L.P.] and received increasing partnership interests in return. All of the contributions were reflected in her capital account, and the value of her daughters' capital accounts was not enhanced because of her contributions. After she contributed the ... securities to the partnership, she made gifts of [additional] interests in the partnership to her daughters.... [The taxpayer] made gifts of interests in Dimar to her daughters and did not make indirect gifts of portions of the ... securities that she had contributed to the partnership." *Id.*

3. *Uncertain Sequence of Events (Senda)*

Two important facts distinguish *Shepherd* from both *Estate of Jones* and *Gross.* First, in *Shepherd,* when property was contributed to the partnership, it was allocated among the partners according to their share of the partnership, whereas in *Estate of Jones* and *Gross,* the transferred property was attributed solely to the donor's capital account. Second, in *Shepherd,* no subsequent gift of partnership interests was involved, whereas in *Estate of Jones* and *Gross,* after the contributed property had been reflected in the donor's account, the donor gave interests in the partnership to the other partners. This sequence of activities, namely first creating the partnership, then contributing property to the partnership (and ascribing it to the taxpayer's own capital account), and finally making a gift of partnership interests, has been described as "critical" in evaluating the tax consequences of the transactions. *See* Senda v. Comm'r, 433 F.3d 1044, 1046 (8th Cir.2006).
In *Senda,* however, the taxpayers did not present "reliable evidence that they contributed the stock to the partnerships before they transferred the partnership interests to the children." *Id.* Absent adequate proof of the chronology of events, the transactions in *Senda* were deemed to mirror those in *Shepherd;* the taxpayers were treated as having gifted partnership interests to their children before transferring property to the partnership, and the contributed property was therefore held to have enhanced the children's partnership interests and constituted an indirect gift to each child. *See* Senda v. Comm'r, T.C.M. (RIA) 2004-160, 2004 WL 1551275, *aff'd,* 433 F.3d 1044 (8th Cir.2006).

4. *Oral Testimony Is Insufficient*

In this case, the Government relies heavily on *Senda* and contends that the sequence of events here was equally uncertain. The various documents, contributing property to WLFB LLC, creating Trusts for each child, and giving each Trust percentage interests in the LLC, were all signed on the same day, January 22, 2003. Although the Trust Agreements and Gift Documents were not dated when executed, they were eventually given the date of January 22, 2003. The Membership Interest Ledger for the LLC shows the transfers of percentage interests from William to Stacy Linton, and from William and Stacy Linton to each of the four Trusts; however, the Ledger does not indicate the dates of these transfers. *See* Exh. K to Linton Decl. (docket no. 23-13); *compare Senda,* 2004 WL 1551275 at *6 (noting that the taxpayers "did not maintain any books or records for the partnerships other than brokerage account statements and partnership tax returns"). In addition, although the

letters directing U.S. Bancorp Piper Jaffray[3] to transfer securities to WLFB LLC were signed and dated on January 22, 2003, they were not received by U.S. Bancorp Piper Jaffray until January 24, 2003, and the instructions were not followed until after the date of receipt. *See* Exh. D to Auchterlonie Decl. (docket no. 20-5); *see also* Exhs. M-Q to Auchterlonie Decl. (docket nos. 20-14, 20-15, 20-16, 20-17, & 20-18) (indicating that Mr. Linton's requested inter-account transfers did not occur until January 24, 2003, at the earliest, and as late as January 31, 2003). The Quit Claim Deed conveying real property in Snohomish County to WLFB LLC was dated and delivered to the Lintons' attorney on January 22, 2003, but it was not recorded until February 13, 2003. The parties, however, agree that this transfer was effective on the date the deed was executed and delivered, not on the date it was recorded. Plaintiffs' Response at 12 (docket no. 25); Government's Reply at 5 (docket no. 29).

In connection with their attempt to establish a chronology of transfers having favorable tax consequences, plaintiffs ask the Court to consider transcripts from the depositions of William Linton, Richard Hack, and Caryl Thorp. The Government contends that this oral testimony is either inadmissible or insufficient, citing an unpublished decision of the Ninth Circuit for the proposition that a taxpayer's claim for refund "must be substantiated by something other than tax returns, uncorroborated oral testimony, or self-serving statements." *Lovelace v. United States,* 1991 WL 275375 at *1 (9th Cir.) (quoting *Mays v. United States,*763 F.2d 1295, 1297 (11th Cir.1985)). The Government also references a tax regulation indicating that the applicability of the gift tax should be "based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor." 26 C.F.R. § 25.2511-1(g)(1).

The Court is persuaded that plaintiffs may offer parol evidence concerning the Trust Agreements and Gift Documents, but concludes that such testimony does not aid plaintiffs in their efforts to obtain a tax refund. The Court is aware of no authority that would preclude the Lintons from testifying they did not place the dates on the Trust Agreements and Gift Documents, or that would bar their attorney from indicating he filled in those dates. Moreover, no evidentiary or tax rule has been cited that would prohibit plaintiffs from proffering evidence about their intent or "state of mind" in connection with these transactions. *See Trucks, Inc. v. United States,* 234 F.3d 1340, 1342 (11th Cir.2000) ("evidence about the state of mind of the [taxpayer] ... is considered direct evidence as to the reasonableness of her decisions, and will not be seen as merely self-serving statements"). Finally, because plaintiffs, as the non-moving party, are entitled to have all reasonable inferences drawn in their favor, for purposes of the Government's summary judgment motion, the Court will treat the deposition testimony at issue as admissible evidence. *See* Fed.R.Civ.P. 56(e)(1) (affidavits supporting or opposing a summary judgment motion must "set out facts that would be admissible in evidence").

Plaintiffs' parol evidence, however, does not prove the sequence of events that they assert in this litigation, and thus, whether or not the Court considers the parol evidence, the result is the same.[4] Each Trust Agreement indicates that it is effective upon contribution of

[3] In his declaration, William Linton describes letters also directing RBC Dain Rauscher to transfer certain assets to WLFB LLC, but the record contains no such documents. *See* Linton Decl. at ¶¶ 12 & 15 and Exh. E.

[4] To be clear, the various subsequently prepared documents in this case do not serve as reliable evidence of plaintiffs' intent. *See Senda,* 433 F.3d at 1047 (the tax returns and certificates of ownership

property to the Trust, and that, at the time of its signing, property consisting of interests in WLFB LLC had been transferred to the Trustee. *See* Exh. E to Auchterlonie Decl. (docket no. 20-6). In turn, in executing each Trust Agreement, the Trustee "acknowledge[d] receipt of such property." *Id.*In addition, the Gift Documents each recite that the respective Trusts are "dated the same date hereof." Exh. G to Linton Decl. (docket no. 23-8). Thus, the express language of these documents establishes that the Trusts were created and the gifts were made on January 22, 2003; on that date, when the Trust Agreements were signed, percentage interests in WLFB LLC had already been or were contemporaneously gifted to the Trusts, thereby making the Trusts effective.

Plaintiffs seek to reform the Trust Agreements and Gift Documents to reflect that both the creation of the Trusts and the gifting to the Trusts occurred on January 31, 2003. They cite to Washington cases describing the circumstances under which a written instrument may be reformed, including to correct a scrivener's error, due to mutual mistake, or as a result of unilateral mistake caused by fraud or other inequitable conduct. *See Wilhelm v. Beyersdorf,* 100 Wash.App. 836, 843-44, 999 P.2d 54 (2000); *Reynolds v. Farmers Ins. Co.,* 90 Wash.App. 880, 884-85, 960 P.2d 432 (1998); *Snyder v. Peterson,* 62 Wash.App. 522, 526-29, 814 P.2d 1204 (1991). Plaintiffs, however, fail to present any evidence to justify the reformation they desire. The proffered testimony proves only that the Lintons did not date the Trust Agreements or the Gift Documents and that the dates on those documents are in Mr. Hack's handwriting. At most, this evidence establishes only a scrivener's error with respect to the date; it does not demonstrate any scrivener's error[5] in the written terms of the documents. Those terms explicitly indicate that the gifting to the Trusts occurred before or with the signing of the Trust Agreements, which undisputedly took place on January 22, 2003. Plaintiffs cannot via parol evidence contradict or modify the express language of the Trust Agreements or the Gift Documents. *Hearst Commc'ns, Inc. v. Seattle Times Co.,*154 Wash.2d 493, 504, 115 P.3d 262 (2005) (Washington courts "do not interpret what was intended to be written but what was written" (clarifying the holding of *Berg v. Hudesman,* 115 Wash.2d 657, 801 P.2d 222 (1990))).

Moreover, plaintiffs have offered no theory under which the Trust Agreements and Gift Documents would have been rendered void or voidable had they never been dated. At oral argument, however, counsel for plaintiffs suggested that the Trusts could not have been

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generated months or weeks later were "unreliable in deciding whether petitioners transferred the partnership interest to the children before or after they contributed the stock to the partnerships" (quoting *Senda,* 2004 WL 1551275 at *6)). For example, the Membership Interest Ledger for WLFB LLC, which was prepared a few months after the transactions at issue, contains no dates and offers no information concerning the sequence of events. *See* Exh. K to Linton Decl. (docket no. 23-13). Likewise, the Moss Adams Report provides no useful data, but rather makes assumptions about the transactions that occurred approximately six months before the report was generated. *See* Exh. H to Linton Decl. (docket no. 23-9). Finally, the tax return for WLFB LLC was filed over a year after events, *see* Exh. J-1 to Linton Decl. (docket no. 23-11), and it does not constitute contemporaneous evidence of plaintiffs' intent.

[5] Plaintiffs do not appear to challenge the Trust Agreements or Gift Documents on the basis of any unilateral mistake generated by fraudulent conduct. At oral argument, counsel for plaintiffs clarified that the mutual mistake doctrine is likewise not alleged as a ground for reformation because the documents at issue convey a gift. In response or perhaps as an addendum, the Government asserted that the failure to join Trustee James Linton as a party was fatal to plaintiffs' request for reformation and that the Court lacks subject matter jurisdiction to grant such relief because it would only flow from state law claims beyond the scope of the Government's waiver of sovereign immunity. In light of its ruling in this matter, the Court need not address either of these contentions.

effective on January 22, 2003, because no trust res existed on that date. This contention is flawed. Although a voluntary trust requires "subject matter" or res to be valid, *e.g., Laughlin v. March,* 19 Wash.2d 874, 878, 145 P.2d 549 (1944), any type of property may be held in trust, including undivided, reversionary, executory, or contingent future interests, remainders (whether contingent, vested, or vested subject to being divested), and choses in action, *see* Restatement (Third) of Trusts § 40 cmt. b (2003). In this case, the res consisted of percentage interests in WLFB LLC, which existed and were contributed to the Trusts at or before the signing of the Trust Agreements on January 22, 2003.

In addition, the percentage interests had value because, as of January 22, 2003, WLFB LLC had both real and personal property. The parties agree that the conveyance of undeveloped real estate in Snohomish County was effective on January 22, 2003, when Mr. Linton signed the Quit Claim Deed. Plaintiffs also contend that the transfer of securities was effective on January 22, 2003, when Mr. Linton executed the Assignment of Assets in favor of WLFB LLC. Although plaintiffs make this argument for another reason, namely in an effort to show that the contribution of securities to the LLC occurred prior to the gifts of LLC interests to the Trusts, having advanced this position, plaintiffs will not be heard to challenge whether WLFB LLC had assets, or whether percentage interests in WLFB LLC constituted adequate trust res, on January 22, 2003.

On their claim for tax refund, plaintiffs bear the burden of proof.[6] *See Helvering v. Taylor,* 293 U.S. 507, 515, 55 S.Ct. 287, 79 L.Ed. 623 (1935). They have not met this burden. They have not demonstrated the existence of any genuine issue for trial, and they have not refuted the appropriateness of treating the transactions in question as indirect gifts to the children's Trusts of the assets of WLFB LLC. The Court concludes, as a matter of law, that the Trusts were valid and irrevocable on January 22, 2003, regardless of what date, if any, was placed on the Trust Agreements. The Court also concludes that the gifts of percentage interests in WLFB LLC were made on January 22, 2003, regardless of what date, if any, was placed on the Gift Documents. In addition, the Court is satisfied that the percentage interests in WLFB LLC constituted sufficient trust res. Because the Trusts were created, and gifts of LLC interests were made to the Trusts, on January 22, 2003, either before or simultaneously with the contribution of property to WLFB LLC, the Court holds that this case is analogous to both *Shepherd* and *Senda,* and that the Lintons' transfers of real estate, cash, and securities enhanced the LLC interests held by the children's Trusts, thereby constituting indirect gifts to the Trusts of pro rata shares of the assets conveyed to the LLC.

[6] Plaintiffs incorrectly suggest that the burden of proof has shifted to the Government pursuant to 26 U.S.C. § 7491(a), which provides that, "[i]f ... a taxpayer introduces credible evidence with respect to any factual issue..., the Secretary shall have the burden of proof with respect to such issue" so long as the taxpayer has satisfied certain prerequisites, including cooperation with the IRS. Plaintiffs have not identified any factual issue on which the Government should bear the burden of proof. Indeed, at oral argument, counsel for plaintiffs conceded that the matter before the Court involves only questions of law. Thus, the burden-shifting provision of the tax code has no relevance to this case. *See Calvert v. Comm'r,* T.C. Summ.Op. 2007-7, 2007 WL 105129 at *1 n. 1 ("Since this case involves only a question of law, sec. 7491 is not applicable here."); *see also Ayres v. Comm'r,* T.C. Summ.Op. 2007-4, 2007 WL 54098 at *1 n. 1 ("The facts are not in dispute, and the issue is a question of law; therefore, with respect to the burden of proof, the Court need not address the applicability of sec. 7491." (citing *Higbee v. Comm'r,* 116 T.C. 438, 2001 WL 617230 (2001))).

5. *Step Transaction Doctrine*

The Court also finds persuasive the Government's alternative theory that, even if plaintiffs could establish the proper sequence of events, namely funding the LLC before gifting interests in it, they nevertheless made indirect gifts to their children's Trusts under the step transaction doctrine. The step transaction doctrine "treats a series of formally separate `steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result." *Penrod v. Comm'r,* 88 T.C. 1415, 1428, 1987 WL 49335 (1987). Taxation is concerned more with the substance of a transaction than with its mere form. *Cal-Maine Foods, Inc. v. Comm'r,* 93 T.C. 181, 197, 1989 WL 87697 (1989). Although a taxpayer has the right to minimize taxes as far as the law will allow, a taxpayer may not "through form alone achieve tax advantages which substantively are without the intent of the statute." *Id.; see also id.* at 197-98 ("A given result at the end of a straight path is not made a different result because reached by following a devious path." (quoting *Minn. Tea Co. v. Helvering,* 302 U.S. 609, 613, 58 S.Ct. 393, 82 L.Ed. 474 (1938))). Accordingly, when "a taxpayer has embarked on a series of transactions that are in substance a single, unitary, or indivisible transaction, the courts have disregarded the intermediary steps and have given credence only to the completed transaction." *Id.* at 198.

Whether a series of transactions should be "stepped" together and treated as a single transaction generally constitutes a question of fact. *Senda,* 433 F.3d at 1048; *Cal-Maine Foods,* 93 T.C. at 198. The proper characterization of a transaction for tax purposes, however, is an issue of law. *Senda,* 433 F.3d at 1048. No specific standard has been universally applied in assessing whether a number of separate steps or activities should be viewed as comprising one transaction; however, courts have generally used one of three alternative tests: (i) the "binding commitment" test; (ii) the "end result" test; and (iii) the "interdependence" test. *Holman v. Comm'r,* 130 T.C. 170, 187-88, 2008 WL 2189089 (2008); *see Cal-Maine Foods,* 93 T.C. at 198-99; *see also Santa Monica Pictures, LLC v. Comm'r,*89 T.C.M. (CCH) 1157, 2005 WL 1111792 at *80-*81 (2005).

The binding commitment test, which is the narrowest alternative, collapses a series of transactions into one "if, at the time the first step is entered into, there was a binding commitment to undertake the later step." *Penrod,* 88 T.C. at 1429. The end result test stands at the other extreme and is the most flexible standard, asking whether the "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result." *Id.*The interdependence test inquires whether, "on a reasonable interpretation of objective facts," the steps were "so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series" of transactions. *Cal-Maine Foods,* 93 T.C. at 199; *Penrod,* 88 T.C. at 1430. The interdependence test focuses on the relationships between the steps, rather than on their end result. *Penrod,* 88 T.C. at 1430. The question is whether "any one step would have been undertaken except in contemplation of the other integrating acts." *Cal-Maine Foods,* 93 T.C. at 199.

Regardless of which of these three alternative tests is applied, plaintiffs made "stepped" indirect gifts to their children's Trusts of the assets they contributed to WLFB LLC. The binding commitment test is met because plaintiffs executed binding Trust Agreements and Gift Documents at the same time they took the first step of contributing property to the LLC;

as counsel for plaintiffs conceded during oral argument, these documents would have been valid after signing had they never been dated. The end result test is likewise satisfied because plaintiffs undisputedly had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability, pursuant to which they crafted, with the aid of an attorney and a tax advisor, a scheme consisting of "pre-arranged parts of a single transaction." *Penrod,* 88 T.C. at 1429. The pre-arrangement is most apparent in Mr. Linton's explanation for why he did not date the Gift Documents, namely in an effort to ensure, for tax purposes, that U.S. Bancorp Piper Jaffray completed the transfers of securities before the gifts became effective. *See,* Linton Dep. at 37:13-38:16, Exh. A to Colvin Decl. (docket no. 22-2). In addition, the interdependence test is met because the undisputed evidence demonstrates that plaintiffs would not have undertaken one or more of the steps at issue absent their "contemplation of the other integrating acts." *Cal-Maine Foods,*93 T.C. at 199. But for the anticipated 40% to 49% discount in calculating gift taxes, premised on the low market appeal of WLFB LLC's structure, plaintiffs would not have contributed assets to the LLC. Indeed, the quantum of property transferred to WLFB LLC was determined solely on the basis of maximizing the tax advantages of the transaction. *See* Linton Dep. at 26:6-23, Exh. B to Auchterlonie Decl. (docket no. 20-3). Because the events here satisfy all three of the step transaction tests, the Court need not choose among the different standards, and the Court holds as a matter of law that, under the step transaction doctrine, plaintiffs made gifts to their children's Trusts of pro rata shares of the assets they contributed to WLFB LLC. Although the applicability of the step transaction doctrine has been described as generally an issue of fact, in this case, no purpose would be served by deferring to trial the legal analysis of the undisputed evidence.

This case is distinguishable from two recent cases in which the Tax Court concluded that the step transaction doctrine did not apply. *See Holman v. Comm'r,*130 T.C. 170, 2008 WL 2189089 (2008); *see also Gross v. Comm'r,* 96 T.C.M. (CCH) 187, 2008 WL 4388277 (2008). In *Holman,* the taxpayers, husband and wife, on the sixth day after the formation and funding of a limited partnership, made gifts of limited partnership shares ("LP units") to a trust for the benefit of their children. 130 T.C. at 174-79. The partnership had been funded with stock in Dell Computer Corporation ("Dell"). *Id.* at 172, 175. The Tax Court, observing that "the passage of time may be indicative of a change in circumstances that gives independent significance to a partner's transfer of property to a partnership and the subsequent gift of an interest in that partnership to another," *id.* at 189, examined the historical prices of Dell stock and concluded that the value of an LP unit changed over time due to its correlation with the worth of Dell stock, which dropped 1.316% during the six days at issue. *Id.* at 189-91. The Tax Court found that, during the six days between funding the partnership and gifting the LP units, the taxpayers bore a "real economic risk" that the value of an LP unit could change, and thus, the Tax Court refused to disregard the passage of time or to treat the contributions to the partnership and the subsequent gifts as occurring simultaneously pursuant to the step transaction doctrine. *Id.*

The facts of *Gross* are similar to those of *Holman.* In *Gross,* the taxpayer and her daughters formed a limited partnership into which they each contributed a small amount of cash, which was reflected in their respective capital accounts. 2008 WL 4388277 at *1-*2. Over the course of three months following the formation of the partnership, the taxpayer transferred various securities to the partnership, each time receiving credit for the contributions on her capital account. *Id.* at *2, *7. The last of these transfers occurred eleven days before the

taxpayer gave each daughter, by way of a "Deed of Gift," a 22.25% limited interest in the partnership. *Id.* In *Gross,* the Tax Court cited to *Holman* as support for its decision that the step transaction doctrine did not apply, focusing on the passage of eleven days between the last transfer of securities and the gifts of partnership interests, as well as on the status of the securities at issue as "common shares of well-known companies." *Id.* at *7-*8. The Tax Court in *Gross* concluded that "[t]he form of the transactions ... accords with their substance." *Id.* at *8.

The case before this Court bears little resemblance to either *Holman* or *Gross.* In contrast to the taxpayers in *Holman* and *Gross,* plaintiffs here did not make affirmative decisions to delay the gifts for some period of time after funding. Rather, with the benefit of hindsight, knowing the date on which U.S. Bancorp Piper Jaffray completed the last transfer of assets to WLFB LLC, plaintiffs devised the passage of time between funding and gifting that would have favorable tax consequences. Moreover, unlike in *Holman,* in this case, plaintiffs have submitted no data concerning the fluctuations, if any, in the prices of the various securities at issue on a daily basis during the period in question. On this subject, the Government contends that, with regard to the bulk of the assets in question, consisting of real property worth approximately $650,000, cash in the amount of $843,724, and municipal bonds valued at roughly $1.54 million, plaintiffs cannot show the volatility necessary to establish a real economic risk associated with the passage of less than ten days. *See,* Exh. 1 to Moss Adams Report (docket no. 23-9 at 35); Exh. E to Linton Decl. (docket no. 23-6); Exh. M to Auchterlonie Decl. (docket no. 20-14). Given the nature of the assets and the dearth of evidence in the record to suggest any real economic risk during the alleged interim between funding the LLC and gifting interests in it, the Court is satisfied that neither *Holman* nor *Gross* raise any doubt concerning the applicability of the step transaction doctrine in this case.

Conclusion

Plaintiffs have raised no genuine issue of material fact concerning their subjective intent, the contemplated sequence of transactions, or the way in which events actually unfolded. On January 22, 2003, plaintiffs executed documents and transferred property in a manner that, as a matter of law, constituted indirect gifts to their children. *See Senda v. Comm'r,* 433 F.3d 1044 (8th Cir.2006). These actions also, as a matter of law, satisfy the step transaction doctrine. *See Penrod v. Comm'r,* 88 T.C. 1415, 1987 WL 49335 (1987). The Court therefore GRANTS summary judgment in favor of the Government and DISMISSES plaintiffs' complaint with prejudice.

IT IS SO ORDERED.

The Clerk is directed to enter judgment consistent with this Order and to send a copy of this Order to all counsel of record.

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

WILLIAM A. LINTON; STACY A. LINTON, *Plaintiffs-Appellants,* v. UNITED STATES OF AMERICA, *Defendant-Appellee.*	No. 09-35681 D.C. No. 2:08-cv-00227-TSZ OPINION

Appeal from the United States District Court
for the Western District of Washington
Thomas S. Zilly, Senior District Judge, Presiding

Argued and Submitted
August 4, 2010—Seattle, Washington

Filed January 21, 2011

Before: John T. Noonan, David R. Thompson and
Marsha S. Berzon, Circuit Judges.

Per Curiam Opinion

COUNSEL

Cory L. Johnson, Seattle, Washington, for the appellants.

Jonathan S. Cohen, Department of Justice, Washington, D.C., for the appellee.

OPINION

PER CURIAM:

Taxpayers William A. Linton and Stacy A. Linton appeal the district court's grant of summary judgment in favor of the United States on their claim for a refund of 2003 federal gift taxes. The Lintons contend that they gifted interests in a limited liability company ("LLC"); the government contends that they gifted cash, securities, and real property. We have jurisdiction under 28 U.S.C. § 1291, and we reverse and remand for further proceedings.

The parties have assumed that in determining the character of the Lintons' gifts, the sequencing of two transactions is "critical," *Senda v. Comm'r*, 433 F.3d 1044, 1046 (8th Cir. 2006), and we do so too, without deciding whether that is always so in cases of this ilk. The transactions at issue are: (1) the contribution of cash, securities, and real property to the limited liability company, and (2) the transfer of LLC interests to the Lintons' children's trusts. If done in that order (and with some lapse of time between the transactions), as the Lintons contend occurred here, the gifts would ordinarily be characterized as gifts of LLC interests, and the value of those LLC interests might be discountable for tax purposes. If, however, the contributions to the LLC occurred *after* the transfer of LLC interests to the children's trusts, the gifts would ordinarily be characterized as indirect gifts of the particular contributed assets and would not be discountable. *See id.*

BACKGROUND

William A. Linton formed WLFB Investments, LLC ("WLFB"), a Washington limited liability company, in November 2002. On January 22, 2003, William and Stacy A. Linton met with attorney Richard Hack to sign a series of documents. At the meeting, William gifted half of the per-

centage interests in WLFB to Stacy. Also, William and/or Stacy signed *and dated* the following documents:

- **Quit Claim Deed**: signed by William and conveying a parcel of his separate property real estate to WLFB. The parties agree the quit claim deed was effective on January 22.

- **Assignment of Assets**: signed by William as assignor and by both William and Stacy as assignees on behalf of the LLC.

- **Letters**: signed by William and authorizing the transfer of securities and cash to WLFB. The parties disagree as to when the transfers of securities and cash were effected.[1]

At the same meeting with attorney Hack, William, Stacy, and William's brother James Linton, signed, *but left undated*, several other *documents:*

- **Trust Agreements** (four total—one for each child): signed by William and Stacy as grantors and by James as trustee; forming and apparently funding irrevocable trusts for the children.

- **Gift Documents** (eight total—one each from William or Stacy to each trust): signed by William or Stacy as assignor and by James as trustee,

[1]U.S. Bancorp Piper Jaffray, Inc., apparently received William's letter on January 24 and made the transfers between January 24 and 31. RBC Dain Rauscher, Inc., appears to have made the transfers between January 24 and 29. The parties dispute whether the transfers were legally completed on those dates or on January 22, when the general "Assignment of Assets" was signed. We need not resolve this dispute. As we conclude that neither party has established when the LLC interests were gifted, neither party is entitled to summary judgment on the present record. Whether the precise date of the funding matters will depend on the gifting date.

> gifting 11.25 percentage interests in WLFB to each respective trust.

Two or three months later, attorney Hack assembled these key documents. For all undated documents, he filled in the missing date as January 22, 2003. In his deposition, Hack stated this insertion was erroneous, and that these documents should have been dated January 31, 2003. William agrees that January 31 was the correct date. This testimony is consistent with that of Caryl Thorp, an accountant with Moss Adams LLP, who advised the Lintons on the ordering of the transactions.

Some of the subsequent reporting and documentation of the transactions also supports the Lintons' alleged sequence of events. *First*, WLFB's federal partnership income tax return for 2003, prepared by Moss Adams, shows the contributions as initially being credited equally to William's and Stacy's *individual* capital accounts in the limited liability company. The return then shows capital transferred from their individual accounts along with a commensurate increase in the capital accounts for the children's trusts. *Second*, William's and Stacy's individual federal gift tax returns for 2003, prepared by attorney Hack, describe the gifts as gifts of percentage interests in "WLBF [sic]" and show the date of the gifts as January 31, 2003. *Third*, WLFB's "Membership Interest Ledger," prepared by attorney Hack's office, shows, in the first row, that William owned 100% of WLFB upon contribution of the real estate and portfolio assets. The first row also shows William's transfer of 50% of his interest in the LLC to Stacy. Subsequent rows show their transfers of percentage interests in the LLC to the children's trusts. However, all dates for all Ledger rows are blank. *Fourth*, a share valuation report, prepared by Moss Adams, states that percentage interests in the LLC were transferred from the Lintons to the children's trusts on January 31.

In their gift tax returns for 2003, the Lintons characterized their gifts to the children's trusts solely as gifts of WLFB percentage interests. The Lintons determined the gifts were worth only 47% of the value of the underlying capital, due to the LLC's restrictions on ownership and control of the LLC interests. The Internal Revenue Service ("IRS") rejected the application of the 47% discount, arguing that: (1) the Lintons made indirect gifts of cash, securities, and real property to the children's trusts, or (2) the Lintons' gifts should be treated as gifts of cash, securities, and real property under the step transaction doctrine.[2] Prior to formal assessment by the IRS, William and Stacy each made an advance payment of the claimed tax deficiency and filed suit in the district court seeking a refund of gift taxes paid.

Upon cross-motions, the district court granted the government's motion for summary judgment and denied the Lintons' motion for partial summary judgment on the indirect gift issue. *Linton v. United States*, 638 F. Supp. 2d 1277 (W.D. Wash. 2009). The district court relied on express language in the Trust Agreements and Gift Documents to determine the children's trusts were created and the gifts of the LLC interests were made to those trusts on January 22, 2003. *Id.* at 1286-87. The court also determined the contributions of cash, securities and real property were made to the LLC either simultaneously with or after the gifts of the LLC interests to the children's trusts. *Id.* at 1287. Thus, the district court concluded, "the Lintons' transfers of real estate, cash, and securities enhanced the LLC interests held by the children's Trusts,

[2]The government also challenged the Lintons' valuation of the gifts. In discounting the value of the gifts by 47%, the Lintons relied on a valuation report prepared by Moss Adams. In that report, Moss Adams determined the LLC interests were less valuable than the corresponding capital accounts because the LLC agreement restricted the transfer of the interests outside the family and reserved all "authority or power to act" to the "Managers"—William and Stacy Linton. The valuation challenge is not at issue on this appeal.

thereby constituting indirect gifts to the Trusts of pro rata shares of the assets conveyed to the LLC." *Id.*

The district court also determined, in the alternative, that even if the Lintons established that the cash, securities and real property were contributed to the LLC before the gifts of the LLC interests to the children's trusts, the Lintons "nevertheless made indirect gifts to their children's Trusts under the step transaction doctrine." *Id.* In arriving at this conclusion, the court considered "three alternative tests: (i) the binding commitment test; (ii) the end result test; and (iii) the interdependence test," and determined that regardless of which test was used, the step transaction doctrine applied. *Id.* at 1288 (quotation marks omitted). The district court noted that the Lintons made no affirmative decision to delay the gifts, and no evidence suggested the trust res was exposed to real economic risk during the alleged interim between the contributions to the LLC and the gifts of the LLC interests to the children's trusts. *Id.* at 1290.

STANDARD OF REVIEW

We review a grant of summary judgment de novo. *Universal Health Servs., Inc. v. Thompson*, 363 F.3d 1013, 1019 (9th Cir. 2004). We view the evidence in the light most favorable to the nonmoving party, determining "whether there are any genuine issues of material fact and whether the district court correctly applied the relevant substantive law." *Id.*

DISCUSSION

I

[1] A gift tax is imposed on a donor for a "transfer of property by gift." 26 U.S.C. § 2501(a)(1). The tax applies "whether the gift is direct or indirect." 26 U.S.C. § 2511(a).

The parties call on us to determine when the Lintons donated the LLC interests to their children's trusts: Did they

do so before they funded the LLC (so the Lintons would potentially be liable for the full value of the assets conferred, as an indirect gift, to their children), or was it after they funded the LLC (so the Lintons would be entitled to marketability and minority discounts on the assets transferred)? The assets were transferred to the LLC at some date or dates between January 22 and January 31.

[2] A gift is complete for federal tax purposes when "the donor has so parted with dominion and control as to leave in him no power to change its disposition . . . ." 26 C.F.R. § 25.2511-2(b); *see also Smith v. Shaughnessy*, 318 U.S. 176, 181 (1943) ("The essence of a [taxable] gift by trust is the abandonment of control over the property put in trust."). The state law of gifts informs our analysis of whether and when the donor has parted with dominion and control in a manner adequate to give rise to federal tax liability. *See Jones v. Comm'r*, 129 T.C. 146, 150 (2007) ("In order to make a valid gift for Federal tax purposes, a transfer must at least effect a valid gift under the applicable State law."); *cf. United States v. Nat'l Bank of Commerce*, 472 U.S. 719, 722 (1985) ("[I]n the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property." (quotation omitted)); *Aquilino v. United States*, 363 U.S. 509, 514 n.3 (1960); *Shepherd v. Comm'r*, 115 T.C. 376, 384 (2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002) ("look[ing] to applicable State law . . . to determine what property rights are conveyed"). This conclusion follows from the general principle that federal tax law "creates no property rights but merely attaches consequences, federally defined, to rights created under state law." *Nat'l Bank of Commerce*, 472 U.S. at 722 (quotation omitted); *Morgan v. Comm'r*, 309 U.S. 78, 80 (1940) ("State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed."); *cf. United States v. Mitchell*, 403 U.S. 190, 197 (1971) (explaining that

"federal income tax liability follows ownership. . . . In the determination of ownership, state law controls.").[3]

[3] Under Washington law, "the elements of a completed gift are (1) an intention of the donor to give; (2) a subject matter capable of delivery; (3) a delivery; and (4) acceptance by the donee." *In re Marriage of Zier*, 147 P.3d 624, 628 (Wash. Ct. App. 2006). The transfer of the LLC interests occurred when all four elements of a completed gift first existed simultaneously. We must determine when that was. We discuss each element individually, but we defer discussion of the first element, intention to give, until the end, as here it is both the decisive element and the most difficult to determine.

[3]The state law of gifts is not determinative of whether a transaction is taxable as a gift for purposes of the federal gift tax or of when a transaction becomes sufficiently complete to be so taxable, though it necessarily informs federal tax law's determination of those questions: State law provides the shape to the transaction which, depending on the transaction's contours, federal law then may characterize as giving rise to gift tax liability. *See Pahl v. Comm'r*, 150 F.3d 1124, 1128 (9th Cir. 1998) (holding that "we look to federal law to determine what interest creates tax liability. We look, however, to state law to determine whether the taxpayer has the requisite interest."); *cf. Morgan*, 309 U.S. at 81 ("If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law."). Thus, for instance, while donative intent may be relevant to the state law question of whether a transfer occurred by gift, by contract, or not at all, *cf. Buckerfield's Ltd. v. B.C. Goose & Duck Farm Ltd.*, 511 P.2d 1360, 1363 (Wash. Ct. App. 1973), if a transfer did occur, donative intent is irrelevant to whether the federal gift tax applies. *See* 26 C.F.R. § 25.2511-1(g)(1) (whether the gift tax applies depends "on the objective facts of the transfer and the circumstances under which [the gift] is made, rather than on the subjective motives of the donor."); *Dickman v. Comm'r*, 465 U.S. 330, 333 (1984) ("The statutory language of the federal gift tax provisions purports to reach *any* gratuitous transfer of any interest in property." (emphasis added)); *cf. Nat'l Bank of Commerce*, 472 U.S. at 722 ("Once it has been determined that state law creates sufficient interests in the taxpayer to satisfy the requirements of the statute, state law is inoperative, and the tax consequences thenceforth are dictated by federal law." (quotation omitted)).

a) *Subject matter capable of delivery*

[4] Subject matter capable of delivery (here, interests in the LLC) existed since the creation of the LLC in November 2002. This element, therefore, existed at all times relevant to the Lintons' January 2003 transactions.

b) *Delivery*

"[O]nly such delivery is required as the nature of the thing given and the circumstances under which it is given will permit, and so it is generally held the delivery may be manual, constructive or symbolic. . . . Whether what was done was sufficient to constitute a delivery depends on the nature of the property and the attendant circumstances." *Marriage of Zier*, 147 P.3d at 628.

[5] Unlike a precious gem or the keys to a vault, LLC interests do not lend themselves to manual delivery. Instead, they are delivered through the execution of papers. As a result, while one might distinguish the manual delivery of a gem from a prior or subsequent transfer of title to the gem, it is somewhat artificial to separate the "delivery" of an LLC interest from the intention to donate it. *Cf. id.* at 629 (delivery of corporation's stock effected, even where stock certificates were not manually delivered to donee); *Henderson v. Tagg*, 412 P.2d 112, 116 (Wash. 1966) (same). We suspect, therefore, that the Washington law of gifts would collapse its analysis of the delivery element of an alleged gift of LLC interests into its analysis of the intent to donate.

[6] In the alternative, the element of delivery was at least present no later than the intent to donate. On January 22, 2003, the taxpayers signed two kinds of documents: one, the gift documents stating that each taxpayer "hereby gifts to the [relevant] Trust . . . a total of 11.25 percentage interests in WLFB Investments, LLC," and another, the trust agreements, stating "at the time of signing this Agreement, the Grantors

have transferred percentage interests in the WLFB Investments, LLC . . . to the Trustee for the Trust." These documents were signed in the presence of the trustee, James Linton, the legal representative of the trust, to whom delivery to the trust would need to be made. On this alternative account, the element of delivery was present on January 22, 2003.

It is true that the gift documents and trust agreements were left undated on January 22, 2003. Washington law might consider the blank space left for the date as creating ambiguity as to whether a delivery occurred on January 22, 2003, especially if it determined the delivery of an LLC interest by looking for an objective manifestation of an intent to deliver. If that were so, then, the inquiries into the delivery and the intent to donate elements of a gift would, as intimated at the outset, be one and the same here. Donation and delivery of an abstract equity interest are hard to distinguish, and, as we later explain, Washington law would also look to an objective manifestation of the intent to donate to determine that element of a gift. In any case, on either interpretation of what Washington law requires for delivery, that element of a gift was present no later than the element of intent to donate.

c) Acceptance

[7] There is little Washington case law on what constitutes "acceptance" of a gift. This dearth of cases is, perhaps, unsurprising, given that the plaintiffs in most disputes over gifts are the alleged donees, so acceptance is not contested. In any case, "acceptance is presumed, subject to the donee's right to refuse or disclaim," RESTATEMENT (THIRD) OF PROP. (WILLS & DON. TRANSFERS) § 6.1(b) (2003), and neither party has directed the court to any evidence that the trustee disclaimed the LLC interests on January 22, 2003, or at any later date. Thus, whether a gift of LLC interests occurred on January 22, 2003 depends entirely on the presence or absence of the remaining element of a gift: the intent to donate.

d) *Intent to Donate*

The Lintons aver that they did not intend to donate the interests on January 22, 2003. But Washington law does not apply a subjective-intent standard in the interpretation of legal instruments. *See Hearst Commc'ns, Inc. v. Seattle Times Co.*, 115 P.3d 262, 267 (Wash. 2005) ("[W]hen interpreting contracts, the subjective intent of the parties is generally irrelevant if the intent can be determined from the actual words used."). In other words, Washington courts "do not interpret what was intended to be written but what was written." *Id.* Washington probate law similarly follows an "objective manifestation" method of interpretation in the exegesis of wills, donative documents that are close cousins of gift documents. *See In re Estate of Curry*, 988 P.2d 505, 508 (Wash. Ct. App. 1999) (explaining that "[e]xtrinsic evidence of surrounding facts and circumstances may be admitted to explain the language of a will when uncertainty arises as to the testator's true intention. But extrinsic evidence may not be considered for the purpose of proving intention as an independent fact, or of importing into the will an intention not expressed therein." (quotations omitted)).

In the absence of contrary authority, therefore, we presume that the Washington law of gifts applies an objective standard to the determination of donative intent generally, especially where a writing exists.[4] *Cf. Proctor v. Forsythe*, 480 P.2d 511,

[4]We acknowledge that the Restatement does make subjective intent the relevant standard for the interpretation of gift documents. *See* RESTATEMENT OF PROP. (THIRD): WILLS AND OTHER DONATIVE TRANSFERS § 10.1 (2003) ("The controlling consideration in determining the meaning of a donative document is the donor's intention. The donor's intention is given effect to the maximum extent allowed by law."); *id.* at § 10.2 ("In seeking to determine the donor's intention, all relevant evidence, whether direct or circumstantial, may be considered, including the text of the donative document and relevant extrinsic evidence."). But Washington courts have not adopted this rule. They disregard it in interpreting wills, *see Curry*, 988 P.2d at 507-08, even though the Restatement applies the rule to all donative documents, including wills. We see no reason to think Washington courts would follow the Restatement on this point with respect to some donative documents, but not others.

513 (Wash. Ct. App. 1971) (finding an intent to give based on the "*expressed* intent" of the donor) (emphasis added).

The gift documents, signed on January 22, 2003, provide that the Lintons "hereby gift" the LLC interests. The objective manifestation of the Lintons' intent to donate the LLC interests on January 22, 2003 might therefore seem plain. If that were so, then, under Washington law, all four elements of a gift would be present on January 22, 2003, and the gift of LLC interests would be complete on that date.

[8] But the story is more complex. First, the gift documents were not dated on January 22, 2003, which creates considerable objective ambiguity as to the Lintons' intent to make the donation effective on that date. More importantly, execution of a gift document, alone, is not a sufficient objective manifestation of an intent to donate. As the Restatement indicates, "[t]he mere preparation of a donative document does not effect a present transfer necessary to perfect a gift. Such a writing becomes effective when the donor manifests the intention that the document is to be operative to make a present transfer." *Id.* at § 6.2 cmt. u. In other words, a writing, on its own, is not a sufficient objective manifestation of intent to donate at the time of the writing, or at all. Circumstances surrounding the writing must show that the writing was meant to be effective.

[9] Most often, the writing will be effective "when the donor puts the document beyond retrieval" by delivering the document to the donee. *Id.*[5] We assume this rule applies in

[5]The Restatement provides:

> The delivery of the document by the donor to the donee is an act manifesting that the donor intends the document to be presently operative, unless there is evidence that the delivery was made for some other purpose. If, for example, the purpose of the delivery was to allow the donee or the donee's representative to inspect the document to see if any portion of it should be rephrased, the delivery would lack its normal significance.

Washington. So the execution of the gift documents on January 22, 2003 was alone not enough to make the gifts effective on that date. To know when the Lintons objectively manifested the intent to donate the LLC interests, we must know when they put the gift documents "beyond retrieval" or otherwise objectively manifested an intent to make them effective. As we explain, we do not see evidence of when they did so in the record before us, so we reverse and remand for such proceedings as the district court finds necessary to make that determination.

After the signing on January 22, 2009, the gift documents remained with the Lintons' attorney, Richard Hack. That Hack retained the documents might indicate there was no intent to donate on January 22, because Hack, the donors' agent, was to await instructions from his clients as to when to make the donation effective. And, indeed, the gift documents provide that the Lintons "appoint Richard Hack, as attorney to transfer the percentage interests on the books of the Company."[6] Moreover, Hack testified that he later came to believe

> Delivery of an inter vivos donative document occurs when the donor puts the document beyond retrieval. . . .
>
> A delivery of the document by the donor to someone other than the donee is a manifestation that the document is presently operative, unless the circumstances indicate otherwise. . . .
>
> A manifestation that the document is to be presently operative may be made without delivery of the document to anyone, if the outward and visible acts of the donor evidence an intent to make a present transfer.

Id.

[6]We note, but do not resolve, a possible ambiguity in the gift documents' appointment of Hack as agent. The gift documents may appoint Hack as an agent to effect the gifts at some later date, or the gift documents may effect the gifts themselves (after all, they do "hereby gift" the LLC interests) and appoint Hack only to do whatever subsequent paperwork is needed to reflect that the gifts were made. While the latter appears the more natural reading to us, we leave this issue open for the district court to resolve if it finds the need to do so.

that his client would have wanted the documents to be dated January 31, suggesting that the Lintons did not intend for the transfer to be effective until January 31 and that Hack, acting as the Lintons' agent, made them effective on that date.

But that conclusion is at odds with the facts before us. At their January 22 meeting, the Lintons did not give Hack instructions as to when to make the gifts effective. Hack testified "When [William Linton] was at my office [on January 22], he didn't know [when he wanted to make the gifts effective], and he wanted to work that out with [his accountant]." William Linton appears, in fact, never to have given Hack any instructions as to when to make the gifts effective. Instead, Hack reconstructed Linton's intent later, apparently in late March or early April, based on documents provided him by the Lintons' accountant. Hack testified: "I didn't circle back with Bill and grab him by the shoulders and say, 'Hey, Bill, is this the date and is this really what you want to do?' We left that open. No, I didn't do that at all. I used the accountant's data to prepare the gift tax return."

Thus, because the Lintons never instructed Hack to make the gifts effective on January 31, they cannot plausibly claim that they left the documents with Hack with instructions to make the gifts effective on January 31. More importantly, even if the Lintons had given Hack such instructions, Hack appears to have taken no action on January 31 that might have made the gifts effective. January 31 cannot, therefore, be the date on which the gifts became effective, at least not for purposes of summary judgment on the record currently before the Court.

If the Restatement represents Washington law in this regard, and we presume it does, the current record suggests two possibilities as to the date the gifts became effective: *Either* James Linton, the trustee (and, therefore, for legal purposes, the donee), left the meeting on January 22, 2003, with copies of the (undated) gift documents, and his doing so was

a sufficient *objective* manifestation that the gift documents were intended to be effective immediately. *Or* Bill and Stacy Linton appointed Hack to be their agent with the power to make the gift documents effective at some later date, that later date occurring whenever Hack finalized the gift documents (by dating them, albeit incorrectly) and made some objective manifestation that the gift was effective (such as by sending a copy of the documents to James Linton). On this second account, the gifts were likely effective, as a matter of Washington law, in March or April, around the time Hack put together the minute book.

[10] In sum, the determinative question as to when the gift of the LLC interests occurred is the first date at which objective circumstances existed that would suggest the gift documents were meant to be operative (and all three other elements of a gift existed under Washington law). The relevant objective circumstance could be, but is not necessarily, when the trustee James Linton was given a copy of the signed gift document, because on that date "the donor put[ ] the document beyond retrieval," RESTATEMENT, § 6.2 cmt. u, thereby objectively manifesting an intent to make the gift documents operative. Because the record is subject to contrary inferences as to when that, or some other event objectively manifesting the Lintons' intent to make the gift documents operative, first occurred, the government is not entitled to summary judgment on this pivotal point. We therefore remand to the district court for such proceedings as it deems necessary to resolve this question.[7]

[7]Of course, though necessarily informed by state law, federal law is not beholden to the technicalities of state law in assessing federal tax liability. *See, e.g.*, *Frank Lyon Co. v. United States*, 435 U.S. 561, 572-73 (1978); *Morgan*, 309 U.S. at 80-81. But we have not discussed the substance-over-form doctrine in our analysis of when the LLC interests were transferred because form is significantly aligned with substance when it comes to the timing of the transactions. Courts have explained, and we elaborate below, that the relative timing of the two transactions required for a gift via a lim-

We recognize the possibility that the district court might determine that there was no one event which independently constituted an objective manifestation of the Lintons' intent to make the gift documents operative, and instead decide that that intent was objectively manifested by the gradual accretion of events, including the signing of the undated gift documents, and various actions the Lintons took on the assumption that the LLC interests already had been transferred. But such a lack of one independently sufficient event should not matter, for present purposes, so as long as the district court can determine that the accumulation of objective circumstances was or was not sufficiently complete before the LLC was funded.

II

The Lintons contend that they are entitled to summary judgment because even if the government is right about timing, no gift would have occurred and so they would therefore have no gift tax liability. Their argument is that if the transactions occurred in the order the government contends (i.e., first, the LLC interests were transferred to the trusts, and then the assets were transferred to the LLC), then no gift to the trusts occurred at all. The Lintons rely on a provision of the

ited liability entity is of importance because of the risk of a change in valuation to which the funded entity interests are exposed before they are transferred to the children. *See Holman v. Comm'r*, 130 T.C. 170, 189 (2008), *aff'd* 601 F.3d 763 (8th Cir. 2010); *Gross v. Comm'r*, 96 T.C.M. (CCH) 187, 192 n.5 (2008). The degree of risk, if any, to which the funded entity interests is exposed is almost wholly dependent on the state law question of when the gifts occurred.

We also observe that the parties and the district court considered the possibility of reforming the gift documents. Reformation, even if possible, would be irrelevant. The question in a tax case such as this is when the LLC interests actually were donated, not when they should have been. When the LLC interests were transferred is an historical fact, which a court may ascertain but which it cannot travel through time to alter retroactively.

LLC agreement, providing that "A Member's Capital Account shall be increased by the Member's capital contributions to the Company . . . ." If the Lintons gifted assets to the company after they had gifted the percentage interests in the company to their children, the gifted assets would, by virtue of this provision, be credited to their own (i.e., the parents') capital accounts. If only the donors' capital accounts were enhanced by the transfer of assets to the LLC and there was no subsequent transfer from the donors' capital accounts to the children's capital accounts, then there was no gift for tax purposes. *See Shepherd v. Comm'r*, 115 T.C. at 389 ("Obviously, not every capital contribution to a partnership results in a gift to the other partners, particularly where the contributing partner's capital account is increased by the amount of his contribution, thus entitling him to recoup the same amount upon liquidation of the partnership."). By contrast, if the transactions had occurred in the order the Lintons intended, then by virtue of the IRC § 704 capital account rules incorporated in the LLC agreement, the transfer of the LLC interests would have effected a pro rata transfer of the donors' capital accounts to the donees' capital accounts. *See* 26 C.F.R. § 1.704-1(b)(2)(iv)(*l*).

The Lintons' "failed-gift" theory is clever; unfortunately for them, it is too clever. The membership ledger of the LLC shows that the capital accounts of the children's trusts were, in fact, increased, as does the LLC's informational return that its accountants prepared and filed with the IRS in March 2004. The Lintons contend that if we conclude the government is right about the timing of the transactions, these documents were prepared on a mistaken assumption (i.e., that the LLC interests were transferred after the assets, and, therefore, by virtue of the IRC § 704 capital account rules, included a pro rata transfer of the assets from the donors' capital accounts to the donees') and should be ignored. On their theory, the informational return and the ledger would only reflect what everyone believed to be the state of the capital accounts, not the actual state of the capital accounts.

[11] But tax law is concerned "with the realities of a situation and not with the formalities of title." *Estate of Fortunato*, 99 T.C.M. (CCH) 1427, 1433 (2010) (quotation omitted)*; cf. Frank Lyon Co.*, 435 U.S. at 572 ("[T]axation is not so much concerned with the refinements of title as it is with . . . the actual benefit for which the tax is paid."); *Pahl*, 150 F.3d at 1127-1129. The membership ledger and the LLC's informational return together reflect the substantive reality of the situation: All parties involved regarded the trusts' capital accounts as having been enhanced. In other words, all concerned parties acted as if William and Stacy Linton had "so parted with dominion and control [over the assets] as to leave in [them] no power to change [their] disposition." 26 C.F.R. § 25.2511-2(b).

[12] The Lintons' failed-gift argument, by contrast, relies on the formal technicalities of state law. (Even though it incorporates the IRC § 704 capital account rules, the LLC agreement is a contract, which, like the background interests in property that it regulates, is governed by state law.) The failed-gift argument is formal because it relies on the technicalities of title (i.e., whether a state court presented with the issue would hold that the capital accounts were legally enhanced by the gifting of the LLC interests), but ignores the substantive reality that all concerned treated the accounts as enhanced and so, for all effective purposes, they were so.

[13] In other words, the Lintons may be right that, if the government is correct about the timing of the transactions, the ledger and informational return may have technically been in error, because the transfer of the assets to the LLC would not have automatically enhanced the trusts' capital accounts, and there was no subsequent transfer from the parents' capital accounts to those of the trusts. But this nicety of state law is too fine to have federal tax consequences, especially given federal tax law's heightened suspicion of state law's formal technicalities when all the parties involved have a familial relationship. *See Brown v. United States*, 329 F.3d 664, 673

(9th Cir. 2003) (holding that where parties to a transaction have a familial relationship, "heightened scrutiny" of its substance is appropriate); *Kornfeld v. Comm'r*, 137 F.3d 1231, 1235 (10th Cir. 1998) (holding that where "parties to the transactions in question are related, the level of skepticism as to the form of the transaction is heightened"). Absent interest from the Internal Revenue Service, the only conceivable way that the substantive realities (i.e., that all concerned treated the capital accounts as enhanced) would be realigned with the short-term formal technicalities of state law (i.e., the absence of adequate paperwork making the transfer to the children's capital accounts) would be if one of the parties concerned became aware of the discrepancy and decided to pursue litigation. Given that all parties involved in the transactions were members of the same family and their interests in the transactions were aligned, *cf. Brown*, 329 F.3d at 673 (disregarding legal form in part because the donee was "unlikely to flout the taxpayer's intention"), that possibility is so remote as not to affect federal tax law's assessment of the transactions' substantive realities.[8] We therefore hold that the Lintons are not entitled to summary judgment on their failed gift theory.

III

The district court determined that, even if the sequence of events was as the Lintons contend, the gifts would still be characterized as gifts of cash, securities, and real property to the children's trusts under the step transaction doctrine. The step transaction doctrine "collapses 'formally distinct steps in an integrated transaction' in order to assess federal tax liability on the basis of a 'realistic view of the entire transaction.' "

[8]Moreover, over time, the formal niceties of state law (i.e., whether a state court would determine that the capital accounts were enhanced) could come to match the substantive reality (i.e., that all concerned regarded the children's capital accounts as enhanced) through the running of state law statutes of limitations, estoppel and other state law doctrines of property.

Brown, 329 F.3d at 671 (quoting *Comm'r v. Clark*, 489 U.S. 726, 738 (1989)).[9]

[9]We note at the outset our hesitation about the need to apply any of the traditional three tests that make up the step transaction doctrine once the issue of the timing of the transactions is resolved. As the government acknowledged at oral argument, the step transaction doctrine "really [is] what drives this kind of case," including the primary question of the order in which the transactions occurred.

The step transaction doctrine is one of the many "substance-over-form" doctrines in tax law. *See Brown*, 329 F.3d at 671; *see generally* Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000) (discussing origins and difficulties of substance-over-form doctrines, including step transaction doctrine). It "combines a series of individually meaningless steps into a single transaction" for purposes of federal tax treatment. *Esmark, Inc. & Affiliated Cos. v. Comm'r*, 90 T.C. 171, 195 (1988).

Courts have insisted that family limited partnerships be funded before the partnership interests are distributed for the same reason that they apply the step transaction doctrine: to ensure that the two transactions are adequately distinct that the second transaction merits independent, and more favorable, tax treatment. *See, e.g.*, *Holman*, 130 T.C. at 189 ("[T]he passage of time may be indicative of a change in circumstances that gives independent significance to a partner's transfer of property to a partnership and the subsequent gift of an interest in that partnership to another."); *Gross*, 96 T.C.M. (CCH) at 192 n.5 (noting the importance of the "real economic risk" of a change in valuation of assets donated to a partnership during an eleven-day "hiatus" before which partnership interests were gifted).

To obtain favorable tax treatment, the Lintons needed to transfer assets to the LLC and then wait at least some amount of time before they gifted the LLC interests to their children. The waiting period would subject the gifted assets to some risk of changed valuation before they were transferred, through the LLC, to the children's trusts. That risk would make the two transactions distinct for tax purposes. (The government has not challenged that the nine days between January 22 and January 31 is a sufficiently long period to make the transactions distinct, notwithstanding that some of the value transferred to the LLC was cash. *Cf. Gross*, 96 T.C.M. at 192 n.5 (noting that the Tax Court "might view the impact of an 11-day hiatus differently in the case of another type of investment[,]" subject to less risk than "heavily traded, relatively volatile common stocks.")). Others have noted, in different contexts, the similarity between the step transaction doctrine and the requirement that two transactions be timed in a

Whether a court's application of the step transaction doctrine to undisputed facts "is an issue of fact or law is a question over which we have struggled." *Brown*, 329 F.3d at 670. As stated previously, we ordinarily review grants of summary judgment de novo. The government contends, however, that the application of the step transaction doctrine to undisputed facts is a question of fact to be reviewed under the clearly erroneous standard. We need not resolve this dispute, as we would reverse the district court under either standard of review.

[14] The step transaction doctrine treats multiple transactions as a single integrated transaction for tax purposes if all of the elements of at least one of three tests are satisfied: (1) the end result test, (2) the interdependence test, or (3) the binding commitment test. *True v. United States*, 190 F.3d 1165, 1174-75 (10th Cir. 1999). Although the doctrine considers the substance over the form of the transactions, " 'anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury.' " *Brown*, 329 F.3d at 671 (quoting *Grove v. Comm'r*, 490 F.2d 241, 242 (2d Cir. 1973)).

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certain manner. *See Weikel v. Comm'r*, 51 T.C.M. (CCH) 432, 438 (1986) ("Courts will often, in addition to the [familiar three step transaction doctrine] tests . . . examine the timing of the transaction at issue."); Yoram Keinan, *Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification*, 22 AKRON TAX J. 45, 74-77 (2007) (discussing relevance of the timing of two transactions to the step transaction doctrine).

In sum, we suspect that the timing requirements discussed above are, in essence, a working out of the step transaction doctrine in a particular set of circumstances, and, therefore, that, if the Lintons or the government prevails as to the issue of timing, there would be no need to apply the three traditional step transaction doctrine tests. But because neither party contests that the three step transaction doctrine tests apply, and because our application of them does not change the result we reach, we apply them.

[15] The step transaction doctrine has been described as "combin[ing] a series of individually meaningless steps into a single transaction." *Esmark, Inc. & Affiliated Cos. v. Comm'r*, 90 T.C. 171, 195 (1988). We note as a threshold matter that the government has pointed to no meaningless or unnecessary step that should be ignored. Nonetheless, examining the step transaction doctrine in light of the three applicable tests, we conclude that its application does not entitle the government to summary judgment.

[16] The end result test asks whether a series of steps was undertaken to reach a particular result, and, if so, treats the steps as one. *True*, 190 F.3d at 1175. Under this test, a taxpayer's subjective intent is "especially relevant," and we ask "whether the taxpayer intended to reach a particular result by structuring a series of transactions in a certain way." *Id.* The result sought by the Lintons is consistent with the tax treatment that they seek: The Lintons wanted to convey to their children LLC interests, without giving them management control over the LLC or ownership of the underlying assets. Ample evidence supports this intention. The end result sought and achieved was the gifting of LLC interests. If the transactions could somehow be merged, the Lintons would still prevail, because the end result would be that their gifts of LLC interests would be taxed as they contend.

[17] The interdependence test asks "whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1523 (10th Cir. 1991) (quotation marks omitted). Under this test, it may be "useful to compare the transactions in question with those we might usually expect to occur in otherwise bona fide business settings." *True*, 190 F.3d at 1176.

[18] The placing of assets into a limited liability entity such as the LLC is an ordinary and objectively reasonable

business activity that makes sense with or without any subsequent gift. In *Holman v. Commissioner*, the Tax Court stated that the creation of a limited partnership was not necessarily "fruitless" even if done in anticipation of gifting partnership interests to the taxpayers' children. 130 T.C. 170, 188, 191 (2008) (holding the creation of the limited partnership and the subsequent transfer of partnership interests should not be treated as a single transaction). The Lintons' creation and funding of the LLC enabled them to specify the terms of the LLC and contribute the desired amount and type of capital to it—reasonable and ordinary business activities. These facts do not meet the requirements of the interdependence test.

[19] The binding commitment test asks whether, at the time the first step of a transaction was entered, there was a binding commitment to take the later steps. *Comm'r v. Gordon*, 391 U.S. 83, 96 (1968). The test only applies to transactions spanning several years. *True*, 190 F.3d at 1175 n.8; *Associated Wholesale Grocers*, 927 F.2d at 1522 n.6; *McDonald's Rests. of Illinois, Inc. v. Comm'r*, 688 F.2d 520, 525 (7th Cir. 1982) (rejecting application of the test for transactions spanning six months). Here, the Lintons' transactions took place over the course of no more than a few months, and arguably a few weeks. The binding commitment test is inapplicable.

[20] The government is therefore not entitled to summary judgment based on an application of the step transaction doctrine.

CONCLUSION

We reverse the district court's grant of summary judgment in favor of the government, determining that the Lintons' gifts to the children's trusts would be valued as though the gifts were indirect gifts of particular assets and not gifts of the LLC interests. Genuine issues of material fact exist as to the sequence of transactions by which the gifts were made. We

remand this question for the district court to determine, following further proceedings, when the four elements of a gift under Washington state law were simultaneously present, and, in particular, to determine when the Lintons first objectively manifested their intent to make the gifts effective. We also reverse the district court's grant of summary judgment in favor of the government as to the application of the step transaction doctrine. Finally, we affirm the district court's order denying summary judgment to the Lintons, holding that they are not entitled to summary judgment on their failed-gift theory.

The government shall bear the costs of this appeal.

AFFIRMED IN PART; REVERSED in PART and REMANDED.

In re Marriage of Lopez (1974)

[Civ. No. 13610. Court of Appeals of California, Third Appellate District. March 26, 1974.]
In re the Marriage of EDITH M. and LEE A. LOPEZ, SR. LEE A. LOPEZ, SR., Respondent, v. EDITH M. LOPEZ, Appellant

(Opinion by Carter, J., with Richardson, P. J., and Janes, J., concurring.)

COUNSEL

John N. Bach for Appellant.

Jack Halpin and Richard J. Asbill for Respondent.

OPINION

CARTER, J.

This is an appeal by the wife from an interlocutory judgment of dissolution of marriage. On appeal, wife urges the following procedural and substantive contentions:

1. The interest of the husband in his law firm as of the date of trial was all community property.

2. The trial court erred in failing to determine the value of husband's interest in the accounts receivable, goodwill and work in progress of his partnership law practice.

3. Wife's motion for inspection, audit and review of husband's partnership legal files should have been granted.

4. The trial court erred in granting husband's motion to defer the issue of wife's request for attorney's fees and costs until after the court's determination of the principal issues.

5. The trial court abused its discretion in its allowance of attorney's fees and costs to wife.

6. The trial court abused its discretion in determining the amount and duration of spousal support.

We conclude the trial court did err on several grounds and will accordingly reverse and award wife costs. **[38 Cal. App. 3d 100]**

Facts

Husband is an attorney, having received his law degree in 1952, passed the Bar Examination in October 1952 and was admitted to practice in California in January 1953. In June 1953 he received a master's degree in law from New York University and two months later commenced the practice of law in Redding, California, as an associate in a law office of an established lawyer, at a salary of $300 per month. On January 1, 1955, without a capital contribution, husband became a 25 percent partner with the lawyer engaging in general practice. On August 8, 1957, while thus engaged in the practice of law, husband and wife were married.

On September 25, 1957, the law partnership was dissolved, and on October 1, 1957, husband opened his own law office as a sole practitioner. He brought into his practice some accounts receivable and cases in progress from the former partnership. In addition he invested the sum of $5,000 in his law office, and purchased some furniture, office equipment and law books. At the time of his marriage, husband owned free of debt a 1956 Oldsmobile, a boat, motor and trailer—all assets which he depreciated in his law practice. Following his marriage and during the first three months as a sole practitioner, husband grossed a total of $6,478.98, with expenses of $5,895.97, for a net income of $583.01.

During the ensuing years husband's law practice and earnings flourished. In 1958 he grossed $40,476.91 and his net income before taxes was $22,793.95; in 1959 his gross and net income before taxes were $54,282.69 and $30,414.61 respectively; in 1960, $61,830.82 and $31,178.25 and in 1961, $77,305.68 and $49,738.38. On January 1, 1962, husband formed a partnership with Willis Haines. Haines contributed no capital to the business, but received 25 percent of the profits. In 1962 the new partnership produced $99,106.85 in gross receipts and husband's share of the net income before taxes was $48,433.58; for the year 1963 the figures were $109,463.16 and husband's share was $49,826.11. The Lopez-Haines partnership was dissolved in April 1964. For the year 1964 the total gross receipts of the partnership plus husband's after-dissolution gross income amounted to the sum of $129,072.30 which provided the husband with a total 1964 net income before taxes of $58,806.07. From 1965 through 1969, husband practiced as sole owner of his law business with associates. His respective gross receipts and net income before taxes during those years were as follows: 1965—$167,872.72, $72,729.03; 1966—$177,259.67, $64,410.88; 1967—$200,608.71, $67,909.67; 1968—$261,831.58, $102,403.67; 1969—$243,478.61, $79,028.03. **[38 Cal. App. 3d 101]**

On January 1, 1970, husband formed a law partnership with two of his associates, Donald R. Kennedy and Robert L. Srite, at which time Srite paid the sum of $53,500 cash for a 25 percent interest in husband's law practice. This cash was deposited in Accounts Nos. 12 and 4239 (4324), Bank of Redding, in husband's name. At the same time, Kennedy paid husband $13,500 in cash and executed an unsecured promissory note in the sum of $40,000 for the purchase of 25 percent of husband's law business. Documents entitled "Agreement for the Sale of an Interest in Fixtures, Equipment, Library and Goodwill of a Law Practice," dated January 1, 1970, were executed by husband and his new partners. Each agreement provided that husband sell an

undivided 25 percent interest in and to the fixtures, equipment and law library to each partner for the sum of $1,224.32, respectively. A 25 percent interest in the law practice goodwill which husband sold to each of his new partners was valued at $52,275.68 in both agreements.

Concurrently, husband and his partners executed a partnership agreement which specified that the beginning capital of the partnership was $214,000 of which $209,895.72 was designated as goodwill. This agreement provided for a schedule of payments to be made to a partner withdrawing voluntarily, with no payment on return of capital investment if voluntary withdrawal occurred the first year (1970). Repayment of capital was provided in varying increments upon voluntary withdrawal by a partner during the ensuing five years.

The Lopez-Kennedy-Srite partnership produced gross receipts of $266,916.66 in 1970 and husband's net income before taxes was $81,508 for that year. For 1971 through the month of September, the partnership gross was $204,775.29 and husband's net income before taxes was $61,145.41.

During the trial, husband testified: "Every year at the end of the year or during the year I withdrew every penny of my income from the practice and used it for the benefit of the community. If there was at the end of the year say ten or fifteen thousand dollars in the office account, I would take that out and put it into a savings account or something such as that, or acquire—make an investment with it for the community." Husband confirmed that there were no cash reserves in his law practice because of this conduct, and that the assets of his law practice consisted only of a library, office equipment and accounts receivable.

Wife left high school at the age of 16, did some office work prior to the marriage, but had no special job training. Before her marriage to husband, wife worked as a cocktail waitress in Redding. Her total wages for the tax year 1957 were $1,320 plus $168 in gratuities. At the time of the **[38 Cal. App. 3d 102]** marriage of the parties, wife was 25 years of age. She had a minor daughter, born of a former marriage, which child was adopted by husband shortly after his marriage to wife. A son, born to the parties in December 1958, was at the time of the trial living with wife and his half-sister.

Since the marriage, wife has not been gainfully employed. She testified that she suffered various health problems, including a quiescent ulcer and degenerative changes to her cervical spine and thoracic spine, which could perhaps limit the kind of activities she might pursue.

During their marriage, husband and wife enjoyed a substantial and comfortable life style, which included expensive cars, home and vacations. Wife spent considerable money on clothes, accessories, fur coats and jewels. At the outset of their marriage the parties established a household budget of $750 per month, which was later changed to $475 cash deposited monthly in wife's personal checking account for her personal use for family food, a housekeeper and ironing lady. In addition, wife charged any items she

felt necessary for herself, the children and husband. These charges, the house payments, taxes and insurance were paid by husband from another account. On this basis at the time of the separation of the parties, wife incurred expenses of about $1,000 per month.

During the course of the trial the parties stipulated to the market value of the community interest in various parcels of real property. The trial court among other things found the nature and net values of the community property of the parties to be as follows:

[Tabular material omitted.] **[38 Cal. App. 3d 103]**

[Tabular material omitted.]

The court awarded to the wife as her one-half share of the community property the following:

[Tabular Material Omitted]

"Alta Mesa residence **[38 Cal. App. 3d 104]** Bank of Redding Account # 6419

The trial court ordered all items of real and personal community property not specifically awarded to the wife to be retained by the husband as his one-half of the community property; the total net worth of this one-half the court found to be in the sum of $151,033.22. In addition, the court ordered the husband and wife to assume the balance due and owing on any property awarded to each and to hold the other party harmless from any liability thereon.

Custody of the minor son was awarded to husband; that award is not challenged. Wife was awarded the sum of $200 per month spousal support to terminate after 24 months. Husband was awarded as his separate property the bank accounts which contained the balance of the cash payments made by Kennedy and Srite, the unpaid balance of the Kennedy note, and a 50 percent interest in the law partnership of Lopez, Kennedy and Srite.

1. Husband's interest in his law partnership and the proceeds from the sale of a one-half interest therein were erroneously found to be all separate property.

For reasons hereafter set forth, we hold that the trial court erred in determining that the 50 percent interest of the husband in his law practice and the proceeds paid him by his two law partners were separate property (findings 20 and 21). Husband asserts in his brief as follows: "It is clear from the uncontradicted evidence, that the law practice of the respondent at the time he opened his office on October 1, 1957, was a continuance of his already existing practice, and it was the sole and separate property of the respondent, and remained the same throughout the marriage." Husband further argues that any community interest in his law practice was withdrawn each year and that he applied the income earned therefrom to community investments. The trial court

accepted this approach. However, such position ignores the law as stated in two earlier decisions of this court.

In *Brawman v. Brawman* (1962) 199 Cal. App. 2d 876 [19 Cal. Rptr. 106], we had occasion to comment on the proper classification of a law **[38 Cal. App. 3d 105]** practice commenced one year before a marriage which lasted 21 years. During his practice husband built up a substantial earning capacity. The divorce decree was silent as to ownership of the law practice; on appeal, wife contended that she was improperly denied alimony. This court therein stated at page 882: "The law business was a substantial part of the community, but was given no valuation by the judge who, in declaring the parties to have been 'marital partners' evidently did not feel that the partnership relationship covered the law business. Where, as here, respondent had commenced the practice of law just one year before his marriage and had built up a lucrative law business by his industry and professional ability, a practice producing $24,000 a year net, the business is community property and it has a substantial value. [Citation.] In considering this value, consideration must be given to the fact that, on divorce and dissolution of the community, a professional practice goes automatically to the spouse licensed to practice it. He is not selling out or liquidating, but continuing in business. Effectually, it is the case of a silent partner withdrawing from a going business. And, if such partner is to receive fair compensation for her share, on her enforced retirement, it should be so evaluated."

[1] *In Todd v. Todd* (1969) 272 Cal. App. 2d 786, 791 [78 Cal. Rptr. 131], we again held that "While the right to practice law is a property right which cannot be classed as community property, the value of the practice at the time of dissolution of the community is community property."

[2] It is generally settled that the efforts, time and skills of the husband are community assets. (*Somps v. Somps* (1967) 250 Cal. App. 2d 328, 332-333 [58 Cal. Rptr. 304].) [3a] Assuming that husband commenced his law practice with certain monies earned by him prior to his marriage which were his separate property, the primary value of his practice was derived from his own individual efforts after marriage, rather than from the negligible sum of money initially invested in his law business. The approach urged by husband on appeal gives the worth of his separate property used in his law practice an exaggerated importance. In the instant case, the value of the law practice was clearly one and the same as the husband's energy, skill, judgment, intelligence and personality as a practicing attorney. Even though, as argued at trial, the retirement and death of other attorneys in the Redding area may have contributed to the growth of husband's practice, these factors cannot be deemed the "other favorable business factors" which were determinative in Somps. In addition, the trial court found in Somps that husband's equity in the engineering partnership was a reasonable return on his separate property, and the various interests in real property were bought and paid for by the business partners as partnership investments, with partnership credit and not from community funds. **[38 Cal. App. 3d 106]**

In *Beam v. Bank of America* (1971) 6 Cal. 3d 12 [98 Cal. Rptr. 137, 490 P.2d 257], our Supreme Court recently discussed the two approaches used by California courts in apportioning earnings between separate and community income. The court stated (at p. 18): "One method of apportionment, first applied in *Pereira v. Pereira* (1909) 156 Cal. 1, 7 [103 P. 488], and commonly referred to as the *Pereira* approach, 'is to allocate a fair return on the [husband's separate property] investment [as separate income] and to allocate any excess to the community property as arising from the husband's efforts.' (*Estate of Neilson* (1962) 57 Cal. 2d 733, 740 [22 Cal. Rptr. 1, 371 P.2d 745].) The alternative apportionment approach, which traces its derivation to *Van Camp v. Van Camp* (1921) 53 Cal. App. 17, 27-28 [199 P. 885], is 'to determine the reasonable value of the husband's services ... , allocate that amount as community property, and treat the balance as separate property attributable to the normal earnings of the [separate estate].' (*Tassi v. Tassi* (1958) 160 Cal. App. 2d 680, 690 [325 P.2d 872].)" (Fns. omitted.)

Factual comparison of *Pereira, Van Camp* and *Beam* with the case at bench demonstrates striking differences. In each of the cited cases, the husband's separate property occupied a key role in the husband's business. In *Van Camp* and *Beam* the husband's efforts had a minor influence on the growth of the investment. In *Pereira*, the case perhaps most analogous to the matter before us, husband's efforts were deemed important but additionally the presence of his separate property capital was considered a requisite. [4] As stated in *Beam* (at p. 18): "'In making such apportionment between separate and community property our courts have developed no precise criterion or fixed standard, but have endeavored to adopt that yardstick which is most appropriate and equitable in a particular situation ... depending on whether the character of the capital investment in the separate property or the personal activity, ability, and capacity of the spouse is the chief contributing factor in the realization of income and profits [citations] ... [Par.] In applying this principle of apportionment the court is not bound either to adopt a predetermined percentage as a fair return on business capital which is separate property [the Pereira approach] nor need it limit the community interest only to [a] salary fixed as the reward for a spouse's service [the *Van Camp* method] but may select [whichever] formula will achieve substantial justice between the parties. [Citations.]' (*Logan v. Forster* (1952) 114 Cal. App. 2d 587, 599-600 [250 P.2d 730] ....)" (Italics added.)

Many past and present distinguished California lawyers of initial humble and impecunious beginnings will attest to the fact that it is not ordinarily capital investment by a sole legal practitioner which is the chief contributing **[38 Cal. App. 3d 107]** factor in the realization of income and profits. [3b] On retrial it will be for the trial court to determine which of the recognized approaches will most effectively achieve substantial justice between the parties. We make this observation with the reservation, however, that the trial court might well conclude that husband's initial investment in his law practice became so commingled with the community that all traces and vestiges of it as separate property have been lost. (See *Mueller v. Mueller* (1956) 144 Cal. App. 2d 245, 250 [301 P.2d 90].)

2. Existence and valuation of goodwill and assets of husband in his law practice.

Several serious questions have been raised as to the valuation of husband's interest in his law partnership. [5] Pursuant to section 4800 of the Civil Code (1970 Family Law Act), a trial court is now required to "divide the community property and the quasi-community property of the parties ... equally." In order to do this, the trial court must make specific findings of fact as to the nature and value of the specific property of the parties. (*May v. May* (1969) 275 Cal. App. 2d 264 [79 Cal. Rptr. 622]; *Hong v. Hong* (1965) 237 Cal. App. 2d 239, 241 [46 Cal. Rptr. 710]; *Cardew v. Cardew* (1961) 192 Cal. App. 2d 502 [13 Cal. Rptr. 620]; Cal. Rules of Court, tit. IV, div. I, ch. 2, rule 1242.)

It has been urged that there can be no "goodwill" in husband's professional law business upon dissolution. Neither *Lyon v. Lyon* (1966) 246 Cal. App. 2d 519, 524 [54 Cal. Rptr. 829], nor *Heywood v. Sooy* (1941) 45 Cal. App. 2d 423 [114 P.2d 361], are applicable to the case at bench, since both cases involved dissolutions of law partnerships between practicing attorneys. The case before us deals solely with a marital dissolution and not a law partnership dissolution. The court in *Golden v. Golden* (1969) 270 Cal. App. 2d 401, 405 [75 Cal. Rptr. 735], noted the crucial distinction: "Where, as in Lyon, the firm is being dissolved, it is understandable that a court cannot determine what, if any, of the good will of the firm will go to either partner. But, in a matrimonial matter, the practice of the sole practitioner husband will continue, with the same intangible value as it had during the marriage. Under principles of community property law, the wife, by virtue of her position of wife, made to that value the same contribution as does a wife to any of the husband's earnings and accumulations during marriage. She is as much entitled to be recompensed for that contribution as if it were represented by the increased value of stock in a family business."

[6] Consistent with this principle of community property law, if "goodwill" in a professional practice as a going business is found to exist **[38 Cal. App. 3d 108]** as an asset at the time of a marital dissolution, such asset is subject to the innumerable consequences of the Family Law Act of 1970. In such cases, professional goodwill may thus be separate property, community property, or varying degrees of both depending upon the particular circumstances. The fact that "professional goodwill" may be elusive, intangible, difficult to evaluate and will ordinarily require special disposition, is not reason to ignore its existence in a proper case.

It has been aptly stated: "Accountants, writers on accounting, economists, engineers, and courts, have all tried their hands at defining goodwill, at discussing its nature, and at proposing means of valuing it. The most striking characteristic of this immense amount of writing is the number and variety of disagreements reached." (Canning, The Economics of Accountancy (1929) p. 28.)

[7] Mindful of the nebulous area into which we venture, we believe that for purposes of a marital dissolution, the parties are primarily concerned with the existence, value and consequences of the "goodwill" of a professional business in an economic sense, as distinguished from legal or accounting concepts. As stated by Professor Norton M.

Bedford, University of Illinois: "It seems to be well established in the literature of economics that the economic value of any asset depends upon the future net receipts which the asset will produce. While these receipts to a consumer are receipts of satisfactions, to a business firm the receipts are cash or cash equivalent (more broadly, purchasing power equivalent). Since the future is unknown, different individuals and business entities will have different expectations as to what these future receipts will be. Thus, there is no certainty in any one valuation of an asset. To the contrary, a considerable amount of uncertainty attaches to any valuation. But subject to this variability, the conceptual view of the economic value of any asset is based on the future receipts which the asset will produce. Because individual assets are not used in isolation but as a part of an organized entity containing a variety of distinct assets, the economic concept of goodwill is introduced when the future receipts of the organization cannot be assigned as a contribution of a finite list of specific assets. That is, the search to assign a specific cause, in the form of a specific asset, for the expected future receipts requires the introduction of goodwill as an asset." (Bedford, Goodwill, in Handbook of Modern Accounting (Davidson ed. 1970) ch. 19, p. 19-5.) (Italics added.)

We think it follows that in marital cases the expectancy of future earnings **[38 Cal. App. 3d 109]** is not synonymous with, nor should it be the basis for, determining the value of "goodwill" of a professional practice, but is simply a factor to consider in deciding if such an asset exists. A community property interest can only be acquired during the marriage, and it would be inconsistent with that philosophy to assign value to the postmarital efforts of either spouse. (*In re Marriage of Fortier* (1973) 34 Cal. App. 3d 384, 387-388 [109 Cal. Rptr. 915].)

[8] We emphasize that no rigid or unvarying rule has been enunciated by our courts for determining the existence or value of the "goodwill" of a law practice or any other profession as a going business, and therefore each case must be determined upon its own facts. Whatever the result in a given case, we hold that where the issue is raised in a marital dissolution action, the trial court must make a specific finding as to the existence and value of the "goodwill" of a professional business as a going concern whether related to that of a sole practitioner, a professional partnership or a professional corporation. (*Golden v. Golden,* supra, 270 Cal. App. 2d 401 (sole medical practitioner); *Todd v. Todd,* supra, 272 Cal. App. 2d 786 (sole legal practitioner); *Brawman v. Brawman,* supra, 199 Cal. App. 2d 876 (sole legal practitioner).)

In so holding, we do not imply that every professional business as a going concern necessarily has a valuable goodwill, or that if found to exist the value thereof may be precisely fixed in terms of so many dollars. Instead, there are certain factors, assuredly not all inclusive, which may tend to provide the trial court with broad latitude in resolving these questions, with one objective being the determination of the fair economic value of all the community property for equal division purposes. (Civ. Code, § 4800.) In addition, if the trial court were to find in a proper case that the asset of professional goodwill is the separate property of the practitioner, where spousal or child support is an issue, a specific finding as to value is required, since it may directly affect the question

of ability to meet those obligations. (*In re Marriage of Cosgrove* (1972) 27 Cal. App. 3d 424, 433-434 [103 Cal. Rptr. 733].)

[9] Certain matters merit consideration which may be said reasonably to contribute to, diminish, or affect the intangible value of professional goodwill at the time of dissolution and the continuity and retention of the benefits thereof which the professional practitioner will continue to enjoy after the marital dissolution. In that context some such factors are the practitioner's age, health, past demonstrated earning power, professional reputation in the community as to his judgment, skill, knowledge, his comparative professional success, and the nature and duration of his **[38 Cal. App. 3d 110]** business as a sole practitioner or as a member of a partnership or professional corporation to which his professional efforts have made a proprietary contribution. In addition, consideration should be given to the value of the "fixed" and "other assets" of the professional business with which the "goodwill" is to continue its relationship.

[10] While "market value" and the value for marital dissolution purposes of "professional goodwill" may be synonymous, in our view such value should be determined with considerable care and caution, since it is a unique situation in which the continuing practitioner is judicially forced to buy an intangible asset at a judicially determined value and compelled to pay a former spouse her share in tangible assets. (Civ. Code, § 4800.) Asset values and liabilities should be determined as near to the date of trial as reasonably practicable (Randolph v. Randolph (1953) 118 Cal. App. 2d 584 [258 P.2d 547]), with the reservation, however, that since the enactment of Civil Code section 5118, effective March 4, 1972, any portion of the law practice assets including goodwill which are attributable to the earnings and accumulations of a spouse living separate and apart are the separate property of the spouse earning or accumulating the same. This could be significant where the earnings of a professional person are substantial and the time lapse from separation to trial is considerable.

[11] In determining the value of a law practice or interest therein, the trial court should determine the existence and value of the following: (a) fixed assets, which we deem to include cash, furniture, equipment, supplies and law library; (b) other assets, including properly aged accounts receivable, costs advanced with due regard for their collectability; work in progress partially completed but not billed as a receivable, and work completed but not billed; (c) goodwill of the practitioner in his law business as a going concern; and (d) liabilities of the practitioner related to his business.

In the case at bench, husband and his two law partners arrived at an agreed value of $209,895.72 for goodwill in husband's law business as of January 1, 1970, some 14 months prior to the husband's filing for a dissolution of the marriage. On remand, the trial court should give careful weight to that agreement, with the observation, however, that the agreement allocated the sum of $4,897.28 to the value of the furniture, equipment and law library. There is no mention in the agreement of the "other assets" of a law practice such as accounts receivable, costs advanced, work in progress not billed, or work completed and not billed. As properly urged by the wife, the value of these "other assets" should be determined, along with the question whether the partners

contemplated the **[38 Cal. App. 3d 111]** inclusion of their value in the $209,895.72 goodwill item. Finally, in light of such findings, the trial court should determine the value of the "goodwill," if any, in husband's law partnership business.

We note that at the time of trial husband's capital account in his law partnership was in excess of $120,000. Whatever its determined amount and ultimate nature, this item, along with the $40,000 Kennedy note and the $67,000 paid to husband by his partners must be considered in the determination of the extent of the community property of the parties.

3. Did the trial court err in denying wife's motion to inspect husband's confidential attorney-client files?

Wife's counsel made a motion to require husband to produce and permit inspection and audit of his legal files by wife's counsel and her certified public accountant. The basis of the motion was the claimed necessity to value accurately the law practice in which the wife asserted a community interest.

[12] After hearing the motion, the court held that the individual client files in husband's law office were confidential and not available for inspection. The court did hold, however, that contracts between clients and their attorney with reference to fees are not confidential; journals, cash receipts and cash receivables were relevant prior to the date of separation; and that the husband should make available to wife's attorney the fee arrangements with each individual client.

Upon dissolution of a marriage, while the nonlawyer spouse may be a silent community property partner withdrawing from a going business (*Todd*, supra), she is not entitled to invade the arena of confidence which exists between her lawyer husband and his clients. Nor is a court entitled under the guise or offer of judicial secrecy to compel a violation of such privilege. Matters which are privileged and confidential between an attorney and his clients are not subject to forceful invasion on the basis of marital economics or discovery convenience. We think the trial court properly disposed of the matter, with the following exception: Wife had the right to depose husband and his law partners concerning the value of all assets of the law practice, as heretofore noted, up to the time of trial in this case without invading privileged matter or information specifically declared to be confidential under Evidence Code section 952. An examination of the record and exhibits discloses there was full compliance with the court's discovery order and the order was broad enough to reach sufficient evidence to support findings as to the existence and value of the "fixed assets," "other assets," "goodwill" of the law practice and husband's income. **[38 Cal. App. 3d 112]**

4. Did the trial court err in deferring the issue of attorney fees and costs until after the decision on the principal issues?

Prior to trial, wife's counsel moved for $5,000 on account of attorney's fees for services which had not yet been rendered, on the representation that such sum was his firm's

minimum retainer. At the time of the hearing on the motion the trial court apprised both attorneys as follows: "I can't anticipate how much work is going to be necessary to resolve the issues here within the realm of any precision, and my attitude, perhaps, is wrong, but I believe it is within the law and practicality to [award] an adequate figure to permit counsel to proceed with whatever is necessary, and leave the ultimate [award] of attorney's fees and costs to the conclusion of the case. I feel that is the real fair way of doing it." [13] At the conclusion of the hearing the court ordered husband to pay wife's counsel the sum of $2,000 on account of attorney's fees to be reasonably incurred, and the further sum of $1,000 for costs. Wife cites *Pope v. Pope* (1951) 107 Cal. App. 2d 537 [237 P.2d 312], for the proposition that the trial court must give the wife sufficient attorney's fees and costs so that she has the means to hire counsel of adequate standing to equalize the contest and protect her rights.

Wife argues that deferral of the determination of an award for her attorney's fees and costs until after the trial court had resolved the other issues of the case was an abuse of judicial discretion which resulted in prejudicial error, urging that such ruling allowed the trial court to consider circumstances that, if offered at the time of the normal course of trial, would have been irrelevant, immaterial, privileged and/or inadmissible. Wife cites no authority for such a concept. The matter of wife's counsel fees and costs were proper issues before the trial court, and the continuation of such issues to the conclusion of the case was authorized by section 1048, subdivision (b), of the Code of Civil Procedure. (See also, 3 Witkin, Cal. Procedure (2d ed. 1971) § 266, p. 1936.) Not only was the wife able to retain counsel of her own choosing, but as evident from the trial record, an attorney of obvious competence. Finally, wife fails to point out what circumstances or matters were improperly considered by the trial court in the determination of fees and costs allowed. Her contention is without merit.

5. Was the award of attorney's fees and costs inadequate?

After trial of the main issues, wife's counsel moved for attorney's fees of $15,345.32, which figure included costs. The trial court concluded that the amount of time invested by wife's counsel was unreasonable and unnecessary. After summarizing its opinion of the way the case was conducted, **[38 Cal. App. 3d 113]** the trial court stated in its memorandum as follows: "The court is of the opinion that Mrs. Lopez could have been well and properly represented, by foresight—not hindsight, with a fee reasonably incurred in the sum of $5,000. The sum of $2,000 has been paid on account. Petitioner will pay counsel for Respondent the additional sum of $3,000. Petitioner will also pay the firm of Matson, Isum & Company [accountants] the sum of $1,500 for accounting services rendered on behalf of Respondent. The parties will otherwise each bear his or her own fees, expenses and costs of suit except as heretofore or herein ordered paid by Petitioner."

Wife contends that this award of attorney's fees and costs was inadequate. To sustain such a position, she carries a difficult burden.

[14] As summarized in *Smith v. Smith* (1969) 1 Cal. App. 3d 952, 958 [82 Cal.Rptr. 282]: "The question of the reasonableness of the order for attorney's fees is addressed to the sound discretion of the trial court [citations], and in the absence of a clear showing of abuse its determination will not be disturbed on appeal. [Citations.] "'Abuse of discretion is never presumed. It must be affirmatively established. A reviewing court is not authorized to revise the lower court's judgment even if it should be of the opinion that it would have made a different award had the matter been submitted to its judgment in the first instance, in the absence of a clear abuse of discretion.'" [Citation.] 'The discretion was the trial judge's, not ours; and we can only interfere if we find that under all the evidence, viewed most favorably in support of the trial court's action, no judge could reasonably have made the order that he did.' [Citations.]"

[15] It is well established that in determining a reasonable fee in dissolution cases the trial court is permitted to consider various factors: namely, the nature of the litigation, its complexity, the nature and extent of the contest, the amount involved, the financial circumstances of the parties, the skill required, the professional standing and reputation of the husband's attorneys and the attorneys selected by the wife. (*Pope v. Pope* (1951) 102 Cal. App. 2d 353 [227 P.2d 867]; *Palmquist v. Palmquist* (1963) 212 Cal. App. 2d 322, 338 [27 Cal. Rptr. 744].)

The exercise of sound discretion by the trial court in the matter of attorney's fees includes also judicial evaluation of whether counsel's skill and effort were wisely devoted to the expeditious disposition of the case. Certainly a desirable objective of domestic litigation is prompt and equitable resolution of marital difficulties rather than their bitter prolongation Conscientious and successful efforts by counsel to resolve as many areas of disagreement as possible without judicial intervention is entitled to serious consideration in awarding attorney's fees. Compensable professional legal skill is not limited to trial time or courtroom techniques alone. **[38 Cal. App. 3d 114]**

Although this court might disagree with the opinion of the trial judge as to the reasonableness or necessity of the time invested by wife's counsel in the representation of her interests, still we cannot say as a matter of law that the order as to fees and costs allowed was unreasonable. The burden is on wife to establish an abuse of discretion, which has been characterized as follows: "In a legal sense discretion is abused whenever in the exercise of its discretion the court exceeds the bounds of reason, all of the circumstances before it being considered. ..." (*Crevolin v. Crevolin* (1963) 217 Cal. App. 2d 565 at p. 572 [31 Cal. Rptr. 622].) No abuse of the trial court's discretion in the matter of counsel fees affirmatively appears of record.

In so holding, we are constrained to point out that our affirmance of the fees and costs awarded the wife is controlled by the application of an "abuse of discretion standard," and thus should not be taken by the trial court as tacit approval of adequacy, particularly with respect to any future request for counsel fees and costs on remand, considering the factors enumerated in *Pope* and *Palmquist*, supra.

6. Was the award of spousal support inadequate in amount and duration?

Wife was awarded the sum of $200 per month spousal support for a period of 24 months. [16a] For reasons hereinafter set forth, we hold that the determination by the trial court of the amount and duration of spousal support was an abuse of discretion. In so holding we are not unmindful of the fact that the scope of review by an appellate court of such a matter is circumscribed. A wide discretion is vested in the trial court (*Hall v. Hall* (1954) 42 Cal. 2d 435, 442 [267 P.2d 249]), and thus an appellate court must act with cautious judicial restraint, even though the particular award might appear on appeal to be modest or generous under the particular circumstances. This court in *Brawman v. Brawman,* supra, 199 Cal.App.2d at pages 879-880 said: "The discretion of the trial court 'is not arbitrary ... "it must be exercised along legal lines, taking into consideration the circumstances of the parties, their necessities and the financial ability of the husband. ... In a legal sense, discretion is abused whenever, in its exercise, a court exceeds the bounds of reason,—all the circumstances before it being considered.'"'

[17] We believe that an abuse of discretion occurs when, after calm and careful reflection upon the entire matter, it can be fairly said that no judge would reasonably make the same order under the same circumstances. Such is the case at bench. **[38 Cal. App. 3d 115]**

The basis for an order of spousal support to be paid to a party in a dissolution action is found in Civil Code section 4801, subdivision (a), which reads in part as follows: "In any judgment decreeing the dissolution of a marriage or a legal separation of the parties, the court may order a party to pay for the support of the other party any amount, and for such period of time, as the court may deem just and reasonable having regard for the circumstances of the respective parties, including the duration of the marriage, and the ability of the supported spouse to engage in gainful employment without interfering with the interests of the children of the parties in the custody of such spouse. ..."

In the case *of In re Marriage of Cosgrove,* supra, 27 Cal.App.3d at page 434, the court in upholding a decision denying spousal support said: "'... In determining the need for, the amount of and the duration of spousal support under The Family Law Act, the court is to ignore marital fault and is to base its determination solely on the circumstances of the parties, including the duration of their marriage and the ability of the supported spouse to engage in gainful employment (Civ. Code, § 4801, subd. (a).) "'Circumstances' includes 'practically everything which has a legitimate bearing upon the present and prospective matters relating to the lives of both parties.' [Citation omitted.] '[I]t refers to the needs of the parties and the abilities of the parties to meet such needs; and in measuring such circumstances, consideration should be given to property owned and obligations to be met as well as ability to earn and actual earnings.' [Citation omitted.]" ..."'

[18] The elimination of "fault" as a factor to be considered by the trial court in the allowance or denial of spousal support under The Family Law Act (Stats. 1969, ch. 1608, p. 3314, effective Jan. 1, 1970; *In re Marriage of Rosan* (1972) 24 Cal. App. 3d 885, 892 [101 Cal. Rptr. 295]; *In re Marriage of Cosgrove,* supra, at pages 433-434) did

not eliminate the requirement of a fair and reasonable consideration of "nonfault" factors which have long been judicially established.

The composition of the family unit in the case at bench appears to be typical in that the husband was the working provider of income, and the wife, who was not gainfully employed outside of the home during the course of the marriage, was committed to care for the home and two minor children. At the time of trial, husband's daughter by step-parent adoption was 15 years of age and her custody was awarded to the wife. Husband was ordered to pay $250 per month for child support. The natural son of the parties was age 12, and his custody was awarded to husband.

[19] While by no means all inclusive, the following are some of the **[38 Cal. App. 3d 116]** circumstances applicable to the case at bench which a trial court should consider in determining the allowance, amount and duration of spousal support:

1. A comparison of the financial position of each of the parties before and after the dissolution (*Huntington v. Huntington* (1953) 120 Cal. App. 2d 705 [262 P.2d 104]) with due consideration given as to property owned and obligations to be met (*Hall v. Hall,* supra, 42 Cal.2d 435).

2. The ability of the wife to work and her potential earnings considered in the context of her age, training, and likelihood of employment. (*Brawman v. Brawman,* supra, 199 Cal. App. 2d 876; *Arnold v. Arnold* (1946) 76 Cal. App. 2d 877 [174 P.2d 674]; *Newbauer v. Newbauer* (1949) 95 Cal. App. 2d 36 [212 P.2d 240]; *Haldeman v. Haldeman* (1962) 202 Cal. App. 2d 498 [21 Cal. Rptr. 75].)

3. The reasonable needs of the wife for sustenance, clothing, shelter and care due her in the station of life to which she is accustomed (*In re Marriage of Siegel* (1972) 26 Cal. App. 3d 88 [102 Cal.Rptr. 613]), within the ability of the husband to provide (*Pope v. Pope,* supra, 102 Cal. App. 2d 353; Civ. Code, § 4801, subd. (a)), and considering her age, mental and physical health.

4. The nature of the separate estate of the wife with its actual and reasonable income potential. (*Dallman v. Dallman* (1959) 170 Cal. App. 2d 729 [339 P.2d 636].)

5. Whether the wife has made adequate effort to find suitable work, consistent with her age, ability and health, and to conscientiously establish herself as genuinely endeavoring to be partially self-supporting, consistent with her maternal obligations. (*Webber v. Webber* (1948) 33 Cal. 2d 153 [199 P.2d 934]; *In re Marriage of Dennis* (1973) 35 Cal. App. 3d 279, 284 [110 Cal. Rptr. 619]; *In re Marriage of Rosan,* supra, 24 Cal. App. 3d 885.)

6. The nature and extent of the community property awarded to each of the parties, with its actual and reasonable potential for the production of net income after state and federal taxes. (*Stuckey v. Stuckey* (1964) 231 Cal. App. 2d 382, 386 [41 Cal. Rptr. 792].)

7. Income tax consequences of spousal support to both the paying and receiving spouse.

8. The needs of the husband, including necessities and reasonable living expenses. (*Hall v. Hall,* supra, 42 Cal. 2d 435; *Jones v. Jones* (1955) 135 Cal. App. 2d 52 [286 P.2d 908].) **[38 Cal. App. 3d 117]**

9. The ability of the spouse to pay, based on his financial condition, resources, ability to earn and actual earnings (*Hall v. Hall,* supra, 42 Cal. 2d 435, 442), with due consideration given to income tax and social security deductions, life and health insurance premiums, and retirement contributions, if any.

10. Other valid support obligations of the paying spouse to his lawful dependents.

11. The duration of the marriage. (Civ. Code, § 4801, subd. (a).)

[16b] A brief summary of the findings of the trial court, in light of the foregoing, establishes the lack of adequate consideration of the essential circumstances to be evaluated in determining the duration and amount of spousal support for the wife. As of the date of trial, the court found the parties possessed $302,699.45 in community property, with husband's net earnings before taxes averaging approximately $7,000 per month during the seven years preceding the dissolution. In addition, the trial court found and awarded husband as his separate property over $120,000 representing his capital account in his law partnership, plus $27,229.20 cash and the balance of the Kennedy note in the sum of $34,670. It is undisputed that husband's earnings from the date of filing for dissolution to time of trial (some nine months) continued at an annual rate of approximately $80,000 per year before taxes. Both husband and wife testified to average living expenses of $1,000 per month, with husband obligated to pay insurance, property taxes, club dues and payments averaging about $2,058 per month. Although not specifically mentioned in the findings, we note that husband receives the further sum of $1,075 per month rental income from the law office building awarded to him which offsets part of his foregoing monthly payments.

The wife was awarded the family residence on which there was a balance of $12,766.57 owing in monthly payments of $160 per month, plus $673 in annual property taxes. Wife is without any separate estate and made no effort to seek employment after separation, but rather maintained the family residence for her and the two minor children. There was no supportive medical evidence to verify wife's physical condition, and she had not sought medical care for her spinal condition during the four years preceding the trial. The trial record supports the finding that wife had the ability to engage in gainful employment, although her education, training, skill and age would appear to limit her earning potential to some degree. Husband is obligated to pay $250 per month for the support of his daughter and to support his son. The duration of the marriage was 14 years and 3 months. **[38 Cal. App. 3d 118]**

A cursory examination of the "community property" awarded wife indicates that 40 percent thereof (i.e., the equity in the family residence, furniture and Mark III Lincoln automobile at a total value of $57,366.48) are without income potential, unless converted to cash, or the family residence sold or rented. An additional 40 percent of the "community property" awarded wife is in the form of 817 shares of stock in the Bank of Redding and a secured note on the Westchester Building, the combined value of which produces a monthly taxable income of $322.92. The balance of the "community property" awarded the wife consisted of cash in the sum of $23,419.47 which if invested at 6 percent interest would produce an additional taxable income of $117.09 per month.

Husband seeks to justify the award of $200 per month spousal support for two years on the premise that the income to be earned from the "community property" awarded wife, plus the $250 per month child support awarded for the daughter will provide wife with a total of $890 per month to meet her needs. Such an assumption completely ignores several crucial factors: namely, husband's ability to pay; duration of the marriage; the tax consequences imposed upon the wife due to the "kind" of community assets awarded to her; and the substantial financial disparity of the parties after the dissolution due to the erroneous finding that husband's interest in his law practice and the proceeds from the sale of one-half thereof were his separate property.

Since oral argument, respective counsel have urged our consideration of two recent cases: *In re Marriage of Patrino* (1973) 36 Cal. App. 3d 186 [111 Cal. Rptr. 367], is clearly distinguishable from the case at bench, not only with respect to comparative ability to pay, but in Patrino the three minor children were awarded to the husband and the wife was able to seek employment free from parental responsibilities. (Civ. Code, § 4801, subd. (d).) Wife's reliance on *In re Marriage of Dennis,* supra, 35 Cal. App. 3d 279, is also without merit. The duration of the marriage in *Dennis* was 25 years, the wife was over 50 years of age with undisputed eyesight problems, which during the allowed four years of fixed terminable support could substantially impair her ability to perform her only skill, that of a seamstress.

Whatever the implications of *Dennis* (supra), we emphasize that in our view the abuse of discretion involved in the case at bench relates solely to the amount and duration of spousal support, and not to the fact that such support was ordered fixed and terminable by the trial court. [20] As noted in *Patrin*o, supra, section 4801, subdivision (d), of the Civil Code now provides for the absolute termination of spousal support unless the trial court in its original order retains jurisdiction to extend an order for **[38 Cal. App. 3d 119]** support. We think this evidences a legislative intent to diminish constant modification proceedings, to provide both parties some degree of post-dissolution economic stability by minimizing the inherent apprehension of the possible loss or extension of spousal support, and in proper cases to eliminate permanent burden or dependence, thus motivating both parties to seek a new life completely free from a former marital failure.

The judgment insofar as it awards the community property of the parties and fixes the amount and duration of spousal support is reversed. In all other respects the judgment is affirmed. Wife is to recover her costs.

Richardson, P. J., and Janes, J., concurred.

T.C. Memo. 2010-104

UNITED STATES TAX COURT

ANDREW K. LUDWICK, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

WORTH Z. LUDWICK, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 3281-08, 3282-08. Filed May 10, 2010.

Paul H. Roskoph, for petitioners.

Andrew R. Moore, for respondent.

MEMORANDUM OPINION

HALPERN, Judge: Respondent determined deficiencies in Federal gift tax for 2005 for Andrew K. Ludwick and Worth Z. Ludwick of $86,529 and $88,785, respectively. Petitioners owned a vacation home as tenants in common, and the only issue for

decision is the value of the interests therein that they separately transferred in trust to a so-called qualified personal residence trust.

Unless otherwise stated, all section references are to the Internal Revenue Code in effect for 2005, and all Rule references are to the Tax Court Rules of Practice and Procedure.

We round all dollar amounts to the nearest dollar.

Background

Some facts have been stipulated and are so found. The stipulation of facts and accompanying exhibits are incorporated herein by this reference.

Petitioners are husband and wife, and they resided in California when they filed the petition.

In 2000, petitioners purchased unimproved real property on a bluff on the north shore of Hawaii's Big Island. By the end of 2003, they had improved the property by constructing a vacation home. In 2004, they owned the improved property (the property) as tenants in common, each having an undivided one-half interest therein.

In December 2004, petitioners executed agreements establishing separate qualified personal residence trust arrangements. In February 2005, petitioners transferred their undivided interests in the property pursuant to those trust agreements. At the time of the transfers, the property had a

fair market value of $7.25 million and an annual operating cost of approximately $350,000.

On their separate 2005 Federal gift tax returns, petitioners each reported a gift resulting from the transfers in trust. They valued their separate one-half interests in the transferred property at a discount of 30 percent; viz, $2,537,500 (0.70 x 0.50 x $7,250,000). In determining the deficiencies in gift tax, respondent allowed a discount of only 15 percent, so that he computed $3,081,250 to be the value of each undivided one-half interest that petitioners transferred. On brief, respondent argues for a discount of no more than 11 percent, which results in a value for each transfer of $3,226,250.

Discussion

I. Introduction

As stated, we must determine the fair market value of each petitioner's undivided one-half interest in the property.

The standard for determining fair market value for purposes of the gift tax 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 to sell and both having knowledge of the relevant facts. Sec. 25.2512-1, Gift Tax Regs. Petitioners bear the burden of proof and do not argue otherwise.

See Rule 142(a).[1] We find that, at the time of the transfer, the fair market value of each undivided one-half interest in the property was $3,000,089, for a discount of approximately 17 percent. We will explain the process by which we reach that result.

II. Valuation of the Gifts

To support their respective valuations, the parties have in part relied on the testimony of experts. We have considered that testimony and have in part relied on it in reaching our conclusion.

A. Method of Valuation

1. The Expert Reports

Petitioners request that we value each undivided interest by discounting half the fair market value of the property ($3,625,000) by 30 percent to reflect the disadvantages of owning an undivided fractional interest in property. Respondent requests a broadly similar approach, although he reaches a different conclusion regarding the size of the proper discount.

Petitioners' expert, Carsten Hoffman, an expert in the valuation of fractional interests in property, relied on analyses of sales of undivided interests and partnership interests.

[1]Petitioners have not raised the issue of sec. 7491(a), which shifts the burden of proof to the Commissioner in certain situations. We conclude that sec. 7491(a) does not apply here because petitioners have not produced any evidence that they have satisfied the preconditions for its application.

Respondent's expert, Stephen Bethel, also an expert in the valuation of fractional interests in property, relied on analyses of sales of undivided interests, various surveys of brokers, a review of tender offers for majority interests in public companies, and lawyers' estimations of the cost of partition. We do not find the analysis of either expert convincing.

Mr. Hoffman, in his direct testimony, compared the discounts from 69 "undivided interest transactions" between 1961 and 2006. He calculated the mean and median discounts for the set of all the transactions and for three subsets: 16 income-producing properties, 26 parcels of raw land, and 22 transactions involving undivided 50-percent interests. He also provided the range of discounts for all the transactions and for each of those three subsets. He provided no way for us to evaluate his analysis, however. He failed not only to explain how the discounts were calculated (i.e., how did he calculate the underlying fair market value?) but also to provide any measure of the variability or dispersion of his data points (e.g., their standard deviations). Most importantly, he did not provide any of the data; we do not know the specifics of any of the "undivided interest transactions". We have no way to know how comparable those properties were to the one here in issue.

Mr. Hoffman also compared petitioners' property to 10 real property limited partnerships. Yet petitioners' property was

never intended to produce income; it was a private vacation home, not a source of revenue. The cashflow statements of the 10 limited partnerships (which held, for instance, apartment buildings and mobile homes) are not relevant.

Mr. Bethel, in his direct testimony, in part relied on four sales of undivided interests between 2002 and 2007. Yet all the sales involved commercial property in the eastern United States. We are not convinced that such data tells us much about the appropriate discount for a multimillion dollar vacation home in Hawaii.

Mr. Bethel also relied on three surveys of California brokers that his firm conducted in 1999, 2005, and 2008. The survey questions involved the discounts associated with fractional interests in property. About 10 brokers responded to each survey by providing a range of discounts and a brief explanation.[2] Yet we have no way of evaluating or of reconciling the brokers' responses because we have no information about the transactions on which the brokers based their opinions. Moreover, the brief explanations are often so cryptic as to

[2]We ignore some responses. For example, one broker opined that the discount associated with the sale of a fractional interest would be 15 percent (he did not give a range), yet the comment beside his estimate stated: "He has never sold a minority position in a tenancy in common, but in his opinion there must be a discount for the position."

reveal almost nothing about the reasons behind the discount ranges. The surveys provide little guidance.

Mr. Bethel also relied on two surveys with brokers regarding so-called pooled public tenancy-in-common investments, which are professionally managed investment properties with multiple owners. Fractional interests in those investments generally trade with almost no discount. In his report, Mr. Bethel conceded that there are "four critical differences" between those investments and petitioners' property,[3] yet he argued that those differences would only "slightly" increase the discount proper here. Mr. Bethel did not explain his conclusion, and, without any reasoning, we are not convinced.

Finally, Mr. Bethel relied on a professional review of tender offers for majority interests in public companies. Specifically, he relied on transactions involving the change of control of real estate companies. He calculated the discounts as follows: If the market price were $100 and a buyer tendered $125, then the premium would be 25 percent and the discount would be 20 percent. As Mr. Bethel noted, however, the size of a control premium depends on many factors (e.g., "the buyer's desire or need to acquire the company * * * to complement his

[3]Pooled public tenancy-in-common investments are professionally managed, and interests therein are readily marketable, represent ownership in a diverse set of properties, and have relatively steady income streams.

present operation") that do not seem relevant to the discount appropriate here. We find the tender offer analysis unhelpful.

2. Partition

At trial, we asked both experts why a buyer of an undivided interest in the property would consider the interest worth any less than a proportional share of the fair market value of the whole property reduced by the cost to the buyer of partition; i.e., the cost to end joint ownership involuntarily by a judicially mandated sale (as a single residential property, the property was unlikely to be divided into separate estates) and to distribute the proceeds appropriately. Both convinced us that a buyer would also take into account marketability or liquidity risk; i.e., "the risk of being unable to sell an asset quickly at its fair market value." Downes & Goodman, Dictionary of Finance and Investment Terms 391 (7th ed. 2006). They disagreed, however, as to the size of the appropriate discount and as to whether partition would even be necessary.

Although Mr. Hoffman insisted that a buyer would consider more than just the cost of partition and the marketability risk, he failed to convince us. Certainly a tenancy in common is not the ideal way for two strangers to own a vacation home. That does not mean, however, that a buyer would discount an undivided interest by any more than the cost of liquidating his investment

and an additional amount to reflect the risk occasioned by a less than immediate sale. Indeed, Mr. Hoffman testified:

> And if you have the right to * * * force a partition, you will certainly consider that. And if an investor were to come to me and say, well, I demand an 80 percent discount because it's an undivided interest, I would say, well, that doesn't make sense because you can partition it for significantly less than that, so why would you demand an 80 percent discount.

The logic of that statement is that a buyer who had a right to partition could not demand a discount greater than (1) the discount reflecting the cost and likelihood of partition and (2) the discount representing the marketability risk because, if he did, another (rational) buyer would be willing to bid more. That iterative process would drive the discount down to the discount reflecting the expected cost of partition and the marketability risk. Mr. Hoffman failed to convince us otherwise.

Petitioners concede that Hawaii law provides for partition of real property. See Haw. Rev. Stat. Ann. sec. 668-1 (Lexis Nexis 2007). A buyer would thus be willing to pay an amount equal to the present value of (1) the fair market value of 50 percent of the property upon sale less (2) his costs of maintaining the property and his costs of selling the property (perhaps including the cost of partition). Accordingly, to determine the price that a buyer would be willing to pay, we must figure (1) the length of the partition process, its costs (including the cost of selling the property), and the likelihood

partition would be necessary, (2) the rate of return the buyer would demand, and (3) the value of 50 percent of the property upon sale. See Estate of Barge v. Commissioner, T.C. Memo. 1997-188.

B. What a Buyer Would Pay

1. Partition

In partition suits, Hawaii courts may sell real property where partition in kind would be impracticable or greatly prejudicial to the interested parties. See Haw. Rev. Stat. Ann. sec. 668-7(6) (Lexis Nexis 2007). Petitioners do not dispute that partition would result in a sale of the property. Mr. Hoffman testified that a contested partition would take 2 to 3 years to resolve and that its costs would include $10,000 of appraisal costs and $70,000 of litigation expenses. Mr. Bethel testified that a contested partition could take up to 2 years to resolve, and he estimated that its costs would include $15,000 to $20,000 “to proceed with filings”, a brokerage fee of 4 to 6 percent, and a closing fee of 1 percent. Mr. Bethel concluded that the total cost of partition would range from 6 to 8 percent of the value of the property. Mr. Bethel testified that, if partition were not necessary, the property could be sold in less than a year.

We find that a contested partition would take 2 years to resolve (including 1 year to sell the property) and that the

costs made necessary by the litigation would be 1 percent of the value of the property (that is, $72,500). Petitioners, however, have failed to convince us that partition will always--indeed, will often--be necessary. In fact, when respondent's counsel suggested that partition was "relatively unlikely", Mr. Hoffman seemed to agree.[4] Nonetheless, neither party suggested the likelihood of partition. Bearing heavily on petitioners, who bear the burden of proof, we find that a buyer would expect partition to be necessary 10 percent of the time. We find that the cost of selling the property (which the sellers would bear in any case) would be 6 percent of the value of the property (that is, $435,000). Finally, the annual operating cost of the property was approximately $350,000. We assume that a buyer of a one-half undivided interest in the property would expect to bear only half the costs described above; the buyer would expect the remaining petitioner to bear the other half.

[4]Respondent's argument is as follows. Suppose petitioner husband had sold his interest. If the buyer then told petitioner wife that he wanted to sell the property, what are the odds that she would object? Not only would he have a right to partition but also a court would ultimately order the property sold (as opposed to divided). Petitioners have failed to explain what (in that hypothetical) petitioner wife would stand to gain by opposing partition. Cf. Estate of Barge v. Commissioner, T.C. Memo. 1997-188 (finding that, in a case in which the property would have been divided (not sold), the other owners might resist partition "to obtain an advantageous partition"). Respondent, however, concedes that such opposition is possible, and we accept that concession.

2. Rate of Return

Mr. Bethel testified that, to account for the marketability risk, a buyer would demand a return of 10 percent. Mr. Hoffman testified that a buyer would demand a return of 30 percent. Nonetheless, he presented no evidence to support that conclusion. Petitioners have failed to prove that a buyer would demand a return greater than 10 percent.

3. Value of Interest After Partition

The parties stipulated that in 2005 the property had a fair market value of $7.25 million. Mr. Hoffman testified that the "long-term sustainable growth [rate] of real estate" was 3 percent annually. Accordingly, at the end of 1 year (if partition were not necessary) or 2 years (if it were) the property would sell for $7,467,500 or $7,691,525, respectively.

III. Fair Market Value

Accordingly, to determine the value of an undivided one-half interest in the property, we use a 10-percent rate of return (discount rate), a partition period of 2 years (including a selling period of 1 year), annual operating costs of $175,000, (possible) partition costs of $36,250 allocated equally to both years, the cost of selling the property ($217,500), and a fair market value of $3,733,750 or $3,845,763 (after a sale in 1 year or 2 years, respectively). We find that the fair market value of

the gift that each petitioner made in 2005 was $3,000,089; our calculations are as follows.

If Partition Is Not Necessary

Year	Operating Costs	Selling Costs	Sale Proceeds	Total	Present Value
1	$175,000	$217,500	$3,733,750	$3,341,250	$3,037,500

If Partition Is Necessary

Year	Operating Costs	Partition and Selling Costs	Sale Proceeds	Total	Present Value
1	$175,000	$18,125	--	($193,125)	($175,568)
2	175,000	235,625	$3,845,763	3,435,138	2,838,957
Total					2,663,388

We have found that a buyer would expect partition to be necessary 10 percent of the time. Thus, the buyer of an undivided one-half interest in the property would have been willing to pay the weighted average of the two present values calculated above; that is, $3,000,089.

Decisions will be entered under Rule 155.

Full Text of Court Cases

Estate of Luton v. Commissioner

Case name: Estate of Luton v. Commissioner
Citation: T.C. Memo 1994-539, 1994 Tax Ct. Memo LEXIS 550
Date of decision: October 27, 1994
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Parr
SIC: 0971 Hunting and Trapping, and Game Propagation
NAICS: 114210 Hunting and Trapping

Keywords: Estate tax

COUNSEL:

For petitioner: Richard J. Sideman and Wendy Abkin.

For respondent: Cynthia K. Hustad and Mary E. Wynne.

JUDGES:

PARR

OPINIONBY:

PARR

OPINION:

MEMORANDUM FINDINGS OF FACT AND OPINION

PARR, Judge: Petitioner is the Estate of William F. Luton. Respondent determined a deficiency of $ 7,212,448 in petitioner's estate tax. Respondent also determined that petitioner was liable for an addition to tax for negligence under section 6653(a)(1)(A) in the amount of $ 360,622, plus 50 percent of the interest due on the deficiency under section 6653(a)(1)(B), and was liable for an addition to tax of $ 1,095,102 for a valuation understatement under section 6660. n1 By amendment to answer, respondent revised the deficiency to $ 7,707,179 and additions to tax for negligence and valuation understatement to $ 385,359 and $ 1,104,675, respectively.

n1 All section references are to the Internal Revenue Code in effect as of the date of decedent's death, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

After stipulations and concessions, the issues for decision are: (1) Whether the value of petitioner's 78-percent interest in the common stock of Rancho San Juan, Inc., on the alternate valuation date n2 was $ 5,336,000 as determined by respondent. We hold that the value was $ 4,492,800. (2) Whether the value of petitioner's one-third interest in the common stock of Dune Lakes, Ltd., on the alternate valuation date was $ 1,440,000 as determined by respondent. We hold that the value was $ 1,040,000. (3) Whether the value of petitioner's 41.9-percent interest in the Miramonte Liquidating Trust on the alternate valuation date was $ 3,250,000 as determined by respondent. We hold for respondent. (4) Whether petitioner is liable for an addition to tax for undervaluation pursuant to section 6660. We hold that petitioner is not liable for such addition.

n2 Petitioner made a valid election under sec. 2032 to value the assets of the estate on the alternate valuation date of Oct. 27, 1987.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts with attached exhibits and stipulation of partial agreement are incorporated herein by this reference. William F. Luton (hereinafter decedent) was a resident of the State of California at the time of his death on April 27, 1987. At the time of the filing of the petition, coexecutor Nancy L. Jackson (decedent's daughter) resided in the State of Idaho, and coexecutors Robert S. Herdman n3 and William F. Luton, Jr. (decedent's son), resided in the State of California.

n3 The record does not indicate the relationship of Mr. Herdman to decedent.

Rancho San Juan

In 1934, decedent acquired by gift a ranch in Santa Barbara County known as Rancho San Juan. In 1936, decedent and his wife, Nancy Luton, established their residence on Rancho San Juan, where they lived until the dates of their respective deaths. In 1941 and 1958, decedent and his wife acquired, as community property, two parcels of land in Santa Barbara County contiguous to Rancho San Juan. Hereafter, unless otherwise stated, the three parcels will be referred to collectively as Rancho San Juan. In 1968, decedent and his wife signed a contract with the County of Santa Barbara concerning limitations on the use and development of Rancho San Juan, pursuant to the California Land Conservation Act of 1965 (hereafter referred to as the Williamson Act). The agreement is effective for 10 years and is automatically extended for 1 year at the end of each year of the contract so that it will always have a term of 10 years, unless notice of termination is given. The quid pro quo for the landowners is favorable property tax treatment.

On August 13, 1982, Rancho San Juan was incorporated under the laws of California as a corporation wholly owned by decedent and his wife. Decedent received 44,760 shares as community property with his wife and 55,240 shares as separate property in exchange for the right, title, and interest in the real property comprising Rancho San Juan. The corporation (RSJ, Inc.) assumed all of the obligations, conditions, and restrictions set forth in the contracts with the county. Effective December 1, 1986, RSJ, Inc., made an election to be treated as an S corporation for Federal tax purposes. Stock in RSJ, Inc., is not publicly traded.

In years 1982-86, decedent transferred some shares of RSJ, Inc. stock (1) into trusts created for the benefit of his grandchildren and (2) into the name of each of his six children. At the time of his death, decedent still held 78-percent (78,000 shares) of the stock of RSJ, Inc., in his own name. n4 Decedent paid RSJ, Inc., rent for the right to live on Rancho San Juan.

n4 Decedent received all of the stock owned by Nancy L. Luton, who had predeceased him in September of 1983.

Dune Lakes, Ltd.

Dune Lakes, Ltd., was formed on June 24, 1931. The principal asset of Dune Lakes, Ltd., is real estate in San Luis Obispo County, California. Most of the corporation's acreage has been operated as a duck-hunting preserve. The remaining sections of the land are either leased for agricultural purposes, zoned for 5-acre lots, or subject to sensitive resource area restrictions. In 1973 and 1974, Dune Lakes, Ltd., entered into a contract with the County of San Luis Obispo concerning limitations on use and development of the property pursuant to the Williamson Act.

In 1983, decedent acquired 1 share of the 3 outstanding shares of Dune Lakes, Ltd., by inheritance from his wife. n5 Effective January 1, 1987, the corporation made an election to be treated as a S corporation for Federal tax purposes. Stock in Dune Lakes, Ltd., is not publicly traded.

n5 As of Apr. 27, 1987, the other shares of Dune Lakes, Ltd. were owned by Nancy Luton's brother, Mr. William Dickinson (1 share), Nancy Luton's niece, Martha May (one-half share), and decedent's son-in-law, Mr. Peter Jackson (one-half share).

Miramonte Trust

As of December 1984, the shareholders of Key Television, Inc., consisted of decedent and members of his family. On December 7, 1984, Key Television, Inc., sold substantially all of its assets to Shamrock Holdings, Inc. (hereafter Shamrock), for cash, plus an unsecured promissory note. Key Television, Inc., changed its name to Miramonte Drive Corp., and filed a certificate of election to wind up and dissolve pursuant to section 337. On or about September 30, 1985, the nondistributed assets of Miramonte Drive Corp., were contributed to the Miramonte Liquidating Trust (hereafter the Miramonte Trust). Decedent and William F. Luton, Jr., were the trustees of the Miramonte Trust. The principal asset of the Miramonte Trust is a note receivable dated December 7, 1984, from Shamrock in the amount of $ 7,700,000 with interest of 10 percent payable semiannually beginning December 31, 1984, through maturity. The principal is payable in 15 semiannual installments of $ 250,000 beginning December 31, 1988, and a final principal payment of $ 3,950,000 on June 30, 1996. The note is not listed on a public exchange. The trust agreement provides that a vote of two-thirds of the trust units could force the trustee to liquidate. The terms of the trust also provide a right of first refusal restriction upon the transfer of any unit. The right of first refusal exists for a 35-day period. At the time of his death, decedent owned 41.9 percent of the units of the Miramonte Trust.

Valuation

Decedent's estate is being administered under the laws of the State of California. The executors engaged an attorney, Mr. Howard M. Simon, to prepare the Federal estate tax return for petitioner. In this regard appraisers were sought to determine the fair market values of the assets included in the gross estate. Mr. Philip Moore, president of Seligman Valuations and an individual with academic and professional experience as an appraiser, was selected to appraise the value of petitioner's interests in the stock of RSJ, Inc., and of Dune Lakes, Ltd., and in the Miramonte Drive Liquidating Trust. Mr. Simon provided Mr. Moore with appraisals of the real estate owned by Dune Lakes, Ltd., and RSJ, Inc., that had previously been prepared by Mr. Harold Miossi and Mr. James Paddock, respectively. Mr. Miossi is a California probate referee for San Luis Obispo County, a position he has held since 1960. Mr. Paddock has over 50 years' experience in appraising real estate in the Santa Barbara area and throughout California. We recognize as experts Mr. Moore, Mr. Miossi, and Mr. Paddock.

In the stipulation of partial agreement, the parties agreed that the value of the underlying real estate would be equal to that amount determined by a Mr. Dunshee, an appraiser since 1952 and recognized as an expert appraiser of agricultural land and cattle ranches. He determined a value of $ 4,800,000 and $ 7,200,000 respectively, for the assets of Dune Lakes and Rancho San Juan, without consideration of any discounts. The amount of discounts is still in dispute.

At trial, petitioner presented testimony and submitted a written report from Dr. Shannon P. Pratt as to the value of the stock and the trust units. See Rule 143(f). Dr. Pratt is the managing director of a firm specializing in financial research and analysis, especially the valuation of businesses and business interests. Dr. Pratt holds a doctorate of finance, is a member of the American Society of Appraisers, and is a certified financial planner. Dr. Pratt is also the author of two reference works on business valuation.

Respondent countered with testimony and a written report from her own expert Ms. Margaret N. Singleton. Ms. Singleton is the president of an appraisal firm doing real estate and business appraisals. She has experience as an appraiser for various private companies and the Wisconsin Department of Revenue, where she valued rural properties and farms. Ms. Singleton is a member of professional valuation organizations; she teaches and has published articles relating to valuation. We recognize both Dr. Pratt and Ms. Singleton as experts.

Respondent issued a statutory notice of deficiency to petitioner, asserting deficiencies in and additions to petitioner's Federal estate tax. The greater part of that deficiency, and the only part here in issue, results from respondent's determination that the fair market value of certain shares of corporate stock and of units in a liquidating trust owned by decedent at the date of his death, and valued at the alternate valuation date, were undervalued on petitioner's estate tax return. Similarly the addition to tax in issue relates to the undervaluation as determined by respondent. The other numerous determinations which make up the determined deficiency relate to undervaluation of other property (including real estate, corporate stocks and bonds, mortgages, and notes owned by decedent at the date of his death and valued at the alternate valuation date); omission of a retained life estate; previously agreed adjustments; disallowance of administration expenses; disallowance of debts of the decedent; adjusted taxable gifts; and penalties for negligence or intentional disregard of rules and regulations. All of these other issues have been resolved in the stipulation of partial agreement.

OPINION

Valuation of Property

The general rule for valuing property to be included in a decedent's gross estate is provided in section 2031 and the regulations thereunder. Property includable in a decedent's gross estate is included at its fair market value as of the date of the decedent's death or the alternate valuation date as provided under section 2032. Secs. 2031(a) and 2032(a); sec. 20.2031-1(b), Estate Tax Regs. Fair market value is a question of fact, with the trier of fact having the duty to weigh all relevant evidence of value and to draw appropriate inferences. Commissioner v. Scottish American Inv. Co., 323 U.S. 119, 123-125 (1944); Helvering v. National Grocery Co., 304 U.S. 282, 294 (1938); Hamm v. Commissioner, 325 F.2d 934, 938 (8th Cir. 1963), affg. T.C. Memo. 1961-347; Skripak v. Commissioner, 84 T.C. 285, 320 (1985); Zmuda v. Commissioner, 79 T.C. 714, 726 (1982), affd. 731 F.2d 1417 (9th Cir. 1984). Fair market value represents 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 to sell and both having reasonable knowledge of relevant facts. United States v. Cartwright, 411 U.S. 546, 551 (1973); Gillespie v. United States, 23 F.3d 36 (2d Cir. 1994); Estate of Hall v. Commissioner, 92 T.C. 312, 335 (1989); sec. 20.2031-1(b), Estate Tax Regs. All relevant facts and elements of value as of the applicable valuation date should be considered in every case. Estate of Johnson v. Commissioner, 77 T.C. 120, 124 (1981), revd. on other grounds 718 F.2d 1303 (5th Cir. 1983); sec. 20.2031-1(b), Estate Tax Regs. And any knowledge of future events not known or reasonably anticipated on the valuation date that might affect the value of the stock cannot be attributed to the willing seller or buyer. Estate of Bennett v. Commissioner, T.C. Memo. 1993-34; sec. 20.2031-1(b), Estate Tax Regs.

The willing buyer and seller are hypothetical persons, instead of specific individuals or entities. Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990). The fair market value of a particular item of property is not to be determined by a forced sale price. Sec. 20.2031-1(b), Estate Tax Regs. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public. Id.

Valuation of Closely Held Stock

In determining the value of stock that is not listed on an exchange, actual arm's-length sales of such stock in the normal course of business within a reasonable time before or after the valuation date are the best criteria of market value. Estate of Andrews v. Commissioner, 79 T.C. 938, 940 (1982); Duncan Industries, Inc. v. Commissioner, 73 T.C. 266, 276 (1979). However, if the stock has never been publicly traded, and there is no evidence of any sales of stock in the corporation at any time near the date of a decedent's death, the value of the closely held stock must be determined indirectly, by weighing the corporation's net worth, prospective earning power, dividend-paying capacity, and other relevant factors. Estate of Andrews v. Commissioner, supra; Estate of Leyman v. Commissioner, 40 T.C. 100, 119 (1963), affd. in part and remanded in part 344 F.2d 763 (6th Cir. 1965), vacated and remanded 383 U.S. 832 (1966); sec. 20.2031-2(f), Estate Tax Regs. These factors cannot be applied with mathematical precision. Estate of Andrews v. Commissioner, supra at 941. Rather, the weight to be given to each factor must be tailored to account for the particular facts of each case. Messing v. Commissioner, 48 T.C. 502, 512 (1967).

Similarly, section 2031(b) provides that the value of unlisted stock "shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange." n6

n6 In addition, we have recognized that Commissioner's Rev. Rul. 59-60, 1959-1 C.B. 237, which both parties' experts have relied upon, has been widely accepted as setting forth the appropriate criteria to consider in determining fair market value of stock of closely held corporations for estate tax purposes. Estate of Newhouse v. Commissioner, 94 T.C. 193, 217 (1990). The revenue ruling recognizes that a determination of fair market value is a question of fact and will depend upon the circumstances of each case:

No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, * * * [the appraiser] should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance. [Rev. Rul. 59-60, 1959-1 C.B. at 238.]

This Court has recognized that the valuation of stock in a closely held family corporation is always a difficult question. Estate of Tompkins v. Commissioner, T.C. Memo. 1961-338. "[Fair market] value is a fact, the determination of which is, at least, generally difficult. The result is rarely satisfactory." Estate of McKitterick v. Commissioner, 42 B.T.A. 130, 136 (1940). The difficulty is compounded where a substantial part of the corporation's assets consists of unimproved land, which is itself difficult to value. Estate of Tompkins v. Commissioner, supra. Before we can place a value on the stock, we must first determine the fair market value, as of the valuation date, of the underlying assets. Id.

Expert Opinion

Both parties relied upon experts to consider and analyze the intrinsic factors of the underlying real estate in order to derive a valuation of the corporations' stock. However, due to fundamental differences in approach between the parties' experts, particularly with respect to the weight to be placed upon net-asset value as opposed to earnings capacity or liquidation analysis, the valuations determined by the experts were quite far apart.

Respondent's determination of the fair market value of petitioner's assets is presumed correct, and petitioner bears the burden of overcoming the presumption of correctness. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933); Estate of Carli v. Commissioner, 84 T.C. 649 (1985); Hutchens v. Commissioner, T.C. Memo. 1993-600; Estate of Yeager v. Commissioner, T.C. Memo. 1986-448. Respondent bears the burden of proof with regard to any amount in excess of the valuation determined in the notice of deficiency. Rule 142(a).

At trial, we received testimony from expert witnesses, and we weigh that testimony in light of the experts' qualifications as well as all the other credible evidence. Estate of Newhouse v. Commissioner, supra; Estate of Gilford v. Commissioner, 88 T.C. 38, 56 (1987). Nonetheless, we are not bound by the opinion of any expert witness and will accept or reject expert testimony in the exercise of sound judgment. Helvering v. National Grocery Co., 304 U.S. at 295; Estate of Newhouse v. Commissioner, supra; Estate of Hall v. Commissioner, 92 T.C. at 338. We may adopt some portions and reject other portions of expert testimony as we weigh its persuasiveness and helpfulness. Chiu v. Commissioner, 84 T.C. 722, 734 (1985); Estate of Bennett v. Commissioner, T.C. Memo. 1993-34. Furthermore, we recognize, "'Valuation is * * * necessarily an approximation * * * It is not necessary that the value arrived at by the trial court be

a figure as to which there is specific testimony, if it is within the range of figures that may properly be deduced from the evidence.'" Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976) (quoting Anderson v. Commissioner, 250 F.2d 242, 249 (5th Cir. 1957)), affg. T.C. Memo. 1974-285; Estate of Bennett v. Commissioner, T.C. Memo. 1993-34.

Issue 1. Value of 78-Percent Stock Interest in Rancho San Juan

Value of Underlying Real Estate

The parties have agreed to the value of $ 7,200,000 for the underlying real estate of RSJ, Inc., However, based on Mr. Dunshee's analysis, petitioner argues that a $ 1 million discount is appropriate for the time it would take to sell Rancho San Juan if all three parcels of the land were placed on the market at the same time. Mr. Dunshee believes that a 13,000-acre parcel would be very difficult to sell, and the highest value for the property could be obtained by dividing the real property into three new parcels and selling them individually. Mr. Dunshee discounted the total anticipated sales proceeds at a discount rate of 12 percent over 2 years, taking into account the cost of money as of the valuation date and accounting for risk factors and some sales costs. Respondent counters that such a discount is inappropriate. The ranches were incorporated and the stock was given to decedent's heirs to ensure that the land would stay in the family. Therefore, the likelihood of sale was speculative. Respondent contends that the proper method of valuation for the underlying real estate is the net asset value approach.

We have repeatedly held that costs of sale or costs incurred in liquidation are not proper deductions in arriving at value for purposes of section 2031 wherein the sale or liquidation is only speculative. Estate of Piper v. Commissioner, 72 T.C. 1062, 1087 (1979); Estate of Cruikshank v. Commissioner, 9 T.C. 162, 165 (1947); Estate of Bennett v. Commissioner, supra; Estate of Munroe v. Commissioner, a Memorandum Opinion of this Court dated Mar. 6, 1946; see also Campbell's Estate v. Kavanagh, 114 F. Supp 780 (E.D. Mich. 1953). We have also held that a discount to asset values for the "lost use of money" is inappropriate. Estate of Andrews v. Commissioner, 79 T.C. at 950. "[D]iscounting for lost use of money is unrealistic because it fails to recognize that the underlying assets will themselves appreciate, most probably, at a rate similar to that applied as a discount." Id.

We find no evidence in the record to support a conclusion that Rancho San Juan would be sold. The ranches have been in the family for over 50 years and based on testimony by family members William Luton, Jr., and Brandy Branquinho and decedent's acts of giving the stock each year to his family members, we conclude that petitioner never intended to have the corporation offer the real estate for sale. The probability of a sale was therefore speculative at best. In addition, Mr. Dunshee acknowledged that the parcels were increasing in value due to the proximity of Rancho San Juan to the Santa Ynez Valley. Accordingly, we sustain respondent's position that no discount is appropriate.

Value of Stock Interest -- RSJ, Inc.

Petitioner valued decedent's interest in RSJ, Inc., on the estate tax return at $ 2,275,000. After concessions, as to the underlying real estate, petitioner asserts that the value of RSJ, Inc., is $ 2,900,000. Respondent determined the value to be $ 5,336,000.

Mr. Moore, petitioner's expert, used a liquidation analysis in valuing petitioner's 78-percent interest because in his opinion the highest value that could be realized for the 78-percent interest would be obtained by liquidating the corporate assets and then selling the underlying real estate. In Mr. Moore's opinion, any substantial development of the real property within the next 10 years was highly unlikely and would be very costly due to the restrictions placed on the real property by the Williamson Act and the prevailing attitude towards development in Santa Barbara County. Furthermore, Mr. Moore claims that the liquidation analysis should be used because the land was not suitable for other productive uses besides cattle ranching, and the corporation would have generated little or no current income other than from lease payments.

Mr. Moore started with an appraised value of the real estate of $ 5,700,000. n7 He then subtracted selling costs and State and Federal capital gains tax and applied a 40-percent lack of marketability discount in arriving at the fair market value of $ 2,281,032 that he assigns to decedent's stock interest in RSJ, Inc. Mr. Moore's approach of calculating value based upon the net proceeds realizable from the sale of the underlying real estate was based on his opinion that the hypothetical willing buyer would evaluate an investment in the stock based upon its potential return, after accounting for transactional costs.

n7 Mr. Moore testified that if he were to use the stipulated value of the real estate (i.e., $ 7,200,000), the value of RSJ Inc., would be $ 2,900,000. If he used $ 6,200,000 ($ 7,200,000 less $ 1 million discount), the value would be $ 2,500,000.

Petitioner asserts that if the Court determines that Mr. Moore's opinion is not persuasive, then, in the alternative, Dr. Pratt's, petitioner's expert's, opinion of the fair market value of the stock should be adopted. Dr. Pratt's analysis was based on comparisons to the stock prices of publicly traded real estate companies. Dr. Pratt's analysis led him to conclude that the valuation of decedent's stock should be based on the value of the publicly traded comparables and should reflect a discount for the lack of marketability of stock in a closely held corporation.

Respondent asserts that the valuation should be based on the net asset value of the corporation. Respondent contends that the corporation's operations are irrelevant since a purchaser/investor is purchasing the controlling interest in a corporation holding real estate that was free and clear of all liens. Accordingly, respondent asserts that the value of the underlying assets is the focus in valuing the real estate company. Furthermore, respondent, citing Rev. Rul. 59-60, argues that the underlying values of the real estate give due weight to the potential earnings and dividends resulting from the assets. Rev. Rul. 59-60, 1959-1 C.B. 237. Respondent would have us reject Dr. Pratt's analysis for lack of a comparable corporation.

Respondent asserts, based on her expert's opinion, that no more than a 5-percent discount for lack of marketability is appropriate. Respondent argues that the 78-percent block provides a holder with voting control in all matters. And pursuant to California law, a corporation may voluntarily liquidate if the shares representing 50 percent or more so vote. Cal. Corp. Code sec. 1900(a) (West Supp. 1994). In addition, California law provides that involuntary dissolution may only be petitioned by shareholders holding at least one-third of the outstanding shares. Cal. Corp. Code sec. 1800 (West Supp. 1994). Because California law provides a 78-percent holder with expansive control of the corporation and its assets, Ms.

Singleton applied a 5-percent marketability discount to decedent's interest in RSJ, Inc., merely to acknowledge the existence of relatively powerless minority shareholders. Respondent asserts that any potential capital gains tax would be avoidable because of RSJ, Inc.,'s status as an S corporation.

Reduction for Selling Costs and Capital Gains Taxes

As discussed above, regarding the discount applied to the underlying real estate, we find no merit to applying reductions for selling costs when the prospect of liquidation is remote. Consequently, we sustain respondent's disallowance of a reduction of fair market value for selling costs.

This Court has consistently held that a discount for potential capital gains tax at the corporate level is unwarranted where there is no evidence that (1) a liquidation of the corporation was planned, or (2) the liquidation could not have been accomplished without incurring a capital gains tax at the corporate level. Estate of Piper v. Commissioner, 72 T.C. at 1087; Estate of Cruikshank v. Commissioner, 9 T.C. at 165; Estate of McTighe v. Commissioner, T.C. Memo. 1977-410; Gallun v. Commissioner, T.C. Memo. 1974-284; Estate of Thalheimer v. Commissioner, T.C. Memo. 1974-203, affd. on this issue and remanded 532 F.2d 751 (4th Cir. 1976).

To the extent a capital gains tax at the corporate level would be relevant, it is mitigated by RSJ, Inc.,'s status as a subchapter S corporation. Prior to the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, an S corporation was not subject to tax with respect to any built-in capital gains if the S corporation election had been in effect for the 3 taxable years immediately preceding the year in which the capital gains were reported. Subchapter S Revision Act of 1982, Pub. L. 97-354, sec. 2, 96 Stat. 1669, 1683. RSJ, Inc., elected S corporation status as of December 1, 1986, and it filed a short year S corporation tax return beginning December 1, 1986, and ending December 31, 1986, and calendar year returns thereafter. The 3-year period ended as of December 31, 1988. Accordingly, with the exception of the 14-month period from the valuation date until December 31, 1988, RSJ, Inc.,'s built-in capital gains could be recognized without a corporate level tax. Notwithstanding the potential elimination of any corporate level tax, we do recognize that some discount is in order. We believe such discount is appropriately considered in the discount for lack of marketability, discussed below. We sustain respondent's disallowance of a reduction of fair market value due to corporate capital gains tax.

Lack of Marketability Discount

"The lack of marketability discount * * * is designed to reflect the fact that there is no ready market for shares in a closely held corporation." Estate of Andrews v. Commissioner, 79 T.C. at 953; see also Central Trust Co. v. United States, 158 Ct. Cl. 504, 305 F.2d 393, 405 (1962). This principle has been applied to controlling as well as minority shares. Estate of Maxcy v. Commissioner, T.C. Memo. 1969-158, revd. on other grounds 441 F.2d 192 (5th Cir. 1971). But this Court has found that a discount for lack of marketability is not warranted where a decedent owned all of the stock of a company whose assets consisted solely of cash and marketable securities (liquid assets). Estate of Jephson v. Commissioner, 87 T.C. 297 (1986). And in a case involving an 80-percent stock interest in a corporation whose underlying asset was a ranch, we held that a lack of marketability discount was inapposite. Estate of O'Connell v. Commissioner, T.C. Memo. 1978-191, affd. in part and revd. in part on other grounds 640 F.2d 249 (9th Cir. 1981). We made our conclusion based on the fact that there were no

publicly traded ranch stocks from which to draw a comparison and no limiting use restriction on the property. We concluded that a discount was inappropriate and determined that the net asset value was the fair market value. Id.

Petitioner has presented a great deal of evidence in the form of testimony and written reports from Dr. Pratt with regard to the selling prices on exchanges of the stock of other corporations which could be classified as real estate holding corporations. In this regard, we have recognized the statutory mandate of section 2031(b) that --

In the case of stock and securities of a corporation the value of which, by reason of their not being listed on an exchange and by reason of the absence of sales thereof, cannot be determined with reference to bid and asked prices or with reference to sales prices, the value thereof shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange. [Emphasis added.]

Estate of Newhouse v. Commissioner, 94 T.C. at 217; Estate of Tompkins v. Commissioner, T.C. Memo. 1961-338. However, this Court has rejected comparables if sufficient dissimilarities exist. Estate of Hall v. Commissioner, 92 T.C. 312 (1989); Northern Trust Co. v. Commissioner, 87 T.C. 349 (1986); Estate of O'Connell v. Commissioner, supra; Estate of Tompkins v. Commissioner, supra.

The comparables chosen by Dr. Pratt were both operating real estate companies. Neither of those corporations held real estate in the form of a ranch. And one of the corporations owned real estate in Orlando, Florida. Respondent questioned Dr. Pratt on cross-examination about why he did not use as a comparable Newhall Land and Farming (Newhall), a corporation which owns ranch land in Southern California, and Tejon Ranch Co. (Tejon), whose primary assets were 270,000 acres of ranch land in Southern California. Dr. Pratt dismissed the use of Tejon, because he claims that he could not obtain sufficient information on the publicly traded company, and Newhall because he claims that the share prices reflected the trades of minority shareholders. Few or no similarities between RSJ, Inc., and the so-called comparable companies were shown. We do not find persuasive petitioner's self-serving statement, on brief, that "Dr. Pratt's analysis would not be different if the comparables owned 'ranching' land rather than a mix of real estate that included undeveloped land." We find that no publicly traded companies are present in the record from which we can draw a comparison.

Notwithstanding the lack of a comparable company, a discount in the value of the closely held stock is appropriate for lack of marketability. The discount should reflect that restrictions are placed on the land as a result of the Williamson Act and that the assets of the corporation are not liquid. Respondent would have us believe that no discount is appropriate, citing Estate of O'Connell v. Commissioner, supra, wherein an 80-percent interest in a ranching corporation was valued at 80 percent of the net asset value. However, the ranch in that case was free of restrictions on use. In contrast, Rancho San Juan is subject to the Williamson Act, for at least 10 years.

Using the stipulated value of the real estate without any discount, using a net asset valuation approach, and applying a 20-percent discount for lack of marketability, the Court's valuation of the 78-percent interest in RSJ, Inc., as of the alternate valuation date is $ 4,492,800.

Issue 2. Value of One-Third Stock Interest in Dune Lakes, Ltd.

Petitioner valued decedent's interest in Dune Lakes, Ltd., on the estate tax return at $ 465,000. After concessions as to the underlying real estate, petitioner asserts that the value of decedent's one-third interest in Dune Lakes, Ltd., is $ 505,000. Respondent determined the value to be $ 1,440,000. Petitioner relies on the valuation used for its estate tax return as prepared by Mr. Moore and as supported by the valuation done for trial by Dr. Pratt.

Mr. Moore used a liquidation analysis in valuing petitioner's one-third interest, because in his opinion the highest value that could be realized for the one-third interest would be obtained by liquidating the corporate assets and selling the real property. Mr. Moore explained that a liquidation analysis was the appropriate valuation method because (1) the corporation had been operating at a loss for several years and required regular infusions of additional capital from its shareholders, and (2) no other significant assets existed on the balance sheet. Mr. Moore concluded that the hypothetical willing buyer would evaluate an investment in the stock based upon its potential return, after accounting for transactional costs. Mr. Moore determined that a 35-percent discount was appropriate in light of the inability of the potential investor to unilaterally cause the liquidation of the corporate assets. Mr. Moore started with an appraised value of the land of approximately $ 4.3 million. He then subtracted selling costs and commissions, a 25-percent lack of marketability, and Federal and California capital gains taxes and arrived at an after-tax selling price of approximately $ 2.1 million. Mr. Moore then divided the interest into thirds and applied a 35-percent minority interest discount in arriving at a fair market value of $ 463,653. n8

n8 At trial, Mr. Moore testified that if one assumed that the value of the real estate of Dune Lakes was $ 4,800,000 on the alternate valuation date (the value stipulated to in the partial agreement), then the fair market value of petitioner's one-third interest would be $ 505,000.

Petitioner asserts that if the Court determines that Mr. Moore's opinion is not persuasive, then, in the alternative, Dr. Pratt's opinion of the fair market value of the stock should be adopted. As he did with RSJ, Inc., Dr. Pratt utilized publicly traded companies in determining a fair market value of $ 641,481 for decedent's interest in Dune Lakes, Ltd.

In her argument respondent asserts that due to the uniqueness of the real estate (1,450 of the 1,700 acres comprises wetlands, also referred to as the duck preserve) the value of the land is in long-term investment. A purchaser would probably be interested in the intangible benefits associated with the scenic beauty and conservational aspects of the property. And respondent further argues that because of the unique nature of the underlying assets, no comparable exists.

Respondent's calculation of fair market value begins with the parties' stipulated amount of $ 4,800,000 for the real estate. Respondent then applies a minority interest discount of 10 percent which she claims is appropriate because California Corporation Law provides substantial protection for minority shareholders holding one-third or more of the stock in a corporation. Respondent argues against imposing a discount for lack of marketability since (1) the property's uniqueness makes it desirable, and (2) there are no corporate tax problems present due to the corporation's status as an S corporation. Accordingly, respondent would have us value petitioner's one-third interest in Dune Lakes, Ltd., at its net asset value adjusted for a 10-percent discount to account for the minority interest and whatever minimal marketability concerns exist.

Reduction for Selling Costs and Capital Gains

As discussed above, costs of sale or costs incurred in liquidation are not proper deductions in arriving at value for purposes of section 2031, wherein the sale or liquidation is only speculative. Estate of Piper v. Commissioner, 72 T.C. at 1087; Estate of Cruikshank v. Commissioner, 9 T.C. at 165; Estate of Bennett v. Commissioner, T.C. Memo. 1993-34.

The Dune Lakes property had been maintained as open space and wetlands for over 60 years and used only by the shareholders, who were all family members, and their guests. In addition, the experts are generally in agreement that the property is unique. In fact, Mr. Miossi stated that he did not believe there was another property like Dune Lakes in California. We conclude that petitioner did not take into account these factors in determining value. Accordingly, we sustain respondent's disallowance of a reduction in value for selling expenses.

With regard to corporate capital gains taxes, we sustain respondent's similar disallowance since we are of the opinion that a liquidation of the company was not planned, or in the alternative, it could be accomplished without incurring a capital gains tax at the corporate level as a result of Dune Lakes' status as an S corporation. n9

n9 Pursuant to the repeal of the "General Utilities doctrine" by the 1986 Act, certain transition rules were enacted that allowed certain corporations, including Dune Lakes, Ltd., to liquidate under the old law before Jan. 1, 1989. See Tax Reform Act of 1986, Pub. L. 99-514, sec. 633(d), 100 Stat. 2085, 2278. Again we note that a purchaser would have to wait 14 months to liquidate without incurring a corporate capital gains tax; however, we will consider this fact in the lack of marketability discount.

Lack of Marketability Discount

As we discussed in our analysis for RSJ, Inc., a lack of marketability discount is appropriate in recognition that there is no ready market for the shares in a closely held corporation. Estate of Andrews v. Commissioner, 79 T.C. at 953; see also Central Trust Co. v United States, 158 Ct. Cl. 504, 305 F.2d 393, 405 (1962). Similarly, we believe that a lack of marketability discount is appropriate due to the Williamson Act restrictions placed on the property.

Since we have already rejected Mr. Moore's liquidation analysis, we turn to Dr. Pratt's use of comparables. Petitioner admits that the Dune Lakes property is a unique piece of real estate in California. Petitioner also admits that the companies selected as comparables differed, but were the best available comparables. As we have previously discussed, we may reject the use of comparables if we find the companies selected to have material dissimilarities. And although the comparables used are the best available, we can still reject the market-comparable approach if we find insufficient similarities for us to rely on the purported comparables. Northern Trust Co. v. Commissioner, 87 T.C. at 377. We do not believe the companies used as comparables are sufficiently similar to Dune Lakes, Ltd. Accordingly, we are not persuaded by Dr. Pratt's analysis.

Respondent contends that lack of marketability has already been considered in determining the value of the underlying real estate, and therefore a lack of marketability discount is not appropriate. We are not persuaded by this contention; as we have already stated, we believe a marketability discount is

appropriate. Based on the evidence submitted and our analysis of the various expert reports, we hold that a lack of marketability discount of 15 percent from net asset value is appropriate.

In arriving at the amount of marketability discount we note that the discounts for minority interest and lack of marketability are conceptually distinct. Estate of Newhouse v. Commissioner, 94 T.C. at 249. Lack of marketability reflects that there is no ready market for the shares, while minority discount reflects the minority shareholders' inability to compel liquidation and inability to realize a pro rata share of the corporation's net asset value. Id. We now turn our analysis to minority discount.

Minority Interest Discount

Petitioner's main argument for upholding a minority discount is the fact that a potential investor could not unilaterally cause the liquidation of the corporate assets. Respondent, relying on California corporate law, argues that a shareholder with a one-third interest with sufficient cause could sue for dissolution and would receive a pro rata share of the corporate equity, whether from liquidation or a buyout.

We have held that a minority discount is appropriate if the block of stock does not enjoy the variety of rights associated with control. Estate of Chenoweth v. Commissioner, 88 T.C. 1577, 1582 (1987); Harwood v. Commissioner, 82 T.C. 239, 267 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986); Estate of Andrews v. Commissioner, supra at 957. We have defined control to mean "that, because of the interest owned, the shareholder can unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation's capital structure, and decide whether to liquidate, merge, or sell assets." Estate of Newhouse v. Commissioner, supra at 251-252. Where indications of value are predicated upon control or complete ownership, a discount must be applied to provide indications of value for a minority or less-than-controlling interest. Estate of Jung v. Commissioner, 101 T.C. 412, 442 n. 11 (1993) (quoting Zukin & Mavredakis, Financial Valuation: Businesses and Business Interests, par. 6.9[2], at 6-39 (1990)). And while the appropriate amount of discount to apply is a question of fact, it is generally unreasonable to argue that no discount should be considered for a minority interest in a closely held corporation. Estate of Newhouse v. Commissioner, supra at 249.

In the instant case, a purchaser of petitioner's interest in Dune Lakes, Ltd., would be acquiring an interest insufficient to exercise control over the corporation. And although we find respondent's argument persuasive, in that a holder of a one-third interest in a California corporation is protected under California corporate law, the right to force a liquidation is not unfettered; grounds are required. Cal. Corp. Code sec. 2004 (West Supp. 1994). Thus, although we believe that a potential investor would apply some discount to a one-third interest in Dune Lakes, Ltd., for lack of control, we believe the safeguards afforded under California corporate law would mitigate the impact. Based on all the facts and circumstances in the record before us, we believe that a minority position discount of 20 percent would be appropriate.

Combining the lack of marketability discount of 15 percent and the minority discount of 20 percent to the stipulated value of the real estate of $ 1,600,000, we hold that the fair market value of petitioner's one-third interest in Dune Lakes, Ltd., on the valuation date was $ 1,040,000.

Issue 3. Value of 41.9-Percent Interest in Miramonte Liquidating Trust

Petitioner claims that the value of its interest in the Miramonte Liquidating Trust on the valuation date was $ 2,150,000. Respondent, after concessions, claims that the value was $ 3,250,000.

Both petitioner and respondent, as well as their experts, are in agreement that the value of the trust units depended on the value of the note held by the trust and issued by Shamrock. Petitioner's expert, Mr. Moore, analyzed the financial condition of Shamrock and the terms of the note, and concluded that the note should be rated at below "investment grade". He examined the current yields of bonds of similar grade and concluded that the note should yield 13.5 percent. He discounted the value of the underlying note by 10 percent to reflect that the note was held by a private liquidating trust and that the interest in the trust was subject to restrictions on transferability. The 10-percent discount also reflected the fact that petitioner's interest was a minority interest with no power to force the trustees to liquidate the note.

Petitioner also asserts that if the Court determines that Mr. Moore's opinion of fair market value is not accepted, then, in the alternative, Dr. Pratt's opinion should be accepted. Based on his review of Shamrock's financial position, the terms of the note, the potential liabilities of the trust, and bonds issued by publicly traded companies with key ratios similar to Shamrock's, Dr. Pratt rated the note at below investment grade. He concluded that the note would have to generate a yield to maturity of 15 percent to attract potential investors. In addition, based on his analysis of the comparables he determined that a 5-percent discount was in order as well as a 10-percent discount to reflect the lack of marketability associated with the trust units.

Respondent argues that based on Shamrock's financial position only a 10-percent discount was in order. Factors such as significant gains in 1987, Shamrock's history of payments on the note, and a $ 30 million line of credit at one-half of 1 percent above prime indicated that Shamrock had a good credit rating and was a good risk. Respondent argues against any discount for lack of marketability because (1) the 10-percent discount computed above is, in part, a marketability discount, (2) the trust units being valued represent a substantial interest in the trust, and (3) the trust has a limited life, and the rights and benefits of the unit holders are definite and ascertainable. Thus, there is less risk of illiquidity.

Similarly, respondent argues against the application of a minority discount, citing 2 Scott & Fratcher, The Law of Trusts, secs. 128.2, 129, 130 (4th ed. 1987):

[in contrast to a minority shareholder in a closely held corporation,] a trust beneficiary has both a proprietary interest in and equitable title to the trust property. The beneficiary has rights against third parties in relation to the trust interest; the nature and extent of the beneficiary's interest is definite and ascertainable upon the creation of the trust; and the economic benefits and rights of ownership cannot be affected under the trust instrument. Since the trustee's relationship to the beneficiary is that of a fiduciary, the trustee must adhere to the terms of the trust and act solely for the benefit of the beneficiary. Id.

Respondent argues that control and management of investment are not factors considered in the valuation of a beneficial interest in a trust. Respondent then subtracted the present value of $ 10,500 of annual trust expenses in arriving at the fair market value of the trust units.

For purposes of estate tax valuation, the fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. Sec. 20.2031-4, Estate Tax Regs. The burden of proof is on the taxpayer to submit satisfactory evidence that the note is worth less than the

face value plus accrued interest (e.g., because of the interest rate, date of maturity, or other cause). Estate of Pittard v. Commissioner, 69 T.C. 391 (1977); Scher v. United States, 39 AFTR 2d 77-1580, 76-2 USTC par. 13163 (D.N.J. 1976); Sec. 20.2031-4, Estate Tax Regs.; see Estate of Berkman v. Commissioner, T.C. Memo. 1979-46 (taking into account low rate of interest, together with the lack of security and the considerable length of time until maturity, the Court concluded that the notes were includable in the decedent's gross estate at their fair market value and not at their face amount). In analyzing the fair market value of notes we have considered the ability of the debtor to repay the notes. Estate of Pittard v. Commissioner, supra; Estate of Burr v. Commissioner, a Memorandum Opinion of this Court dated Nov. 27, 1945; see also Whitlow v. Commissioner, 82 F.2d 569, 574 (8th Cir. 1936) ("the main factor in so determining the value of these notes would be the probability of their being paid when due"), affg. 30 B.T.A. 1465 (1934). Moreover, another court has held that notes should be valued at face value at date of death even though the maker may have been insolvent at that time. Scher v. United States, supra. In so holding, the court determined that at the time of valuation, from all that could be known in the market, there was every reasonable expectation that the notes would be paid when due. Id. Similar notes were being issued to ready lenders; interest on outstanding obligations was being paid; notes due at or about this time were honored when presented for payment, and the debtor was still considered sound by the financial community.

Fair Market Value of the Note

Based on Shamrock's never missing a payment on the note from its inception in 1984 until valuation date of October 27, 1987, Shamrock's net book value of approximately $ 83 million, n10 the reputation of its principal shareholder, Roy Disney, and its ability to obtain bank financing, respondent argues that Shamrock was a relatively good credit risk.

n10 Per Shamrock's financial statements for year ended Dec. 31, 1987, assets totaled $ 252,311 million and liabilities totaled $ 169,089 million.

Petitioner presents a number of arguments why we should view Shamrock as a credit risk. Petitioner contends that Shamrock's gains in 1987 were one-time sales of assets and not income from operating revenues and thereby distort the company's financial position. We find no merit to this argument. Shamrock's financial statements reflect approximately $ 62.8 million in net income for the year ended December 31, 1987. If we subtract out the "gain on sale of discontinued operations" of approximately $ 45.7 million, Shamrock would still have over $ 17 million net income for the year. In addition, the financial statements for the year ended December 31, 1986 reflect approximately $ 10.3 million net income.

Next, petitioner would have us believe that Shamrock was a credit risk because the note was not collateralized. While this is true, we believe that Shamrock's net assets, history of repayment, and overall financial condition (which was sufficient security for obtaining other unsecured borrowing, including bank advances in excess of $ 30 million at around prime rate) constituted evidence of Shamrock's creditworthiness. Finally, petitioner would have us discount the note based on the value of comparable publicly traded investments. Petitioner's expert used as a comparable a company involved in television broadcasting; however, the company had reported deficits of $ 131 million and $ 187 million in 1987 and 1986, respectively. As we have stated before, we will reject comparables if the

dissimilarities so warrant. Estate of Hall v. Commissioner, 92 T.C. 312 (1989); Northern Trust Co. v. Commissioner, 87 T.C. at 377. Accordingly, we sustain respondent's disallowance of discounting the note.

However, our analysis does not end because the note is privately held in a liquidating trust. Accordingly, we must analyze the applicability of discounts for lack of marketability and minority interest.

Lack of Marketability

As we have discussed above, the lack of marketability discount is designed to reflect the fact that there is no ready market for shares in a closely held corporation. Estate of Andrews v. Commissioner, 79 T.C. at 953. Assuming the principle applies to the trust units at issue, we hold that a discount is not appropriate. We have held that a discount is not warranted where the assets consist solely of liquid assets. Estate of Jephson v. Commissioner, 87 T.C. 297 (1986). In the instant case, the terms of the trust call for a distribution by the trustees within 60 days after receipt of payment on the note. The trust has a definite term, set to expire no later than January 31, 1997, a date 31 days after the last payment is due on the note. Furthermore, the trustees had no authority to conduct a trade or business, or to invest trust funds other than in interest-bearing accounts or short-term interest-bearing investments.

We also believe that the right of first refusal has no effect on the marketability of the trust units. We note that a commodity freely salable is obviously worth more on the market than a precisely similar commodity which cannot be freely sold. Worcester County Trust Co. v. Commissioner, 134 F.2d 578 (1st Cir. 1943), revg. and remanding Estate of Smith v. Commissioner, 46 B.T.A. 337 (1942); Estate of Johnson v. Commissioner, 77 T.C. 120 (1981), revd. on other grounds 718 F.2d 1303 (5th Cir. 1983); Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970). However, we have held that a right of first refusal without a fixed price will have little, if any, effect on fair market value and clearly will have a less drastic effect than fixed-price restrictions. Estate of Cotchett v. Commissioner, T.C. Memo. 1974-31. Although the restriction in the instant case restricts the field of available purchasers in the first instance, it does not affect marketability because the price is not fixed.

Respondent has provided for a 10-percent discount to account for a lack of marketability. Petitioner has not persuaded us that any additional amount is appropriate. We sustain respondent's disallowance of petitioner's discount and uphold her 10-percent discount for lack of marketability.

Minority Interest Discount

Petitioner's sole contention is that a holder of the trust units has no power to force the trustees to liquidate the note. Respondent argues that since the trustee's relationship to the beneficiary is that of a fiduciary, the trustee must adhere to the terms of the trust and act solely for the benefit of the beneficiary. Pursuant to the trust agreement, and Cal. Prob. Code secs. 16008(a) and 16040 (Deering 1994), the trustees had a duty to dispose of any trust assets included at the time of creation of the trust that would not be a proper investment for the trustee to make. The trustees had to exercise their powers, including the power to sell the note, according to the "prudent man standard." And if the trustees breached their fiduciary duty to the beneficiaries by not selling the note, any beneficiary could sue to force the sale of the note. Cal. Prob. Code sec. 16420 (Deering 1994). We find respondent's argument persuasive and hold that a discount for minority interest was inappropriate.

We sustain respondent that the fair market value of petitioner's 41.9-percent interest in the Miramonte Trust was $ 3,250,000 on the valuation date.

Issue 4. Addition to Tax for Valuation Understatement

Respondent determined an addition to tax under section 6660. Respondent contends that petitioner did not have a reasonable basis for the valuation claimed on its tax return for Dune Lakes, Ltd., and RSJ, Inc. Petitioner contends that there should be no addition to tax because: (1) There was a reasonable basis for the estate tax return value; (2) petitioner claimed the value in good faith; and (3) respondent abused her discretion in failing to waive the addition.

Section 6660(a) provides that in the case of an underpayment of a tax imposed by subtitle B (relating to estate and gift taxes) which is attributable to a valuation understatement, there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributed. There is a valuation understatement if the value of any property claimed on any return is 66-2/3 percent or less of the amount determined to be the correct amount of such valuation. Sec. 6660(c). If the valuation claimed is (1) 50 percent or more, but not more than 66-2/3 percent, of the correct valuation, the applicable percentage is 10 percent; (2) 40 percent or more but less than 50 percent, the applicable percentage is 20 percent, and (3) less than 40 percent, the applicable percentage is 30 percent. Sec. 6660(b). The section does not apply if the underpayment is less than $ 1,000. Sec. 6660(d). The Secretary may waive all or any part of the addition to tax provided by section 6660 on a showing by the taxpayer that there was a reasonable basis for the valuation claimed on the return and that such claim was made in good faith. Sec. 6660(e).

In the instant case there is an underpayment of estate tax attributable to a valuation understatement, and the underpayment is at least $ 1,000 of the estate tax imposed. The value of the 78-percent stock interest in RSJ, Inc., claimed by petitioner on its estate tax return is approximately 50.6 percent of the correct valuation, as redetermined by this Court. Thus, the applicable percentage is 10 percent of the resulting underpayment. The value of the one-third stock interest in Dune Lakes, Ltd., claimed by petitioner on its estate tax return is approximately 44.7 percent of the correct valuation, as redetermined by this Court. Thus, the applicable percentage is 20 percent of the attributable underpayment. We must now consider whether the addition to tax should be waived.

The denial of a waiver by the Secretary is reviewable by this Court on an abuse-of-discretion basis. Mailman v. Commissioner, 91 T.C. 1079, 1082-1084 (1988). The burden of proof is on petitioner. Rule 142; Mailman v. Commissioner, supra.

We believe petitioner exercised good faith in determining the values reported in its estate tax return. The coexecutors sought professional advice and obtained the services of an experienced lawyer to prepare the estate tax return and experts to appraise the value of the stock and the underlying assets in the corporation.

Respondent challenges the reasonableness of petitioner in relying on these professionals and the values determined. As we have noted in the past, this is a more difficult question. Estate of Jung v. Commissioner, 101 T.C. at 450. Mr. Moore undervalued petitioner's stock interests, as reported on the tax return, by approximately 45-50 percent from what we determined to be the correct value. His valuations were undervalued by 57 percent and 68 percent respectively, when compared to respondent's valuation. Therefore, we did not place a great deal of weight on his valuations. However,

his analysis and conclusions were based on his extensive experience as an appraiser. His report, although not helpful for purposes of assisting the Court in determining the value of petitioner's interests, does give some explanation of his conclusion, analysis, and process. Furthermore, we have recognized that valuation is not a precise science. Messing v. Commissioner, 48 T.C. at 512.

We find that petitioner reasonably relied on professional advice and expert appraisals. Although we disagree with their conclusions, we believe petitioner's experts acted reasonably and in good faith in determining fair market value. Thus, we do not sustain respondent's determination of an addition to tax under section 6660.

To reflect the foregoing and concessions by the parties,

Decision will be entered under Rule 155.

T.C. Memo. 1995-153

United States Tax Court

MAD AUTO WRECKING, INC., Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Tax Ct. Dkt. No. 1959-94 Filed April 5, 1995

Mark C. Goldenberg, for petitioner.

Thomas C. Pliske, for respondent.

HELD: Compensation paid by P to its only two officers/shareholders is reasonable.

MEMORANDUM FINDINGS OF FACT AND OPINION

LARO, JUDGE: Mad Auto Wrecking, Inc. petitioned the Court to redetermine respondent's determination of deficiencies of $230,867, $138,718, and $166,530 in its 1989, 1990, and 1991 Federal income taxes, respectively. We must decide whether amounts paid by petitioner to its only officers/shareholders are reasonable compensation under section 162(a)(1); respondent determined that $1,503,322 of the $2,173,000 claimed by petitioner as officers' compensation for the years in issue was unreasonable.[1] We hold that all of the claimed officers' compensation is reasonable. Unless otherwise stated, section references are to the Internal Revenue Code in effect for the years in issue. Rule references are to the Tax Court Rules of Practice and Procedure. We separately refer to Richard Andrews and Melvin Waier, the officers/shareholders, as Andrews and Waier, respectively. We refer to them collectively as the Shareholders.

FINDINGS OF FACT

Most of the facts have been stipulated and are so found. The stipulations and attached exhibits are incorporated herein by this reference. Petitioner's principal office was in Florissant, Missouri, when it petitioned the Court. Petitioner filed a Federal income tax return for each year in issue based on the calendar year and using the cash receipts and disbursements method.

1. PETITIONER

Petitioner is a high-volume, wholesale scrap business that purchases wrecked automobiles and dismantles, sorts, and sells most of the automobiles' parts at wholesale. Petitioner crushes each automobile's remaining body and sells the crushed bodies as scrap metal. The fact that petitioner performs both of these functions is unique in the industry in petitioner's area; no competitor within 300 miles performs such an all-inclusive job. Although many of petitioner's competitors sell automobile parts or crush wrecked

automobiles in their entirety, petitioner practically stands alone in the industry because it strips each automobile of its parts before crushing the automobile, AND it sells the stripped parts. Petitioner is also virtually alone in the industry because it strips the automobiles using an innovative and efficient production-like technique designed to quickly remove the automobiles' sellable parts, such as engines, transmissions, radiators, starters, batteries, generators, air conditioners, carburetors, master cylinders, and power steering pumps. Petitioner uses a customized mobile car crusher to crush the automobile's remaining body.

Petitioner's business is mainly performed outdoors, and petitioner is open for business notwithstanding inclement weather such as snow, rain, or excessive heat. Petitioner does not own or rent a permanent place of business; it generally operates on the grounds of two salvage yards with the mutual understanding that petitioner will continually supply the yards with material for their operations.[2] Petitioner stores its disassembled parts at these salvage yards in truck beds that are located on the grounds.

2. PETITIONER'S OWNERS

Petitioner was formed by the Shareholders in the State of Missouri on June 5, 1979, with the Shareholders transferring $100 to it in exchange for separate 50-percent interests.[3] The Shareholders are the only members of petitioner's board of directors and are its sole officers. The Shareholders perform all of petitioner's executive and managerial functions.[4] The Shareholders perform or oversee all of petitioner's manual labor.

a. RICHARD ANDREWS

Andrews is petitioner's president. He graduated in 1973 from the University of Missouri-St. Louis with a bachelor of arts degree in psychology. Before petitioner was formed, Andrews worked in the construction industry and in the automobile salvage business on a part-time basis while in college. During the years in issue, Andrews worked for petitioner approximately 70 hours per week, 52 weeks a year. Andrews is a devoted workaholic who is totally dedicated and committed to petitioner's business and its success.

b. MELVIN WAIER

Waier is petitioner's secretary and treasurer. He studied mechanical engineering for 1 year before he was drafted into the military. After 2 years of military service, Waier returned to school and received an associate's degree in mechanical engineering. Certain courses that Waier completed in pursuing his degree helped him to develop and improve petitioner's business. The courses provided Waier with a background in mechanics and helped him direct the construction and repair of tools, trucks, and machinery, all of which benefit petitioner's business. During the years in issue, Waier worked for petitioner for approximately 65 hours per week. Like Andrews, but to a slightly lesser extent, Waier is a devoted employee who is totally dedicated and committed to petitioner's business and its success.

c. THE SHAREHOLDERS' RELATIONSHIP BEFORE PETITIONER'S FORMATION

The Shareholders informally worked together during the 5-year period before petitioner was formed, using their own equipment to tow and salvage wrecked automobiles. The Shareholders learned during this 5-year period that an automobile scrap business was a viable entity, primarily due to an abundant supply of wrecked automobiles, and updated equipment was essential to a scrap business' growth. With these ideas in mind,[5] the Shareholders agreed to pool their resources and form petitioner.

3. THE SHAREHOLDERS' COMPENSATION FROM PETITIONER

a. OVERVIEW

Petitioner has neither a written employment agreement with the Shareholders, nor a written policy concerning their compensation.

b. PRIOR TO THE YEARS IN ISSUE

Petitioner paid the following total compensation to each of the Shareholders for the years prior to the years in issue:

Year	Compensation
1980	$42,200
1981	93,600
1982	74,560
1983	111,840
1984	278,320
1985	304,000
1986	256,000
1987	656,000
1988	1,106,000

This compensation included annual bonuses that petitioner began paying to the Shareholders in 1984. The annual bonuses paid to both Shareholders prior to the years in issue ranged in the aggregate from $100,000 to $950,000.

c. DURING THE YEARS IN ISSUE

Petitioner paid the Shareholders a base salary of $1,500 per week, i.e., $78,000 per year, and it paid them bonuses during the second, third, and fourth quarters of each year. Each Shareholder generally received the same amounts as bonuses, except that Andrews received a larger bonus during each year to reflect the fact that he devoted more time than Waier to petitioner's business. The Shareholders' total compensation during the years in issue was:

Andrews	Waier

1989		
Salary	$78,000	$78,000
2d quarter bonus	50,000	50,000
3d quarter bonus	100,000	100,000
4th quarter bonus	150,000	50,000
4th quarter bonus	100,000	100,000
Total compensation	478,000	378,000
1990		
Salary	$78,000	$78,000
2d quarter bonus	75,000	75,000
3d quarter bonus	100,000	--
4th quarter bonus	100,000	100,000
Total compensation	353,000	253,000
1991		
Salary	$78,000	$78,000
2d quarter bonus	75,000	75,000
3d quarter bonus	40,000	40,000
4th quarter bonus	175,000	150,000
Total compensation	368,000	343,000

4. PETITIONER'S OPERATIONS

a. EARLY YEARS AND THE SHAREHOLDERS' WORK TO IMPROVE PETITIONER'S OPERATIONS

Petitioner did not operate efficiently immediately after its incorporation. The Shareholders undertook efforts to improve petitioner's operations and their effectiveness. The Shareholders designed innovative equipment that was tailored to petitioner's business, allowing petitioner to improve its efficiency and profitability. The Shareholders also sought and found companies that sold specialized equipment that would better accommodate petitioner's operations. The innovative and specialized equipment allowed petitioner to remove sellable parts from the automobiles quickly and with minimal labor. Petitioner's purchase of a mobile car crusher, for example, allowed it to bring in 15 to 20 automobiles at a time, rather than the 4 or 5 automobiles that it could bring in without the machine.

The Shareholders also changed petitioner's operation with respect to the sale of disassembled parts, allowing petitioner to improve its efficiency and increase its profitability. Prior to the change, petitioner sold its parts to middlemen who resold the parts to wholesalers at higher prices. Starting in or around 1989, the Shareholders eliminated the middlemen in most cases and sold the parts directly to the wholesalers at the higher price. Selling directly to the wholesalers increased petitioner's profit margin on its parts sales.

The Shareholders also developed relationships with salvage yards, enabling petitioner to eliminate the costs that it had previously incurred to transport its equipment between job locations and allowing it to minimize the cost of disassembling the automobiles. Prior to the time that the Shareholders developed these relationships, petitioner's work was performed at multiple locations, and petitioner had to move its operations from one location to another. After the Shareholders became primarily affiliated with two salvage yards, petitioner's operations were generally fixed at two yards. Petitioner was stationary during the years in issue, which increased its profits from its earlier years.

b. PETITIONER'S OPERATIONS DURING THE YEARS IN ISSUE

Petitioner's gross receipts (net of returns and allowances), gross income, book income (loss), taxable income (loss), officers' compensation, officers' compensation percentages, and shareholders' equity were (rounded off to the nearest dollar):

Year	Gross Receipts (Net)	Book Net Income (Loss)	Taxable Net Income (Loss)	Officers' Compensation	Gross Income
1989	$2,554,942	$57,257	$67,690	$856,000	$1,459,351
1990	2,169,125	23,951	56,974	606,000	1,186,978
1991	1,884,853	(32,647)	(22,199)	711,000	1,186,458

Compensation Percentages				Shareholders' Equity[1] as of Jan. 1	Shareholders' Equity[1] as of Dec. 31
1	2	3	4		
34	59	94	93	$360,250	$417,507
28	51	96	91	417,507	441,458
38	60	105	103	441,458	408,810

1 Officers' compensation divided by gross receipts.

2 Officers' compensation divided by gross income.

3 Officers' compensation divided by book net income (before deducting officers' compensation).

4 Officers' compensation divided by taxable net income (before

deducting officers' compensation).

FOOTNOTE TO TABLE

1. All but $100 of the Shareholders' equity is attributable to retained earnings.

Petitioner's sale of scrap metal to one entity accounted for approximately 63 percent, 63 percent, and 53 percent of its total sales during its 1989, 1990, and 1991 taxable years, respectively. Approximately 90 percent of petitioner's cost of goods sold (wrecked automobiles) was purchased from entities that were entirely or partially owned by the Shareholders (these entities are collectively referred to as the Sellers). Petitioner, through the Shareholders, devoted some of its time to (and performed services on behalf of) the operations of the Sellers. Neither petitioner nor the Shareholders were compensated by the Sellers for these services.

c. PETITIONER'S EMPLOYEES

Approximately four persons are needed to remove the sellable parts from an automobile, and the disassembling process takes approximately 10 minutes per automobile. During the years in issue, petitioner had seven full-time employees, not including the Shareholders, and it paid them on an hourly basis (hereinafter, these seven employees are referred to as the Other Employees). The Other Employees, who were generally neither specialized mechanics nor college educated, were hired and trained by the Shareholders. The Other Employees performed manual labor, such as disassembling the automobiles and sorting the relevant parts, and did not perform management, sales, or executive functions. The Other Employees typically worked a 40-hour week and received overtime for any additional hours. The Other Employees' were paid annual compensation (including bonuses of up to $3,460) ranging from $12,350 to $41,630. The Other Employees were covered by a group medical plan.

The Shareholders did not receive overtime and were not reimbursed for their out-of-pocket expenses incurred on behalf of petitioner. Although the Shareholders were covered by a group medical plan, they did not receive special fringe benefits such as pension plans, profit-sharing plans, company owned automobiles, or disability insurance. During each year in issue, petitioner paid a $10,382 premium on $1 million of life insurance in the names of each of the Shareholders and for which it was the beneficiary. The cash surrender value of these policies was:

Year	Andrews	Waier
12-31-88	$4,744	$4,855
12-31-89	9,023	9,158
12-31-90	13,567	13,729
12-31-91	18,277	18,432

d. PETITIONER'S RETAINED EARNINGS AND ITS DIVIDEND POLICY

Petitioner had retained earnings at the end of its 1980 through 1991 taxable years as follows:

Year	Retained Earnings	Year	Retained Earnings
1980	$76,869	1986	$343,136
1981	113,438	1987	345,882
1982	146,565	1988	360,150
1983	284,918	1989	417,407
1984	310,134	1990	441,358
1985	352,020	1991	408,711

Petitioner has never paid a dividend. During the years in issue, petitioner's board of directors discussed the possibility of paying dividends, but decided not to do so. The board decided that petitioner would retain its earnings to further petitioner's growth.

5. DETERMINATION OF THE SHAREHOLDERS' BONUSES

Petitioner measured its success for each year based on the amount of cash that remained in its bank accounts following the payment of its expenses and a set aside of cash to be used to finance improvements.[6] Petitioner paid most of this "net cash" to the Shareholders as bonuses. From 1984 through the years in issue, petitioner consistently used this criterion for paying bonuses to the Shareholders.

OPINION

This is another case pertaining to whether amounts paid by a closely held corporation to its shareholders/employees are deductible compensation under section 162(a)(1). Inherently, there is a natural tension between: (1) Shareholders/employees who feel that they are entitled to be paid from a corporation's profits, even to the exhaustion thereof, of an amount that reflects their skills and efforts, and (2) a provision in the tax law that conditions the deductibility of compensation on the concept of reasonableness. What is reasonable to the entrepreneur/employee often may not be to the tax collector. Accordingly, this and other courts are repeatedly asked to examine the relevant facts and circumstances of the business and the underlying employment relationship in order to render an opinion as to whether the compensation paid was reasonable. In so doing, we must be careful not to define the term "reasonable" too narrowly. The dynamic nature of business, the entrepreneurial spirit, and the dedication of purpose all play a role in the composition of reasonable compensation. We must not rigidly apply form over substance when we measure one's contribution to the success of his or her business. Of course, it may be argued that when an individual chooses to conduct business in the corporate form, he or she is obligated to observe all of the corporate formalities inherent in that form, including the standard that to be deductible, the compensation paid must be reasonable. The term "reasonable", however, must reflect the intrinsic value of employees in the broadest and most comprehensive sense.

Turning to the facts at hand, respondent disallowed $614,136, $377,193, and $511,993 of officers' compensation deducted by petitioner for its 1989 through 1991 taxable years, respectively.[7] According to respondent, these disallowed amounts are unreasonable. Petitioner disagrees. According to petitioner, all of the amounts paid to the Shareholders are reasonable compensation for the services that they rendered to it.

Section 162(a)(1) allows a corporation to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered" as an ordinary and necessary business expense. To be deductible under section 162(a)(1), compensation must be both: (1) Reasonable and, (2) paid purely for services rendered to the corporation. Charles Schneider & Co. v. Commissioner, 500 F.2d 148, 151 (8th Cir. 1974), affg. T.C. Memo. 1973-130; sec. 1.162-7(a), Income Tax Regs. Petitioner bears the burden of proving respondent's determination of deductible compensation incorrect. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933); RTS Inv. Corp. v. Commissioner, 877 F.2d 647, 650 (8th Cir. 1989), affg. per curiam T.C. Memo. 1987-98.

1. WAS THE COMPENSATION PAID BY PETITIONER REASONABLE

OVERVIEW

Reasonable compensation is determined by comparing the compensation paid to an employee with the value of the services that he or she performed in return. Such a determination is made with respect to employees individually, rather than with respect to the compensation paid to all employees collectively. Such a determination is a question of fact. RTS Inv. Corp. v. Commissioner, supra at 650; Charles Schneider & Co. v. Commissioner, supra at 151; Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949), revg. and remanding a Memorandum Opinion of this Court; Estate of Wallace v. Commissioner, 95 T.C. 525, 553 (1990), affd. 965 F.2d 1038 (11th Cir. 1992).

The cases concerning reasonable compensation are numerous and list many factors to be considered in making this factual determination. The factors which may be considered, none of which is controlling in itself, include: (a) The employee's qualifications; (b) the nature, extent, and scope of the employee's work; (c) the size and complexities of the employer's business; (d) a comparison of salaries paid with the employer's gross and net income; (e) the prevailing general economic conditions; (f) a comparison of salaries with distributions to shareholders and retained earnings; (g) the prevailing rates of compensation for comparable positions in comparable concerns; (h) the salary policy of the employer as to all employees; (i) the amount of compensation paid to the particular employee in previous years; (j) the employer's financial condition; (k) whether the employer and employee dealt at arm's length; (l) whether the employee guaranteed the employer's debt; (m) whether the employer offered a pension plan or profit-sharing plan to its employees; and (n) whether the employee was reimbursed by the employer for business expenses that the employee paid personally. Rutter v. Commissioner, 853 F.2d 1267, 1274 (5th Cir. 1988), affg. T.C. Memo. 1986-407; Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1245-1248 (9th Cir. 1983), revg. and remanding T.C. Memo. 1980-282;

Kennedy v. Commissioner, 671 F.2d 167, 174 (6th Cir. 1982), revg. and remanding 72 T.C. 793 (1979); Charles Schneider & Co. v. Commissioner, supra at 151-152; Mayson Manufacturing Co. v. Commissioner, supra at 119; Estate of Wallace v. Commissioner, supra at 553; Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142, 1155-1156 (1980); see also Acme Constr. Co. v. Commissioner, T.C. Memo. 1995-6; BOCA Constr. Inc. v. Commissioner, T.C. Memo. 1995-5. In analyzing these factors, the Court must carefully scrutinize the facts of a case in which the paying corporation is controlled by the employees to whom the compensation is paid. In such a situation, we must be convinced that the purported compensation was paid for services rendered by the employees/shareholders, as opposed to a distribution of earnings to them that the payor could not deduct. RTS Inv. Corp. v. Commissioner, supra at 650; Paul E. Kummer Realty Co. v. Commissioner, 511 F.2d 313, 315-316 (8th Cir. 1975), affg. T.C. Memo. 1974-44; Charles Schneider & Co. v. Commissioner, supra at 152- 153.

a. EMPLOYEE'S QUALIFICATIONS

The Shareholders are exceptionally qualified for petitioner's business, by virtue of their training, experience, and dedication, and understand and control every aspect of petitioner's operations. The Shareholders are also highly motivated and extremely productive employees, and are the primary reason for petitioner's success. We conclude that this factor favors petitioner. The Shareholder's outstanding qualifications justify high compensation. Petitioner's profitability rests upon its sales, and the Shareholders' ambition, inventiveness, and energy (as opposed to petitioner's investment in capital) are the primary reasons for petitioner's sales, growth, and success. See Home Interiors & Gifts, Inc. v. Commissioner, supra at 1158; Dave Fischbein Manufacturing Co. v. Commissioner, 59 T.C. 338, 352-353 (1972).

b. NATURE, EXTENT, AND SCOPE OF THE EMPLOYEE'S WORK

The nature, extent, and scope of petitioner's work performed by the Shareholders is fundamental, substantial, and all-encompassing. The Shareholders performed all of petitioner's executive and managerial functions, except accounting, and performed or oversaw all of its manual labor. The Shareholders also supervised petitioner's daily operations, including supervising and directing the Other Employees, and made petitioner's business decisions. Given the vital role played by the Shareholders in petitioner's operations and success, and the long hours that they each dedicated thereto, we view the Shareholders as indispensable to petitioner's business. Petitioner's growth and prosperity is due directly to their skills, dedication, and creativity. If petitioner were to lose either of the Shareholders, it would be in a rough situation until a suitable replacement (if any) could be found. We conclude that this factor favors petitioner. See Elliotts, Inc. v. Commissioner, supra at 1245- 1246; Kennedy v. Commissioner, supra at 176; Home Interiors & Gifts, Inc. v. Commissioner, supra at 1158; Dave Fischbein Manufacturing Co. v. Commissioner, supra at 352-353.

c. SIZE AND COMPLEXITIES OF THE EMPLOYER'S BUSINESS

Petitioner is a highly specialized company, and its operations demand expertise. Petitioner's business operations could be very complex, but for the simplification that the Shareholders have added to it. Petitioner's gross receipts during the years in issue totaled more than $6.4 million. We conclude that this factor favors petitioner. See Elliotts, Inc. v. Commissioner, supra at 1246.

d. COMPARISON OF SALARIES PAID TO NET AND GROSS INCOME

The percentage of officers' salaries to gross receipts for 1989, 1990, and 1991 was 34, 28, and 38, respectively. The percentage of officers' salaries to gross income for 1989, 1990, and 1991 was 59, 51, and 60, respectively. The percentage of officers' salaries to book net income (before deducting officers' compensation) for 1989, 1990, and 1991 was 94, 96, and 105, respectively. The percentage of officers' salaries to taxable net income (before deducting officers' compensation) for 1989, 1990, and 1991 was 93, 91, and 103, respectively.

These percentages are reasonable in light of the qualifications of the Shareholders and the nature, extent, and scope of their work. We also find relevant the fact that petitioner reported more than $55,000 in taxable income during each of 2 of the years in issue notwithstanding its payment of large compensation to the Shareholders. Given the additional fact, however, that petitioner's payment of the bonuses kept corporate taxes at a low level, we conclude that this factor favors neither party. See Paul E. Kummer Realty Co. v. Commissioner, supra at 315 (officers' compensation not reasonable where payment of bonuses kept corporate taxes at a low level). We consider this factor neutral.

e. GENERAL ECONOMIC CONDITIONS

The record does not indicate to what extent petitioner's performance during the years in issue reflected general economic conditions. General economic conditions may affect a business' performance and indicate the extent (if any) of the employee's effect on the company. Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115, 119-120 (6th Cir. 1949), revg. and remanding a Memorandum Opinion of this Court. Adverse economic conditions, for example, tend to show that an employee's skill was important to a company that grew during the bad years. We conclude that this factor favors neither party. We consider it neutral.

f. COMPARISON OF SALARIES WITH DISTRIBUTIONS TO SHAREHOLDERS AND RETAINED EARNINGS

The absence of a dividend history is a significant factor that may suggest that some of the amounts paid as compensation to a shareholder/employee is really a dividend. Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1322-1323 (5th Cir. 1987), affg. T.C. Memo. 1985-267. Such an absence may raise a "red flag" that invites special scrutiny of the Court, Edwin's, Inc. v. United States, 501 F.2d 675, 677 n.5 (7th Cir. 1974), and justifies an inference that some of the purported compensation was actually a distribution of profits, Charles Schneider & Co. v. Commissioner, 500 F.2d at 153. Such an absence

(and inference), however, does not automatically convert compensation that would otherwise be reasonable into a dividend. Corporations are not required to pay dividends. Instead, an individual shareholder may participate in the success of a corporation through the appreciation in the value of his or her stock brought on by retained earnings and the possibility of a future return. Thus, a corporate employer with little or no dividend history may be able to pay and deduct large amounts of compensation if the Court is convinced that a reasonable person would still have invested in the corporation. Courts sometimes apply a hypothetical investor test to determine whether a reasonable person would have invested in the corporation. Critical to this test is whether the shareholders of the corporation received a fair rate of return (without taking into account any compensation) from the total of their initial and subsequent investments. Owensby & Kritikos, Inc. v. Commissioner, supra at 1326-1327; Elliotts, Inc. v. Commissioner, 716 F.2d at 1244; Medina v. Commissioner, T.C. Memo. 1983-253; see also Rev. Rul. 79-8, 1979-1 C.B. 92 (compensation is not unreasonable merely because a corporation pays an insubstantial portion of its earnings as dividends).

Respondent determined that part of the compensation paid to the Shareholders was actually a dividend. Respondent argues in her brief that petitioner's failure to pay dividends during its existence indicates that the Shareholders' compensation was unreasonable. We disagree that the compensation was unreasonable. Although petitioner has never paid a dividend during its existence, its choice not to do so stemmed from its board's decision that petitioner needed to retain funds in order to grow. We refuse to second guess the board's wisdom under the facts of this case; we view its choice not to pay dividends as a reasonable business decision. As a point of fact, petitioner invested over $286,000 in fixed assets during the years in issue, and its equity grew from the Shareholders' initial contributions totaling $100, to $408,810 on December 31, 1991. Petitioner's retained earnings also steadily grew from its genesis to $408,711 on December 31, 1991.[8] See Comtec Sys., Inc. v. Commissioner, T.C. Memo. 1995- 4. In addition to the fact that the increase in petitioner's retained earnings most likely increased the value of its stock, we believe that a hypothetical investor would have considered $408,711 in retained earnings to have been a worthy return over the 12- to 13- year period on his or her investment of $100. We conclude that this factor favors petitioner.[9]

g. PREVAILING RATES OF COMPENSATION FOR COMPARABLE POSITIONS IN COMPARABLE COMPANIES

Both petitioner and respondent rely on expert testimony with respect to this factor. Expert testimony is appropriate to help the Court understand an area requiring specialized training, knowledge, or judgment. Fed. R. Evid. 702; Snyder v. Commissioner, 93 T.C. 529, 534 (1989). The Court, however, is not bound by an expert's opinion. We weigh an expert's testimony in light of his or her qualifications, and with respect to all credible evidence in the record. Depending on what we believe is appropriate under the facts and circumstances of the case, we may either reject an expert's opinion in its entirety, accept it in its entirety, or accept selective portions of it. Helvering v. National Grocery Co., 304 U.S. 282, 294-295 (1938); Seagate Technology v. Commissioner, 102 T.C. 149, 186 (1994); Parker v. Commissioner, 86 T.C. 547, 562 (1986).

Petitioner's expert is Lawrence J. LeGrand, a tax partner in the manufacturing, retailing, and distribution practice of KPMG Peat Marwick LLP. Mr. LeGrand's clients are mainly closely held businesses, and he specializes in executive compensation. Respondent's expert is E. James Brennan III, president of Brennan, Thomsen Associates, Inc., of Chesterfield, Missouri. Mr. Brennan is no stranger to this Court, having testified before us on no fewer than 10 prior occasions.[10]

We are not persuaded by either of the experts. Mr. LeGrand's testimony was unconvincing because it did not directly address the factor at hand; i.e., the prevailing rates of compensation for comparable positions in comparable concerns. Considering his testimony in its entirety, we find that Mr. LeGrand was retained by petitioner to advocate its position herein. See Laureys v. Commissioner, 92 T.C. 101, 129 (1989). We are no more convinced by Mr. Brennan. As has been true in a majority of the cases in which he has testified before this Court, his conclusions are not based on data from businesses that are akin to the business at hand, i.e., automobile salvage, automobile disassembling, and the wholesale of scrap metal. See, e.g., BOCA Constr. Inc. v. Commissioner, T.C. Memo. 1995-5; L & B Pipe & Supply Co. v. Commissioner, T.C. Memo. 1994-187; Thomas A. Curtis, M.D., Inc. v. Commissioner, T.C. Memo. 1994-15; Automotive Inv. Dev. Inc. v. Commissioner, T.C. Memo. 1993-298; Diverse Indus., Inc. v. Commissioner, T.C. Memo. 1986-84: Owensby & Kritikos, Inc. v. Commissioner, T.C. Memo. 1985-267, affd. 819 F.2d 1315 (5th Cir. 1987). To restate what we have previously stated with respect to Mr. Brennan's "expert" testimony: "We are not satisfied that a reasonable level of compensation for an executive like * * * [the Shareholders] can be accurately determined by reference to the industries Brennan surveyed because of the absence of significant information on other businesses similar to petitioner's." Thomas A. Curtis, M.D., Inc. v. Commissioner, supra; Diverse Indus., Inc. v. Commissioner, supra. Indeed, comparing compensation paid to officers of companies that differ markedly provides guidance of dubious value. See Diverse Indus., Inc. v. Commissioner, supra; Niagara Falls Coach Lines, Inc. v. Commissioner, T.C. Memo. 1977-269. We conclude that this factor favors neither party. We consider it neutral.

h. EMPLOYER'S SALARY POLICY AS TO ALL EMPLOYEES

The record is unclear as to petitioner's salary policy as to all of its employees. We look to this factor to determine whether the Shareholders were compensated differently than the Other Employees merely because of the Shareholders' status as shareholders. Owensby & Kritikos, Inc. v. Commissioner, supra at 1322-1323. A reasonable, longstanding, and consistently applied compensation plan, for example, is evidence that compensation is reasonable. Elliotts, Inc. v. Commissioner, 716 F.2d at 1247. We conclude that this factor favors neither party. We consider it neutral.

i. COMPENSATION PAID IN PRIOR YEARS

The compensation (including bonuses) paid by petitioner to the Shareholders prior to the years in issue ranged from $42,200 to $1,106,000. An employer may deduct

compensation paid to an employee in a year although the employee performed the services in a prior year. Lucas v. Ox Fibre Brush Co., 281 U.S. 115, 119 (1930); see also R. J. Nicoll Co. v. Commissioner, 59 T.C. 37, 50-51 (1972), and the cases cited therein. In order to do so, the employer must show: (1) That the employer intended to compensate the employee for past undercompensation, and (2) the amount of the undercompensation. Pacific Grains, Inc. v. Commissioner, 399 F.2d 603, 606 (9th Cir. 1968), affg. T.C. Memo. 1967-7; Estate of Wallace v. Commissioner, 95 T.C. 525, 553-554 (1990), affd. 965 F.2d 1038 (11th Cir. 1992).

Petitioner has not argued that, and we are unable to determine whether, any of the payments in issue were intended to compensate either of the Shareholders for his service provided to petitioner in earlier years. We conclude that this factor does not apply.

j. EMPLOYER'S PAST AND PRESENT FINANCIAL CONDITION

Petitioner grew and became very profitable. Its equity grew from the Shareholders' initial contributions totaling $100, to $408,810 on December 31, 1991. We conclude that this factor favors petitioner.

k. WHETHER EMPLOYER AND EMPLOYEE DEALT AT ARM'S LENGTH

The Shareholders were purportedly paid high compensation as petitioner's principal employees. Given their relationship to petitioner as its only shareholders, we must inquire whether an independent investor would have paid the Shareholders the amount of compensation that they received during the years in issue. See Owensby & Kritikos, Inc. v. Commissioner, supra at 1326-1327; see also Elliotts, Inc. v. Commissioner, supra at 1246-1247. We conclude that an independent investor would have done so in view of the nature and quality of the services that the Shareholders performed for petitioner, and the effect of their services on a hypothetical investor's return on his or her investment. We conclude that this factor favors petitioner. In so concluding, we downplay the lack of adherence to corporate formalities shown by petitioner in paying the bonuses to the Shareholders. As the Court observed in Levenson & Klein, Inc. v. Commissioner, 67 T.C. 694, 714 (1977) (quoting Reub Issacs & Co. v. Commissioner, 1 B.T.A. 45, 48 (1924)), "Closely held corporations, as is well known, often act informally, 'their decisions being made in conversations, and oftentimes recorded not in minutes, but by action.'" See also Levenson & Klein, Inc. v. Commissioner, supra at 713-714 (courts may give little or no weight to the lack of corporate formality in closely held corporations). We also find relevant the following testimony from Waier with respect to the pay differential:

> Dick [Andrews] is more like a workaholic. And anybody that works that hard has got to be compensated for the work that they do. If you don't do that, your business is going to suffer because the guy that is putting in more hours and not receiving any money -- he is definitely going to reject the idea, not work as hard.
> And if he doesn't work as hard, I don't receive my salary, too.

l. WHETHER EMPLOYEE GUARANTEED EMPLOYER'S DEBT

The record does not indicate whether the Shareholders personally guaranteed any of petitioner's debt. Courts have considered whether an employee personally guaranteed his or her employer's debt, in determining whether the employee's compensation was reasonable. In certain situations, an employee's personal guarantee of his or her employer's debt may entitle the employer to pay a greater salary to the employee than the employer would otherwise have paid. See Owensby & Kritikos, Inc. v. Commissioner, supra at 1325 n.33; R. J. Nicoll Co. v. Commissioner, supra at 51; see also Acme Constr. Co. v. Commissioner, T.C. Memo. 1995-6; BOCA Constr. Inc. v. Commissioner, T.C. Memo. 1995-5. We conclude that this factor favors neither party. We consider it neutral.

m. ABSENCE OF PENSION PLAN/PROFIT-SHARING PLAN

The Shareholders were not participants in any pension plan or profit-sharing plan offered by petitioner. Courts have considered the absence of a pension plan or a profit-sharing plan in determining reasonable compensation. Rutter v. Commissioner, 853 F.2d 1267, 1274 (5th Cir. 1988), affg. T.C. Memo. 1986-407; Kennedy v. Commissioner, 671 F.2d 167, 174-175 (6th Cir. 1982), revg. and remanding 72 T.C. 793 (1979). Such an absence may allow the employer to pay the employee more compensation than the employer would have paid had the employer offered the employee a pension plan or a profit-sharing plan. Rutter v. Commissioner, supra at 1274. We conclude that this factor favors petitioner.

n. LACK OF REIMBURSEMENT OF BUSINESS EXPENSES

The Shareholders were not reimbursed for their out-of-pocket expenses incurred on behalf of petitioner. Courts have considered the lack of reimbursement of business expenses in determining reasonable compensation. An employer may pay greater compensation to an employee to reflect the fact that the employee is not being reimbursed for expenses that he or she paid on behalf of the employer. Id. at 1274.

We consider this factor neutral, and we give it no weight. The record is insufficient for us to determine the amount of the business expenses paid by the Shareholders during the years in issue for which they were not reimbursed. We also find that the lack of reimbursement was the personal choice of the Shareholders, rather than the policy of petitioner.

o. CONCLUSION ON REASONABLENESS

Most of the factors described above favor petitioner. None favor respondent. We conclude that the $478,000, $353,000, and $368,000 paid to Andrews in 1989, 1990, and 1991, respectively, was reasonable compensation for those years. We conclude likewise with respect to the $378,000, $253,000, and $343,000 paid to Waier in 1989, 1990, and 1991, respectively.

2. WAS COMPENSATION PAID FOR SERVICES RENDERED TO PETITIONER

According to respondent, petitioner is not entitled to deduct all of the compensation paid to the Shareholders because it paid part of this compensation for services that they performed on account of other, related companies (e.g., the Sellers). We disagree. Although the Shareholders provided some services to other related entities, we are unable to find that these services were performed on behalf of anyone other than petitioner. We hold that petitioner paid the Shareholders the compensation in issue for services that they rendered to it.

3. CONCLUSION

The $478,000, $353,000, and $368,000 paid to Andrews in 1989, 1990, and 1991, respectively, is deductible for those years under section 162(a)(1). The $378,000, $253,000, and $343,000 paid to Waier in 1989, 1990, and 1991, respectively, is also deductible for those years under section 162(a)(1).

We have considered all arguments made by respondent and, to the extent not discussed above, find them to be without merit. To reflect the foregoing,
Decision will be entered for petitioner.

FOOTNOTES

1. Respondent also determined: (1) Petitioner did not have a net operating loss in 1991, that could be carried back to earlier years, (2) petitioner had a $954 general business credit for 1988, that it could apply in 1989, and (3) petitioner was not entitled to report an additional $3,000 and a $344 credit in its 1989 and 1990 taxable years, respectively. Our resolution of the reasonable compensation issue automatically disposes of these other determinations.

2. The fact that petitioner did not operate out of its own building is also unique in the industry. By operating on other people's property, petitioner was able to minimize its expenses (as compared to its competitors) by practically eliminating its general administrative expenses such as rent, real estate taxes, and utilities.

3. The Shareholders have always owned petitioner equally.

4. In connection therewith, petitioner retains an accounting firm to report its payroll, review its financial operations, and prepare its tax returns.

5. The Shareholders learned after the formation of petitioner that purchasers of shredded automobiles would pay a progressive pay scale to volume haulers.

6. During the years in issue, petitioner purchased fixed assets worth more than $286,000.

7. More specifically, respondent disallowed $339,792, $222,253, and $254,282 paid to Andrews for 1989, 1990, and 1991, respectively, and $274,344, $154,940, and $257,711 paid to Waier.

8. We recognize that petitioner's retained earnings at the end of its 1991 taxable year were $32,647 less than at the beginning of that year. Petitioner's gross receipts for 1991, however, were also $284,272 less than the prior year.

9. In so concluding, we also find relevant the fact that the total bonuses paid to the Shareholders during each year did not bear a relationship to the percentage of stock held by each of them. See Paul E. Kummer Realty Co. v. Commissioner, 511 F.2d 313, 316 (8th Cir. 1975), affg. T.C. Memo. 1974-44; see also Kennedy v. Commissioner, 671 F.2d 167, 174-175 (6th Cir. 1982), revg. and remanding 72 T.C. 793 (1979).

10. See BOCA Constr. Inc. v. Commissioner, T.C. Memo. 1995-5; L & B Pipe & Supply Co. v. Commissioner, T.C. Memo. 1994-187; Mortex Manufacturing Co. v. Commissioner, T.C. Memo. 1994-110; Thomas A. Curtis, M.D., Inc. v. Commissioner, T.C. Memo. 1994-15; Automotive Inv. Dev. Inc. v. Commissioner, T.C. Memo. 1993-298; RTS Inv. Corp. v. Commissioner, T.C. Memo. 1987-98, affd. 877 F.2d 647 (8th Cir. 1989); Rutter v. Commissioner, T.C. Memo. 1986-407, affd. 853 F.2d 1267 (5th Cir. 1988); Diverse Indus., Inc. v. Commissioner, T.C. Memo. 1986-84: Owensby & Kritikos, Inc. v. Commissioner, T.C. Memo. 1985-267, affd. 819 F.2d 1315 (5th Cir. 1987); Lefkowitz v. Commissioner, T.C. Memo. 1983-356.

Mandelbaum v. Commissioner

Case name: Mandelbaum v. Commissioner
Citation: T.C. Memo 1995-255
Date of decision: June 12, 1995
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Laro
Experts: Paul R. Mallarkey (for respondent) Roger J. Grabowski (for petitioner)
SIC: 5621 Women's Clothing Stores (except dress shops and bridal shops)
NAICS: 448120 Women's Clothing Stores
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Keywords: Gift tax , Initial public offering (IPO), Restricted stock studies

Counsel for petitioners: Henry M. Matri, David M. Kohane, and Thomas J. LaConte

Counsel for respondent: Clare W. Darcy.

Judge: Laro

The subject cases were consolidated for trial, briefing, and opinion. Bernard Mandelbaum (Bernard), Leon Mandelbaum (Leon), Beverly Mandelbaum (Beverly), Max Mandelbaum (Max), and Pearl Mandelbaum (Pearl) petitioned the Court to redetermine respondent's determinations with respect to their 1986 through 1990 taxable years. n2 Respondent initially determined (and reflected in her notices of deficiency) the following deficiencies in Federal gift tax and additions to tax under section 6660: n3

			Additions to Tax
Taxpayer	Year	Deficiency	Sec. 6660
Bernard	1987	$ 9,057	--
Leon	1987	38,761	--
Max	1987	37,772	--
Pearl	1987	36,911	--
Beverly	1987	38,761	--
Bernard	1988	47,033	$ 9,406
Leon	1988	49,410	9,882
Max	1988	43,308	8,662

Pearl	1988	43,308	8,662
Beverly	1988	49,410	9,882
Bernard	1989	25,833	7,750
Leon	1989	39,235	11,771
Max	1989	27,398	8,219
Pearl	1989	27,398	8,219
Beverly	1989	39,235	11,771
Bernard	1990	472,370	94,474
Leon	1990	752,715	150,543
Max	1990	10,451	2,090
Pearl	1990	486,023	97,205
Beverly	1990	11,292	2,258

n2 Respondent audited petitioners' 1986 Federal gift tax returns and increased the amounts of their taxable gifts that were exempted from gift tax by application of the unified credit for that year. The increase, in turn, decreased the unified credits available to petitioners with respect to taxable gifts made in years after 1986. Petitioners' 1986 taxable year is before the Court solely to determine their unified credits.

n3 Unless otherwise indicated, section references are to the Internal Revenue Code in effect for the years in issue. Rule references are to the Tax Court Rules of Practice and Procedure.

In her answers (including amendments thereto) for 1987, respondent asserted that the deficiencies in Federal gift tax and additions under section 6660 are as follows:

		Additions to Tax
Taxpayer	Deficiency	Sec. 6660
Bernard	$ 66,134	$ 19,840
Leon	122,401	36,720
Max	115,577	34,673
Pearl	114,579	34,374
Beverly	122,401	36,720

In her answers (including amendments thereto) for 1989 and 1990, respondent asserted that she had erroneously referenced section 6660 in the related notices of deficiency, instead of section 6662(a) and (g), and that the additions to the tax for those years are as follows:

		Additions to Tax
Taxpayer	Year	Sec. 6662(a) and (g)
Bernard	1989	$ 5,167
Leon	1989	7,847

Max	1989	5,480
Pearl	1989	5,480
Beverly	1989	7,847
Bernard	1990	122,284
Leon	1990	198,860
Max	1990	2,090
Pearl	1990	64,232
Beverly	1990	2,258

Following concessions, n4 we must decide:

n4 Petitioners alleged in their petitions that respondent mailed her notices of deficiency to them after the statutory period of limitations for assessment and collection of gift tax. Respondent's pleadings contain denials of this allegation, and set forth affirmative facts to support her denials. Because petitioners did not raise this issue at trial or in their briefs, we hold that their silence amounts to a concession of this issue. Burbage v. Commissioner, 82 T.C. 546, 547 n.2 (1984), affd. 774 F.2d 644 (4th Cir. 1985). We note, however, that the record indicates that respondent issued the subject notices of deficiency to petitioners before the expiration of the period of limitations.

1. What discount for lack of marketability should be applied to determine the fair market value of certain shares of stock owned by some or all of petitioners on the following valuation dates: December 31, 1986, December 16, 1987, December 23, 1988, December 15, 1989, February 1, 1990, and December 30, 1990. We hold the marketability discount is 30 percent on all of these dates.

2. Whether petitioners are liable for additions to their 1987 and 1988 Federal gift taxes for valuation understatements under section 6660. We hold they are not.

3. Whether petitioners are liable for additions to their 1989 and 1990 Federal gift taxes for substantial gift tax valuation understatements under section 6662(a) and (g). We hold they are not.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations and attached exhibits are incorporated herein by this reference. Each petitioner was a resident of New Jersey when he or she petitioned the Court. They each filed Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for the 1986 through 1990 taxable years. Each reported on Form 709 that he or she had made a gift of the stock of Big M, Inc. (Big M), during the corresponding year.

1. The Mandelbaum Family

Leon, Max, and Bernard are brothers. Leon is married to Beverly, and they have four children: Kenneth, Beth, Joan, and Michael. Max is married to Pearl, and they have three children: Laurence, Alan, and Susan. Bernard is divorced and has three children: Ken, Lee, and Gini.

We hereinafter collectively refer to these 15 people as the Mandelbaum family.

2. Big M

a. Background

Big M is a privately held, family-owned corporation that was incorporated as a C corporation under the laws of the State of New Jersey. Big M operated as a C corporation until it elected to be an S corporation effective with its taxable year beginning on July 26, 1987. Big M uses a fiscal year to report its income and expenses for Federal income tax purposes. Big M's fiscal year originally ended on the last Saturday in July. Big M changed its taxable year in July 1988 to a fiscal year ending on the last Saturday in January.

b. Capital Structure

Big M was originally founded by Leon, Max, and Bernard. These three men, who initially were equal shareholders, were Big M's sole shareholders until 1976. In 1976, Leon and Max began transferring some of their Big M shares to their children. Bernard began transferring some of his Big M shares to his children in 1978. Big M stock has always been owned within the three branches of the Mandelbaum family formed by the brothers and their children. The Mandelbaum family does not plan to make Big M public, sell it, or seek nonfamily equity investors.

Big M had one class of common stock outstanding in its 1986 and 1987 taxable years. This stock, totaling 9,643 shares, was owned by all members of the Mandelbaum family except for Pearl and Beverly. Big M restructured its corporate form during its taxable year ended July 30, 1988. Big M recapitalized, exchanging 9,643 shares of its common stock for 6 shares of its newly issued class A voting common stock and 9,637 shares of its newly issued class B nonvoting common stock. One share of class A voting stock each was issued to Leon, Bernard, Laurence, Kenneth, Ken, and Alan. n5 Shares of class B nonvoting stock were issued to each member of the Mandelbaum family in the same ownership percentages that they each had held before the recapitalization. All members of the Mandelbaum family, except for Pearl and Beverly (who were not shareholders at that time), agreed that a share of class A stock would become a share of class B stock if it was transferred. These members also agreed that Big M's board of directors (the Board) could restore the voting rights to the transferred share if the transferee was a member of the Board.

n5 Accordingly, each branch of the family had two voting shares.

c. Type of Business

Big M operates predominantly in a single industry segment; i.e., women's apparel retail stores, in the States of New York, New Jersey, Pennsylvania, Delaware, Maryland, and Virginia. Bernard, Max, Leon, and their mother opened Big M's first store in 1950. All three brothers were actively involved in the business then, and they and their children continue to operate the business today. A number of the children are currently active in the management of the business on a full-time basis. The oldest of these children is Max's son, Laurence, who is currently Big M's chief executive officer and president. Several of the grandchildren of Leon, Max, and Bernard also work in the business.

Big M has two retail divisions: Mandee Shops and Annie Sez. n6 Mandee Shops offers popular-priced contemporary junior fashions. Its average store size is 8,000 square feet. Annie Sez offers off-price, designer, and brand name women's clothing. Its average store size is 15,000 square feet. Each store employs approximately 15 people. Big M employs between 3,500 and 4,000 people, depending on the season, including 250 at its Totowa, New Jersey, headquarters.

n6 Mandee Shops does business in certain States under the name "Karin Morgan".

Big M's stores are primarily situated in downtown locations of densely populated cities and "strip center" locations on major highways. Big M had the following number of stores as of the end of the years indicated:

Year	Number of Stores
1983	48
1984	60
1985	71
1986	105
1987	110
1988	107
1989	115
1990	122

Retail sales of women's apparel is highly competitive. Competition relates to price, style, selection, quality, display, customer service, and store location. Mandee Shops and Annie Sez have different competitors. Their competitors include specialty stores, department stores, factory outlet malls, and mills projects.

Big M purchases practically all of its merchandise on the open market from various suppliers. Big M maintains sufficient inventory in its stores throughout the year, and it promotes its goods to the public through different methods of advertisement, such as radio, television, and newspapers. Big M accepts national credit cards and offers layaway plans.

d. Management

On November 4, 1982, Big M and its then shareholders (i.e., all members of the Mandelbaum family except Beverly, Pearl, Lee, and Gini) executed an agreement (First Agreement). The First Agreement required that Laurence be elected as Big M's president; that Leon be elected as vice president and chairman of the Board; and that Bernard be elected as secretary and vice chairman of the Board.

The First Agreement was revoked by a second agreement (Second Agreement) dated June 13, 1988. The Second Agreement was executed by Big M and its then shareholders; i.e., all members of the Mandelbaum family except Beverly and Pearl. The Second Agreement required that Laurence be elected as Big M's president; that Leon be elected as vice-president and chairman of the Board; that Bernard be elected as secretary, treasurer and vice chairman of the Board; that Kenneth be elected as vice president of real estate; that Ken be elected as vice president of retail operations; and that Alan be elected as vice president of merchandising.

3. Freely Traded Values of Big M Stock n7

The freely traded values of 1 share of the 9,643 shares of Big M common stock outstanding on December 31, 1986, and December 31, 1987, were $ 7,505 and $ 6,631, respectively. The freely traded values of 1 share of the 9,637 shares of Big M class B common stock outstanding on December 23,

1988, December 15, 1989, February 1, 1990, and December 30, 1990, were $ 7,376, $ 8,675, $ 7,325, and $ 4,397, respectively.

n7 The parties have stipulated these freely traded values. These values take into account any minority interest discount that is applicable.

4. Shareholders' Agreements

The First Agreement and the Second Agreement (collectively referred to as the Shareholders' Agreements) were executed with respect to Big M's stock. The Shareholders' Agreements were prepared by Big M's outside counsel, Arne Siegel (Siegel), n8 and Big M's outside accountant, Robert Kaye (Kaye). Both Siegel and Kaye are longtime advisers to Big M.

n8 Siegel is also a certified public accountant.

Siegel and Kaye initially met with Leon to discuss the advantages and disadvantages of the Shareholders' Agreements. Leon later met with Big M's other shareholders to discuss the agreements with them. None of the shareholders were personally represented by counsel during any discussion of the Shareholders' Agreements. The Shareholders' Agreements were approved by Big M's shareholders without meaningful negotiations. The shareholders merely adopted the recommendations of Siegel and Kaye, making no significant changes to the terms of either agreement.

The First Agreement provided that Big M and its shareholders "believe it is in their best interest to provide for continuity in the management and policies of * * * [Big M]." The First Agreement required the shareholders to elect the following individuals to the Board: Leon, Bernard, Laurence, Kenneth, Ken, and Alan. n9 The First Agreement required that vacancies in the Board be filed by the remaining board members, and that any new director must be an "issue" of a current shareholder or a spouse of a current shareholder. The First Agreement did not provide a price or a formula for determining the fair market value of transferred shares of Big M stock. The First Agreement, however, provided the following rules with respect to such a transfer: (1) The representative of an estate of a deceased shareholder could sell the decedent's stock to Big M, and Big M had to purchase the stock in accordance with the laws of the State of New Jersey pertaining to the purchase by a corporation of its own shares of stock. Big M was given the sole discretion to pay for the stock over any length of time (with interest at 10 percent) that Big M desired; (2) a shareholder could freely transfer Big M stock to his or her immediate family; and (3) except as provided elsewhere in the First Agreement, a shareholder wanting to transfer Big M stock had to first offer the stock to Big M on the same terms and conditions as the proposed transfer. Big M had 90 days to decide whether it would purchase the stock. Big M had the sole discretion to pay for the stock over any length of time (with interest at 10 percent) that Big M desired.

n9 Or, in other words, two persons from each branch of the Mandelbaum family.

The Second Agreement provides that Big M's shareholders "desire to maintain ownership and control of * * * [Big M] among themselves and to provide for continuity in the management and ownership of * * * [Big M]", and "It is the desire of all of the parties to maintain, if at all possible, the same proportionate interest of each [family] Group in * * * [Big M]." Like the First Agreement, the Second Agreement requires the shareholders to elect the following individuals to the Board: Leon, Bernard, Laurence, Kenneth, Ken, and Alan. n10 The Second Agreement requires that vacancies on the Board be filled by the remaining board members, and any new director must be a child of a current shareholder or a

spouse of a current shareholder. The Second Agreement, which may be changed at any time by unanimous consent of Big M's shareholders, provides the following rules with respect to a transfer of Big M stock: (1) Each shareholder may freely transfer Big M stock to members of his or her family group; (2) if a shareholder wants to transfer Big M stock outside of his or her family group, the shareholder must first offer the stock to the members of his or her family group on the same terms and conditions on which the stock is offered to others. The members of the shareholder's family group have 90 days to exercise a right of first refusal. If the family members do not exercise such a right, Big M has 30 days to exercise the right of first refusal. Big M has the sole discretion to pay for the stock over any length of time (with interest at the prime rate) that Big M desires. If Big M does not exercise its right of first refusal, the shareholder may transfer the stock to an outsider. The shareholder must transfer all of his or her stock, and the transferee must agree to be bound by the Second Agreement; and (3) upon the death of a shareholder, the representative of the estate may sell the decedent's stock to Big M, and it must purchase the stock in accordance with the laws of the State of New Jersey that pertain to the purchase by a corporation of its own stock. Big M has the sole discretion to pay for the stock over any length of time (with interest at the prime rate) that Big M desires. The price at which Big M will purchase the stock is determined solely by the holders of the voting stock.

n10 Or, in other words, two persons from each branch of the Mandelbaum family.

5. Big M's Financial History

Relevant data from the consolidated financial statements of Big M and its subsidiaries are as follows:

Taxable year ended	7/27/85	7/26/86
Current assets	$ 25,493,497	$ 30,530,663
Other assets	22,701,570	31,934,578
Total assets	48,195,067	62,465,241
Current liabilities	12,011,827	15,993,239
Other liabilities	1,850,755	7,550,747
Total liabilities	13,862,582	23,543,986
Stockholders' equity	34,332,485	38,921,255
Total liabilities and equity	48,195,067	62,465,241
Net sales	122,517,683	142,105,100
Other income	2,381,289	2,726,960
Total revenue	124,898,972	144,832,060
Costs and expenses		
Cost of sales	72,211,079	82,833,851
Selling and administrative expense	39,067,790	48,343,988
Depreciation and amortization	1,997,689	3,278,966

Interest expense	154,566	258,270
Total expenses	113,431,124	134,715,075
Income before income taxes and cumulative effect of a change in accounting principle	11,467,848	10,116,985
Provision for income taxes	5,628,000	5,480,000
Cumulative effect on prior years of change in method of computing depreciation, net of income taxes	(468,320)	-0-
Net Income	6,308,168	4,636,985

Relevant data (in thousands) from the financial statements of Big M are as follows:

Taxable year ended	7/25/87	1/30/88	7/30/88
Current assets	$ 47,723	$ 53,176	$ 62,088
Other assets	38,397	40,998	40,862
Total assets	86,120	94,174	102,950
Current liabilities	24,155	22,741	26,544
Other liabilities	15,802	12,712	12,320
Total liabilities	39,957	35,453	38,864
Stockholders' equity	46,163	58,721	64,086
Total liabilities & equity	86,120	94,174	102,950
Net sales	194,876	n/a	217,398
Other income	4,682	n/a	7,081
Total revenue	199,558	n/a	224,479
Costs and expenses			
Cost of sales	114,133	n/a	129,244
Selling and administrative expense	65,535	n/a	76,654
Depreciation and amortization	4,604	n/a	5,281
Interest expense	682	n/a	1,169

Total expenses	184,954	n/a	212,348
Income before income taxes and cumulative effect of a change in accounting principle	14,604	n/a	12,131
Provision for income taxes	7,314	n/a	848
Release of deferred Federal and State income taxes	-0-	n/a	(5,414)
Cumulative effect on prior years (to July 25, 1987) of the change in inventory costing method	-0-	n/a	(1,226)
Net income	7,290	n/a	17,923

Taxable year ended	1/28/89	1/27/90	1/26/91
Current assets	$ 70,988	$ 72,283	$ 76,327
Other assets	43,089	47,448	48,331
Total assets	114,077	119,731	124,658
Current liabilities	30,484	37,381	50,985
Other liabilities	11,679	16,330	9,016
Total liabilities	42,163	47,711	60,001
Stockholders' equity	71,914	72,020	64,657
Total liabilities & equity	114,077	119,731	124,658
Net sales	227,057	251,602	264.100
Other income	8,472	9,214	8,803
Total revenue	235,529	260,816	270,903
Costs and expenses			
Cost of sales	136,163	151,112	156.130
Selling and administrative expense	77,662	92,506	101,530
Depreciation and amortization	6,332	6,622	6,743
Interest expense	1,275	4,006	4,933
Total expenses	221,432	254,246	269,336
Income before income taxes and			

cumulative effect of a change			
in accounting principle	14,097	6,570	1,567
Provision for income taxes	904	406	116
Release of deferred Federal and			
State income taxes	0	0	0
Cumulative effect on prior			
years (to July 25, 1987) of			
the change in inventory			
costing method	0	0	0
Net income	13,193	6,164	1,451

n/a -- Data not available

For its fiscal years that ended before 1983, Big M generally paid annual dividends of $ 3.50 per share. Big M paid dividends of $ 28,350, $ 32,400, $ 36,450, $ 48,215, and $ 48,000 during its fiscal years ended in 1983, 1984, 1985, 1986, and 1987, respectively.

In 1988 and 1989, Big M made distributions sufficient to cover its shareholders' tax liabilities. In 1990, Big M made distributions sufficient to cover its shareholders' tax liabilities, and it distributed approximately $ 52 per share to all of its shareholders in connection with the establishment of three grantor trusts. n11

n11 The three trusts -- the Bernard Mandelbaum Retained Interest Trust, the Leon Mandelbaum Retained Interest Trust, and the Pearl Mandelbaum Retained Interest Trust -- were each established on Feb. 1, 1990, and were irrevocable. Under their terms, each grantor could receive all of the income from the transferred property for a set period of time (e.g., 10 years), and the remainder interest would pass to his or her children equally.

6. Federal Gift Tax Returns

a. Overview

In 1976, Siegel and Kaye advised Leon, Max, and Bernard that they should establish a program under which they would give stock to their children. Each year thereafter, Siegel and Kaye advised Leon, Max, and Bernard as to the number of shares to give to their children. The following tables show the gifts of Leon, Max, and Bernard on each valuation date and list each shareholder's holding immediately after the gifts. n12

n12 We note that the percentages of the shareholders' holdings contain rounding errors of .01.

	December 31, 1986	
	Gifts	Holdings
	Shares	
	of Stock	Class A

SHAREHOLDERS OF RECORDS:	Received by Gift	%	Common	%
Leon Mandelbaum	--	--	1,415	14.7
Kenneth A. Mandelbaum *	60	0.6	835	8.7
Beth Mandelbaum *	40	0.4	447	4.6
Joan Mandelbaum	30	0.3	437	4.5
Michael Mandelbaum *	30	0.3	437	4.5
Sub-Total	160	1.7	3,571	37.0
Max Mandelbaum	--	--	1,575	16.3
Laurence H. Mandelbaum *	50	0.5	825	8.6
Alan W. Mandelbaum *	50	0.5	825	8.6
Susan Mandelbaum *	25	0.3	346	3.6
Sub-Total	125	1.3	3,571	37.0
Bernard Mandelbaum	---	---	1,585	16.4
Ken Mandelbaum	40	0.4	648	6.7
Lee Elliot Mandelbaum	0	0.0	134	1.4
Gini Mandelbaum	0	0.0	134	1.4
Sub-Total	40	0.4	2,501	25.9
Total	325	3.4	9,643	100.0

* Note -One-half of these gifts was considered made by the donor's spouse.

	December 16, 1987	
	Gifts	Holdings
	Shares	
	of Stock	Class A

SHAREHOLDERS OF RECORDS:	Received by Gift	%	Common	%
Leon Mandelbaum	--	--	1,200	12.4
Kenneth A. Mandelbaum *	80	0.8	915	9.5
Beth Mandelbaum *	55	0.6	502	5.2
Joan Mandelbaum	40	0.4	477	4.9
Michael Mandelbaum *	40	0.4	477	4.9
Sub-Total	215	2.2	3,571	37.0
Max Mandelbaum	--	--	1,375	14.3
Laurence H. Mandelbaum *	75	0.8	900	9.3
Alan W. Mandelbaum *	75	0.8	900	9.3
Susan Mandelbaum *	50	0.5	396	4.1
Sub-Total	200	2.1	3,571	37.0
Bernard Mandelbaum	---	---	1,510	15.7
Ken Mandelbaum	55	0.6	703	7.3
Lee Elliot Mandelbaum	10	0.1	144	1.5
Gini Mandelbaum	10	0.1	144	1.5
Sub-Total	75	0.8	2,501	25.9
Total	490	5.1	9,643	100.0

* Note - One-half of these gifts was considered made by the donor's spouse.

	December 23, 1988	
	Gifts	Holdings
SHAREHOLDERS OF		Shares of Stock

SHAREHOLDERS OF RECORD:	BY Gift	Cla Com- mon	Common (Voting)	Class B ss A (Nonvoting)	Total Common	%
Leon Mandelbaum	--	--	1	1,134	1,135	11.8
Kenneth A. Mandelbaum *	25	0.3	1	939	940	9.7
Beth Mandelbaum *	16	0.2	0	518	518	5.4
Joan Mandelbaum *	12	0.1	0	489	489	5.1
Michael Mandelbaum *	12	0.1	0	489	489	5.1
Sub-Total	65	0.7	2	3,569	3,571	37.0
Max Mandelbaum	--	--	0	1,320	1,320	13.7
Laurence H. Mandelbaum *	21	0.2	1	920	921	9.6
Alan W. Mandelbaum *	21	0.2	1	920	921	9.6
Susan Mandelbaum *	13	0.1	0	409	409	4.2
Sub-Total	55	0.6	2	3,569	3,571	37.0
Bernard Mandelbaum	--	--	1	1,479	1,480	15.3
Ken Mandelbaum	20	0.2	1	722	723	7.5
Lee Elliot Mandelbaum	5	0.1	0	149	149	1.5
Gini Mandelbaum	5	0.1	0	149	149	1.5
Sub-Total	30	0.3	2	2,499	2,501	25.9

Total	150	1.6	6	9,637	9,643	100.0

* Note - One-half of these gifts was considered made by the donor's spouse.

December 15, 1989

	Gifts		Holdings			
			Shares of Stock			
SHAREHOLDERS OF RECORD:	Received BY Gift	Com-mon	Class A Common (Voting)	Class B (Nonvoting)	Total Common	%
				%		
Leon Mandelbaum	--	--	1	1,099	1,100	11.4
Kenneth A. Mandelbaum *	16	0.2	1	955	956	9.9
Beth Mandelbaum *	7	0.1	0	525	525	5.4
Joan Mandelbaum*	6	0.1	0	495	495	5.1
Michael Mandelbaum *	6	0.1	0	495	495	5.1
Sub-Total	35	0.4	2	3,569	3,571	37.0
Max Mandelbaum	--	--	0	1,295	1,295	13.4
Laurence H. Mandelbaum *	8	0.1	1	928	929	9.6
Alan W. Mandelbaum *	8	0.1	1	928	929	9.6
Susan Mandelbaum *	9	0.1	0	418	418	4.3
Sub-Total	25	0.3	2	3,569	3,571	37.0
Bernard Mandelbaum	--	--	1	1,467	1,468	15.2
Ken Mandelbaum	4	0.0	1	726	727	7.5
Lee Elliot	4	0.0	0	153	153	1.6

Mandelbaum						
Gini Mandelbaum	4	0.0	0	153	153	1.6
Sub-Total	12	0.1	2	2,499	2,501	25.9
Total	72	0.7	6	9,637	9,643	100.0

* Note - One-half of these gifts was considered made by the donor's spouse.

	February 1, 1990					
	Gifts		Holdings			
			Shares of Stock			
SHAREHOLDERS OF RECORD:	Received BY Gift	Common %	Class A Common (Voting)	Class B (Nonvoting)	Total Common	%
Leon Mandelbaum	--	--	1	99	100	1.0
Kenneth A. Mandelbaum	0	0.0	1	955	956	9.9
Beth Mandelbaum	0	0.0	0	525	525	5.4
Joan Mandelbaum	0	0.0	0	495	495	5.1
Michael Mandelbaum	0	0.0	0	495	495	5.1
L. Mandelbaum Retained Interest Trust	1,000	10.4	0	1,000	1,000	10.4
Sub-Total	1,000	10.4	2	3,569	3,571	37.0
Max Mandelbaum	--	--	0	295	295	3.1
Laurence H. Mandelbaum	0	0.0	1	928	929	9.6
Alan W. Mandelbaum	0	0.0	1	928	929	9.6

Susan Mandelbaum	0	0.0	0	418	418	4.3
P. Mandelbaum Retained Interest Trust *	1,000	10.4	0	1,000	1,000	10.4
Sub-Total	1,000	10.4	2	3,569	3,571	37.0
Bernard Mandelbaum	--	--	1	467	468	4.9
Ken Mandelbaum	0	0.0	1	726	727	7.5
Lee Elliot Mandelbaum	0	0.0	0	153	153	1.6
Gini Mandelbaum	0	0.0	0	153	153	1.6
B. Mandelbaum Retained Interest Trust	1,000	10.4	0	1,000	1,000	10.4
Sub-Total	1,000	10.4	2	2,499	2,501	25.9
Total	3,000	31.3	6	9,637	9,643	100.0

* Note - Max gave these shares to Pearl, who, in turn, gave them to this trust.

	December 30, 1990					
	Gifts		Holdings			
			Shares of Stock			
SHAREHOLDERS OF	Received		Class A	Class B		
SHAREHOLDERS OF RECORD:	BY Gift	Com-mon	Common (Voting)	(Nonvoting)	Total Common	%
Leon Mandelbaum	--	--	1	59	60	0.6
Kenneth A. Mandelbaum *	10	0.1	1	965	966	10.0
Beth Mandelbaum *	10	0.1	0	535	535	5.5

Joan Mandelbaum *	10	0.1	0	505	505	5.2
Michael Mandelbaum *	10	0.1	0	505	505	5.2
L. Mandelbaum Retained Interest Trust	1,000	10.4	0	1,000	1,000	10.4
Sub-Total	40	0.4	2	3,569	3,571	37.0
Max Mandelbaum	--	--	0	265	265	2.7
Laurence H. Mandelbaum *	10	0.1	1	938	939	9.7
Alan W. Mandelbaum *	10	0.1	1	938	939	9.7
Susan Mandelbaum *	10	0.1	0	428	428	4.4
P. Mandelbaum Retained Interest Trust *	0	0.0	0	1,000	1,000	10.4
Sub-Total	30	0.3	2	3,569	3,571	37.0
Bernard Mandelbaum	--	--	1	452	453	4.7
Ken Mandelbaum	5	0.1	1	731	732	7.6
Lee Elliot Mandelbaum	5	0.1	0	158	158	1.6
Gini Mandelbaum	5	0.1	0	158	158	1.6
B. Mandelbaum Retained Interest Trust	0	0.0	0	1,000	1,000	10.4
Sub-Total	15	0.2	2	2,499	2,501	25.9
Total	85	0.9	6	9,637	9,643	100.0

* Note - One-half of these gifts was considered made by the donor's spouse.

b. Filing of Gift Tax Returns

Beginning in 1976 and for most years thereafter (including each of the years in issue), Bernard, Leon, and Max filed Federal gift tax returns and reported the transfer of Big M stock to their children and/or the grantor trusts. For the 1986 through 1989 calendar years, Beverly and Pearl each agreed to split the gifts with their husbands, see sec. 2513, and filed Federal gift tax returns.

c. Preparation of Gift Tax Returns

Petitioners' 1976 through 1989 Federal gift tax returns were prepared by Siegel. Siegel and Kaye valued the shares of Big M for reporting on these returns. In valuing the shares, Siegel and Kaye first determined the total value of Big M stock by subtracting the net asset value of Big M's leasehold improvements from Big M's shareholders' equity. Siegel and Kaye then determined the per-share value of Big M by multiplying Big M's total value (as determined by them) by 50 percent (to reflect a minority and marketability discount) and dividing the product by Big M's outstanding shares (9,643). Siegel and Kaye determined that each share of Big M stock was worth $ 1,469, $ 2,335, and $ 2,473 on the 1987, 1988, and 1989 valuation dates, respectively.

Petitioners' 1990 Federal gift tax returns were prepared by the firm of Cole, Schotz, Bernstein, Meisel & Forman, P.A. (Cole, Schotz). Cole, Schotz valued the subject shares of Big M based on Big M's average income for the current and prior 4 years. Cole, Schotz first computed Big M's average income for these years, and then reduced the average amount by 50 percent in order to reflect a discount for minority interest and lack of marketability. Cole, Schotz determined that each share of Big M stock was worth $ 1,560 on both valuation dates in 1990. Cole, Schotz determined that the values of the gifts in trust made by Pearl, Leon, and Bernard were $ 504,638, $ 746,972, and $ 498,390, respectively.

d. Respondent's Audits of Gift Tax Returns

Respondent conducted two separate audits with respect to petitioners' gifts of Big M stock. Siegel and Kaye represented petitioners during each audit. Respondent conducted the first audit on the 1976, 1977, and 1978 Federal gift tax returns of Max, Pearl, Leon, and Beverly. Respondent conducted the second audit on the 1981 and 1982 Federal gift tax returns of Max, Pearl, Leon, Beverly, and Bernard. Leon, Max, Pearl, and Bernard consented to an additional gift tax assessment in connection with respondent's audit of 1982.

7. The Notices of Deficiency and Amendments to Answers

In her notices of deficiency, respondent determined that the values shown on petitioners' gift tax returns were incorrect. Respondent determined that the per-share values of Big M stock on the relevant valuation dates in 1987, 1988, and 1989 were $ 2,789, $ 5,129, and $ 8,020, respectively. Respondent determined that the per-share value of Big M stock on December 30, 1990, was $ 3,377, n13 and that the February 1, 1990, values of the gifts in trust by Pearl, Leon, and Bernard were $ 1,092,412, $ 1,617,006, and $ 1,078,887, respectively. Respondent also determined (and reflected in her notices of deficiency) additions to tax under section 6660 for valuation understatements for 1988, 1989, and 1990.

n13 Contrary to her determination with respect to Leon, Pearl, Beverly, and Bernard, respondent determined the value of Max's gift on Dec. 30, 1990, by reference to a per-share value of $ 3,777. The record does not support a different value for Max, as opposed to the other four petitioners, and we

assume that respondent's reference to the higher per-share value in Max's notice of deficiency was an error.

In her answers for the 1989 and 1990 years, respondent clarified that the additions to tax for valuation understatements for those years were asserted under section 6662(a) and (g). In October 1994, respondent amended her answers for the 1987 year to increase the deficiencies asserted against petitioners n14 and to assert that petitioners were liable for additions to tax under section 6660 for valuation understatements for that year.

n14 Respondent asserted in her amendments that the per-share value on the 1987 valuation date was $ 4,784.

In March 1995, following the trial of these cases, respondent moved the Court for leave to amend her answers to the 1990 petitions of Pearl, Leon, and Bernard, to conform her pleadings to the proof. We granted respondent's motion shortly thereafter. Respondent currently alleges that the per-share values of Big M stock were $ 5,127 and $ 3,077 on February 1, 1990, and December 30, 1990, respectively; i.e., the freely traded values of Big M stock, as stipulated to by the parties, less a 30-percent marketability discount. Respondent also currently alleges that Pearl, Leon, and Bernard are liable for additions to their 1990 gift taxes under section 6662(a) and (g).

OPINION

Issue 1. Marketability Discount

a. Overview

The parties have stipulated the fair market values of the subject shares of Big M stock on the relevant valuation dates, but their stipulated values do not include any discount for lack of marketability. After a trial during which each side introduced expert testimony on the subject of a proper discount, we are asked to determine the correct allowance for the subject shares' lack of marketability. The record is replete with charts, graphs, factual data, testimony, and expert opinion. We must evaluate all of the evidence and render a judgment. We are not bound by precise appraisal formulas. As the Court has previously observed, the valuation of property is an inexact science, and, if not settled by the parties, must be resolved by the judiciary by way of "Solomon-like" pronouncements. Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 452 (1980); Messing v. Commissioner, 48 T.C. 502, 512 (1967).

As typically occurs in a case of valuation, the parties primarily rely on their experts' testimony and reports to support the parties' contrary positions on the valuation issue. Expert testimony sometimes aids the Court in determining valuation. Other times, it does not. n15 The Court is not bound by an opinion of an expert. We weigh an expert's testimony in light of his or her qualifications, as well as with regard to all other credible evidence in the record. Depending on what we believe is appropriate under the facts and circumstances of the case, we may reject an expert's opinion in its entirety, accept it in its entirety, or accept only selective portions of it. Helvering v. National Grocery Co., 304 U.S. 282, 294-295 (1938); Seagate Tech., Inc., & Consol. Subs. v. Commissioner, 102 T.C. 149, 186 (1994); Parker v. Commissioner, 86 T.C. 547, 562 (1986); see also Estate of Levenson v. Commissioner, 282 F.2d 581, 582 (3d Cir. 1960), remanding T.C. Memo. 1959-120.

n15 For example, expert testimony is not useful to the Court when the expert is merely an advocate for the position argued by the party. Laureys v. Commissioner, 92 T.C. 101, 129 (1989).

Petitioners must prove that respondent's determinations of value set forth in her notices of deficiency are incorrect. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933); Estate of Gilford v. Commissioner, 88 T.C. 38, 51 (1987). Respondent bears the burden of proving the increases in the deficiency (including additions thereto) asserted in her amended answers. n16 Rule 142(a); Estate of Bowers v. Commissioner, 94 T.C. 582, 595 (1990). Valuation is a question of fact, and the trier of fact must weigh all relevant evidence to draw the appropriate inferences. Commissioner v. Scottish Am. Inv. Co., 323 U.S. 119, 123-125 (1944); Helvering v. National Grocery Co., supra at 294; Publicker v. Commissioner, 206 F.2d 250, 252 (3d Cir. 1953), affg. a Memorandum Opinion of this Court; Estate of Newhouse v. Commissioner, 94 T.C. 193, 217 (1990); Skripak v. Commissioner, 84 T.C. 285, 320 (1985); see also Rev. Rul. 59-60, 1959-1 C.B. 237.

n16 Petitioners allege in their brief that respondent has the burden of proof with respect to the additions to their 1989 and 1990 gift taxes under sec. 6662(a) and (g). Petitioners contend that respondent bears this burden because she stated in her notices of deficiency that she determined the additions under sec. 6660, and restated in her answers that the determinations were made under sec. 6662(a) and (g). We disagree with petitioners that respondent bears the burden of proof on this issue. Although we agree with petitioners that respondent must prove any new matter pleaded in her answers, Rule 142(a), we do not agree with them that respondent's correction of her reference to former sec. 6662(a) and (g) is a new matter. Given the fact that respondent's notices clearly state that she determined valuation understatement penalties for 1989 and 1990, the mere fact that she mistakenly referred to the predecessor section (which mistake she quickly corrected in her answers) does not raise a new matter or otherwise shift the burden of proof. Estate of Jayne v. Commissioner, 61 T.C. 744, 748-749 (1974); McSpadden v. Commissioner, 50 T.C. 478, 492-493 (1968).

For Federal gift tax purposes, the fair market value of the subject property is determined as of the date of each gift, and, ordinarily, no consideration is given to any unforeseeable future event that may have affected the value of the property. Sec. 2512(a); sec. 20.2031-1(b), Estate Tax Regs.; see also First Natl. Bank v. United States, 763 F.2d 891, 893-894 (7th Cir. 1985); Estate of Newhouse v. Commissioner, supra at 218; Estate of Gilford v. Commissioner, supra at 52-53. Fair market value is defined for both estate tax and gift tax purposes to mean the price that a willing buyer would pay a willing seller, both persons having reasonable knowledge of all the relevant facts and neither person being under a compulsion to buy or to sell. Sec. 20.2031-1(b), Estate Tax Regs.; see also United States v. Cartwright, 411 U.S. 546, 551 (1973); Dorn v. United States, 828 F.2d 177, 180 (3d Cir. 1987); Snyder v. Commissioner, 93 T.C. 529, 539 (1989); Estate of Hall v. Commissioner, 92 T.C. 312, 335 (1989). The willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the individual characteristics of these hypothetical persons are not necessarily the same as the individual characteristics of the actual seller or the actual buyer. First Natl. Bank v. United States, supra at 893-894; Estate of Curry v. United States, 706 F.2d 1424, 1428-1429, 1431 (7th Cir. 1983); Estate of Bright v. United States, 658 F.2d 999, 1005-1006 (5th Cir. 1981); Estate of Newhouse v. Commissioner, supra at 218.

Special rules govern the valuation of corporate stock. When stock is listed on an established securities market, the stock's value usually equals its listed market price. When stock is not listed on such a market, the stock's value may be based on the unlisted stock's recent arm's-length sales. Estate of Andrews v. Commissioner, 79 T.C. 938, 940 (1982); Duncan Indus., Inc. v. Commissioner, 73 T.C. 266, 276 (1979). In the absence of recent sales, the value of unlisted stock is determined by taking into consideration the value of the corporation's listed stock, or, if the corporation has no listed stock, the listed stock of corporations engaged in the same or a similar line of business. Sec. 2031(b); Estate of Hall v. Commissioner, supra at 336. Unlisted stock must also be valued indirectly by reference to the subject corporation's net worth, its prospective earning power, its dividend-earning capacity, its goodwill, its management, its position in the industry, the economic outlook for its industry, the degree of control represented by the block of its stock to be valued, and the amount and type of its nonoperating assets if not considered elsewhere. See Estate of Hall v. Commissioner, supra at 336; Estate of Andrews v. Commissioner, supra at 940; sec. 20.2031-2(f), Estate Tax Regs.

When determining the value of unlisted stock by reference to listed stock, a discount from the listed price is typically warranted in order to reflect the unlisted stock's lack of marketability. Such a discount, commonly known as a "lack of marketability discount" (or, more succinctly, a "marketability discount"), reflects the absence of a recognized market for closely held stock and accounts for the fact that closely held stock is generally not readily transferable. A marketability discount also reflects the fact that a buyer may have to incur a subsequent expense to register the unlisted stock for public sale. See Estate of Trenchard v. Commissioner, T.C. Memo. 1995-121; Rev. Rul. 77-287, 1977-2 C.B. 319, 320-321.

The parties have stipulated the "freely traded" values of Big M's class B common stock on the pertinent valuations dates. These stipulated values take into account any applicable minority discount. The stipulated values must be discounted to reflect the fact that Big M's stock is unlisted and is not easily marketable. Ascertaining the appropriate discount for limited marketability is a factual determination. Critical to this determination is an appreciation of the fundamental elements of value that are used by an investor in making his or her investment decision. A nonexclusive list of these factors includes: (1) The value of the subject corporation's privately traded securities vis-a-vis its publicly traded securities (or, if the subject corporation does not have stock that is traded both publicly and privately, the cost of a similar corporation's public and private stock); (2) an analysis of the subject corporation's financial statements; (3) the corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends; (4) the nature of the corporation, its history, its position in the industry, and its economic outlook; (5) the corporation's management; (6) the degree of control transferred with the block of stock to be valued; (7) any restriction on the transferability of the corporation's stock; (8) the period of time for which an investor must hold the subject stock to realize a sufficient profit; (9) the corporation's redemption policy; and (10) the cost of effectuating a public offering of the stock to be valued, e.g., legal, accounting, and underwriting fees. See Estate of Gilford v. Commissioner, 88 T.C. 38, 60 (1987); Northern Trust Co. v. Commissioner, 87 T.C. 349, 383-389 (1986); see also Rev. Rul. 77-287, 1977-2 C.B. 319 (valuation of restricted securities).

b. Respondent's Determination and Her Expert

Respondent determined that the freely traded value of Big M stock must be discounted by 30 percent to reflect its lack of marketability on the six valuation dates. Respondent supports her determination with the testimony of her expert, Paul R. Mallarkey (Mallarkey). Mallarkey is the Northeast regional valuation

director for Valuation and Appraisal Services at BDO, Seidman, a major international accounting firm. Mallarkey is also a senior member and accredited senior appraiser in business valuation with the American Society of Appraisers, and a chartered financial analyst with the Institute of Chartered Financial Analysts.

Mallarkey used three studies on the sale of "restricted stock" n17 to ascertain the marketability discount for the subject shares. n18 The first study, Securities and Exchange Commn., Institutional Investor Study Report, H.R. Doc. 92-64 (Vol. 5), 92d Cong., 1st Sess. (1971), is based on more than 300 private transactions of the restricted stock of corporations that had shares of the same class of stock which were publicly traded. The study finds that the median discount for restricted stock of over-the-counter nonreporting companies is between 30.1 and 40 percent. n19 The second study, Moroney, "Most Courts Overvalue Closely Held Stocks", 51 Taxes 144 (1973), is based on 10 registered investment companies that held a total of 146 blocks of restricted equity securities. The study finds that the companies' original cash-purchase discounts averaged 36 percent, in comparison to the prices of securities of the same issuers which were not restricted. The third study, Maher, "Discounts for Lack of Marketability for Closely Held Business Interests", 54 Taxes 562 (1976), is based on reports filed with the Securities and Exchange Commission by four mutual companies for their 1969 through 1973 years, with respect to restricted common stock purchased by them. The study finds that the stocks' mean discount are 34.73 percent. Discounts in the third study were derived by comparing the funds' costs for the stock to market values of unrestricted securities of the same classes of stock in the same companies on the same acquisition days.

n17 Restricted stock is stock acquired from an issuer in a transaction exempt from the registration requirements of the Federal securities law. Transfers of restricted stock are generally restricted within the first 2 years after issuance.

n18 See generally Pratt, Valuing a Business 238-247 (2d ed. 1989), for a discussion of studies on restricted stock transactions.

n19 For this purpose, a nonreporting company is not required to file certain documents, such as quarterly disclosure reports, although it has stock which is publicly traded over the counter.

Given the fact that these three restricted stock studies find that restricted stock generally sells at a 30- to 35-percent discount from unrestricted stock, Mallarkey concluded that a 30-percent discount is appropriate for all six valuation dates. Mallarkey found that the risk associated with holding Big M stock is neutralized by its size and stable gross profits, which have allowed Big M to remain profitable. Mallarkey also found that the Shareholders' Agreements do not seriously affect the marketability of Big M stock.

c. Petitioners' Position and Their Expert

Petitioners contend that a 75-percent marketability discount applies to 1986 through 1989, and a 70-percent discount applies for 1990. Petitioners support their 70- and 75-percent rates with the testimony of their expert, Roger J. Grabowski (Grabowski). Grabowski is a principal and the national director of Valuation Services Group at Price Waterhouse, LLP. Grabowski valued the subject shares and calculated the following range of marketability discounts for the shares:

Date	Discount Range

1986	66-94%
1987	63-93
1988	69-95
1989	73-96
Feb. 1990	68-83
Dec. 1990	64-78

Grabowski opined that a 75-percent discount applies for 1986 through 1989 and a 70-percent discount applies for 1990.

In reaching his opinion, Grabowski concluded that Big M stock is "virtually illiquid" and assumed that an investor in Big M would have to wait 10 to 20 years for his or her investment to become liquid. Grabowski based his conclusions primarily on the fact that Big M's shareholders executed the Shareholders' Agreements. n20 Grabowski also based his conclusions on the facts that: (1) Members of the Mandelbaum family have always owned Big M, (2) the family has no plans to make Big M public or to seek outside investors, (3) Big M's senior management is relatively young and approximately 20 years from normal retirement age; and (4) none of the gifts in issue significantly changed the voting power of Big M. Grabowski further based his conclusions on his allegations that Big M had an erratic dividend history, and that any investor in Big M would be uncertain as to whether he or she would receive regular dividends.

n20 According to Grabowski, the Shareholders' Agreements "severely restrict" the marketability of Big M shares because the agreements contain a waiting period (with a right of first refusal) with respect to all sales of Big M stock to prospective buyers who are outside of the Mandelbaum family, and contain numerous provisions that minimize the possibility that such a buyer could ever vote on corporate matters or serve on the Board. Grabowski also concluded that an investor in Big M stock would demand a higher rate of return on his or her investment, as compared to an investment in a freely traded comparable company, because of the transferability restrictions embodied in the Shareholders' Agreements.

Grabowski analyzed the same three restricted stock studies analyzed by Mallarkey. Grabowski also analyzed four other restricted stock studies and three studies on initial public offerings (IPO). The four other restricted stock studies were: Gelman, An Economist-Financial Analysts Approach 353 (1972) (average discount on restricted stock purchased by four closed-end investment companies that specialized in restricted stock); Trout, "Estimation of the Discount Associated with the Transfer of Restricted Securities", 55 Taxes 381 (1977) (average discount on restricted stock purchased by mutual funds from 1968 to 1972); Pittock & Stryker, "Revenue Ruling 77-287 Revisited", SRC Quarterly Reports 1 (Spring 1983); and Willamette Management Associates Study, as described in Pratt, Valuing a Business 247 (2d ed. 1989) (median discount for 33 arm's-length private placements of restricted stock, as compared to their freely traded counterparts, from January 1, 1981, through May 31, 1984). These four studies, taken together with the other three studies, generally find a 35-percent marketability discount for transfers of restricted stock.

Grabowski also analyzed IPO studies. n21 IPO studies report the differences between the sale prices of stocks in IPO's and the sale prices of the same stocks in private sales occurring shortly before the public transactions. The three IPO studies analyzed by Grabowski were: Emory, "The Value of Marketability as

Illustrated in Initial Public Offerings of Common Stock -- January 1980 through June 1981", Business Valuation News 21 (Sept. 1985); Emory, "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock -- January 1985 through June 1986", Business Valuation Reviews 12 (Dec. 1986); and Willamette Management Associates Studies, as described in Pratt, supra at 250. These IPO studies find average marketability discounts of 45 percent.

n21 See generally Pratt, supra, for a discussion of studies on IPO's.

Grabowski concluded that the marketability discount for the subject shares is higher than the discounts in the restricted stock and IPO studies because Big M stock is illiquid. Grabowski interviewed a number of investment firms to ascertain the rate of return that they would require from an investment in a company similar to Big M stock. These investors generally reported returns ranging from 25 to 40 percent. Grabowski concluded that an investor's required rate of return for an investment in Big M would be 35 to 40 percent. Grabowski assumed that such an investor would have to hold his or her stock for 10 to 20 years. Grabowski calculated his range of discounts based on his assumed holding period of 10 to 20 years and his ascertained required rate of return of 35 to 40 percent. Grabowski's calculations for 1990 reflect the fact that Big M made larger distributions during that year than in prior years.

d. Court's View on Experts

We are unpersuaded by Mallarkey's analysis and conclusions. Given the fact that the record adequately shows that the Mandelbaum family plans to keep Big M family controlled and privately held, we do not believe that Mallarkey gave enough weight to the fact that a person outside of the Mandelbaum family would acquire no meaningful powers in Big M if he or she invested in the company. We also find that Mallarkey did not give enough weight to the transferability restrictions embodied in the Shareholders' Agreements. Although we conclude below that these restrictions are not determinative with respect to the valuation issue, we believe that the Shareholders' Agreements create a chilling effect on prospective investors, and, accordingly, that some consideration must be given to the agreements' effect on the issue of marketability. Spitzer v. Commissioner, 153 F.2d 967 (8th Cir. 1946), affg. a Memorandum Opinion of this Court; Estate of Hall v. Commissioner, 92 T.C. 312, 325 (1989); Harwood v. Commissioner, 82 T.C. 239, 260, 263-264 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986).

We are further troubled by the fact that Mallarkey relied primarily (if not entirely) on the restricted stock studies to support his conclusion of a 30-percent discount rate. Because the restricted stock studies analyzed only "restricted stock", the holding period of the securities studied was approximately 2 years. Mallarkey has not supported such a short holding period for Big M stock, and we find no persuasive evidence in the record to otherwise support it. n22 In addition, the restricted stock studies analyzed only the restricted stock of publicly traded corporations. Big M is not a publicly traded corporation.

n22 As mentioned infra at 49, the period of time for which an investor must hold stock may affect the value of that stock.

We are no more persuaded by Grabowski's analysis or conclusions. First, Grabowski's determination of fair market value focuses only on a hypothetical willing buyer and does not reflect the view of a hypothetical willing seller. Although the record indicates that petitioners adamantly desire to keep the ownership of Big M within their family, the test of fair market value rests on the concept of a hypothetical willing buyer and a hypothetical willing seller. Ignoring the views of a willing seller is contrary to this well-

established test. In this regard, Grabowski failed to consider any person who could be considered a hypothetical willing seller of Big M stock. He also did not consider whether such a seller would sell his or her Big M stock for at least 70 percent less than its freely traded value. We find incredible the proposition that any shareholder of Big M would be willing to sell his or her stock at such a large discount.

Second, we give the Shareholders' Agreements less weight than Grabowski. According to Grabowski, the right of first refusal contained in the Shareholders' Agreements "severely restricts" marketability of Big M stock. Grabowski, however, has not persuaded us that his assertion is true, let alone that the right results are 70- and 75-percent marketability discounts. We find Grabowski's heavy reliance on the Shareholders' Agreements especially troublesome, given the fact that the agreements specify no price or formula (such as book value per share) at which the shares must be offered to Big M or to its other shareholders. In most cases, especially where an operating company is concerned, a right of first refusal without a fixed price has little, if any, effect on fair market value (which inherently includes any marketability discount), see, e.g., Couzens v. Commissioner, 11 B.T.A. 1040, 1164 (1928), and such an absence of a fixed price clearly has a less dramatic effect than fixed-price restrictions, see e.g., Worcester County Trust Co. v. Commissioner, 134 F.2d 578, 581-582 (1st Cir. 1943), revg. Estate of Smith v. Commissioner, 46 B.T.A. 337 (1942); Estate of Reynolds v. Commissioner, 55 T.C. 172, 188-190 (1970). Indeed, a right of first refusal without a fixed price does not limit the buyers to whom a seller could sell his or her stock, or the price for that stock, but merely governs the order in which prospective buyers must stand in line to buy the stock. Couzens v. Commissioner, supra at 1163-1164. Given the fact that the right actually protects and benefits the other shareholders, who are given the first right to purchase the shares that a fellow shareholder desires to sell, the depressant effect (if any) on the value of privately held stock subject to a right of first refusal is not necessarily substantial.

Third, we are troubled by the fact that Grabowski failed to consider hypothetical willing buyers who are genuine representatives of prospective investors in Big M. Although Grabowski conducted interviews with nine investors, Grabowski's interviewees included only leveraged buyout groups, merchant bankers, and venture capitalists. Such a group of investors may (and did) require a higher rate of return than other investors. Grabowski should have included in his test a more representative sample of willing buyers of Big M stock, e.g., competitors of Big M or independent investors. Grabowski did not do so. We find that Grabowski's failure to do so weakens his testimony. n23 See Estate of Salsbury v. Commissioner, T.C. Memo. 1975-333.

n23 We are also troubled by the fact that Grabowski failed to give these interviewees relevant information about the subject stock. See Commissioner v. Estate of Stewart, 153 F.2d 17 (3d Cir. 1946) (willing buyer and seller presumed to know all essential facts), affg. a Memorandum Opinion of the Court. Although Grabowski gave each of the interviewees selective information on the subject shares, Grabowski did not give the interviewees vital information that is extremely probative on the shares' value. This omitted information includes the names of Big M and its retail stores.

Fourth, we have problems with many of the assumptions that Grabowski relied on to determine the marketability discount. Grabowski relied on his interviews for the proposition that a willing buyer of Big M stock must receive a 35- to 40-percent annual rate of return for his or her investment. As mentioned above, we find this reliance misplaced. Grabowski also relied on his assumption that a buyer would have to hold Big M stock for 10 to 20 years in order to make his or her investment worthwhile. We find

this reliance equally misplaced. Although Grabowski mentioned retirement for the current generation in the same breath as his 10-to 20-year assumption, Grabowski fails to explain how the current generation's retirement will add to the marketability of Big M stock. Grabowski also mentioned petitioners' intent to keep the stock family owned. The record, however, does not support Grabowski's assumption that petitioners will surrender family control in 10 to 20 years.

e. Court's Determination of Marketability Discount

Having found limited refuge in the opinions of either expert, we proceed to determine the value of the marketability discount. We do so by analyzing the above mentioned factors as of the following valuation dates: December 31, 1986, December 16, 1987, December 23, 1988, December 15, 1989, February 1, 1990, and December 30, 1990. n24

n24 Because the parties used Big M's yearend statements to determine its freely traded values on these valuation dates, we do the same with respect to the marketability discount.

1. Private Versus Public Sales of the Stock

To determine a marketability discount for unlisted stock, sales of similar interests in like companies are frequently considered. Numerous studies have been made with respect to this factor. We find that the 10 studies analyzed by Grabowski are more encompassing than the three studies analyzed by Mallarkey. Because Grabowski's studies found that the average marketability discount for a public corporation's transfer of restricted stock is 35 percent, and that the average discount for IPO's is 45 percent, we use these figures as benchmarks of the marketability discount for the shares at hand.

2. Financial Statement Analysis

Investors normally regard the analysis of a company's financial statements as a significant factor for determining the worth of the company's stock. Financial statements include the annual results of a company's operations (an income statement) and the company's status at its yearend (a balance sheet). Financial statements also include relevant footnotes relating to the statements, and the opinion of the preparer, e.g., an independent certified public accountant (C.P.A.), as to the condition of the company and the presentation of its financial statements. A nonexclusive list of relevant inquiries to make when analyzing financial statements includes the type of opinion rendered by the preparer; the soundness of the company's capitalization; the ratio of the company's assets to liabilities; the company's net worth and future earning power; the quality of the company's revenue and earnings; and the company's goodwill.

Turning to the facts at hand, we find that Big M engaged independent C.P.A.'s to perform certified audits on, and gave unqualified opinions with respect to, Big M's financial position on (and for the taxable years ended) January 26, 1991; January 27, 1990; January 28, 1989; July 30, 1988; and July 25, 1987. Big M's independent C.P.A.'s also performed certified audits on, and gave unqualified opinions with respect to, Big M and its subsidiaries' financial position on (and for the taxable years ended) July 26, 1986, and July 27, 1985.

Big M had strong capitalization on the six valuation dates. It also had solid current ratios of assets to liabilities. Accordingly, Big M was able to finance its operations to the extent necessary.

Big M's net worth, revenue, and earnings also were substantial for the subject years: For example, the net sales of Big M and its subsidiaries increased approximately 16 percent from their taxable year that ended in 1985 to their taxable year that ended in 1986; Big M's net sales continually increased for each of its taxable years ended in 1987 to 1991; Big M's net sales increased by 35.5 percent from its taxable year that ended in 1987 to its taxable year that ended in 1991; the net income for Big M and its subsidiaries exceeded $ 4.6 million for their taxable years ending in 1985 and 1986; Big M's net income exceeded $ 6.1 million for all of its taxable years that ended in 1987 through 1990; and Big M's net income exceeded $ 1.4 million for its taxable year that ended in 1991. We also find relevant the fact that Big M paid $ 5,719,000 in cash to purchase 30 retail stores of a competitor in 1986. The presence of cash is important in an apparel business, and Big M had sufficient cash during each of the subject years. Given the additional fact that Big M's stores are widely recognized in the industry, we conclude that these factors favor a below-average marketability discount for stock in Big M on each of the six valuation dates.

3. Company's Dividend Policy

Investors regard a company's dividend policy as a factor to consider in determining the worth of that company's stock. Critical to this factor is whether an investor will receive a fair rate of return on his or her investment. The fact that a company pays small or no dividends will not always negatively affect the company's marketability. Northern Trust Co. v. Commissioner, 87 T.C. 349, 388-389 (1986).

Even if a corporation seldom pays dividends, an investor may aim to participate in the corporation's success mainly through the appreciation in the value of his or her stock brought on by retained earnings and the possibility of a future return.

Turning to the facts at hand, Big M has paid small dividends in comparison to its net income. We do not find this fact determinative. Big M's net income exceeded $ 6.1 million for each of its years ended in 1987 through 1990, and its net income exceeded $ 1.4 million for its year ended in 1991. Big M also had sufficient cash during each of those years. Accordingly, the Big M stock might attract an investor more interested in long-term growth than in current return.

This factor favors a below-average marketability discount.

4. Nature of the Company, Its History, Its Position in the Industry, and Its Economic Outlook

Investors generally regard the nature of a company, its history, its position in the industry, and its economic outlook as relevant factors for determining the worth of the company's stock.

In the instant case, Big M was not the leader in its industry. Its operations, however, were diversified and very profitable as of all six valuation dates. The future of Big M looked bright on each of these dates.

This factor favors a below-average marketability discount.

5. Company's Management

Investors regard the strength of a company's management as a factor to consider when determining the worth of that company's stock. Id. at 388-389. In the instant case, Big M has a proven and experienced management team that is well known in the industry. Based on its track record, an investor would have

reason for confidence in Big M's management team. Big M's policy decisions have furthered the business of the company as a whole, rather than promoting the interests of only the shareholders belonging to a particular branch of the family.

This factor favors a below-average marketability discount.

6. Amount of Control in Transferred Shares

Investors regard the control inherent in transferred shares as a relevant factor for determining the worth of the stock. Control reflects a shareholder's ability to direct a corporation through his or her dictation of its policies, procedures, or operations. Control of a closely held corporation represents an element of value that justifies a higher value for a controlling block of stock. An investor will pay more for a block of stock that represents control than for a block of stock that is merely a minority interest in the company. Estate of Chenoweth v. Commissioner, 88 T.C. 1577, 1588-1589 (1987).

None of the blocks of stock that are at issue herein represent control of Big M. This factor favors an average marketability discount.

7. Restrictions on Transferability of Stock

Investors consider transferability restrictions as a factor to consider in determining the worth of that company's stock. Harwood v. Commissioner, 82 T.C. 239, 260, 263-264 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986). In the instant case, we do not regard the Shareholder Agreements as a major factor because they specify no price (or formula to determine a price) for the right of first refusal. We are mindful that the agreements are enforceable legal documents. All the same, the Shareholders' Agreements, on their face, serve the legitimate business purpose of preserving family ownership and control of Big M. Nevertheless, we are not persuaded that the restrictions embodied therein result in severe restrictability on the transfer of Big M's shares or in a large marketability discount.

This factor favors an above-average to average marketability discount.

8. Holding Period for Stock

The length of time that an investor must hold his or her investment is a factor to consider in determining the worth of a corporation's stock. An interest is less marketable if an investor must hold it for an extended period of time in order to reap a sufficient profit. Market risk tends to increase (and marketability tends to decrease) as the holding period gets longer.

Grabowski assumed that an investor in Big M stock must hold his or her stock for 10 to 20 years. Mallarkey assumed a shorter period of 2 years. We are unpersuaded by either assumption.

We consider this factor to be neutral.

9. Company's Redemption Policy

A company's redemption policy is a factor to consider in determining the worth of the company's stock. Turning to the facts at hand, the record does not disclose whether Big M has a set redemption policy. We know, however, that Big M redeemed its shares on at least one occasion. In or about 1974, Big M redeemed 900 of its shares from Bernard for $ 400,000 in cash. Big M did so because Bernard needed

the money to settle a divorce from his former spouse. We also know that the Shareholders' Agreements give Big M the right to purchase its shares before a buyer outside of the Mandelbaum family may do so and do not set a price for these shares.

Given that Big M has previously redeemed shares for the sole benefit of one of its shareholders, we find nothing that would prevent it from later redeeming the shares of a seller at their freely traded value (or greater) in order for Big M to remain family owned. We believe that a hypothetical buyer or seller would consider Big M's prior redemption in a favorable light when viewing the price that he or she would assign to the shares.

This factor favors a below-average marketability discount.

10. Costs Associated With Making a Public Offering

Investors consider the costs associated with making a public offering in determining the value of unlisted stock. An above-average to average discount is warranted if the buyer completely bears the cost of registering the purchased stock. The discount is lessened, however, to the extent that the buyer has the ability to minimize his or her registration costs. Registration costs may be minimal to the buyer, for example, if he or she has the right to compel the corporation to register (or otherwise "piggyback") the unlisted shares at its expense.

This factor favors an above-average to average marketability discount.

11. Conclusion

Based on the record as a whole, and on our evaluation of the above-mentioned factors, we conclude that the marketability discount for the subject shares on each of the valuation dates is no greater than the 30 percent allowed by respondent.

We hold that a 30-percent marketability discount is to be applied to determine the fair market values of Big M shares on the relevant dates.

Issue 2. Valuation Understatement Penalties

a. Overview

Respondent determined that petitioners are liable for additions to their 1987 through 1990 Federal gift taxes for valuation understatements. Petitioners alternatively argue that they are not liable for these additions because: (1) The subject stock either was not undervalued or was not undervalued by the statutory thresholds; (2) they used acceptable valuation methods; or (3) they justifiably relied upon professionals to value the subject shares.

b. Section 6660

With respect to petitioners' 1987 and 1988 taxable years, section 6660(a) imposes additions to gift tax in the case of an underpayment of gift tax that is attributable to a valuation understatement. A valuation understatement occurs if the value of any property claimed on the taxpayer's Federal gift tax return is 66-2/3 percent or less of the amount determined to be the correct value. Sec. 6660(c). The additions range from 10 to 30 percent, depending on the amount of the understatement. Sec. 6660(b). Respondent may waive all or part of the addition if the taxpayer shows that: (1) He or she had a reasonable basis for the valuation reported on the return and (2) the value was reported in good faith.

Sec. 6660(e). Respondent's refusal to grant such a waiver is reviewable by the Court under an abuse of discretion standard. Estate of Jung v. Commissioner, 101 T.C. 412, 449 (1993); Mailman v. Commissioner, 91 T.C. 1079, 1082-1084 (1988).

Petitioners must prove that they are not liable for the additions to their 1988 Federal gift taxes or that respondent abused her discretion in not waiving these additions. Respondent must prove that petitioners are liable for the additions to their 1987 taxes; she raised these additions in her amendments to her answers. Respondent may prove that petitioners: (1) Did not have a reasonable basis for the valuations claimed on their returns or (2) did not report the valuations in good faith. Failing that, respondent must prove that her refusal to waive these additions: (1) Was not arbitrary; (2) was not capricious, and (3) had a sound basis in fact. Estate of Jung v. Commissioner, supra at 450; Mailman v. Commissioner, supra at 1084.

Based on the record as a whole, we find that petitioners had a reasonable basis for the values claimed on their 1987 and 1988 gift tax returns and that they reported the value in good faith. We also find that respondent abused her discretion with respect to these years. n25 Respondent primarily argues in her brief that the additions are appropriate because petitioners unreasonably relied on the valuations of Siegel and Kaye. Respondent states that petitioners should have known that their professionals' valuations were unreasonable based on the prior audits and the results thereof. To this proposition, we cannot agree. The mere fact that respondent challenged petitioners' valuation method in prior years does not mean that the method was unreasonable. Indeed, the written agreements signed by petitioners in connection with respondent's audits neither bound the parties thereto in future years nor constituted an acknowledgment that respondent was correct. See Consolidated Freightways, Inc. v. United States, 223 Ct. Cl. 443, 620 F.2d 862, 867-868 (1980). Accordingly, we find that respondent's failure to waive the additions for 1987 and 1988 was an abuse of her discretion. In so doing, we stress the fact that petitioners reasonably relied on the apparent expertise of Siegel, as displayed to them by his manner, education, and legal experience, and petitioners reasonably reported Siegel's valuation to respondent in good faith.

n25 Accordingly, we do not pass on the other arguments made by petitioners with respect to the 1987 and 1988 additions to tax.

c. Section 6662(a) and (g)

For gift tax returns due after December 31, 1989, e.g., petitioners' 1989 and 1990 returns, a penalty under section 6662(a) and (g) applies to any underpayment of gift tax that is attributable to a valuation understatement. A valuation understatement occurs if the value of property claimed on the return is 50 percent or less of the amount determined to be its correct value, and the portion of the underpayment attributable to the substantial gift tax understatement exceeds $ 1,000. Sec. 6662(g). The penalty equals 20 percent of the portion of the underpayment attributable to the understatement. Sec. 6662(a). The penalty does not apply to any portion of the underpayment for which the taxpayer shows that he or she: (1) Had reasonable cause and (2) acted in good faith with respect thereto. Sec. 6664(c); see also United States v. Boyle, 469 U.S. 241, 242 (1985).

Whether a taxpayer had reasonable cause and acted with good faith is a factual determination. Sec. 1.6664-4(b), Income Tax Regs. Critical to this test is whether the taxpayer used ordinary business care and prudence in attempting to assess his or her proper tax liability. Ordinary business care and

prudence may be present if the taxpayer had an honest misunderstanding of fact or law that is reasonable in light of his or her experience, knowledge, and education. Ordinary business care and prudence may also be present if the taxpayer reasonably relied on competent professional advice. Such is the case, even if the professional's advice proved to be erroneous. Sec. 1.6664-4(b)(1), Income Tax Regs.; see also United States v. Boyle, supra at 242, 251.

The record shows that petitioners made a reasonable attempt to assess their proper tax liability with respect to the gifts at issue. Because petitioners lacked sophistication in valuation and tax matters, they retained Siegel and Kaye to value the subject shares. Petitioners reasonably relied on the judgment and advice of their two longtime, professional advisers. Under the facts herein, petitioners were not required to second-guess their professionals' advice.

Respondent mainly argues that petitioners' reliance was unreasonable because her prior audits put them on notice that she disagreed with their valuation method. For the same reasons as mentioned above, we disagree. We hold for petitioners on this issue.

We have considered all arguments made by the parties and, to the extent not discussed above, find them to be without merit.

To reflect the foregoing,

Decisions will be entered under Rule 155.

110 T.C. No. 18

United States Tax Court

MARTIN ICE CREAM COMPANY, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 1477-93 Filed March 17, 1998

Frank Agostino, Alan G. Merkin, Mary Ann Perrone, and Susan M. Flynn, for petitioner.

Patricia Y. Taylor and Clare W. Darcy, for respondent.

A and his son M were shareholders of MIC, an S corporation that distributed ice cream products to supermarket chains, independent grocery stores, and food service accounts. MIC's supermarket business was largely attributable to the close personal relationships that A had developed and maintained for decades, beginning before the creation of MIC in 1971, with the owners and managers of the supermarket chains. Since 1974, MIC had distributed the ice cream products of HD, pursuant to an oral agreement entered into between A and the founder of HD. In 1987 and 1988, following the acquisition of HD by a public company, HD initiated negotiations with MIC to acquire MIC's rights to distribute HD ice cream products to MIC's customers. After some but not all terms of the acquisition had been negotiated in the 1988 negotiations, A and M caused SIC, a wholly owned subsidiary of MIC, to be created, and HD was notified that SIC would be the seller of the assets that HD wished to acquire. MIC then transferred to SIC all of MIC's rights to distribute HD ice cream products to the supermarket chains and food service accounts, and business records relating thereto, in exchange for all the stock of SIC, and immediately distributed the SIC stock to A in exchange for all of A's stock in MIC. Following further negotiations, A and SIC, 3 weeks thereafter, entered into a contract to sell HD all their intangible assets relating to distribution of HD ice cream products. Two weeks thereafter, following the determination of a purchase price adjustment provided for in the final version of the contract, the sale closed and SIC received the proceeds of sale, which it distributed to A.

1. HELD: The benefits of the personal relationships developed by A with the supermarket chains and A's oral agreement with the founder of HD were not assets of MIC that were transferred by MIC to SIC and thereafter sold by SIC to HD; A was the owner and seller of those assets.

2. HELD, FURTHER, respondent's attempt to apply Commissioner v. Court Holding Co., 324 U.S. 331 (1945), to regard MIC as the seller of assets to HD is rejected because the final sale to HD was on terms that were negotiated with HD by A and SIC that were significantly different from the terms of the earlier proposed transaction under negotiation between MIC and HD.

3. HELD, FURTHER, MIC's distribution of SIC stock to A was not entitled to nonrecognition of gain under sec. 355, I.R.C., because SIC was not engaged in the active conduct of a trade or business after the distribution of SIC stock to A.

4. HELD, FURTHER, although MIC's transfer of intangible assets to SIC in exchange for SIC stock was entitled to nonrecognition of gain under sec. 351, I.R.C., the immediate distribution of SIC stock in redemption of A's stock in MIC was a distribution of appreciated property under secs. 311(b) and 317(b), I.R.C., on which recognized gain in the amount of $141,000 is taxable to MIC under sec. 1374, I.R.C.

5. HELD, FURTHER, MIC is not liable for a negligence addition to tax under sec. 6653(a), I.R.C., but is liable for a substantial understatement addition under sec. 6661, I.R.C.

BEGHE, JUDGE: Respondent determined the following deficiency and additions to tax:

		Additions to Tax	
Year	Deficiency	Sec. 6653(a)(1)	Sec. 6661
1988	$477,816	$23,891	$119,454

In so doing, respondent determined that Martin Ice Cream Co. (MIC or petitioner) recognized taxable gain of $1,430,340 on the distribution of stock of its newly created subsidiary, Strassberg Ice Cream Distributors, Inc. (SIC), to one of petitioner's two shareholders, Arnold Strassberg (Arnold), in redemption of his 51-percent stock interest in petitioner. Shortly before trial, we granted respondent's motion for leave to amend answer to allege that a subsequent sale of assets to the Haagen-Dazs Co., Inc. (Haagen-Dazs), by Arnold and SIC should be attributed to petitioner under Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

We reject respondent's attempt to apply Court Holding, although we uphold respondent's original determination that petitioner recognized gain on the redemption of Arnold's stock in petitioner. We find that petitioner's gain is substantially less than the gain determined by respondent. We reject respondent's imposition of an addition to tax under section 6653(a)(1) but uphold the addition to tax for substantial understatement under section 6661.[1]

FINDINGS OF FACT

Some of the facts are stipulated and are so found. MIC is a New Jersey corporation whose principal place of business was Bloomfield, New Jersey, when it filed its petition.

MIC was incorporated in 1971 as a wholesale ice cream distributor, with Martin Strassberg (Martin) as its sole shareholder. MIC was a C corporation from 1971 through 1986. On December 30, 1986, MIC filed with the Internal Revenue Service a Form 2553, Election by a Small Business Corporation, which took effect on November 1, 1987. As a result of the election, the accounting period of MIC was changed, commencing January 1, 1988, from an October 31 fiscal year to the calendar year.

Soon after World War II, Arnold, Martin's father, a high school mathematics teacher, began a part-time business after school hours, selling ice cream products wholesale to stores in Newark, New Jersey. During summer vacations, Arnold expanded his coverage to small stores and ice cream parlors on the Jersey Shore. By 1960, Arnold had incorporated his own company, Arnold's Ice Cream, and was engaging full time in the wholesale distribution of ice cream. In the 1960's, Arnold began to develop relationships with the owners and managers of several supermarket chains when he conceived an innovative packaging and sales campaign that used bright colors and catchy slogans to market ice cream products to supermarkets for resale to consumers. Ice cream had hitherto been sold by supermarkets to consumers as an undifferentiated product in large containers and multiserving packages with plain brown wrappers. Arnold subsequently developed other packaging ideas for ice cream products that helped supermarkets sell ice cream products under their private labels. Even with different kinds of packaging, supermarkets marketed ice cream to consumers mainly on the basis of price. In the late 1960's, Arnold had a falling-out with his major supplier, Eastern Ice Cream, which forced Arnold's Ice Cream into bankruptcy.

In 1971, Martin and Arnold organized MIC as a part-time business, with one delivery truck, distributing ice cream to small grocery stores and food service accounts (restaurants, hotels, and clubs) in northern New Jersey. Martin joined the business after having completed virtually all requirements for a Ph.D. in statistics and after spending several years doing operations research and statistical analysis as an employee of large corporations. In 1975, Martin began working in the ice cream distribution business full time. During most of the 1970's, Arnold owned no stock in MIC because he wished to avoid the claims of creditors of Arnold's Ice Cream. In 1979, Arnold became a 51-percent shareholder in MIC, and Martin's interest was reduced to 49 percent. At no time did Arnold or Martin have an employment agreement with MIC.

In 1974, Ruben Mattus (Mr. Mattus), the founder of Haagen-Dazs, asked Arnold to use his ice cream marketing expertise and relationships with supermarket owners and managers to introduce Haagen-Dazs ice cream products into supermarkets. Haagen-Dazs manufactured an entirely new range of "super-premium" ice cream products that were differentiated from the competition by both higher quality and higher price. Haagen-Dazs had initially marketed its products to small stores and restaurants for single-serving on- premises consumption. Haagen-Dazs had made only minimal inroads into the supermarkets, and now Mr. Mattus wanted to intensify his marketing efforts in that sector. Mr. Mattus asked for Arnold's help because he had been unable to convince the supermarkets to carry his products; they saw super-premium ice cream as too expensive for a retail setting designed for off-premises consumption.

Arnold, as the first distributor of Haagen-Dazs ice cream to supermarkets, sparked a revolution in the retail sale of ice cream. Arnold and Haagen-Dazs tapped a hitherto hidden demand for a super-premium ice cream in supermarkets by consumers who were willing to pay higher prices for higher quality. By the late 1970's, MIC was distributing ice cream products, including Haagen-Dazs ice cream, to four major supermarket chains, Pathmark, Shop Rite, Foodtown, and Acme in New York, New Jersey, Connecticut, and Pennsylvania (the supermarkets) and to smaller grocery stores. However, neither Arnold nor MIC ever entered into a written distribution agreement with Haagen-Dazs or Mr. Mattus.

Arnold was so successful that in the late 1970's or early 1980's Mr. Mattus invited Arnold to become his partner in a planned expansion of Haagen-Dazs' supermarket sales to the West Coast. Arnold declined the offer and continued to use MIC as his corporate vehicle to distribute Haagen-Dazs products in New Jersey and adjacent areas.

Martin did not support or participate in Arnold's efforts to expand ice cream distribution to the supermarkets. Martin disliked the social activities necessary to developing and sustaining personal relationships with supermarket owners and managers -- activities that Arnold thrived on. Martin preferred to manage day-to-day operations at the MIC warehouse, arriving at work as early as 3 to 4 a.m. to supervise the loading of MIC's delivery trucks for delivery to the supermarkets and the small stores.[2] Martin employed route salesmen to expand and maintain wholesale distribution of ice cream, primarily Haagen-Dazs, to small independent grocery stores and food service accounts in New Jersey and New York. Martin did little or no solicitation himself. Arnold did not participate in Martin's development of the business of wholesale ice cream distribution to small grocery stores and food service accounts, focusing instead on the supermarkets.

In 1985, the Borden Co. (Borden) retained Arnold to use his contacts with the supermarkets to put Borden's ice cream products into supermarket freezers. Arnold worked as a broker for Borden, personally earning commissions on Borden's sales of ice cream products to supermarkets, rather than as a distributor buying from the manufacturer and reselling to retailers. MIC did not participate in Arnold's work for Borden. Arnold had the ability to -- and did -- put Borden's ice cream products into supermarket freezers at a time when many of his original contacts from the 1960's and earlier had passed from the scene. By 1988, Arnold no longer had a business relationship with Borden.

At some time in the early to mid-1980's, Ben and Jerry's, a competitor of Haagen-Dazs in the manufacture and marketing of super-premium ice cream, asked Arnold to help obtain supermarket freezer space for its products. Haagen-Dazs had not objected to Arnold's work for Borden but told him that he could not continue to distribute Haagen-Dazs ice cream products if he were to distribute Ben and Jerry's ice cream products. Arnold thereupon terminated further contact with Ben and Jerry's.

In 1983, the Pillsbury Co. (Pillsbury) purchased Haagen-Dazs from Mr. Mattus. Pillsbury promptly initiated a business plan to consolidate the distribution of Haagen-Dazs ice cream products into its own distribution centers, with the goal of delivering directly to retail stores, especially large supermarket chains. Pillsbury believed it could deliver a uniformly higher quality product to supermarkets at lower cost than independent distributors whose refrigeration equipment was not as reliable. Pillsbury believed that ensuring high quality was vital to its basic corporate strategy of continuing to differentiate Haagen-Dazs products from those of its competitors.

Another important component of the Haagen-Dazs corporate strategy was to enter into written distribution contracts, explicitly terminable at will by Haagen-Dazs on short notice, with distributors that it was not ready to buy out. Since 1974, MIC, like other regional distributors, had distributed Haagen-Dazs products on the basis of Arnold's original oral agreement with Mr. Mattus. After its acquisition by Pillsbury, Haagen-Dazs always maintained that distributors such as MIC did not have enforceable rights to continue to distribute Haagen-Dazs ice cream. In June 1988, the U.S. District Court, Northern District of California, MDL docket No. 682, ordered summary judgment in distributed ice cream products for a direct competitor.[3] The grounds were that the termination did not violate antitrust laws and that the oral agreement with the distributor did not prevent termination at will.[4]

In late 1985 or early 1986, representatives of Haagen-Dazs first approached the Strassbergs about acquiring direct access to Arnold's relationships with the supermarkets and removing him as a middleman in the chain of distribution. Haagen-Dazs also wanted to forestall competitors, such as Ben and Jerry's, from using Arnold's contacts and knowledge to gain access to the supermarkets. Haagen-Dazs also did not want to leave distributors like Arnold, who had been with Haagen-Dazs since the early days of Mr. Mattus, without adequate reward for the role they had played in bringing Haagen-Dazs to prominence. Also, because Arnold was a high-profile, well- respected ice cream distributor, Haagen-Dazs did not wish to alienate Arnold and risk having him stir up the other independent distributors before Haagen-Dazs was ready to take similar steps against them. Haagen-Dazs believed that these various relationships, personal to Arnold, had value for which it was willing to pay. At the same time, Haagen-Dazs wished to terminate any residual rights to distribute Haagen-Dazs ice cream that its distributors might have acquired over the years, even as it maintained that neither Arnold nor MIC, or later, SIC, had any enforceable "distribution rights" as such. Haagen-Dazs was not interested in acquiring MIC as an ongoing distributor to either the supermarkets or the small grocery stores and food service accounts or in acquiring its physical assets.

During the early to mid-1980's, Arnold and Martin had increasingly vocal disagreements over the future direction of MIC. Arnold wished to expand the supermarket business, and Martin wished to expand the small store business. They were unable to agree on which course to take or otherwise to agree on coordinating their different business objectives.

Martin was concerned about MIC's overdependence on a small number of large supermarket accounts. He felt that a diversified customer base of small independent stores with higher gross profits carried less risk. Martin was concerned about the smaller profit margins of the supermarket business and also felt that the small stores had a better record of paying MIC's invoices in full and on time.

Arnold attributed Martin's disparagement of the supermarket business to his dislike of the process of developing and maintaining the personal relationships with the managers and owners of the supermarkets that was needed to maintain access to supermarket freezer space. Arnold believed that the small volume of sales generated by each of the independent stores did not justify the effort to acquire and service their accounts.

Arnold and Martin each blamed the other's approach to management of his own line of the business for MIC's not being more profitable during the mid-1980's.

From 1985 through 1988, Arnold's and Martin's disagreements intensified, especially in the aftermath of Arnold's promotion of MIC's failed investment in a warehouse facility in central Newark that would have substantially expanded MIC's capability to distribute ice cream to the supermarkets, just as Haagen-Dazs was building its own large distribution facility in the Bronx. MIC's share of the total cost of the Newark facility would have been about $2.5 million. In 1987 or early 1988, Arnold and Martin ultimately abandoned the project after MIC had invested approximately $100,000.

By 1988, Martin no longer wanted to work with Arnold, and Arnold felt that Martin was pushing him to retire. They were looking for a way to end their constant strife over the future direction of petitioner. Their disagreement had made them both receptive to the first overture from Haagen-Dazs in May 1986. At that time, Arnold and Martin began consulting with their attorney, Russell L. Hewit (Mr. Hewit), concerning the negotiations with Haagen-Dazs.[5] Arnold was the primary negotiator in the talks with Haagen-Dazs. To that end, Arnold executed a series of confidentiality agreements. In March 1987, the initial talks broke down because the parties could not agree on the price for the business with the supermarkets.

To memorialize the termination of discussions, Mr. Hewit sent Haagen-Dazs a letter dated April 7, 1987, stating that he understood Haagen-Dazs to have made an initial offer of $3 million for "the Haagen-Dazs portion of the business". In a letter dated April 16, 1987, Haagen-Dazs replied that it had not offered $3 million, and that the distribution rights under discussion were worth approximately $1 million. Despite the breakdown in formal negotiations, the parties remained in contact. On January 8, 1988, Arnold signed a new confidentiality agreement.

On May 4, 1988, the MIC board of directors, consisting of Martin, Arnold, and Mr. Hewit, and Arnold and Martin as MIC's shareholders, adopted and approved resolutions to form a subsidiary of MIC, to be called SIC. Later that month, negotiations resumed between Haagen-

Dazs and Arnold and Martin regarding the possible sale of Arnold's supermarket distribution rights.

As with the earlier negotiations, Arnold took the lead in the negotiations with Haagen-Dazs. Between May 13 and May 23, 1988, Arnold and Martin met at least three times with Haagen-Dazs representatives. On May 16, 1988, Hewit wrote a letter to Charles McGill, vice president -- acquisitions, for Pillsbury, stating that, on May 13, proposals for Haagen-Dazs to buy MIC's "supermarket and food service business only" for up to $2.5 million had been rejected and that one of the obstacles was the possible sale of the remaining business to another distributor acceptable to Haagen-Dazs. However, neither Martin nor MIC thereafter pursued the possibility of such a sale, and the subject was never raised in subsequent negotiations with Haagen-Dazs.

On May 19, 1988, the parties discussed the outlines of an agreement to sell the supermarket and food service distribution business to Haagen-Dazs. On May 23, 1988, Mr. Hewit wrote another letter to Mr. McGill detailing the terms discussed in the meetings, including an overall price of $1.5 million for that business, $350,000 in additional contingent payments payable over 3 years, and annual payments of $150,000 to Arnold for 3 years, and of $50,000 to Martin for 5 years in return for consulting services and covenants not to compete in the retail super-premium ice cream distribution business, except as MIC and Martin would continue to distribute ice cream to stores other than the supermarket chains. Mr. Hewit's letter did not refer to any allocation of the total price between distribution rights as such and the business records related to those rights, or even refer to any such records. Haagen-Dazs had derived the total price it was willing to pay from a formula based upon MIC's annual sales of Haagen-Dazs products to the supermarkets.

On May 31, 1988, SIC's certificate of incorporation was filed with the New Jersey secretary of state, and SIC was organized as a wholly owned subsidiary of MIC. On June 2, 1988, Stan Oleson of Pillsbury sent Mr. Hewit a draft "Agreement for Purchase and Sale of Assets" and other associated draft documents. The Agreement documents listed Arnold, Martin, MIC, and SIC collectively as "Sellers" and provided for the purchase of any and all of Sellers' distribution rights, "including but not limited to supermarket and food service distribution rights, if any" and their cancellation by the "Buyer". On June 6, 1988, Mr. Hewit replied to Mr. Oleson with a letter containing a number of modifications to the proposed agreements, chief among which was elimination of all references to Martin and MIC as parties to the proposed sale so as not "to increase the risk that the 355 Exchange will be collapsed". During the negotiations that culminated in the signing on July 8 of a sale agreement between Arnold and SIC as sellers and Haagen-Dazs as buyer, Mr. Hewit did not draft his own version of the sale agreement; he made mark-ups of his suggested changes and sent copies of the marked-up drafts back to Haagen-Dazs.

On June 14, 1988, Beth L. Bronner, vice president for strategic and business development for Haagen-Dazs, replied to Mr. Hewit's letter of June 6, stating that Haagen-Dazs had

"incorporated, where possible, the suggested changes in your redraft and letter of June 6. However, many of the points in your letter reflected a transaction materially different from the one we believed we had negotiated with your clients". Ms. Bronner's letter stated that Haagen-Dazs had incorporated "your proposed exclusion of Martin Strassberg and * * * [MIC] from the Purchase Agreement," although it created "an important issue with which we must deal" in light of Haagen-Dazs' main objective of obtaining "ANY AND ALL distribution rights" of both Arnold and Martin and their respective companies. Ms. Bronner proposed to resolve this issue through a separate "side agreement" in which Martin and MIC "would clearly acknowledge" that all rights to distribute "Haagen-Dazs products have been transferred to * * * [SIC] and that he * * * [Martin] claims no rights to distribute Haagen-Dazs."[6]

Mr. Hewit sought advice from two tax attorneys, Charles E. Falk, an attorney C.P.A. with an LL.M. in taxation from New York University School of Law, and Martin's brother-in-law, Jan Neiman, an attorney practicing tax law in Miami Beach, Florida, on the tax structuring of the transactions creating SIC and distributing its stock to Arnold.[7] Mr. Hewit sought their advice to ensure that he properly drafted all documents necessary to effect the separation of Martin and MIC from Arnold and SIC. There is no evidence in the record that Mr. Hewit considered trying to obtain a private letter ruling from the Internal Revenue Service, or that he rendered a written opinion to petitioner or Martin or Arnold regarding the tax consequences of the transactions at issue, or that Mr. Hewit or any of the parties in interest received a written tax opinion from Mr. Neiman or Mr. Falk.

On June 15, 1988, Arnold, Martin, and Mr. Hewit executed documents providing for the transfer of MIC's interests in the supermarket business and associated customer and pricing lists from MIC to SIC and the exchange of Arnold's stock in MIC for the stock of SIC (the split-off). The first of these documents, entitled "Agreement", provided for the transfer of

> All of the Corporation's [MIC's] rights to distribute Haagen-Dazs Ice Cream products to supermarket chains (Pathmark, Shop Rite, Foodtown and Acme) and food service accounts (restaurants, hotels and clubs), and the business records of said distributorship, including but not limited to customer lists and pricing lists, to the Subsidiary * * * for the purpose of transferring to Arnold all of the outstanding shares of the Subsidiary in exchange for the surrender by Arnold of all of his shares of the Corporation, in a transaction intended to qualify as a tax-free split-off under Internal Revenue Code Section 355, as amended * * *

A second document, dated June 15, 1988, also entitled "Agreement", stated that Martin and Arnold were operating separate businesses that were formerly jointly operated by MIC, and that both Arnold and Martin "wish to assure a smooth transition so that neither party loses customers or employees as a result of * * * misunderstanding". The document further stated that

> Following the Exchange, * * * [MIC] shall cooperate with * * * [SIC] and provide such assistance that is reasonably necessary for * * * [SIC] to conduct its business, provided that the rendering of such services does not unduly interfere with the conduct

> of * * * [MIC]'s business. * * * [SIC] shall pay to and reimburse * * * [MIC] for all costs incurred by * * * [MIC] in providing such services.

This agreement provided, among other things, that MIC would continue to deliver ice cream from its warehouse to SIC's supermarket accounts after the June 15 transactions separating MIC and SIC. MIC did continue to do so until the closing of Arnold's and SIC's sale of assets to Haagen-Dazs on July 22.

On June 15, 1988, the MIC board of directors, consisting of Arnold, Martin, and Mr. Hewit, adopted a resolution, which was approved by Arnold and Martin as shareholders, declaring that MIC was in two separate businesses of equal fair market value, one distributing ice cream to supermarket chains and food service accounts and another distributing ice cream to small independent grocery stores. The resolutions stated that MIC undertook the transaction to split into two corporations in order to resolve the dispute between Arnold and Martin over the future direction of MIC and whether it would focus on distribution to supermarkets or to food service accounts and small stores and that Martin wished to operate the business of distribution of Haagen-Dazs ice cream products to nonsupermarket stores. Martin and Arnold each submitted his written resignation as a director, officer, and employee of the other company, Martin from SIC, and Arnold from MIC. Each of these documents bore the typed date "June 3, 1988", which was crossed out and amended by hand to read "June 15, 1988". None of the resolutions, agreements, or resignations contain any guaranty or indemnification from SIC or Arnold that would protect MIC or Martin from any tax liabilities arising from the split-off or the contemplated sale to Haagen-Dazs.

On June 20, 1988, Arnold and Mr. Hewit signed a directors' resolution of SIC, submitting to Arnold, as sole shareholder of SIC, an offer by Haagen-Dazs to "purchase all of the rights of the Corporation [SIC] to distribute Haagen-Dazs ice cream products". Arnold then signed a shareholder's resolution to authorize SIC to enter into negotiations with Haagen-Dazs. In an undated memorandum, Arnold disclosed his customer list to Haagen-Dazs, most likely in response to a June 30 letter from Ms. Bronner.

In a letter to Mr. Hewit, dated July 1, 1988, Richard Wegener, a Pillsbury attorney, summarized changes made "to the various distributor agreements" pursuant to negotiations that had taken place the previous week. Mr. Wegener stated that, in the wake of those negotiations, Haagen-Dazs "clearly * * * [had its] work cut out concerning the financial issues raised by Section 4.5 of the proposed agreement." Mr. Wegener exhorted Arnold "to get out * * * on the table" all relevant information required to complete that section, which was a warranty and representation by Arnold and SIC concerning sales of Haagen-Dazs ice cream products to supermarkets by MIC and SIC for the period of June 1, 1987, to May 31, 1988. On July 5, 1988, Mr. Hewit sent Ms. Bronner documentation of the sales to supermarkets for the 12-month period ending May 31, 1988. On July 7, 1988, Mr. Oleson wrote Mr. Hewit a letter asking whether Haagen-Dazs' refusal to agree to deposit money in escrow on signing the

purchase agreement would be a "deal breaker" that would require cancellation of this planned July 8 meeting to sign the agreement. He also expressed optimism that the deal would be signed. [34] On July 8, 1988, Arnold, individually, and as president of SIC, and Ms. Bronner, on behalf of Haagen-Dazs, signed an "Agreement For Purchase and Sale of Assets" by Arnold and SIC, as "Sellers", in which the parties agreed to the terms of the sale and related documents. Notwithstanding that the documents effectuating the split- off provided only for the transfer of supermarket and food service distribution rights and records to SIC, the Arnold-SIC-Haagen-Dazs agreement recited that SIC "owns all of the rights to distribute Haagen-Dazs product which were or may have been owned by Martin Strassberg and [MIC]," and purported to provide, consistent with the Haagen-Dazs first draft, for the purchase of all distribution rights including but not limited to supermarket rights.[8] This agreement specifically stated that "Buyer is not purchasing assets relating to the 'non-banner' business of * * * [MIC], the former parent of [SIC],"[9] and allocated the stated $1.5 million price to be paid at the closing, $300,000 to "Records" and $1,200,000 to "Sellers' Rights". There is no evidence in the record of any negotiation over this allocation or of any of the considerations that led Haagen-Dazs to allocate the purchase price in this fashion.

Unlike prior drafts of the purchase agreement in the record, the agreement as executed on July 8, 1988, between Haagen- Dazs and SIC and Arnold contains an Article 2.4 that makes the closing contingent on an audit by a '"Big-8' auditing firm" of the documentation of the sales to supermarket chains, independent supermarkets, and food service accounts for the 12-month period ending May 31, 1988. The audit was required to ascertain the actual sales figures in order to set the purchase price under Article 2.4 in accordance with a purchase price reduction clause that applied to both the payment to be made at the closing and the contingent annual payments to be made over the following 3 years.[10] Article 2.4 also provided that Haagen-Dazs would have no obligation to close if the audited sales were less than $4 million for the period under audit.

On July 20, 1988, Touche Ross & Co. submitted an audit report to Haagen-Dazs, stating that the audited sales were less than represented by Arnold and SIC. As late as July 21, Mr. Hewit was still negotiating with Haagen-Dazs on behalf of petitioner concerning the list of accounts that MIC would continue to service after the sale.

On July 22, 1988, Arnold and representatives of Haagen- Dazs closed the sale to Haagen-Dazs. The employees of MIC who had reported to Arnold before June 15 continued to do so until that date. Arnold thereupon notified MIC in writing that SIC no longer required the services of MIC in delivering ice cream products to the supermarkets or in otherwise servicing their accounts.[11] SIC then paid MIC for services rendered. MIC's customers had not been notified of any changes in its business until they were notified of the sale of the supermarket distribution business to Haagen-Dazs.

The closing documents contained an amendment to the purchase agreement -- signed July 22 after receipt of the Touche Ross & Co. audit of the supermarket sales figures -- stating that

during the 12-month period ending May 31, 1988, the sales of Haagen-Dazs products to the four supermarket chains, food service accounts, and independent supermarkets had totaled $4,528,000. Pursuant to the purchase price reduction clause of the Agreement, that sales figure resulted in a downward price adjustment of $86,000, of which $69,660 reduced the purchase price paid by Haagen-Dazs at the closing, and $16,340 of which reduced the amount of contingent additional payments payable to Arnold over 3 years. Consequently, the first closing document, entitled "Closing Statement", reduced the agreed sale price of $1.5 million to $1,430,340, and reduced the maximum amount of contingent annual payments of $350,000 to $333,660.

The bill of sale, signed by Arnold individually and as president of SIC, listed the items acquired from SIC as all existing customer lists, price lists, historical sales records, promotional allowance and rebate records, "and other business records as requested by Buyer, and the goodwill associated therewith".

Arnold also signed an "Assignment of Rights", which referenced -- and transferred to Haagen-Dazs -- the rights described supra, in two capacities: first, as president of SIC, and second, as an individual; there was no allocation of the consideration paid for the rights as between Arnold and SIC.[12] Ms. Bronner also signed the Assignment of Rights on behalf of Haagen-Dazs. Arnold signed a "Consulting and Non-Competition Agreement" with Haagen-Dazs, for which he was to be paid $150,000 annually for a period of 3 years. Martin also signed a "Consulting and Non-Competition Agreement" with Haagen-Dazs, for which he was to be paid $50,000 annually for a period of 5 years. Finally, Haagen-Dazs entered into three nonexclusive distribution agreements with petitioner for its continued distribution of Haagen-Dazs ice cream products to specified small independent stores and food service accounts in a limited geographical area.

On March 3, 1989, petitioner filed a Form 1120S for 1988, reporting gross sales of $6,021,394 and an ordinary loss of $278. Rudolph Bergwerk signed the return as preparer. MIC's 1988 Form 1120S contained no reference to the creation of SIC, the transfer to it of assets, or their basis, or the distribution of SIC stock to Arnold in redemption of his stock in MIC. Nor did the return refer to SIC's and Arnold's subsequent sale of assets to Haagen-Dazs, contain any of the other information required by the regulations under sections 351, 355, or 368, or allocate earnings and profits between petitioner and SIC as required by section 312(h) and associated regulations with respect to a transaction governed by sections 355 and 368(a)(1)(D).

On April 10, 1989, SIC filed Form 1120S for its tax year 1988, which included a statement disclosing the sale of assets by SIC, including records and goodwill for $286,068 and the "right to distribute the product of buyer for $1,144,272".[13] The statement also disclosed that Arnold, as sole stockholder distributee, would report the gain on his personal income tax return for taxable year 1988. On July 14, 1989, Arnold caused SIC to be dissolved under New Jersey law.

For each tax year thereafter through 1995, MIC reported the following losses and gross sales as compared with 1988 and earlier years:

Year	Gross Sales	Taxable Income	Retained Earnings
1986 [1]	$8,488,491	$68,728	$551,383
1987 [2]	1,137,298	284	551,676
1988[3]	6,021,394	(278)	551,398
1989	4,718,087	(316,793)	238,541
1990	5,532,675	(58,153)	180,388
1991	5,882,632	(122,534)	59,654
1992	5,518,248	(75,726)	(16,072)
1993	6,032,463	(69,622)	(85,694)
1994	5,619,756	(201,778)	(287,472)
1995	5,472,912	(49,396)	(336,868)

FOOTNOTES TO TABLE

1. Tax year Nov. 1, 1986-Oct. 31, 1987.

2. Tax year Nov. 1, 1987-Dec. 31, 1987.

3. Supermarket distribution rights and records sold to Haagen- Dazs July 22, 1988.

ULTIMATE FINDINGS OF FACT

1. The intangible assets embodied in Arnold's oral agreement with Mr. Mattus and personal relationships with the supermarket owners and managers were never corporate assets of petitioner. Until the sale to Haagen-Dazs on July 22, 1988, Arnold was the sole owner of those assets, whose use he had hitherto made available to petitioner. Accordingly, neither any transfer of rights in those assets to SIC nor their sale or other disposition to Haagen-Dazs is attributed to petitioner.

2. The fair market value of the SIC stock distributed by petitioner to Arnold in redemption of his stock in petitioner was $141,000.

3. Immediately after the distribution of the stock of SIC to Arnold, and thereafter, SIC did not engage in the active conduct of a trade or business.

OPINION

1. ASSETS TRANSFERRED BY MIC

Respondent advances two alternative grounds in support of the original determination that the $1,430,340 consideration received by Arnold and SIC measures the gain realized and recognized by petitioner: First, Arnold negotiated the sale of assets on behalf of MIC, and MIC should therefore be regarded as the true seller of the assets under the principle of Commissioner v. Court Holding Co., 324 U.S. 331 (1945); alternatively, the amount paid by Haagen-Dazs to SIC and Arnold measures the gain realized and recognized by petitioner on the redemption of Arnold's stock in petitioner, a split-off that fails to qualify for nonrecognition of corporate gain under section 355.

We disagree with respondent's overall position, insofar as it is predicated on the assumption or conclusion that petitioner owned assets with a value of $1,430,340 that were sold to Haagen-Dazs. Petitioner never owned all the assets sold to Haagen-Dazs. The record shows, and we have found as facts, that Arnold, acting on his own behalf and as agent for SIC, of which he was the sole shareholder, entered into a contract to sell Haagen-Dazs two distinctly different types of assets: The first, and much more valuable, was the intangible assets of Arnold's rights under his oral agreement with Mr. Mattus and his relationships with the owners and managers of the supermarkets, which formed the basis of his ability to direct the wholesale distribution of super-premium ice cream to the supermarkets; the second, and much less valuable, was the business records that had been created by petitioner during Arnold's development of the supermarket business, and transferred by petitioner to SIC.

Arnold built the business of wholesale distribution of super-premium ice cream to supermarkets on the twin foundations of his personal relationships with the supermarket owners, the development of which preceded the creation of petitioner by some years, and his personal, handshake understanding with Mr. Mattus, which continued with Haagen-Dazs after its sale to Pillsbury. In developing his supermarket distribution business, Arnold changed the way ice cream was marketed to customers in supermarkets. The success of the venture depended entirely upon Arnold. Mr. Mattus' offer to go into business with Arnold distributing Haagen-Dazs ice cream products on the West Coast attests to the value that Mr. Mattus, Haagen-Dazs, and later, Pillsbury, placed on Arnold's position in the market, which retained considerable value as late as June 1988, when petitioner distributed the SIC stock to Arnold in redemption of his stock in petitioner.

Ownership of these intangible assets cannot be attributed to petitioner because Arnold never entered into a covenant not to compete with petitioner or any other agreement -- not even an employment agreement -- by which any of Arnold's distribution agreements with Mr. Mattus, Arnold's relationships with the supermarkets, and Arnold's ice cream distribution expertise became the property of petitioner. This Court has long recognized that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate asset of corporate goodwill. See, e.g., Estate of Taracido v. Commissioner, 72 T.C. 1014, 1023 (1979) (where sole shareholder was sine qua non of corporation's success,

corporation's goodwill did not include the personal qualities of its sole shareholder); Cullen v. Commissioner, 14 T.C. 368, 372 (1950) (personal ability, personality, and reputation of sole active shareholder not a corporate intangible asset where there is no contractual obligation to continue shareholder's services); MacDonald v. Commissioner, 3 T.C. 720, 727 (1944) ("We find no authority which holds that an individual's personal ability is part of the assets of a corporation by which he is employed where * * * the corporation does not have a right by contract or otherwise to the future services of that individual."); Providence Mill Supply Co. v. Commissioner, 2 B.T.A. 791, 793 (1925).

In the case at hand, as in MacDonald v. Commissioner, supra, petitioner never obtained exclusive rights to either Arnold's future services or a continuing call on the business generated by Arnold's personal relationships with the supermarket owners and the rights under his agreement with Mr. Mattus; petitioner never had an agreement with Arnold that would have caused those relationships and rights to become petitioner's property. Even if there had been such an agreement, and the record shows that there was none, the value of these relationships and rights would not have become petitioner's property in toto. In 1974, Mr. Mattus sought Arnold as his agent to create a substantial presence for Haagen-Dazs ice cream in supermarkets after Mr. Mattus had been able to achieve only minimal market penetration through his own efforts. Mr. Mattus wanted what Arnold had already created in the 1960's when he operated Arnold's Ice Cream -- the critical relationships with key supermarket owners and managers and the marketing know-how necessary to put ice cream products in supermarket freezers. See, e.g., Coskey's Television & Radio Sales & Serv., Inc. v. Foti, 602 A.2d 789, 795 (N.J. Super. Ct. App. Div. 1992) ("What * * * [the employee] brought to his employer, he should be able to take away."). The record shows that, at most, petitioner had only the benefit of the use of these assets while Arnold was associated with petitioner -- which contributed heavily to the profitability of petitioner during the years before the split-off.

Our conclusion that the rights under the oral agreement with Mr. Mattus, the personal relationships with supermarket owners and managers and the ice cream distribution expertise, belonged to Arnold rather than petitioner is confirmed by the disparity between the sales price paid by Haagen-Dazs to Arnold and SIC and the value of petitioner as an ongoing business just before the split-off. The sales figures from petitioner's tax returns show that the supermarket business generated slightly more than one-half of the pre-split-off sales. Were petitioner to have been the owner of the rights sold to Haagen-Dazs, then the $1,430,340 paid to Arnold and SIC would have been approximately half the value of petitioner, and petitioner would presumably have had an overall fair market value approaching $3 million, a conclusion that would logically follow from respondent's arguments. For reasons discussed infra, $3 million far exceeds any possible fair market value that petitioner, as a corporation with less than $8.5 million in gross sales and $70,000 net income in its best year, fiscal 1987, might have had immediately before the transactions in issue.

Our conclusion is not impaired by the fact that the corporate documents created by Mr. Hewit to accomplish the transfer of some of petitioner's assets to SIC and the distribution of SIC stock

to Arnold purported to transfer supermarket distribution rights owned by petitioner.[14] We have already found that petitioner never owned the rights under Arnold's oral agreement with Mr. Mattus, nor his personal relationships with the supermarkets or his ice cream distribution expertise; petitioner merely had the benefits of the use of those assets during the years up to the split-off. What petitioner did not own, petitioner could not transfer; these documents transferred only that which belonged to MIC -- the business records generated by the supermarket business that were subsequently transferred by petitioner to SIC in exchange for its stock.[15] Accordingly, we find that the sale to Haagen-Dazs of Arnold's supermarket relationships and distribution rights cannot be attributed to petitioner. All that is at stake in this case is the value of Arnold's remaining stock interest in petitioner, shorn of his supermarket relationships and distribution rights under his agreement with Mr. Mattus.

2. MIC IS NOT THE DEEMED SELLER OF ASSETS TO HAAGEN-DAZS UNDER COURT HOLDING

Respondent argues that Arnold began and completed the negotiations with Haagen-Dazs for the sale of distribution rights on behalf of petitioner. Respondent would have us believe that all essential terms fixed by the negotiations had been settled before Mr. Hewit informed Haagen-Dazs that SIC and Arnold would be the named sellers of the assets in the purchase agreement and instructed Haagen-Dazs to omit all references to Martin and petitioner from the purchase agreements. Respondent urges the Court to apply the principle of Commissioner v. Court Holding Co., 324 U.S. 331 (1945),[16] to find that petitioner is the true seller of the assets, and that SIC is a mere conduit whose existence and participation in the sale to Haagen-Dazs should be ignored for Federal income tax purposes. Respondent's argument implies that petitioner constructively received the proceeds from the sale of assets to Haagen-Dazs, and then constructively distributed those proceeds to Arnold in redemption of his stock in petitioner.[17]

In Commissioner v. Court Holding Co., supra, a corporation with two shareholders, husband and wife, owned an apartment building as its only asset. Negotiating on behalf of the corporation, the husband entered into an oral agreement with the lessee that fixed all the terms and conditions for the sale of the apartment building and received a payment on account from the purchaser. After the negotiations had been completed, the husband was informed of the adverse tax consequences of a sale by the corporation. He thereupon caused shareholder resolutions to be adopted under which the corporation declared and distributed the apartment building to the shareholders as a "liquidating dividend". The shareholders then sold the apartment building on the same conditions and terms previously agreed upon to the same purchaser, and the prior payment received by the corporation was applied in part payment of the purchase price. The Supreme Court affirmed the finding of the Tax Court that the transaction, in substance, was a sale by the corporation, and that the shareholders were mere conduits whose formal participation in the closing with the buyer was to be ignored for Federal income tax purposes. The corporation was therefore liable for a corporate level tax on the gain recognized on the sale of the apartment building.

Any analysis of Court Holding would be incomplete without an examination of United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 455 (1950). In Cumberland Pub. Serv., corporate assets were distributed in liquidation and thereafter sold by the corporation's shareholders. Unlike Court Holding, the corporation at no time entered into negotiations to make the sale itself. Instead the shareholders first offered to sell the buyer their stock; after the buyer rejected their offer, they conducted on their own behalf all the negotiations to sell the assets to the buyer. The Supreme Court concluded that the shareholders were the sellers of the assets and refused to find that, in substance, the corporation was the actual seller.

Court Holding and Cumberland Pub. Serv. together support a narrow rule or holding on the genuineness of corporate liquidations. In Court Holding, the Supreme Court upheld this Court's factual finding that the liquidation of the corporation was not genuine and never occurred for Federal income tax purposes. Therefore, the corporation continued to own the apartment building for tax purposes, and the shareholders were mere conduits used to pass title. In contrast, the Supreme Court in Cumberland Pub. Serv. upheld the factual finding of the Court of Claims that a genuine liquidation had occurred, and therefore the subsequent sale of assets by the shareholders was respected.

Court Holding and Cumberland Pub. Serv. also provide a broader principle that helps to explain why a corporate liquidation is respected in one setting and disregarded in another.[18] The substance of a transaction can be found in the negotiations leading up to the closing. Where the negotiations have culminated in an understanding that is inconsistent with the form of the final transaction, that form is said to be inconsistent with the substance, and the substance must prevail. Such is the case when a corporation negotiates all the terms and conditions of a sale of its assets, and then, at the last minute, distributes assets to its shareholders and the shareholders' names are conveniently inserted as sellers; the substance of the negotiations will prevail, and the corporation will be regarded as the seller for Federal income tax purposes.

This Court and others have acknowledged this broader principle of what Court Holding and Cumberland Pub. Serv. stand for.[19] Where shareholders are found to have negotiated the sale of corporate assets independently, on their own behalf, the form of the transaction is respected, and the corporation is not recast as the seller, notwithstanding that some negotiations were carried on by the shareholders before the liquidation. See, e.g., Bolker v. Commissioner, 81 T.C. 782 (1983), affd. 760 F.2d 1039 (9th Cir. 1985); Doyle Hosiery Corp. v. Commissioner, 17 T.C. 641 (1951); Amos L. Beaty & Co. v. Commissioner, 14 T.C. 52 (1950).[20] Where a corporation is found to have negotiated a transaction, and at the last minute, the shareholders are substituted for the corporation as sellers, Court Holding has been applied to regard the corporation as the seller for Federal income tax purposes. See, e.g., Waltham Netoco Theatres, Inc. v. Commissioner, 401 F.2d 333 (1st Cir. 1968), affg. 49 T.C. 399, 405 (1968); Kaufmann v. Commissioner, 175 F.2d 28 (3d Cir. 1949), affg. 11 T.C. 483 (1948).[21]

Arnold, on behalf of himself as well as petitioner, began negotiations with Haagen-Dazs with respect to the sale of distribution rights in January 1988. On May 4, 1988, MIC adopted

corporate resolutions authorizing the creation of a wholly owned subsidiary to be called SIC. Over the following weeks, Arnold, Mr. Hewit, and representatives of Haagen-Dazs continued to negotiate the price and terms of a sale of distribution rights by MIC to Haagen-Dazs. On May 31, 1988, SIC was organized as a wholly owned subsidiary of MIC. On June 6, 1988, in response to the Haagen-Dazs first draft of purchase agreement, which provided for the sale of all distribution rights, Mr. Hewit informed Haagen-Dazs that Martin and MIC would not be parties to the sale transaction. In a letter sent to Mr. Hewit dated June 14, 1988, Ms. Bronner stated that Haagen-Dazs, as requested by Mr. Hewit, would eliminate references to Martin and MIC from the purchase agreement, but she insisted that Haagen-Dazs had to acquire "any and all" of the distribution rights owned by Martin, Arnold, and their respective companies. On June 15, 1988, MIC executed documents providing for the transfer of supermarket chain and food service distribution rights, and business records related thereto, from MIC to SIC. Thereafter, Arnold continued to negotiate with Haagen-Dazs on behalf of himself and SIC until the purchase agreement was signed on July 8. The purchase agreement, as finally negotiated and amended at the closing on July 22, provided that Haagen-Dazs could walk away from the deal if an audit by a "Big-8" accounting firm disclosed ice cream sales by petitioner of less than $4 million for the 12-month period ended May 31, 1988, and for a reduction in both the fixed and deferred contingent portions of the purchase price if such sales amounted to less than $4.7 million. On July 22, following the Touche-Ross sales audit and the parties' agreement that ice cream sales amounted to $4,528,000, the sales price paid at the closing was reduced to $1,430,340 and the maximum deferred contingent payments were reduced to $333,660.

The facts of this case are distinguishable from those of Court Holding. In Court Holding and other cases applying its holding, such as Waltham Netoco Theaters, Inc. v. Commissioner, supra, the change in the identity of the sellers took place at the last minute. In such cases, the only difference in whether the corporation or all its shareholders are regarded as the seller(s) lies in whether the proceeds of the sale to which the shareholders become entitled will be decreased by the amount of the corporate level tax imposed. In the present case, the change in the identity of the sellers, namely the removal of Martin and MIC, resulted in a significant economic change that was independent of any change in tax consequences. Once SIC, wholly owned by Arnold, was designated as the seller, along with Arnold, a situation was created in which all proceeds of the sale would come under the control of Arnold, to the exclusion of Martin and MIC.[22]

The change in the identity of the sellers was not a "last minute" change in a deal that had already been consummated, or whose terms had been completely negotiated. Rather, it signaled the birth of a new deal significantly different from its predecessor, both in terms of what would be sold and who would receive the proceeds. Stated differently, having Arnold and SIC, rather than petitioner, sell assets to Haagen-Dazs was not a mechanism to give effect to a transaction that had already been negotiated by, or on behalf of, petitioner. See Kaufmann v. Commissioner, 11 T.C. at 490-491 (Kern, J., concurring).

Not only are the facts of this case distinguishable from those of Court Holding, but they also fall under the rubric of Cumberland Pub. Serv., where the taxpayer corporation did not negotiate a

sale of assets. As in Cumberland Pub. Serv., we focus on the "negotiation substance" of the transaction to determine whether it is consistent with its form. This requires us to first identify the transaction, whose negotiations we examine. Where, as here, a change in the identity of a seller occurs during the negotiation process, and that change has business purposes and economic effects that are independent of any tax consequences, then the transaction is transformed and a new transaction arises. In then determining whether the form of the new transaction is consistent with its substance, the only negotiations that are relevant are those that occur after the identity of the seller has changed.

After SIC became a party to the sale transaction, replacing petitioner, the transaction was transformed. In determining whether the form of the transaction is consistent with its substance, we focus on the negotiations that occurred once SIC became the named seller in the proposed new transaction. Petitioner took no part in these subsequent negotiations for the sale of distribution rights, and therefore the final form of the transaction is consistent with its substance. We accordingly deny respondent's attempt to apply Court Holding to treat petitioner as a seller of assets to Haagen-Dazs.

3. SPLIT-OFF DID NOT QUALIFY UNDER SECTION 355

Section 355 generally allows a corporation to make a tax- free distribution of an amount of stock constituting control of a corporation (control being defined in section 355(a)(1)(D)(ii) for purposes of section 355 by reference to section 368(c))[23] to its shareholders, provided the active business requirement of section 355(b) is satisfied, and the transaction is not deemed a "device" to make a tax-free distribution of earnings and profits, which otherwise would be taxable as a dividend. The section 355 regulations impose other requirements, which we need not address.

Respondent determined that petitioner failed to satisfy several of the requirements for nonrecognition of gain under section 355 when it distributed SIC stock to Arnold in redemption of Arnold's stock in petitioner. We need consider only whether SIC was actively engaged in a trade or business immediately after the split-off within the meaning of section 355(a)(1)(C) and (b)(1)(A), which requires that the distributing corporation and the subsidiary corporation both be "engaged immediately after the distribution in the active conduct of a trade or business". Sec. 355(b)(1)(A).

The determination of whether a trade or business is actively engaged in is a factual question requiring an examination of all the facts and circumstances. Under section 1.355-(1)(c), Income Tax Regs., a corporation is treated as engaged in a trade or business immediately after the distribution if it

> consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms part of, or a step in, the process of earning income or profit from such group. * * *

By requiring that a trade or business be actively conducted, section 355 envisions a corporation with substantial management and operational activities directly carried on by the corporation itself. See sec. 1.355-3(b)(2)(iii), Proposed Income Tax Regs., 42 Fed. Reg. 3870 (Jan. 21, 1977);[24] see also Rev. Rul. 73- 236, 1973-1 C.B. 183.

Petitioner's distribution of SIC stock does not qualify for nonrecognition of gain under section 355(c) because SIC was not engaged in the active conduct of a trade or business immediately after the distribution. SIC received no operating assets from petitioner on the transfer of intangible assets by petitioner to SIC in exchange for SIC stock. During the 6-week period from the time of the split-off until the sale of all of the assets of SIC to Haagen-Dazs, SIC did not directly carry on any operational activities. SIC had neither the assets nor the employees required to engage in the active conduct of an ice cream distributorship.

SIC used petitioner's employees in all of its operational activities. Petitioner was retained as an independent contractor by SIC. Petitioner and Martin's agreement with SIC and Arnold stated that MIC would provide all services "reasonably necessary" for SIC to carry on during an interim period while it made alternative arrangements. Pursuant to that agreement, drivers employed by MIC made all the deliveries to SIC's supermarket accounts during the interim 6-week period. Other than perhaps Arnold, its sole shareholder, SIC had no employees.

SIC used petitioner's tangible assets in all of its operational activities. After the distribution, petitioner continued to own all the refrigerated trucks and storage facilities required to operate both the small store and supermarket businesses. During the period between the split-off and the sale to Haagen-Dazs, trucks owned by MIC made all the deliveries to the supermarkets, and the MIC warehouse and refrigeration facilities were used to store the Haagen-Dazs ice cream products until they could be delivered to the supermarkets. The supermarket customers themselves were largely unaware until the closing of the transactions with Haagen-Dazs on July 22 that Martin and MIC had parted company from Arnold and SIC.

4. PETITIONER'S GAIN RECOGNIZED ON DISTRIBUTION OF SIC STOCK

Because petitioner's transfer of assets to SIC and distribution of SIC stock to Arnold do not qualify for nonrecognition of gain under section 355, we must determine the Federal income tax consequences of these transactions under other provisions of the Code.

Respondent acknowledges that petitioner was entitled to nonrecognition of gain under section 351 upon the transfer of assets to SIC in exchange for its stock[25] but argues that petitioner recognized gain under section 311(b) on the immediately following distribution of the SIC stock to Arnold in redemption of his stock in petitioner. We agree with respondent.

a. MIC'S TRANSFER OF ASSETS TO SIC

Under section 351(a), a transfer of property to a corporation solely in exchange for its stock does not trigger a recognition event, provided that immediately after the transfer the transferor or transferors "are in control (as defined in section 368(c))" of the transferee. Section 351(c) modifies the controlling interest requirement, providing that, in determining control for this purpose, the fact that a corporate transferor distributes to its shareholders all or part of the stock of the transferee "shall not be taken into account."

The June 15, 1988, transfer of assets by MIC to SIC, solely in exchange for the stock of SIC, is a nonrecognition event under section 351(a). Immediately after the transfer, MIC received all the stock of SIC, which it thereupon distributed to one of its shareholders, Arnold. By reason of section 351(c), the distribution of SIC stock to Arnold does not adversely affect the conclusion that MIC had a controlling interest in SIC immediately after the transfer.

In Rev. Rul. 68-298, 1968-1 C.B. 139, a corporation transferred property to a newly created subsidiary in exchange for all the stock of the subsidiary, whereupon the transferor distributed 25 percent of the transferee corporation's stock to a shareholder in complete redemption of the shareholder's stock in the transferor. The Commissioner ruled that the transferor had maintained its controlling interest under section 351(a) and (c), notwithstanding that the transferor's remaining interest in the transferee was less than 80-percent control as defined in section 368(c).

We agree with the conclusion of Rev. Rul. 68-298, supra, which is consistent with the statutory language of section 351. Section 351(c) provides that a transferor corporation's subsequent distribution of transferee stock to its shareholders "shall not be taken into account"; this means that the transferor will not be deemed to have relinquished control immediately after the transfer by reason of having distributed to one or more of its shareholders all or part of the stock of the transferee, even though the distribution effects a termination of the shareholder's interest in the transferor.

b. DISTRIBUTION OF SIC STOCK TO ARNOLD IN REDEMPTION OF HIS STOCK IN PETITIONER

While the transfer of assets by MIC to SIC was a nonrecognition event for Federal income tax purposes, the subsequent distribution of SIC stock to Arnold by MIC was not. The rules of subchapter C determine whether and to what extent an S corporation recognizes gain on the distribution of property in redemption of its stock. S. Rept. 100-445, at 66 (1988); see also Eustice & Kuntz, Federal Income Taxation of S Corporations, par. 8.02[1][a], at 8-24, par. 13.06[2], at 13-40 (3d ed. 1993).

The distribution of SIC stock to Arnold in exchange for his stock in petitioner was a distribution of property under section 317(a), amounting to a redemption by petitioner of its stock held by Arnold.[26] Sec. 317(b). [27] Section 311(a), as enacted by the 1954 Code, codified the rule of General Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935), by providing that a

distributing corporation generally recognizes no gain or loss on distributions of property with respect to its stock. However, section 631(c) of the Tax Reform Act of 1986 (TRA), Pub. L. 99-514, 100 Stat. 2272, amended section 311(b) so as to effectively repeal the rule of General Utilities where there is a gain on distributions of property with respect to stock. Section 311(b) now provides that a corporation recognizes gain to the extent that the fair market value of the distributed property exceeds its adjusted basis in the hands of the distributing corporation. Petitioner therefore recognized the gain that it realized on the distribution of SIC stock in redemption of Arnold's stock in petitioner, measured by the excess of fair market value over the basis of the SIC stock distributed.

Petitioner presented no evidence to establish the adjusted basis of assets transferred to SIC in the section 351 exchange. Inasmuch as petitioner has the burden of proof with respect to this issue and presented no evidence, we accept respondent's determination of the adjusted basis of the SIC stock, which is zero, the same as the adjusted basis of the assets that petitioner transferred to SIC in the section 351 exchange. Sec. 358(a)(1).

c. AMOUNT REALIZED ON DISTRIBUTION OF SIC STOCK

We next determine the fair market value of the appreciated property that petitioner distributed to Arnold -- the SIC stock. To ascertain the fair market value of property, whether for income tax purposes or for estate tax purposes, Champion v. Commissioner, 303 F.2d 887, 892-893 (5th Cir. 1962), revg. and remanding on other grounds T.C. Memo. 1960-51, we must determine "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 to sell and both having reasonable knowledge of relevant facts." United States v. Cartwright, 411 U.S. 546, 551 (1973); sec. 20.2031-1(b), Estate Tax Regs. This determination presents a question of fact, Estate of Andrews v. Commissioner, 79 T.C. 938, 940 (1982), based on all the evidence in the record, Helvering v. Safe Deposit & Trust Co., 316 U.S. 56, 66-67 (1942); Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo. 1974-285.

Our task is made all the more difficult by the lack of any direct evidence in the record of the market value of the SIC stock. However, we may approximate the value of the SIC stock by determining the fair market value of Arnold's previously held stock in MIC, inasmuch as the taxable event at issue is the distribution by MIC of SIC stock in redemption of Arnold's stock in MIC. See United States v. Davis, 370 U.S. 65, 72 (1962); Philadelphia Park Amusement Co. v. United States, 130 Ct. Cl. 166, 126 F. Supp. 184, 189 (1954); Spruance v. Commissioner, 60 T.C. 141, 157 (1973), affd. without published opinion 505 F.2d 731 (3d Cir. 1974); Williams v. Commissioner, T.C. Memo. 1997-326.

Respondent did not submit an expert's report valuing the SIC stock, arguing that this is not a valuation case. In respondent's view, the intervening transfer of property by MIC to SIC and exchange of SIC stock for Arnold's MIC stock are to be disregarded, and petitioner held, under the Court Holding theory, to be the constructive seller of all property sold to Haagen-

Dazs, having a fair market value of $1,430,340, as established by the price paid by Haagen-Dazs for assets purchased less than 6 weeks later. Similarly, respondent argues, even if respondent loses on the Court Holding theory, that the price paid in the Haagen-Dazs sale is the best evidence of the value of the assets transferred from MIC to SIC and of the value of Arnold's MIC stock that was redeemed. For reasons previously discussed, we have rejected respondent's overall position equating petitioner's gain with the total amount of the consideration paid by Haagen-Dazs in the purchase and sale transaction.

Petitioner submitted an expert witness report that valued Arnold's share of MIC as an ongoing business prior to the June 15 transfer at $141,000. Rudolph Bergwerk, a certified public accountant, prepared the report for petitioner. Expert opinions can aid the Court in understanding an area of specialized training, knowledge, or judgment, such as valuation. Perdue v. Commissioner, T.C. Memo. 1991-478. While we may accept an expert's opinion in its entirety, Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 452 (1980), we are not bound to do so, Silverman v. Commissioner, supra, and may selectively use any portion of the report and testimony in determining fair market value of property, IT&S of Iowa, Inc. v. Commissioner, 97 T.C. 496, 508 (1991); Parker v. Commissioner, 86 T.C. 547, 562 (1986).

Respondent urges the Court to reject Mr. Bergwerk's report in its entirety on the ground that he was a "hired gun". Cf. Estate of Mueller v. Commissioner, T.C. Memo. 1992-284. Experts are not supposed to be "hired guns"; they lose their usefulness and credibility to the extent to which they become mere advocates for the side that hired them. Estate of Halas v. Commissioner, 94 T.C. 570, 577 (1990); Buffalo Tool & Die Manufacturing Co. v. Commissioner, supra at 452.

Mr. Bergwerk is a certified public accountant who had an ongoing professional relationship with petitioner as petitioner's tax return preparer from 1982 through 1985. Mr. Bergwerk prepared personal income tax returns for Martin and Arnold during this same period. He also represented petitioner before the IRS in the audit that preceded the issuance of the deficiency notice at issue in this case. Respondent argues that these prior relationships so infect Mr. Bergwerk's report with bias that we should completely disregard it. The mere existence of the relationships does not automatically disqualify Mr. Bergwerk as petitioner's expert. See, e.g., Estate of Bennett v. Commissioner, T.C. Memo. 1993-34 (appraiser was a longtime family adviser and was a coexecutor of the estate). Nor is Mr. Bergwerk automatically disqualified by his lack of formal qualifications as an appraiser. Id. (citing Fed. R. Evid. 702; Grain Dealers Mut. Ins. Co. v. Farmers Union Coop. Elevator & Shipping Association, 377 F.2d 672, 679 (10th Cir. 1967)).

In Estate of Halas v. Commissioner, supra at 578, we stated that an "appraiser's duty closely corresponds to the public duty of an auditor or certified public accountant." On the basis of the nature of the report, which we discuss infra, Mr. Bergwerk's professional qualifications as a certified public accountant, and the testimony of Mr. Bergwerk, we are satisfied that Mr. Bergwerk was not acting as a mere advocate for petitioner, but as an appraiser with a duty to the Court. Id. at 577. However, we do not ignore or disregard this prior and continuing

relationship between Mr. Bergwerk and petitioner, Arnold, and Martin and weigh it in the balance of whether -- and the degree to which -- to accept Mr. Bergwerk's expert opinion.

Mr. Bergwerk stated that he had based his report on the methodology set forth in Rev. Rul. 59-60, 1959-1 C.B. 237, modified by Rev. Rul. 65-193, 1965-2 C.B. 370, and Rev. Rul. 68-609, 1968-2 C.B. 327, and amplified by Rev. Rul. 77-287, 1977-2 C.B. 319, Rev. Rul. 80-213, 1980-2 C.B. 101, and Rev. Rul. 83-120, 1983-2 C.B. 170. We follow the principles set forth in Rev. Rul. 59-60, supra, which we recognize as having been "widely accepted as setting forth the appropriate criteria to consider in determining fair market value", Estate of Newhouse v. Commissioner, 94 T.C. 193, 217 (1990), to the extent they represent a correct approach to the valuation of closely held corporations, see Stark v. Commissioner, 86 T.C. 243, 250-251 (1986).

Mr. Bergwerk's report characterized petitioner as an undiversified company engaged in a single line of business, the wholesale distribution of ice cream products, which was highly dependent on weather and time of year. Petitioner also had "an unhealthy concentration" of its business in Haagen-Dazs products. Despite such drawbacks, the company had expanded its gross sales substantially in the 5 years before the distribution of SIC stock. Mr. Bergwerk opined that the potential for further growth was limited because of the ability of supermarkets and ice cream manufacturers to eliminate independent wholesale distributors from business.[28]

Mr. Bergwerk expressly considered each of the factors set forth in Rev. Rul. 59-60, 1959-1 C.B. at 238-239, as a basis for valuation of closely held corporations. In arriving at his valuation of MIC as an ongoing business, Mr. Bergwerk assigned relative weights to the three valuation factors that he found persuasive -- 50 percent to capitalized earnings, 30 percent to petitioner's dividend-paying capacity, and 20 percent to petitioner's book value -- and then averaged the factors in accordance with those relative weights. In so doing, he appropriately gave primary consideration to petitioner's earnings history, as recommended by Rev. Rul. 59-60, sec. 5, 1959-1 C.B. at 242, and estimated petitioner's fair market value as an ongoing business prior to the separation of the business lines to be $276,509, and Arnold's 51-percent share, which was redeemed upon distribution of SIC stock, to be $141,000.

Mr. Bergwerk used the same three factors and approach used in Bader v. United States, 172 F. Supp. 833 (S.D. Ill. 1959), a case decided prior to the issuance of Rev. Rul. 59-60, supra, which also averaged the results of the factors. Mr. Bergwerk did not discount his valuation on account of lack of marketability, as did the court in Bader, nor did he provide an explanation of why he used the particular weights he used, or of why he had disregarded the admonishment of Rev. Rul. 59-60, 1959-1 C.B. at 243, that "no useful purpose is served by taking an average of several factors * * * and basing the valuation on the result."

Despite the problems we have with Mr. Bergwerk's report, we find that Mr. Bergwerk's estimate of the fair market value of petitioner just prior to the transactions in issue provides a

reasonable upper limit on the value of petitioner as of June 1988; we adopt Mr. Bergwerk's figure, in the absence of countervailing expert opinion and testimony from respondent.

Of the three valuation factors used by Mr. Bergwerk, the highest amount was book value as of October 31, 1987, $552,061.[29] In calculating the capitalized earnings of petitioner at $331,394, Mr. Bergwerk estimated the earning capacity of petitioner as $53,023 per year after taxes, based on a weighted average of the 5 years of operations ending on October 31, 1987,[30] and a price-earnings ratio of 6.25:1, the same as used by this Court in Estate of Little v. Commissioner, T.C. Memo. 1982-26, to determine the value of a closely held, diversified corporation engaged in light manufacturing. Mr. Bergwerk discounted the price-earnings ratio because of the corporate shortcomings noted above, the dependence of the business on Arnold's personal relationships with the supermarkets, and the lack of a second tier of management.

Mr. Bergwerk opined that the corporation had no goodwill because the rate of return on tangible assets did not exceed 10 percent, a rate of return on tangible assets suggested by Rev. Rul. 68-609, 1968-2 C.B. 327. Under the approach of Rev. Rul. 68-609, supra, any return in excess of 10 percent would be attributable to goodwill or other intangibles for tax purposes. See also Financial Valuation: Businesses and Business Interests, par. 16.4[7], at 16-10 (Zukin ed. 1990). However, petitioner did have some intangibles in the form of customer lists and pricing lists. Petitioner transferred those business records pertaining to the supermarket distribution business to SIC in the initial tax-free exchange for SIC stock. Petitioner retained other proprietary information pertaining to the independent grocery store business that Martin continued to conduct in the years subsequent to the transactions at issue.

Mr. Bergwerk determined that petitioner had no dividend- paying capacity, using the methodology that this Court used in Bardahl Manufacturing Corp. v. Commissioner, T.C. Memo. 1965-200, to determine reasonable business needs for retained earnings. He therefore assigned a fair market value of zero to MIC as an ongoing business on the basis of this lack of dividend-paying capacity. In so doing, Mr. Bergwerk disregarded an explicit instruction in Rev. Rul. 59-60, 1959-1 C.B. at 241, which points out that, where

> an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.

Even though a valuation derived from dividend-paying capacity is an inappropriate factor in this case, the relative lack of dividend-paying capacity cannot be entirely ignored in that it shows the extent to which petitioner was undercapitalized in those years -- a factor that negatively affects petitioner's fair market value.[31]

Under the circumstances of this case, use of book value would tend to overvalue petitioner, especially in light of the effect of the relatively low -- and dropping -- ratio of net income to sales during the mid-1980's on the value of petitioner and the relative lack of dividend-paying capacity, which shows the precarious nature of petitioner's financial health. Capitalized earnings at a 6.25:1 price/earnings ratio, $331,394, also over-values petitioner to the extent that it does not sufficiently take into account a number of other factors not fully considered by Mr. Bergwerk.

Although Mr. Bergwerk discussed petitioner's overreliance on Haagen-Dazs as its major supplier, he did not expressly take into account the negative effect on marketability -- and hence fair market value -- of Haagen-Dazs' effective veto over any sale to an unrelated third party. Because of the tenuous nature of petitioner's distribution rights -- if any -- to Haagen-Dazs products, Haagen-Dazs could effectively stop a sale of petitioner, if it did not approve of the buyer, by threatening to stop supplying petitioner with its product. The withdrawal of Haagen-Dazs as a supplier would leave petitioner as little more than a collection of physical assets and a distribution network with nothing to distribute. Haagen-Dazs' cold shoulder to Mr. Hewit's overture in his May 16, 1988, letter concerning the possible sale of the nonbanner business to an unrelated third party, and the abandonment of any further effort to sell by Martin, is probative, not only of the effect of Haagen-Dazs' veto on petitioner's marketability -- and its market value -- but also of the likelihood that Haagen-Dazs would have used such a veto.

Another factor having a depressing effect on fair market value is the lack of value that Haagen-Dazs attached to petitioner as an ongoing business concern. This is demonstrated by the refusal of Haagen-Dazs to consider buying any of petitioner's assets beyond a few business records that documented the sales to the supermarkets. Despite petitioner's investment in refrigerated trucks and warehouse facilities during the mid-1980's -- which contributed to the anemic position of its net current assets and its inability to pay dividends -- Haagen-Dazs still considered petitioner's physical plant and equipment to be substandard for purposes of distributing Haagen-Dazs ice cream.

We must also consider the effect of petitioner's being a small, family-owned business on the sale by either Arnold or Martin of his interest in petitioner without the sale of the other interest. While we do not assign a precise value to this discount factor, the closely held nature of petitioner and the reluctance of a third party to buy into a family-owned business, especially one with the handicaps we have just recited, could serve only to decrease the market value of the interest for sale.

Also important is that the conditions under which petitioner had operated during the 1970's had changed in the 1980's, when Pillsbury acquired Haagen-Dazs, with the avowed goal of distributing ice cream to supermarkets itself rather than relying on independent distributors such as petitioner -- a fact well known at the time of the redemption of Arnold's stock in MIC. These changed conditions render suspect any fair market value based on past earnings.

Most importantly, petitioner's earnings in the years preceding the split-off were substantially attributable to Arnold's oral agreement with Mr. Mattus and his relationship with the supermarkets. As we have found, the supermarket distribution rights were personal to Arnold and did not belong to petitioner. The assumption underlying a capitalization of earnings approach is that, barring adverse developments, the historical earnings will continue. Therefore, in valuing petitioner as of the time of the split-off, which marks the parting of the ways between petitioner and Arnold, an adverse development indeed, it makes no sense to assume that petitioner's earnings would continue at the same level in the future, or even that there would be no more than a pro rata reduction of such earnings by reason of Arnold's departure.

Under the circumstances of this case, where there was a heavy investment in physical assets during a period when the corporation had been unable to pay dividends, an absence of a second tier of management, a lack of diversification in business, an overdependence on one supplier, Haagen-Dazs, and on one primary "rainmaker", Arnold, who was leaving, the risk of petitioner's being completely eliminated from business as an independent wholesale distributor, the effective veto Haagen-Dazs had over any sale to a third party, the fact that petitioner is a closely held, family-owned business, and the declining ratio of net income to sales, we find that a value of $276,509 is the upper limit to a fair estimate of the value of petitioner immediately prior to the transactions at issue.

Respondent's determination of the value of assets sold to Haagen-Dazs by SIC, and the corresponding value of SIC stock distributed to Arnold, is presumptively correct, and the burden of proving a lower value rests on petitioner. Rule 142(a); Frazee v. Commissioner, 98 T.C. 554, 562 (1992); Pessin v. Commissioner, 59 T.C. 473, 480 (1972). In the present case, respondent did not present the testimony or report of an expert upon which to consider an alternative valuation. Petitioner, on the other hand, did present the report and testimony of Mr. Bergwerk, and has thereby effectively rebutted respondent's original determination. Although Mr. Bergwerk's methodology was flawed, his conclusion is only erroneous insofar as his $276,509 value for petitioner results in an overstatement of the fair market value of the SIC stock distributed to Arnold. Petitioner has carried its burden of reducing respondent's determination of $1,430,340 to $141,000 (51 percent of the value of petitioner) but has not carried the burden of reducing the value any further. See Hess v. Commissioner, 24 B.T.A. 475, 478 (1931) (Court adopted taxpayer's asserted value where the Commissioner introduced no evidence to rebut taxpayer's expert testimony, citing Baldwin v. Commissioner, 10 B.T.A. 1198 (1928)); cf. Anselmo v. Commissioner, 80 T.C. 872, 886 (1983), affd. 757 F.2d 1208 (11th Cir. 1985); Estate of Trompeter v. Commissioner, T.C. Memo. 1998-35. Taking into account Mr. Bergwerk's valuation conclusion, we find that the fair market value of Arnold's 51-percent interest in petitioner, which petitioner redeemed for all of SIC's stock, was $141,000.[32]

d. PETITIONER'S TAX LIABILITY UNDER SECTION 1374

Section 1363(a) provides that, generally, S corporations are not subject to income tax. However, when a former C corporation such as MIC elects S corporation status and then

distributes or sells appreciated property, it may be liable for tax under section 1374 if the S corporation election was made prior to January 1, 1987. TRA sec. 633(b), 100 Stat. 2277; H. Conf. Rept. 99-841 (Vol. II), at II- 203 (1986), 1986-3 C.B. (Vol. 4) 1, 203. Petitioner is a former C corporation that elected S status prior to January 1, 1987.

Section 1374, as applicable to petitioner for the year in issue, reads in pertinent part:

> SEC. 1374(a). General Rule. -- If for a taxable year of an S corporation --
>
> > (1) the net capital gain of such corporation exceeds $25,000, and exceeds 50 percent of its taxable income for such year, and
> >
> > (2) the taxable income of such corporation for such year exceeds $25,000, There is hereby imposed a tax (computed under subsection (b)) on the income of such corporation.
> >
> > * * * * * * *
> >
> > > (d) Determination of Taxable Income. -- For purposes of this section, taxable income of the corporation shall be determined under section 63(a) without regard to --
> >
> > (1) the deduction allowed by section 172 (relating to net operating loss deduction), and
> > (2) the deductions allowed by part VIII of subchapter B (other than the deduction allowed by section 248, relating to organization expenditures)

In order for section 1374 to apply, petitioner must have recognized "net capital gain", which means the excess of net long- term capital gain over net short-term capital loss, as defined in section 1222. Given that petitioner reported no capital gains or losses on its 1988 income tax return, in order for section 1374 to apply, petitioner's distribution of SIC stock to Arnold must have resulted in a long-term capital gain, exceeding $25,000. This, in turn, requires that SIC stock be a capital asset in the hands of petitioner and that petitioner be deemed to have held the SIC stock longer than 1 year. See sec. 1222(3), as amended by sec. 1402(a), Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1731.

The SIC stock was a capital asset in the hands of petitioner. Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 222-223 (1988). Petitioner relies on section 1221(3) to argue that the business records of MIC, which were subsequently transferred to SIC, are not capital assets, and that the SIC stock received in exchange is consequently also not a capital asset. Section 1221(3) provides that the term "capital asset" does not include "a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by -- (A) a taxpayer whose personal efforts created such property". Section 1253(c) extends the exception

to property whose basis is determined by reference to the basis of such property in the hands of a taxpayer as described in subparagraph (A) of section 1221(3). We do not agree with petitioner. The legislative history of section 117(a)(1)(C) of the 1939 Internal Revenue Code, the predecessor to section 1221(3), states that the exception was intended to deal with the writing of books and other artistic works in a very narrow sense. See S. Rept. 2375, 81st Cong., 2d Sess. 43-44 (1950), 1950-2 C.B. 483, 543-544; S. Rept. 91-552, at 198-199 (1969), 1969-3 C.B. 423, 549-550 (discussing the addition of "letters, memorandums, papers, etc." to section 1221(3) under the Tax Reform Act of 1969, Pub. L. 91-172, sec. 514(a), 83 Stat. 643); see also Commissioner v. Ferrer, 304 F.2d 125, 132 (2d Cir. 1962), revg. in part and remanding 35 T.C. 617 (1961). MIC's business records do not fall under the narrow category of assets described in section 1221(3).

Second, petitioner is deemed to have held the SIC stock for more than 1 year. Respondent acknowledged that petitioner's transfer of assets in exchange for the stock of SIC qualified for nonrecognition under section 351. See supra p. 45. Under sections 1223 and 358, where a taxpayer has transferred property in a transaction that qualifies for nonrecognition under section 351, the taxpayer's holding period in the stock received in the transaction includes the period for which the taxpayer has held the property transferred in the transaction. Petitioner's holding period in SIC stock therefore includes the period it held the assets transferred to SIC. Petitioner presented no evidence to establish that its holding period of the assets, or any part of the assets, transferred to SIC was less than 1 year. Inasmuch as petitioner has the burden of proof on this issue and has presented no evidence, we accept respondent's determination that the gain realized by petitioner was a long-term capital gain.

Petitioner's long-term capital gain of $141,000, resulting from petitioner's distribution of SIC stock in redemption of Arnold's stock in petitioner, is petitioner's only capital gain in 1988. Accordingly, petitioner had "net capital gain" (as defined in section 1222) for purposes of section 1374. When the $141,000 of capital gain is included, petitioner's net capital gain exceeds $25,000 and also exceeds 50 percent of petitioner's taxable income for 1988, as defined in section 1374(d).[33] Accordingly, petitioner satisfies the requirements of section 1374(a) and is liable for tax imposed by section 1374(b) on its recognized gain of $141,000.

5. ADDITIONS TO TAX

a. NEGLIGENCE

For taxable year 1988, section 6653(a)(1) adds to tax an amount equal to 5 percent of an underpayment of tax required to be shown on the return that is due to negligence or disregard of rules or regulations. Sections 6653(c)(1) and 6212 essentially define an underpayment for purposes of this section as the equivalent of a deficiency.

Section 6653(a)(3) provides that negligence includes "any failure to make a reasonable attempt to comply with the provisions of this title, and the term 'disregard' includes any careless, reckless, or intentional disregard." Courts have defined negligence as the lack of due care or

failure to do what an ordinarily prudent person would do under the circumstances. Bassett v. Commissioner, 67 F.3d 29, 31 (2d Cir. 1995), affg. 100 T.C. 650 (1993); Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), affg. in part and remanding in part 43 T.C. 168 (1964). Petitioner bears the burden of showing that it was not negligent. Rule 142(a); Goldman v. Commissioner, 39 F.3d 402, 407 (2d Cir. 1994), affg. T.C. Memo. 1993-480.

In United States v. Boyle, 469 U.S. 241, 251 (1985), the Supreme Court held that "When an accountant or attorney ADVISES a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice." Ordinary business prudence or due care does not demand that a taxpayer seek a second opinion, id., so long as such advice is reasonable under the circumstances and is based on full disclosure by the taxpayer, see, e.g., Sim-Air, USA, Ltd. v. Commissioner, 98 T.C. 187, 201 (1992) (reliance on tax professional's advice was reasonable when a corporate subsidiary failed to qualify as a DISC when the advice turned out to be erroneous, especially in light of the complexity of section 992 and associated regulations).

In this case, Martin, as president of petitioner, and Arnold both relied on legal advice from Mr. Hewit throughout the protracted negotiations with Haagen-Dazs. Even though Mr. Hewit never gave a written tax opinion to petitioner or Arnold or Martin, Martin and petitioner were entitled to rely and proceed on the assumption that the transactions at issue were nontaxable to petitioner because of the way Mr. Hewit had structured the transactions and drafted the documents effecting the transactions that separated the two business lines. Mr. Hewit, in turn, sought advice from third-party tax professionals on how to structure a tax-efficient solution to resolve the growing dispute between Martin and Arnold over the future direction of petitioner as an ice cream distributor. Like the advice sought by the taxpayer in Sim-Air, USA, Ltd. v. Commissioner, supra at 201, the advice that petitioner sought from Mr. Hewit, who in turn also sought expert advice, was subject to section 355, a complex section of the Code.[34] We find that Martin and petitioner acted as ordinarily prudent business persons would under the circumstances and that petitioner is not liable for an addition to tax under section 6653(a)(1).

b. SUBSTANTIAL UNDERSTATEMENT

For tax year 1988, section 6661(a) provides for an addition to tax of "25 percent of the amount of any underpayment attributable" to "a substantial understatement of income tax for any taxable year", for penalties assessed after October 21, 1986. Section 6661(b)(1) defines a substantial understatement as any understatement that exceeds the greater of $10,000 in the case of corporations, sec. 6661(b)(1)(B), or 10 percent of the tax required to be shown on the return for the taxable year, sec. 6661(b)(1)(A)(i). An understatement of income tax occurs when the tax actually shown on the return is less than the amount required to be shown on the return. Sec. 6662(b)(2); Woods v. Commissioner, 91 T.C. 88, 95 (1988). Petitioner bears the burden of proving that respondent's determination of the deficiency, the understatement with respect to the deficiency, and the addition to tax based on the understatement are erroneous. Rule 142(a);

Conti v. Commissioner, 39 F.3d 658, 664 (6th Cir. 1994), affg. on this issue and remanding 99 T.C. 370 (1992).

Section 6661(b)(2)(B) provides a means to reduce the amount of the addition to tax, stating that

> The amount of the understatement * * * shall be reduced by that portion of the understatement which is attributable to --
>
> > (i) the tax treatment of any item by the taxpayer if there is or was substantial authority * * *, or
> >
> > (ii) any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

Petitioner failed to disclose on its 1988 return or in a statement attached to the return, as required by section 1.6661-4, Income Tax Regs., the existence of its transfer of assets to SIC and its distribution of SIC stock to Arnold in redemption of his stock in petitioner. We note that sections 1.368-3(a), 1.355-5(a), and 1.351- 3(a), Income Tax Regs., also require disclosure of all plans of reorganization, distributions of stock of a controlled subsidiary, and transfers to controlled corporations, respectively. Because petitioner failed to disclose the transactions at issue on its 1988 income tax return, the understatement may not be reduced on the ground of adequate disclosure. Sec. 6661(b)(2)(B)(ii); sec. 1.6661-4, Income Tax Regs.

Substantial authority is defined in section 1.6661- 3(a)(2), Income Tax Regs., as

> less stringent than a "more likely than not" standard (that is, a greater than 50-percent likelihood of being upheld in litigation), but stricter than a reasonable basis standard (the standard which, in general, will prevent imposition of the penalty under section 6653(a), relating to negligence or intentional disregard of rules and regulations). Thus, a position with respect to the tax treatment of an item that is arguable but fairly unlikely to prevail in court would satisfy a reasonable basis standard, but not the substantial authority standard.

With respect to the issue of whether Commissioner v. Court Holding Co., 324 U.S. 331 (1945), controls the transactions in question, petitioner has prevailed and thus had substantial authority for its position with respect to the form of the transactions. Sec. 1.6661-3(a)(2), Income Tax Regs.

Petitioner has not prevailed on the issue of whether section 355 confers nonrecognition of gain realized in the split-off. Petitioner must therefore demonstrate that substantial authority supports the positions taken on the income tax return with respect to those transactions. Gallade v. Commissioner, 106 T.C. 355, 367 (1996); sec. 1.6661-3(b)(1), Income Tax Regs. Petitioner

cited no case law or regulations in support of its position. Petitioner has cited as substantial authority only the advice given by its hired professionals. Advice of hired professionals, even when reasonable under the circumstances -- and regardless of the form in which it is rendered -- does not constitute substantial authority. Gallade v. Commissioner, supra at 367; sec. 1.6661-3(b)(2), Income Tax Regs. Indeed, in light of the facts in this case, the weight of authority directly supported respondent on the issue of "active conduct of a trade or business". Sec. 355(a)(1)(C) and (b). Petitioner did not have substantial authority for taking a position that the split-off qualified for nonrecognition of gain under section 355.

Section 6661(c) authorizes the Commissioner to waive "all or any part of the addition to tax * * * on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith." While the authority to waive the section 6661(a) addition to tax rests with the Commissioner and not with this Court, we review a denial of waiver by the Commissioner under the abuse of discretion standard. Gallade v. Commissioner, supra at 367-368; Mailman v. Commissioner, 91 T.C. 1079, 1084 (1988).

We find no evidence in the record that petitioner ever requested a waiver. Accordingly, as we noted in Alondra Indus., Ltd. v. Commissioner, T.C. Memo. 1996-32, and Brown v. Commissioner, T.C. Memo. 1992-15, "we cannot find that respondent abused his discretion when the petitioner never requested respondent to exercise it." See also McCoy Enters., Inc. & Subs. v. Commissioner, 58 F.3d 557, 563 (10th Cir. 1995), affg. T.C. Memo. 1992-693; Estate of Reinke v. Commissioner, 46 F.3d 760, 765-766 (8th Cir. 1995), affg. T.C. Memo. 1993-197; Mailman v. Commissioner, supra at 1082-1084; Dugow v. Commissioner, T.C. Memo. 1993-401, affd. without published opinion 64 F.3d 666 (9th Cir. 1995); Klieger v. Commissioner, T.C. Memo. 1992-734; sec. 1.6661-6, Income Tax Regs.; cf. Gallade v. Commissioner, supra at 369 (citing Estate of Reinke v. Commissioner, supra at 765, for the proposition that, while the existence of "a taxpayer's request for a waiver can establish the Commissioner's degree of fault for failing to waive, it [Estate of Reinke] does not hold that a request is a requirement or prerequisite for a waiver.").[35]

Even if petitioner had requested a waiver, we would hold that petitioner has not established that respondent would have committed an abuse of discretion in refusing the request. In this case, petitioner would have been required to show that reliance on the professional advice of Mr. Hewit was reasonable and that petitioner acted in good faith under the circumstances. Sec. 1.6661- 6(b), Income Tax Regs. While we have held that petitioner has established, by the preponderance of the evidence, that it was not negligent for purposes of section 6653(a), the evidence before us on that issue was not completely uncontroverted, especially in light of petitioner's failure to disclose the split-off on its 1988 income tax return. We therefore cannot say that reasonable cause and good faith were so clear that any refusal by respondent to waive the addition to tax would have amounted to an abuse of discretion as being without sound basis in fact. See, e.g., Vandeyacht v. Commissioner, T.C. Memo. 1994-148; Klavan v. Commissioner, T.C. Memo. 1993-299.

Accordingly, we sustain respondent's determination that petitioner is liable for the section 6661(a) addition to tax on the underpayment.

To reflect the foregoing,

Decision will be entered under Rule 155.

FOOTNOTES

1. All section references are to the Internal Revenue Code in effect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

2. Haagen-Dazs delivered its products to the MIC warehouse, where they were transferred to MIC trucks for delivery to both the supermarkets and the small grocery stores and food service accounts.

3. In re Super Premium Ice Cream Distribution Antitrust Litig., 691 F. Supp. 1262 (N.D. Cal. 1988), affd. without published opinion sub nom. Haagen-Dazs Co. v. Double Rainbow Gourmet Ice Creams, Inc., 895 F.2d 1417 (9th Cir. 1990).

4. During the negotiations with Arnold, attorneys for Pillsbury sent Russell L. Hewit (Mr. Hewit), attorney for Arnold, Martin, and MIC, a copy of applicable sections of two treatises on franchising, Rosenfield, The Law of Franchising, and Brown, Franchising Realities and Remedies (1982 rev.), in support of its contention that MIC, SIC, Arnold, and Martin had no enforceable rights to distribute Haagen- Dazs ice cream products that could not be terminated at will.

5. There is no evidence in the record that it ever occurred to Mr. Hewit, Martin, or Arnold that Martin and MIC should obtain separate legal representation, independent from Arnold, in negotiating and effectuating the split-off and the transactions with Haagen-Dazs.

6. The record includes an "Agreement", signed by Martin and Ms. Bronner on behalf of MIC and Haagen-Dazs, respectively, on July 8, 1988, that appears to be the contemplated "side agreement" referred to by Ms. Bronner in her June 14 letter. This agreement states that Haagen-Dazs and MIC would enter into three distribution agreements upon the closing of the Haagen-Dazs agreement with Arnold and SIC. The three distribution agreements, which were signed July 22, 1988, provide MIC with various rights to distribute certain Haagen-Dazs ice cream products in specified convenience stores, delis, places where ice cream is consumed on the premises, and other small independent grocery stores in New Jersey and parts of New York.

7. Martin also consulted with Mr. Neiman, who told him that "this is the way you should do it", referring to a distribution of stock under sec. 355 as a means of dissociating Arnold from MIC.

It is unclear from the record whether Mr. Falk and Mr. Neiman were aware of the ongoing negotiations with Haagen-Dazs.

8. The Agreement enumerated the "Sellers' Rights" as

> Any and all of Seller's rights and the rights of any corporations or entities owned or controlled by Sellers obtained from Buyer, its predecessors, its customers or others to distribute the products of Buyer within the states of New York, New Jersey, Pennsylvania, Massachusetts, Delaware, Connecticut and elsewhere including but not limited to supermarket and food service distribution rights, if any (the "Sellers' Rights") * * *. Upon Closing of the transactions contemplated herein, any and all of such Sellers' Rights obtained by Sellers from Buyer or its predecessors shall be cancelled.

9. "Non-banner" business was defined by the Agreement as "independent convenience stores and delis that have no more than two cash registers * * * 'independent' shall mean a firm which operates from one to ten stores".

10. The Agreement provided that if the audited supermarket sales were greater than $4 million but less than $4,700,000, then there would be a downward adjustment to the purchase price equal to:
[1 - (audited sales figures/$4,700,000)] x $2,350,000.
The Agreement allocated 81 percent of the downward adjustment to the purchase price to be paid at closing and 19 percent to the contingent annual payments payable to Arnold over the following 3 years.

11. Martin testified that MIC and SIC delayed changing how product was delivered to the supermarket customers in order to get through the busy summer season.

12. Subsequent to trial, respondent submitted to the Court a facsimile of the face of a Haagen-Dazs check to SIC in the amount of $1,430,340, accompanied by an affidavit that Haagen-Dazs issued the check to SIC as payment due at the closing of the sale of assets purportedly sold by SIC to Haagen-Dazs. We do not admit the facsimile and affidavit into evidence; there is sufficient evidence in the record to support a finding that SIC received the entire payment from Haagen-Dazs. However, because we decide this case as we do, initial receipt of payment by SIC instead of Arnold does not determine the Federal tax treatment to petitioner of the transactions at issue.

13. This statement attached to the SIC Form 1120S indicates that the downward adjustment of $69,660 to the purchase price paid by Haagen-Dazs at closing was allocated between the distribution rights and business records of SIC in the same proportions as the relative amounts of the preadjustment allocation of the purchase price to be paid at the closing -- 80 percent, or $55,728, to the distribution rights, and 20 percent, or $13,932, to the business records. The closing documents do not set forth or otherwise contain any reference to the allocation between distribution rights and business records of the reduction in the price paid at closing.

14. We note that the record contains no documents that actually transfer assets from MIC to SIC in exchange for SIC stock. The record contains only the MIC corporate resolutions stating the intention to make such transfer. However, we are satisfied by those corporate resolutions and testimony by Arnold, Martin, and Mr. Hewit that such a transfer did occur, in the sense that petitioner transferred to SIC the records of the supermarket business and whatever rights petitioner had in that business.

15. Petitioner may have had some residual rights to distribute Haagen-Dazs ice cream, but they were independent of Arnold's supermarket relationships and his value as a middleman. To the extent that they existed at all, they were in relationship to Haagen-Dazs' ability to terminate petitioner as a distributor. Haagen-Dazs was certainly interested in acquiring those rights as it rationalized and consolidated its wholesale distribution network as one of the assets it was buying from Arnold and SIC. However, in light of the summary judgment by the District Court, Northern District of California, in favor of Haagen-Dazs against a similarly situated distributor, the value of those rights in the event of termination by Haagen-Dazs was highly speculative at best.

16. Shortly after issuance of Rev. Rul. 96-30, 1996-1 C.B. 36, respondent first raised this theory with petitioner in a stipulation conference held on June 19, 1996, and was given leave to incorporate it in an amended answer filed less than 3 weeks before trial. Generally, when the Commissioner makes allegations in an amended answer requiring the presentation of different evidence, then the Commissioner "has introduced a new matter" or a new issue that requires the shifting of the burden of proof to the Commissioner as to the new matter or issue. Achiro v. Commissioner, 77 T.C. 881, 890 (1981); see also Seagate Tech. Inc. & Consol. Subs. v. Commissioner, 102 T.C. 149, 169 (1994).

Because the determination of the applicability of Commissioner v. Court Holding Co., 324 U.S. 331 (1945), required respondent to present evidence of the events leading up to the sale of assets which is different from the evidence showing that the requirements of sec. 355 were not met, we issued an order shifting the burden of proof to respondent on the Court Holding issue. However, we decide the issue on a preponderance of the evidence; therefore, the allocation of the burden of proof does not determine the outcome. See Kean v. Commissioner, 91 T.C. 575, 601 n.40 (1988) (citing Deskins v. Commissioner, 87 T.C. 305, 323 n.17 (1986)).

17. Implicit in respondent's Court Holding argument is the view that SIC's ownership of the assets transferred to it by MIC, and Arnold's ownership of SIC stock were too transitory to be recognized for tax purposes. However, we need not grapple with the transitory nature of SIC and the tax consequences of such a designation on the transactions in the case at hand. Respondent acknowledges that if we decide that Court Holding does not apply to attribute the sale to petitioner, then the transaction should be regarded as a sec. 351 transfer from MIC to SIC, followed by a taxable redemption of Arnold's shares in petitioner, thereby acknowledging

the existence of SIC for Federal income tax purposes under respondent's alternative argument. See infra pp. 45-48.

18. See Isenbergh, "Musings on Form and Substance in Taxation", 49 U. Chi. L. Rev. 859, 871-874 (1982), for a discussion of the narrow and broad interpretations.

19. The Supreme Court noted in Central Tablet Manufacturing Co. v. United States, 417 U.S. 673, 680 (1974), that its earlier decisions in Court Holding and United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 455 (1950), "created a situation where the tax consequences were dependent upon the resolution of often indistinct facts as to whether the negotiations leading to the sale had been conducted by the corporation or by the shareholders." See also Bolker v. Commissioner, 81 T.C. 782, 799 (1983), affd. 760 F.2d 1039 (9th Cir. 1985).

20. There is some discussion in the above-cited cases concerning whether shareholders who are corporate officers or directors can negotiate a sale of assets in corporate solution on their own behalf, rather than on the corporation's behalf, especially when the negotiations take place before the corporation resolves to liquidate the assets that are to be sold.

21. Although Commissioner v. Court Holding Co., supra, deals with corporations that distribute assets to their shareholders in complete liquidation, the Commissioner has recently applied its conduit theory to sec. 355 distributions. In Rev. Rul. 96-30, 1996-1 C.B. 36, D, a publicly traded corporation, distributes the stock of C, its wholly owned subsidiary, to its shareholders in a spin-off. C then enters into negotiations with Y, an unrelated corporation, and is merged into Y, after a vote to do so by C's shareholders, under a plan that meets all the requirements of sec. 368(a)(1)(A). Rev. Rul. 96-30, supra, specifically cites the complete lack of negotiations regarding the acquisition of C by Y before the spin-off as the determining factor in respecting the form of the transactions under Commissioner v. Court Holding Co., supra, in addition to the shareholder vote cited in Rev. Rul. 75-406, 1975-2 C.B. 125. Although respondent did not cite Rev. Rul. 96-30, supra, on brief, see supra note 16.

While Rev. Rul. 96-30, supra, indicates that a complete lack of negotiations before the spin-off will prevent the recasting of transactions under Court Holding, situations where there have been some, or even substantial, negotiations are not addressed. Nor does Rev. Rul. 96-30, supra, deal with a non pro rata distribution such as a split-off, as in the case at hand.

22. Compare the ownership position of the single shareholder, which remained unchanged, in Idol v. Commissioner, 38 T.C. 444 (1962), affd. 319 F.2d 647 (8th Cir. 1963), with Standard Linen Serv., Inc. v. Commissioner, 33 T.C. 1 (1959), and Esmark, Inc. & Affiliated Cos. v. Commissioner, 90 T.C. 171 (1988), affd. without published opinion 886 F.2d 1318 (7th Cir. 1989), where redemptions accomplished a substantial change in the ownership of the stock of the taxpayer corporation. Similar to Standard Linen and Esmark, MIC's redemption of Arnold's stock substantially changed the proportionate ownership of MIC by eliminating one of the two

shareholders and assured that Arnold would receive the entire consideration paid by Haagen-Dazs for acquisition of the distribution rights.

23. The corporation must also be in control of the corporation whose stock is being distributed immediately before the distribution. Sec. 355(a).

24. The proposed regulations were finalized by T.D. 8238, 1989- 1 C.B. 92. The final regulations, however, are effective for transactions occurring after Feb. 6, 1989. In response to several comments received by practitioners requesting guidance, the final regulations also state that in determining whether a corporation is actively conducting a trade or business, activities performed by independent contractors will generally not be taken into account. See sec. 1.355-3(b)(2)(iii), Income Tax Regs.

25. The record is not clear whether petitioner received the stock of SIC on May 31, 1988, the date of its incorporation, or June 15, 1988, the effective date of the transfer of assets from petitioner to SIC. Because respondent acknowledges on brief that petitioner's basis in SIC stock is determined under secs. 351 and 358, we treat the operative events as having occurred simultaneously.

26. Stock redemptions by S corporations are governed by the provisions of subch. C. Sec. 1371(a)(1); S. Rept. 100-445, at 66 (1988); see also Eustice & Kuntz, Federal Income Taxation of S Corporations, par. 8.02[1][a], at 8-24, par. 13.06[2], at 13-40 (3d ed. 1993).

27. Sec. 317(b) provides:

> For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

28. The evidence in the record strongly supports Mr. Bergwerk's opinion concerning petitioner's market position and relative vulnerability to outside forces.

29. Mr. Bergwerk estimated the book value as $554,061 in the text of his report and $552,061 in the exhibit. The exhibit corresponded to the book net worth shown in the tax balance sheet in petitioner's 1987 tax return.

30. Petitioner's net income rose from $40,873, or 0.0081 percent of gross sales, in 1983, to $55,914, or 0.0066 percent of gross sales, in 1987.

31. Using the formula used in Bardahl Manufacturing Corp. v. Commissioner, T.C. Memo. 1965-200, which calculates the amount available for dividends as the working capital at year's end less necessary working capital and capital expenditures actually made in the following year, petitioner was insufficiently capitalized in the years immediately preceding the separation of the business lines. Necessary working capital was determined as a function of working capital

requirements for the year and the length of petitioner's operating cycle, which is determined by inventory and accounts receivable turnover and the credit period extended by suppliers -- primarily Haagen-Dazs.

32. Respondent argues that petitioner, under the rule of Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), vacating and remanding 44 T.C. 549 (1965), cannot unilaterally vary the terms of a contract for tax purposes and must therefore abide by the terms of the sale to Haagen-Dazs in determining the value of assets distributed to SIC and, in turn, the value of SIC stock distributed to Arnold.

As we stated in Hospital Corp. of Am. v. Commissioner, T.C. Memo. 1996-559:

> As we understand the Danielson rule, it is not applicable where the parties have not established the fair market value of the property at the time agreement is adopted because, under those circumstances, there is no agreement to which a party may be held. See Campbell v. United States, 228 Ct. Cl. [661,] 675-677 (1981); * * * see also Commissioner v. Danielson, 378 F.2d 771, 778 [(3d Cir. 1967)] ("it would be unfair to assess taxes on the basis of an agreement the taxpayer did not make"). Furthermore, the Danielson rule is not applicable if the contract is ambiguous. See North American Rayon Corp. v. Commissioner, 12 F.3d [583,] 589 [(6th Cir. 1993), affg. T.C. Memo. 1992-610] ("the Danielson rule does not apply if there is no contract between the parties or if the contract is ambiguous"). * * *

The allocation by the sale agreement of the $1,430,340 sales price paid by Haagen-Dazs to SIC and Arnold between "Sellers' Rights", $1,144,272, and the records, $286,068, is not an agreement made by petitioner as to the value of SIC stock. At best it is an ambiguous indication. Furthermore, because petitioner was not a party to the transaction with Haagen-Dazs, the Danielson rule does not apply.

MIC cannot be held to an allocation that it did not bargain for with a party with opposing interests in an arm's-length negotiation. Neither MIC, SIC, nor Arnold actively negotiated the allocation with Haagen-Dazs. It remained unchanged from the June 2 draft agreement through the closing of the sale on July 22. See Particelli v. Commissioner, 212 F.2d 498, 501 (9th Cir. 1954), affg. a Memorandum Opinion of this Court dated Feb. 20, 1952; Berry Petroleum Co. & Subs. v. Commissioner, 104 T.C. 584, 615 (1995).

33. Petitioner reported an ordinary loss of $278 on its Form 1120S filed for the 1988 taxable year. Petitioner's 1988 taxable income did not include any net operating loss deductions pursuant to sec. 172, nor any deduction for organization expenditures allowed by sec. 248.

34. We note the recent debate over the amendment to sec. 355 enacted in sec. 1012, Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 788, 914.

35. Under sec. 6664(c) of the current law, the Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, sec. 7721(a), 103 Stat. 2398, effective for returns with a due date after Dec. 31, 1989, the Commissioner no longer has this discretion, and no penalty may be imposed for understatements if the taxpayer can show that it had reasonable cause for the understatement and that it acted in good faith.

120 T.C. No. 13

UNITED STATES TAX COURT

CHARLES T. MCCORD, JR., AND MARY S. MCCORD, DONORS, Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 7048-00. Filed May 14, 2003.

Ps, their children, and their children's partnership formed a family limited partnership (PT). In 1996, Ps assigned interests in PT to several assignees pursuant to an agreement that contains a formula clause. The formula clause provides that (1) Ps' children, trusts for their benefit, and S, a charitable organization, are to receive interests having an aggregate fair market value of a set dollar amount, and (2) C, another charitable organization, is to receive any remaining portion of the assigned interests. Ps' children agreed to pay all transfer taxes resulting from the transaction, including the estate tax liability under then sec. 2035(c), I.R.C. 1986, that would arise if one or both Ps were to die within 3 years of the date of the assignments.

Pursuant to a second agreement, the assignees allocated the assigned interests among themselves in

accordance with the formula clause, based on an agreed aggregate value of $7,369,277.60 for the assigned interests. Less than 6 months after the date of the assignment, PT redeemed the interests of S and C pursuant to a call option contained in PT's partnership agreement.

1. Held: Ps assigned only economic rights with respect to PT; such assignments did not confer partner status on the assignees.

2. Held, further, the aggregate fair market value of the interests assigned by Ps on the date of the gifts was $9,883,832.

3. Held, further, the amount of Ps' aggregate charitable contribution deduction under sec. 2522, I.R.C. 1986, resulting from the transfer to C is determined on the basis of the fair market value of the interest actually allocated to C under the second agreement, rather than the interest that would have been allocated to C under the second agreement had the donees determined a fair market value for the assigned interests equal to the fair market value determined by the Court.

4. Held, further, Ps' respective taxable gifts for 1996 are determined without reference to the contingent estate tax liability that their children assumed under the first agreement.

John W. Porter and Stephanie Loomis-Price, for petitioners.

Lillian D. Brigman and Wanda M. Cohen, for respondent.

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HALPERN, Judge: By separate notices of deficiency dated April 13, 2000 (the notices), respondent determined deficiencies in Federal gift tax for calendar year 1996 with respect to petitioner Charles McCord, Jr. (Mr. McCord) and petitioner Mary McCord (Mrs. McCord) in the amounts of $2,053,525 and $2,047,903, respectively. The dispute centers around the gift tax consequence of petitioners' assignments to several charitable and noncharitable donees of interests in a family limited partnership.

Unless otherwise noted, all section references are to the Internal Revenue Code in effect on the date of the assignments, and all Rule references are to the Tax Court Rules of Practice and Procedure. All dollar amounts have been rounded to the nearest dollar.

FINDINGS OF FACT

Some facts are stipulated and are so found. The stipulation of facts, with accompanying exhibits, is incorporated herein by this reference.

Petitioners

Petitioners are husband and wife. They have four sons, all adults (the children): Charles III, Michael, Frederick, and Stephen. In response to the notices, petitioners filed a single petition. At the time they filed the petition, petitioners resided in Shreveport, Louisiana.

Formation of McCord Interests, Ltd., L.L.P.

McCord Interests, Ltd., L.L.P. (MIL or the partnership), is a Texas limited partnership formed on June 30, 1995, among petitioners, as class A limited partners; petitioners, the children, and another partnership formed by the children (McCord Brothers Partnership), as class B limited partners; and the children as general partners (all such partners being hereafter referred to as the initial MIL partners).

On formation, as well as on the date of the assignments in question, the principal assets of MIL were stocks, bonds, real estate, oil and gas investments, and other closely held business interests. On the date of the assignments, approximately 65 percent and 30 percent of the partnership's assets consisted of marketable securities and interests in real estate limited partnerships, respectively. The remaining approximately 5 percent of the partnership's assets consisted of direct real estate holdings, interests in oil and gas partnerships, and other oil and gas interests.

In mid-October 1995, the MIL partnership agreement was amended and restated, effective as of November 1, 1995 (such amended and restated partnership agreement being referred to hereafter as, simply, the partnership agreement). Attached to the partnership agreement is a schedule setting forth the capital

contributions and ownership interests of the initial MIL partners, as follows:[1]

Class and Contributor	Contribution	Percentage Interest
Class A limited partners:		
Mr. McCord	$10,000	--
Mrs. McCord	10,000	--
General partners:		
Charles III	40,000	0.26787417
Michael	40,000	0.26787417
Frederick	40,000	0.26787417
Stephen	40,000	0.26787417
Class B limited partners:		
Mr. McCord	6,147,192	41.16684918
Mrs. McCord	6,147,192	41.16684918
McCord Brothers	2,478,000	16.59480496
Total	14,952,384	100.0

Relevant Provisions of the Partnership Agreement

Among other things, the partnership agreement provides as follows:

MIL will continue in existence until December 31, 2025 (the termination date), unless sooner terminated in accordance with the terms of the partnership agreement.

Any class B limited partner may withdraw from MIL prior to the termination date and receive a payment equal to the fair market value (as determined under the partnership agreement) of

[1]Under the terms of the partnership agreement, a class A limited partnership interest does not carry with it a "Percentage Interest" (as that term is defined in the partnership agreement) in MIL.

such partner's class B limited partnership interest (the put right).

Partners may freely assign their partnership interests to or for the benefit of certain family members and charitable organizations (permitted assignees).

A partner desiring to assign his partnership interest to someone other than a permitted assignee must first offer that interest to MIL and the other partners and assignees, who have the right to purchase such interest at fair market value (as determined under the partnership agreement).

The term "partnership interest" means the interest in the partnership representing any partner's right to receive distributions from the partnership and to receive allocations of partnership profit and loss.

Regardless of the identity of the assignee, no assignee of a partnership interest can attain the legal status of a partner in MIL without the unanimous consent of all MIL partners.

MIL may purchase the interest of any "charity assignee" (i.e., a permitted assignee of a partnership interest that is a charitable organization that has not been admitted as a partner of MIL) at any time for fair market value, as determined under the partnership agreement (the call right).

For purposes of the partnership agreement, (1) a class B limited partner's put right is disregarded for purposes of

determining the fair market value of such partner's class B limited partnership interest, and (2) any dispute with respect to the fair market value of any interest in MIL is to be resolved by arbitration as provided in Exhibit G attached to the partnership agreement.

Limited partners generally do not participate in the management of the partnership's affairs. However, limited partners do have veto power with respect to certain "major decisions", most notably relating to voluntary bankruptcy filings. In addition, if any two of the children are not serving as managing partners, class B limited partners have voting rights with respect to certain "large dollar" managerial decisions. Limited partners also have access to certain partnership financial information.

Southfield School Foundation

On November 20, 1995, petitioners assigned their respective class A limited partnership interests in MIL to the Hazel Kytle Endowment Fund of The Southfield School Foundation (the foundation) pursuant to an Assignment of Partnership Interest and Addendum Agreement (the Southfield agreement). The recitals to the Southfield agreement provide that "all of the partners of the Partnership desire that Assignee become a Class A Limited Partner of the Partnership upon execution of this Assignment of Partnership Interest" and "all consents required to effect the

conveyance of the Assigned Partnership Interest and the admission of Assignee as a Class A Limited Partner of the Partnership have been duly obtained and are evidenced by the signatures hereto". All of the initial MIL partners executed the Southfield agreement.

Further Assignments

On January 12, 1996 (the valuation date), petitioners, as assignors, entered into an assignment agreement (the assignment agreement) with respect to their class B limited partnership interests in MIL. The other parties to the assignment agreement (the assignees) were the children, four trusts for the benefit of the children (the trusts), and two charitable organizations-- Communities Foundation of Texas, Inc. (CFT) and Shreveport Symphony, Inc. (the symphony). By the assignment agreement, petitioners relinquished all dominion and control over the assigned partnership interests and assigned to the assignees all of their rights with respect to those interests. The assignment agreement does not contain language similar to that quoted above from the Southfield agreement regarding the admission of the assignees as partners of the partnership, and two of the partners of the partnership, McCord Brothers Partnership and the foundation, did not execute the assignment agreement in any capacity. The interests that petitioners assigned to the

assignees by way of the assignment agreement (collectively, the gifted interest) are the subject of this dispute.

Under the terms of a "formula clause" contained in the assignment agreement (the formula clause), the children and the trusts were to receive portions of the gifted interest having an aggregate fair market value of $6,910,933; if the fair market value of the gifted interest exceeded $6,910,933, then the symphony was to receive a portion of the gifted interest having a fair market value equal to such excess, up to $134,000; and, if any portion of the gifted interest remained after the allocations to the children, trusts, and symphony, then CFT was to receive that portion (i.e., the portion representing any residual value in excess of $7,044,933). The children (individually and as trustees of the trusts) agreed to be liable for all transfer taxes (i.e., Federal gift, estate, and generation-skipping transfer taxes, and any resulting State taxes) imposed on petitioners as a result of the conveyance of the gifted interest.

The assignment agreement leaves to the assignees the task of allocating the gifted interest among themselves; in other words, in accordance with the formula clause, the assignees were to allocate among themselves the approximately 82-percent partnership interest assigned to them by petitioners. In that regard, the assignment agreement contains the following instruction concerning valuation (the valuation instruction):

> For purposes of this paragraph, the fair market value of the Assigned Partnership Interest as of the date of this Assignment Agreement shall be the price at which the Assigned Partnership Interest would change hands as of the date of this Assignment Agreement between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Any dispute with respect to the allocation of the Assigned Partnership Interests among Assignees shall be resolved by arbitration as provided in the Partnership Agreement.

The Confirmation Agreement

In March 1996, the assignees executed a Confirmation Agreement (the confirmation agreement) allocating the gifted interest among themselves as follows:

Assignee	Assigned Partnership Interest
Charles T. McCord, III, GST Trust	8.24977954%
Michael S. McCord GST Trust	8.24977954
Frederick R. McCord GST Trust	8.24977954
Stephen L. McCord GST Trust	8.24977954
Charles III	11.05342285
Michael	11.05342285
Frederick	11.05342285
Stephen	11.05342285
CFT	3.62376573
Symphony	1.49712307
Total	82.33369836%

The assignees based that determination on an appraisal report, dated February 28, 1996, prepared at the behest of the children's

counsel[2] by Howard Frazier Barker Elliott, Inc. (HFBE). That report (the 1996 HFBE appraisal report) concludes that, taking into account discounts for lack of control and lack of marketability, the fair market value of a 1-percent "assignee's interest in the Class B Limited Partnership Interests" on the valuation date was $89,505.

Representatives of CFT and the symphony, respectively (including their respective outside counsel), reviewed the 1996 HFBE appraisal report and determined that it was not necessary to obtain their own appraisals. Furthermore, under the terms of the confirmation agreement, CFT and the symphony (as well as the other assignees) agreed not to seek any judicial alteration of the allocation in the confirmation agreement and waived their arbitration rights granted under the assignment agreement.

MIL's Exercise of the Call Right

On June 26, 1996, MIL exercised the call right with respect to the interests held by the symphony and CFT. It did so pursuant to a document styled "Agreement--Exercise of Call Option By McCord Interests, Ltd., L.L.P." (the exercise agreement). The purchase price for the redeemed interests was based on a two-page letter from HFBE (the HFBE letter) previewing an updated appraisal report to be prepared by HFBE. The HFBE letter

[2] The children's counsel had also represented petitioners in connection with the transaction. However, petitioners were not involved in the allocation of the gifted interest among the assignees pursuant to the confirmation agreement.

concludes that the fair market value of a 1-percent "assignee's interest in the Class B Limited Partnership Interests" as of June 25, 1996 was $93,540. CFT and the symphony raised no objections to the value found in the HFBE letter and accepted $338,967 and $140,041, respectively, in redemption of their interests.

The Gift Tax Returns

Petitioners timely filed Forms 709, United States Gift (and Generation Skipping Transfer) Tax Return, for 1996 (the Forms 709). In schedules attached to the Form 709, petitioners reported a gross value of $3,684,639 for their respective shares of the gifted interest. Each petitioner reduced that amount by the amount of Federal and State (Louisiana) gift tax generated by the transfer that the children agreed to pay as a condition of the gift. Each petitioner further reduced that amount by a computation of the actuarial value, as of the valuation date, of the contingent obligation of the children to pay (again, as a condition of the gift) the additional estate tax that would result from the transaction if that petitioner were to die within 3 years of the valuation date. Based on those adjustments, Mr. and Mrs. McCord reported total gifts of $2,475,896 and $2,482,605, respectively.[3] Mr. and Mrs. McCord each claimed an annual exclusion amount of $60,000 and a charitable contribution

[3] Those figures also reflect cash gifts of $10 by each petitioner to nominally fund the trusts.

deduction of $209,173, yielding taxable gifts of $2,206,724 and $2,213,432, respectively.

The Notices

By the notices, respondent determined deficiencies in gift tax with respect to Mr. and Mrs. McCord in the amounts of $2,053,525 and $2,047,903, respectively, based on increases in 1996 taxable gifts in the amounts of $3,740,904 and $3,730,439, respectively. Respondent determined that each petitioner (1) understated the gross value of his or her share of the gifted interest, and (2) improperly reduced such gross value by the actuarial value of the children's obligation to pay additional estate taxes potentially attributable to the transaction.

OPINION

I. Introduction

MIL is a Texas limited partnership formed on June 30, 1995. In exchange for their class B limited partnership interests in MIL, petitioners contributed to MIL closely held business interests, oil and gas interests, real estate, stocks, bonds, and other securities. The parties have stipulated that the value of petitioners' contributions in exchange for their class B limited partnership interests was $12,294,384 ($6,147,192 apiece). On January 12, 1996, petitioners assigned (as gifts) their partnership interests in MIL (the gifted interest). On that date, approximately 65 percent of the partnership's assets

consisted of marketable securities and approximately 30 percent consisted of interests in real estate limited partnerships. The assignees were petitioners' children, trusts for the benefit of the children, and two charitable organizations (Communities Foundation of Texas, Inc. (CFT) and Shreveport Symphony, Inc. (the symphony)). In calculations submitted with their Federal gift tax returns, petitioners reported the gross value of the gifted interest as $7,369,278 ($3,684,639 apiece). Respondent's adjustments reflect his determination that the gross fair market value of the gifted interest was $12,426,086 ($6,213,043 apiece). Principally, we must determine the fair market value of the gifted interest and whether each petitioner may reduce his or her one-half share thereof to account for the children's contingent obligation (as a condition of the gift) to pay the additional estate tax that would result from the transaction if that petitioner were to die within 3 years of the date of the gift. Preliminarily, we must determine whether petitioners transferred all of their rights as class B limited partners or only their economic rights with respect to MIL. We must also determine the amount of the gift to CFT.

II. Relevant Statutory Provisions

Section 2501(a) imposes a tax on the transfer of property by gift. Section 2512(a) provides that, if a gift is made in

property, the value of the property on the date of the gift is considered the amount of the gift. In determining the amount of "taxable gifts" for any particular year, a donor is entitled to deduct the amount of gifts made during the year that qualify for the charitable contribution deduction provided for in section 2522. Sec. 2503(a).

Section 2502(c) provides that the donor is the person liable for the payment of the gift tax. If a donor makes a gift subject to the condition that the donee pay the resulting gift tax, the amount of the gift is reduced by the amount of such gift tax. Rev. Rul. 75-72, 1975-1 C.B. 310. Such a gift is commonly referred to as a "net gift" (net gift).

Under section 2035(c) (current section 2035(b)), a decedent's gross estate is increased by the amount of any gift tax paid by the decedent or his estate on any gift made by the decedent during the 3-year period preceding the decedent's death. For purposes of this "gross-up" provision, gift tax "paid by the decedent or his estate" on gifts made during the relevant 3-year period is deemed to include gift tax attributable to net gifts made by the decedent during such period (i.e., even though the donees are responsible for paying the gift tax in such situation). Estate of Sachs v. Commissioner, 88 T.C. 769, 777-778 (1987), affd. in part and revd. in part on another ground 856 F.2d 1158, 1164 (8th Cir. 1988).

III. Arguments of the Parties

Petitioners contend that they correctly valued the gifted interest in determining their respective taxable gifts. Petitioners contend in the alternative that, if we determine an increased value for the gifted interest, then, by operation of the formula clause in the assignment agreement, they are entitled to an identical increase in the amount of their aggregate charitable contribution deduction under section 2522, resulting in no additional gift tax due.[4] Petitioners also contend that, under net gift principles enunciated in Rev. Rul. 75-72, supra, and Estate of Sachs v. Commissioner, supra, they properly reduced their respective taxable gifts by the actuarial value of the children's contingent obligation, under the terms of the assignment agreement, to pay additional estate tax under section 2035(c).

Respondent contends that petitioners undervalued the gifted interest by mischaracterizing the assignment and applying excessive discounts. Respondent also contends that the formula clause in the assignment agreement, designed to neutralize the tax effect of any upward adjustment to the valuation of the gifted interest, is ineffectual. Finally, respondent contends that petitioners improperly reduced the amount of their taxable

[4] Consistent with that argument, petitioners have preserved their right to claim an increased charitable contribution deduction under sec. 170 on an amended income tax return for 1996. Petitioners' 1996 income tax liability is not before us.

gifts to account for the possibility that the children would be obligated to pay additional estate tax under section 2035(c) by reason of the transaction.

The parties have stipulated that respondent bears the burden of proof, and we accept that stipulation.[5]

IV. Extent of the Rights Assigned

The divergence of the parties' valuations of the gifted interest is attributable in part to their disagreement regarding the extent of the rights assigned by petitioners. Petitioners contend that they assigned to the assignees certain rights with respect to their class B limited partnership interests in MIL but did not (and could not) admit the assignees as class B limited partners. The assignment, they argue, did not entitle the assignees to exercise certain rights that petitioners possessed (as partners) under the partnership agreement. Thus, they argue, the value of the gifted interest is something less than the value of all of their rights as class B limited partners. Respondent, on the other hand, argues that the gifted interest consists of the sum and total of petitioners' rights as class B limited partners (i.e., that, as a result of the assignment, the

[5] The parties have not informed us of their basis for stipulating that respondent bears the burden of proof. The burden of proof is normally on petitioner. See Rule 142(a)(1). Under certain circumstances, the burden of proof can be shifted to the Commissioner. See sec. 7491; Rule 142(a)(2). We assume (without deciding) that the conditions necessary to shift the burden to respondent have been satisfied.

assignees became class B limited partners). The parties' experts agree that, if the gifted interest does not include all of petitioners' rights as class B limited partners, the fair market value of the gifted interest is lower than it would be if the gifted interest did include all such rights.

Whenever the concept of "property" is relevant for Federal tax purposes, it is State law that defines the property interest to which Federal tax consequences attach. E.g., United States v. Craft, 535 U.S. 274, 278-279 (2002) (Federal tax lien attaches to property held, under State law, as tenants by the entireties). Thus, in order to determine the Federal gift tax consequences that attach to petitioners' assignment of the gifted interest, we look to applicable State law to determine the extent of the rights transferred. Because petitioners transferred interests in a Texas limited partnership, Texas law governs our determination in that regard. Specifically, we look to the Texas Revised Limited Partnership Act (the Act), Tex. Rev. Civ. Stat. Ann. art. 6132a-1, as in effect on the date of the gift.

Under the Act, a partnership interest is personal property. Tex. Rev. Civ. Stat. Ann. art. 6132a-1, sec. 7.01 (Vernon 2001). A partnership interest is assignable in whole or in part unless the partnership agreement provides otherwise. Id. sec. 7.02(a)(1). However, an assignee of a partnership interest attains the legal status of a limited partner only if the

partnership agreement so provides or all of the partners consent. Id. sec. 7.04(a). Section 8.01 of the partnership agreement governs the admission of new partners to MIL. That section provides that, notwithstanding the occurrence of a valid assignment of a partnership interest in MIL in compliance with the terms of the partnership agreement, no person shall become a partner without the unanimous consent of the existing partners.

There is no evidence indicating that all of the MIL partners explicitly consented to the admission of the assignees as partners in MIL. Our inquiry does not end there, however. In Kerr v. Commissioner, 113 T.C. 449 (1999), affd. on another issue 292 F.3d 490 (5th Cir. 2002), we demonstrated our willingness to look beyond the formalities of intrafamily partnership transfers to determine what, in substance, was transferred. In that case, also involving Texas partnership law, the taxpayers argued that the interests they transferred to two grantor retained annuity trusts (GRATs) were "assignee interests"[6] because the other general partners of the partnership (the taxpayers' adult children, whose trusts were the remainder beneficiaries of the GRATs) did not consent to the admission of the GRATs as additional partners. Id. at 464. We found that such lack of formal consent did not preclude a finding that the taxpayers

[6] For purposes of this report, we use the term "assignee interest" (assignee interest) to signify the interest held by an assignee of a partnership interest who has not been admitted as a partner in the partnership.

effected a transfer of all their rights as partners. Id. In essence, we inferred the necessary consent of the other general partners to admit the GRATs as partners based on all of the facts and circumstances. Id. at 464-468.

Our decision in Kerr was influenced by a number of factors that are not present in this case. For instance, the taxpayers in Kerr asked us to construe strictly the consent provision in their partnership agreement in the context of their transfers to the GRATs, notwithstanding the fact that they had disregarded that provision in other situations. Id. at 464-465. In addition, we found it difficult to reconcile the taxpayers' characterization of the transfers with the language of their assignment documents, each of which contained the following statement: "The Assigned Partnership Interest constituted a Class B Limited Partnership interest in * * * [the partnership at issue] when owned by Assignor and, when owned by Assignee, shall constitute a Class B Limited Partnership Interest in said partnership." Id. at 466. Finally, from an economic reality standpoint, we found it significant that the taxpayers and their children, being all of the general partners of the partnership, could have formally admitted the assignee GRATs as partners at any time without having to obtain the consent of any other person. Id. at 468.

In the instant case, there is no evidence that petitioners and the other partners of MIL ever disregarded section 8.01 of the partnership agreement, the provision on which they now rely. Indeed, when petitioners assigned their class A limited partnership interests to the foundation in 1995, all of the initial MIL partners consented in writing to the admission of the foundation as a class A limited partner, as required by said section 8.01. Furthermore, the assignment agreement with respect to the gifted interest does not contain language of the type quoted above from the Kerr assignment documents, nor does it contain any of the language in the Southfield agreement relating to the admission of the assignee as a partner in MIL. Finally, petitioners and their children could not unilaterally admit the assignees as partners in MIL; any such admission required the consent of the foundation, an unrelated third party.

Respondent makes note of the fact that the assignment agreement provides that "Assignors hereby relinquish all dominion and control over the Assigned Partnership Interest and assign to Assignees all of Assignors' rights with respect to the Assigned Partnership Interest". However, the issue in this case is not whether petitioners transferred partnership interests; under the terms of the Act, the partnership agreement, and the assignment agreement, they undoubtedly could and did. That having been said, both the Act and the partnership agreement define the term

"partnership interest" in terms of economic rights (and do not equate the term with membership in the partnership).[7] Thus, it is entirely consistent to say that petitioners assigned all of their rights with respect to their partnership interests, yet did not assign all of their rights as class B limited partners (i.e., did not cause the assignees to be admitted as substitute class B limited partners).

In sum, we conclude that the facts in this case do not permit us to infer, as we did in Kerr, that petitioners intended to transfer all of their rights as partners and that all of the other partners effectively consented to the admission of the assignees as partners. Rather, petitioners assigned only economic rights with respect to MIL, and we shall proceed to value the gifted interest on that basis.[8]

[7] The partnership agreement provides that the term "partnership interest" means the interest in the partnership representing any partner's right to receive distributions from the partnership and to receive allocations of partnership profit and loss. The statutory definition is similarly worded. See Tex. Rev. Civ. Stat. Ann. art. 6132a-1, sec. 1.02(11) (Vernon 2001) (the Act) and accompanying bar committee comment; see also id. sec. 7.02(a)(1), (3), and (4) (assignment of partnership interest entitles the assignee to distributions and allocations, but the assignor continues to be a partner and to have the power to exercise any rights or powers of a partner, until the assignee becomes a partner).

[8] To use the terminology favored by the parties, we shall value the gifted interest as an assignee interest.

V. Fair Market Value of the Gifted Interest

A. Introduction

1. General Principles

Section 25.2512-1, Gift Tax Regs., provides that the value of property for gift tax purposes is "the price at which such 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."[9] The willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the donor and the donee. Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990) (citing Estate of Bright v. United States, 658 F.2d 999, 1006 (5th Cir. 1981)).[10] The hypothetical willing buyer and willing

[9] Relying on Morrissey v. Commissioner, 243 F.3d 1145, 1148 (9th Cir. 2001), revg. Estate of Kaufman v. Commissioner, T.C. Memo. 1999-119, and Estate of Smith v. Commissioner, T.C. Memo. 1999-368, petitioners contend that the confirmation agreement is conclusive proof of the value of the gifted interest because such agreement was an arm's-length transaction that was the "functional equivalent of an actual sale." We disagree. Suffice it to say that, in the long run, it is against the economic interest of a charitable organization to look a gift horse in the mouth.

[10] Although the cited cases involved the estate tax, it is well settled that the estate tax and the gift tax, being in pari materia, should be construed together. See, e.g., Shepherd v. Commissioner, 283 F.3d 1258, 1262 n.7 (11th Cir. 2002) (citing Harris v. Commissioner, 340 U.S. 106, 107 (1950)), affg. 115 T.C. 376 (2000).

seller are presumed to be dedicated to achieving the maximum economic advantage. Id. at 218.

2. Expert Opinions

a. In General

In deciding valuation cases, courts often look to the opinions of expert witnesses. Nonetheless, we are not bound by the opinion of any expert witness, and we may accept or reject expert testimony in the exercise of our sound judgment. Helvering v. Natl. Grocery Co., 304 U.S. 282, 295 (1938); Estate of Newhouse v. Commissioner, supra at 217. Although we may largely accept the opinion of one party's expert over that of the other party's expert, see Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 452 (1980), we may be selective in determining what portions of each expert's opinion, if any, to accept, Parker v. Commissioner, 86 T.C. 547, 562 (1986). Finally, because valuation necessarily involves an approximation, the figure at which we arrive need not be directly traceable to specific testimony if it is within the range of values that may be properly derived from consideration of all the evidence. Estate of True v. Commissioner, T.C. Memo. 2001-167 (citing Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo. 1974-285).

b. Petitioners' Expert

Petitioners offered William H. Frazier (Mr. Frazier) as an expert witness to testify concerning the valuation of the gifted interest. Mr. Frazier is a principal of Howard Frazier Barker Elliott, Inc. (HFBE), a Houston-based valuation and consulting firm. He is a senior member of the American Society of Appraisers and has been involved in valuation and general investment banking activities since 1975. The Court accepted Mr. Frazier as an expert in the valuation of closely held entities and received written reports of HFBE into evidence as Mr. Frazier's direct and rebuttal testimony, respectively.

In his direct testimony, Mr. Frazier concludes that, based on a 22-percent minority interest discount and a 35-percent marketability discount, the fair market value of a 1-percent assignee interest in MIL on the valuation date was $89,505. Based on that figure, Mr. Frazier further concludes that the fair market value of each petitioner's one-half share of the gifted interest on the valuation date was $3,684,634 (a figure that, due to rounding, is slightly lower than the value reported on the Forms 709).[11]

[11] Mr. Frazier asserts that a 41.167-percent assignee interest in MIL (i.e., one-half of the gifted interest) has no more proportionate value than a 1-percent assignee interest therein, and respondent's expert does not dispute that assertion.

c. Respondent's Expert

Respondent offered Mukesh Bajaj, Ph.D. (Dr. Bajaj), as an expert witness to testify concerning the valuation of closely held entities. Dr. Bajaj is the managing director of the finance and damages practice of LEC, LLC. He also has experience as a university professor of finance and business economics. Dr. Bajaj has lectured extensively on valuation issues, and he has testified as an expert in several valuation cases. The Court accepted Dr. Bajaj as an expert in the valuation of closely held entities and received his written reports into evidence as his direct and rebuttal testimony, respectively.

In his direct testimony, Dr. Bajaj concludes that, based on an 8.34-percent minority interest discount and a 7-percent marketability discount, the fair market value of a 1-percent assignee interest in MIL on the valuation date was $150,665.64. Based on that figure, Dr. Bajaj further concludes that the fair market value of each petitioner's one-half share of the gifted interest on the valuation date was $6,202,429.67.

B. Value of Underlying Assets

The parties agree that, on the valuation date, MIL's net asset value (NAV) was $17,673,760, broken down by asset class as follows:

Asset Type	Value
Equities portfolio	$3,641,956
Bond portfolio	8,040,220
Real estate partnerships	5,194,933

Real estate	581,553
Oil and gas interests	215,098
Total	17,673,760

In determining the value of the gifted interest, Mr. Frazier first (i.e., before applying any discounts) subtracts $20,000 from MIL's NAV to reflect the class A limited partner's $20,000 priority claim against MIL's assets under the terms of the partnership agreement.[12] Dr. Bajaj makes no such preliminary adjustment. We concur with Mr. Frazier's approach in that regard, and, therefore, we conclude that the appropriate base amount for determining the value of the gifted interest is $17,653,760.[13]

C. Minority Interest (Lack of Control) Discount

1. Introduction

A hypothetical buyer of the gifted interest would have virtually no control over his investment. For instance, such

[12] We note that the class A limited partner's sole economic interest in MIL consists of a guaranteed payment for the use of such partner's (nominal) capital. This case does not require us to determine whether the class A limited partner is a partner of MIL for Federal tax purposes.

[13] For purposes of determining MIL's NAV, Mr. Frazier does not apply discounts to the real estate limited partnership interests that McCord Brothers Partnership contributed to MIL upon formation. Mr. Frazier did, however, discount the value of those real estate limited partnership interests by 57.75 percent for purposes of valuing McCord Brothers Partnership's capital contribution to MIL and determining the MIL partners' percentage interests in MIL. This case does not require us to address the gift tax consequences, if any, of the initial capital contributions to, and allocation of percentage interests in, MIL.

holder (1) would have no say in MIL's investment strategy, and (2) could not unilaterally recoup his investment by forcing MIL either to redeem his interest or to undergo a complete liquidation. Mr. Frazier and Dr. Bajaj agree that the hypothetical "willing buyer" of the gifted interest would account for such lack of control by demanding a reduced sales price; i.e., a price that is less than the gifted interest's pro rata share of MIL's NAV. They further agree that, in the case of an investment company such as MIL, the minority interest discount should equal the weighted average of minority interest discount factors determined for each type of investment held by MIL: equities, municipal bonds, real estate interests, and oil and gas interests.

2. Discount Factors by Asset Class

a. Equity Portfolio

Mr. Frazier and Dr. Bajaj both determine the minority interest discount factor for MIL's equity portfolio by reference to publicly traded, closed end equity investment funds. Specifically, they both derive a range of discounts by determining for a sample of closed end equity funds the discount at which a share of each sample fund trades relative to its pro rata share of the NAV of the fund.[14] They differ in their

[14] Unlike a shareholder of an open-end fund, a shareholder of a closed end fund cannot, at will, by tendering his shares to the fund for repurchase, obtain the liquidation value of his
(continued...)

selection of measurement dates, sample funds, and representative discounts within the range of the sample fund discounts.

(1) Measurement Date

Mr. Frazier calculates discounts for his sample of closed end equity funds on the basis of January 11, 1996, trading prices and December 22, 1995, NAV information. Dr. Bajaj, on the other hand, utilizes trading prices and NAV data as of the valuation date; i.e., January 12, 1996. We agree with Dr. Bajaj that, to the extent possible, data from January 12, 1996, should be utilized to determine discounts with respect to the sample funds.

(2) Sample of Funds

Mr. Frazier derives his sample of closed end equity funds from the list of "domestic equity funds" set forth in Morningstar's Mutual Funds Guide. From that list, he purports to exclude from consideration "special purpose" funds (i.e., those primarily invested in a specific industry), funds with a stated maturity, and funds "that had provisions regarding votes to open-

[14](...continued)
investment (i.e., his pro rata share of the fund's NAV). For that reason, a share of a closed end fund typically trades at a discount relative to its pro rata share of the fund's NAV. Since, according to the expert witnesses, that discount has no marketability element, it is, to some extent, considered reflective of a minority interest discount.

end the fund."[15] That screening process produced a sample of 14 funds.

Dr. Bajaj derives his sample of closed end equity funds from the list of "general equity" funds set forth in the January 12, 1996 edition of the Wall Street Journal. For reasons not entirely clear, Dr. Bajaj excludes two of those funds from consideration, leaving a sample of 20 funds.[16]

Dr. Bajaj's sample contains nine funds that Mr. Frazier excludes from his sample. With regard to the first two of Mr. Frazier's three screening criteria, Dr. Bajaj states in his rebuttal testimony that none of those nine funds was a special purpose fund and that none had a stated maturity date. With regard to Mr. Frazier's third screening criterion, Dr. Bajaj states that the fact that a fund's shareholders can vote to open-end the fund does not mean that such a conversion is imminent. Dr. Bajaj also states that the summary descriptions (contained in Mr. Frazier's direct testimony) of five of the funds included by

[15] As noted earlier, a shareholder of an open-end fund generally can obtain the liquidation value of his investment (i.e., his pro rata share of the fund's NAV) by tendering his shares to the fund for repurchase. It stands to reason that, to the extent the conversion of a closed end fund to open-end status is imminent, the share price of such fund will tend to approach the fund's NAV per share.

[16] In his direct testimony, Dr. Bajaj states that the two excluded funds "could not be identified in Morningstar Principia dataset as of December 31, 1996". Since Mr. Frazier excludes those funds from his sample as well, we similarly exclude them from consideration.

Mr. Frazier in his sample of funds mention open-ending votes or procedures, which, according to Mr. Frazier's criteria, should have required their exclusion.

In his rebuttal testimony, Mr. Frazier does not directly challenge Dr. Bajaj's inclusion of any specific fund in his sample; rather, he simply asserts that "some of these funds could have announced their intent to convert to an open-end fund" and that "other funds may be non-diversified". In the absence of more specific objections to Dr. Bajaj's additional sample funds, we are persuaded to include such funds in our own analysis.

Mr. Frazier's sample contains three funds that Dr. Bajaj excludes from his sample: Gemini II, Quest for Value, and Liberty All Star Growth Fund. Gemini II and Quest for Value were "dual purpose" funds, which were scheduled for either liquidation or open-ending in January 1997.[17] Given the effect that the impending liquidation or conversion may have had on share prices of those funds, we exclude them from our analysis. Since Dr. Bajaj's rebuttal testimony raises no specific objection to the inclusion of Liberty All Star Growth Fund in the sample, we include that fund in our analysis.[18]

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[17] A dual purpose fund has both income shares and capital shares. At a set expiration date, the fund redeems all income shares, and the capital shareholders then vote either to liquidate the fund or convert it to open-end status.

[18] Dr. Bajaj may have excluded Liberty All Star Growth Fund from his sample due to the lack of NAV information with respect

(continued...)

(3) Representative Discount Within the Range of Sample Fund Discounts

Mr. Frazier concludes that, because an interest in MIL's equity portfolio would not compare favorably to an interest in an institutional fund, the minority interest discount factor for MIL's equity portfolio should derive from the higher end of the sample's range of discounts. Dr. Bajaj, on the other hand, concludes that such discount factor should derive from the lower end of the range of discounts. For the reasons discussed below, we find neither expert's arguments convincing on that point.

Mr. Frazier concludes that a higher than average minority interest discount factor for MIL's equity portfolio is warranted in part because of the relative anonymity of MIL's investment managers, the relatively small size of MIL's equity portfolio, and MIL's policy of not making distributions (other than distributions to satisfy tax obligations). However, Mr. Frazier elsewhere testifies that, based on his regression analysis, there is no clear correlation between the discounts observed in his sample of closed end funds and any of the variables he analyzed, including Morningstar rating (largely indicative of management reputation), the size of the fund, and distributions as a percentage of NAV. We are similarly unpersuaded by Mr. Frazier's

[18](...continued)
to such fund as of the valuation date. For purposes of our analysis, we utilize the fund's NAV and price data as of Jan. 5, 1996, which is in the record.

assertion (unsupported by empirical evidence) that fewer administrative and regulatory controls on MIL's investment activity (as compared to that of institutional funds) should result in a higher discount factor as a matter of course.[19]

Dr. Bajaj's argument that the minority interest discount factor for MIL's equity portfolio should derive from the lower end of the range of observed discounts is based primarily on the premise that, on the valuation date, MIL was akin to a new investment fund. Dr. Bajaj's research, along with that of others cited in his direct testimony, indicates that new investment funds tend to trade at lower discounts than seasoned funds. However, Dr. Bajaj's analysis fails to recognize that, while MIL was a relatively new entity on the valuation date, its equity portfolio had been in place (in the hands of the contributing partners) for years. Furthermore, of the four factors that Dr. Bajaj specifically identifies as possible determinants of lower initial fund discounts, only one--lack of unrealized capital gains--perhaps would have informed the pricing decision of a hypothetical buyer of an interest in MIL.[20] The other factors

[19] For instance, less regulation implies lower compliance costs, which seemingly would offset, at least to some extent, any pricing effect of relatively lax investor protections.

[20] Although MIL inherited any unrealized gain with respect to assets contributed by the initial MIL partners, see sec. 723, the portion of such precontribution gain otherwise allocable to a subsequent purchaser of an interest in MIL, see sec. 1.704-3(a)(7), Income Tax Regs., generally would be eliminated if the

(continued...)

cited by Dr. Bajaj (the initial diminution of fund NAV relative to issue proceeds due to flotation and other startup costs, the prevalence of new funds in "hot" investment sectors, and the initial lack of management inefficiencies) simply do not readily translate from the public capital markets to the hypothetical private sale of an interest in MIL.

Because we are unpersuaded by the respective arguments of Mr. Frazier and Dr. Bajaj for a higher than average or lower than average minority interest discount factor for MIL's equity portfolio, we utilize the average discount of the sample funds under consideration.[21]

(4) Summary

In determining the appropriate minority interest discount factor for MIL's equity portfolio, we utilize (1) Dr. Bajaj's price and NAV data as of January 12, 1996 (with the exception of Liberty All Star Growth Fund, for which we utilize NAV data from January 5, 1996, contained in the record); (2) Dr. Bajaj's sample of funds, with the addition of Liberty All Star Growth Fund; and

[20](...continued)
general partners of MIL were to agree to make a timely sec. 754 election with respect to MIL. See secs. 754, 743(b); sec. 1.755-1(b)(1)(ii), Income Tax Regs. The same would be true with respect to any postcontribution unrealized appreciation with respect to MIL's assets.

[21] In their reports, Mr. Frazier and Dr. Bajaj determine the average, but not the weighted average, of the discounts with respect to the equity funds in their respective samples. We follow the same approach here.

(3) the average discount of the sample funds. The resulting discount factor is 9.96 percent, which we round up to 10 percent.

b. Municipal Bond Portfolio

Both Mr. Frazier and Dr. Bajaj determine the minority interest discount factor for MIL's municipal bond portfolio by reference to publicly traded, closed end municipal bond investment funds. Once again, they disagree on measurement dates, sample funds, and representative discounts within the range of the sample fund discounts.

(1) Measurement Date

Mr. Frazier calculates discounts for his sample closed end municipal bond funds on the basis of January 11, 1996, trading prices and December 25, 1995, NAV data. Dr. Bajaj utilizes trading prices and NAV information as of the valuation date; i.e., January 12, 1996. We agree with Dr. Bajaj that, to the extent possible, data from January 12, 1996, should be utilized in determining discounts with respect to the sample funds.

(2) Sample of Funds

Mr. Frazier derives his sample of closed end municipal bond funds from the list of municipal bond funds set forth in Morningstar's Mutual Funds Guide. In his direct testimony, Mr. Frazier indicates that he excluded from consideration funds that were "heavily weighted toward a specific sector" and funds with scheduled liquidation dates. With regard to the first screening

factor, it appears that Mr. Frazier was referring to single-State funds. Mr. Frazier's screening process produced a sample of eight funds.

Dr. Bajaj derives his sample from the list of 140 closed end municipal bond funds set forth in the January 15, 1996 edition of the Wall Street Journal. For reasons not entirely clear, Dr. Bajaj excludes six of the funds from consideration, leaving a sample of 134 funds.[22] That sample includes numerous single-State funds and funds with scheduled liquidation dates.

We agree with Mr. Frazier that funds with scheduled liquidation dates should not be included in the sample. However, given the fact that Louisiana-based obligations accounted for approximately 75 percent of the value of MIL's bond portfolio, we are somewhat puzzled by Mr. Frazier's exclusion of single-State funds from his sample. Indeed, we believe that the sample should consist entirely of single-State funds. We therefore utilize a sample consisting of the 62 single-State funds in Dr. Bajaj's sample that do not have scheduled liquidation dates.

(3) Representative Discount Within the Range of Sample Fund Discounts

As is the case with MIL's equity portfolio, Mr. Frazier concludes that the minority interest discount factor for MIL's bond portfolio should derive from the higher end of the sample's

[22] In his direct testimony, Dr. Bajaj states that the six excluded funds "could not be identified in Morningstar Principia dataset as of December 31, 1996".

range of discounts, while Dr. Bajaj concludes that such discount factor should derive from the lower end of the range of discounts. Once again, we find neither expert's arguments convincing on this point.

Mr. Frazier states that, according to his regression analysis, the three factors that are the most determinative of discounts with respect to the closed end funds in his sample are (1) distributions as a percentage of NAV, (2) built-in gain as a percentage of NAV, and (3) 3-year average annual return. We see no error in Mr. Frazier's calculation of his first factor, although he seems to take the same factor into account as an aspect of the discount for lack of marketability. With regard to the second two factors, Mr. Frazier provides no data with respect to MIL's bond portfolio that can be compared to the data from his sample funds. Mr. Frazier also repeats factors that he deemed relevant in the context of MIL's equity portfolio, notwithstanding the fact that his own regression analysis indicates little, if any, correlation between those factors (management quality and the size of the fund) and the level of discounts in his bond fund sample.[23]

[23] Mr. Frazier's regression analysis produced R-squared calculations of 0.29 for the Morningstar rating (management quality) variable and 0.01 for the fund size variable. Elsewhere in his direct testimony, Mr. Frazier indicates that an R-squared calculation of 0.34 is "relatively low", leading to the conclusion of "no clear correlation" between the variable in question and the level of sample fund discounts.

Dr. Bajaj applies his "new fund" analysis, discussed above in the context of MIL's equity portfolio, to MIL's bond portfolio as well. Again, Dr. Bajaj's analysis fails to recognize that, while MIL was a relatively new entity on the valuation date, its bond portfolio had been in place (in the hands of the contributing partners) for years. For that reason and the other reasons discussed supra in section V.C.2.a.(3), we reject this portion of Dr. Bajaj's analysis.

Because we are unpersuaded by the respective arguments of Mr. Frazier and Dr. Bajaj for a higher than average or lower than average minority interest discount factor for MIL's bond portfolio, we utilize the average discount of the sample funds under consideration.[24]

(4) Summary

In determining the appropriate minority interest discount factor for MIL's bond portfolio, we utilize (1) Dr. Bajaj's price and NAV data as of January 12, 1996, (2) a sample of funds consisting of the 62 single-State funds in Dr. Bajaj's sample that do not have scheduled liquidation dates, and (3) the average discount of the sample funds. The resulting discount factor is 9.76 percent, which we round up to 10 percent.

[24] In their reports, Mr. Frazier and Dr. Bajaj determine the average, but not the weighted average, of the discounts with respect to the bond funds in their respective samples. We follow the same approach here.

c. Real Estate Partnerships[25]

(1) The Appropriate Comparables

In contrast to their opinions regarding MIL's equity and bond portfolios, Dr. Bajaj and Mr. Frazier sharply disagree on the general type of publicly traded entity from which to extrapolate the minority interest discount factor for MIL's real estate partnership interests. Dr. Bajaj argues that the discount factor should be based on data pertaining to real estate investment trusts (REITs).[26] Mr. Frazier, on the other hand, excludes REITs from consideration "since they are primarily priced on a current yield basis because REITs are required by law to annually pay out a large portion of earnings to shareholders." That justification overlooks the fact that the investment funds Mr. Frazier analyzes in determining the minority interest discount factors for MIL's equity and bond portfolios are also required to distribute substantially all of their income each year in order to maintain their tax-favored status as regulated investment companies (RICs). Compare sec. 852(a)(1) (income distribution requirement for RICs) with sec. 857(a)(1) (income distribution requirement for REITs). In the absence of any

[25] Dr. Bajaj limits his real estate analysis to MIL's real estate partnership interests. We address the minority interest discount factor for MIL's direct real estate holdings infra in sec. V.C.2.d.

[26] A real estate investment trust is a tax-favored vehicle through which numerous investors can pool their resources to invest in real estate. See secs. 856-859.

explanation as to why the current distribution requirement should disqualify REITs (but not RICs) from consideration in our analysis, we are persuaded to evaluate the REIT data.

We are further persuaded to utilize the REIT data in light of the alternative offered by Mr. Frazier. Mr. Frazier's search for "comparable" publicly traded real estate companies yielded a sample of five companies, and he derives his range of discounts from only three of those companies. While we have utilized small samples in other valuation contexts, we have also recognized the basic premise that "[a]s similarity to the company to be valued decreases, the number of required comparables increases". Estate of Heck v. Commissioner, T.C. Memo. 2002-34. One of Mr. Frazier's three sample companies developed planned communities, conducted farming operations, and owned royalty interests in more than 200 oil and gas wells. Another owned and managed shopping centers and malls and developed the master-planned community of Columbia, Maryland. The assets and activities of those companies are not sufficiently similar to those of MIL's real estate partnerships to justify the use of such a small sample.[27]

In contrast, Dr. Bajaj's REIT sample consists of 62 companies. In recognition of the fact that two of the real estate limited partnerships in which MIL was a partner owned

[27] Cf. Estate of Desmond v. Commissioner, T.C. Memo. 1999-76 (approving the use of the market approach for valuing an operating business based on two guideline companies in the same --as opposed to similar--line of business).

unimproved land that could be used for a variety of purposes, Dr. Bajaj's sample includes REITs specializing in a broad array of real estate investments, including office, residential, and retail properties. Given the size of the sample, we believe that any dissimilarities in the assets and activities of particular REITs in the sample as compared to those of MIL's real estate partnerships are tolerable.[28]

(2) Determining the Discount Factor

Because REITs offer investors the opportunity to invest in an illiquid asset (i.e., the underlying real estate) in liquid form (i.e., the REIT shares), investors in REITs are willing to pay a liquidity premium (relative to NAV) to invest in REIT shares. According to Dr. Bajaj, that does not imply that a minority discount is nonexistent; it only means that the difference between price and NAV for a REIT may have two components, one positive (the liquidity premium) and one negative (the minority discount). From his sample data, Dr. Bajaj calculated a median price-to-NAV premium of 3.7 percent. To be conservative and to reflect MIL's distribution policy, Dr. Bajaj looked below the median, to the 25th percentile, and began with a price-to-NAV discount of 1.3 percent (an adjustment to NAV of minus (-) 1.3 percent). Since Dr. Bajaj believes that that

[28] We note that, while Mr. Frazier questions the composition of Dr. Bajaj's sample of REITs, he offers no specific suggestions for modifying the sample.

adjustment reflects both a minority discount and a (smaller) liquidity premium, he then proceeded to identify (and eliminate the effect of) the liquidity premium in order to determine the minority discount. Based on his opinion that, as of the valuation date, the prevailing "illiquidity" discount for privately placed restricted stock was approximately 7 percent, he calculated a 7.53-percent liquidity premium.[29] Based on that liquidity premium of 7.53 percent and his selected price-to-NAV discount of 1.3 percent from his REIT sample, Dr. Bajaj added the two percentages to calculate a minority discount of 8.83 percent (i.e., he increased the price-to-NAV discount to reflect the elimination of the effect of the liquidity premium), which he rounded to 9 percent.

Using the same procedure as Dr. Bajaj, but substituting an illiquidity discount of 18 percent for his 7-percent figure, we arrive at a liquidity premium of 22 percent and therefore conclude that the minority discount imbedded in the 1.3-percent price-to-NAV discount selected from the REIT sample is 23.3 percent, which we shall apply to MIL's real estate partnership interests. We have substituted 18 percent for 7 percent because, as discussed infra in section V.D.5.a., Dr. Bajaj has not been clear in distinguishing between the apparently different (but

[29] As Dr. Bajaj explains his calculation: "If an illiquid security trades at a discount of 7% relative to a liquid asset, this suggests that the liquid asset is trading at a premium of about 7.53% relative to the illiquid asset (1/[1-7%])."

overlapping) concepts of "marketability" and "liquidity". Our substitute percentage derives from a published study referenced in his direct testimony (the Wruck study)[30] which reported that, on average, discounts observed in private placements of unregistered shares exceeded those observed in private placements of registered shares (freely tradable in the public market) by 17.6 percentage points, which we round up to 18 percent. The theory, discussed in more detail infra in section V.D.4., is that such additional discount represents, to some degree, pure illiquidity concerns, since a ready, public market is available to owners of registered shares and unavailable to owners of restricted shares.

d. Direct Real Estate Holdings

Respondent has instructed Dr. Bajaj to base his value conclusion regarding MIL's direct real estate holdings on the 40-percent minority interest discount factor for those assets appearing in the 1996 HFBE appraisal report. On that basis, we find that the minority interest discount factor for MIL's direct real estate holdings is 40 percent.

e. Oil and Gas Interests

Mr. Frazier assigns a 33.5-percent minority interest discount factor to MIL's oil and gas interests. Respondent has

[30] Wruck, "Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings," 23 J. Fin. Econ. 3 (1989).

instructed Dr. Bajaj to base his value conclusion regarding the oil and gas component of MIL's portfolio on the 33.5-percent minority interest discount factor for those assets appearing in the 1996 HFBE appraisal report. On that basis, we find that the minority interest discount factor for MIL's oil and gas investments is 33.5 percent.

3. Determination of the Minority Interest Discount

The minority interest discount factors determined above yield a weighted average discount of 15.18 percent, determined as follows:[31]

Asset Class	Percent of NAV	Percent Disc. Factor	Percent Weighted Average
Equities	20.6	10.0	2.06
Bonds	45.5	10.0	4.55
R.E. pships.	29.4	23.3	6.85
Real estate	3.3	40.0	1.32
Oil and gas	1.2	33.5	0.40
discount			15.18

Rounding to the nearest percentage point, we conclude that the appropriate minority interest discount with respect to the gifted interest is 15 percent.

D. Marketability Discount

1. Introduction

The parties agree that, to reflect the lack of a ready market for assignee interests in MIL, an additional discount (after applying the minority interest discount) should be applied

[31] Mr. Frazier and Dr. Bajaj agree on the percentages of NAV assigned to each asset class.

to the net asset value of MIL's assets to determine the fair market value of the gifted interest. Such a discount is commonly referred to as a "marketability discount". The marketability discount analyses of Mr. Frazier and Dr. Bajaj differ from their minority interest discount analyses in that they seek to identify a single, "entity-wide" discount rather than a weighted average of discount factors specific to each category of assets held by MIL. The parties disagree as to the amount of that discount.

2. Traditional Approaches to Measuring the Discount

a. In General

Mr. Frazier and Dr. Bajaj agree that empirical studies of the marketability discount fall into two major categories. The first major category, the IPO approach, consists of studies that compare the private-market price of shares sold before a company goes public with the public-market price obtained in the initial public offering (IPO) of the shares or shortly thereafter. The second major category, the restricted stock approach, consists of studies that compare the private-market price of restricted shares of public companies (i.e., shares that, because they have not been registered with the Securities and Exchange Commission, generally cannot be sold in the public market for a 2-year period)[32] with their coeval public-market price. Mr. Frazier

[32] See 17 C.F.R. sec. 230.144(d)(1) (1996). The required holding period was shortened to 1 year in 1997. See 62 Fed. Reg. 9242 (Feb. 28, 1997).

relies primarily on data from the restricted stock approach to support a marketability discount of 35 percent, although he also contends that data from the IPO approach strongly support that level of discount. Dr. Bajaj relies on a variant of the restricted stock approach, which we shall refer to as the private placement approach, to support a marketability discount of 7 percent.

b. Rejection of IPO Approach

Dr. Bajaj argues that the IPO approach is flawed both in concept and in application. His principal criticism is that the IPO premium (over the pre-IPO private market price) may reflect more than just the availability of a ready market. He believes that buyers of shares prior to the IPO are likely to be insiders who provide services to the firm and who are compensated, at least in part, by a bargain price. More importantly, he believes that a pre-IPO purchaser demands compensation (in the form of a lower price) for bearing the risk that the IPO will not occur or will occur at a lower price than expected. His opinion is: "[T]he IPO approach probably generates inflated estimates of the marketability discount. Consequently, it is of limited use in estimating the value of closely held firms."

In his rebuttal testimony, Mr. Frazier fails to offer any rebuttal of Dr. Bajaj's criticism of the IPO approach. Mr. Frazier's support for the IPO approach consists only of his

reference to a series of studies undertaken by Shannon Pratt, Chairman of Willamette Management Associates, Inc., a national business valuation firm (the Willamette studies). Without explaining the basis of his testimony, Mr. Frazier's opinion is: "[T]he evidence from the Willamette study was quite compelling and offered strong support for the hypothesis that the fair market values of minority interests in privately held companies were and should be greatly discounted from their publicly-traded counterparts."

By contrast, in his rebuttal testimony, Dr. Bajaj offers a compelling criticism of both the Willamette studies and another series of studies undertaken by John D. Emory, vice president of appraisal services at Robert W. Baird and Co., a regional investment banking firm.[33] He concludes that the latest study conducted by Mr. Emory is biased because it does not adequately take into account the highest sale prices in pre-IPO transactions, and he criticizes the Willamette studies for not disclosing enough data to reveal whether they suffer from a similar bias. Dr. Bajaj has convinced us to reject as unreliable Mr. Frazier's opinion to the extent it is based on the IPO approach. We shall proceed to consider Mr. Frazier's restricted stock analysis and Dr. Bajaj's private placement analysis.

[33] Mr. Frazier relied on Mr. Emory's studies in the 1996 HFBE appraisal report but makes no mention of those studies in either his direct testimony or his rebuttal testimony.

3. Mr. Frazier's Restricted Stock Analysis

Mr. Frazier reviews four studies under the restricted stock approach[34] and then attempts to infer an appropriate marketability discount by "placing" MIL within the range of observed discounts in those studies and the Willamette studies, on the basis of certain characteristics of MIL (revenue, income, and NAV) and the gifted interest (size of the interest, expressed both as a percentage of MIL and as a dollar amount). The results of that attempt are set forth in Table 31 of the report constituting Mr. Frazier's direct testimony (Table 31). Based on data from the five studies, Mr. Frazier identifies 10 hypothetical discount levels for the gifted interest (some expressed as a specific percentage, e.g., "33.6%", and some expressed as being greater or less than a specific percentage, e.g., ">35%"). Six of the hypothetical discounts were greater than 35 percent and four were less than 35 percent. He states:

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[34] Mr. Frazier reviews the following studies (the restricted stock studies):

1. Securities and Exchange Commission, Discounts Involved in Purchases of Common Stock (1966-1969), H.R. Doc. No. 64, Part 5, at 2444-2456 (1971).

2. Silber, "Discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices," Financial Analysts Journal, July-August 1991, at 60.

3. A study only described as "The Standard Research Consultants (SRC) Study".

4. Hertzel & Smith, "Market Discounts and Shareholder Gains for Placing Equity Privately," 48 J. Fin. 459 (1993).

"Based on these studies alone, we concluded that the discount applicable to the Partnership's block should approximate 35 percent."

We find several flaws in Mr. Frazier's analysis. For example, Table 31 indicates that MIL's projected revenue of $681,000 is consistent with a discount of 51.9 percent based on data from the Willamette studies. The Willamette studies are IPO studies rather than restricted stock studies, and they do not, so far as we can tell from Mr. Frazier's testimony, analyze firm revenues.[35] Table 31 also indicates that one can infer a discount from the "Hertzel and Smith" study based on the proportional size of the offering, although Mr. Frazier gives no indication that that study drew any correlations between that variable and the level of discount. Furthermore, under the heading "Size of Block as % Total Outstanding" in Table 31, the entry corresponding to MIL is "1.0%", when in fact each half of the gifted interest represents a greater than 40-percent interest with respect to MIL. Similarly, although there is no entry in Table 31 for the dollar size of the gifted interest, it is evident that the ">35%" discount inferred from that variable in Table 31 is based on the same mischaracterization of each half of

[35] Indeed, under the heading "Revenues" in Table 31 of Mr. Frazier's direct report, the entry corresponding to "Willamette" is "NA".

the gifted interest as a 1-percent interest in MIL.[36] In light of those numerous defects, we give little weight to Mr. Frazier's restricted stock analysis.

4. Dr. Bajaj's Private Placement Analysis

a. Comparison of Registered and Unregistered Private Placements

Dr. Bajaj believes that the discounts observed in restricted stock studies are attributable in part to factors other than impaired marketability.[37] In support of his position, Dr. Bajaj analyzes data from studies (including his own unpublished study)[38] involving both registered private placements and unregistered private placements (the private placement studies). He observes that, if discounts found in unregistered (restricted) private placements are attributable solely to impaired marketability, then there should be no discounts associated with

[36] Specifically, one restricted stock study, the Silber study, found that the average dollar size of private placements with discounts in excess of 35 percent was $2.7 million, while the average dollar size of private placements with discounts less than 35 percent was $5.8 million. Even taking into account Mr. Frazier's suggested minority interest discount of 22 percent, the "dollar size" of each half of the gifted interest was approximately $5.7 million. That would indicate that, based on the Silber study, a discount of less than 35 percent would be appropriate for each half of the gifted interest.

[37] We note that such other factors should not include the purchaser's minority ownership position, if applicable; presumably, a minority interest discount is already reflected in the market price of a share of the issuer.

[38] Other than his own study, he refers to the Wruck study, supra note 30, and the Hertzel & Smith study, supra note 34.

registered private placements (i.e., because such shares can be sold in the public market). However, the results of the private placement studies indicate that even registered private placement shares are issued at a discount, although such discounts tend to be lower than those observed in unregistered private placements. Dr. Bajaj explains that phenomenon by positing that privately placed shares, whether registered or unregistered, tend to be issued to purchasers of large blocks of stock who demand discounts to compensate them for assessment costs and anticipated monitoring costs. He states: "The discount offered to buyers is a compensation for the cost of assessing the quality of the firm and for the anticipated costs of monitoring the future decisions of its managers."

b. Refinement of Registered/Unregistered Discount Differential

Dr. Bajaj further contends that the additional discount typical of unregistered private placements (as compared to registered private placements) is not entirely attributable to the fact that unregistered shares, unlike registered shares, generally cannot be sold in the public market. Rather, he contends that such differential is attributable in part to higher assessment and monitoring costs incurred in unregistered private placements as compared to registered private placements. In support of his theory, Dr. Bajaj suggests four factors that might have a correlative relationship to assessment and monitoring

costs and, by extension, to private placement discounts: (1) the size of the private placement relative to the issuer's total shares outstanding, (2) the volatility of the issuer's recent economic performance, (3) the overall financial health of the issuer, and (4) the size of the private placement in terms of total proceeds. Dr. Bajaj posits that the additional discount observed in unregistered issues could be attributable solely to impaired marketability only if those four additional factors were present in equal measure among both registered and unregistered private placements.

Dr. Bajaj analyzes the effects of the four additional factors listed above and concludes that the first three (but not the fourth) of those factors are systematically related to the level of private placement discounts. Specifically, he concludes that, relatively speaking, a high ratio of privately placed shares to total shares of the issuer, high issuer volatility, and weak financial health of the issuer tend to be indicative of higher discounts. Dr. Bajaj then demonstrates that, as compared to registered private placements, unregistered private placements tend to involve a higher percentage of the issuer's total shares, higher issuer volatility, and financially weaker issuers. That being the case, Dr. Bajaj concludes that the registered-unregistered private placement discount differential must be attributable in part to those three factors rather than just

impaired marketability. In other words, the additional discount typical of unregistered private placements as compared to registered private placements does not represent solely compensation for impaired marketability but represents in part compensation for the relatively higher assessment and anticipated monitoring costs normally associated with unregistered issues.

Having concluded that factors unrelated to impaired marketability play a variable role in the total discounts observed in private placement transactions, Dr. Bajaj then attempts to isolate the effect that impaired marketability has on such total discounts. To that end, he adds a variable for stock registration to variables representing the three additional correlative factors and uses the statistical technique of multivariate regression to determine the effect of each such variable on the discounts observed in his sample of private placements. He concludes from that analysis that, over the 1990 to 1995 period of his study, a private issue that was registered (thereby allowing purchasers to immediately resell in the public market) would have required a discount that was 7.23 percentage points less than an otherwise identical issue (in terms of the three additional correlative factors) that was unregistered.

c. Further Adjustments

Dr. Bajaj considers and rejects any additional adjustment (discount) on account of the long-term impaired marketability of

an assignee interest in MIL[39] as compared to the limited impaired marketability of restricted shares of stock. His rejection is based primarily on his opinion, supported by the economic analysis of others,[40] that the level of discount does not continue to increase with the time period of impaired marketability, because investors with long-term horizons would provide a natural clientele for holding illiquid assets and would compete to purchase all or a portion of the gifted interest.

d. Application to MIL

Dr. Bajaj concludes:

> Considering the available data, the Partnership's holdings and history, and the marketability discount of 7.23% suggested by my regression analysis involving a broad range of economic sectors, I conclude that a marketability discount of 7% [rounded from 7.23 percent] is appropriate for all the assets held by MIL when valuing the subject interest. * * *

5. Determination of the Marketability Discount

a. Discussion

Mr. Frazier, in his testimony in rebuttal to Dr. Bajaj, criticizes Dr. Bajaj for focusing narrowly on "liquidity" at the expense of other factors that contribute to a lack of marketability. Mr. Frazier states that "[t]he impediments to value associated with inability to easily sell an interest in a

[39] Both experts operate under the assumption that there will not be a ready market for assignee interests in family limited partnerships during the remainder of MIL's 30-year term.

[40] Amihud & Mendelson, "Asset Pricing and Bid-Ask Spread," 17 J. Fin. Econ. 223 (1986).

closely-held entity go well beyond the narrowly defined 'liquidity costs' Dr. Bajaj has isolated in his analysis" and that "the [marketability] discount is caused not by just 'liquidity' but the other negative characteristics that attend securities issued by small closely-held entities."

Dr. Bajaj has indeed been helpful in focusing our attention (and Mr. Frazier's attention) on the distinction between illiquidity and other factors (e.g., assessment and monitoring costs) that contribute to private placement discounts. However, his apparent confusion regarding the nature of the discount for lack of marketability (i.e., whether such discount can be explained purely in terms of illiquidity or whether other factors may be involved) is troubling. In his direct testimony, Dr. Bajaj is fairly clear that assessment and monitoring costs associated with private placements are outside the realm of the marketability discount. In his rebuttal testimony, however, he indicates that such costs may contribute to the marketability discount for a closely held entity. That leads us to question whether other "negative characteristics" (in the words of Mr. Frazier) associated with closely held entities may contribute to the appropriate marketability discount for an assignee interest in MIL. Therefore, while we are impressed by portions of Dr. Bajaj's analysis, he has not convinced us that the

appropriate marketability discount in this case can be inferred from the illiquidity cost associated with private placements.

Although we reject Dr. Bajaj's quantification of the appropriate marketability discount in this case, we look to the data from his private placement study for two reasons. First, we believe that, given MIL's status as an investment company,[41] what Dr. Bajaj refers to in the context of private placements as assessment and monitoring costs would be relatively low in the case of a sale of an interest in MIL. That belief, coupled with Dr. Bajaj's persuasive argument that such costs are relatively high in unregistered private placements, leads us to conclude that a sample consisting entirely of unregistered private placements would be inappropriately skewed. Second, only Dr. Bajaj's study (and not the other private placement studies on which he relies) covers the period (1990-1995) immediately preceding the valuation date.

In Table 10 of the report constituting his direct testimony, Dr. Bajaj separates the 88 private placements in his sample into three groups according to the level of discounts (i.e., the 29 lowest discounts, the middle 29 discounts, and the 30 highest discounts). Presumably, the "low" category is dominated by

[41] On the valuation date, 65 percent of MIL's assets consisted of marketable securities and an additional 30 percent consisted of real estate limited partnership interests, subject to well-known and relatively routine appraisal techniques (such as cashflow analysis or market multiple methods).

registered private placements which, unlike an assignee interest in MIL, did not suffer from impaired marketability. Similarly, it is likely that the "high" category is dominated by unregistered private placements which, unlike the sale of an interest in an investment company, entailed relatively high assessment and monitoring costs. Accordingly, we look to the "middle" group of private placements in Dr. Bajaj's sample in determining the appropriate marketability discount for an assignee interest in MIL. The average discount of that group of private placements was 20.36 percent.[42] We are not persuaded that we can refine that figure any more to incorporate characteristics specific to MIL.

b. Conclusion

We find that a discount for lack of marketability of 20 percent (rounded from 20.36 percent) is appropriate in determining the fair market value of each half of the gifted interest.

E. Conclusion

We conclude that the fair market value of each half of the gifted interest is $4,941,916, determined as follows:[43]

[42] That discount is consistent with the average discount (20.14 percent) observed in the Hertzel & Smith private placement study, supra note 34, the study (other than his own) primarily relied upon by Dr. Bajaj.

[43] For ease of computation, we determine the fair market value of a 1-percent interest.

Total NAV	$17,673,760
Less: Class A preference	(20,000)
"Net" NAV	17,653,760
1 percent of net NAV	176,538
Less: 15-percent minority interest discount	(26,481)
Marketable value	150,057
Less: 20-percent marketability discount	(30,011)
FMV of 1-percent interest	120,046
FMV of 41.16684918-percent interest	4,941,916

VI. Charitable Contribution Deduction for Transfer to CFT

A. Introduction

The gift tax is imposed on the value of what the donor transfers, not what the donee receives. Shepherd v. Commissioner, 115 T.C. 376, 385 (2000) (citing, inter alia, Robinette v. Helvering, 318 U.S. 184, 186 (1943)), affd. 283 F.3d 1258 (11th Cir. 2002). In essence, petitioners contend that because (1) they transferred to CFT a portion of the gifted interest corresponding to the excess of the fair market value of that interest over $7,044,933, and (2) we have determined the fair market value of the gifted interest to be $9,883,832, it follows from the maxim beginning this paragraph that they are entitled to a charitable contribution deduction in the amount of $2,838,899 for their gift to CFT. Because the assignment agreement does not equate the term "fair market value" with the term "fair market value as finally determined for Federal gift tax purposes," petitioners' argument must fail.

B. The Assignment Agreement

By way of the assignment agreement, petitioners transferred to CFT the right to a portion of the gifted interest. That portion was not expressed as a specific fraction of the gifted interest (e.g., one-twentieth), nor did petitioners transfer to CFT a specific assignee interest in MIL (e.g., a 3-percent assignee interest). Rather, CFT was to receive a fraction of the gifted interest to be determined pursuant to the formula clause contained in the assignment agreement. The formula clause provides that CFT is to receive that portion of the gifted interest having a fair market value equal to the excess of (1) the total fair market value of the gifted interest, over (2) $7,044,933. The formula clause is not self-effectuating, and the assignment agreement leaves to the assignees the task of (1) determining the fair market value of the gifted interest and (2) plugging that value into the formula clause to determine the fraction of the gifted interest passing to CFT.

Petitioners argue that, because the assignment agreement defines fair market value in a manner that closely tracks the definition of fair market value for Federal gift tax purposes, see sec. 25.2512-1, Gift Tax Regs., the assignment agreement effects a transfer to CFT of a portion of the gifted interest determinable only by reference to the fair market value of that interest as finally determined for Federal gift tax purposes. We

do not believe that the language of the assignment agreement supports petitioners' argument. The assignment agreement provides a formula to determine not only CFT's fraction of the gifted interest but also the symphony's and the children's (including their trusts') fractions.[44] Each of the assignees had the right to a fraction of the gifted interest based on the value of that interest as determined under Federal gift tax valuation principles. If the assignees did not agree on that value, then such value would be determined (again based on Federal gift tax valuation principles) by an arbitrator pursuant to the binding arbitration procedure set forth in the partnership agreement. There is simply no provision in the assignment agreement that contemplates the allocation of the gifted interest among the assignees based on some fixed value that might not be determined

[44] If *f* equals the fair market value of the gifted interest (determined by the assignees (or an arbitrator) based on Federal gift tax valuation principles), and the gifted interest is shown as the 82.33369836 percent class B assignee interest in MIL transferred by petitioners, then, assuming *f* is equal to or greater than $7,044,933, the products of the following formulas show the percentage assignee interests apportioned to the children (including the trusts), the symphony, and CFT, expressed as x_1, x_2, and x_3, respectively:

$$\frac{\$6{,}910{,}933}{f} \times 82.33369836\% = x_1$$

$$\frac{\$7{,}044{,}933 - 6{,}910{,}933}{f} \times 82.33369836\% = x_2$$

$$\frac{f - \$7{,}044{,}933}{f} \times 82.33369836\% = x_3$$

for several years. Rather, the assignment agreement contemplates the allocation of the gifted interest based on the assignees' best estimation of that value. Moreover, each of the assignees' percentage interests was determined exactly as contemplated in the assignment agreement (without recourse to arbitration), and none can complain that they got any less or more than petitioners intended them to get.[45] Had petitioners provided that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes,[46] we might have reached a different result. However, that is not what the assignment agreement provides.

---

[45] We suppose that, at least in theory, there might be a difference between (1) petitioners' and the assignees' expectation on Jan. 12, 1996 (the valuation date), regarding the value of the portion of the gifted interest passing to CFT and (2) the value of that portion as subsequently determined by the assignees. However, no one has suggested how to value the first quantity or that, on the facts before us, the difference would be significant.

[46] See, e.g., sec. 1.664-2(a)(1)(iii), Income Tax Regs. (providing that a sum certain may be expressed as a fraction or percentage of the value of property "as finally determined for Federal tax purposes", but requiring that actual adjusting payments be made if such finally determined fair market value differs from the initially determined value); sec. 20.2055-2(e)(2)(vi)(a), Estate Tax Regs. (similar); sec. 25.2702-3(b)(1)(ii)(B), Gift Tax Regs. (similar); Rev. Proc. 64-19, 1964-1 C.B. 682 (discussing conditions under which the Federal estate tax marital deduction may be allowed where, under the terms of a will or trust, an executor or trustee is empowered to satisfy a pecuniary bequest or transfer in trust to a decedent's surviving spouse with assets at their value as finally determined for Federal estate tax purposes).

Of course, the assignees' determination of the fair market value of the gifted interest, while binding among themselves for purposes of determining their respective assignee interests, has no bearing on our determination of the Federal gift tax value of the assignee interests so allocated. Since we find that the fair market value of a 1-percent assignee interest in MIL on the valuation date was $120,046, the following table expresses the fair market values of the percentage assignee interests passing to the various assignees:

Assignee	Percentage Assignee Interest	Fair Market Value
Children and trusts	77.21280956	$9,269,089
Symphony	1.49712307	179,724
CFT	3.62376573	435,019
		9,883,832

C. Conclusion

We find that the fair market value of the property right transferred by petitioners to CFT was $435,019.[47] Taking into

[47] The rule is well established that we may approve a deficiency on the basis of reasons other than those relied on by the Commissioner. See Wilkes-Barre Carriage Co. v. Commissioner, 39 T.C. 839, 845 (1963) (and cases cited therein), affd. 332 F.2d 421 (2d Cir. 1964). Because our conclusion that the valuation clause of the assignment agreement does not achieve the claimed "tax neutralization" effect is based on the language of the assignment agreement, we need not address respondent's arguments that (1) the formula clause is against public policy, and (2) the transaction should be recast as transfers of cash by petitioners to CFT and the symphony under an integrated transaction theory. We note that the application of respondent's integrated transaction theory would result in an initial increase in the amount of petitioners' aggregate taxable gift of only $90,011 (less than 1 percent), which would be partially offset by the resulting increase in the gift tax liability that the noncharitable donees assumed under the assignment agreement.

account annual exclusions, see sections 2503(b) and 2524, each petitioner is entitled to a charitable contribution deduction under section 2522 of $207,510 resulting from the transfer to CFT.[48]

VII. Effect of Children's Agreement To Pay Estate Tax Liability

A. Introduction

Recently, in Ripley v. Commissioner, 105 T.C. 358, 369 (1995), revd. on another issue 103 F.3d 332 (4th Cir. 1996), we described the nature of a net gift as follows:

> Where a "net gift" is made, the donor and donee agree that the donee will bear the burden of the gift tax. The value of the property transferred is reduced by the amount of the gift tax paid by the donee, resulting in the net amount transferred by gift, or the "net gift". The IRS has provided an algebraic formula for determining the amount of gift tax owed on a "net gift" in Rev. Rul. 75-72, 1975-1 C.B. 310. It is important to keep in mind that once the "net gift" is calculated, the full amount of the gift tax is paid on the "net gift".
>
> When a "net gift" is made, a portion of the property is transferred by gift and the remaining portion is transferred by sale. * * *

The net gift rationale flows from the basic premise that the gift tax applies to transfers of property only to the extent that the value of the property transferred exceeds the value in money or

[48] We note that, under our analysis, the assignee interest received by the symphony is worth more than $134,000. Nevertheless, we do not believe that petitioners have claimed any increased charitable contribution deduction under sec. 2522 on account of the transfer to the symphony. If we are mistaken on that point, petitioners can bring that to our attention (or perhaps petitioners and respondent can deal with it in the Rule 155 computation).

money's worth of any consideration received in exchange therefor. See sec. 2512(b); sec. 25.2512-8, Gift Tax Regs.

Petitioners each reported his or her transfer of one-half of the gifted interest as a net gift. Each treated as sales proceeds (consideration received) (1) the amount of Federal and State gift taxes that he or she calculated were to be paid by the children (the gift tax amount) and (2) an amount described on brief as the "mortality-adjusted present value" (mortality-adjusted present value) of the children's contingent obligation to pay the additional estate tax that would have been incurred on account of section 2035(c) (the 2035 tax) if that petitioner had died within 3 years of the date of the gift. Petitioners describe their computation of the mortality-adjusted present value as follows:

> Petitioners * * * estimated the amount of estate tax that would be owed under I.R.C. § 2035(b) based on an expected 55% marginal estate tax rate. Then Petitioners adjusted that amount to present value at the applicable discount rate under I.R.C. § 7520 for January 1996, with further adjustment for the possibility that they would survive each year of the three-year period with no estate tax actually being owed. The probability of death in each of the ensuing three years was calculated, and then the probability-weighted tax amounts were discounted to present value at the required interest rate. All calculations were made, as required under I.R.C. § 7520, by reference to Petitioners' ages as of their nearest birthdays, the applicable interest rate under I.R.C. § 7520 for January, 1996, and mortality factors provided by Table 80CNSMT (as found in Respondent's Pub. 1457, "Actuarial Values, Alpha Volume").

Petitioners computed the mortality-adjusted present values of the above described obligations as being $149,813 and $139,348 with respect to Mr. and Mrs. McCord, respectively.

Respondent does not take issue with petitioners' treatment of the gift tax amounts as sale proceeds. However, he disputes petitioners' treatment of the mortality-adjusted present values as sale proceeds, primarily on the grounds that those amounts are too speculative to be taken into account. Respondent cites Armstrong Trust v. United States, 132 F. Supp. 2d 421 (W.D. Va. 2001), affd. sub nom. Estate of Armstrong v. United States, 277 F.3d 490 (4th Cir. 2002). In Armstrong Trust, supra, a gift was made and, because of (current) section 2035(b), the donees were subject to a potential liability, as transferees, for estate taxes. See sec. 6324(a)(2). Plaintiffs argued that liens or encumbrances were created on the gift by reason of the potential estate tax liability assumed by the donees, thereby reducing the value of the gift. Id., 132 F. Supp. 2d at 430. The District Court found that the possibility of future estate tax liability was too speculative to reduce the value of the gift.

Relying on an opinion of the United States Court of Claims, Murray v. United States, 231 Ct. Cl. 481, 687 F.2d 386 (1982), the Court of Appeals for the Fourth Circuit affirmed the District Court's decision in Armstrong Trust, also on the basis that the donees' potential liability for the donor's estate tax was too

speculative to reduce the value of the gifts. Estate of Armstrong v. United States, supra at 498. It was of no moment to the Court of Appeals that the donor had in fact died within 3 years of the gift, thus causing a 2035 tax to be due, or that the plaintiffs apparently had produced expert calculations of an amount similar to the mortality-adjusted present value at issue in this case. The Court of Appeals said:

> The litigation attempts of the Estate and the Trust to quantify through expert calculations the value of potential estate taxes at the time of the transfers is irrelevant. What is relevant is that the children's obligation to pay any estate taxes was then "highly conjectural," Murray, 687 F.2d at 394, and so provides no ground for applying net gift principles. [Id.]

In Murray v. United States, supra, the donor had made gifts in trust pursuant to an instrument that obligated the trustees to pay, among other debts, the donor's estate and death taxes liabilities. The plaintiffs (executors of the donor's estate) argued that the obligation to pay the donor's estate and death taxes rendered the gifts without value when made. The Court of Claims disagreed, finding that the obligation to pay estate and death taxes "was not * * * susceptible to valuation at the date of the gifts because the economic burden of paying these taxes was then unknown." Id., 687 F.2d at 394. The Court questioned whether it was even possible to approximate the value of the trustee's obligation to pay the donor's estate and death tax liabilities:

> the amount of estate and death taxes payable from the * * * [trusts] was highly conjectural. If Oliver lived until May 1971, the value of the 1968 Family Trust would no longer have been included in his estate as a gift in contemplation of death under section 2035, significantly reducing his estate tax liability. Moreover, had he lived for several more years, the size of his estate would have continued to diminish, leaving the 1970 Family Trusts with an ever-decreasing estate tax obligation. * * *

Id. at 394-395. The Court of Claims concluded: "Thus, plaintiffs' inability to reasonably estimate the amount of tax, if any, to be paid from the * * * [trusts] made it proper to compute the gift tax on the basis of the full value of the trust assets. Robinette v. Helvering, 318 U.S. 184, 188-89 (1943)." Id. at 395.[49]

B. Discussion

The specific question before us is whether to treat as part of the sale proceeds (consideration) received by each petitioner on the transfer of the gifted interest any amount on account of the children's obligation pursuant to the assignment agreement to pay the 2035 tax that would be occasioned by the death of that petitioner within 3 years of the valuation date. We have not faced that specific question before.[50] Neither Armstrong Trust

[49] In Robinette v. Helvering, 318 U.S. 184, 188-189 (1943), the Supreme Court held that, in computing the value of a gift of a remainder interest in property, the value (as an offset) of the donor's contingent reversionary remainder interest was to be disregarded because there was no recognized method of determining its value.

[50] Nevertheless, in Estate of Armstrong v. Commissioner, (continued...)

v. United States, supra, nor Murray v. United States, supra, is binding on us, and, indeed, the facts of both cases are somewhat different from the facts before us today. Armstrong Trust did not involve a specific assumption of the potential 2035 tax as a condition of the underlying gift (as is the case here); rather, the donees were statutorily liable for any 2035 tax under section 6324(a)(2). In Murray, unlike the instant case, the obligation was not limited to the "gross-up" tax of (original) section 2035(c), with its preordained inclusion amount and accompanying 3-year window of inclusion (indeed, that provision and the unified gift and estate tax system had yet to be enacted). Nevertheless, we agree with what we believe to be the basis of those two opinions, i.e., that, in advance of the death of a person, no recognized method exists for approximating the burden of the estate tax with a sufficient degree of certitude to be effective for Federal gift tax purposes. See also Estate of Armstrong v. Commissioner, 119 T.C. 220, 230 (2002).

Petitioners' computation of the mortality-adjusted present value of the children's obligation to pay the 2035 tax does

[50](...continued)
119 T.C. 220, 230 (2002) (addressing certain Federal estate tax questions with respect to the same gifts in question in Armstrong Trust v. United States, 132 F. Supp. 2d 421 (W.D. Va. 2001), affd. sub nom. Estate of Armstrong v. United States, 277 F.3d 490 (4th Cir. 2001)), we said: "The donee children's mere conditional promise to pay certain additional gift taxes that decedent might be determined to owe does not reduce the amount of decedent's gift taxes included in the gross estate under section 2035(c)."

nothing more than demonstrate that, if one assumes a fixed dollar amount to be paid, contingent on a person of an assumed age not surviving a 3-year period, one can use mortality tables and interest assumptions to calculate the amount that (without any loading charge) an insurance company might demand to bear the risk that the assumed amount has to be paid. However, the dollar amount of a potential liability to pay the 2035 tax is by no means fixed; rather, such amount depends on factors that are subject to change, including estate tax rates and exemption amounts (not to mention the continued existence of the estate tax itself[51]). For that reason alone, we conclude that petitioners are not entitled to treat the mortality-adjusted present values as sale proceeds (consideration received) for purposes of determining the amounts of their respective gifts at issue.[52] See Robinette v. Helvering, 318 U.S. 184, 188-189 (1943) (donor's reversionary interest, contingent not only on donor outliving

[51] See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, secs. 501(a), 901(a), 115 Stat. 38, 69, 150 (repealing the estate tax with respect to decedents dying after Dec. 31, 2009, and reinstating same with respect to decedents dying after Dec. 31, 2010).

[52] We recognize that, in Harrison v. Commissioner, 17 T.C. 1350, 1354-1355 (1952), we reduced the amount of a gift of a trust remainder by the present value of the trustee's obligation, under the terms of the trust agreement, to pay the settlor-life beneficiary's income tax liability attributable to the trust's income for the remainder of her life: "Federal income taxes have become a permanent and growing part of our economy, and there is no likelihood that such taxes will not continue to be imposed throughout the life expectancy of petitioner." We do not have occasion today to reconsider that opinion.

30-year old daughter, but also on the failure of any issue of the daughter to attain the age of 21 years, is disregarded as an offset in determining the value of the gift; actuarial science cannot establish the probability of whether the daughter would marry and have children).

Our conclusion is further buttressed by broader considerations of Federal gift tax law. Under the "estate depletion" theory of the gift tax, it is the benefit to the donor in money or money's worth, rather than the detriment to the donee, that determines the existence and amount of any consideration offset (sale proceeds) in the context of an otherwise gratuitous transfer. See Commissioner v. Wemyss, 324 U.S. 303, 307-308 (1945); 2 Paul, Federal Estate and Gift Taxation 1114-1115 (1942). When a donee agrees to pay the gift tax liability resulting from a gift, the benefit to the donor in money or money's worth is readily apparent and ascertainable, since the donor is relieved of an immediate and definite liability to pay such tax. If that donee further agrees to pay the potential 2035 tax that may result from the gift, then any benefit in money or money's worth from the arrangement arguably would accrue to the benefit of the donor's estate (and the beneficiaries thereof) rather than the donor. The donor in that situation might receive peace of mind, but that is not the type of tangible benefit required to invoke net gift principles.

C. Conclusion

Because petitioners have failed to show that their computation of the value of the children's obligation to pay any 2035 tax is reliable, we do not accept it as establishing any proceeds received by petitioners and reducing the value of the net gifts made by them.

VIII. Conclusion

The fair market value of the gifted interest on the date of the gift was $9,883,832 ($4,941,916 for each half thereof). Petitioners are entitled to an aggregate charitable contribution deduction under section 2522 for the transfer to CFT in the amount of $415,019 ($207,510 apiece).

To reflect the foregoing,

Decision will be entered under Rule 155.

Reviewed by the Court.

WELLS, COHEN, SWIFT, GERBER, COLVIN, GALE, and THORNTON, JJ., agree with this majority opinion.

SWIFT, J., concurring: The majority opinion adopts an interpretation of the "fair market value" language of the formula clause that recognizes the sophistication of the tax planning before us and that gives significance to the failure of that formula clause to use commonly recognized language in the estate planning profession under which--had it been intended--a fair market value determination (and an allocation between the donees of the gifted interest based thereon) "as finally determined for Federal gift tax purposes" would have been made explicit. In my opinion, the failure of the formula clause to reflect such well-recognized language belies petitioners' claim that such language, interpretation, and result were intended and now should be inferred.

Under the majority's interpretation of the formula clause, the abuse potential inherent therein is essentially negated.

If, however, petitioners' interpretation of the formula clause were adopted, under which petitioners claim an increasd charitable deduction equal to all excess value of the gifted interest over $7,044,093, as finally determined for Federal gift tax purposes, without property representing such excess value actually passing to charity, the long-standing "reasonable probability" and "public policy" doctrines applicable generally to gifts would become applicable. See, e.g., Hamm v. Commissioner, T.C. Memo. 1961-347, affd. 325 F.2d 934 (8th Cir. 1963), applying the reasonable probability standard to the

question of whether a charitable donee will ever receive gifted property; Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), applying public policy principles to the question of whether abusive valuation or adjustment clauses are to be respected.

With regard to Judge Foley's criticism of these doctrines, see dissenting op. pp. 94-95, 107-108, I would suggest that the reasonable probability and public policy doctrines should not be confined to stale factual situations involved in old cases. To the contrary, these doctrines live and breathe and have a life that should be broad and flexible enough to apply to contemporary and overly aggressive gift and estate tax planning (such as that involved herein)--particularly where charity is involved.

With regard further to the nature or extent of the gift to charity involved herein, I would emphasize that not "all" of petitioners' MIL partnership interest was transferred. Respondent argues that "all" of petitioners' MIL partnership interest was transferred, but petitioners contend otherwise, and the majority opinion concludes that something less than all of petitioners' interest in the MIL partnership was transferred (namely, only an "assignee" interest was transferred). See majority op. pp. 19-24. In light of the majority's conclusion in that regard, had respondent argued in the alternative that the "partial interest" gift rules of section 2522(c)(2) and section 25.2522(c)-3(c), Gift Tax Regs., were applicable to petitioners'

gift to charity, it would appear that petitioners' claimed charitable deduction herein would have been completely disallowable. See the analysis below relating to the deductibility of gifts to charity of partial interests.

The Gift

Petitioners formed MIL as a Texas family limited partnership and made gifts of a portion of their interests therein by way of an assignment agreement and a formula clause which, according to petitioners and the majority opinion, transferred only assignee interests in MIL to four levels of donees, generally as follows:

> First and Second Level (Noncharitable) Donees: Trusts for the benefit of the donors' four children (first level donees) to receive portions of the gifted interest and outright gifts to the donors' four children (second level donees) with an aggregate fair market value on the valuation date up to $6,910,933;
>
> Third Level Donee: If the fair market value of the gifted interest exceeds $6,910,933, Symphony, a charitable donee, to receive such excess up to a maximum value of $134,000;
>
> Fourth Level Donee: If the fair market value of the gifted interest exceeds $7,044,933 ($6,910,933 plus $134,000), CFT, also a charitable donee, to receive such excess without limit.

Focusing on the gift to the fourth level charitable donee (the gift to CFT), petitioners themselves allege (in order to beef up the valuation discounts they seek) and the majority opinion finds, majority op. pp. 19-24, that the gifted MIL partnership interest transferred to CFT included only certain

"economic rights" with regard to the gifted interest and did not consist of all of the donors' rights as limited partners in that particular limited partnership interest. Upon petitioners' transfer and upon CFT's receipt of the gifted interest in the MIL partnership, petitioners retained, and CFT never received, the following rights associated with petitioners' interest in MIL (references are to the MIL amended partnership agreement):

> (1) The right to vote on MIL partnership matters (section 3.10);
>
> (2) The right to redeem the MIL partnership interest (section 9.02(b));
>
> (3) The right to inspect financial and other pertinent information relating to MIL (section 3.09(d)(i)-(v));
>
> (4) The right to access any properties or assets owned by MIL (section 3.09(d)(vi)); and
>
> (5) The right to veto early liquidation of MIL, unless such liquidation is required by State law (section 10.01).

Under section 7.02 of the Texas Revised Limited Partnership Act, a partnership agreement may, but is not required to, limit the partnership rights that may be transferred when a partner transfers or assigns an interest in a partnership. In this case, petitioners made their retention of the above rights (and the nonreceipt thereof by CFT) explicit by the terms of the MIL partnership agreement that they adopted. Section 8.03 of the MIL partnership agreement, discussing the transfer of a limited

partnership interest to an assignee, is set forth, in part, below:

> [A]n Assignee shall be entitled only to allocations of Profits and Losses * * * and distributions * * * which are attributable to the Assigned Partnership Interests held by the Assignee and shall not be entitled to exercise any Powers of Management nor otherwise participate in the management of the Partnership nor the control of its business and affairs. * * *

As explained, the above limitations on the charitable gift transferred by petitioners to CFT are the basis for petitioners' claimed characterization and valuation of the gift to CFT as an assignee interest in MIL, as distinguished from an MIL partnership interest, and (as petitioners themselves contend) they would appear to constitute substantive and significant limitations.

Deductibility of Gifts to Charity of Partial Interests

Generally, and apart from certain specified statutory exceptions noted below, where less than donors' entire interests in property are transferred to charity, the charitable contributions--for Federal gift tax purposes, as well as for Federal income and estate tax purposes--are to be treated as partial interests and any claimed gift, income, and estate tax charitable deductions relating thereto are to be disallowed. See secs. 2522(c)(2) (gift tax disallowance), 170(f)(3) (income tax disallowance), 2055(e)(2) (estate tax disallowance).

Set forth below, in part, is the statutory language of section 2522(c)(2) that, for Federal gift tax purposes, generally disallows charitable deductions for gifts to charity of partial interests:

SEC. 2522(c). Disallowance of Deductions in Certain Cases.--

* * * * * * *

(2) Where a donor transfers an interest in property (other than an interest described in section 170(f)(3)(B)) to a person, or for a use, described in subsection (a) or (b) [qualified charities] and an interest in the same property is retained by the donor, or is transferred or has been transferred (for less than an adequate and full consideration in money or money's worth) from the donor to a person, or for a use, not described in subsection (a) or (b), no deduction shall be allowed under this section for the interest which is, or has been transferred to the person, or for the use, described in subsection (a) or (b) * * *

Treasury regulations applicable to the above statutory provisions provide examples of charitable gifts of partial interests subject to the above disallowance rule. Section 1.170A-7(d), Example (1), Income Tax Regs., treats as a partial interest a gift to charity of the rent-free use of one floor of an office building where the donor owns the entire office building.

Section 20.2055-2(e)(2)(i), Estate Tax Regs., classifies as a partial interest a gift to charity of a reversionary interest in an office building where the decedent transfers to his wife a

life estate in the office building and where the decedent's wife is still living when the reversionary interest passes to charity.

Section 25.2522(c)-3(c)(1)(i), Example (3), Gift Tax Regs., treats as a partial interest a gift to charity of the right to rental income from real property where the remaining interest in the property is transferred to a noncharitable donee.

Other authorities recognize and discuss the above general rule under which charitable deductions are disallowed for gifts to charity of partial interests.

In Stark v. Commissioner, 86 T.C. 243 (1986), we held that a gift to the U.S. Forest Service of real property constituted a partial interest where the donor retained a mineral interest in the real property. The gift to charity, however, of the partial interest was deductible because the particular restricted mineral interest retained by the taxpayer was not regarded as substantial. In interpreting section 170(f)(3) for income tax purposes, we stated that the partial interest rule "applies to contributions [to charity] of less than the taxpayer's entire interest in property, including, but not limited to, contributions of the right to use property." Id. at 250.

In Rev. Rul. 81-282, 1981-2 C.B. 78, it was held that a gift to charity of corporate stock constituted a disallowed partial interest where the donor retains the right to vote the gifted stock (a gift not dissimilar from the gift to CFT of the

nonvoting, assignee interest in the MIL partnership). See also Stewart et al., Charitable Giving and Solicitation, par. 9004 at 9002 (1999), which states that "A donor can run afoul of the partial interest rules by retaining a property interest or right while transferring the primary incidents of ownership to charity."[1]

As indicated previously, for Federal gift, income, and estate tax purposes, certain limited statutory exceptions to the above rule applicable to partial interests are available under which specified types of partial interests transferred to charity will qualify for charitable deductions (namely, certain fixed income transfers to charity and certain remainder interests gifted to charitable annuity trusts, to unitrusts, and to pooled income funds). See secs. 2522(c)(2)(A) and (B) (gift tax), 170(f)(2)(A) and (B) (income tax), 2055(e)(2)(A) and (B) (estate tax). These statutorily qualified forms of deductible partial

[1] Treatises discussing charitable contributions interpret the relevant Code provisions as outlined above, and I have not discerned how the situation involved in the instant case would not be covered by the above Code provisions disallowing a tax deduction for gifts to charity of partial interests. See, e.g., 8 Mertens, Law of Federal Income Taxation, secs. 31:97 to 31:112 (1999 rev.); Beckwith, 839 Tax Mgmt. (BNA), "Estate and Gift Tax Charitable Deductions", secs. V, XI at A-50 (2001); Kirschten & Freitag, 521-2d Tax Mgmt. (BNA), "Charitable Contributions: Income Tax Aspects", sec. II-F (2002); Samansky, Charitable Contributions and Federal Taxes, ch. 8 (1993); Stephens et al., Federal Estate and Gift Taxation, secs. 5.05, 11.02 (8th ed. 2002); Stewart et al., Charitable Giving and Solicitation, pars. 9001-9012, 10,022, 11,012 (1999).

interest charitable gifts are subject to strict guidelines which provide assurance that the charitable deductions to be allowed reflect the approximate amount to be received by charity. See sec. 25.2522(c)-3(d)(2)(iv), Gift Tax Regs.

In addition to the above statutorily qualified forms of deductible partial interests transferred to charity, section 170(f)(3)(B) sets forth a number of other types of partial interest gifts with respect to which charitable deductions are allowable. Under section 170(f)(3)(B), charitable deductions are allowed for gifts not in trust of remainder interests in a personal residence or farm (sec. 170(f)(3)(B)(i)), gifts to charity not in trust of an "undivided portion" of a transferor's entire interest in property (sec. 170(f)(3)(B)(ii)), and qualified conservation contributions (sec. 170(f)(3)(B)(iii)). With regard to charitable gifts of an undivided portion of a transferor's entire interest in property, section 25.2522(c)-3(c)(2)(i), Gift Tax Regs., provides, in part, as follows:

> An undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property * * *.[2] * * *

[2] Parallel provisions for income and estate tax purposes with regard to deductions relating to charitable gifts of an undivided portion of a taxpayer's entire interest in property are set forth in sec. 1.170A-7(b)(1)(i), Income Tax Regs., and sec. 20.2055-2(e)(2)(i), Estate Tax Regs.

In Stark v. Commissioner, supra at 252-253, we explained as follows:

> Where the interest retained by the taxpayer is so insubstantial that he has, in substance, transferred his entire interest in the property, the tax treatment should so reflect. * * *
>
> * * * A charitable contribution deduction should be allowed only where the retained interest has a de minimis value. Moreover, the insubstantial retained interest must not potentially interfere in any manner with the donee's interest. * * * [Citation omitted.]

In Rev. Rul. 81-282, 1981-2 C.B. 78, it was concluded that a taxpayer's retention of a right to vote shares of stock contributed to charity constitutes a substantial right because a right to vote gives the holder a voice in the management of the company and is crucial to protecting a stockholder's financial interest.

In Miami Natl. Bank v. Commissioner, 67 T.C. 793, 800 (1977), (involving the transfer of stock into a subordinated securities account), we concluded that retained voting rights, among others, constitute substantial rights.

Application to McCord

As stated, the retained rights involved in Rev. Rul. 81-282, 1981-2 C.B. 78, appear to be analogous to the rights retained by petitioners herein. By providing in the MIL partnership agreement limitations on transfers of MIL partnership interests and by transferring to CFT only an assignee interest in MIL,

petitioners retained the voting and the other rights in the MIL limited partnership associated with the assignee interest transferred to charity. Because the rights retained by petitioners with regard to their MIL limited partnership interest would be treated as substantial, under section 170(f)(3)(B)(ii) the portion thereof transferred to CFT would appear not to qualify as an undivided portion of petitioners' entire MIL limited partnership interest.

I would reiterate that it is the perceived substantial significance of petitioners' retained rights on which petitioners themselves, petitioners' valuation experts, and the majority opinion rely to justify assignee status and increased valuation discounts for the gifted interest.

It would appear that for the above analysis not to apply to the gift involved in the instant case, petitioners' MIL limited partnership interest would have to be interpreted as consisting of two separate and distinct interests (an economic interest and a noneconomic interest) with petitioners transferring to CFT an undivided portion of the separate economic interest.

I submit that the correct interpretation would be to treat petitioners' MIL limited partnership interest as one interest consisting of both economic and noneconomic rights, with petitioners having transferred to CFT only their economic rights therein. Under this interpretation, it would appear that

petitioners should be regarded as having made a charitable gift to CFT of a partial interest in their MIL limited partnership interest, which charitable gift would be subject to the gift tax disallowance provision of section 2522(c)(2).[3]

[3] I recognize that under the disallowance rule of sec. 2522(c)(2), as suggested herein, petitioners' claimed charitable deduction for their gift to Symphony also would be disallowed as a gift of a partial interest.

CHIECHI, J., concurring in part and dissenting in part: I concur in result with respect to the portions of the majority opinion under the headings "IV. Extent of the Rights Assigned" and "VII. Effect of Children's Agreement To Pay Estate Tax Liability".

I cannot responsibly cast an affirmative vote with respect to the portion of the majority opinion under the heading "V. Fair Market Value of the Gifted Interest". The determination of fair market value is a factual determination and is necessarily a matter of judgment and approximation. See, e.g., Estate of Davis v. Commissioner, 110 T.C. 530, 537 (1998). I am not in a position to state that I agree with every judgment and every approximation made by the majority opinion in determining the fair market value of the gifted interest. Moreover, because valuation is a factual matter and necessarily an approximation and a matter of judgment, I do not believe that the Court is bound in other cases by the judgments and approximations in the majority opinion.

I dissent from the portion of the majority opinion under the heading "VI. Charitable Contribution Deduction for Transfer to CFT" and from the ultimate holding of the majority opinion under the heading "VIII. Conclusion". Although I join Judge Foley's dissent, I write separately to express additional reasons for my

dissent and to emphasize certain of the reasons for Judge Foley's dissent.

I disagree with the following characterization by the majority opinion of what petitioners transferred to CFT under the assignment agreement: "By way of the assignment agreement, petitioners transferred to CFT the right to a portion of the gifted interest." Majority op. p. 61 (emphasis added). Under the assignment agreement, petitioners did not transfer to CFT merely "the right to" a specified portion of the gifted interest. On January 12, 1996, petitioners transferred to CFT the portion of the gifted interest described in that agreement. In other words, on that date, petitioners transferred to CFT that portion, if any, of the 82.33369836-percent assignee interest in MIL remaining after the respective transfers under the assignment agreement to petitioners' children, the trusts, and the Symphony; i.e., that portion of such assignee interest having a fair market value as of the date of that agreement in excess of $7,044,933.

I also disagree with the position of the majority opinion, see majority op. pp. 61-65, that under the assignment agreement petitioners transferred to CFT a 3.62376573-percent assignee interest in MIL. The 3.62376573-percent assignee interest was set forth in the confirmation agreement that was executed in March 1996. The majority opinion does not mention the confirmation agreement but nevertheless requires that agreement

to control for purposes of determining the assignee percentage interest that petitioners transferred under the assignment agreement to CFT (as well as the respective assignee percentage interests that petitioners transferred under the assignment agreement to petitioners' children, the trusts, and the Symphony). The confirmation agreement on which the majority opinion relies was not executed until March 1996, 2 months after the assignment agreement was effective, and is not the controlling donative instrument.

Instead of referring to the confirmation agreement in support of the position that petitioners transferred to CFT a 3.62376573-percent assignee interest in MIL, the majority opinion maintains that there is in effect a valuation instruction in the assignment agreement which mandates that result. According to the majority opinion, pursuant to that purported valuation instruction, the fair market value agreed upon by the donees to determine the assignee percentage interest transferred to CFT (as well as to determine the respective assignee percentage interests transferred to petitioners' children, the trusts, and the Symphony) is fixed and may never change for purposes of determining such interest, even if such value agreed upon by the donees is ultimately determined not to be the fair market value of such interest. The majority opinion concludes that therefore the resulting assignee percentage interest transferred to CFT (as

well as the respective assignee percentage interests transferred to petitioners' children, the trusts, and the Symphony), as set forth in the confirmation agreement, is fixed and may never change.

The assignment agreement does not contain a valuation instruction that requires what the majority opinion indicates that agreement requires. According to the majority opinion, that valuation instruction appears in the following paragraph in the assignment agreement:

> For purposes of this paragraph [the paragraph transferring to petitioners' children, the trusts, the Symphony, and CFT certain portions of the 82.33369836-percent assignee interest in MIL that petitioners transferred under the assignment agreement], the fair market value of the Assigned Partnership Interest [the gifted interest consisting of the 82.33369836-percent assignee interest in MIL] as of the date of this Assignment Agreement shall be the price at which the Assigned Partnership Interest would change hands as of the date of this Assignment Agreement between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Any dispute with respect to the allocation of the Assigned Partnership Interests among Assignees shall be resolved by arbitration as provided in the Partnership Agreement.

As can be seen from reading the foregoing paragraph, the purported valuation instruction consists of a paragraph in the assignment agreement which defines the term "fair market value". Petitioners required the donees to use that definition when they allocated among themselves the respective portions of the gifted interest which petitioners transferred to them under the

assignment agreement. The definition of the term "fair market value" for that purpose is the same definition used for Federal gift tax purposes. See sec. 25.2512-1, Gift Tax Regs. The last sentence of the above-quoted paragraph merely requires that any dispute with respect to the allocation of the gifted interest among the donees be resolved by arbitration as provided in the partnership agreement. Nothing in that paragraph mandates that if the fair market value of the gifted interest to which the various donees agreed is ultimately determined not to be the fair market value of that interest, no adjustment may be made to the respective assignee percentage interests allocated to CFT and the other donees, as set forth in the confirmation agreement. I believe that the majority opinion's construction of the above-quoted paragraph is strained, unreasonable, and improper and leads to illogical results.

In essence, the majority opinion concludes that the donees of the gifted interest made a mistake in determining the fair market value of that interest and that petitioners are stuck with that mistaken value solely for purposes of determining the respective assignee percentage interests transferred to the donees under that agreement.

The majority opinion states that

> the assignment agreement contemplates the allocation of the gifted interest based on the assignees' best estimation of that value. Moreover, each of the assignees' percentage interests was determined

> exactly as contemplated in the assignment agreement (without recourse to arbitration), and none can complain that they got any less or more than petitioners intended them to get. * * * [Majority op. p. 63.]

The assignment agreement does not "contemplate", as the majority opinion states, that the allocation of the gifted interest be "based on the assignees' best estimation of that [fair market] value." Id. Under the assignment agreement, petitioners transferred to the donees specified portions of the gifted interest determined by reference to the fair market value of such portions, as defined in that agreement, and not upon some "best estimation of that value."

The assignment agreement required that the allocation be based upon fair market value as defined in that agreement, which the majority opinion acknowledges is the same definition of that term for Federal gift tax purposes. The majority opinion has found that the donees did not make the allocation on the basis of that definition. The donees thus failed to implement the donors' (i.e., petitioners') mandate in the assignment agreement when they arrived at amounts which they believed to be the respective fair market values of the specified portions of the gifted interest that petitioners transferred to them but which the majority opinion has found are not the fair market values of such portions.

The majority opinion, using the definition of fair market value in the Federal gift tax regulations and the assignment agreement, determines that the fair market value of the gifted interest used by the donees is not the fair market value of such interest. It follows that the assignee percentage interest allocated to CFT in the confirmation agreement in March 1996 (as well as the respective assignee percentage interests allocated in that confirmation agreement to petitioners' children, the trusts, and the Symphony) is not the assignee percentage interest that petitioners transferred in the assignment agreement to that donee on January 12, 1996.

The position of the majority opinion conflicts with the provisions of the assignment agreement as to the respective portions of the gifted interest that petitioners transferred under that agreement to petitioners' children, the trusts, the Symphony, and CFT. Consequently, that position leads to results that are in violation of what petitioners transferred to the donees under that agreement. According to the majority opinion, the aggregate fair market value of the aggregate 77.21280956-percent assignee interests allocated to petitioners' children and the trusts is $9,269,089. Majority op. p. 64. However, under the assignment agreement, petitioners transferred to their children and the trusts portions of the gifted interest having an aggregate fair market value equal to $6,910,933, determined

according to the definition of the term "fair market value" in the assignment agreement, which is the same definition in the Federal gift tax regulations.[1] Thus, the aggregate fair market value of the aggregate assignee percentage interests transferred to petitioners' children and the trusts, as determined by the majority opinion (i.e., $9,269,089), exceeds the aggregate fair market value of such interests that petitioners transferred to those donees in the assignment agreement (i.e., $6,910,933). Such a result is rejected by and violates that agreement.[2]

FOLEY, J., agrees with this concurring in part and dissenting in part opinion.

[1]According to the majority opinion, the fair market value of the 1.49712307-percent assignee interest allocated to the Symphony is $179,724. Majority op. p. 64. However, under the assignment agreement, petitioners transferred to the Symphony a portion of the gifted interest having an aggregate fair market value of at most $134,000, determined according to the definition of the term "fair market value" in the assignment agreement, which is the same definition in the Federal gift tax regulations.

[2]The same is true of the result with respect to the Symphony under the majority opinion's analysis.

FOLEY, J., concurring in part[1] and dissenting in part: Undaunted by the facts, well-established legal precedent, and respondent's failure to present sufficient evidence to establish his determinations, the majority allow their olfaction to displace sound legal reasoning and adherence to the rule of law. The gift closed on January 12, 1996, and on that date petitioners transferred to CFT all of petitioners' assigned partnership interests exceeding $7,044,933 (i.e., the amount exceeding the $6,910,933 transferred to the sons and the trusts plus the $134,000 transferred to the Symphony).

As the trial judge, I concluded that, on January 12, 1996, petitioners transferred a $2,838,899 assignee interest to CFT. On that date, the interest was accepted and received by CFT, and not subject to a condition precedent or subsequent. Sec. 25.2522(c)-3(b)(1), Gift Tax Regs.; see also Commissioner v. Sternberger's Estate, 348 U.S. 187 (1955); Hamm v. Commissioner, T.C. Memo. 1961-347, affd. 325 F.2d 934 (8th Cir. 1963). Furthermore, I concluded that respondent fell woefully short of meeting his burden[2] regarding the applicability of the substance over form, violation of public policy, and reasonable probability

[1] I concur only in result with respect to secs. IV, V(E), and VII(C) of the majority opinion.

[2] The parties agree that respondent, pursuant to sec. 7491, had the burden of proof.

of receipt doctrines.[3] Inexplicably, the majority ignore respondent's primary contentions (i.e., that the substance over form and violation of public policy doctrines are applicable) and base their holding on an interpretation of the assignment agreement that respondent never raised. In section I, I address the majority's holding. In sections II and III, respectively, I address respondent's contentions relating to the substance over form and violation of public policy doctrines.

I. The Majority's Analysis of the Assignment Agreement Is Faulty

The majority begin by stating correctly that the "gift tax is imposed on the value of what the donor transfers, not what the donee receives." Majority op. p. 60. Yet, they then proceed to rely on a tortured analysis of the assignment agreement that is, ostensibly, justification for shifting the determination of transfer tax consequences from the date of the transfer (i.e., January 12, 1996, the date of the assignment setting forth what petitioners transferred) to March 1996 (i.e., the date of the confirmation agreement). The majority's analysis of the assignment agreement requires that petitioners use the Court's valuation to determine the value of the transferred interests, but the donees' appraiser's valuation to determine the percentage

[3] The reasonable probability of receipt doctrine was not one of respondent's primary contentions, but it was referenced in his opening brief.

interests transferred to the charitable organizations. There is no factual, legal, or logical basis for this conclusion.

A. The Gift Was Complete on January 12, 1996

The value of the transferred property and the amount of the transferor's charitable deduction are determined as of the date the gift became complete. Sec. 2512(a). Pursuant to Texas law, the transfer became complete on January 12, 1996, the date petitioners and the donees executed the assignment agreement. In fact, respondent states:

> It is undisputed that the January 12, 1996 Assignment Agreement was executed by competent donors, evidenced the donors' present intent to irrevocably divest themselves of ownership of the partnership interests, delivered to the partnership, and signed and accepted by donees competent to receive such a transfer. Accordingly, the Assignment Agreement effected the present transfer under Texas law of beneficial and legal title to the partnership interests to the donees. (Emphasis added.)

The Court, like petitioners and respondent, is bound by section 2512(a), which requires us to value the property "at the date of the gift" (emphasis added). The charitable donees and the amount allocated to them were specifically identified, and thus ascertainable, upon the execution of the assignment agreement. Respondent readily acknowledges, and petitioners undoubtedly agree, that the January 12, 1996, assignment agreement was "signed and accepted by donees competent to receive such a transfer." Yet, in determining the charitable deduction, the majority rely on the confirmation agreement without regard to

the fact that petitioners were not parties to this agreement, and that this agreement was executed by the donees more than 2 months after the transfer.[4]

The majority state that the property transferred to CFT "was not expressed as a specific fraction of the gifted interest (e.g., one-twentieth), nor did petitioners transfer to CFT a specific assignee interest in MIL (e.g., a 3-percent assignee interest)." Majority op. p. 61. The majority appear to assert, without any authority, that petitioners' charitable deduction cannot be determined unless the gifted interest is expressed in terms of a percentage or fractional share.[5] The assignment agreement specifically identified the transferees and the transferred property. Regardless of how the transferred interest was described, it had an ascertainable value.

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[4] Subsequent events typically do not affect the value of transferred property. See Ithaca Trust Co. v. United States, 279 U.S. 151 (1929); Estate of McMorris v. Commissioner, 243 F.3d 1254 (10th Cir. 2001), revg. T.C. Memo. 1999-82; Estate of Smith v. Commissioner, 198 F.3d 515 (5th Cir. 1999), revg. 108 T.C. 412 (1997); Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982).

[5] This position is reminiscent of previous attempts by respondent to impose a fractional, or percentile, share rule in the marital deduction context--a position that was consistently rejected by the courts and not implemented until Congress amended sec. 2056 to conform with respondent's position. See sec. 2056(b)(5), (7) and (10); Northeastern Pa. Natl. Bank & Trust Co. v. United States, 387 U.S. 213 (1967); James v. United States, 366 U.S. 213 (1961); Estate of Alexander v. Commissioner, 82 T.C. 34 (1984), affd. without published opinion 760 F.2d 264 (4th Cir. 1985).

Accordingly, pursuant to section 2501, the entire $9,883,832 transfer is subject to gift tax, and a charitable deduction is allowed for the $2,972,899 (i.e., $9,883,832 - $6,910,933) transferred to or for the use of the Symphony and CFT. Sec. 2522. CFT's retention of a much smaller interest (i.e., 3.62376573 percent) than what petitioners transferred to it has no effect on the value of the transferred property on the date the gift became complete.[6]

B. Determination by the Donees Does Not Bind This Court

The majority conclude that petitioners may deduct the $2,838,899 (i.e., $9,883,832 - $7,044,933) transferred to CFT on January 12, 1996, only if the agreement gave each donee "an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes". Majority op. p. 63 (emphasis added). Simply put, the majority are wrong.

First, a $2,838,899 MIL interest was transferred to or for the use of CFT. In their fervor to reject this transaction, the

[6] CFT's subsequent transfer of MIL interests may have conferred an impermissible private benefit on petitioners' sons. See Am. Campaign Acad. v. Commissioner, 92 T.C. 1053 (1989)(holding that conferral of a benefit on an unrelated person may constitute an impermissible private benefit). The deduction pursuant to sec. 2522 is not allowed for a transfer to an organization unless such organization is operated exclusively for one or more of its charitable purposes. Sec. 25.2522(a)-1(b), Gift Tax Regs. Respondent, however, did not raise, or present any evidence relating to, this issue.

majority assert a line of analysis that is contrary to both the established facts and respondent's litigating position. Pursuant to the assignment agreement, the gift closed, and beneficial and legal title to the assigned interest was transferred to CFT on January 12, 1996. Respondent contends that, irrespective of when the gift closed, the Court must ignore all intermediate steps and focus on the end result (i.e., the cash received in redemption). The majority sidestep the assignment agreement and redemption, and focus on the allocation in the confirmation agreement.

Second, the majority cite regulations that are inapplicable to petitioners' transfer. See sec. 1.664-2(a)(1)(iii), Income Tax Regs. (relating to charitable remainder annuity trusts); sec. 20.2055-2(e)(2)(v) and (vi)(a), Estate Tax Regs. (relating to guaranteed annuity interests), and 25.2702-3(b)(1)(ii)(B) and (b)(2), Gift Tax Regs. (relating to qualified annuity interests). Majority op. pp. 63-64 note 46. The deductibility of all transfers to charities is not governed by these requirements.

Third, as the majority acknowledge, petitioners transferred to the donees "a fraction of the gifted interest based on the value of that interest as determined under Federal gift tax valuation principles." Majority op. p. 62. There is no material difference between fair market value "as determined under Federal gift tax valuation principles" and fair market value "as finally determined for Federal gift tax purposes". Once this Court's

jurisdiction is properly invoked, the fair market value of any property is what this Court determines it is, and a determination relating to a charitable deduction pursuant to section 2522 requires use of the Court's fair market value of the transferred property. Our determination of fair market value is both fair market value under gift tax principles and as finally determined for Federal gift tax purposes. Moreover, had petitioners' assignment agreement included the magical words "as finally determined for Federal gift tax purposes", the majority assert only that they "might have reached a different result." Majority op. p. 63.

Fourth, the majority state:

> There is simply no provision in the assignment agreement that contemplates the allocation of the gifted interest among the assignees based on some fixed value that might not be determined for several years. Rather, the assignment agreement contemplates the allocation of the gifted interest based on the assignees' best estimation of that value. [Majority op. pp. 62-63.]

The fact is, the assignment agreement effected the transfer of an assignee interest. Petitioners' assignment agreement could not, and does not, limit the Court's ability to correctly determine the fair market value of such interest. Nor could the assignment agreement mandate that the donees' determination of fair market value is conclusive and final for gift tax purposes.

Finally, unlike respondent, who contends that the charitable deduction is limited to the $338,967 CFT received in the

redemption, the majority seek to restrict petitioners' charitable deduction to the $435,019 interest (i.e., 3.62376573 percent) CFT retained pursuant to the confirmation agreement. In essence, the reasoning set forth by the majority borrows from both the integrated transaction and violation of public policy doctrines. The majority's disregard of the transfer of property interests pursuant to the assignment agreement, and focus on the allocation of interests pursuant to the confirmation agreement, implicates the integrated transaction doctrine. Similarly, the majority's refusal to adhere to the explicit terms of the assignment agreement implicates the violation of public policy doctrine.

II. Respondent Did Not Establish Applicability of the Substance Over Form Doctrine

Respondent contended that formation of the limited partnership, assignment of partnership interests, confirmation of the assignment, and redemption of the charities' partnership interests were all part of an integrated transaction where petitioners intended to transfer all of their assets to their sons and the trusts. Respondent simply failed to meet his burden.

Courts have employed the substance over form doctrine where a taxpayer, intending to avoid the gift tax, transfers property to an intermediary who then transfers such property to the intended beneficiary.[7] In some instances the intermediary was

[7] The Court of Appeals for the Fifth Circuit and other (continued...)

used to disguise the transferor. See Schultz v. United States, 493 F.2d 1225, 1226 (4th Cir. 1974) (finding that brothers planned to avoid gift taxes through repeated reciprocal gifts to each others' children); Griffin v. United States, 42 F. Supp.2d 700, 707 (W.D. Tex. 1998) (finding that husband and wife engaged in a scheme where the wife "was merely the intermediary through which the stock passed on its way to the ultimate beneficiary"); Estate of Murphy v. Commissioner, T.C. Memo. 1990-472 (disregarding an intrafamily stock transfer where the Court found an informal family agreement to control the stock collectively). In Heyen v. United States, 945 F.2d 359 (10th Cir. 1991) (disregarding as shams 27 transfers of stock to intermediate beneficiaries who then transferred the stock to the original transferor's family), however, the intermediary was used in an attempt to disguise the transferee. Respondent, relying on Heyen, asserts that the Symphony and CFT were merely intermediaries in petitioners' plan to transfer their MIL interests to their sons and the trusts.

In Heyen, a taxpayer, seeking to avoid the gift tax by taking advantage of the annual gift tax exclusion, transferred stock to 29 intermediate recipients, all but two of whom made

[7](...continued)
courts have been reluctant to use substance over form in certain cases involving completed gifts to charity. E.g., Carrington v. Commissioner, 476 F.2d 704 (5th Cir. 1973) (holding, in an income tax case, that where respondent seeks to use the step transaction doctrine to disregard a donation of appreciated property to a charitable organization, the central inquiry is whether the donor parted with all dominion and control), affg. T.C. Memo. 1971-222.

blank endorsements of the stock, which the issuing bank subsequently reissued to the intended beneficiaries. The court stated:

> The [intermediate] recipients either did not know they were receiving a gift of stock and believed they were merely participating in stock transfers or had agreed before receiving the stock that they would endorse the stock certificates in order that the stock could be reissued to decedent's family. [Id. at 361.]

The court further stated:

> The evidence at trial indicated decedent intended to transfer the stock to her family rather than to the intermediate recipients. The intermediary recipients only received the stock certificates and signed them in blank so that the stock could be reissued to a member of decedent's family. Decedent merely used those recipients to create gift tax exclusions to avoid paying gift tax on indirect gifts to the actual family member beneficiaries. [Id. at 363.]

In order for us to ignore petitioners' allocation in the assignment agreement, respondent must establish that petitioners coordinated, and the charities colluded in or acquiesced to, a plan to avoid petitioners' gift taxes by undervaluing the transferred interests and intended to divert CFT's interest to their sons and the trusts. See Heyen v. United States, supra; Schultz v. United States, supra; Griffin v. United States, supra; Estate of Murphy v. Commissioner, supra. Respondent did not present the requisite evidence for us to invoke the substance over form doctrine.

Respondent stated on brief that, after execution of the assignment agreement, petitioners "washed their hands" of the

transaction, and the donees took over. Petitioners' sons' involvement in the subsequent allocation of the transferred interests does not affect the petitioners' gift tax liability, particularly in the absence of a showing that petitioners retained some control over the subsequent allocation. See sec. 25.2511-2(a), Gift Tax Regs. (stating that the gift tax is measured by the value of the property passing from the donor). Petitioners' sons and the estate planner made all the arrangements relating to the valuation. This Court, however, will not impute to petitioners an intent to avoid the gift tax merely from the appraiser's valuation of the transferred partnership interests, the sons' involvement in the planning process, or the hiring of an estate planner charged with tax minimization. See Estate of Strangi v. Commissioner, 115 T.C. 478, 484-485 (2000) ("Mere suspicion and speculation about a decedent's estate planning and testamentary objectives are not sufficient to disregard an agreement in the absence of persuasive evidence"), revd. on other grounds 293 F.3d 279 (5th Cir. 2002); Hall v. Commissioner, 92 T.C. 312 (1989).

Respondent failed to establish that the Symphony or CFT participated, knowingly or otherwise, in a plan to facilitate petitioners' purported avoidance of gift tax. Indeed, the testimony and evidence established that the Symphony and CFT acted independently. CFT did not hire its own appraiser because it had confidence in the appraiser hired by petitioners' sons. While in hindsight (i.e., after this Court's valuation) it was

imprudent for the charitable organizations to forgo an independent appraisal,[8] these organizations were not sham intermediaries. Prior to signing the confirmation agreement, the Symphony and CFT could have independently valued MIL, forced arbitration, and thwarted any purported plan to avoid the gift tax. Cf. Compaq v. Commissioner, 277 F.3d 778, 784 (5th Cir. 2001) (declining, in an income tax case, to disregard a transaction that involved even a minimal amount of risk and was conducted by entities separate and apart from the taxpayer), revg. 113 T.C. 214 (1999).

There is no evidence of an implicit or explicit agreement, between petitioners and either the Symphony or CFT, that the Symphony or CFT would accept less than that which petitioners transferred to each organization. In fact, respondent stipulated that "Before the call right was exercised, there was no agreement among Mr. or Mrs. McCord, the McCord brothers, the Symphony or CFT as to when such a buyout would occur or to the price at which the buyout would occur."

In sum, respondent failed to establish that the undervaluation of MIL, reallocation of MIL interests, and

[8] Ms. Willhoite, president of the Symphony, and Mr. Fjordback, president of CFT, each had an obligation to ensure receipt of the property interests petitioners transferred to the Symphony and CFT, respectively. See Tex. Socy. DAR, Inc. v. Ft. Bend Chapter, 590 S.W.2d 156, 164 (Tex. Civ. App. 1979), (citing Intl. Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567 (Tex. Sup. Ct. 1963)); see also Texas Non-Profit Corporation Act, Tex. Rev. Civ. Stat. art. 1396-2.22 (2002).

subsequent transfer of a portion of CFT's MIL interest to the sons and the trusts, were parts of a plan by petitioners to avoid the gift tax. CFT's retention of a much smaller interest (i.e., 3.62376573 percent) than petitioners transferred, pursuant to the assignment agreement, has no effect on the value of the transferred property on January 12, 1996, the date the gift became complete.

III. Formula Clause Does Not Violate Public Policy

Relying primarily on Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), respondent contended that petitioners' formula clause was against public policy, and therefore void, because such clause "is a 'poison pill' created to discourage audit of the gifts and to fabricate phantom charitable gift and income tax deductions."

In Commissioner v. Procter, supra, the court considered a clause causing a gift to revert to the donor if a court determined that the gift was taxable. The court held that such a clause "is clearly a condition subsequent and void because contrary to public policy." Id. at 827. The court reasoned that the clause would discourage the collection of tax because attempted collection would defeat the gift, the clause would "obstruct the administration of justice by requiring the courts to pass upon a moot case", and the clause, if allowed to stand, would defeat the judgment of a court. Id. Likewise, in Ward v. Commissioner, 87 T.C. 78 (1986), a clause allowed the taxpayer to

revoke a gift of stock if it was determined that, for gift tax purposes, the fair market value of such stock exceeded $2,000 per share. The Court similarly concluded that such a clause was a condition subsequent and void because it was against public policy.

Contrary to the valuation clauses in Commissioner v. Procter, supra, and Ward v. Commissioner, supra, which adjusted the amount transferred based upon a condition subsequent, petitioners' valuation clause defined the amount of property transferred. Simply put, petitioners' gift does not fail upon a judicial redetermination of the transferred property's value. Petitioners made a legally enforceable transfer of assignee interests to CFT, with no provision for the gift to revert to petitioners or pass to any other party on the occurrence of adverse tax consequences. CFT merely failed to protect its interest adequately. Procter and Ward are distinguishable. Petitioners' formula clause was not against public policy.

IV. Conclusion

The majority seek to restrict petitioners' charitable deduction to that which CFT accepted in the confirmation agreement. The parties agree that the gift closed upon the execution of the assignment agreement. At that moment, petitioners transferred and CFT had a $2,838,899 MIL interest. CFT waived its arbitration rights, and petitioners did not participate in the subsequent allocation. Whether CFT failed to

adequately protect its interest or was swindled by petitioners' sons does not affect the value of what petitioners transferred to CFT.

The majority prudently avoid using the substance over form, violation of public policy, or realistic possibility of receipt doctrines as support for their holding. The majority, however, disregard the assignment agreement, other established facts, and applicable case law in order to support a line of analysis and conclusion that even respondent did not advocate. We are not responsible for protecting the fisc. Rather, our role and duty are to interpret and adhere to the rule of law–-even if uncomfortable with the result.

CHIECHI, J., agrees with this concurring in part and dissenting in part opinion.

LARO, J., dissenting: A thin majority holds today that "each petitioner is entitled to a charitable contribution deduction under section 2522 of $207,510 resulting from the transfer to CFT [Communities Foundations of Texas, Inc.]." Majority op. at 65. Each petitioner reported for that transfer a charitable deduction of $162,172.60, and CFT is not entitled to enjoy any funds in excess of that amount. In that the majority respects the subject transaction and allows each petitioner to deduct a charitable contribution of approximately $45,000 for value that a charity will never enjoy, I dissent.

1. Majority Applies Its Own Approach

To reach the result that the majority desires, the majority decides this case on the basis of a novel approach neither advanced nor briefed by either party and concludes that the Court need not address respondent's arguments as to public policy and integrated transaction. Majority op. p. 64 note 47. Specifically, under the majority's approach (majority's approach), the term "fair market value" as used in the assignment agreement denotes simply the value ascertained by the parties to that agreement (or, in certain cases by an arbitrator) and not the actual amount determined under the firmly established hypothetical willing buyer/hypothetical willing seller test that has been a fundamental part of our Federal tax system for decades on end. Majority op. p. 64 note 47; see also United States v. Cartwright, 411 U.S. 546, 550-551 (1973) ("The willing buyer-

willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves"). Whereas the majority ostensibly recognizes that firmly established test in its determination of the fair market value of the subject property, majority op. p. 64 note 46, the majority essentially holds that the parties to the assignment agreement are not bound by that test when they themselves ascertain the fair market value of that property, id. at 61-64.

As I understand the majority's rationale, the parties to the assignment agreement are not bound by that test because the assignment agreement only uses the phrase "fair market value" and not the phrase "fair market value as finally determined for Federal gift tax purposes". To my mind, the subject property's fair market value is its fair market value, notwithstanding whether fair market value is ascertained by the parties or "finally determined for Federal gift tax purposes". I know of nothing in the tax law (nor has the majority mentioned anything) that provides that property such as the subject property may on the same valuation date have one "fair market value" when "finally determined" and a totally different "fair market value" if ascertained beforehand.[1] The majority's interpretation of the

[1] The three regulatory provisions relied upon by the majority (majority op. p. 64 note 46) in support of its position do not adequately support that position. Sec. 1.664-2(a)(1)(iii), Income Tax Regs., for example, uses the phrase

(continued...)

assignment agreement is at odds with the interpretation given that agreement by not only the trial Judge, but by both parties as well.

The majority allows petitioners an increased charitable contribution that would be disallowed under either the public policy or integrated transaction doctrine. In that both of these doctrines are fundamental to a proper disposition of this case, it is incumbent upon the Court to address one or both of them. The majority inappropriately avoids discussion of these doctrines by relying on the principle that the Court "may approve a deficiency on the basis of reasons other than those relied upon by the Commissioner". Majority op. p. 64 note 47. The majority, however, fails to recognize that the majority is not approving respondent's deficiency in full but is rejecting a portion of it. In fact, the majority even acknowledges that "the application of respondent's integrated transaction theory would result in an initial increase in the amount of petitioners' aggregate taxable gift by only $90,011". Id. Whereas the majority attempts to downsize the significance of a $90,011 adjustment by recharacterizing it as "only" and "less than 1 percent", id., the fact of the matter is that the dollar magnitude of a $90,011

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[1](...continued)
"fair market value * * * incorrectly determined by the fiduciary" to refer to an earlier determination of fair market value that is inconsistent with the fair market value "finally determined for Federal tax purposes".

increase is significant to the fisc (as well as to most people in general) notwithstanding that it may constitute a small percentage of the aggregate taxable gift as found by the majority.[2] I know of no principle of tax law (nor has the majority cited one) that provides that an adjustment otherwise required by the tax law is inappropriate when it is a small percentage of a base figure such as aggregate taxable gifts.

2. Increased Charitable Deduction Is Against Public Policy

Allowing petitioners to deduct as a charitable contribution the increase in value determined by the Court is against public policy and is plainly wrong. No one disputes that CFT will never benefit from the approximately $45,000 that each petitioner is entitled to deduct as a charitable contribution pursuant to the majority opinion. Nor does anyone dispute that the only persons benefiting from the increased value are petitioners and that the only one suffering any detriment from the increased value is the fisc. I do not believe that Congress intended that individuals such as petitioners be entitled to deduct charitable contributions for amounts not actually retained by a charity. See Hamm v. Commissioner, T.C. Memo. 1961-347 (charitable contribution under sec. 2522 requires "a reasonable probability

[2] The majority does not state what the $90,011 is less than 1 percent of. I believe the majority is referring to the relationship of the $90,011 to the aggregate taxable gift as found by the majority.

that the charity actually will receive the use and benefit of the gift, for which the deduction is claimed"), affd. 325 F.2d 934 (8th Cir. 1963).

I would deny a charitable deduction for the increased value by applying to this case a public policy doctrine that is similar to the doctrine applied by the Courts in Commissioner v. Procter, 142 F.2d 824, 827 (4th Cir. 1944), revg. on other grounds a Memorandum Opinion of this Court, and Ward v. Commissioner, 87 T.C. 78 (1986). In Commissioner v. Procter, supra, the taxpayer transferred certain property interests to a trust benefiting his children. The trust instrument provided that, if a competent Federal court of last resort should find any part of the transfer to be subject to gift tax, then that portion of the property subject to such tax would not be considered to have been transferred to the trust. The Court of Appeals for the Fourth Circuit declined to respect this adjustment provision. The court stated:

> We do not think that the gift tax can be avoided by any such device as this. Taxpayer has made a present gift of a future interest in property. He attempts to provide that, if a federal court of last resort shall hold the gift subject to gift tax, it shall be void as to such part of the property given as is subject to the tax. This is clearly a condition subsequent and void because contrary to public policy. A contrary holding would mean that upon a decision that the gift was subject to tax, the court making such decision must hold it not a gift and therefore not subject to tax. Such holding, however, being made in a tax suit to which the donees of the property are not parties, would not be binding upon them and they might later enforce

> the gift notwithstanding the decision of the Tax Court. It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained. [Id. at 827. * * *]

The court also noted that the adjustment clause was contrary to public policy because: (1) Public officials would be discouraged from attempting to collect the tax since the only effect would be to defeat the gift; (2) the adjustment provision would tend to obstruct the administration of justice by requiring the court to address a moot case; and (3) the provisions should not be permitted to defeat a judgment rendered by the court. Id.

We followed Procter in Ward v. Commissioner, supra. In Ward, the taxpayers, husband and wife, each transferred 25 shares of stock to each of their three sons. At the time of the gifts, the taxpayers and their sons executed a "gift adjustment agreement" that was intended to ensure that the taxpayers' gift tax liability for the stock transfers would not exceed the unified credit against gift tax that the taxpayers were entitled to at that time. Id. at 87-88. The agreement stated that, if it should be finally determined for Federal gift tax purposes that the fair market value of the transferred stock either was less than or greater than $2,000 per share, an adjustment would be made to the number of shares conveyed so that each donor would have transferred $50,000 worth of stock to each donee. Id. We concluded that the fair market value of the stock exceeded $2,000 per share for each of the relevant years. Id. at 109.

More importantly, we declined to give effect to the gift adjustment agreement. We noted that honoring the adjustment agreement would run counter to the policy concerns articulated in Commissioner v. Procter, supra. Ward v. Commissioner, supra at 113. We also concluded that upholding the adjustment agreement would result in unwarranted interference with the judicial process, stating:

> Furthermore, a condition that causes a part of a gift to lapse if it is determined for Federal gift tax purposes that the value of the gift exceeds a given amount, so as to avoid a gift tax deficiency, involves the same sort of "trifling with the judicial process" condemned in Procter. If valid, such condition would compel us to issue, in effect, a declaratory judgment as to the stock's value, while rendering the case moot as a consequence. Yet, there is no assurance that the petitioners will actually reclaim a portion of the stock previously conveyed to their sons, and our decision on the question of valuation in a gift tax suit is not binding upon the sons, who are not parties to this action. The sons may yet enforce the gifts. [Id. at 114.]

Here, CFT receives no benefit from the Court-determined increase in the value of the subject property, but petitioners benefit in that they are entitled to an additional charitable deduction. As was true in Commissioner v. Procter, supra, the possibility of an increased charitable deduction serves to discourage respondent from collecting tax on the transaction because any attempt to enforce the tax due on the transaction is of no advantage to the fisc.

3. Each Step of the Transaction Is Part of an Integrated Transaction

All of the steps which were taken to effect the transfer of petitioners' partnership interests to their sons (inclusive of the trusts) were part of a single integrated transaction. The purpose of that transaction was to transfer the interests with an avoidance of Federal gift taxes, while, at the same time, discouraging audit of the transfer and manufacturing phantom charitable gift and income tax deductions in the event that the value of the transfer was later increased. I reach my conclusion in light of the following facts which were found by the trial judge or are reasonable inferences therefrom: (1) Petitioners were seeking expert advice on the transfer of their wealth with minimal tax consequences, (2) the transaction contemplated that the charities would be out of the picture shortly after the gift was made, (3) the transfers of the partnership interests to the charities were subject to a call provision that could be exercised at any time, (4) the call provisions were exercised almost contemporaneously with the transfers to the charities, (5) the call price was significantly below fair market value, (6) the charities never obtained a separate and independent appraisal of their interests (including whether the call price was actually the fair market value of those interests), (7) neither charity ever had any managerial control over the partnership, (8) the charities agreed to waive their arbitration

rights as to the allocation of the partnership interests, and (9) petitioners' sons were at all times in control of the transaction. I also query as to this case why a charity would ever want to receive a minority limited partnership interest, but for an understanding that this interest would be redeemed quickly for cash, and find relevant that the interest was subject to the call provision that could be exercised at any time.

4. Conclusion

The majority has placed its stamp of approval on a transaction that not only is a prime example of clear taxpayer abuse but has as its predominant (if not sole) purpose the avoidance of Federal taxes. The majority has done so either because it does not recognize the abuse or, more likely, that it feels impotent to stop the abuse. The majority has gone as far as to condone taxpayer-abusive behavior by allowing petitioners to deduct a charitable contribution for amounts which will never benefit a charity. For these and the other reasons stated herein, I dissent.

VASQUEZ, J., agrees with this dissenting opinion.

Full Text of Court Cases

McSparron v. McSparron

Case name: McSparron v. McSparron
Citation: 662 N.E.2d 745,1995 N.Y. LEXIS 4451
Date of decision: December 7, 1995
Country: US
State or Federal: State
State/Jurisdiction: New York
Court: Supreme Court
Type of action: Marital Dissolution
Judge: Titone
SIC: 8111 Legal Services
NAICS: 541110 Offices of Lawyers
44

COUNSEL:

Jerome K. Frost, P. C., Troy (Joel R. Brandes and Jerome K. Frost of counsel), for appellant. I. As a consequence of defendant's limited notice of appeal and his presentation of evidence of the value of his law license at trial, the court below lacked jurisdiction to determine defendant's cross appeal from that part of the judgment that valued his law license in the amount requested by him and distribute its value to him. (Hecht v City of New York, 60 NY2d 57, 467 N.Y.S.2d 187, 454 N.E.2d 527; Royal v Brooklyn Union Gas Co., 122 AD2d 132, 504 N.Y.S.2d 519; Christian v Christian, 55 AD2d 613, 389 N.Y.S.2d 136; Nemia v Nemia, 124 AD2d 407, 507 N.Y.S.2d 768.) II. The Court should overrule the holding of O'Brien v O'Brien 66 NY2d 576, 498 N.Y.S.2d 743, 489 N.E.2d 712 [1985]) that a professional license earned during a marriage constitutes marital property to be evaluated for equitable distribution. (Elkus v Elkus, 169 AD2d 134, 572 N.Y.S.2d 901; Golub v Golub, 139 Misc 2d 440, 527 N.Y.S.2d 946; Martin v Martin, 200 AD2d 304, 614 N.Y.S.2d 775.) III. If the Court does not overrule O'Brien, it should limit its application to the working spouse/student spouse scenario, and not apply it to this case. (Perri v Perri, 97 AD2d 399, 467 N.Y.S.2d 226.) IV. Defendant failed to establish the value of plaintiff's medical license. V. Either defendant's license or his career is a marital asset subject to equitable distribution. (Marcus v Marcus, 137 AD2d 131; Finocchio v Finocchio, 162 AD2d 1044, 556 N.Y.S.2d 1007; DiCaprio v DiCaprio, 162 AD2d 944, 556 N.Y.S.2d 1011; Elkus v Elkus, 169 AD2d 134, 572 N.Y.S.2d 901; Phelps v Phelps, 199 AD2d 608, 604 N.Y.S.2d 339; Martin v Martin, 200 AD2d 304, 614 N.Y.S.2d 775; Maher v Maher, 196 AD2d 530, 601 N.Y.S.2d 165.) VI. Under the totality of circumstances of this case, defendant should not be awarded any interest in plaintiff's medical license. (Morrongiello v Paulsen, 195 AD2d 594, 601 N.Y.S.2d 121; Musumeci v Musumeci, 133 Misc 2d 139, 506 N.Y.S.2d 629; Duspiva v Duspiva, 181 AD2d 810, 581 N.Y.S.2d 376; McAlpine v McAlpine, 176 AD2d 285, 574 N.Y.S.2d 385; Savasta v Savasta, 146 Misc 2d 101.) VII. The predominating and pervasive factor governing equitable distribution in this case is the fact that gifts from plaintiff's parents, particularly plaintiff's mother, constitute the

source of the vast bulk of the marital estate. Given with the intent primarily to benefit plaintiff, the number and magnitude of these gifts dictate that the bulk of marital property be awarded plaintiff. (Ackley v Ackley, 100 AD2d 153, 472 N.Y.S.2d 804; Arvantides v Arvantides, 64 NY2d 1033, 489 N.Y.S.2d 58, 478 N.E.2d 199; Guarnier v Guarnier, 155 AD2d 744, 547 N.Y.S.2d 455; Zacharek v Zacharek, 116 AD2d 1004, 498 N.Y.S.2d 625; Palmer v Palmer, 156 AD2d 651, 549 N.Y.S.2d 148; Kobylack v Kobylack, 111 AD2d 221, 489 N.Y.S.2d 257; Barnes v Barnes, 106 AD2d 535, 483 N.Y.S.2d 358; Michalek v Michalek, 114 AD2d 655, 494 N.Y.S.2d 487; Kawasaki v Kasting, 124 AD2d 1034, 508 N.Y.S.2d 762; Vogel v Vogel, 156 AD2d 671, 549 N.Y.S.2d 438.) VIII. The trial court erred in terminating defendant's obligation to pay spousal maintenance. (Miklowitz v Miklowitz, 79 AD2d 795, 435 N.Y.S.2d 116; Matter of Kronenberg v Kronenberg, 101 AD2d 951, 475 N.Y.S.2d 638; Matter of Doscher v Doscher, 80 A.D.2d 945, 54 N.Y.2d 655; People v De Leo, 185 AD2d 374, 585 N.Y.S.2d 629; Blinderman v Blinderman, 80 AD2d 907, 437 N.Y.S.2d 404; Matter of Knights v Knights, 71 NY2d 865, 527 N.Y.S.2d 748, 522 N.E.2d 1045; Romanous v Romanous, 181 AD2d 872, 581 N.Y.S.2d 410; Hickland v Hickland, 39 NY2d 1, 382 N.Y.S.2d 475, 346 N.E.2d 243; Alfano v Alfano, 151 AD2d 530, 542 N.Y.S.2d 313; Matter of Moore v Moore, 115 AD2d 894, 496 N.Y.S.2d 583.) IX. The court below erred in awarding plaintiff, as part of her equitable distribution, her mother's bonds. (Hull v Littauer, 162 NY 569, 57 N.E. 102; Jarrett v Madifari, 67 AD2d 396, 415 N.Y.S.2d 644.)

Friedman and Manning, P. C., Delmar (Michael P. Friedman and Stephen L. Molinsek of counsel), for respondent. I. Defendant's license to practice law has merged into his career as a public servant and his career has no value for purposes of equitable distribution. (O'Brien v O'Brien, 66 NY2d 576, 498 N.Y.S.2d 743, 489 N.E.2d 712; Maher v Maher, 196 AD2d 530, 601 N.Y.S.2d 165; Marcus v Marcus, 137 AD2d 131; Parlow v Parlow, 145 Misc 2d 850, 548 N.Y.S.2d 373; Burns v Burns, 84 NY2d 369, 618 N.Y.S.2d 761, 643 N.E.2d 80; Elkus v Elkus, 169 AD2d 134, 572 N.Y.S.2d 901.) II. Defendant established his entitlement to a share of plaintiff's medical license. III. Defendant has established the value of plaintiff's medical license and degree. (Maloney v Maloney, 137 AD2d 666, 524 N.Y.S.2d 758; Bugliari v Bugliari, 169 AD2d 697, 564 N.Y.S.2d 186.) IV. The court below properly terminated defendant's maintenance obligation to plaintiff. (Dowdle v Dowdle, 114 AD2d 699, 494 N.Y.S.2d 548; Schnoor v Schnoor, 189 AD2d 809, 592 N.Y.S.2d 460; Anglin v Anglin, 148 AD2d 833, 538 N.Y.S.2d 668.) V. The trial court correctly held that bearer bonds in the parties' safety deposit box were marital property. (Sarafian v Sarafian, 140 AD2d 801, 528 N.Y.S.2d 192; Lischynsky v Lischynsky, 120 AD2d 824, 501 N.Y.S.2d 938; Di Nardo v Di Nardo, 144 AD2d 906, 534 N.Y.S.2d 25; Brown v Brown, 148 AD2d 377, 538 N.Y.S.2d 945.) VI. The court below properly determined that gifts received from plaintiff's mother were marital assets subject to equitable distribution. (Carney v Carney, 202 AD2d 907, 609 N.Y.S.2d 425; Graham v Graham, 175 AD2d 540, 572 N.Y.S.2d 800.) VII. The Court has jurisdiction to review the disposition of defendant's law license.

JUDGES:

Chief Judge Kaye and Judges Simons, Bellacosa, Smith and Ciparick concur; Judge Levine taking no part.

OPINIONBY:

TITONE

OPINION:

Titone, J.

In O'Brien v O'Brien (66 N.Y.2d 576, 498 N.Y.S.2d 743, 489 N.E.2d 712), this Court held that a professional license acquired two months before the commencement of the matrimonial action was marital property subject to equitable distribution under Domestic Relations Law § 236 (B). Since that decision, the courts of this State have struggled with the problems involved in distributing the value of older professional licenses that have been utilized in the development of their holders' careers. The primary question presented by this appeal is whether a license that has been exploited by the licensee to establish and maintain a career may be deemed to have "merged" with the career and thereby lost its character as a separate distributable asset. D1I

The parties were married in 1969. At the time of their marriage, both parties had undergraduate college degrees and neither possessed any appreciable assets. Defendant husband attended law school during the first three years of the marriage, gaining admission to the Bar in 1973. He thereafter practiced law and was earning an annual salary of $ 97,000 as a Deputy First Assistant Attorney-General when the parties separated in mid-1989.

Plaintiff wife acquired a master's degree in psychology during the early years of her marriage. Over the next 12 to 13 years, she worked as a school psychologist, taking time off occasionally to care for the couple's children or to attend graduate school. In 1984, plaintiff began attending medical school. She graduated in 1988 and, after completing a one-year internship, she received a license to practice medicine in July of 1989. Plaintiff commenced this matrimonial action on September 1, 1989, four months before the completion of her second internship.

By a judgment of divorce dated October 1, 1991, the Supreme Court awarded each party custody of one of the couple's two children. Defendant was ordered to pay child support and weekly maintenance and the marital property was divided equally between the parties. In determining the total value of the marital estate, the court included the value of each party's professional license as measured by the increased earning capacity it represented: $ 529,363 for defendant's law license and $ 903,406 for plaintiff's medical license. The marital estate was then divided so that each party retained the value of his or her license and pension interest. The marital residence was to be sold and the proceeds distributed equally. The other marital assets, including vehicles, investments and vacation property were also distributed. Both parties then appealed from the portions of the judgment that they deemed objectionable.

The Appellate Division modified in several important respects. On defendant's appeal, the Court held that defendant's law license should not have been treated as separate marital property available for equitable distribution because it had "long since merged into [defendant's] professional career" and was not " 'an asset ... possess[ing] an independent identity for the purpose of computing appreciation' " (190 A.D.2d 74, 81, quoting Kalisch v Kalisch, 184 A.D.2d 751, 752, 585 N.Y.S.2d 476). Several of plaintiff's arguments regarding the distribution of marital property were rejected, but the Court agreed with her contention that her medical license had been overvalued. Based on these and other perceived problems in the divorce judgment, the Appellate Division reversed and remitted to the Supreme Court for a redistribution of the marital assets as well as for a modification of the conditions imposed in connection with defendant's visitation rights.

On the remand, Supreme Court redistributed the marital property in accordance with the Appellate Division's decision. The court also granted a defense motion to eliminate defendant's prospective maintenance because of his recent job loss. Defendant had applied for relief from his maintenance obligation during the pendency of the appeal to the Appellate Division after plaintiff had appeared at a press conference and accused him of engaging in criminal activity. The acknowledged purpose of this press conference was to embarrass defendant's employer, the then-State Attorney-General, who was campaigning for a different office. As a result of these accusations, defendant was forced to resign from his position and had been unable to find new employment. The court found that defendant's job loss was not a self-imposed hardship and that, in view of plaintiff's current annual income, defendant should not be obliged to continue paying her maintenance. Plaintiff then took a second appeal.

On that appeal, the Appellate Division affirmed, rejecting plaintiff's contentions regarding the elimination of her maintenance and the purported one-sidedness of the redistribution of marital property. The Court also declined either to exclude plaintiff's medical license from the marital estate or to reconsider its earlier conclusion that defendant's law license was improperly included. Plaintiff took the present appeal by permission of this Court.

II.

Initially, we reject plaintiff's arguments regarding the inclusion of her own medical license as an item of marital property available for equitable distribution. Contrary to plaintiff's contentions, nothing that has occurred in the 10 years since O'Brien was decided suggests a reason to overrule it. The "chaos" and "confusion" that plaintiff perceives are really nothing more than reflections of how difficult it is to achieve true fairness in the division of a married couple's tangible and intangible assets. Far from undermining O'Brien's pragmatic and theoretical worth, the decade of case law history that plaintiff cites is an example of the kind of experimentation and creative problem solving that the Domestic Relations Law and equity itself demand.

Equally unpersuasive is plaintiff's contention that O'Brien should be limited to cases in which one spouse worked and supported the family financially while the other went to school and earned a professional license. Plaintiff's emphasis on the nontitled spouse's financial subsidy to the exclusion of all other forms of contribution represents an unacceptably narrow view of the economic partnership that characterizes the institution of marriage. Here, for example, although defendant apparently did not finance plaintiff's medical education, he was the primary provider of economic support to the family while plaintiff was in school. Additionally, he prepared family meals and tended to the children's needs so that plaintiff could devote her time to her studies and work. Thus, the evidence supports the affirmed finding below that defendant "contributed to the functioning of the household while plaintiff attended medical school." Under these circumstances, inclusion of plaintiff's license as an item of distributable marital property is appropriate to fulfill the core purpose of the O'Brien rule: to assure the nontitled spouse an equitable share of the license to which that spouse's efforts contributed. Accordingly, there is no sound basis for withholding O'Brien's application here. We note that, contrary to plaintiff's contentions, there is also record support for the Appellate Division's valuation of her medical license. Consequently, the lower courts' distribution of plaintiff's professional license will not be disturbed. *

* Plaintiff has also argued that the bulk of the marital estate should have been awarded to her because a considerable portion of it was derived from gifts from plaintiff's parents. However, the courts below both found that the gifts in question were given with an intent to benefit the parties equally and were therefore

properly included as marital property. This conclusion, as well as the Supreme Court's affirmed rulings with respect to defendant's maintenance obligation and the distribution of certain bonds, were supported by the record and thus there is no basis for this Court to intervene.

III.

We reach a different conclusion, however, with respect to the Appellate Division's disposition of defendant's professional license to practice law. As a threshold matter, we reject plaintiff's contention that the Appellate Division lacked the power to modify Supreme Court's decision to distribute the license's value because defendant did not specifically mention that aspect of the judgment in his notice of appeal. Contrary to plaintiff's contentions, the scope of the Appellate Division's review power was not limited by the recitations in defendant's notice of appeal. Notably, there is no indication on this record that plaintiff was prejudiced by any ambiguity or omission in the notice. Accordingly, there is no basis for this Court to interfere with the Appellate Division's discretionary choice to construe defendant's notice of appeal liberally or even to reach beyond the issues it cited.

Turning to the substantive question, we find considerable merit in plaintiff's contention that the Appellate Division erred in treating defendant's law license as having "merged" with defendant's career. The "merger" principle on which the Court's decision was based is derived from the Second Department's ruling in Marcus v Marcus 137 A.D.2d 131), in which it was held that a professional license should not be assigned an independent value where the licensee has maintained a professional practice for a substantial period. In that situation, the Marcus Court stated, the license "should be deemed to have merged with and been subsumed by the practice itself" (id., at 139). The underlying rationale is that "the equitable considerations that ... motivated the O'Brien court are fundamentally different" where the license has been utilized for a substantial period to establish a career or professional practice and to generate tangible assets for the family (Parlow v Parlow, 145 Misc. 2d 850, 856, 548 N.Y.S.2d 373; see, Maher v Maher, 196 A.D.2d 530, 531, 601 N.Y.S.2d 165).

In the years since the merger theory was first articulated, the lower courts of this State have applied it with varying results. While the theory has repeatedly been reaffirmed (see, e.g., Duffey v Duffey, 198 A.D.2d 581, 603 N.Y.S.2d 234; Maher v Maher, supra, at 531; Kalisch v Kalisch, supra; McGowan v McGowan, 142 A.D.2d 355, 359, 535 N.Y.S.2d 990, n; Madori v Madori, 151 Misc. 2d 737, 573 N.Y.S.2d 553, affd 201 AD2d 859, 608 N.Y.S.2d 331; Vanasco v Vanasco, 132 Misc. 2d 227, 503 N.Y.S.2d 480; but see, Holihan v Holihan, 159 A.D.2d 685, 553 N.Y.S.2d 434), the courts have also found it necessary to make significant modifications to address the myriad of situations in which the problem of matured professional licenses has arisen. In Shoenfeld v Shoenfeld (168 A.D.2d 674, 563 N.Y.S.2d 500), for example, the Second Department upheld the lower court's holding that a two-year-old practice was too new to have subsumed the underlying professional license. Similarly, in Phelps v Phelps (199 A.D.2d 608, 609, 604 N.Y.S.2d 339), the Third Department held that it was not error to assign separate distributable value to a medical license that had been in use for seven years because the licensee had made several changes in the form of his practice and his earnings had not yet "stabilized sufficiently to permit a valuation of his practice which would truly reflect the increased earning capacity [attributable to his] license." In Aborn v Aborn (196 A.D.2d 561, 601 N.Y.S.2d 339), the Second Department declined to apply the merger rule to a spouse's professional license where the licensee had dissolved what had once been a profitable professional partnership and had relocated his practice several times.

In yet another approach to the problems created by professional mobility, the lower courts have held that a license which has previously "merged" with a professional career or practice may "reemerge" as a significant and separately distributable asset if the licensed spouse experiences a significant career change. This principle was applied where the licensed spouse sold a long-standing medical practice and opened a new one in another State (Behrens v Behrens, 143 A.D.2d 617, 532 N.Y.S.2d 893; cf., Marano v Marano, 200 A.D.2d 718, 607 N.Y.S.2d 359) and where a spouse with a law license terminated his career as a United States Congressman shortly after the matrimonial action was commenced (Martin v Martin, 200 A.D.2d 304, 614 N.Y.S.2d 775). It was also applied, in combination with the Shoenfeld-Phelps-Aborn exception, where a licensed attorney who had worked as a law assistant for 10 years switched to private practice and the four-year history of that practice did not "warrant the finding" that the practice had subsumed the license (Wells v Wells, 177 A.D.2d 779, 780, 576 N.Y.S.2d 390).

Yet another variant of the merger rule was applied by the Fourth Department in Finocchio v Finocchio (162 A.D.2d 1044, 556 N.Y.S.2d 1007) and DiCaprio v DiCaprio (162 A.D.2d 944, 556 N.Y.S.2d 1011). The Courts in those cases acknowledged the applicability of the merger principle but treated the enhanced earning power associated with a spouse's professional license as a marital asset anyway. Over a vigorous dissent, the Finocchio majority reasoned that the merger principle should not be applied "in a way which would deprive the nonlicensee spouse of ... any interest [in] the marital asset beyond commencement of the matrimonial action" (162 A.D.2d at 1045). Accordingly, while the spouse's professional license had "merged" into his career, that conclusion meant only that the method for valuing the license "must include a projection of the licensee's future earnings 'based on actual past earnings produced by actual practice' " (id., at 1046, quoting McGowan v McGowan, supra, at 359, n; accord, DiCaprio v DiCaprio, supra, at 945). In other words, under Finocchio "the only effect of the merger is that the court uses the owner's actual earnings to compute the [license's] value instead of using the projected earnings of the average professional" (Turner, Equitable Distribution of Property § 6.19A, at 227 [1993 Cum Supp]).

Although the Finocchio approach has much merit, it is ultimately flawed because of its continued reference to the concept of "merger." As is evident from the case law, the use of that term injects an artificial and unnecessarily confusing element into an already difficult assessment process.

One objection to the concept of "merger" is that it rests on the notion that an unrevoked professional license can somehow lose its character as a component of marital property solely because of its use in advancing its holder's career. If, as we held in O'Brien, a currently valid professional license is a distributable item of economic value, it should logically retain that quality throughout its existence. It would be anomalous to suggest that a marital asset may "merge" or disappear and perhaps even "reemerge" or reappear depending on the vicissitudes of the licensee's professional career (cf., Oldham, Divorce, Separation and Distribution of Property § 9.02 [1], at 9-11 ["(i)t would be Alice-in-Wonderlandish to say that education is property only sometimes"]).

A second objection to the "merger" theory is that it is difficult to apply. Even the doctrine's simplest application is problematic, since there can be no clear yardstick for measuring when the licensee's practice or career has matured to the point where it has "subsumed" the license (see, Scheinkman, Supplementary Practice Commentaries, McKinney's Cons Laws of NY, Book 14, Domestic Relations Law § 236, C236B:6, at 40 [1995 Cum Ann Pocket Part]). The doctrine's proper use becomes even

more confusing when it is applied to the many situations in which the licensee has experienced career reversals, has opted to change professional direction or has simply selected a career that does not "square up exactly" with the scope of the license (id., at 40-41).

Finally and most fundamentally, the merger doctrine is flawed because its practical effect is to limit the O'Brien rule's application to recently acquired licenses (see, DiCaprio v DiCaprio, supra, at 946-948 [Lawton, J., dissenting]; Marcus v Marcus, supra, at 139). Such a narrow approach is inconsistent with the equitable goal of assuring both spouses a fair share of all of the assets that were produced by the marital partnership. Application of the merger doctrine is particularly inimical to the statutory purposes because it generally favors the nonlicensed spouse in a shorter marriage over the nonlicensed spouse who is faced with rebuilding his or her economic life after the breakup of a long-term marriage (see, Scheinkman, op. cit., C236B:6, at 40 [1995 Cum Ann Pocket Part]).

In view of these logical and practical difficulties, we conclude that the letter and spirit of our holding in O'Brien is best served by eliminating the concept of "merger" from the inquiry. The merger doctrine should be discarded in favor of a commonsense approach that recognizes the ongoing independent vitality that a professional license may have and focuses solely on the problem of valuing that asset in a way that avoids duplicative awards. O'Brien permits the court to include in the marital estate the present value of any increased earning capacity attributable to a professional license earned during the marriage. That increased earning capacity continues to exist, to a greater or lesser degree, throughout the life of the license. Even after the licensee has had the time and opportunity to exploit the license and to realize a portion of the enhanced earning potential it affords, the license itself retains some residual economic value, although in particular cases it may be nominal (see, Turner, op. cit., at 227-228). That value can be measured and distributed just as a newly acquired license is valued through various actuarial techniques that are well known to valuation experts.

To be sure, the valuation inquiry is made more complicated by the passage of time and the licensee's harvesting of some portion of the enhanced earning capacity that accompanies the license. The value of a newly earned license may be measured by simply comparing the average lifetime income of a college graduate and the average lifetime earnings of a person holding such a license and reducing the difference to its present value (see, O'Brien v O'Brien, supra, at 582; 2 McCahey, Valuation & Distribution of Marital Property § 30.03 [3], at 30-19--30-21). In contrast, where the licensee has already embarked on his or her career and has acquired a history of actual earnings, the foregoing theoretical valuation method must be discarded in favor of a more pragmatic and individualized analysis based on the particular licensee's remaining professional earning potential (see, Finocchio v Finocchio, supra, at 1045-1046; Scheinkman, op. cit., C236B:6, at 48 [1995 Cum Ann Pocket Part]). Moreover, care must be taken to ensure that the monetary value assigned to the license does not overlap with the value assigned to other marital assets that are derived from the license such as the licensed spouse's professional practice. The courts must also be meticulous in guarding against duplication in the form of maintenance awards that are premised on earnings derived from professional licenses.

The existence of these complications, however, is not a sound reason to introduce nettlesome legal fictions or to excise an asset to which the nontitled spouse has contributed from the marital estate. As we stated in O'Brien, the complexity of calculating the present value of a partially exploited professional license is no more difficult than the problem of computing wrongful death damages or the loss of earning potential that is occasioned by a particular injury (66 N.Y.2d at 588). Nor does it lead to significantly

more speculation than is involved in the now-routine task of valuing a professional practice for the purpose of making a distributive award (see, id., citing Arvantides v Arvantides, 64 N.Y.2d 1033, 489 N.Y.S.2d 58, 478 N.E.2d 199; Litman v Litman, 93 A.D.2d 695, 463 N.Y.S.2d 24, affd 61 N.Y.2d 918, 474 N.Y.S.2d 718, 463 N.E.2d 34;see also, Burns v Burns, 84 N.Y.2d 369, 376-377, 618 N.Y.S.2d 761, 643 N.E.2d 80).

IV.

In this case, no distributive award representing the value of defendant's law license was made because of the Appellate Division's prior ruling that the license had merged with defendant's legal career. This ruling was error, since the license had a residual economic value independent of defendant's career. Accordingly, the matter must be remitted to the Supreme Court so that a new distribution of the marital assets taking into account the value of defendant's law license, can be made. Notably, the question of valuation will probably have to be tried de novo, since it appears that the experts' assessments and the Supreme Court's initial valuation determination were made without compensating for the portion of the enhanced earning capacity attributable to the license that has already been realized through defendant's legal career (see, Turner, op. cit., at 227-228). However, a full de novo inquiry into the other distributive issues is not necessary, since those issues have already been resolved in prior proceedings and, as noted elsewhere in this opinion, we find no basis to disturb their disposition in the courts below.

Inasmuch as there must be a new trial on this narrow point, we turn briefly to the question of whether the trial court may consider the postcommencement events that may have affected the value of defendant's license. Of course, the most significant of these is defendant's 1992 job loss, which was caused in part by what the Appellate Division characterized as plaintiff's " 'acrimonious and vindictive conduct' " (208 AD2d, at 837).

Domestic Relations Law § 236 (B) (1) (c) provides that the classification of property as "marital" or "separate" is governed by the date on which the matrimonial action was commenced or the parties' separation agreement executed. However, the equitable distribution statute does not specify the date that is to be used as the touchstone for measuring the value of the marital property (see, Scheinkman, op. cit., C236B:26, at 287). Thus, the appropriate date for measuring the value of marital property has been left to the sound discretion of the trial courts, which should make their determinations with due regard for all of the relevant facts and circumstances (see, Domestic Relations Law § 236 [B] [4] [b]).

In attempting to select a suitable valuation date, some courts have drawn a distinction between "active" assets (i.e., those whose value depends on the labor of a spouse) and "passive assets" (i.e., those whose value depends only on market conditions). These courts have concluded that "active" assets should be valued only as of the date of the commencement of the action, while the valuation date for "passive" assets may be determined more flexibly (see, Smerling v Smerling, 177 A.D.2d 429, 576 N.Y.S.2d 271; Heine v Heine, 176 A.D.2d 77, 580 N.Y.S.2d 231; Zelnik v Zelnik, 169 A.D.2d 317, 573 N.Y.S.2d 261; Kallins v Kallins, 170 A.D.2d 436, 565 N.Y.S.2d 227; Greenwald v Greenwald, 164 A.D.2d 706, 565 N.Y.S.2d 494). Such formulations, however, may prove too rigid to be useful in particular cases. Thus, they should be regarded only as helpful guideposts and not as immutable rules of law (see generally, Scheinkman, op. cit., C236B:26, at 79-80 [1995 Cum Ann Pocket Part]).

Here, for example, defendant's law license would probably be classified as an "active" asset in the lower courts' taxonomy. Yet, one of the apparent goals of using the date of the action's commencement for measuring the assets' worth, i.e., preventing the licensed spouse from unilaterally manipulating the asset's value, may not be relevant in this case, where the actions of the nonlicensed spouse may have undermined the license's residual economic value.

In the final analysis, whether the unusual postcommencement events that led to defendant's job loss should be considered in assessing the residual value of his law license is a question that lies squarely within the trial court's discretion. We hold only that the timing of these events should not by itself be a legal impediment to such consideration.

Accordingly, the order of the Appellate Division should be modified, with costs to appellant, and the case remitted to Supreme Court for further proceedings in accordance with this opinion and, as so modified, affirmed.

Chief Judge Kaye and Judges Simons, Bellacosa, Smith and Ciparick concur; Judge Levine taking no part.

Order modified, etc.

552 F.2d 1239 (1977)

Elmer E. MILLS and Louis Susman, Plaintiffs-Appellants, Cross-Appellees, v. The ELECTRIC AUTO-LITE COMPANY et al., Defendants-Appellees, Cross-Appellants.

Nos. 75-1558, 75-1559.

United States Court of Appeals, Seventh Circuit.

Argued April 6, 1976.
Decided April 7, 1977.
Rehearing and Rehearing Denied June 3, 1977.

Barnabas F. Sears, Arnold I. Shure, Alex Elson, Harry B. Reese, Aaron S. Wolff, Thomas L. Brejcha, Jr., Willard J. Lassers, Chicago, Ill., for plaintiff-appellants.

Jerold S. Solovy, Joan M. Hall, Alan L. Metz, Michael J. Rovell, Michael J. Place, and Jenner & Block, of counsel, Chicago, Ill., for appellees.

Before SWYGERT and CUMMINGS, Circuit Judges, and JAMESON, Senior District Judge.[1]

Rehearing and Rehearing En Banc Denied June 3, 1977.

SWYGERT, Circuit Judge.

The principal issue in this appeal is whether the terms of a merger between Mergenthaler Linotype Company ("Mergenthaler") and the Electric Auto-Lite Company ("Auto-Lite") were fair to Auto-Lite's minority shareholders. We hold that the merger terms were fair and reverse the judgment of the district court.

I

This is the second time that this case has come before us. In order to place this appeal in its proper perspective, we will briefly review the case's history.

Prior to 1960 Auto-Lite primarily manufactured automotive parts and equipment. Because of changes in the automobile industry in the late 1950's, the continuation of its traditional business was threatened and it began a program of diversification into other industries. Nonetheless, in 1963 a substantial percentage of its sales remained tied to the automobile industry.

[1] The Honorable Willian J. Jameson, United States Senior District Judge for the District of Montana, is sitting by designation.

Mergenthaler produced and distributed typesetting equipment. It began to purchase Auto-Lite stock in 1957 and by March 1962 had acquired 54.2 percent of Auto-Lite. At that point Auto-Lite became a subsidiary of Mergenthaler and Mergenthaler obtained control of the Auto-Lite Board of Directors.

In early 1963 Mergenthaler decided to attempt a merger of itself and Auto-Lite into a new company to be called "Eltra Corporation." The Auto-Lite Board voted to accept the proposed merger on May 28, 1963 and on May 29 a request for proxies was sent to shareholders accompanied by a statement in which the Board endorsed the merger. The holders of approximately thirteen percent of the minority shares had to approve the merger in order to secure the two-thirds vote necessary for ratification. The merger was approved at a shareholders' meeting on June 27, 1963 and became effective on June 28, 1963.

Plaintiffs, who were Auto-Lite shareholders representing themselves and all other minority Auto-Lite shareholders, filed suit on June 26, 1963 in the district court for the Northern District of Illinois. They sought to set aside the merger on the ground that the proxy statement was deceptive because it endorsed the merger without clearly disclosing that the Auto-Lite Board was controlled by Mergenthaler. The district court agreed with plaintiffs' theory and held that the proxy statement violated section 14(a) of the Securities Exchange Act of 1934. It also held that the plaintiffs had shown a causal relationship between the proxy statement and the consummation of the merger. 281 F.Supp. 826 (N.D.Ill.1967).

This court affirmed the district court's holding that the proxy statement was illegally deceptive but reversed on the causality issue, holding that no relief could be appropriate if the defendants could show "by a preponderance of probabilities" that the merger would have been approved even if the proxy statement had not been deceptive. 403 F.2d 429, 436 (7th Cir. 1968).

The Supreme Court reversed and reinstated the judgment of the district court. It held that "[w]here there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction." 396 U.S. 375, 385, 90 S.Ct. 616, 622, 24 L.Ed.2d 593 (1970).

The Court went on to consider the relief to which plaintiffs were entitled. It noted that the merger did not need to be set aside because of the deception in the proxy statement, though a court could order such action if it were warranted by equitable considerations. It then discussed the possibility of monetary relief and stated:

[W]here, as here, the misleading aspect of the solicitation did not relate to terms of the merger, monetary relief might be afforded to the shareholders only if the merger resulted in a reduction of the earnings or earnings potential of their holdings. In short, damages should be recoverable only to the extent that they can be shown. If commingling of the assets and operations of the merged companies makes it impossible to establish direct injury from the merger, relief might be predicated on a determination of the fairness of the terms of the merger at the time it was approved. These questions, of course, are for decision in the first

instance by the District Court on remand, and our singling out of some of the possibilities is not intended to exclude others. 396 U.S. at 388-89, 90 S.Ct. at 624.

Finally, the Court held that the plaintiffs were entitled to be reimbursed by the corporation for litigation expenses and reasonable attorneys' fees.

The case then moved back to the district court for a determination of the appropriate relief. The court first held that the merger should not be rescinded. It then determined that the merger terms were unfair to plaintiffs and awarded the class they represent $1,233,918.35, as well as approximately $740,000 in prejudgment interest. It further held that plaintiffs' attorneys should be compensated out of this award.

Both parties now appeal from the district court's judgment. Plaintiffs contend that the amount of damages was too low and that their attorneys' fees should be assessed against defendants rather than against the damages awarded. Defendants assert that no damages should have been awarded because the terms of the merger were fair.

II

The district court considered two possible theories of damages in attempting to follow the Supreme Court's mandate: (1) to compensate plaintiffs for the reduction of the earnings potential of their holdings in Auto-Lite as a result of the merger; or (2) an award based on a determination of the fairness of the terms of the merger at the time it was approved. It rejected the use of the first theory under the circumstances of this case and adopted the second. We shall evaluate both whether the district court was erroneous in its choice of remedies and whether it correctly applied the second theory.

In order to perform this evaluation, it is first necessary to describe the merger terms. They called for the minority Auto-Lite shareholders to receive 1.88 preferred shares of Eltra for each share of Auto-Lite common that they held and the Mergenthaler shareholders to receive one common share of Eltra for each share of Mergenthaler common that they held. Eltra preferred shares were convertible into common shares on a one-to-one basis for the first two years following the merger and on a slightly decreasing basis for the next three years.[2] At the time of the merger Mergenthaler common paid a dividend of $1 per share and Auto-Lite common paid a dividend of $2.40 per share. Under the merger terms Eltra common was to pay a dividend of $1 per share and Eltra preferred a dividend of $1.40 per share. The dividend received by the Auto-Lite minority shareholders was therefore increased as a result of the merger by twenty-three cents for each share of Auto-Lite that they had held, because 1.88 × $1.40 = $2.63.

The preferred Eltra stock was clearly worth more than Eltra common because it paid a higher dividend and represented a more secure investment if the new corporation encountered financial difficulties, yet was convertible into common stock. During the month following the merger, the average market value of Eltra preferred was $31.06 per share. Consequently the Auto-Lite minority shareholders received stock worth $58.39 on the

[2] In the third, fourth, and fifth years following the merger, one share of Eltra preferred was convertible into .955, .910, and .865 shares respectively of Eltra common.

market for each share of Auto-Lite that they had previously held, because 1.88 × $31.06 = $58.39. The average market value of Eltra common for this month was $25.25 per share. Since the Mergenthaler shareholders received one share of Eltra common for each share of Mergenthaler common, the Auto-Lite shareholders received stock for each share of Auto-Lite that they held worth $58.39/$25.25 = 2.31 times as much on the market as the stock that the Mergenthaler shareholders received for each share of Mergenthaler that they held. We therefore hold that the exchange ratio for the merger was effectively 2.31 to 1.[3]

III

A theory of damages based on the "reduction of the earnings or earnings potential" of the Auto-Lite minority shareholders caused by the merger is an attempt to discern, by looking at the postmerger performance and activities of the Auto-Lite subsidiary in comparison to the other components of Eltra, whether the value placed on the Auto-Lite shares at the time the merger took place was fair to those shareholders. Plaintiffs contend that the postmerger record of Eltra demonstrates the unfairness of the merger in two significant ways: first, by showing that Eltra appropriated for use in its other divisions liquid assets held by Auto-Lite prior to the merger; and second, by showing that Eltra continually siphoned off Auto-Lite's postmerger earnings.

Even if plaintiffs' assertions are true, they cannot form the basis for an award of damages. Plaintiffs assume that it would be unfair to the former minority Auto-Lite shareholders if, after the merger, the Eltra management "weakened" the Auto-Lite divisions by shifting liquid assets or earnings to other divisions. This assumption is incorrect. After the merger the former Auto-Lite shareholders had become Eltra shareholders and had no more interest in the Auto-Lite divisions than any other Eltra shareholder. Therefore, they could not be injured by intra-corporate transfers of assets designed to strengthen the corporation as a whole. The interests of the former Auto-Lite shareholders and former Mergenthaler shareholders coincided after the merger, and the Eltra management could not possibly take actions that benefitted "its" shareholders at the expense of the Auto-Lite shareholders.

Plaintiffs rely heavily on *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1975); *Gerstle v. Gamble-Skogmo, Inc.,* 478 F.2d 1281 (2d Cir. 1973); and *Janigan v. Taylor,* 344 F.2d 781 (1st Cir.), *cert. denied,* 382 U.S. 879, 86 S.Ct. 163, 15 L.Ed.2d 120 (1965), to support their theory of postmerger damages. They contend that under these decisions the defendants must be compelled to disgorge any "profits" realized as a consequence of the deceptive proxy statement and that those profits should be measured by the sum of assets which moved from Auto-Lite to the other divisions of Eltra following the merger. However, plaintiffs misconceive the holdings of these cases. The cases all involved situations where defendants had realized demonstrable profits, at the expense of plaintiffs, through misrepresentation. Under such circumstances all three courts permitted a postmerger valuation of property which plaintiffs had been fraudulently induced to sell. But whether the exchange of Auto-Lite stock for Eltra stock profited Mergenthaler at the expense of the Auto-Lite minority shareholders is precisely the issue we are trying to

[3] The district court, after considering the factors we have just reviewed, found the effective exchange ratio to be 2.25 to 1. Although the court never explained precisely how it arrived at this figure, the difference of .06 between the two ratios will not prove to be significant in subsequent calculations.

resolve. Damages must be based on evidence that the Auto-Lite minority shareholders were not paid a fair price and the fact that Eltra shifted assets away from Auto-Lite following the merger is not satisfactory evidence of unfairness at the time the merger was consummated.

Plaintiffs ignored the only theory on which relief based on the postmerger performance of Eltra might be granted. If the ratio of the postmerger earnings of the Auto-Lite subsidiary of Eltra to the postmerger earnings of the Mergenthaler subsidiary were unusually high given the terms of the merger, it would be evidence that those terms were unfair to the Auto-Lite minority shareholders. This is true not because the former Auto-Lite minority shareholders are entitled to any percentage of the earnings of the Auto-Lite subsidiary after the merger, but because a high ratio would indicate that in retrospect the merger terms underestimated Auto-Lite's value as an enterprise.

Eltra's financial records show that for the ten year period beginning in 1963 and ending in 1972 the Auto-Lite divisions earned $122,501,632 while the Mergenthaler divisions earned $58,827,595. Before the merger Auto-Lite had 1,159,265 shares outstanding while Mergenthaler had 2,698,822 shares outstanding. Arguably, therefore, Auto-Lite would have had average yearly earnings per share of $10.57 between 1963 and 1972 if there had been no merger because its average yearly earnings would be $122,501,632/10 = $12,250,163 and $12,250,163/1,159,265 = $10.57. By the same reasoning, Mergenthaler's average yearly earnings per share for the same period would be $2.18 because $58,827,595/10 = $5,882,759 and $5,882,759/2,698,822 = $2.18. The ratio of $10.57 to $2.18 is 4.85, indicating that the actual effective exchange ratio of 2.31 underestimated the value of Auto-Lite in comparison to Mergenthaler.

An award of damages based on the comparative postmerger earnings of Auto-Lite and Mergenthaler, however, depends upon the assumption that the two subsidiaries continued to function independently after the merger was consummated. If the assets or operations of the two subsidiaries were commingled, it would be improper to utilize the postmerger performance of either one as evidence that at the time of the merger Auto-Lite was a stronger company than the merger terms indicated, because Auto-Lite's increase in earnings following the merger might have been the result of input from Mergenthaler that it would not have received without the merger.

The district court held that there was substantial commingling of the assets and operations of Auto-Lite and Mergenthaler during the period following the merger. It found that the plaintiffs' statistics failed to measure the change in the quality of management that flowed to the Auto-Lite divisions of Eltra as a consequence of the merger or the economies of scale that the merger produced. It also found the statistics to be misleading because the postmerger Eltra statements underestimated the expenses of the Auto-Lite divisions, making the earnings of those divisions appear higher than they really were. These findings are supported by substantial evidence and we affirm them.

Given the fact that significant commingling occurred, the postmerger earnings of Auto-Lite and Mergenthaler cannot supply a reliable guide to whether the merger terms were fair to the Auto-Lite minority shareholders. Even in the absence of commingling, postmerger evidence can only create a rebuttable inference of unfairness because it is impossible to

know with certainty whether the increase in earnings of one partner to a merger should have been predictable at the time the merger took place. In this case the ratio of the earnings per share of the two companies for the four years prior to and including 1963 were all at or below the effective exchange ratio of 2.31 to 1.[4] Plaintiffs have not shown that the management of Mergenthaler should have known in 1963 that Auto-Lite's earnings were going to increase faster than Mergenthaler's during the next decade. The more plausible inference is that, insofar as Auto-Lite's business became more productive because of factors unrelated to commingling, they were unforeseeable at the time the merger was consummated. Accordingly, we hold that the district court did not abuse its discretion in refusing to award damages based on postmerger data.

IV

A.

The district court based its award of damages on an assessment of the fairness of the merger terms at the time the merger took place. It evaluated five criteria in making this assessment: (1) the market value of each corporation's stock; (2) each corporation's earnings; (3) the book value of each corporation's assets; (4) the dividends that each corporation paid on its stock; and (5) other "qualitative factors" indicating the strength of each corporation. The court found market value to be an unreliable criterion and discounted the importance of dividends. It found that the comparative earnings and book values of each corporation were significant and demonstrated that the merger terms were unfair to the Auto-Lite minority. The court did not indicate what significance it was attributing to "qualitative factors."

Based on these findings the court held that the merger would have been fair if the Auto-Lite minority shareholders had received the equivalent of 2.35 shares of Eltra common for each share of Auto-Lite that they held and Mergenthaler shareholders had received one share of Eltra common for each share of Mergenthaler that they held. It also found that the effective exchange ratio for the actual merger, where the Auto-Lite minority shareholders received 1.88 shares of Eltra preferred for each share of Auto-Lite common that they held, was 2.25 to 1 in terms of Eltra common.[5] It then awarded damages of $1,233,918.35 to plaintiffs based on the differential of .10 between the effective exchange ratio of 2.25 to 1 and the fair exchange ratio of 2.35 to 1.[6]

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[4] Plaintiffs assert that the ratio of Auto-Lite's earnings per share to Mergenthaler's earnings per share was 2.2 in 1960, 1.0 in 1961, 1.5 in 1962, and 2.33 in 1963. Defendants assert that the ratio was 1.0 in 1961, 1.27 in 1962, 1.79 in the fiscal year 1963, and 1.90 in the calendar year 1963. They do not provide figures for 1960.

[5] *See* note 3 *supra.*

[6] The district court used the following method of reaching the figure of $1,233,918.35:

(1) Since each share of Auto-Lite was exchanged for the equivalent of 2.25 shares of Eltra common while each share of Mergenthaler was exchanged for one share of Eltra common, the holder of one share of Auto-Lite received 67.38 percent of the interest in Eltra distributed for one share of Auto-Lite and one share of Mergenthaler, because 2.25/(2.25 + 1) = .6738.

B.

The district court discounted the significance of the comparative market values of Auto-Lite and Mergenthaler stock during the five year period preceding the merger because it found that purchases of Auto-Lite stock by Auto-Lite itself and by Mergenthaler, and of Mergenthaler stock by the American Manufacturing Company,[7] made market value an unreliable indicator during that period of the true worth of the two parties to the merger. Defendants challenge the district court's assessment while plaintiffs contend that it was correct, at least for the period after 1960. We agree with defendants.

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(2) If a fair exchange ratio of 2.35 had been employed, the holder of one share of Auto-Lite would have received 70.15 percent of the interest in Eltra distributed for one share of Auto-Lite and one share of Mergenthaler, because 2.35/(2.35 + 1) = .7015.

(3) Since 70.15-67.38 = 2.77, the Auto-Lite minority shareholders were unfairly deprived of 2.77 percent of the combined value of an Auto-Lite share and a Mergenthaler share for each share of Auto-Lite that they held.

(4) In July 1963, the month following the merger, the average market value of the Eltra stock that was distributed for one share of Mergenthaler was $25.25 and the average market value of the Eltra stock that was distributed for one share of Auto-Lite was $58.39. Accordingly, the combined value of one share of Mergenthaler and one share of Auto-Lite was $25.25 + $58.39 = $83.64.

(5) 2.77 percent of $83.64 is $2.317. Since there were 532,500 minority shares of Auto-Lite, the total damages were 532,500 X $2.317 = $1,233,918.35.

The district court's method of calculation was mathematically unsound. First, there was an arithmetic error in step one because 2.25/(2.25 + 1) is .6923 rather than .6738. The more fundamental error, however, lies in the court's premise in steps 3, 4, and 5 that the 2.77 percent figure could be multiplied by the combined market value of one share of Auto-Lite and one share of Mergenthaler to calculate the per share dollar loss which the Auto-Lite shareholders had suffered. It is circular reasoning to use the market value generated by the actual merger. If a different exchange ratio had been employed, the market value of Eltra stock undoubtedly would have been different. Moreover, the mathematical significance of the 2.77 percent figure is questionable.

What the court should have done, if its differential of .10 were correct, was simply multiply the differential by the number of minority Auto-Lite shares to calculate the number of additional Eltra common shares that should have been distributed to plaintiffs to make the merger terms fair.

[7] Auto-Lite purchased 579,883 of its own shares in 1960-61, 31,500 shares in 1962, and 4,900 shares in 1963 before May 24. Mergenthaler purchased 212,600 shares of Auto-Lite between February 1957 and the end of 1958, and an additional 167,350 shares in 1959. It owned 408,950 shares by May 24, 1960. After Auto-Lite purchased some of its own shares in August 1961, Mergenthaler's holdings constituted approximately thirty-four percent of Auto-Lite. In March 1962 Mergenthaler purchased an additional 219,065 shares of Auto-Lite, increasing its holdings to approximately fifty-four percent of Auto-Lite's stock.

American had 43,100 shares of Mergenthaler prior to 1958. By December 1960 it had increased its holdings to 190,834 shares, which became 763,336 shares after a 4 for 1 stock split in March 1961. It purchased an additional 108,073 shares in 1962 and 12,700 shares in 1963 before May 24. Its holdings in Mergenthaler at the time of the merger constituted approximately thirty-three percent of Mergenthaler's stock. American also purchased an additional 2,800 shares of Mergenthaler between May 27 and June 14, 1963. However, these purchases are irrelevant because the final comparison of the market value of Auto-Lite and Mergenthaler stock used in setting the merger terms was made on May 24, 1963.

The district court's holding depends upon the validity of two premises: first, that the inter- and intra-company purchases substantially affected the market value of either corporation's stock immediately prior to the merger and second, that any effect which these purchases did have caused the price of Auto-Lite stock to fall relative to the price of Mergenthaler stock.[8] We find neither premise to be supported by the evidence. The great portion of the inter- and intra-company purchases took place before the six month period immediately preceding the merger, and the effect of those purchases during that period was negligible.[9] There was no manipulation of stock prices immediately before the merger by any of the companies involved in an effort to secure more favorable merger terms. Moreover, the price ratio of the two stocks was the same during 1961 and 1962, when there were substantial purchases by Auto-Lite, Mergenthaler, and American, and the first half of 1963, when there were not.[10] This is a strong indication that the price of both corporations' stock was responding to factors other than these transactions.

Even if we assume that the purchases had an effect, it is difficult to see how it could be detrimental to the price of Auto-Lite relative to the price of Mergenthaler. Since all of the transactions at issue were purchases, they would have tended to raise rather than lower the price of the stock that was traded. But there was a greater volume of Auto-Lite stock purchases by Auto-Lite itself and by Mergenthaler than of Mergenthaler purchases by American.[11] Second, during the eighteen months prior to the merger the ratio of the inter- and intra-company purchases of Auto-Lite to the total amount of Auto-Lite stock traded was greater than the ratio of American's purchases of Mergenthaler to the total amount of Mergenthaler stock traded.[12] Finally, a greater proportion of the Auto-Lite purchases took

[8] Since defendants contend that market value should be used to measure the fairness of the merger terms, we need not be concerned with whether the purchases in question adversely affected the price of Mergenthaler stock relative to Auto-Lite stock.

[9] *See* note 7 *supra.* Auto-Lite's purchases of 4,900 shares of its own stock in 1963 up to May 24 constituted 8.2 percent of the 59,900 shares of Auto-Lite traded on the New York Stock Exchange during that period, and .42 percent of the 1,160,565 shares of Auto-Lite outstanding. American's purchases of 12,700 shares of Mergenthaler stock in 1963 up to May 24 constituted 6.3 percent of the 201,200 shares of Mergenthaler traded on the New York Stock Exchange during that period and .47 percent of the 2,698,822 shares of Mergenthaler outstanding. Mergenthaler acquired no Auto-Lite stock between March 1962 and the time of the merger.

[10] The ratio of the average price of Auto-Lite stock to the average price of Mergenthaler stock was 2.0 in 1961, 2.1 in 1962, and 2.1 in 1963 up to May 24, the last date on which the prices were compared for purposes of the merger

[11] The best evidence of this is the simple statistic that at the time of the merger Mergenthaler held approximately fifty-four percent of Auto-Lite's stock while American held approximately thirty-three percent of Mergenthaler's stock. Mergenthaler purchased all of its Auto-Lite shares after February 1957 while American purchased all but 2,000 of its Mergenthaler shares after June 1956. Therefore, Mergenthaler acquired its interest in Auto-Lite during roughly the same period that American acquired its interest in Mergenthaler, indicating that during this period the inter- and intra-company purchases of Auto-Lite stock constituted a greater percentage of the total amount of trading in that stock than did the inter-company purchases of Mergenthaler stock.

[12] In 1962 Mergenthaler acquired 219,065 shares of Auto-Lite through a tender offer to Auto-Lite shareholders and Auto-Lite itself purchased 31,500 shares out of the 171,300 shares traded on the New York Stock Exchange. In 1963 up to May 24 Auto-Lite purchased 4,900 of its shares out of the 59,900 shares traded on the New York Stock Exchange. Therefore, the inter- and intra-company transactions in Auto-Lite represented 56.7 percent of the total transactions in Auto-Lite during this period.

place in the period between 1961 and 1963, when they were likely to have a more substantial effect on price than earlier purchases.[13] The combination of these three factors indicates that the inter- and intra-company purchases pushed the price of Auto-Lite stock upward relative to Mergenthaler stock rather than producing the opposite effect.

We therefore hold that the inter- and intra-company transactions did not unfairly distort the relative market prices of Auto-Lite and Mergenthaler for purposes of determining the fairness of the merger. We must now decide what period of time should be used in calculating a price ratio between each corporation's stock. Since prices from the period immediately preceding the merger are the most likely to reflect the actual value of each corporation at the time the merger was consummated, we begin with a presumption that a short period is appropriate. Accordingly, we hold that the average market value for approximately the six month period preceding the merger should be used unless there are special factors indicating that this period is unreliable. Six months is long enough so that very short term price fluctuations will not play an unfairly important role and short enough so that the calculated ratio does not reflect business conditions that have substantially changed as of the time of the merger.

In this case the ratio between the average price of Auto-Lite and the average price of Mergenthaler during 1963 prior to the formulation of the merger terms in late May was 2.1. Our confidence that this figure accurately reflects the relative worth of the two corporations is bolstered by the fact that the ratio for 1962 was also 2.1 and was 2.0 for 1961. The similarity of these numbers is evidence that the ratio immediately preceding the merger was not the result of a short term anomaly caused either by the merger itself or by other factors.

Plaintiffs argue, however, that market prices were an unreliable indicator of the true worth of Auto-Lite and Mergenthaler between 1961 and 1963 but did provide a valid measure of each corporation's value between 1958 and 1960. We find these arguments to be unpersuasive. Plaintiffs first assert that Mergenthaler used its control over Auto-Lite in 1961-63 to compel it to pay unusually high dividends, with the effect of depressing the price of Auto-Lite stock by draining Auto-Lite of capital and raising the price of Mergenthaler stock by giving Mergenthaler funds with which to pay higher dividends. This reasoning is inconsistent. If the payment of higher dividends by Mergenthaler increased the value of Mergenthaler stock, it would follow that the payment of high dividends by Auto-Lite increased the attractiveness of Auto-Lite stock on the market. There is no reason to believe that a reduction in the Auto-Lite dividend would have resulted in raising the price of Auto-Lite stock. It is more likely that such a dividend reduction would have decreased the value of

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In 1962 American purchased 103,073 shares of Mergenthaler out of the 522,900 shares traded on the New York Stock Exchange. In 1963 American purchased 12,700 shares of Mergenthaler out of 201,200 shares traded on the New York Stock Exchange. Therefore, American purchased 16.0 percent of the Mergenthaler stock sold during this period.

[13] Auto-Lite purchased 270,355 of its own shares in 1958-60 and 345,793 of its own shares in 1961-63. Mergenthaler purchased 282,550 shares of Auto-Lite in 1958-60 and 219,065 additional shares in 1961-63. Thus, the distribution of inter- and intra-company transactions in Auto-Lite between these two periods was roughly equal.

American purchased 147,734 shares of Mergenthaler in 1958-60 which became 590,936 shares after a 4 for 1 stock split. It purchased 139,766 shares of Mergenthaler in 1961-63. Thus, the great proportion of the inter-company trading in Mergenthaler was prior to 1961.

each corporation's stock. Accordingly, we hold that Auto-Lite's high dividends between 1961 and 1963 did not unfairly distort the relative market values of Auto-Lite and Mergenthaler.

Plaintiffs also urge that market prices between 1958 and 1960 provided a more accurate picture of each corporation's actual value than prices during the later period because a substantial change in the nature of Auto-Lite's business following 1960 temporarily depressed the price of its stock. We find this to be an argument for using the later prices rather than the earlier ones. The fact that Auto-Lite's traditional business was eroding by 1961 renders unreliable market values based on that business. In 1961 the market began to reflect the uncertainty in Auto-Lite's future which most observers perceived. That uncertainty remained at the time of the merger and should properly have been a factor in determining the merger terms.[14]

C.

After finding that market value provided an inaccurate measure of the true worth of Auto-Lite and Mergenthaler, the district court determined whether the merger terms were fair on the basis of comparative earnings and book value. Given our conclusion that market prices were an accurate gauge of actual value, we must decide whether the other criteria on which the district court relied should properly be considered in evaluating whether the merger was fair.

We hold that when market value is available and reliable, other factors should not be utilized in determining whether the terms of a merger were fair. Although criteria such as earnings and book value are an indication of actual worth, they are only secondary indicia. In a market economy, market value will always be the primary gauge of an enterprise's worth. In this case thousands of shares of Auto-Lite and Mergenthaler were traded on the New York Stock Exchange during the first part of 1963 by outside investors[15] who had access to the full gamut of financial information about both corporations, including earnings and book value. If we were to independently assess criteria other than market value in our effort to determine whether the merger terms were fair, we would be substituting our abstract judgment for that of the market. Aside from the problems that would arise in deciding how much weight to give each criterion, such a method would be economically unsound.

D.

We turn now to a determination of whether the merger terms were fair, based on the comparative market price of each corporation's stock during the first part of 1963. The simplest method of resolving this issue would be to compare the price ratio, in this case 2.1, to the effective exchange ratio, which we have previously established as 2.31. Under this framework the merger would be fair since the effective exchange ratio gave the Auto-Lite

[14] Another reason why we cannot accept plaintiffs' assertion that the 1958-60 prices were reliable while the 1961-63 prices were not is that there were more inter- and intra-company transactions during the earlier period than during the latter.

[15] *See* note 9 *supra.*

minority shareholders more Eltra stock than they were entitled to in the judgment of the market.

This method of calculation, however, assumes that the new corporation that results from a merger is worth exactly as much as the sum of what its two component parts were worth before the merger. As Professors Brudney and Chirelstein have cogently pointed out, this assumption is usually false because a merger produces a synergistic effect resulting in the merged corporation being worth more than the sum of the two old corporations. Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers,* 88 Harv.L.Rev. 297, 308-09 (1974). They demonstrate that fairness requires that minority shareholders be compensated not only for the market value of their shares in the old corporation but also for the share of the synergism generated by the merger that is proportionate to the interest that those shares represented in the combined premerger value of the two old corporations. *Id.* at 313-25.

We adopt the approach formulated by Professors Brudney and Chirelstein and will attempt to apply it to this case. At the time of the merger there were 532,550 minority shares of Auto-Lite and 2,698,822 shares of Mergenthaler outstanding. During the first part of 1963 the average market price of Auto-Lite was $52.25 per share and the average market price of Mergenthaler was $24.875 per share. Thus, the premerger value of the minority holdings in Auto-Lite was 532,550 × $52.25 = $27,825,737 and the premerger value of Mergenthaler was 2,698,822 × $24.875 = $67,133,197. The combined premerger value of the two corporations was $27,825,737 + $67,133,197 = $94,958,934.[16]

In the month following the merger, Eltra common stock had an average market value of $25.25 per share. Eltra preferred stock had an average market value of $58.39 per 1.88 shares, the amount of stock which Auto-Lite shareholders had received for each share of Auto-Lite that they had held. The postmerger value of Eltra was therefore (2,698,822 × $25.25) + (532,550 X $58.39) = $68,145,255 + $31,095,594 = $99,240,849. The difference between the combined premerger value of Auto-Lite and Mergenthaler and the postmerger value of Eltra, which was $99,240,849 - $94,958,934 = $4,281,915, can be attributed to the synergism generated by the merger.

According to the fairness formula devised by Professors Brudney and Chirelstein, the minority shareholders of Auto-Lite should have received Eltra stock worth at least as much as the premerger market value of their holdings in Auto-Lite and a share of the synergism produced by the merger proportionate to the percentage of the combined premerger value of Auto-Lite and Mergenthaler which their holdings represented. The premerger value of the Auto-Lite minority shares was $27,825,737, which represented 29.3 percent of $94,958,934, the combined premerger value of Auto-Lite and Mergenthaler. Thus, to satisfy the constraints of fairness, the Auto-Lite minority shareholders should have received stock worth at least $27,825,737 + (.293 × $4,281,915) = $29,080,338. This would be equivalent to 1,151,696.5 shares of Eltra common at $25.25 per share. Had this many shares been

[16] Although Mergenthaler owned more than half of the Auto-Lite stock, this holding should not be independently counted as part of the combined value of the two corporations because it was already reflected in the value of Mergenthaler stock.

distributed to the Auto-Lite minority shareholders, the exchange ratio would have been 1,151,696.5/532,550 = 2.16 to 1.[17]

The Auto-Lite minority shareholders actually received preferred stock worth $58.39 on the market for each share of Auto-Lite that they had held. As a group, their Eltra holdings were worth 532,550 × $58.39 = $31,095,594. This was $31,095,594 - $29,080,338 = $2,015,256 more than fairness required. This result can be expressed in terms of Eltra common shares. Since the effective exchange ratio of the merger was 2.31 to 1, the property given the Auto-Lite minority was worth 2.31 - 2.16 = .15 shares of Eltra common per share of Auto-Lite more than what a fair amount would have been.

We therefore hold that the terms of the merger were fair and that plaintiffs should recover no damages. A numerical example may help to show the justice of this result. In early 1963, an Auto-Lite shareholder with one hundred shares and a Mergenthaler shareholder with 210 shares each owned stock worth approximately $5225. After the merger, the former Auto-Lite shareholder had 188 shares of Eltra preferred worth approximately $5839 while the former Mergenthaler shareholder had 210 shares of Eltra common worth approximately $5302. Both individuals benefitted from the merger, but the former Auto-Lite minority shareholder benefitted more.

V

The district court held that plaintiffs should recover their attorneys' fees and other litigation expenses out of the damages which the court awarded them. Since we have found that plaintiffs were treated fairly in the merger and are not entitled to damages, we must face the question of whether and how much they nonetheless should be compensated by Eltra for their fees and expenses.

When this case was before the Supreme Court, the Court held "that petitioners, who have established a violation of the securities laws by their corporation and its officials, should be reimbursed by the corporation or its survivor for the costs of establishing the violation." 396 U.S. at 389, 90 S.Ct. at 624 (footnote omitted). The Court later stated that "[w]hether petitioners are successful in showing a need for significant relief may be a factor in determining whether a further award should later be made. But regardless of the relief granted, private stockholders' actions of this sort `involve corporate therapeutics,' and furnish a benefit to all shareholders by providing an important means of enforcement of the proxy statute." *Id.* at 396, 90 S.Ct. at 627 (footnotes omitted).

We interpret this language to mean that plaintiffs should recover from Eltra all fees and expenses related to the establishment of a violation of the federal securities laws. This would encompass the litigation through the decision in the Supreme Court. The Court has

[17] We note that the price of Eltra common depended in part on the exchange ratio actually used. For example, if we assume that Eltra stock was distributed at an effective exchange ratio of 2.16 to 1, there would have been the equivalent of 2,698,822 + (2.16 × 532,550) = 3,849,130 Eltra common shares outstanding. Since the total postmerger value of Eltra was $99,240,849, the price of one share of Eltra common would rise to $99,240,849/3,849,130 = $25.78. However, the figures in the text give a good approximation of the number of Eltra common shares or their equivalent that the Auto-Lite minority shareholders should have received.

indicated that the award is not contingent upon the existence of a fund created from any damages eventually awarded the plaintiffs.[18]

The Court left open the question of whether plaintiffs should also be compensated for fees and expenses incurred in a trial and subsequent appeals on the issue of damages, implying that whether or not plaintiffs obtained damages should be a factor in resolving that question. We hold that plaintiffs are not entitled to be compensated for fees and expenses they have incurred since the Supreme Court's decision in this case. In *Alyeska Pipeline Co. v. Wilderness Society,* 421 U.S. 240, 95 S.Ct. 1612, 44 L.Ed.2d 141 (1975), the Supreme Court held that, absent statutory authority, the only exceptions to the general American rule that a litigant must pay his own fees and expenses are in situations where the litigant confers a common benefit on the class that he represents or where a losing party acts in bad faith. Since the Securities Exchange Act provides no authorization for fee-shifting in this type of case and the bad faith exception is inapposite here, plaintiffs cannot recover fees and expenses unless they demonstrate that their work on the issue of damages produced a common benefit for the former Auto-Lite minority shareholders. Plaintiffs cannot meet this burden. They have conferred no benefit upon the class they represent beyond the "corporate therapeutics" produced by their showing that the proxy statute was violated, and they must pay their own fees and expenses for their unsuccessful attempt to obtain damages for that violation.

The judgment of the district court is reversed and the cause is remanded for further proceedings consistent with this opinion.

[18] In its most recent decision dealing with the issue of fee-shifting, the Court by implication approved its earlier reasoning in *Mills, See Alyeska Pipeline Co. v. Wilderness Society,* 421 U.S. 240, 257-58, 95 S.Ct. 1612, 44 L.Ed.2d 141 (1975).

Full Text of Court Cases

Estate of Mitchell v. Commissioner (I)

Case name: Estate of Mitchell v. Commissioner (I)
Citation: T.C. Memo. 1997-461, 1997 Tax Ct. Memo LEXIS 546
Date of decision: October 9, 1997
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Jacobs
Experts: George B. Weiksner (for estate)
Kenneth W. McGraw (for estate)
Martin D. Hanan (for IRS)
E. James Brennan (for IRS)
SIC: 2844 Perfumes, Cosmetics, and Other Toilet Preparations (toothpaste, gel, and dentifrice powders)
NAICS: 325620 Toilet Preparation Manufacturing
323

Keywords: Estate tax

COUNSEL:

David W. K. Wong, B. John Williams, Jr., Miriam Louise Fisher, Karen L. Hirsh, and Melvin E. Lefkowitz, for petitioner.

Henry E. O'Neill, Alan Summers, and Paul G. Robeck, for respondent.

JUDGES:

JACOBS, JUDGE.

OPINIONBY:

JACOBS

OPINION:

MEMORANDUM FINDINGS OF FACT AND OPINION

JACOBS, JUDGE: Respondent determined a $45,117,089 Federal estate tax deficiency, an $8,396,020 penalty under section 6662(g), and a $147,623 penalty under section 6662(h). After concessions, the issues remaining for decision are: (1) The moment-of-death value of 1,226 shares of John Paul Mitchell Systems common stock; and (2) whether petitioner is liable for the section 6662(g) penalty. n1

All section references are to the Internal Revenue Code as amended and in effect at decedent's date of death, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulations of facts, stipulations of settled issues, and attached exhibits are incorporated herein by this reference.

A. BACKGROUND

Paul Mitchell (Mr. Mitchell or decedent) was a resident of Hawaii when he died on April 21, 1989. Patrick T. Fujieki is the executor of the Estate of Paul Mitchell. Mr. Fujieki resided in Honolulu, Hawaii, at the time the petition in this case was filed.

Among the assets included in Mr. Mitchell's taxable estate were 1,226 shares of John Paul Mitchell Systems common stock held by the Paul Mitchell Trust (the Trust), a revocable trust established by Mr. Mitchell. It is the value of these shares at the moment of Mr. Mitchell's death that we must determine. n2

B. PAUL MITCHELL

Paul Mitchell was born Cyril Thomson Mitchell in Scotland on January 27, 1936. His mother was a hairdresser. At the age of 16, he enrolled in beauty school, and after a 5-year apprenticeship, he became a "qualified hairdresser". Thereafter, Mr. Mitchell worked in four salons and won several competitive hair contests in England.

In the early 1960's, Mr. Mitchell pursued fashion hair styling working with Vidal Sassoon and became one of London's best known hair stylists. When Mr. Sassoon opened his first U.S. salon, he chose Mr. Mitchell to train the staff. While employed with Vidal Sassoon, Mr. Mitchell brought to the United States the "blow dry" look.

In 1966, Mr. Mitchell left Mr. Sassoon and became director of Bendel's Beauty Floor at Henri Bendel's in New York City. While he was at Bendel's, his work was featured on the covers and pages of major fashion magazines. He became known as the "haircutter's haircutter".

In 1967, Mr. Mitchell and other investors opened Crimpers Salon, a successful high-fashion cutting salon, in New York City. Other Crimpers Salons subsequently opened in Boston, Chicago, Dallas, and Philadelphia. In 1971, Mr. Mitchell sold his share in Crimpers and spent a year away from the hair styling industry.

In 1972, Mr. Mitchell returned to the hair styling industry, opening the Superhair Salon in New York City, a high- fashion salon and cutting school. Several years later, he moved to Hawaii. His reputation as a master stylist continued, and he was invited to perform as a guest platform artist at professional beauty shows throughout the United States.

While demonstrating his techniques at professional beauty shows, Mr. Mitchell developed the "sculpted look" of hair styling. This new look started with an excellent cut. A product was introduced by Mr. Mitchell that gave the cut greater versatility, permitting the setting of hair without rollers or a curling iron. Mr. Mitchell's product, called "liquid styling tool", was a gel-like liquid that set hair in the shape into which it was combed. Mr. Mitchell's product line was marketed in orange and white bottles and sold only at the hair shows where Mr. Mitchell demonstrated his hair styling techniques. Mr. Mitchell's initial efforts to market his product line proved unsuccessful.

C. THE HAIR CARE INDUSTRY

The hair care products industry is segmented by distribution channels. "Mass market" products are sold directly to consumers through major retail outlets, such as supermarkets, drugstores, and discount stores. Products sold through this distribution channel are heavily dependent upon extensive and expensive mass-media advertising to generate an awareness of the product and consumer demands. "Over-the-counter" products are sold through beauty supply stores, which sell products that are not "salon-only" products (and are generally not available in the mass market). "Salon-only" (or "professional-only") products (such as the Paul Mitchell line described hereinafter) are available to the public only through professional hair salons. Throughout the 1980's, the greatest growth in sales of hair care products was in the salon-only market.

Salon-only products do not require a high level of advertising expenditures, but they are heavily dependent upon the recommendation of a brand, product, or system, by the hair stylist to the consumer in the salon. Because of the hair stylist's ability to influence the consumer, companies that sell their products through salons emphasize marketing to hair stylists and salon owners. Furthermore, these companies place importance on educating hair stylists and salon owners about their products in order to ensure correct recommendations to consumers, which in turn increase the possibility of repeat sales.

The professional hair care industry is trendy and fashion oriented and sells the public on changes in looks. Hair stylists learn the latest trends and fashions through trade magazines (such as Modern Salon, Salon Today, American Salon, and Salon News). Growth in sales for a professional hair care company depends upon maintaining a forward edge in fashion and trends. n3

There are three categories of liquid hair products: "Hair care" (shampoos, conditioners, and rinses); "styling products" (hair sprays, fixatives, mousses, sculpture lotions, etc.); and "chemical reactive products" (hair color, perms, and bleaches).

Professional-only hair care products are marketed on an implied promise to the hair stylists that such products will not be mass marketed or sold through drugstores, supermarkets, or discount stores. Professional hair stylists will not sell or use mass-marketed products in their salons. Mass marketing a product closes the salon or professional market to that product. n4

Education is an important aspect of marketing hair care products to hair stylists. This education includes hair shows, product knowledge classes, and styling classes (featuring new ways to cut hair and new products to achieve the latest looks). During hair shows, platform artists demonstrate new styles and techniques, using the promoted products. Hair shows occur at the international, national, regional, and local levels.

Hair care industry market revenues grew to $4.2 billion in 1988. During that year, shampoo sales rose by 4 percent, conditioner sales rose by 9 percent, and styling products sales rose by 30.7 percent. Hair sprays and hair styling products were growing at double-digit rates.

D. THE CREATION OF JOHN PAUL MITCHELL SYSTEMS

John Paul "Jones" DeJoria grew up in Los Angeles. Following his graduation from high school, he enlisted in the Navy. Upon his discharge therefrom, he had a variety of sales jobs, selling products such as encyclopedias, photocopiers, insurance, and magazines. In the early 1970's, Mr. DeJoria began working in the beauty products industry for Redken. He held several positions including field sales

representative, district manager (Texas), and national chain and salon manager. While employed at Redken, Mr. DeJoria gained extensive experience in the sale, marketing, promotion, and distribution of beauty products. He possessed exceptional organizational, managerial, and marketing skills.

Messrs. Mitchell and DeJoria first met in the early 1970's. They eventually developed a close friendship. In 1979, they joined forces to market Mr. Mitchell's hair care products (particularly the sculpting lotion) through professional-only hair salons. Mr. DeJoria believed he could successfully market the line. Initially, Messrs. Mitchell and DeJoria were unable to find anyone willing to provide financial assistance; thus, they pooled their resources of $700 to purchase an answering machine, bottles, and caps and hire an artist to design a logo for their labels. Mr. DeJoria persuaded a cosmetics laboratory to manufacture the first batch of products on credit. Instead of the orange and white bottles Mr. Mitchell had previously used, these products were packaged in white bottles with Paul Mitchell's name displayed in black lettering down the side.

At all relevant times, Paul Mitchell products were sold to the public only through professional hair salons.

1. STRUCTURE AND OWNERSHIP

On March 31, 1980, Messrs. Mitchell and DeJoria formed Paul Mitchell Systems, Inc. On May 9, 1985, the corporation changed its name to John Paul Mitchell Systems (JPMS). Messrs. Mitchell and DeJoria granted JPMS all proprietary and distribution rights to the hair and skin products that Mr. Mitchell developed (or had developed under his direction), including the products' trademark, service mark, or other intellectual property rights.

JPMS' articles of incorporation authorized the issuance of 10,000 shares of common stock. Between March 31, 1980, and April 21, 1989 (the date of Mr. Mitchell's death), JPMS had 2,500 shares issued and outstanding. Article VII of JPMS' bylaws provided that any transfer of JPMS stock was subject to a right of first refusal, exercisable first by the corporation, then by each nontransferring shareholder.

Initially, Mr. DeJoria owned 1,250 shares of JPMS common stock and Paul Mitchell Associates, Ltd. (PMA), owned 1,250 shares. Mr. Mitchell owned all of PMA. On February 20, 1982, PMA assigned its JPMS shares to Mr. Mitchell. On November 20, 1984, Mr. Mitchell assigned his JPMS shares to the Trust. On August 1, 1987, Mr. Mitchell, acting as trustee of the Trust, assigned 16 shares of JPMS common stock to Jeanne Braa, his long-time stage partner in hair shows, and 8 shares of JPMS common stock to Angus Mitchell, his son. Mr. DeJoria and JPMS executed written waivers of the right of first refusal with respect to all of these transfers.

As of April 21, 1989, the common stock of JPMS was owned as follows:

	Number of Shares	Percent
Mr. DeJoria	1,250	50.00
The Trust	1,226	49.04
Ms. Braa	16	0.64
Angus Mitchell	8	0.32

Total	2,500	100.00

JPMS' bylaws provided for a board of directors (the Board) consisting of four directors. However, from 1984 until April 15, 1989, Mr. Mitchell, Mr. DeJoria, and Peter Langenberg were the only Board members. On April 15, 1989, Mr. Langenberg resigned and Ms. Braa was elected to replace him.

From 1984 until April 1989 Mr. Mitchell served as president of JPMS; Mr. DeJoria served as chairman of the Board, chief executive officer, chief financial officer, and secretary.

As of April 21, 1989, the stock in JPMS had not been registered under any securities law; moreover, neither Mr. DeJoria nor Mr. Mitchell had ever contemplated such a registration or a public offering of JPMS' common stock.

2. PRODUCTS

JPMS debuted its products at the West Coast Beauty Supply Spring Style show in 1980, with Mr. Mitchell demonstrating the product line. JPMS sold the entire first batch of its products at the show, generating revenue of approximately $10,000.

That same year, JPMS began selling Paul Mitchell products through distributors. At the time, the product line consisted of "Shampoo One", "Shampoo Two", "The Conditioner", and "Hair Sculpting Lotion". The new hair sculpting lotion and sculpted look were well received in the market. Messrs. Mitchell and DeJoria began promoting JPMS products as a "system" of products to be used in conjunction with each other to achieve "the look".

At the time of Mr. Mitchell's death, JPMS sold the following products, which were formulated by independent chemists:

Shampoo products	Shampoo One; Shampoo Two; Awapuhi Shampoo; Tea Tree Special Shampoo
Hair conditioning products	The Conditioner; Super-Charged Conditioner; Hair Repair Treatment
Hair setting and styling products	Hair Sculpting Lotion; The Spray; Fast Drying Sculpting Spray; Freeze and Shine Super Spray; Super Clean Gel; Sculpting Foam; Super Clean Spray
Permanent wave products	The Solution; Special Perm Neutralizer; Awapuhi Conditioning (Box) Perm

3. MARKETING AND DISTRIBUTION

JPMS' marketing effort primarily targeted, and the distribution network was primarily oriented toward, hair stylists and salon owners who sold hair care products to their customers, rather than direct marketing to the consumers themselves. Mr. Mitchell's popularity and reputation with hair stylists were used to introduce JPMS' products, and the hair shows were used to increase the visibility of JPMS and its products.

JPMS' marketing strategy included the use of distributors to promote its products. As of April 21, 1989, JPMS had 38 distributors in the United States and 13 distributors in 12 other countries. Nearly all of the distributors had an exclusive geographic territory. The distribution network was generally composed of

friends of Messrs. Mitchell and DeJoria who believed that Mr. Mitchell's reputation as an avant-garde hair stylist, and Mr. DeJoria's business background, would sell the JPMS products. As of April 21, 1989, JPMS had no written agreements with its U.S. distributors.

Mr. DeJoria's organizational and marketing skills, combined with Mr. Mitchell's artistic creativity and expertise, allowed JPMS to create a successful and effective product line. The JPMS products were marketed only to salons and emphasized education as a selling technique.

E. MR. MITCHELL'S ROLE IN JPMS

In 1980, Mr. Mitchell promised hair stylists that his products, marketed through JPMS (then Paul Mitchell Systems, Inc.), would be sold only through professional salons. Mr. Mitchell's promise carried credibility due to his stature in the professional beauty industry. The promise to remain "professional-only" was important to the successful marketing of the Paul Mitchell products.

Mr. Mitchell was the heart of JPMS' connection to hair stylists, who were the foundation for JPMS' marketing strategy of promoting and selling products that Mr. Mitchell developed. Mr. Mitchell was JPMS' creative trendsetter, and his hair sculpting technique revolutionized hair styling.

In order to further promote its products, JPMS developed the "Associates Program" to train hair stylists in the Paul Mitchell system. This program became an integral part of JPMS' marketing effort. JPMS associates underwent special training in both hair styling and JPMS products. Once trained, the associates went to salons to teach the proper techniques to promote the products.

By April 21, 1989, JPMS had 700 associates. The associates were paid by the distributors, and they were involved with JPMS because they sought professional advancement and financial rewards. The associates program played a large part in JPMS' success.

Mr. Mitchell was a popular "draw" at industry hair shows, performing on a regular basis from 1980 until July 1988. During the show season, Mr. Mitchell, along with his stage partner, Jeanne Braa, would travel to as many as four cities a week for approximately 3 months at a time. This included shows for each distributor as well as demonstrations through in-salon classes. Mr. Mitchell traveled with distributors' salesmen who assisted in the introduction and sale of JPMS products.

Mr. Mitchell was the focal point of JPMS' advertising campaign. In 1986, JPMS came up with the "Creative" concept campaign, putting Mr. Mitchell literally behind the product, using photographs of him taken by Irving Penn, a noted fashion photographer. This campaign, which ran through 1987, was bifurcated into a consumer version for Vogue, Mademoiselle, and Glamour magazines with the caption "Can you say 'Paul Mitchell does my hair?'", as well as a trade version for Modern Salon and American Salon magazines with the caption "Paul Mitchell works for me". A similar 1988 advertising campaign also featured Mr. Mitchell.

F. MR. MITCHELL'S ILLNESS AND DEATH

Mr. Mitchell's health had been good until approximately May 1988, when he returned from a series of hair shows in Japan and began to experience loss of appetite, weight loss, and the onset of jaundice. on July 18, 1988, he was admitted to Cedars Sinai Hospital in Los Angeles and was diagnosed as having pancreatic cancer. Four days later his pancreas, spleen, gall bladder, and a portion of his stomach were surgically removed. He remained in the hospital until September 30, 1988, undergoing additional

surgeries and medical procedures, including radiation therapy. Upon release, he returned to his home in Hawaii, where he had full-time private duty nursing. Throughout this period, Mr. Mitchell continued his roles as the JPMS creative force, company spokesman, and executive.

Following his hospitalization, Mr. Mitchell was required to take insulin to control diabetes. In October and November 1988, he consulted with and received treatment from doctors in Hawaii, Los Angeles, and New York. Although he continued experiencing bouts of nausea, his medical condition improved, and he gained weight. Mr. Mitchell began receiving acupuncture treatments, keeping his medication intake at a minimum. Although follow-up tests revealed no evidence of metastasis, a November 1988 blood test raised a possibility of a recurrence of cancer but was inconclusive.

Mr. Mitchell's medical condition prevented him from working or performing at hair shows until approximately January 1989, when he performed at a hair styling show in New York City and participated in the JPMS distributors meeting in Vail, Colorado. During this time, he also continued his role in product development, meeting with an independent chemist regarding his ideas for future products. In February 1989, tests revealed a recurrence of cancer. Physicians in Hawaii encouraged Mr. Mitchell to begin chemotherapy, but he refused.

Mr. DeJoria avoided disclosing the severity of Mr. Mitchell's illness to quell any fears about the uncertainty of JPMS' future without Mr. Mitchell. Upon Mr. DeJoria's instruction, Mr. Mitchell's illness was portrayed as bacterial food poisoning. Rumors circulated that Mr. Mitchell was suffering from AIDS or cancer.

To a degree, the 1989 advertising campaign (which was shot in November or December 1988) still focused on Mr. Mitchell. However, Mr. DeJoria and JPMS began shifting emphasis away from Mr. Mitchell as an individual and towards the products themselves. In fact, one campaign attempted to focus on Mr. DeJoria, featuring him and his daughter in an advertising campaign for "Baby Don't Cry" shampoo.

After performing at the West Coast Beauty show in San Francisco in March 1989, Mr. Mitchell returned to Honolulu, where he visited physicians. Later that month he traveled to Mexico to begin receiving laetrile treatments. He remained in Mexico until his return to Cedars Sinai Hospital, where he died on April 21, 1989, at the age of 53. The cause of death was listed as liver failure due to liver and pancreatic cancer. As of the time of his death, the public at large was generally unaware of who Paul Mitchell was or that he had died.

Following Mr. Mitchell's death, the hair care industry widely perceived that JPMS had lost its creative and artistic leader. Rumors about JPMS becoming a mass marketer resurfaced, and there was uncertainty whether JPMS would become just another company. Distributors (both exclusively JPMS and multiline) feared that the loss of Paul Mitchell's creative force would at least slow product sales. However, they did not consider dropping the JPMS product line, primarily because of its profitability.

G. JPMS' OPERATIONS AND MANAGEMENT

As of April 21, 1989, JPMS had some 50 employees, approximately 21 of whom worked in a 90,000-square-foot warehouse space, with an additional 10,000 square feet of office space, in Santa Clarita, California, owned by Mr. DeJoria and the Trust as tenants in common and leased by JPMS. As of April

21, 1989, the warehouse space was not in compliance with the local fire code and had no environmental controls for drainage of waste or runoff water in the event of fire or disposal of poor-quality product. (Some materials used to make hair care products are categorized as hazardous waste.)

JPMS had no useful inventory controls. By April 21, 1989, the warehouse was in disarray, and there was a several-months' supply of products stacked up in JPMS' parking lot. In fact, JPMS tracked its sales by manually recording them on a blackboard. None of the JPMS staff knew how to use computers.

As of April 21, 1989, JPMS' products were formulated by independent chemists and manufactured at independent laboratories. n5 JPMS did not have the formulas for many of its products. Relying on unrelated contract manufacturers to supply the products prior to Mr. Mitchell's death, JPMS generally had no confidentiality agreements with the contract manufacturers covering the proprietary nature of the formulas.

Prior to Mr. Mitchell's death, JPMS was managed as a partnership wherein each partner had a unique role. Mr. Mitchell's strength was his artistry, creativity, and relationship with hair stylists, and JPMS relied on his foresight and artistry to develop products. Mr. DeJoria's strength was in sales, distribution, and promotion.

Mr. DeJoria ran the daily operations at JPMS, making all management decisions and having all managers reporting directly to him (because JPMS had no middle management). Mr. Mitchell, however, was the "senior partner", having the last word on all policy matters. Following Mr. Mitchell's death, Mr. DeJoria became critical to JPMS' future.

H. JPMS' POSITION IN THE INDUSTRY

JPMS was known for its styling products. Over the years, JPMS developed into a major force in the hair care industry, with brand recognition by the consuming public, a sophisticated distribution network, and hundreds of hair stylists trained in the use of the company's products. From 1982 through April 21, 1989, JPMS' share of the salon-only market, in comparison with those of its chief competitors, improved every year. In April 1989, JPMS was among the top five companies in the salon-only market. The success of the salon-only product companies attracted the attention of the large, well-capitalized mass-market companies, which competed in the premium-price market with products that attempted to capture the salon-only aura but were in reality mass marketed.

I. COMPENSATION

From JPMS' inception until Paul Mitchell's death, neither Mr. Mitchell nor Mr. DeJoria had any formal contract with JPMS regarding compensation. Instead, they set sales and profitability goals for JPMS at the beginning of each fiscal year. Thereafter, in September or October of each year, they divided equally the company's available income.

For fiscal years ended July 31, 1984 through 1988, Messrs. Mitchell and Dejoria each received the following payments from JPMS:

For Year Ended	Salary	Management Fees	Total

7/31/84	---	---	1,086,500	n1 7/31/85	---	---	2,305,000	
n1 7/31/86	---	---	4,162,525					
n1 7/31/87	$185,125	$8,565,000	8,750,125	7/31/88	1,308,000	10,500,000	11,808,000	

FOOTNOTE TO TABLE

n1 Payments to Messrs. Mitchell and DeJoria for this year were not broken down into salary or management fees.

END OF FOOTNOTE TO TABLE

JPMS characterized these payments as compensation for services rendered.

Between August 1, 1988, and April 21, 1989, JPMS paid Mr. Mitchell $10,758,046 (which JPMS characterized as compensation for services rendered). For fiscal year 1989, Messrs. Mitchell and Dejoria agreed that each of them would receive a $2 million annual salary and a $15 million management fee. The JPMS Board approved these compensation amounts on October 21, 1988.

From the inception of JPMS until the moment of Mr. Mitchell's death, the only dividend declared by JPMS was for its fiscal year ended July 31, 1988. The dividend was originally set at $1.4 million but was subsequently raised to $2.5 million.

During the latter part of Mr. Mitchell's illness, Messrs. DeJoria and Mitchell discussed Mr. DeJoria's future compensation. Mr. DeJoria promised Mr. Mitchell that in the event of Mr. Mitchell's death, he would reduce his management fee from $15 million to $10 million for JPMS' fiscal year ending July 31, 1990. Mr. DeJoria's $2 million salary for that year was to remain intact.

J. DISCUSSIONS AND AGREEMENT WITH GILLETTE

In 1987, the Gillette Co. (Gillette) was interested in entering the salon-only (or professional-only) products segment of the hair care market. JPMS was one of the primary candidates that Gillette considered purchasing.

In the fall of 1987, Gillette and Messrs. DeJoria and Mitchell discussed a potential joint venture between Gillette and JPMS to distribute a Gillette permanent wave product through the JPMS distribution system. Gillette also sought an option to purchase JPMS, but Messrs. DeJoria and Mitchell would agree only to grant Gillette a right of first refusal.

Accordingly, on December 18, 1987, Aapri Cosmetics, Inc., a wholly owned subsidiary of Gillette, and JPMS entered a joint venture, which began on January 1, 1988, and was to last for an initial 2-year period. The joint venture agreement provided Gillette with a right of first refusal to purchase JPMS at a formula price of 10 times JPMS' prior 12 months' operating income, after deducting the maximum Federal and State corporate income taxes (assumed to be 50 percent of income), and excluding from JPMS' operating income officers' salaries and car expenses. Until July 1988, the price payable pursuant to the right of first refusal was capped at $150 million. Gillette's ultimate goal in entering into the joint venture was to acquire JPMS; Gillette had no interest in a minority shareholder position.

Gillette neither exercised nor waived its right to exercise its right of first refusal contained in the joint venture agreement. During the pendency of the joint venture, Gillette received no notification concerning any offers by third parties to purchase the stock or assets of JPMS.

Only Gillette's board of directors could approve an acquisition the size of JPMS. No formal proposal was ever made to Gillette's board of directors to approve the acquisition of JPMS. n6

The permanent wave product marketed through the joint venture agreement was not well received in the salon market. The joint venture lost $1 million in the first 2 years and was unsuccessful. Accordingly, the joint venture agreement was terminated in December 1989.

K. SALE DISCUSSIONS WITH MINNETONKA

Another suitor of JPMS was Minnetonka Corp. (Minnetonka), a publicly traded company. Robert Taylor was Minnetonka's president and chief executive officer. Mr. Taylor co-founded Minnetonka in 1961 and took the company public in 1968.

Minnetonka was involved in consumer product brands, primarily those that were sold through the department store, gift, or beauty trade. Minnetonka was the licensee for Calvin Klein and created Obsession and Eternity women's fragrances. In addition, Minnetonka created Foltene, a treatment used in the beauty salon business for fine and thinning hair, a product line for home fragrance, and a gift soap product line for department stores.

In 1990, Mr. Taylor started a salon-only hair products company, Graham Webb International, which grew to $25 million in sales in 5 years. From 1992 or 1993 to approximately 1995, Mr. Taylor was on the board of directors of Banker's Trust Venture Capital Fund in New York (Bankers Trust), which specializes in providing funds for small businesses or recapitalization funds. n7

As chairman, Mr. Taylor was responsible for Minnetonka's strategic acquisitions. n8 In 1985, when JPMS' sales approximated $10 million, a financial adviser to JPMS solicited Mr. Taylor's interest in acquiring JPMS. However, Minnetonka determined that JPMS was too small and that the Paul Mitchell brand name was not strong enough to stand on its own; accordingly, Mr. Taylor declined to enter discussions at that time.

Two years later, Minnetonka targeted the salon industry for acquisition candidates, and Mr. Taylor contacted Redken, Sebastian, and JPMS. During this time, the annual sales of these companies were approximately $120 million, $60 million, and $50 million, respectively. Although Minnetonka agreed to acquire Sebastian for $100 million in late 1987, the sale was not consummated.

Mr. Taylor initiated discussions with Mr. DeJoria in the fall of 1987 (JPMS' 1988 fiscal year) when JPMS' sales were approximately $50 million. Mr. Taylor informed Mr. DeJoria that Minnetonka was willing to pay $100 million to acquire all of the JPMS stock, assuming officers' salaries were revised. n9 Mr. DeJoria insisted on a $125 million acquisition price. Mr. Taylor refused to raise Minnetonka's bid, and the negotiations were terminated.

In the fall of 1988, Mr. Taylor again approached Messrs. DeJoria and Mitchell. (At the time, JPMS' sales were in the $65 million range.) Mr. Taylor offered $125 million n10 to acquire all of the JPMS stock. (At this time, Mr. Taylor was unaware that Mr. Mitchell was seriously ill.) The proposed acquisition price assumed that: (1) Mr. DeJoria would continue managing JPMS; (2) Mr. Mitchell would continue promoting the products for at least 18 months to 2 years as a transition period; and (3) both Messrs. Mitchell and DeJoria would be compensated in salary and stock at a level paid to officers of other Minnetonka subsidiaries, such as Calvin Klein.

Mr. DeJoria did not accept Minnetonka's $125 million offer; he believed that Minnetonka was "just a little short every time". (Mr. DeJoria represented to Mr. Taylor that he had received from Gillette a $150 million offer plus a royalty of 2 percent of sales for lifetime. Mr. Taylor informed Mr. DeJoria that he could not match Gillette's offer.) Sales discussions with Minnetonka thus ended.

L. FINANCIAL INFORMATION AVAILABLE AT DATE OF DEATH

JPMS adopted a fiscal year ending July 31. Beginning with the fiscal year ended July 31, 1984, the shareholders elected subchapter S status for Federal income tax purposes. JPMS remained a subchapter C corporation for State of California income tax purposes until the 1988 fiscal year, when the shareholders elected subchapter S status for California.

KPMG Peat Marwick (KPMG) (or one of its predecessors) certified JPMS' audited financial statements. JPMS' net sales and net income after taxes for fiscal years ended July 31, 1982 through 1988, inclusive, were as follows:

Fiscal Year Ended 7/31	Net Sales	Net Income After Taxes
1982	$1,369,316	$142,375
1983	3,590,641	159,947
1984	5,349,152	4,004
1985	11,266,610	n1 207,777
1986	24,131,739	2,265,875
1987	41,371,318	281,777
1988	60,693,857	2,569,297

FOOTNOTE TO TABLE

n1 The audited financial statements for the years ended July 31, 1986 and 1985, state this amount as $10,918,252.

END OF FOOTNOTE TO TABLE

At Mr. Mitchell's death, the most recent available certified financial statements were for JPMS' fiscal year ended July 31, 1988. The most recent interim financial statements available were for the 6 months ended January 31, 1989. (In addition to the annual audited financial statements, KPMG also prepared unaudited financial statements on a quarterly basis.)

Except for motivational sales goals announced at semiannual distributors meetings as of April 21, 1989, JPMS did not project future revenues, expenses, costs of maintaining the Paul Mitchell brand name, or income. Between December 1989 and January 1990 KPMG prepared projections of JPMS' revenues and expenses for fiscal years 1990-94.

M. POST-DEATH EVENTS

1. MR. FUJIEKI'S REQUEST FOR JPMS DOCUMENTS

On June 29, 1989, Patrick Fujieki, trustee of the Trust, and Michaeline Re n11 were elected to the JPMS Board. (The Board was thus comprised of Mr. DeJoria, Ms. Braa, Mr. Fujieki, and Ms. Re.) At this time, the Trust was the shareholder of record of 49.04 percent of the outstanding common shares of JPMS, of

which 1 percent was to be transferred to Mr. DeJoria in accordance with the terms of Mr. Mitchell's Will and Trust.

Mr. Fujieki (in his capacities as director of JPMS, trustee for the Trust, and executor of Paul Mitchell's estate) asked to inspect the JPMS corporate records and financial information at the June 29, 1989, JPMS Board meeting and in later correspondence with Ms. Re, Mr. DeJoria, and other JPMS employees. Through December 19, 1989, Mr. Fujieki was not provided with financial statements for the JPMS fiscal year ended July 31, 1989. On April 10, 1992, representatives of Mr. Fujieki were permitted to review JPMS' financial records but were not allowed to make copies. Before permitting Mr. Fujieki's representatives to review its financial records, JPMS required Mr. Fujieki and his representatives to execute confidentiality agreements.

Mr. Fujieki continually questioned the actions of the JPMS Board at its meetings and the accuracy of the corporate minutes. Beginning July 30, 1992, through at least April 20, 1993, James Ukropina, Esq., outside legal counsel for JPMS, attended the JPMS Board meetings.

2. PURCHASE OFFER FROM MR. DEJORIA

On April 21, 1989, JPMS faced losing its subchapter S status when the Trust ceased to qualify as a subchapter S shareholder. Maintaining JPMS' subchapter S status would have been beneficial to its shareholders because no corporate-level tax would be imposed on JPMS' income. One option would have been for Mr. DeJoria to purchase the Trust's shares of JPMS; however, Mr. DeJoria refused to consider this option because it would have gone against Mr. Mitchell's wishes of providing for his son Angus, for which reason the Trust had been created. Gregg Ritchie, an accountant with KPMG who oversaw the preparation of JPMS' annual audited financial statements, began to explore various scenarios for maintaining JPMS' subchapter S status.

On April 4, 1991, Mr. DeJoria offered, through Mr. Ritchie, to purchase the Trust's share of JPMS common stock for $47 million. Mr. DeJoria's offer included $4.7 million in cash on April 15, 1991, with the balance in 10 annual installments of $4.23 million commencing April 15, 1992 (the unpaid principal balance would bear interest at 8 percent per year, payable quarterly). On April 10, 1991, Mr. Fujieki rejected the offer. Mr. Fujieki invited Mr. DeJoria to make a higher bid; Mr. DeJoria refused, indicating that his next offer would be $37 million ($10 million less than his April 4, 1991, offer).

3. COMPENSATION DISPUTE

Mr. DeJoria assumed many of Mr. Mitchell's corporate responsibilities following Mr. Mitchell's death. Between April 22 and July 31, 1989, JPMS paid Mr. DeJoria $4,901,537 as compensation for services rendered to JPMS. For JPMS' fiscal year ended July 31, 1990, Mr. DeJoria agreed to reduce his management fee from $15 million to $10 million, as promised to Mr. Mitchell. Mr. DeJoria also received $2 million in salary for that year. In summary, JPMS paid Mr. DeJoria the following amounts for fiscal years ended July 31, 1990 through 1994:

For Year Ended	Amount
7/31/90	$12,000,000
7/31/91	17,025,000

7/31/92	17,025,568
7/31/93	17,000,000
7/31/94	17,000,000

JPMS characterized these payments as compensation for services rendered.

From August 1, 1989 through 1992, Mr. Fujieki repeatedly requested in letters and at Board meetings that the Board retain an independent compensation consultant to consider the reasonableness of Mr. DeJoria's compensation. The Board rejected Mr. Fujieki's requests. At this time, tension began to mount among members of the Board.

In late 1990, Mr. Fujieki retained Coopers & Lybrand to determine a reasonable level of compensation for Mr. DeJoria. On January 11, 1991, Coopers & Lybrand preliminarily determined that a reasonable level of compensation was within the range of $600,000 to $1 million, with a possible $2 million ceiling. At the January 10, 1992, Board meeting, the Board approved Mr. DeJoria's compensation at 13 percent of JPMS' gross sales, not to exceed $17 million per year, for JPMS' fiscal years ended July 31, 1992 through 1996. Mr. Fujieki objected to this approval by the Board.

Mr. Fujieki proposed to have the compensation dispute resolved by arbitration, but Mr. DeJoria refused. Accordingly, in June 1993, Mr. Fujieki brought suit against Mr. DeJoria, Ms. Re, and JPMS on the Trust's behalf, alleging that Mr. DeJoria's compensation was excessive. The suit was filed in both the Superior Court for the State of California and the U.S. District Court for the Central District of California.

In response to Mr. Fujieki's allegations of shareholder derivative claims, JPMS formed a Special Litigation Committee (SLC) comprising JPMS' outside directors: Kenin Spivak, Paul Rupert, and David Tisdale. Among other things, the SLC was to evaluate Mr. Fujieki's allegations to decide whether to pursue the derivative claims on JPMS' behalf. The SLC hired Towers Perrin as executive compensation consultants to assist the SLC.

In April 1995, the litigation between the Trust and JPMS was settled; the SLC determined that the settlement agreement was in JPMS' best interests. The JPMS Board and shareholders, as well as the court, approved the settlement agreement. Neither the SLC, the JPMS Board, nor the court determined that Mr. DeJoria's compensation was unreasonable.

N. THE ESTATE TAX RETURN, NOTICE OF DEFICIENCY, AND PETITION

On its estate tax return, petitioner valued the Trust's interest in the 1,226 shares of JPMS common stock at the moment of decedent's death at $28.5 million. This figure was based upon a KPMG valuation analysis prepared at Mr. Fujieki's request. (KPMG utilized both the comparable companies and discounted cash-flow analyses.)

In the notice of deficiency, respondent determined, in pertinent part, that petitioner had undervalued the JPMS common stock. Respondent determined that the fair market value of the Trust's interest in the 1,226 shares of JPMS common stock at the moment of death was $105 million. Accordingly, respondent determined that the value of the gross estate should be increased by $76.5 million. The notice also determined section 6662(g) and (h) penalties.

Petitioner filed a petition in this Court challenging respondent's moment-of-death valuation for the Trust's 1,226 shares of JPMS common stock, essentially restating the position taken on the estate tax return. In the original answer to petitioner's petition, respondent restated the position taken in the notice of deficiency. Following the trial in this case, petitioner filed an amended petition alleging that the value of the 1,226 shares of JPMS common stock as of April 21, 1989, was $23,062,000, rather than the $28.5 million reflected on both the estate tax return and the original petition. In the answer to the amended petition, respondent denied the allegations contained in petitioner's amended petition.

ULTIMATE FINDING OF FACT

The moment-of-death value of the 1,226 shares of JPMS common stock held by the Trust and includable in decedent's gross estate was $41,532,600.

OPINION

ISSUE 1. MOMENT-OF-DEATH VALUE OF JPMS STOCK

The primary issue for decision is the moment-of-death value of 1,226 shares of JPMS common stock held by the Trust. Petitioner now contends that the stock was worth between $23,062,000 and $29 million. Respondent now asserts the value to be $81 million, or $24 million less than that determined in the notice of deficiency.

Section 2031(a) requires a decedent's "gross estate" to be determined for Federal estate tax purposes "by including * * * the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." Value is determined at the moment of death. n12 Ahmanson Found. v. United States, 674 F.2d 761, 767 (9th Cir. 1981); Estate of McClatchy v. Commissioner, 106 T.C. 206, 210 (1996). The standard for valuation is fair market value, defined as "'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 to sell and both having reasonable knowledge of relevant facts.'" United States v. Cartwright, 411 U.S. 546, 551 (1973) (quoting section 20.3031-1(b), Estate Tax Regs.); Collins v. Commissioner, 3 F.3d 625, 633 (2d Cir. 1993), affg. T.C. Memo. 1992-478. This objective test requires property to be valued from the viewpoint of a hypothetical buyer and seller, each of whom would seek to maximize his or her profit from any transaction involving the property. See Estate of Watts v. Commissioner, 823 F.2d 483, 486 (11th Cir. 1987), affg. T.C. Memo. 1985-595; Estate of Bright v. United States, 658 F.2d 999, 1005-1006 (5th Cir. 1981). The value of property is a question of fact, and we consider all relevant facts and circumstances. E.g., Ahmanson Found. v. United States, supra at 769; Hamm v. Commissioner, 325 F.2d 934, 938 (8th Cir. 1963), affg. T.C. Memo. 1961-347; Estate of Jung v. Commissioner, 101 T.C. 412, 423-424 (1993); Messing v. Commissioner, 48 T.C. 502, 512 (1967); sec. 20.2031-1(b), Estate Tax Regs. Fair market value may be affected by future events that were reasonably foreseeable at the valuation date. Estate of Gilford v. Commissioner, 88 T.C. 38, 52 (1987); Gray v. Commissioner, 2 B.T.A. 672, 682 (1925); Estate of Livermore v. Commissioner, T.C. Memo. 1988-503.

Determining the fair market value of a closely held corporation's capital stock is difficult because it involves property that has no public market. The best method for valuing closely held stock is by reference to an actual arm's-length sale of the stock in the normal course of business within a reasonable time before or after the valuation date. See Estate of Andrews v. Commissioner, 79 T.C. 938,

940 (1982); Estate of Campbell v. Commissioner, T.C. Memo. 1991-615; sec. 20.2031-2(b), Estate Tax Regs. In the absence of an arm's-length sale, the fair market value of closely held stock must be determined indirectly by considering, inter alia:

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend paying capacity of the company.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) * * * the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same line or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Rev. Rul. 59-60, sec. 4.01, 1959-1 C.B. 237, 238-239; see also sec. 20.2031-2(f), Estate Tax Regs. These factors cannot be applied with mathematical precision. See Rev. Rul. 59-60, supra, 1959-1 C.B. at 238. Rather, the weight accorded each factor must be tailored to account for the particular facts under consideration. See Messing v. Commissioner, supra.

Both parties relied upon expert valuations. At times, expert testimony aids the Court in determining valuation; in other instances, it does not. See Laureys v. Commissioner, 92 T.C. 101, 129 (1989). We are not bound by an expert's formulae and opinions, especially when they run contrary to our judgment. Chiu v. Commissioner, 84 T.C. 722, 734 (1985). Instead, we may reach a decision as to the value of the property based on our own analysis of all the evidence in the record, Hamm v. Commissioner, supra at 941, using all of one party's expert opinion, Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 452 (1980), or selectively using any portion of such an opinion, see Parker v. Commissioner, 86 T.C. 547, 562 (1986).

In sum, we will consider expert opinion testimony to the extent it assists our fair market value determination. Valuation is an approximation, and the figure we reach need not be one as to which there is specific testimony. Our role is to approximate fair market value as closely as possible, within the range of figures that may properly be deduced from the evidence. Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo. 1974-285.

A. VALUATIONS OF PETITIONER'S EXPERTS

1. THE WEIKSNER REPORT

Petitioner's first expert, George B. Weiksner, is a managing director and senior adviser of CS First Boston, an investment banking firm. Mr. Weiksner has 25 years of investment banking experience.

Mr. Weiksner's report valued the Trust's 49.04 percent interest in JPMS common stock (1,226 shares) at $20,634,000 to $25,489,000, with a midpoint value of $23,062,000. Mr. Weiksner's report began with a comparable companies analysis n13 that (1) selected five standard multiples (net sales, operating cash-flow -- EBITDA, operating income -- EBIT, net income, and cash flow), (2) determined the ranges of

applicable multiples from the comparable companies data, and (3) applied the multiple ranges to JPMS' "normalized" financial data (making adjustments to the financial data generated in the earnings model). n14 From the value ranges thus derived, Mr. Weiksner determined a comparable companies value range for JPMS of $85 million to $105 million. He then determined JPMS' public value n15 of $76.5 million to $94.5 million by subtracting from JPMS' comparable companies value a 10-percent extraordinary risk discount. This discount accounted for: (1) The approximate cost of replacing Mr. Mitchell's services that was estimated in the projections of JPMS' operating expenses; (2) operational difficulties; (3) dependence on Mr. Dejoria; and (4) difficulty in maintaining future growth. Mr. Weiksner believed that these risks were unique to JPMS at the valuation date and warranted the discount of the stock.

Mr. Weiksner subsequently calculated the proportionate public value of the shares and adjusted that value by a 45-percent discount to reflect minority interest and lack of marketability, n16 to arrive at a $20,634,000 to $25,489,000 private value n17 for the 1,226 JPMS shares. At trial, Mr. Weiksner suggested a 30- to 50- percent range for these discounts.

In addition to the comparable companies analysis, Mr. Weiksner utilized the comparable acquisitions and discounted cash- flow analyses as confirming methodologies. Mr. Weiksner valued JPMS through the comparable acquisitions analysis by reference to private market sales of similar businesses, thereby generating control values. n18 Mr. Weiksner identified appropriate comparable transactions and measured the enterprise and equity values of target companies as multiples of financial benchmarks. Then he applied those multiples to the corresponding actual and projected financial benchmarks of JPMS. Accordingly, Mr. Weiksner applied his comparable acquisitions multiples to the normalized data for JPMS that he created from his earnings model to determine a range of control values for JPMS. The $110 million to $135 million control value that he determined exceeded JPMS' comparable companies value by approximately 29 percent and exceeded JPMS' public value by approximately 43 percent, within his expectations of an appropriate control premium.

In his discounted cash-flow analysis, Mr. Weiksner valued JPMS as the sum of its projected cash-flows before financing costs over several years plus an estimated value of the company at the end of the forecast period, all discounted to present value. He determined a range of terminal values through his comparable companies analysis and a range of appropriate discount rates through an adjusted weighted average cost of capital analysis. The $115 million to $140 million control value that Mr. Weiksner determined for JPMS through this analysis exceeded JPMS' comparable companies value by approximately 34 percent and JPMS' public value by approximately 49 percent, within his expectation of an appropriate premium.

We note that at trial, Mr. Weiksner suggested a $110 million to $135 million range of control values for JPMS on April 21, 1989.

2. THE McGRAW REPORT

Petitioner's second expert, Kenneth W. McGraw, is managing director of Patricof & Co. Capital Corp., an investment banking firm. He has approximately 36 years of experience in finance markets and investment banking.

Utilizing a comparative companies analysis, Mr. McGraw valued the 1,226 shares of JPMS common stock at approximately $29 million. (In this analysis, he used virtually the same group of comparable public companies as Mr. Weiksner.) Mr. McGraw adjusted JPMS' financial data in deriving an earnings model to which he applied his comparable companies analysis. To represent the amount JPMS would have to spend to replace the benefits of Mr. Mitchell's services, Mr. McGraw estimated that additional expenditures for advertising and administrative expenses would increase JPMS' advertising and promotional expenses to 16 percent of total revenues. He also removed Mr. Mitchell's compensation expense from the financial data. n19

Mr. McGraw reduced his approximate $109 million theoretical publicly traded value for JPMS by an extraordinary risk discount, through a 15-percent reduction to his average EBIT and average EBITDA. Mr. McGraw then applied a 45-percent marketability discount n20 to the value he determined through the comparative companies analysis, resulting in a $29.5 million value for the 1,226 shares of JPMS common stock.

In addition to his comparative companies analysis, Mr. McGraw utilized a discounted cash-flow analysis, determining a pro rata equity value of $49.5 million. In this analysis, he also applied a 45-percent discount for lack of marketability, yielding a $27.2 million value for the 1,226 shares of JPMS common stock.

Mr. McGraw weighed his comparative companies analysis more heavily than his discounted cash-flow analysis; in his opinion, the comparative companies analysis was the "more reliable indicator of value". Accordingly, relying on this analysis, Mr. McGraw concluded that the fair market value of the 1,226 shares of JPMS common stock was approximately $29 million.

B. VALUATIONS OF RESPONDENT'S EXPERTS

1. THE HANAN REPORT

Respondent offered Martin D. Hanan, president of Business Valuation Services, Inc. (BVS), as an expert witness. He has worked as an appraiser for many years. Mr. Hanan valued the 1,226 shares of JPMS common stock at $81 million, relying on both the comparable companies n21 and discounted cash-flow analyses.

In his comparable companies analysis, Mr. Hanan utilized practically the same group of comparable public companies used by Mr. Weiksner. Mr. Hanan began with normalizing JPMS' financial results. For instance, Mr. Hanan concluded that the combined compensation paid to Messrs. Mitchell and DeJoria would not have exceeded $2.5 million if they were paid under arm's-length conditions; Mr. Hanan thus adjusted the historical financial performance to reflect arm's-length rates. He believed that a shareholder of the 49-percent block would likely reach an accommodation with Mr. DeJoria regarding his compensation before agreeing to a price for those shares. For purposes of this analysis, Mr. Hanan accordingly assumed Mr. DeJoria's compensation would be set at $5 million per year after the valuation date.

Mr. Hanan's comparable companies analysis indicated a $272 million value for JPMS on a publicly traded, minority interest basis. He subsequently applied a 30-percent discount for lack of marketability (concluding that JPMS' size, profitability, shareholder rights, dividend paying capacity and policy, as well as transfer restrictions, all favored a below-average marketability discount, while Mr. DeJoria's

anticipated intention to continue drawing excessive compensation favored an above-average marketability discount). By applying the 30-percent discount to his $272 million value for JPMS, Mr. Hanan determined an $81 million fair market value for the 1,226 shares of JPMS common stock as of April 21, 1989.

In his discounted cash-flow analysis, Mr. Hanan projected JPMS' anticipated cash-flows for 5 years after 1989, and discounted the cash-flows to a present value at the valuation date. For purposes of this analysis, Mr. Hanan again assumed executive compensation would be set at $5 million. Accordingly, Mr. Hanan determined that as of April 21, 1989, the discounted cash-flow control value of JPMS was $295 million, while the discounted cash-flow value of JPMS' equity was $218 million on a publicly traded, minority-interest basis.

Finally, although Mr. Hanan proposed an $81 million fair market value for the 1,226 shares of JPMS common stock, he concedes that "because of a likely disagreement between the buyer/seller and Mr. DeJoria over Mr. DeJoria's compensation and the possibility of litigation, the value of the subject stock could be as high as $165.3 million and as low as $57.7 million." n22

2. THE BRENNAN REPORT

Respondent also offered the expert report of E. James Brennan III, n23 president of Brennan, Thomsen Associates, Inc. Mr. Brennan regularly testifies as an expert witness regarding personnel management and pay practices, particularly in the area of executive compensation.

Mr. Brennan's report evaluated the reasonable level of compensation for services provided by Messrs. Mitchell and DeJoria prior to Mr. Mitchell's death and made an estimate of the reasonable level of compensation for Mr. DeJoria for the 5 fiscal years following Mr. Mitchell's death. Mr. Brennan opined that the amounts Messrs. Mitchell and DeJoria paid themselves for the 1984-89 fiscal years were far in excess of the maximum amounts paid to comparable top executives at equivalent enterprises for employee services. Mr. Brennan concluded that the maximum level of reasonable compensation for Mr. DeJoria for 1990-94 would range between $820,300 and $1,159,420, based on projections of an increase in sales revenue for those years.

C. CRITIQUE OF EXPERTS

Not unexpectedly, each party criticized the opposing experts' analyses. The following points highlight these disparate perspectives.

1. RESPONDENT'S ARGUMENTS

Respondent criticizes Messrs. Weiksner's and McGraw's valuations as based on the mistaken assumption that JPMS was a fragile, disorganized, mismanaged, problem-ridden company on the verge of collapse as of April 21, 1989. Moreover, respondent criticizes three aspects of petitioner's comparable companies analyses: (1) The kinds of multiples selected, the time periods to which the multiples relate, and their weighting; (2) the adjustments made to JPMS' financial data; and (3) the adjustments for risk and illiquidity. Respondent argues that petitioner's experts' analyses were essentially based upon subjective judgment. In fact, respondent believes that petitioners' experts failed to offer a credible basis for their extraordinary risk or illiquidity discounts.

Respondent further argues that Mr. Weiksner's "normalized" earnings model, which he applies over a 3-year period, is inaccurate and misleading because 2 of the 3 years ended after the valuation date; thus, the figures for those years are essentially a projection rather than an analysis of actual results.

With regard to Messrs. Weiksner's and McGraw's discounted cash-flow analyses, respondent first argues that these analyses fail to confirm the comparative companies method values these experts determined. Respondent posits that Mr. Weiksner's discounted cash- flow analysis assumes that Mr. DeJoria's future compensation will conform to Mr. DeJoria's expectation of $12 million in fiscal year 1990 and $17 million per year thereafter. However, according to respondent, Mr. Weiksner's discounted cash-flow analysis actually presumes no control over Mr. DeJoria's compensation or any other element of JPMS' cash-flows. Thus, respondent argues that Mr. Weiksner's result is a minority interest value rather than a control value.

2. PETITIONER'S ARGUMENTS

Petitioner counters that Mr. Hanan's valuation has four erroneous bases: (1) Nonexistent "projections" of Mr. DeJoria; (2) an unreasonable assumption that Mr. DeJoria would unilaterally reduce his compensation to $5 million as of the valuation date; (3) a nonexistent "transition plan"; and (4) financial information not available as of Mr. Mitchell's date of death. (In fact, petitioner asserts that both Mr. Hanan's discounted cash-flow and comparable companies analyses improperly rely on KPMG's projections of JPMS' operating results following Mr. Mitchell's death.)

More specifically, petitioner first argues that the "DeJoria projections" referred to by respondent are the projections developed by KPMG with the benefit of 8 months of hindsight and yearend audited financial data not available on April 21, 1989. Petitioner contends that the projections did not exist at the valuation date and would not have been knowable to a hypothetical buyer or seller.

Second, petitioner contends that it would be unreasonable and unrealistic to assume, as Mr. Hanan did, that Mr. DeJoria's compensation could be reduced by any means short of litigation. Petitioner contends that most buyers are litigation averse. Therefore, petitioner posits, the only reasonable assumption is that Mr. DeJoria would receive compensation in the amounts of $12 million for JPMS' 1990 fiscal year and $17 million per year thereafter.

Third, according to petitioner, respondent refers to a "transition plan" Mr. DeJoria developed when he learned of Mr. Mitchell's illness. Petitioner suggests that no concrete plan ever existed.

Fourth, petitioner argues that Mr. Hanan relied on post- April 21, 1989, information in developing his discounted cash-flow model. He used data from fiscal year ended July 31, 1989 (taken from JPMS' annual certified financial statements) in deriving his April 21, 1989, base year. However, this information was not available until the late fall of 1989. Thus, petitioner argues, Mr. Hanan premised his base year data on JPMS' actual financial results that, by definition, could not have been available at the valuation date. Furthermore, petitioner contends that Mr. Hanan mechanically used the KPMG projections (which he referred to as the "DeJoria projections") to compute his discounted cash-flow.

In short, petitioner contends that while Mr. Hanan's discounted cash-flow purports to be a minority interest discounted cash-flow, in reality it is a control discounted cash-flow. According to petitioner, Mr. Hanan improperly changed the capital structure of JPMS, adding long-term debt on the assumption that a minority shareholder could influence capital structure.

Finally, petitioner opines that Mr. Hanan's exorbitant control value is irreconcilable with Minnetonka's $125 million offer for all of the JPMS stock. Petitioner urges the Court to dismiss Mr. Hanan's conclusions as unrealistic.

D. COURT'S ANALYSIS AND CONCLUSION

We have considered all of the testimony before us, as well as the expert witness reports, and have weighed all other relevant factors. As articulated by the parties, each expert witness report is susceptible to criticism. We are unable to accept the moment-of-death valuations given to the 1,226 shares of JPMS common stock by any of the expert witnesses. Instead, we rely on our own analysis, based on all the evidence in the record.

We begin our analysis by placing a $150 million value on JPMS at the moment immediately prior to Mr. Mitchell's death. In determining this value, we considered all the evidence but gave the greatest consideration to Minnetonka's "real world" $125 million offer in the fall of 1988 (which Mr. DeJoria found "a little short") and Mr. DeJoria's representation to Mr. Taylor that he had received from Gillette a $150 million offer PLUS a royalty of 2 percent of sales for a lifetime (which Mr. Taylor found to be an offer he could not match).

We next consider the impact of Mr. Mitchell's death on JPMS. Mr. Mitchell embodied JPMS to distributors, hair stylists, and salon owners. He was vitally important to its product development, marketing, and training. Moreover, he possessed a unique vision that enabled him to foresee fashion trends in the hair styling industry. It is clear that the loss of Mr. Mitchell, along with the structural inadequacies of JPMS, created uncertainties as to the future of JPMS at the moment of death.

In particular, a hypothetical buyer or seller would have to consider the following factors in valuing the 1,226 shares of JPMS common stock at the moment of Mr. Mitchell's death: (1) Whether it would be necessary to increase JPMS' advertising and marketing expenses; n24 (2) whether litigation concerning Mr. DeJoria's compensation would ensue; (3) whether the lack of a ready or available market for the stock would affect its fair market value; (4) whether and how JPMS would continue its history of successful product development and styling leadership; (5) whether rumors concerning JPMS "going retail" would adversely affect its relationships with salons; (6) whether JPMS' history of unreliable suppliers would continue; (7) whether JPMS would solve its inventory control and financial information reporting problems; and (8) whether JPMS' thin management and total reliance on Mr. DeJoria would hinder its performance.

Nonetheless, Mr. DeJoria stepped in to single-handedly run JPMS upon Mr. Mitchell's death. Mr. DeJoria had always overseen JPMS' marketing. Indeed, despite his reputation for creativity, Mr. Mitchell had not succeeded in marketing his product line in the late 1970's. Although there is no doubt that Mr. Mitchell's fame was an important component in launching JPMS in the early 1980's, Mr. DeJoria's salesmanship, marketing savvy, and construction of the distribution network were also vitally important.

In addition, Mr. Taylor, whom we found extremely credible, testified that Mr. Mitchell was not as essential to Minnetonka's interest in JPMS as Mr. DeJoria. Mr. Taylor also observed that the deaths of fashion designers Perry Ellis and Anne Klein did not affect their ongoing businesses to any significant degree "because the consumer somehow is so far removed from the actual * * * involvement of that designer * * * they're still buying the product."

In our opinion, the $150 million value for JPMS at the moment immediately prior to Mr. Mitchell's death should be discounted by 10 percent to reflect the loss of Mr. Mitchell to JPMS. Thus, we believe that at the moment of Mr. Mitchell's death, JPMS had a value of $135 million.

We further believe: (1) A total 35-percent discount is appropriate, reflecting combined discounts for lack of marketability and minority interest; and (2) a $1.5 million discount, reflecting the possibility of a lawsuit over Mr. DeJoria's compensation, should be applied. Taking these factors into consideration, we find, and thus hold, that the value of decedent's interest was $41,532,600 n25 as of the moment of his death.

ISSUE 2. SECTION 6662(g) PENALTY

The final issue is whether petitioner is liable for the section 6662(g) penalty. A substantial estate tax valuation understatement occurs if the value of property claimed on a return is 50 percent or less of the amount determined to be its correct value, and the portion of the underpayment attributable to the understatement exceeds $5,000. Sec. 6662(g). The penalty equals 20 percent of the portion of the underpayment attributable to the understatement. Sec. 6662(a). The penalty does not apply to any portion of the underpayment for which the taxpayer shows that he or she: (1) Had reasonable cause, and (2) acted in good faith with respect thereto. Sec. 6664(c); see also United States v. Boyle, 469 U.S. 241, 242 (1985). Whether a taxpayer had reasonable cause and acted with good faith is a factual determination. Sec. 1.6664-4(b), Income Tax Regs.

The parties agree that the section 6662(g) penalty is inapplicable unless the Court decides that the moment-of-death value of the 1,226 shares of JPMS common stock was $57 million or more. n26 On the basis of our determination that the fair market value of the 1,226 shares of JPMS stock as of April 21, 1989, was $41,532,600, the section 6662(g) penalty does not apply.

In light of the foregoing, and to reflect concessions and settled issues,

Decision will be entered under Rule 155.

FOOTNOTES

n1 On June 11, 1996, petitioner filed a Motion to Shift the Burden of Persuasion. By Order dated July 8, 1996, we denied petitioner's motion. On brief, petitioner again raised this issue. We reaffirm our conclusions as stated in our July 8, 1996, Order. But even assuming arguendo we would have granted petitioner's motion, our valuation of the stock at issue would not be altered.

n2 We believe the moment-of-death valuation is appropriate in this case due to the importance of Mr. Mitchell to, and the impact of his death on, John Paul Mitchell Systems.

n3 For instance, Redken was a professional hair care company that dominated the salon-only market through the 1970's. In the early 1980's, Mr. Mitchell began to convince hair stylists that the new trend in styling was the "sculpted look". Redken's sales growth flattened when it did not keep abreast of this trend.

n4 During the 1960's and 1970's, companies such as Wella Balsam, Aqua Net, Vidal Sassoon, and Jhirmack broke the implied promise and changed their distribution from salon-only to the mass market. The products of each of these companies were closed out of the professional market shortly after being mass marketed.

n5 From September 1983 through August 1988, Star Laboratories of California (Star), an independent contract manufacturer, produced most of JPMS' products. In August 1988, JPMS' relationship with Star ended, and JPMS' manufacturing was switched to Sun Laboratories (Sun). JPMS' relationship with Sun was terminated in April 1989; thereafter, JPMS' manufacturer became Bocchi Laboratories, a corporation in which Mr. DeJoria was a 50-percent owner.

n6 According to Mr. DeJoria, a Gillette representative orally proposed the acquisition of JPMS for $150 million and a 1-percent royalty payment to each of Messrs. Mitchell and DeJoria. Mr. DeJoria responded that he thought JPMS was worth more. However, Roland L. Loper, Gillette's vice president and controller of the personal care division from 1987 through 1988, and vice president for finance and strategic planning of the personal care group in 1989, insisted that no such offer was made.

n7 Bankers Trust had $200 million to invest in recapitalizations or buyouts that it used primarily for companies in the $5 million to $100 million range. During his tenure with Bankers Trust, Mr. Taylor reviewed approximately 100 proposals for the use of this money.

n8 Mr. Taylor was involved in the August 1987 sale of Minnetonka's liquid soap business to Colgate-Palmolive Co. for $60 million, the November 1988 acquisition of the Vitabath business from Quintessence for $38 million, and the July 1989 sale of Minnetonka to Unilever for $376 million at approximately two times sales. When the Unilever acquisition was announced the price of Minnetonka stock was at $14 per share, and the transaction was consummated at $22.50 a share, a 60-percent premium over the freely traded value.

Mr. Taylor used two "rules of thumb" with regard to the valuation of a company under consideration for acquisition: two times sales and/or five times operating income. Mr. Taylor measured these rules against other standards, such as potential for future growth, quality of management, capital requirements, and strength of brand name.

n9 Minnetonka would not have been interested in purchasing a 49-percent interest in JPMS.

Mr. Taylor regarded the level of compensation for Messrs. Mitchell and DeJoria as too high; he considered a more appropriate level of compensation to be in the $500,000 to $1 million range, including performance bonuses.

n10 In determining the value of JPMS, Mr. Taylor considered the company's growth potential. In the fall of 1988, he thought that JPMS could perhaps double or triple in size within 5 years.

n11 Ms. Re, an attorney, joined JPMS on Jan. 1, 1989, as vice president and general counsel, to oversee the correction of certain operational problems. On Mar. 1, 1989, she became JPMS' chief operating officer.

n12 The following statements made by the Court of Appeals for the Fifth Circuit in United States v. Land, 303 F.2d 170, 172 (5th Cir. 1962), are, in our opinion, pertinent to our determination that the valuation of the 1,226 shares of JPMS common stock held by the Trust must be pinpointed to the moment of Mr. Mitchell's death:

Brief as is the instant of death, the court must pinpoint its valuation at this instant -- the moment of truth, when the ownership of the decedent ends and the ownership of the successors begins. It is a fallacy, therefore, to argue value before -- or -- after death on the notion that valuation must be determined by

the value either of the interest that ceases or of the interest that begins. Instead, the valuation is determined by THE INTEREST THAT PASSES, and the value of the interest before or after death is pertinent only as it serves to indicate the value AT death. In the usual case death brings no change in the value of property. It is only in the few cases where death alters value, as well as ownership, that it is necessary to determine whether the value at the time of death reflects the change caused by death, for example, loss of services of a valuable partner to a small business.

n13 Comparable companies analysis is a public market valuation tool that values a company by reference to publicly traded companies with similar operating and financial characteristics. The first step involves identifying appropriate comparable companies and measuring their enterprise and equity values as multiples of financial benchmarks. Mr. Weiksner considered seven comparable companies.

The second step in the comparable companies analysis involves applying the derived multiples to the corresponding actual and projected financial benchmarks of the company subject to valuation. In order to create that set of financial benchmarks, Mr. Weiksner developed an earnings model for JPMS, which forecast the company's results for a 5-year period and "normalized" the actual and projected financial results to reflect JPMS' profile going forward.

n14 Mr. Weiksner used the earnings model to portray how a hypothetical buyer or seller of the JPMS stock would perceive JPMS as of the moment of decedent's death, given the information available at that date. Among other things, Mr. Weiksner's adjustments to JPMS' historical financial data included: (1) The removal of Mr. Mitchell's compensation as an expense; (2) adding an amount equal to 8 percent of net sales as additional sales, general, and administrative expenses in lieu of Mr. Mitchell's compensation; and (3) the adjustment of Mr. DeJoria's compensation to $16 million to reflect his average anticipated compensation.

n15 Public value refers to the estimated value of liquid, freely trading shares of JPMS as if it had been a public company.

n16 A minority shareholder discount reflects the decreased value of shares that do not convey control of a closely held corporation. A lack of marketability discount reflects the fact that there is no ready market for shares in a closely held corporation.

n17 Private value refers to the value of a minority interest in stock for which no liquid public trading market exists.

n18 Control value is the value of a company in a transaction in which the acquirer acquires the controlling stock.

n19 Mr. McGraw did not believe that a reduction in Mr. DeJoria's compensation was a circumstance upon which a prospective purchaser of the shares could reasonably depend. Thus, he did not adjust Mr. DeJoria's historical compensation for purposes of this analysis.

n20 On the basis of Mr. McGraw's methodology, no discount for minority interest was taken.

n21 Mr. Hanan refers to this approach as the "guideline company" approach.

n22 Mr. Hanan reached the $57.7 million figure by assuming that Mr. DeJoria's compensation would be set at $12 million for fiscal year 1990 and $17 million per year thereafter.

n23 Respondent chose not to put E. James Brennan III on the stand.

n24 William E. Peplow, vice president of salon relations for Redken, wrote a report and testified on petitioner's behalf. He foresaw that JPMS would have to increase its advertising budget to sustain sales after Mr. Mitchell's death.

n25 This amount is calculated as follows:

Value of JPMS at the moment immediately		
prior to Mr. Mitchell's death	$150,000,000	
Less: Discount to reflect the loss of		
Mr. Mitchell to JPMS	(15,000,000)	
Value of JPMS at the moment of Mr.		
Mitchell's death	135,000,000	
Percent of Trust's interest in JPMS	x	49.04
Value of Trust's interest in JPMS prior		
to discounts	66,204,000	
Discount for lack of marketability and		
minority interest (35%)	(23,171,400)	
	43,032, 600	
Discount for possibility of lawsuit	(1,500,000)	
Value of Trust's interest in JPMS after		
discounts	41,532,600	

n26 The Federal estate tax return valued the stock at $28.5 million. For sec. 6662(g) to apply, the value reported on the return must not be more than 50 percent of the correct value.

END OF FOOTNOTES

Full Text of Court Cases

In re the Marriage of Monaghan

Case name: In re the Marriage of Monaghan
Citation: 78 Wn. App. 918, 899 P.2d 841
Date of decision: August 9, 1995
Country: US
State or Federal: State
State/Jurisdiction: Washington
Court: Court of Appeals
Type of action: Marital Dissolution
Judge: Houghton
SIC: 8021 Offices and Clinics of Dentists
NAICS: 621210 Offices of Dentists
9

Keywords: Marital dissolution

COUNSEL:

For Appellant: Michael Joseph Turner, Attorney at Law, Tacoma, WA.

For Respondent: Patrick Karl Daly, Daly and Macfie, Tacoma, WA.

JUDGES:

Acting Chief Judge Elaine M. Houghton; Judge J. Dean Morgan, Judge C. C. Bridgewater, concur

OPINIONBY:

ELAINE M. HOUGHTON

OPINION:

HOUGHTON, A.C.J. -- Dolores Monaghan appeals from a denial of her motions for imposition of judgment and clarification of her 1987 decree of dissolution of marriage. We reverse and remand.

I. FACTS

Dolores Monaghan and Robert Monaghan were married in 1956. n1 The marriage was dissolved by decree of dissolution (Decree) on September 1, 1987.

n1 The court meaning no disrespect, but for the sake of simplicity and clarity, identifies the parties using their first names. Additionally, the legal documents are inconsistent in the spelling of Dolores, sometimes spelling it "Delores". We spell her name "Dolores" as she signs all documents in that spelling.

The decree divided the parties' community property equally, designated by two separate property schedules. The property schedule awarded to Robert, among other items not at issue:

12. His dental practice, subject to [an] interest in favor of the petitioner, Dolores Monaghan, in an amount computed as 50% of the gross funds received in excess of $ 80,000.00, from the sale of the dental practice.

Both parties were required to pay all encumbrances, liens or debts associated with the property each received and to hold the other harmless from liabilities regarding that property. Each party was further responsible for any income tax liability arising out of the sale of any divided property and debts and obligations accrued since the date of the separation.

On December 24, 1991, Robert executed a contract to sell his dental practice to Alison Polwarth, D.D.S. Dolores did not take part in the negotiations for the sale. That sale consisted of:

[the] entire practice, together with all equipment, improvements, apparatus, furniture and fixtures, leasehold improvements, patients' files/charts, supplies, and all other items located in Monaghan's office and which were used in the practice (except cash and personal effects of Monaghan) . . ..

In the contract of sale, the purchase price, $ 160,000, was apportioned as follows:

Equipment and Leasehold Improvements	$	0
Inventory and Supplies	$	20,000
Covenant Not to Compete	$	109,000
Patient List	$	15,000
Goodwill	$	16,000n2

n2 There are many inconsistencies in the assigned value
for the different assets comprising the dental practice.
For example, the contract of sale values the inventory
and supplies at $ 20,000 and the equipment at $ 0,
while exhibit A to the contract, inventory appraisal,
values inventory and supplies and equpment at $ 30,000.
These inconsistencies, however, are not determinative
of this court's decision, but are factors to be
considered on remand.

The sale documents did not identify any accounts receivable or other monies owed to Robert before the closing date, January 3, 1992. Likewise, accounts payable, obligations incurred or claims against Robert were to be his responsibility. Pursuant to the covenant not to compete, Robert agreed not to practice within Pierce County for five years, subject to specific exceptions. The sale of the practice included a 10% sales commission, payable by the seller. n3

n3 The commission, $ 14,000, represented a total sale price of $ 160,000 less cost of furniture and fixtures, $ 20,000, for a revised total price of $ 140,000. Robert moved to strike the source document for this commission figure. The admissibility of this document was not addressed at the clarification hearing.

Dolores and Robert dispute the value of the dental practice and what the sale of the practice included. Dolores claims the practice sold for $ 160,000 -- the contract-stated price. Robert claims it sold for $ 31,000. He arrived at this figure based upon a value of $ 7.50 per active patient and inclusion of only the patient list and goodwill in the sales price. His calculation excludes the inventory and supplies, and the covenant not to compete. Because, by Robert's calculation, the practice sold for less than his allotted $ 80,000, he believed he owed Dolores nothing and therefore did not share any of the proceeds with her.

On July 17, 1992, Dolores moved for imposition of judgment against Robert. In an accompanying affidavit, Dolores requested an entry of judgment against Robert for 50% of the gross funds received in excess of $ 80,000 from the sale of the practice. By separate motion, Dolores also requested the trial court to clarify the content of the decree regarding the accounts receivable for Robert's dental practice. In an accompanying affidavit, Dolores sought an accounting of the amounts of the accounts receivable that Robert received from the practice. n4

n4 It is not clear what accounts receivable were requested -- at the time of dissolution or at the time of sale.

The matter was submitted to the trial court on affidavits, the contract for the sale of the practice, the decree of dissolution and the property settlement agreement. The trial court granted Robert's motion to strike portions of Dolores' accountant's affidavit to the extent it contained legal conclusions. The trial court did not rule on Robert's other motions to strike portions of Dolores' affidavits and the letter of compromise sent to her counsel.

After the trial court reviewed submitted material, it issued a document entitled "Findings of Fact and Conclusions of Law Re: Petitioner's Motion for Summary Judgment." The trial court denied both of Dolores' motions.At oral argument on this appeal, counsel for both parties conceded that the order below was improperly characterized as summary judgment. The parties agree that on appeal the court should review the record for substantial evidence.

II. ANALYSIS

[1] On review, we therefore determine whether the findings are supported by substantial evidence, and in turn, whether the findings support the conclusions of law and judgment. State v. Halstien, 122 Wash. 2d 109, 128-29, 857 P.2d 270 (1993). Substantial evidence is evidence sufficient to persuade a fair-minded person of the truth of the declared premise. Robinson v. PEMCO Ins. Co., 71 Wash. App. 746, 753, 862 P.2d 614 (1993).

A. Motion for Clarification of Decree

Dolores contends the trial court erred in denying her motion for clarification of the decree's terms regarding Robert's dental practice. n5 She asserts that she is entitled to one-half of the gross funds in excess of $ 80,000. According to Dolores, she is entitled to $ 40,000 and requests a judgment accordingly.

n5 The trial court entered the following findings of fact and conclusions of law:

FINDINGS OF FACT

1. On or about the 1st day of September, 1987, the parties' marriage was dissolved.

2. The respondent husband received his dental practice as part of the property settlement, subject to an interest in favor of the petitioner wife in an amount computed as 50% of the gross funds received in excess of $ 80,000.00 from the sale of the dental practice.

3. The respondent husband sold his dental practice in January, 1992 for the sum of $ 31,000.00

4. The accounts receivable were not sold as part of the dental practice.

5. The covenant not to compete was not sold as part of the dental practice.

. . . .

CONCLUSIONS OF LAW

1. The respondent's dental practice was sold for less than $ 80,000.00, and consequently there is no money due and owing to the petitioner.

2. The accounts receivable were not a part of the sale of the dental practice, and the covenant not to compete was not a part of the sale, and therefore there is no money due and owing to the petitioner.

3. The petitioner's motions are hereby denied.

[2] A clarification of a dissolution decree explicitly defines the rights and obligations that were previously granted. In re Marriage of Jarvis, 58 Wash. App. 342, 345, 792 P.2d 1259 (1990). Construction of a decree is a question of law to be determined by examining the document itself to find out its intended effect. In re Marriage of Bocanegra, 58 Wash. App. 271, 275, 792 P.2d 1263 (1990), review denied, 116 Wash. 2d 1008, 805 P.2d 813 (1991). The court uses general rules of construction applicable to statutes, contracts and other writings to ascertain the meaning of the decree. In re Marriage of Sager, 71 Wash. App. 855, 862, 863 P.2d 106 (1993).

Dolores contends that the trial court erred in ascribing a $ 31,000 value to the dental practice because it did not interpret the contract of sale as a whole pursuant to Berg v. Hudesman, 115 Wash. 2d 657, 801 P.2d 222 (1990). Dolores asserts that when engaging in such an interpretation, the court must "'declare the meaning of what is written, and not what was intended to be written.'" Berg v. Hudesman, at 669 (quoting J.W. Seavey Hop Corp. v. Pollack, 20 Wash. 2d 337, 348-49, 147 P.2d 310 (1944)). "Unilateral and subjective" beliefs about the impact should not be considered as representing the intent of the parties. Olympia Police Guild v. City of Olympia, 60 Wash. App. 556, 559, 805 P.2d 245 (1991). Dolores asserts that a plying these stated principles to the sales contract for the dental practice compels a finding that Robert sold his practice for $ 160,000. She further asserts that there is substantial evidence that at the time of dissolution, the parties placed a much higher value on the sale than $ 31,000. Furthermore, she argues that the $ 31,000 figure is at odds with the decree itself in which she says the court assigned a minimum value of $ 80,000.

[3] The basis for the trial court's conclusion that the dental practice sold for less than $ 80,000 is not evident from the record. Findings of fact and conclusions oflaw should be sufficient to suggest the factual basis for the ultimate conclusions. Groff v. Dept. of Labor and Industries, 65 Wash. 2d 35, 40, 395 P.2d 633 (1964); see also In re Marriage of Berg, 47 Wash. App. 754, 756, 737 P.2d 680 (1987) (A trial court is required to create an adequate record of the proceedings for appellate review); In re LaBelle, 107 Wash. 2d 196, 219, 728 P.2d 138 (1986), citing, Maehren v. Seattle, 92 Wash. 2d 480, 487-88, 599 P.2d 1255 (1979), cert. denied, 452 U.S. 939 (1981) (trial court must establish and set forth the

existence or nonexistence of determinative factual matters). Inadequate written findings may be supplemented by the trial court's oral decision or statements in the record. LaBelle, at 219 (citations omitted). Supplementing the trial court record with the court's oral ruling here, however, is not helpful because the trial court did not explain how it reached its conclusion. In its oral ruling, the trial court said:

I don't think anything other than the goodwill was contemplated here. I don't think anything as far as the fixtures, furniture, equipment is contemplated here. The covenant not to compete I don't believe is contemplated here.

[4] In valuing a closely-held business or a business largely dependent upon intangible assets associated with a professional practice, the trial court "'must set forth on the record which factors and methods were used in reaching its finding' of value". Berg, 47 Wash. App. at 757, quoting, In re Marriage of Hall, 103 Wash. 2d 236, 247, 692 P.2d 175 (1984). In Berg, the trial court simply accepted the husband's (the managing spouse's) value of a closely-held corporation in contravention to the expert's testimony. On appeal, the court found nothing in the record to rebut the expert's testimony, and thus remanded for redetermination of book value of the corporation. The circumstances in Berg are similar to those here. The trial court agreed with Robert's valuation of the practice without explaining how it reached its conclusion and despite Dolores providing an accountant's affidavit as to what the "value" of a business typically includes.

From our review of the record, there was not substantial evidence to support the trial court's finding that Robert sold his dental practice for the sum of $ 31,000. Furthermore, not only is the record silent as to how the trial court reached its overall conclusion, but also the record is incomplete as to how the court reached its determination of value for goodwill.

[5] Goodwill is an intangible asset of a business representing the expectation of a continued public patronage. It cannot be disposed of apart from the business as a whole. In re Marriage of Knight, 75 Wash. App. 721, 726, 880 P.2d 71 (1994), review denied, 126 Wash. 2d 1011, 892 P.2d 1089 (1995). Our Supreme Court has held that a trial court evaluating goodwill must use one or more of the accepted methods in determining value when appropriate. Hall, 103 Wash. 2d at 243-45. n6 The Hall court recognized that the methods are not exclusive, but may be used in conjunction with the factors laid out In re Marriage of Fleege, 91 Wash. 2d 324, 588 P.2d 1136 (1979), "to achieve a just and fair evaluation of the existence and value of any professional's goodwill." Hall, at 245. Fleege involved a dispute about whether a dental practice included goodwill which could be valued. The Fleege court set forth factors to consider in valuing goodwill such as: "the practitioner's age, health, past demonstrated earning power, professional reputation in the community as to his judgments, skill, knowledge and his comparative professional success." Hall, 242. On remand the trial court is to set forth specifically the method used in determining the value of the goodwill.

n6 The Hall court recognized the following methods as acceptable for determining value of goodwill: Straight capitalization accounting method, capitalization of excess earnings, IRS variation of capitalized excess earnings method, market value approach and buy/sell agreement method. Hall, at 243-45.

[6] Dolores further contends that the covenant not to compete is interrelated to goodwill and should be included in the total value of the practice. We agree with thetrial court that a covenant not to compete is not an asset of the dental practice. However, while a covenant not to compete is the separate property of the covenantee because it restricts the covenantee's future conduct, it is related to and

interdependent to goodwill. See Knight, Vale & Gregory v. McDaniel, 37 Wash. App. 366, 369-70, 680 P.2d 448, review denied, 101 Wash. 2d 1025 (1984). Moreover, because the trial court failed to make adequate findings regarding the assigned value of the various assets of the practice, we have no way of determining whether the $ 109,000 assigned to the noncompetition clause is fair. Dolores' accounting expert opined that for accounting purposes, the seller would amortize the $ 160,000 sales figure, not just the $ 31,000, and therefore that was the proper sale price.

Washington courts have not addressed the treatment of a covenant not to compete in a dissolution context, but other jurisdictions have. See, e.g., Lucas v. Lucas, 95 N.M. 283, 621 P.2d 500, 502 (N.M. 1980); Also see Carr v. Carr, 108 Idaho 684, 701 P.2d 304 (Idaho 1985) (goodwill and a covenant not to compete essentially the same here, because both spouses involved in daily operations of truck stop). In these jurisdictions, the court basically assesses the fairness of the segregation and assigned value of the noncompetition clause in relation to other assets. If the apportionment is unfair because the assigned value is the majority of the business assets, then a more fair and objective apportionment is needed. See In re Marriage of Quay, 18 Cal. App. 4th 961, 22 Cal.Rptr.2d 537, 541-42 (1993) (preliminary determination of fairness of covenant not to compete in relation to the assigned value of the other business' assets is necessary).

In Lucas, the wife filed for divorce and requested the court to divide the property equitably. The community property included some stock in a funeral home -- a business operated by the husband. The business was sold shortly after the divorce was final. Part of the sales agreement was a covenant not to compete between the husband and the buyer. The wife asked the court to consider the covenant not to compete community property. The court stated:

Upon the lawful dissolution of marriage, the right to compete becomes a personal right and, therefore, the separate property of the owner, who may then relinquish or exercise that right to his or her own benefit.

Lucas, 621 P.2d at 502. The court held that the valuation and segregation of the business assets were fair. The court reasoned that each shareholder could determine whether the price paid was adequate and that the evidence presented distinguished the amount paid for the sale of the stock from the amount paid for the covenant not to compete. Lucas, at 502. Thus the covenant not to compete was the personal property of the husband. Lucas, at 502. We find the reasoning of Lucas and Quay persuasive.

Here, we cannot determine the fairness of the assigned value of the covenant not to compete relative to the other assets. Dolores had no part in the negotiations and valuations for the sale of the dental practice, yet the trial court erroneously found that she was bound by Robert's determination, fair or not. Generally, covenants not to compete are used to protect a legitimate business interest and "should be no greater in scope than is necessary to protect the business or goodwill of the employer." Knight, Vale & Gregory, 37 Wash. App. at 370. On remand, the trial court is to segregate the value of the practice from the value of the covenant not to compete based upon all of the evidence rather than one party's bald assertions. The trial court is further required to evaluate the equity of the apportioned value of all assets and make adequate findings to support its conclusion.

B. Tenants in Common: Accounts Receivable

Dolores contends that if the accounts receivable were not included in the sale of the dental practice, then they are undistributed property. Dolores' accountant testified by affidavit that accounts receivable usually are included for business valuation purposes. The sales documents excluded the accounts receivable.

[7] Community property not disposed of by decree is held by the parties as tenants in common. In re Marriage of De Carteret 26 Wash. App. 907, 908, 615 P.2d 513 (1980). The adjudication of rights in property not disposed of in a dissolution decree requires an independent action for partition. Devine v. Devine, 42 Wash. App. 740, 743, 711 P.2d 1034 (1985). The court in the partition action is to determine the value of the accounts receivable at the time of dissolution. Where property is held as tenants in common, our Supreme Court has held that the parties intended them to share the property equally, unless the court is shown otherwise. Cummings v. Anderson, 94 Wash. 2d 135, 141, 614 P.2d 1283 (1980). Accounts receivable at the time of sale may have been earned subsequent to the dissolution and would be Robert's separate property. On remand, the trial court is to determine what accounts receivable are undistributed community property.

C. Motion to strike

Robert moved to strike portions of James Hughes' affidavit to the extent he offered a legal opinion and portions of Dolores' and Hughes' affidavits that reference offers of compromise. n7 The trial court partially granted Robert's motion to strike, but did not address the admissibility of the motion to strike portions of Dolores' affidavit and the entire letter of compromise. Generally, after a trial court has made a tentative ruling on a matter or has refused to rule entirely, the party requesting the ruling is obligated to raise the motion again to ensure that there is an adequate record on appeal. State v. Noltie, 116 Wash. 2d 831, 844, 809 P.2d 190 (1991). Here, however the trial court found that the practice sold for less than $ 80,000, which ended further analysis. On remand the trial court will have to rule on the admissibility of this evidence. We note, however, that the documents may indeed include offers of compromise which can be excluded upon proper motion pursuant to ER 408.

n7 Attached to Hughes' affidavit is a letter of compromise between the parties' counsel.

[8] Additionally, on appeal, Dolores contends that the trial court improperly considered portions of Robert's affidavit that discussed how she and Robert reached their property agreement. Dolores did not properly preserve this objection for appeal and thus it will not be considered. See Parkin v. Colocousis, 53 Wash. App. 649, 652, 769 P.2d 326 (1989) (failing to make appropriate objection to affidavit at the trial court generally waives the issue on appeal).

D. Attorney fees

Dolores requests attorney fees. She believes that she is entitled to them because of Robert's opposition to her motion, maintaining it was frivolous. However, Robert's opposition to Dolores' contentions is not so devoid of merit as to justify the imposition of attorney fees. There being no other basis for the award of fees, we decline to award attorney fees.

Houghton, A.C.J.

We concur:

Morgan, J.

Bridgewater, J.

61 T.C.M. 2445 (1991)
T.C. Memo. 1991-178

Nancy N. Mooneyham
v.
Commissioner.

Docket No. 1.5661-89.

United States Tax Court.

Filed April 17, 1991.

Glenn C. Carpenter and John O. Germino, for the petitioner. Mary E. Wynne, for the respondent.

Memorandum Findings of Fact and Opinion

COHEN, Judge:

Respondent determined a deficiency of $59,650 in petitioner's gift tax liability for 1985. The issue for decision is the value of a one-half undivided interest in real property given by petitioner to her brother.

Findings of Fact

Operative Facts

Some of the facts have been stipulated, and the stipulated facts are incorporated in our findings by this reference. Petitioner was a resident of Rancho Mirage, California, at the time she filed her petition.

Prior to January 2, 1985, petitioner owned 100 percent of certain real property consisting of approximately 62,000 square feet on North Wolfe Road in Sunnyvale, California (the property). On January 2, 1985, petitioner transferred a 50-percent undivided interest in the property to her brother.

In 1985, petitioner and her brother each contributed an undivided 50-percent interest in the property to a partnership known as "Nancy-Wolfe Investments, A California General Partnership." The partnership constructed a single-story commercial building on the property. The building was completed in September 1986.

Petitioner filed a gift tax return for the calendar year ended December 31, 1985, reporting a gift in the amount of $488,000 arising out of the transfer of the property. The amount reported on the gift tax return was supported by an appraisal, dated April 11, 1985, by David Ingram, Jr. (Ingram), attached to the return (the Ingram I appraisal). The Ingram I appraisal

determined that the value of the property as a whole, as of October 10, 1984, was $1,302,000, but that, after applying a discount of 25 percent for a fractional interest, the value of the portion transferred was $488,000.

In the notice of deficiency sent March 31, 1989, respondent determined that the fair market value of the gift was $651,000, 50 percent of the value of the whole property determined in the Ingram I appraisal.

Procedural Facts

In the petition filed June 30, 1989, petitioner alleged, among other things:

(1) The fair market value of the Property gifted to Justin J. Jacobs, Jr. on January 2, 1985 was correctly valued at $488,000, based on comparable sales of similar properties as substantiated by an informed Member of the American Institute of Real Estate Appraisers.

By notice served May 9, 1990, this case was set for trial in San Francisco, California, on October 15, 1990. Attached to the Notice Setting Case for Trial was the Court's Standing Pre-Trial Order, which stated, among other things, that documentary and written evidence was to be marked and stipulated in accordance with Rule 91(b), Tax Court Rules of Practice and Procedure, and that:

Any documents or materials which a party expects to utilize in the event of trial (except for impeachment), but which are not stipulated, shall be identified in writing and exchanged by the parties at least 15 days before the first day of the trial session. The Court may refuse to receive in evidence any document or material not so stipulated or exchanged, unless otherwise agreed by the parties or allowed by the Court for good cause shown. * * *

The Standing Pre-Trial Order required that trial memoranda be submitted to the Court and served on the adverse party at least 15 days before the trial date.

The Standing Pre-Trial Order also set forth the requirement that any expert witness to be called by a party prepare a written report to be submitted to the Court and served upon the adverse party at least 30 days before the trial, in accordance with Rule 143(f), Tax Court Rules of Practice and Procedure.

In a letter dated September 13, 1990, which was submitted as an expert report for petitioner, Ingram valued the property as a whole at $1,105,000, and he valued a one-half interest in the property at $414,375 on the date of the gift (the Ingram II appraisal). The Ingram II appraisal ignored comparable sales used in the Ingram I appraisal and set forth various statistics purportedly demonstrating a decline in the market for industrial properties in Santa Clara County (including, but not limited to, Sunnyvale) during 1985.

Neither the Ingram I appraisal nor the Ingram II appraisal set forth any comparable sales or other explanation supporting the opinion of Ingram that a 25-percent discount for a fractional interest was appropriate.

A report of John H. Denton (Denton), a lawyer and real estate appraiser, was also submitted for petitioner. Denton reviewed various reasons why a discount for a fractional interest would be required, based on his experience, and rendered the opinion that a discount in the range of 15 percent to 30 percent would be appropriate. He did not identify factors that would determine whether the discount in a particular case would be at the upper or lower end of the range he used.

On October 17, 1990, at the commencement of trial, petitioner's counsel indicated for the first time that he wished to offer in evidence copies of deeds reflecting sales that counsel's office "handled years ago." By using those deeds, petitioner's counsel intended to support Denton's trial testimony that Denton then believed that 25 percent was the proper discount. Petitioner's counsel sought to justify the belated tender of the documents by reference to a contention in respondent's trial memorandum that comparable sales are necessary to satisfy petitioner's burden of proof. That memorandum, however, had been served September 28, 1990. The Court sustained respondent's objection on the ground that the documents had not been exchanged in accordance with the Standing Pre-Trial Order, when petitioner's counsel first secured the copies of the deeds, or at the calendar call on October 15, 1990, and respondent was prejudiced in being unable to verify the facts that the deeds supposedly established.

Ultimate Findings of Fact

As of the date of the gift, the fair market value of the property owned by petitioner on North Wolfe Road in Sunnyvale, California, was $1,302,000. The value of a 50-percent fractional interest was 50 percent of the total less 15 percent, or $553,350.

Opinion

We have set forth as facts found by us the procedural history and the methodology used by petitioner's experts because those facts are material to our rejection of the conclusions of those experts.

Petitioner used the fair market value set out in the Ingram I appraisal on the gift tax return filed in relation to the gift and reaffirmed that value in her petition filed with this Court. As an owner, her opinion of value may be given weight. Her return and petition were admissions that should be binding on petitioner absent cogent proof that the reported value was erroneous. See, *e.g., Estate of Hall v. Commissioner* [Dec. 45,484], 92 T.C. 312, 337-338 (1989). The testimony offered by petitioner in this case to support a lower value is not cogent proof; it is barely evidence.

Ingram testified at trial and attempted to disavow his 1985 appraisal, which was proximate in time to the gift, by indicating that he had then been away from and had lost touch with the geographical area. He acknowledged that the comparables used by him in 1985 were still comparables, although his 1990 appraisal ignored them. On cross-examination, he testified about his 1990 use of statistics as follows:

Q Then these numbers may not be indicative and probably are not indicative of the value of the subject property?
A There was no attempt to make them comparable.
Q Thank you. Your letter states that Sunnyvale was not affected by the down turn in the market until later than the rest of Silicon Valley. Isn't it true that North San Jose was hit harder and faster than Sunnyvale by the down turn in the market?
A Yes. I think so.
Q So then doesn't the averaging of North San Jose sales figures with Sunnyvale sales figures distort the picture of Sunnyvale land values as portrayed in your Table 3?
A There may be some distortion.

We conclude that the Ingram I appraisal as to the value of the whole property, which was initially asserted by petitioner and was adopted by respondent, is much more reliable than the Ingram II appraisal.

Denton, although claiming to be a real estate appraiser, did not give an opinion of the value of the whole property. His report set out various reasons why a 15 to 30-percent discount for a fractional interest of property would be appropriate. Neither his report nor his testimony at trial gave any reason for choosing 25 percent as applied to the property in issue other than the use of 25 percent by Ingram.

Petitioner's counsel complained at trial that Denton was prevented from explaining his conclusion that 25 percent was appropriate because respondent objected to and the Court excluded documents from petitioner's counsel's file shown to the witness shortly prior to trial but not shown to respondent prior to trial. Regardless of the untimeliness of this tender of documents, an expert's opinion should be based on objective information that he independently has available or secures, not information so blatantly foisted upon him by a party's representative. His credibility is adversely affected when he is thus made into an advocate for the party. See *Estate of Halas v. Commissioner* [Dec. 46,522], 94 T.C. 570, 577-579 (1990). Cross-examination of Denton disclosed further that his report and testimony were in large part petitioner's counsel's argument in the form of testimony. The Court disapproves of this methodology in this case and as a general practice.

On the other hand, the testimony of Ingram and of Denton was some, although weak, evidence that the fair market value of a fractional interest in real property cannot be derived merely by applying the percentage of the interest in the whole to the value of the whole property. Petitioner contends that a discount is appropriate because of problems of control, lack of marketability, and costs of partition relating to a fractional undivided interest. Petitioner's arguments are logical and are supported by numerous precedents. See *Propstra v. United States* [82-2 USTC ¶ 13,475], 680 F.2d 1248 (9th Cir. 1982) [15 percent]; *Estate of Campanari v. Commissioner* [Dec. 14,685], 5 T.C. 488, 492 (1945) [12-1/2 percent]; *Estate of Henry v. Commissioner* [Dec. 14,259], 4 T.C. 423, 447 (1944) [10 percent], affd. [47-1 USTC ¶ 10,558] 161 F.2d 574 (3rd Cir. 1947); *Stewart v. Commissioner* [Dec. 8710], 31 B.T.A. 201 (1934) [15 percent]; *Estate of Youle v. Commissioner* [Dec. 45,579(M)], T.C. Memo. 1989-138 [12-1/2 percent].

Respondent argues that a discount is not appropriate in this case because petitioner and her brother had a plan jointly to develop the property through a partnership. Respondent

persists in attempting to have the Court consider the identity of a related transferee of property in determining fair market value a position that has repeatedly been rejected in favor of assuming a hypothetical unrelated buyer. See, e.g., *Propstra v. United States* [82-2 USTC ¶ 13,475], 680 F.2d at 1251-1252; *Estate of Bright v. United States* [81-2 USTC ¶ 13,436], 658 F.2d 999, 1001 (5th Cir. 1981); *Minahan v. Commissioner* [Dec. 43,746], 88 T.C. 492, 499 (1987). In any event, the reasons for discounting the fractional interest in this case continued to have force even after the transfer, because the donee only had a 50-percent interest in the subsequent venture.

Respondent also contends that petitioner has not satisfied her burden of proving that any discount is appropriate. Respondent relies on *Estate of Campanari v. Commissioner, supra; Estate of Clapp v. Commissioner* [Dec. 40,642(M)], T.C. Memo. 1983-721; and *Estate of Iacono v. Commissioner* [Dec. 37,414(M)], T.C. Memo. 1980-520. There is, however, evidence in this case that a discount is appropriate and, as indicated above, that evidence is consistent with common sense and precedent. Respondent has presented no evidence from which the Court could conclude that, under the facts of this case, no discount or a lesser discount was appropriate.

We are not bound by the opinion of any expert witness when that opinion is contrary to our own judgment, and we may embrace or reject expert testimony, whichever, in our best judgment, is appropriate. *Chiu v. Commissioner* [Dec. 42,027], 84 T.C. 722, 734 (1985), and cases cited therein; see *Estate of Fawcett v. Commissioner* [Dec. 33,387], 64 T.C. 889, 900-901 (1975). Based on this unsatisfactory record, therefore, our best judgment is that a discount is appropriate and that in this case a discount of 15 percent must be applied to one-half of the value of the whole property as found in the Ingram I appraisal to obtain the fair market value of the 50-percent interest given by petitioner to her brother.

Decision will be entered under Rule 155.

MPM Enterprises, Inc. v. Gilbert (1998)

Full Text of Court Cases

MPM Enterprises, Inc. v. Gilbert (1998)

Case name: MPM Enterprises, Inc. v. Gilbert
Citation: 1998 Del. Ch. LEXIS 60
Date of decision: April 24, 1998
Country: US
State or Federal: State
State/Jurisdiction: Delaware
Court: Court of Chancery
Type of action: Dissenting Shareholder
Judge: Steele
Experts: Patricof & Co. Capital Corp. (for petitioner) Advest, Inc. (for respondent)
SIC: 3672 Printed Circuit Boards
NAICS: 334412 Bare Printed Circuit Board Manufacturing

Keywords: Dilution, Discount rate, Fair value, Going concern

COUNSEL:

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JUDGES:

MYRON T. STEELE, VICE-CHANCELLOR.

OPINIONBY:

MYRON T. STEELE

OPINION:

Petitioner seeks appraisal of his shares in respondent MPM Enterprises, Inc. ("MPM") pursuant to 8 Del. C. § 262. On September 29, 1997, I issued an Opinion ("the September Opinion") that determined the fair value of petitioner's shares should be calculated using a discounted cash flow analysis. Despite the guidance provided in the September Opinion, the parties later informed me that they were unable to agree on the appropriate discount rate, a necessary element of a discounted cash flow analysis. Although the parties agree that the discount rate should be based on MPM's weighted average cost of capital ("WACC"), the parties dispute each component of the WACC: the cost of debt, the cost of equity and the debt to total capital ratio.

I consider the parties' submissions as motions for reargument. None of the issues I decide in this Opinion were presented to the Court at the December 1996 appraisal hearing. Thus, arguably, I wrote the September Opinion while laboring under a misapprehension of fact, and therefore grant the motions

for reargument. I heard the parties' motions for reargument on February 26, 1998.

A. Cost of Debt and Debt to Total Capital Ratio

During the December 1996 hearing, petitioner, on the advice of his appraisal expert Patricof & Co. Capital Corp. ("Patricof"), and respondent, on the advice of its appraisal expert Advest, Inc. ("Advest"), each proposed a discount rate to the Court. The September Opinion stated: "Because I find that petitioner has presented a more thorough and convincing approach to the determination of the discount rate, I accept petitioner's overall method...." n1 Petitioner's discount rate was based on, among other things, a cost of debt of 10.5% and a debt to total capital ratio of 5%.

n1 Gilbert v. MPM Enters., Inc., Del. Ch., 709 A.2d 663, 1997 Del. Ch. LEXIS 141, *14, 1997 WL 63298 at *4 (1997).

Ironically, petitioner later realized that the cost of debt and debt to total capital ratio that respondent proposed at the December 1996 hearing were more favorable to petitioner's position than those statistical elements petitioner himself proposed. Thus, although petitioner is content to use his overall method for calculating the discount rate, he now wishes to use respondent's cost of debt (9.6% n2) and debt to total capital ratio (10%). Respondent correctly notes that the September Opinion did not indicate that there should be any change to the values petitioner proffered and opposes the use of respondent's own proffered values absent a ruling from this Court.

n2 Petitioner contends that respondent used a cost of debt of 9.5%, but the record indicates that the figure used was 9.6%.

In support of his request to use respondent's values, petitioner explains that the values he submitted to the Court at the December 1996 hearing were merely assumptions, and were presented to the Court as such, whereas respondent's values represented its true or actual cost of debt and debt to total capital ratio. It is certainly plausible that Advest was able to discern from its client's records the actual cost of debt and the actual debt to total capital ratio on the merger date.

The Court's goal in an appraisal action is to determine with as much accuracy as possible the fair value of petitioner's shares on the date of the merger. For this reason, the Court prefers to rely on actual information taken from the company's financial or other records rather than on experts' estimates wherever possible. Thus, were petitioner's explanation of his new-found preferred reliance on respondent's number entirely accurate, it might be appropriate to revise the September Opinion to take account of MPM's actual information.

Respondent argues, however, that the values proffered in the earlier hearing were not, in fact, "actual," but were merely its own "estimates" based on its expert's judgment. Respondent is partially correct. Advest's valuation report clearly states that the capital structure or debt to total capital ratio used was based on the market average ratio of debt to total capital. n3 Thus, Advest did not use MPM's actual capital structure or debt to total capital ratio, and there is no clear basis upon which to revise the September Opinion on the theory the revision would be more factually accurate.

n3 Advest valuation report at 8, 46, 47, Ex. F. p.160. Elsewhere in the report, Advest clearly states that it relied on a company's "own" or "actual" capital structure. Id. at 41.

Advest's valuation report does, however, purport to use MPM's actual cost of debt on the merger date. n4 William Linquist, one of Advest's employees, also testified at the December 1996 hearing that Advest used MPM's actual cost of debt on the merger date. n5 In keeping with the Court's goal of determining with as much accuracy as possible the fair value of petitioner's shares on the merger date, the parties should use MPM's actual cost of debt when calculating the discount rate.

n4 Advest valuation report at 8.

n5 Direct Examination of William A. Linquist, December 18, 1996. Trial Transcript at 510.

B. Cost of Equity

1. Beta

Beta is a measure of a stock's volatility relative to the stock market as a whole. Because privately held companies such as MPM have no observable betas, the parties used the median beta of comparable companies as the beta for MPM. At the December 1996 hearing, petitioner's proffered beta was based on the median beta of seven companies, and respondent's proffered beta was based on the median beta of three companies. Because respondent's three companies were "more comparable" to MPM than petitioner's seven companies, I stated in the September Opinion that the cost of equity should be calculated using Patricof's overall method "except that the comparable beta employed shall be based on the average beta of respondent's comparable companies." n6

n6 Gilbert, 709 A.2d 663, 1997 Del. Ch. LEXIS 141 at *29, 1997 WL 63298 at *8. The parties have agreed to use the median beta of the comparable companies.

Unknown to me, and seemingly of no concern to the parties at the original hearing, the parties' experts defined beta differently in their valuation reports. Petitioner's expert used "adjusted" beta to calculate the discount rate, and respondent's expert used "raw" beta. I had assumed that both experts used "raw beta," commonly referred to simply as "beta."

Several entities publish lists of public companies' "raw" betas. Because the entities that publish "raw" betas use different data collection intervals and measurement periods, it may appear that one public company has several "raw" betas. If one controls for the different data collection intervals and measurement periods, however, one company's "raw" beta would, in principle, not vary among the reporting services. "Adjusted" beta is calculated by plugging "raw" beta into an adjustment formula. The entities that publish companies' "raw" betas usually publish the companies' "adjusted" betas as well. Because adjustment formulae may differ among the publications, the same company may have several "adjusted" betas.

The parties presented no evidence at the December 1998 hearing on the subject of "raw" or "adjusted" betas. Respondent correctly discerned that the September Opinion assumed that "raw" beta would be used, and respondent opposed using "adjusted" beta without a ruling from this Court.

Bloomberg, the source petitioner originally used to find his "adjusted" beta values, also publishes "raw" betas. At the February 1998 hearing, petitioner's counsel candidly admitted that he did not understand the difference between "raw" and "adjusted" beta and that he did not know why Patricof chose to use "adjusted" beta rather than "raw" beta. More importantly, Patricof's representative testified at his

deposition that he did not know how Bloomberg "adjusted" the comparable companies' "raw" betas or why "adjusted" betas were used in this case instead of "raw" betas. n7 Petitioner did not attempt to clarify this point at the February 1998 hearing.

n7 Deposition of Kenneth W. McGraw, October 23, 1996, at 286-87.

After the February 1998 hearing, the parties submitted numerous affidavits from finance professors explaining and extolling the virtues of either "adjusted" or "raw" beta. I decline, however, to consider those affidavits as evidence in this action. Most are based on the review of two letters to the Court and the September Opinion, not on the entire record or even on the experts' valuation reports. Furthermore, the affidavits, not surprisingly, offer contradictory conclusions on the issue of "raw" versus "adjusted" beta. Because there has been no opportunity to examine the affiants, the Court has no basis to determine their reliability.

Based on the remaining evidence in the record, I conclude that "raw" beta should be used to calculate the discount rate. Although "adjusted" beta may be appropriately used in future cases when supported by a record subject to the crucible of cross-examination, I find that petitioner did not meet his burden to prove why "adjusted" beta should be used in this case.

This Court (and respondent) recognizes Bloomberg as an appropriate source for determining "raw" betas. Therefore, the median "raw" beta, as published by Bloomberg, of respondent's three comparable companies will be used to determine the discount rate.

2. Small Company Premium

Petitioner included a small company premium of 2% in his cost of equity calculation. A small company premium "is appropriate to reflect that 'on average, smaller companies have higher rates of return than larger companies.'" n8 Petitioner determined the amount of the small company premium by relying on tables published by Ibbotson & Associates.

n8 Hintmann v. Fred Weber, Inc., 1998 Del. Ch. LEXIS 26, *11, Del. Ch., C.A. No. 12839, 1998 WL 83052 at *4, Steele, V.C. (Feb. 17, 1998)(citing SHANNON P. PRATT ET AL., VALUING A BUSINESS 171 (3d ed. 1996)).

The small company premia that Ibbotson publishes are based on companies' market capitalization. In its valuation report, Patricof stated that based on MPM's size, approximately $ 366 million under the discounted cash flow analysis, the Ibbotson table listed a corresponding small company premium in the range of 0-5%. Patricof chose a small company premium in the middle of that range, 2%.

After this Court's Opinion and the parties' negotiations, it appears that MPM's market capitalization is closer to $ 200 million. Thus, MPM is a smaller company than Patricof originally calculated, and a small company premium would seem even more appropriate. The Ibbotson table, however, suggests a different range of small company premia for a company of MPM's size: 2.67 to 3.14. n9 Respondent suggests a small company premium in the middle of that range, 2.87%.

n9 It makes sense that as the value of the company goes down, the small company premium goes up because the premium is meant to reflect that smaller companies require greater returns.

Petitioner seeks to eliminate the small company premium altogether. In support of his position, petitioner suggests that a small company premium was used in his original calculation because MPM is significantly smaller than the seven comparable companies he chose. The Court, however, ordered petitioner to use respondent's three companies, which are smaller than MPM. Petitioner suggests that if Patricof had itself chosen the three comparable companies at the outset of its analysis, it would not have added a small company premium because MPM is larger than those companies.

Petitioner seems to be confusing the small company premium used in a cost of equity calculation with an adjustment for small size in a market-based guideline comparable company analysis. When one estimates a private company's value based on the value of comparable, public companies, it may be appropriate to account for the fact that the company being valued is smaller than the guideline companies used for comparative purposes. In this case, however, the Court ordered the parties to use an income method of valuation known as a discounted cash flow analysis. A discount rate is a necessary part of the discounted cash flow analysis, and a cost of equity is a necessary part of every discount rate.

The cost of equity is the amount of expected return that is required to attract investment in an equity instrument. Obviously, one would expect a return at least as great as the return on a virtually risk free investment in Treasury bills. Because investment in equity instruments is not risk free, investors in equity instruments would also expect some premium over the expected return on a T-bill. If investing in equity instruments from a small company, one might expect an additional premium over the basic equity premium to reflect that investments in smaller companies generally entail a higher degree of risk than investments in larger companies. n10 Finally, when the cost of equity is estimated using the CAPM, as here, the equation also includes beta, which I addressed above.

n10 This is not to say that only a basic equity premium and a small company premium may be considered when estimating a cost of equity Additional premia may be added, if appropriate, for industry-specific risks or for other investment-specific risks not captured by the other three categories of premia.

In theory, then, one would expect the cost of equity for a $ 200 million company to be greater than the cost of equity for a $ 357 million company. Thus, if a small company premium was appropriate for a $ 357 million company, an issue settled by the September Opinion and not before me today, then it should also be appropriate for a $ 200 million company. The parties shall include a small company premium of 2.87% in their calculation of MPM's cost of equity.

CONCLUSION

The parties shall calculate MPM's WACC using a cost of debt of 9.6% and a debt to total capital ratio of 5%. MPM's cost of equity shall include (1) the median of the comparable companies' "raw" betas, as published by Bloomberg, and (2) a small company premium of 2.87%.

IT IS SO ORDERED.

Myron T. Steele

Vice Chancellor

Full Text of Court Cases

MPM Enterprises, Inc. v. Gilbert (Supreme Court)

Case name: MPM Enterprises, Inc. v. Gilbert
Citation: 731 A.2d 790,1999 Del. LEXIS 205
Date of decision: June 25, 1999
Country: US
State or Federal: State
State/Jurisdiction: Delaware
Court: Supreme Court
Type of action: Dissenting Shareholder
Judge: Veasey
Experts: Patricof & Co. Capital Corp. (for Gilbert)
Advest, Inc. (for MPM)
SIC: 3555 Printing Trades Machinery and Equipment
NAICS: 333293 Printing Machinery and Equipment Manufacturing
1760

Keywords: Dilution, Discount rate, Fair value, Going concern

COUNSEL:

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Allen M. Terrell, Jr., Esquire (argued), and Srinivas M. Raju, Esquire, of Richards, Layton & Finger, Wilmington, Delaware, for Appellee.

JUDGES:

Before VEASEY, Chief Justice, WALSH and HARTNETT, Justices.

OPINIONBY:

VEASEY

OPINION:

Upon appeal from the Court of Chancery.

VEASEY, Chief Justice:

In this appeal of a statutory appraisal action under 8 *Del. C.* § 262, we consider whether the Court of Chancery committed legal error or, alternatively, abused its discretion by applying an appraisal analysis that accorded no weight to the terms of the merger giving rise to the appraisal action or to the terms of two prior offers for equity stakes in the subject corporation. We further consider whether the Court of Chancery erred in refusing to consider the dilutive effect of alleged obligations incurred by the company to non-stockholder employees. We affirm the judgment of the Court of Chancery on the ground that under well-established precedent of this Court, the Court of Chancery did not commit legal error or abuse its discretion in its choice and application of appraisal methods.

Facts

Petitioner below-appellee, Jeffrey D. Gilbert instituted a statutory appraisal action as the sole dissenting stockholder of respondent below-appellant, M.P.M. Enterprises, Inc. ("MPM"), following MPM's merger into a subsidiary of Cookson Group, PLC ("Cookson") a London-based industrial concern, on May 2, 1995.

Prior to the merger, MPM was a Delaware corporation, headquartered in Franklin, Massachusetts. It was engaged in the design, manufacture and distribution of screen printers. n1 Business was very good in the 1980s and early 1990s. In fact, according to MPM's consolidated financial statements, in fiscal years 1991-94, MPM's sales increased from $ 13.5 million to $ 55.5 million and MPM's net income increased from $ 8,300 to $ 6.5 million. In March 1995, MPM and Cookson signed an Agreement of Merger that provided for immediate payments by Cookson of $ 65 million upon consummation of the merger, with contingent earn-out payments up to an additional $ 73,635 million. n2 On May 2, 1995, the parties consummated the merger.

n1 Screen printers are one form of machine used in the surface mount technology industry to attach electronic components to circuit boards. Screen printers use a squeegee to push solder paste through a stencil onto specific points on circuit boards where components need to be attached.

n2 The contingent earn-out depended on MPM's average annual earnings between June 1, 1995 and June 30, 1998. If the average annual earnings met or exceeded $ 35 million, the entire contingent payout became due. If the average annual earnings fell between $ 14 million and $ 35 million, some contingent payout less than the maximum became due. If the average annual earnings fell below $ 14 million, no contingent payout became due.

Gilbert owned 600 shares of MPM's common stock and 200 shares of MPM's preferred stock, giving him an ownership stake in MPM of 7.273% on a fully diluted basis. Under the terms of the merger, Gilbert would have received $ 4.56 million (minus transactional costs) and the opportunity to receive contingent payments of up to an additional $ 5.36 million if MPM reached the earn-out goals set forth in the Merger Agreement. Apparently believing that these sums did not reflect MPM's going concern value at the date of the merger, Gilbert chose to exercise his statutory appraisal right, pursuant to 8 *Del. C.* § 262(a), and filed an action in the Court of Chancery.

In the appraisal action, MPM presented expert testimony concerning MPM's going concern value at the date of the merger from William A. Lundquist and Advest, Inc. (collectively "Lundquist"). In response, Gilbert presented expert testimony from Kenneth W. McGraw and Patricof & Co. (collectively "McGraw"). As is often the case in such actions before the Court of Chancery, these experts came up with widely divergent appraisal values. Lundquist, focusing on a supposedly gloomy outlook for MPM and its industry, placed MPM's going concern value at $ 81.7 million. In contrast, McGraw focused on a particularly rosy outlook for MPM and its industry, placing MPM's going concern value at $ 357.1 million.

Lundquist arrived at his appraisal value through two separate discounted cash flow ("DCF") analyses along with a comparable public companies analysis. He constructed both a "sell-side" DCF (representing the transaction from MPM's point of view) and a "buy-side" DCF (representing the transaction from a buyer's point of view). The buy-side analysis, representing the price at which all of the synergies from the transaction go to the seller, resulted in the highest price a reasonable buyer would pay for MPM. As part of his analysis, Lundquist compared the values derived from the buy-side analysis to the terms of the merger, as well as two earlier offers for equity interests in MPM from Dover Technologies n3 and TA Associates, Inc. n4 (the "prior offers"). In his comparable public companies analysis, Lundquist compared MPM's EBITDA, EBIT and P/E ratios to those of comparable public companies to determine a fair market value for MPM.

n3 Dover is the parent company of one of MPM's principal competitors. In 1994, following due diligence, Dover offered to pay $ 50 million and assume certain MPM liabilities for all of the equity in MPM. MPM claims that it did not accept this offer because of antitrust concerns, not because of any insufficiency in the offer.

n4 TA is a venture capital group that, in October 1994, offered to invest $ 10- $ 20 million in MPM based on an assumed equity value for MPM of between $ 50- $ 65 million.

After examining the data, Lundquist concluded that the comparable public companies approach was problematic because MPM was not in a position to go public, rendering comparison unhelpful. He also concluded, based on the sell-side DCF, that MPM's equity value at the time of the merger was $ 90.5 million. He then discounted this amount by 8.8% (the amount of alleged obligations to non-stockholder employees) and again by 1% (the transaction costs borne by approving stockholders) to arrive at a fair market value for MPM at the date of the merger of $ 81.7 million. n5 Assuming that this last figure included some synergies from the merger (disallowed by § 262), n6 Lundquist pegged it as the highest possible going concern value for MPM at the date of the merger.

n5 The Court of Chancery ignored the 1% reduction for transaction costs and used $ 82.5 million as the fair value arrived at by Lundquist.

n6 As explicated later in this Opinion, section 262(h) directs the Court of Chancery to "appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation. . . ."

McGraw performed two analyses: a DCF analysis and a comparative public companies analysis. McGraw took the values from each of these approaches, weighted them equally, and arrived at a fair market value for MPM's equity at the date of the merger of $ 357.1 million. n7

n7 McGraw found a value of $ 347.5 million using the comparative public company approach and $ 366 million using the DCF approach.

In evaluating the various approaches, the Court of Chancery settled on a DCF analysis as the best method for discerning MPM's going concern value at the date of the merger. n8 It first noted that it could not consider Lundquist's buy-side DCF analysis because this method approached the value from the buyer's perspective, rather than valuing the company as a going concern, as required by § 262. n9 In addition, the Court of Chancery stated that it would not use Lundquist's proffer of previous offers to invest in MPM because "these figures represent nothing more than offers to purchase, which were surely based on the value of MPM to a particular entity." n10 Finally, the Court discarded the opposing comparative public company analyses as being relatively weak in comparison to the DCF analyses. n11 Finding that the DCF analysis conducted by McGraw, Gilbert's expert, was the more "thorough and convincing approach to the determination of the discount rate," the Court accepted Gilbert's framework as a starting point. n12

n8 *Gilbert v. MPM Enterprises, Inc., Del. Ch., 709 A.2d 663, 668 (1998).*

n9 *Id.*

n10 *Id.*

n11 *Id.*

n12 *Id. at 669.*

The first step in the Court of Chancery's manipulation of this framework was to determine revenue growth projections. The Court found that, although MPM management had predicted 1995 sales of $ 108 million in April 1995, it was apparent by the date of the merger that MPM would have a very difficult time meeting this projection. n13 Therefore, the Court based the cash flow forecast on the assumption that MPM's 1995 revenues would be lower than the April projection. n14

n13 *Id.*

n14 *709 A.2d at 669-70.*

Also included in the April management projection were projected revenue growth rates of 38.9% for 1996, 20% for 1997 and 22.2% for 1998. At the date of the merger, MPM had recently developed a new product. Gilbert argued that, at the date of the merger, this product was expected to revolutionize the screen printing industry and, therefore, the Court of Chancery should adjust the growth rates upward. MPM, on the other hand, noted that this new product was experiencing serious development problems at the date of the merger and, therefore, the trial court should adjust the growth rates

downward. The Court rejected both attempts to adjust the growth rates, finding no way to conclude that the April 1995 projection had not incorporated both of these claims. n15 For the same reason, it refused to adjust the April 1995 projection for research and development expenses. n16

n15 *Id. at 671.*

n16 *Id.* This projection had research and development expenses at 10% of sales for 1995 and 14% of sales for 1996-1998.

Assuming a five year DCF projection, the next step was to determine the terminal value of MPM at the end of fiscal year 2000. n17 Both experts used comparable public companies to make this determination. Finding that Lundquist, MPM's expert, had "convincingly demonstrated the appropriateness of [his] selection [of comparable companies]" the Court of Chancery used the terminal value multiple of 7.5 provided by MPM. n18

n17 *Id.*

n18 *Id. at 672.*

The Court of Chancery next moved to the determination of the proper discount rate. It approved of McGraw's methods, but disapproved of the comparable companies McGraw used in applying these methods. n19 It solved this problem by holding that "MPM's discount rate shall be that rate determined through use of [McGraw's] CAPM model except that the comparable beta employed shall be based on the *average beta of [MPM's] comparable companies."* n20

n19 *709 A.2d at 672-73.*

n20 *Id. at 673* (emphasis in original).

As a final matter, the Court of Chancery considered MPM's claim that Gibson's ownership percentage in MPM should be diluted by 8.8%, or the amount of obligations it claimed to have outstanding to non-stockholder employees. It found that MPM had failed to provide any evidence that these obligations existed, or that litigation had been threatened over them. n21 Accordingly, the Court refused to allow a dilution of Gibson's ownership percentage based on these alleged obligations. n22

n21 *Id.*

n22 *Id.*

The opinion of the Court of Chancery left some issues unanswered, as it never provided the actual discount rate that the parties should apply. On April 24, 1998, the Court issued a second opinion, in which it determined several components of the discount rate: the cost of debt (9.6%); the debt to total capital ratio (5%); the source of "raw" beta data (Bloomberg); and a small company premium (2.87%). n23 On May 22. 1998, the Court issued a final order and judgment, in which it determined that MPM's equity value at the date of the merger was $ 156,331,000. n24 On a per share basis, this translated into a value of $ 14,211.91, or a total of $ 11,369,528 for Gilbert's 800 shares. n25

n23 *Gilbert v. M.P.M. Enterprises, Inc., 1998 Del. Ch. LEXIS 60,* *13, Del. Ch., C.A. No. 14416-NC (April 24, 1998).

n24 *Gilbert v. MPM Enterprises, Inc.,* Del. Ch., C.A. No. 14416-NC (May 22, 1998).

n25 *Id.* The trial court also added interest of 8.15%, compounded monthly, from May 2, 1995 to the date of payment. The trial court calculated this amount as $ 3,921.46 per share. *Id.*

MPM appealed to this Court, challenging the decision of the Court of Chancery on two grounds. First, MPM claimed that the Court erred in failing to consider the terms of the merger or the terms of the prior offers in its determination of fair value. Second, MPM challenged the Court's conclusion that there was no evidence of record to support the dilution of Gilbert's ownership share due to obligations owed to non-stockholder employees.

From the language in the opinions of the Court of Chancery, we were unable to discern why the Court did not use the values derived from the merger and the prior offers in its determination of fair value. We could not determine whether it accorded these values no weight after admitting them into evidence, or whether it refused to admit them into evidence as inconsistent with legally acceptable methods of valuation under § 262. We remanded this matter to the Court of Chancery for clarification so that it could provide a better explanation of its analysis with respect to both the merger and the prior offers. n26 In the event its determination was factual and not legal, we further asked the Court to recite the facts it relied on in according zero weight to these values. n27

n26 *MPM Enterprises v. Gilbert,* Del. Supr., No. 266, 1998, Walsh, J. (Nov. 23, 1998) (Order).

n27 *Id.*

In its remand opinion, the Court of Chancery clarified its position with respect to the merger and the prior offers. n28 The Court stated that it did not mean to imply that § 262 barred consideration of specific offers for a company, and that it did, in fact, consider the relevance of each of these offers to the fair value of MPM at the date of the merger. n29 It explained that, while potentially relevant, the evidence with respect to both the merger and the prior offers was of only marginal utility and therefore received no weight in the final analysis. n30 The Court further explained that, rather than relying on specific evidence supporting its decision to accord zero weight to these offers, it relied on the absence of any credible evidence provided by MPM that established a nexus between the values derived from the offers at issue and the going concern value of MPM at the date of the merger. n31

n28 *Gilbert v. M.P.M. Enterprises,* Del. Ch., C.A. No. 16158-NC/ 14416-NC (Feb. 4, 1999).

n29 *Gilbert v. M.P.M. Enterprises,* Del. Ch., C.A. No. 16158-NC/ 14416-NC (Feb. 4, 1999) slip op. at 2-4.

n30 *Id.*

n31 *Id.* at 5-6.

The Relevance of the Merger and Prior Offers

We review the findings of the trial court in a statutory appraisal proceeding with a high level of deference. n32 In such cases, "the discretion to weigh the evidence belongs to the Court of Chancery with our review one of abuse of that discretion." n33 But our review is *de novo* to the extent the trial court decision implicates the statutory construction of § 262. n34

n32 *See In re Shell Oil Co., Del. Supr., 607 A.2d 1213, 1219 (1992).*

n33 *Id. at 1221.*

n34 *See M. G. Bancorporation v. Le Beau, 737 A.2d 513, 1999 Del. LEXIS 143,* (Del. 1999), *reh'g den.,* May 27, 1999.

In this case, the Court of Chancery did not err in its decision regarding the admissibility of the terms of the merger and of the prior offers. It did admit all of these offers into evidence, although it did not dwell on them and ultimately chose not to accord them any weight. Therefore, the inquiry must shift to whether the Court abused its discretion in refusing to give any weight to the terms of the merger and of the prior offers in its appraisal of Gilbert's shares.

Section 262(h) requires the trial court to "appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation." n35 Fair value, as used in § 262(h), is more properly described as the value of the company to the stockholder as a going concern, rather than its value to a third party as an acquisition. We have long recognized that failure to value a company as a going concern may result in an understatement of fair value. n36

n35 8 *Del. C.* § 262(h).

n36 *See Gonsalves v. Straight Arrow Publishers, Inc., Del. Supr., 701 A.2d 357, 362 (1997); Cede & Co. v. Technicolor, Del. Supr., 684 A.2d 289, 299 (1996); Baron v. Pressed Metals of America, Inc., Del. Supr., 35 Del. Ch. 581, 123 A.2d 848, 854 (1956).*

In *Weinberger v. UOP* n37 and its progeny, n38 we elucidated the extent of the discretion of the Court of Chancery in choosing a method of valuation in a statutory appraisal. *Weinberger* acknowledged the Court's discretion to use "any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court, subject to our interpretation of 8 *Del. C.* § 262(h)." n39 Assuming the variables applied by the trial court are proper, a DCF analysis is one such technique or method of determining going concern value that is within the trial court's discretion to use. n40

n37 *Del. Supr., 457 A.2d 701 (1983).*

n38 *See, e.g., Le Beau, 1999 Del. LEXIS 143, 737 A.2d at 524; Cede & Co., 684 A.2d at 297; Rosenblatt v. Getty Oil Co., Del. Supr., 493 A.2d 929, 940 (1985).*

n39 *457 A.2d at 713.*

n40 *See Id. Compare Le Beau, 1999 Del. LEXIS 143, 737 A.2d at 524* (DCF analysis rejected due to the experts' use of improper variables); *Cede & Co., 684 A.2d at 299* (same).

In this appeal, MPM does not challenge the DCF analysis employed by the Court of Chancery or the specific variables used in the analysis. n41 Instead, MPM focuses on other language in § 262(h) requiring the trial court to "take into account all relevant factors" when determining the fair value of a petitioner's shares. n42 MPM contends that the figures derived from the merger and the prior offers are "relevant factors" that the trial court impermissibly ignored in its determination of fair value. According to MPM, if the trial court had considered these "real world" values, it would have realized that the results of the DCF analysis did not accurately reflect the going concern value of MPM at the date of the merger.

n41 Although MPM objected to some specific variables before the Court of Chancery, it did not raise these issues in its opening brief so we need not consider them.

n42 8 *Del. C.* § 262(h).

The initial determination by the Court of Chancery of the variables the parties should employ in the DCF analysis was a well-reasoned use of discretion. The Court certainly acted as an independent appraiser of MPM, using its judgment to discern which facets of the experts' competing analyses correctly set forth the assumptions necessary for a proper DCF analysis. The only question remaining is whether the Court abused its discretion in refusing to compare the figures derived from this properly-applied DCF analysis to the merger value and the valuations implicit in the prior offers. Values derived in the open market through arms-length negotiations offer better indicia of reliability than the interested party transactions that are often the subject of appraisals under § 262. n43 But the trial court, in its discretion, need not accord any weight to such values when unsupported by evidence that they represent the going concern value of the company at the effective date of the merger or consolidation.

n43 *See, e.g., Le Beau, 737 A.2d 513, 1999 Del. LEXIS 143,* *30 (merger of target into stockholder of 95% of target); *Rapid-American Corp. v. Harris, Del. Supr., 603 A.2d 796 (1992)* (parent-subsidiary merger); *Bell v. Kirby Lumber Corp., Del. Supr., 395 A.2d 730 (1978)* (parent-subsidiary merger).

In this case, MPM proffered evidence of the merger and the prior offers only as part of Lundquist's buy-side DCF. The Court of Chancery properly rejected this DCF approach because it focused on the elements of value that would arise from the merger, rather than on the going concern value of MPM without any consideration of such synergistic values. As noted, section 262(h) explicitly states that the trial court "shall appraise the shares, determining their fair value *exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation . . . ."* n44 By determining the highest price at which all synergies devolved to the seller, this buy-side analysis was undoubtedly proscribed by § 262(h).

n44 8 *Del. C.* § 262(h) (emphasis supplied).

Irrespective of that fact, MPM contends that the Court of Chancery still should have considered the terms of the merger and the prior offers in its final appraisal decision. To support this contention, MPM points to *Van de Walle v. Unimation Inc.,* n45 where the Court of Chancery found that such transactions are the most reliable indicia of fair value, even more reliable than expert testimony

concerning DCF analyses. n46 But *Van de Walle* differs from this case in a very significant respect. In *Van de Walle,* certain minority stockholders claimed that the target company's board of directors had breached its fiduciary duties in accepting an unfair merger price. In essence, the stockholders argued that the board of directors had failed to obtain the best price available in executing a merger. In this case, a dissenting stockholder petitioned the Court of Chancery to determine the fair value of his shares. Under section 262, the fairness of the price on the open market is not the overriding consideration. Instead section 262(h) requires that the Court of Chancery discern the going concern value of the company irrespective of the synergies involved in a merger. A fair merger price in the context of a breach of fiduciary duty claim will not always be a fair value in the context of determining going concern value.

n45 *1991 Del. Ch. LEXIS 27,* Del. Ch., C.A. No. 7046, Jacobs, V.C. (March 6, 1991).

n46 The court stated that "the fact that a transaction price was forged in the crucible of objective market reality (as distinguished from the unavoidably subjective thought process of a valuation expert) is viewed as strong evidence that the price is fair." *1991 Del. Ch. LEXIS 27,* *50.

We agree with the general statement made by the Court in *Van de Walle.* A merger price resulting from arms-length negotiations where there are no claims of collusion is a very strong indication of fair value. But in an appraisal action, that merger price must be accompanied by evidence tending to show that it represents the going concern value of the company rather than just the value of the company to one specific buyer. In this case, MPM failed to present this additional evidence with respect to either the merger or the prior offers. n47 This led the Court of Chancery to decide that these values were of only marginal relevance, if any. In our view, this determination was not an abuse of discretion.

n47 The prior offers suffered from flaws that made them marginally useful in an appraisal under section 262, under the best of circumstances. Both were remote in time from the date of the merger and neither was actually consummated.

Alleged Obligations to Non-Stockholder Employees

On a claim of error, we review specific factual findings made by the trial court in a section 262 appraisal with a high level of deference. n48 This Court will reverse the findings of the trial court only in cases of clear error and where justice so requires. n49

n48 *Kahn v. Household Acquisition Corp., Del. Supr., 591 A.2d 166, 175 (1991).*

n49 *In re Shell Oil, 607 A.2d at 1219.*

At trial, MPM provided two forms of evidence to prove that it was obliged to provide equity to non-stockholder management. This consisted of three written employment agreements and the live testimony of Thomas Bagley, MPM's President and Chief Executive Officer.

The three written employment agreements each include a section entitled "Long-Term Incentive." According to this section, the specified employees *"will be* granted an option, *subject to rules, regulations, and restrictions* as determined by the Board of Directors of the Company in their sole

discretion to acquire . . . stock in the company." n50 This section goes on to define the specific number of shares that the employee *"shall possibly have the right to acquire...."* n51 The Court of Chancery did not have before it a later agreement showing that these contingent obligations actually vested, and in what amount they vested. Also, MPM's financial statements prior to the merger did not contain any indication of these options. The trial court did not err in finding that the employment agreements alone did not provide sufficient proof of the alleged obligations.

n50 Employment Agreement, P11 (emphasis supplied).

n51 *Id.* (emphasis supplied) (original in uppercase).

Bagley's testimony could have provided the extra element lacking in the employment agreements. He testified that MPM made oral commitments to the non-stockholder management. When asked how MPM determined that payments would be made to non-stockholders, Bagley answered that "we had in all of these instances with all of these people had discussions with them. In some cases we had written commitments to them to provide them with equity participation in the organization, in MPM." The trial court was not convinced by this testimony and found that MPM had failed to provide sufficient evidence to prove that these payments of equity actually were legal obligations of MPM rather than merely costs of the merger. As we have stated, "when the determination of facts turns on a question of credibility and the acceptance or rejection of 'live' testimony by the trial judge, [the trial court's] findings will be approved on review." n52

n52 *Levitt v. Bouvier, Del. Supr., 287 A.2d 671, 673 (1972).*

Conclusion

The Court of Chancery's appraisal of Gilbert's shares in MPM is affirmed in all respects.

143 N.J. 168 (1996)
669 A.2d 1382

RALPH MUELLENBERG AND BIKON-TECHNIK, G.m.B.H., PLAINTIFFS-RESPONDENTS, v. BIKON CORPORATION, DEFENDANT, AND KURT W. BURG, DEFENDANT-APPELLANT, AND ADDA FINANZIARIA, S.R.L. AND DARIO PASSERINI, DEFENDANTS-RESPONDENTS.

The Supreme Court of New Jersey.

Argued September 27, 1995.
Decided January 18, 1996.

Eugene H. Gilmartin argued the cause for appellant (*Barry G. Leveen,*attorney).

Frederick A. Nicoll argued the cause for respondents Ralph Muellenberg and Bikon-Technik, G.m.b.H.

William F. Campbell, III, argued the cause for respondents Adda Finanziaria, S.R.L., and Dario Passerini (*Dillon, Bitar & Luther,* attorneys).

The opinion of the Court was delivered by O'HERN, Justice.

This appeal concerns a court's authority to order shareholders representing a majority of corporate ownership to sell their shares to a minority shareholder whose rights had been oppressed by the majority. We find that the provisions of the New Jersey Corporation Business Act, *N.J.S.A.* 14A:12-7(1)(c) and 14A:12-7(8), do, in rare circumstances, authorize a buy-out of the majority. Because unfolding events in this case have confirmed the judgment of the Chancery Division that the parties would be unable to cooperate in the joint management of the enterprise, we reinstate its judgment ordering the majority shareholders to sell their interest to a minority shareholder. For purposes of this appeal, we accept generally the facts set forth in the majority shareholders' brief.

I

Ralph Muellenberg is a mechanical engineer and an inventor. He has held some 80 patents worldwide in the field of locking devices used generally in the building of machines. These are described variously as "shaft to hub connections," "clamping devices" and "locking assemblies." The devices allow component parts of a machine to attach efficiently to a shaft. In 1972, Muellenberg founded Bikon-Technik GmbH (BTG) in Germany to promote products of his invention. BTG owns the trademarks BIKON, DOBIKON, and BIKON-Technik.

Adda Finanziaria, S.R.L. (Adda) is an Italian holding company owned by the defendant Dario Passerini who is also the general manager and a shareholder in another Italian company, Tecnomeccanica S.N.S. di Sacchi & C. (TM).

Kurt Burg is a mechanical engineer who came to the United States in 1976 from Germany and was employed here by a company known as Ringfeder Corp., also in the clamping device business and a competitor of BTG.

Muellenberg's goal was to establish a family of companies related through common ownership and contract to market his products throughout the world. This integrated ownership structure was aimed at assuring quality and sources of supply. By the end of 1992, worldwide sales of Bikon and Dobikon products (collectively "Bikon Products") totaled nearly $5 million. BTG does not manufacture locking devices itself. In 1979 BTG entered an agreement with TM, which was owned equally by Muellenberg and Adda (Passerini's holding company), to manufacture Bikon products. The agreement provided, among other things, that TM would be the exclusive manufacturer of products for BTG in Italy, that BTG would make specified annual minimum purchases and that BTG would have the exclusive right to sell products manufactured by TM in various countries including the United States (the "Cooperation Agreement"). No royalty or license fees were due to BTG or Muellenberg under the Cooperation Agreement with TM.

Sometime in 1980, Muellenberg and Burg began discussions concerning Burg's possible participation in a United States company to be formed by Muellenberg and Passerini for the promotion and sale of Bikon products in the United States and Canada.[1] Muellenberg had met Burg some years earlier when Burg was a German resident.

To that end Bikon Corp. (BNJ) was incorporated in New Jersey on June 25, 1982. A Stockholders' Agreement provided that Muellenberg, Burg and Passerini would be the initial directors and officers and that Muellenberg would be president. The parties also executed a License Agreement and a Distribution Agreement dated April 12, 1982. The License Agreement granted BNJ the right to exploit Bikon products in the United States in consideration of a license fee to Muellenberg, as owner of the patents, of 5 per cent of the gross receipts of BNJ, payable quarterly.

Pursuant to Burg's request, the Distribution Agreement gave BNJ the right to produce and distribute products developed in accordance with Muellenberg's patents. The Distribution Agreement licensed BNJ to use the common law trademarks BIKON, DOBIKON and the trade name BIKON-Technik in exchange for a fee of 2 per cent of BNJ's gross receipts. BTG also obliged itself to offer newly developed products in the field of shaft to hub connections to BNJ for distribution in the United States. To ensure quality and protect valuable patent and trademark rights, Muellenberg included in the Distribution Agreement a provision requiring that production in the United States be in accordance with drawings and blueprints supplied by BTG which could not be altered without BTG's permission.

Muellenberg, Burg and Passerini subscribed for 100 shares of BNJ stock for $30,000 each. Only Muellenberg invested cash. Burg's subscription was provided in exchange for his

[1] For convenience, we sometimes use the name Passerini to denote the interests of Adda and TM and Muellenberg to denote the interests of BTG.

knowledge of the trade and Passerini's was credited against merchandise to be manufactured by TM for sale by BNJ. Certificates evidencing ownership of 100 shares of BNJ were issued to Muellenberg, Burg and Passerini.

Muellenberg claims that prior to the formation of Bikon Corp., he made it clear to Burg that he, Muellenberg, was to be in control of the company and would be its president, Burg would be general manager and Passerini would be treasurer. Business operations commenced in Burg's River Vale, New Jersey home. In June 1984, Burg and his wife bought a house with an out-building in Monroe, New York and moved the business there. The out-building was renovated with offices upstairs and a warehouse on the first floor. Eventually, BNJ expanded to a warehouse in Monroe. BNJ always paid rent to Burg and his wife for the office space in River Vale and Monroe ($1350/month in 1992).

Despite differences that developed between Muellenberg and Burg, the business prospered. As General Manager and the only officer on site on a regular basis, Burg handled the day-to-day business of BNJ. Muellenberg claims that Burg acted as though he had exclusive control over the business. Disputes arose about the introduction of new products into the BNJ line, the patent and trademark royalty fees, the rent that Burg paid to himself, and Muellenberg's desire to see detailed reports of sales and activities.

Muellenberg also complained that when Passerini fell behind in production capacity, Burg went to Italy without notice to Muellenberg and unilaterally engaged other suppliers. Muellenberg regarded some of them as direct competitors and did not want them to threaten his interests. He viewed introduction into the United States of the Bikon products produced by unlicensed manufacturers as a violation of his patent rights. Burg countered that Passerini had encouraged him to engage the other contractors with Muellenberg's tacit approval.

At first Passerini appeared neutral or inactive. A question arose concerning Passerini's fulfillment of his capital subscription. Claiming that the corporation was deadlocked, Muellenberg instituted these proceedings in the Chancery Division, seeking a dissolution of the corporation and other relief. Burg counterclaimed, seeking to confirm that Passerini was not a shareholder and to compel Muellenberg to sell his stock to Burg.

When Passerini resumed his role, notice was given of a meeting of the shareholders and directors to be held on January 20, 1993, to consider dissolution. On Burg's application, the Chancery Division enjoined any action to dissolve, but not the meeting. Muellenberg and Passerini traveled from Europe to attend the meeting. BNJ's secretary attempted to persuade Burg to attend either by telephone or in person. When Burg refused, the meeting proceeded in his absence.

At that meeting, Muellenberg and Passerini voted to declare a dividend of $180,000 ($600 per share), to retain an outside accountant to determine accrued royalties, to require the signatures of Burg and Muellenberg or Muellenberg alone for future bank withdrawals, and to require Board approval for the selection of suppliers and purchases over $1,000.[2] Muellenberg and Passerini assumed that they had regained control of BNJ and dismissed

[2] On Burg's motion, the Chancery Division enjoined the payment of the dividend and modified the requirements for approval of purchases over $1,000. The court also modified the banking arrangements.

their court actions, except for their application to purchase Burg's stock. The ensuing disputes were tried over eleven days between May 10, 1993 and June 22, 1993.

At trial, the court found that Passerini was a stockholder, having paid for his stock in the transfer of goods. The issues it posed for decision were: (1) Had defendant Burg proven a triggering event under *N.J.S.A.* 14A:12-7 authorizing a buy-out of shares or dissolution, and (2) if a triggering event occurred, should a sale of stock be directed and, if so, from whom to whom? After reviewing the various claims of oppression and mismanagement, the court found that at the January 20, 1993, shareholders' meeting, Muellenberg and Passerini had begun efforts to freeze out Burg. They had declared a $180,000 dividend that they should have known would deprive Bikon of needed cash to operate and thus take away Burg's ability to perform successfully as general manager. In addition, despite the lack of any showing of abuse by Mr. Burg in operating the company, they began to strip Burg of his day-to-day control as general manager by resolving that bank account withdrawals should be made only by plaintiff or by joint signatures of plaintiff and defendant Burg. And, finally, the court found that the majority directors, as "[p]laintiff's counsel acknowledged ... in summation," intended to vote Burg out as a director and terminate him as general manager and employee of the company.

The trial court determined that this course of conduct amounted to oppression. It held that the only fair and equitable remedy under the circumstances was to have one or more of the parties buy the stock of the others. The court concluded that Burg should buy out the interests of Muellenberg and Passerini. The parties agreed on the value of the stock. No stay of the order of the Chancery Division having been obtained, Burg tendered $235,000 each to Muellenberg and Passerini and thereafter changed the name of the corporation to B-Loc Corporation.

On appeal, the Appellate Division reversed and remanded the portion of the trial court's judgment ordering the sale of the shares of Muellenberg and Adda to Burg and terminating Muellenberg and Passerini as corporate officers and directors. It found that the Chancery Division's holding that the facts satisfy the oppression and unfairness standards of *N.J.S.A.* 14A:12-7(1)(c) was "premature and, therefore, erroneous as a matter of law."

It is not sufficient that Muellenberg and Passerini "had started to freeze out" Burg. The statutory remedies of dissolution or buy-out, available when oppression or unfairness has occurred, are so terminal in the context of a corporation's life, that a court should be loathe to reach either result except as a last resort. *See Brenner v. Berkowitz,* 134 *N.J.*488, 510-15 [634 *A.*2d 1019] (1993). * * * Before ordering so extreme a remedy as a buy-out, other less harsh remedies could have been applied.

[*Muellenberg v. Bikon Corp.,* 277 *N.J. Super.* 67, 75-76, 648 *A.*2d 1161 (App.Div. 1994) (citation omitted).]

The Appellate Division held that the trial court should have given the parties an opportunity to operate under their newly adopted governance structure before declaring an impasse. It reasoned that "there was always the possibility that the parties might, out of self-interest, find a way to resolve their differences so as to preclude a maturing `freeze out' from actually occurring, or that they might be assisted in doing so by orders of the court less extreme

than dissolution or buy-out." *Id.* at 76, 648 *A.*2d 1161. Because requiring majority shareholders to sell their interests to a minority shareholder is so contrary to our laws' majoritarian principles of corporate governance, the Appellate Division said courts should contemplate such relief only when "extraordinary equitable considerations and unavoidable consequences" arise.

Defendant Burg petitioned this Court for certification, arguing that the Appellate Division incorrectly limited the scope of *N.J.S.A.* 14A:12-7, improperly invoked a majoritarian principle of corporate governance with respect to a close corporation, and erroneously rejected the decision of the trial court. We granted Burg's petition for certification, 142 *N.J.* 448, 663 *A.*2d 1356 (1995), and stayed the effect of the Appellate Division's opinion until we had reviewed it. We now reverse and reinstate the judgment of the Chancery Division.

II

Unlike their counterparts in a publicly held corporation, shareholders in a close corporation are typically involved in the management and operation of the company. Oftentimes, these parties consist of family members or friends whose participation in the business is their principal source of employment and income. The existence of these family or other bonds may intensify conflicts and misunderstandings between the parties and lead to the deterioration of the company. 2 F. Hodge O'Neal & Robert B. Thompson, *O'Neal's Close Corporations*§ 8.13 at 67 (Callaghan & Co., 3rd ed. 1994). "[M]any participants in closely held corporations are `little people,' unsophisticated in business and financial matters." F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform,* 33 *Bus.Law.* 873, 884 (1978). "As minority participants in a close corporation may not anticipate dissension or oppression, and indeed may be unaware of their vulnerability, they frequently fail to bargain for adequate protection against mistreatment." *Id.* at 881.

Because majority shareholders have the power to dictate to the minority the manner in which the corporation is run, a minority shareholder in a close corporation becomes vulnerable when dissension develops. *Bostock v. High Tech Elevator Indus.,* 260 *N.J. Super.* 432, 443-44, 616 *A.*2d 1314 (App.Div. 1992). The controlling shareholders' voting power enables them to freeze-out minority shareholders by terminating their employment, excluding them from participation in management decision-making, and reducing their salary and other income. *Meiselman v. Meiselman,* 309 *N.C.* 279, 307 *S.E.*2d 551, 558 (1983).

The vulnerability of minority shareholders is exacerbated by the illiquidity of their financial stake in the company. They cannot dissolve the company at will like members of a partnership, nor can they sell their shares on the open market like shareholders in a publicly held corporation. *Ibid.* As a consequence, a shareholder challenging the majority in a close corporation is on the horns of a dilemma. The shareholder can neither profitably leave nor safely stay with the corporation. In reality, the only prospective buyer turns out to be the majority shareholder. *Brenner, supra,* 134 *N.J.* at 505, 634 *A.*2d 1019 (quoting *Orchard v. Covelli,* 590 *F. Supp.* 1548, 1557 (W.D.Pa. 1984), *aff'd,* 802 *F.*2d 448 (3d Cir.1986)). This inability of minority shareholders to withdraw from the venture on their own terms makes it easy for controlling shareholders to exploit minority shareholders and defeat their reasonable expectations.

Traditionally, American courts were reluctant to interfere in the internal affairs of a corporation. *Meiselman, supra,* 307 *S.E.*2d at 559 (quoting F. O'Neal, *Oppression of Minority Shareholders* § 9.04, at 582 (1975)). However, "[t]he two principal conceptual barriers to the court granting relief to aggrieved minority shareholders—the principle of majority rule in corporate management and the business judgment rule—actually have only limited validity in small business corporations." O'Neal, *supra,* 33 *Bus.Law.* at 884.

Some courts, like the Supreme Judicial Court of Massachusetts, did recognize that shareholders' interests are different in close corporations, and stated that those shareholders are subject to a higher standard of duty than shareholders and directors of publicly held corporations. In *Donahue v. Rodd Electrotype Co.,* 367 *Mass.* 578, 328 *N.E.*2d 505 (1975), the Massachusetts court held that "stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another." *Id.* at 515 (footnote omitted). This heightened duty, which the court labelled one of "utmost good faith and loyalty," was described by then Chief Judge Cardozo of the New York Court of Appeals in *Meinhard v. Salmon:* "Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties." *Meinhard v. Salmon,* 249 N.Y. 458, 164 *N.E.* 545, 546 (1928), *quoted in Donahue, supra,* 328 *N.E.*2d at 516.

Historically, state corporation statutes had provided minority shareholders with little protection against exploitation by controlling shareholders. As Professor O'Neal explained, "Corporation legislation, although designed primarily to meet problems of public-issue corporations, nevertheless applied indiscriminately to all corporations; the statutes did not differentiate between public-issue corporations and close corporations." O'Neal, *supra,* 33 *Bus.Law.* at 873.

Thus for years there was little or no protection that a court could afford oppressed minority shareholders. In *Brenner v. Berkowitz,* Justice Garibaldi furnished an historical overview of the New Jersey Legislature's approach to protecting minority shareholders. She noted that it was not until 1973 that the legislature amended section 14A:12-7 of the Corporation Business Act to provide a specific cause of action to protect minority interests. The present language in 14A:12-7(1)(c) was added by L. 1973, c. 366, § 67, effective May 1, 1974. It provides:

> (1) The Superior Court, in an action under this section, may appoint a custodian, appoint a provisional director, order a sale of the corporation's stock as provided below, or enter a judgment dissolving the corporation, upon proof that
>
> * * * * * * * *
>
> (c) In the case of a corporation having 25 or less shareholders, the directors or those in control have acted fraudulently or illegally, mismanaged the corporation, or abused their authority as officers or directors or have acted oppressively or unfairly toward one or more minority shareholders in their capacities as shareholders, directors, officers, or employees.

The legislature intended to expand the protection available to minority shareholders "who are powerless within a corporation, as well as powerless to leave." *Brenner, supra,* 134 *N.J.* at 506, 634 *A.*2d 1019 (citing *N.J.S.A.* 14A:12-7 (West 1968) Comment on 1972 Amendments).

The first New Jersey case to construe section 14A:12-7(1)(c) was *Exadaktilos v. Cinnaminson Realty Co.,* 167 *N.J. Super.* 141, 400 *A.*2d 554 (Law Div. 1979), *aff'd o.b.,* 173 *N.J. Super.* 559, 414 *A.*2d 994 (App.Div.), *certif. denied,* 85 *N.J.* 112, 425*A.*2d 273 (1980). The court examined the various techniques that controlling members of a close corporation could use to freeze out minority shareholders. *Id.*at 153, 400 *A.*2d 554. It noted that section 14A:12-7(1)(c) had been enacted in response to the failure of traditional principles of corporate law, such as the business judgment rule, to curb these abuses. *Id.* at 154, 400 *A.*2d 554.

In determining whether a particular course of conduct has oppressed a minority shareholder in violation of the new provision, courts should examine the understanding of the parties concerning their roles in corporate affairs.

The special circumstances, arrangements and personal relationships that frequently underlie the formation of close corporations generate certain expectations among the shareholders ... [that] preclude the drawing of any conclusions about the impact of a particular course of corporate conduct on a shareholder without taking into consideration the role that he is expected to play. Accordingly, a court must determine initially the understanding of the parties in this regard. Armed with this information, the court can then decide whether the controlling shareholders have acted in a fashion that is contrary to this understanding or in the language of the statute, "have acted oppressively * * * toward one or more minority shareholders."
[*Id.* at 154-55, 400 *A.*2d 554.]

In this Court's most recent application of section 14A:12-7(1)(c), we defined oppressive conduct to include that which frustrates the reasonable expectations of the minority shareholder. *Brenner, supra,* 134 *N.J.* at 506, 634 *A.*2d 1019 (citing 2 F. Hodge O'Neal & Robert B. Thompson, *O'Neal's Close Corporations* § 9.29 at 132 (Callaghan & Co., 3rd ed. 1988)). This approach takes into account the fact that shareholders in close corporations may have expectations that differ substantially from those of shareholders in public corporations. It also requires courts to be flexible in their treatment of section 14A:12-7(1)(c) cases because of the fact-sensitive nature of their inquiry. *Brenner, supra,* 134 *N.J.* at 516, 634 *A.*2d 1019.

We agree with the emphasis in the Appellate Division's opinion that minority shareholders' expectations must, however, be balanced against the corporation's ability to exercise its business judgment and run its business efficiently. *Id.* at 517, 634 *A.*2d 1019. Thus, courts should always be wary of interfering in the internal affairs of a corporation. As we stated in *Brenner:*

> The limited bases for statutory relief * * * reflect an awareness that minority shareholders know the limitations of their power at the time they make their investment in a close corporation. Mere disagreement or discord between the

> shareholders is not sufficient for a violation of the close corporation statutory provision.
> [*Id.* at 506, 634 *A.*2d 1019.]

With these principles in mind, we turn to the facts of the case to determine whether the conduct of Muellenberg and Passerini reflects more than a disagreement or discord among shareholders, but rather amounted to the oppression of Burg within the meaning of section 14A:12-7(1)(c).

III

To repeat, *N.J.S.A.* 14A:12-7(1)(c) allows a court to grant relief when controlling shareholders "have acted fraudulently or illegally, mismanaged the corporation, or abused their authority as officers or directors or have acted oppressively or unfairly" toward a minority shareholder. The trial court did not find any fraud or mismanagement on the part of Muellenberg or Passerini. The question is whether their actions were oppressive. Ordinarily, oppression by shareholders is clearly shown when they have awarded themselves excessive compensation, furnished inadequate dividends, or misapplied and wasted corporate funds. *Giannotti v. Hamway,* 239 *Va.* 14, 387 *S.E.*2d 725 (1990). This did not occur here.

The remaining measure of oppression in the small corporation is whether the fair expectations of the parties have been met. When personal relations among the participants in a close corporation break down, the "reasonable expectations" that participants had, for example, the expectation that their employment would be secure or that they would enjoy meaningful participation in the management of the business, become difficult, if not impossible, to fulfill. *Meiselman, supra,* 307 *S.E.*2d 551. A person who buys a minority interest in a close corporation does so, not only in the hope of enjoying an increase in the value of the shareholder's stake in the business, but for the assurance of employment in the business in a managerial position. In addition to the security of long-term employment and the prospect of financial return in the form of salary, the expectation includes a voice in the operation and management of the business and the formulation of its plans for future development. *Ingle v. Glamore Motor Sales,* 73 *N.Y.*2d 183, 538 *N.Y.S.*2d 771, 779-80, 535 *N.E.*2d 1311, 1319 (1989) (Hancock, J., dissenting). In this case, it is reasonable to conclude that Burg's fair expectations were that should he give up his prior employment with a competitor company and enter this small corporation, he would enjoy an important position in the management affairs of the corporation.

It is a close question whether the actions taken by Muellenberg and Passerini at the January 20, 1993, meeting amounted to oppression, as Burg contends. Muellenberg and Passerini claim that their declaration of the first dividend in company history was "fair and reasonable" in light of the company's favorable financial position at that time. They dispute the trial court's conclusion that the dividend would deprive Burg of the needed cash to operate BNJ, asserting that sufficient assets were still available to run the company. Muellenberg also maintains that Burg could not have reasonably expected that he would have exclusive authority and control over the business when BNJ's by-laws named Muellenberg president and chief executive officer.

We agree that it cannot be considered oppression when controlling shareholders seek to rein in management and control the affairs of their corporation. But the expectations of Muellenberg and Passerini that they might exercise majority power conflicted with the expectations of Burg, and were confined by their fiduciary duties to their co-venturer. *Bostock, supra,* 260 *N.J. Super.* at 444, 616 *A.*2d 1314. The equities were close. Burg had devoted the most productive years of his life to building up the company. Due in large measure to Burg's efforts, North American sales of Bikon products rose to over $2,000,000 per year. He could not reasonably have expected that after ten years as general manager he would be frozen out of the business. On the other hand, Muellenberg could not reasonably have expected that he, the founder of the enterprise, and Passerini would be ignored in the conduct of the company's affairs.

In other circumstances, the solution proposed by the Appellate Division might have resolved the impasse. Burg could have learned to manage the business more as a partner than as a sole proprietor. But the events that followed the Appellate Division's decision have confirmed that the trial court, which could assess the demeanor and relationship of the witnesses, had a better sense of the internal dynamics among the shareholders and could foreshadow Burg's inevitable ouster from Bikon's picture. That ouster would not have been a fair accommodation of the reasonable expectations of all shareholders.

The remaining issue was whether Burg or Muellenberg and Passerini should survive with BNJ. In 1988, the Legislature amended *N.J.S.A.* 14A:12-7(8) to permit minority shareholders to petition a court to order a buy-out of the majority. As amended, section 14A:12-7(8) provides that if there is a triggering event,

> *[u]pon motion of* the corporation or *any shareholder* who is a party to the proceeding, the court may order the sale of all shares of the corporation's stock held by any other shareholder who is a party to the proceeding to either the corporation or the moving shareholder or shareholders, whichever is specified in the motion, if the court determines in its discretion that such an order would be fair and equitable to all parties under all of the circumstances of the case. (emphasis added).

The statute thus plainly allows the minority to seek a court order for the sale of the stock of "any other shareholder." In most situations, oppressed minority shareholders will lack the resources to buy out the interests of controlling shareholders. As a result, claims of oppression are typically remedied by arranging for the corporation or the majority shareholders to buy out the interests of the minority shareholder. In this case, the record contained the following evidence in support of Burg: Burg was willing and able to purchase the shares of Muellenberg and Passerini; Burg, who owns the land on which BNJ's offices are located, was most active in operating the company since its inception; Burg is the only shareholder who works full-time for BNJ and the company has been his only source of income for over ten years; Burg was primarily responsible for developing the company's contacts in the United States and Canada and is best situated to maintain the existing operation; and finally, it was Burg who sought to preserve the corporation at a time when Muellenberg and Passerini attempted to dissolve it. *See Musto v. Vidas,* 281 *N.J. Super.* 548, 658 *A.*2d 1305 (App.Div. 1995) (reversing minority buy-out of the majority when minority shareholder had not been actively involved in the operation of the company for seven years).

On the other hand, without Muellenberg there would have been no business to divide since he had furnished all the start-up capital and was the inventor of the special design features that propelled the company's sales. Much of BNJ's good will may have derived from the use of the Bikon name. It is, however, too close a call to say that the Chancery Court erred in finding a slight edge in favor of Burg as the surviving shareholder.

Thus, while a minority buy-out of the majority is an uncommon remedy, it was the appropriate one here. The trial court acted within its discretion in ordering Muellenberg and Adda to sell their shares in BNJ to Burg. This remedy is authorized by *N.J.S.A.* 14A:12-7(8) and is consistent with decisions holding that courts are not limited to statutory remedies, but have a wide variety of equitable remedies also available to them. *Brenner, supra,* 134 *N.J.* at 516, 634 *A.*2d 1019; *Walensky v. Jonathan Royce Int'l,* 264 *N.J. Super.* 276, 279, 624 *A.*2d 613 (App.Div.), *certif. denied,* 134 *N.J.* 480, 634 *A.*2d 527 (1993).

Any doubt as to which shareholder should be permitted to invoke the buy-out remedy has been largely dissipated by circumstances. Without resolving the factual disputes set forth in the motions to supplement the record, it appears that since we stayed the Appellate Division's decision, Muellenberg has demonstrated an ability to market his products in the United States without Burg. Muellenberg, on behalf of his solely owned company BTG, made arrangements with a company called North American, Inc. for it to market products under the "Bikon" name that may compete with B-Loc. North American began soliciting B-Loc's customers, advising them that it had been granted the exclusive license to manufacture and distribute "Bikon" locking devices in the United States, Canada and Mexico. In addition, its sales catalogue is similar to the catalogue BNJ used previously. Oral argument convinces us that there is nothing to stand in the way of Muellenberg and Passerini continuing in the American market without real detriment to their reasonable expectations in forming BNJ. The trial court's solution is thus "fair and equitable to all parties" as required by *N.J.S.A.* 14A:12-7(8).

As it stands, BNJ (now B-Loc) no longer can use the "Bikon" trade name. That license was terminated by BTG prior to the commencement of this litigation. The good will and trade name of Bikon inures to Muellenberg's new venture, which may engage in the sale of Bikon fasteners in the domestic U.S. market. Now that the patent has expired on the only Bikon product to generate significant sales in this country, B-Loc and North American are able to compete freely with each other. Realistically, all that plaintiffs Muellenberg and Passerini might reasonably require to advance their undertaking would be the customer lists generated during the period of their joint enterprise with Burg. If those lists are not available to them now, a customer list as of the date of the buy-out should be furnished by Burg.

Accordingly, we reverse the judgment of the Appellate Division and reinstate the judgment of the Chancery Division. We leave to that court the resolution of any unresolved issues attendant to the buy-out.

For Reversal and Reinstatement—Chief Justice WILENTZ, and Justices HANDLER, POLLOCK, O'HERN, GARIBALDI, STEIN and COLEMAN—7.

Opposed—None.

Estate of Mueller v. Commissioner

Full Text of Court Cases

Estate of Mueller v. Commissioner

Case name: Estate of Mueller v. Commissioner
Citation: T.C. Memo 1992-284, 1992 Tax Ct. Memo LEXIS 310
Date of decision: May 18, 1992
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Beghe
SIC: 3494 Valves and Pipe Fittings, NEC (except metal pipe hangers and supports)
NAICS: 332919 Other Metal Valve and Pipe Fitting Manufacturing
9500

Keywords: Estate tax, Valuation date

COUNSEL:

Stevan Uzelac, Michael A. Indenbaum, and Paul L. Winter, for petitioner.

Thomas M. Rath, for respondent.

JUDGES:

BEGHE

OPINIONBY:

BEGHE

OPINION:

MEMORANDUM FINDINGS OF FACT AND OPINION

BEGHE, Judge. Respondent determined a deficiency of $ 1,985,624 in petitioner's Federal estate tax. The sole issue for decision is the date-of-death fair market value of the 8,924 shares of common stock of the Mueller Co. (the Company) included in the gross estate of Bessie I. Mueller (decedent).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. We incorporate the stipulation of facts with attached exhibits. Unless otherwise noted, all section references are to the Internal Revenue Code in effect on decedent's date of death, and all Rule references are to the Tax Court Rules of Practice & Procedure.

John S. Mueller, the personal representative of the estate of Bessie I. Mueller, resided in Naples, Florida, at the time the petition in this case was filed.

Bessie I. Mueller, a resident of Port Huron, Michigan, died March 24, 1986, 3 days after the board of directors of the family-owned Mueller Co. apparently approved the cash merger of the Company with an acquisition vehicle to be organized by a Middle East-backed investment bank. Her gross estate included 8,924 common shares of the Company, or 7.5 percent of those outstanding. n1 On May 30, 1986, 67 days after decedent's death, the merger was consummated, essentially on the terms presented at the March 21, 1986, directors' meeting, and all shareholders of the Company received $ 2,150 per share for their stock.

n1 The estate tax return showed 3,500 shares as held by "Ebert B. Mueller, Trustee Under Will -- Marital Trust," 274 shares as held by "Ebert B. Mueller, Trustee Under Life Insurance Agreement -- Marital," and 5,150 shares as held by "Bessie I. Mueller Trust -- property transferred August 9, 1979." Ebert B. Mueller was decedent's husband, who predeceased her. There is no dispute that these shares were includable in the gross estate. The parties have not argued that the holding of the shares in three separate trusts should have any impact on our valuation analysis. We therefore value these shares as if they were held by a single entity on the valuation date.

The estate valued the shares at $ 1,505 per share on the Federal estate tax return, but did not provide any appraisal documentation with the return. Respondent determined that the fair market value of the shares was $ 2,150 per share, the price received by all shareholders of the Company in the merger. At trial, respondent's expert opined that the fair market value of the shares was $ 2,007 per share. One of petitioner's two experts opined that the shares had a value of $ 1,527 per share. The other opined that the value of the shares was between $ 1,400 and $ 1,700 per share, most likely the average of these two extremes, or $ 1,550.

History of the Company

In 1857, Hieronymus Mueller founded the Mueller Co. as a sole proprietorship when he opened a gunsmith shop in Decatur, Illinois. In 1871, Mueller was appointed the Decatur city plumber. The following year he invented the Mueller tapping machine, which enabled gas and water pipes to be tapped while the pipes were under full pressure. This invention is still used throughout the world. The tapping machine was followed in 1882 by Mueller's water pressure regulator, which permitted the main water line pressure to be increased to fight fires without damaging the soft lead pipes used in home plumbing at that time.

In 1885, Mueller converted the business to a partnership with one of his sons and began large-scale manufacturing operations. By 1896, the business had been converted to a corporation, with Hieronymus Mueller owning one-third of the stock, and each of his six sons owning one-ninth. In 1900, Hieronymus Mueller died and his son Henry was named president. Two years later, Henry's brother Adolph succeeded Henry.

Adolph and his descendants tried to keep the Company's stock in the Mueller family. In 1915, 5 years after Henry's death, Adolph bought all the shares of Henry's widow and sold them to his four remaining brothers and one sister, Leda Mueller Cruikshank, on the condition that they not sell or encumber them without family approval. In 1929, however, the Cruikshank family disregarded this condition and offered their Mueller Co. shares to the public. The Mueller family and the Company bought 84 percent of the shares offered, and the balance found its way into outside hands. In response to the Cruikshank

episode, in 1929 Adolph organized a family voting trust with a 10-year term, which was renewed for additional 10-year terms in 1939 and 1949. All shareholder branches of the family, except the Henry Mueller branch, joined the trust, comprising 52 percent of the outstanding shares.

Adolph continued as president until 1939, when his son, William Everett Mueller, succeeded him. William Everett Mueller died in 1947 as the last Mueller to be president of the Company. The Company then sought outside managers and adopted a policy of not hiring family members as new managers, in the belief that family member managers would receive special treatment not necessarily in the interest of family member shareholders. Also, the four remaining shareholder branches of the family became adversarial. The result was that during the period 1953-57, an executive committee of outside directors assumed total management control of the Company. A change in Illinois law in 1957 forbidding such arrangements ended the executive committee's control. The emphasis on outside management continued, however, and in 1968 the last Mueller retired as an officer of the Company.

In 1977, Harlan White, an outsider who had served as president of the Company since 1972, unexpectedly announced his resignation. The board appointed an executive search committee, and after a year's search the committee recommended and the board accepted Edward D. Powers, a professional manager, to replace White as president and chief executive officer. Until 1 year before Powers joined the Company, he had been head of one of the Company's major competitors, the valve division of International Telephone & Telegraph. Powers is currently chairman and chief executive officer of Burnham Service Co., a transportation, warehousing, and distribution firm owned by Investcorp, the Middle East-backed firm that eventually acquired Mueller Co. From approximately 1985 to 1991 he was a member of the board of the Federal Reserve Bank of Chicago, and he currently serves on the boards of directors of Schneider National, Little Rapids Paper Co., and Burnham Service Co.

At about the time Powers became the Company's chief executive, the shareholders began to amend the bylaws of the Company, changing the size and structure of the board of directors. The board was reduced from 12 to 7 members, 4 of whom were "family-designated directors", each representing a surviving shareholder branch of the Mueller family. Illinois law requires cumulative voting for directors, unless the articles of incorporation otherwise provide. Ill. Ann. Stat. ch. 32, par. 7.40(a) (Smith-Hurd 1985). The Company's bylaws also provided for cumulative voting. Inasmuch as each branch of the family held approximately one quarter of the stock, each branch could cumulate its votes and perpetuate its representation on the board. In 1979, the shareholders amended the bylaws to require that three family-designated directors be present to constitute a quorum (family quorum), and that three family-designated directors assent to any board action (family veto). After these changes, the family-designated directors were decedent's son John S. Mueller, Adolph Mueller II, Philip M. Mueller, and A.E. Staley III. Powers, chairman Robert V. Krikorian, and corporate counsel Dudley J. Godfrey were the nonfamily directors.

In 1982, the board unanimously resolved to submit to the shareholders a recapitalization plan whose objective was to freeze the bulk of the then-current value of the Company's stock for estate tax purposes. The plan was opposed by John A. Schluter, a member of the Adolph Mueller branch of the family. Schluter and other members of the Schluter/Adolph Mueller branch of the family believed their branch did not face estate valuation problems and did not see any other need for the proposed recapitalization. Some directors believed the Schluter family planned to take over the Company by

purchasing stock from estates that needed money to pay death taxes. The recapitalization plan was defeated because less than the required two-thirds of the Company's outstanding shares were voted in favor of the plan. Schluter was instrumental in blocking the recapitalization.

Lines of Business

In its early years, the Company had a number of lines of business, from sporting goods to munitions. The Company fabricated one of the earliest automobiles in the United States, and held patents on some of the earliest designs for automobile radiators, spark plugs, and variable speed transmissions. Hieronymus Mueller was experimenting with high-test gasoline when a spark from his pipe ignited some fuel. After he died from burns suffered in the fire, the Company got out of the automobile business and sold its automotive patents.

The "flow control" products -- the tapping machine and the pressure regulator -- became the core of the Company's business. These products evolved into lines of valves and fire hydrants, manufactured in the United States and Canada. The Company's products are used exclusively in large water supply systems. A foray into porcelain bathroom fixtures was abandoned in 1933, and the Company stopped all manufacturing of household plumbing products with the advent of World War II.

The Company is a longtime member of the American Water Works Association (AWWA), the standard-setting organization for municipal flow control products. In 1986, Mueller Co. products satisfied AWWA's standards, and many municipalities required contractors to use Mueller Co. products.

The core business was vulnerable to economic cycles. Management knew it could expect about $ 100 in revenue and $ 40 in pretax profits per housing start, so the Company's revenues and profits were reduced when housing starts declined. Powers convinced the board of directors to authorize a diversifying acquisition program. In the period 1982-84, the Company acquired six firms in an effort to diversify its product lines. The companies acquired were:

Year	Firm acquired	Product
1982	Judd Valve	High-pressure oil field valves
1982	Leopold Co.	Municipal water filters
1982	Superior Stainless	Stainless steel valves and fittings for sanitary use
1984	Valley Pump	Submersible, jet, and turbine pumps for special applications. Renamed Mueller Pump
1984	Tri-Canada, Inc.	Stainless steel valves and fittings for sanitary use. Merged into Superior Stainless to form TCI-Superior
1984	LFE B.V.	Large vacuum-process castings. Located in Northern Ireland. Renamed Mueller Flow Products B.V.

In 1985, the Company also acquired Canada Valve, Inc., another water and gas valve maker. In 1986, the Company had 9 wholly owned subsidiaries and 18 manufacturing facilities in the United States, Canada, and the United Kingdom.

After the acquisition program, and on the valuation date, the Company was a world leader in production of flow control products, processing systems, and pumps for water and natural gas distribution, fire protection, oil and natural gas production, domestic water supply, farm irrigation, and food, beverage, and pharmaceutical processing. The Company was also the largest manufacturer of fire hydrants in the world.

Even after the diversification program, 90 percent of the Company's earnings still came from the core business. The core business is capital intensive, requiring foundries costing tens of millions of dollars. In addition, the foundries create environmentally dangerous wastes. The Company's relative lack of diversification, capital intensiveness, and environmental risks tended to reduce its value.

Despite these vulnerabilities, the Company was doing well financially by the mid-1980's. Under an incentive program created in 1985, in which the Company's return on equity was compared to 30 "peer group" public companies, the Company's return on equity would have ranked as follows:

Year	Rank	Return on Equity
1980	28th	4.41 percent
1981	18th	9.27 percent
1982	23d	2.83 percent
1983	2d	18.28 percent
1984	3d	22.56 percent
1985	2d	22.61 percent

In addition, the Company posted record sales and earnings in 5 of the 7 years ending with 1985. In 1981, the Company reported record sales and earnings, despite the lowest number of housing starts in 30 years. Dividends steadily increased from a low of $ 13 a share in 1975 to $ 32.25 a share in 1985, when the Company earned $ 18.3 million on $ 277.2 million in sales:

	Sales	Earnings	Dividends
Year	($ mil)	($ mil)	($ /share)
1974	$ 90.5	$ 4.8	$ 17.75
1975	72.8	3.3	13.00
1976	79.5	1.4	16.75
1977	97.6	3.1	16.50
1978	117.5	3.5	18.00
1979	127.1	5.6	19.50
1980	121.4	2.7	19.75
1981	142.2	5.7	21.20

1982	130.6	1.8	22.20
1983	176.8	11.5	27.90
1984	212.2	16.0	30.00
1985	277.2	18.3	32.25

The Buyout Transaction

In October or November 1985, Powers told the Company's board of directors that Amsted Industries had expressed some interest in acquiring the Company, but had later decided on a different course of action. The board discussed the possibility of selling the Company. In November, the board voted to form a search committee to interview investment bankers. Philip M. Mueller appeared to oppose selling the Company and voted against the resolution. While Adolph Mueller II was in favor of selling the Company, the rest of his branch of the family, including Schluter, appeared to be against selling. John Mueller was not present at the meeting.

Powers sent letters to several Wall Street investment banking firms, including Morgan Stanley & Co. The search committee interviewed four firms. At a special meeting of the board in December 1985, the directors unanimously chose Morgan Stanley to find a buyer for the Company. Morgan Stanley's representative, Frank Sica, told the board that the Company could bring more than $ 2,000 per share. Powers and John Mueller both thought that estimate was optimistic in light of the business' cyclical nature, capital intensiveness, and environmental risks.

At the December 1985 meeting, Adolph Mueller II retired as a director of the Company. At the board's January 1986 meeting, Schluter replaced Adolph Mueller II as the Adolph Mueller branch's family designated director.

Also at the December 1985 meeting, the board approved a special stock appreciation rights plan (takeover rights plan) whose stated purpose was to:

provide additional incentive to those employees of Mueller Co. and its subsidiaries whose decisions and services are considered to have a significant impact upon the profits of the Company and to encourage those employees to remain as employees throughout and to cooperate with any change in control of the Company.

The takeover rights plan provided that on retirement each of the 11 participants would receive in cash the equivalent of the per share book value of the stock times the number of rights granted to him. If, however, the Company underwent a change in control, then the plan would pay the equivalent of the sales price per share times the number of each participant's rights. These rights were to expire on December 31, 1988. Thus, management had substantial incentive to have the Company acquired at a premium over book value prior to the end of 1988, both under the takeover rights plan and under other stock appreciation rights plans in which members of management had become vested. For example, upon consummation of the merger, Powers received approximately $ 4.8 million with respect to his 2,250 rights, of which 1,200 were granted under the takeover rights plan. But because management did not own any stock, it could not participate in the shareholder vote on a takeover proposal.

On February 21, 1986, the board of directors approved an amendment to the fee agreement with Morgan Stanley. The original agreement compensated Morgan Stanley at a rate of 0.75 percent of the first $ 240 million paid for the Company and 3 percent of any amount more than $ 240 million, plus expenses. The amendment provided that Morgan Stanley would receive an amount equal to 0.75 percent of the purchase price up to $ 240 million, 3 percent of the purchase price between $ 240 million and $ 260 million, and 5 percent of the purchase price greater than $ 260 million, plus expenses. The amendment also provided that if a deal was not consummated, Morgan Stanley would to be entitled to a $ 3 million "breakup fee".

The Company had instructed Morgan Stanley not to make a public announcement of the Company's desire to be acquired. Morgan Stanley instead used its extensive network of business contacts and approached 43 companies it thought would make suitable buyers. Nonetheless, the fact that the Company was seeking a buyer became known in the corporate community, and a number of unsolicited bidders contacted Morgan Stanley, although none of them made an acceptable bid. By February 21, 1986, 16 companies were examining the proposal and 5 had expressed interest. Four interested firms -- British Tire & Rubber (BTR), Kohlberg, Kravis & Roberts (KKR), Georgetown Industries, Inc., and Investcorp -- visited Mueller Co. offices and facilities to conduct due diligence investigations. Of these four firms, Investcorp devoted the most resources to its investigation of the Company. Investcorp sent representatives two separate times; the second time 12-14 Investcorp representatives spent 3 days at the Company. KKR bid $ 235 million to $ 240 million, and BTR bid between $ 220 million and $ 250 million, but the initial bids from Georgetown and Investcorp were the highest.

Prior to March 20, 1986, the Company simultaneously negotiated with Investcorp and Georgetown at the offices of Morgan Stanley in New York. Georgetown ultimately bid $ 270 million. Georgetown's negotiator, former Secretary of the Treasury William Miller, claimed that Georgetown represented the Kuwaiti Investment Authority, a fund operated by the Government of Kuwait. Powers demanded proof of an agency relationship. The negotiations adjourned for a day, but when Miller did not provide an authorization letter from the Kuwaitis, Powers broke off talks with Miller and instead negotiated directly with the president and chief executive officer of Investcorp, Nemir A. Kirdar.

Investcorp refers to itself as a "publicly held investment bank" based in Bahrain, but from the evidence available to us, an important aspect of its operations is to take long-term, controlling positions in companies in which it acquires equity and debt interests. Investcorp had acquired other American companies prior to 1986, such as Tiffany's, Bertram-Trojan Yachts, and A&W Brands, but the Company was Investcorp's biggest acquisition until that time and its first occasion to finance an acquisition with money raised in the U.S. public capital markets.

Investcorp's highest bid had been $ 260 million, but because Sica and Powers expected problems with Schluter if management recommended an offer less than the highest one, Powers pressed Kirdar to increase Investcorp's bid. Kirdar agreed to match Georgetown's $ 270 million offer. After expenses and incentive payments to management, the offer promised to net shareholders $ 2,150 a share. The Investcorp offer also provided for allowing Mueller Co. management to acquire 150,000 shares (of 1 million fully diluted shares) of the surviving corporation's stock on favorable financing terms. In addition, management was to receive an option to purchase an additional 90,000 shares, and an employee stock ownership plan was to receive an option on 60,000 shares.

Investcorp's offer was to be held open only until the Mueller Co. board's March 21, 1986, meeting. Thus, the offer was to terminate by its own terms if not accepted by that date. In addition, completion of the deal was to be conditioned on the following:

. that the warranties each of the parties had made to each other were true, including warranties regarding the nature and ownership of patents and know-how,

. that each party would perform its obligations under the acquisition agreement,

. that the parties would each receive opinion letters from counsel stating that the other party was legally empowered to complete the transaction,

. that the transaction be approved, or the time for objection expire, under the Hart-Scott-Rodino Antitrust Improvements Act and the Canadian Foreign Investment Review Act,

. that no lawsuit seeking to halt the transaction be filed,

. that key employees (including Powers) sign 5-year employment contracts with the Company, and

. that a registration statement or private placement memorandum for the financing of the transaction become effective.

If any of these conditions was not satisfied or waived, the agreement could have been terminated. The agreement also could have been terminated by mutual consent, by failure to win shareholder approval, or by either party without cause after July 31, 1986, if the transaction had not closed.

Investcorp secured financing commitments on March 20, 1986. On that date, Merrill, Lynch, Pierce, Fenner & Smith agreed to place or sell $ 125 million in senior subordinated debentures and issued its "highly confident" letter that it could place $ 60 million of 10-year senior secured notes. Investcorp told Merrill Lynch it would not ask Merrill Lynch to raise the money unless Investcorp had $ 66 million in other funds to invest in the deal.

The Mueller Co. board of directors met on March 21, 1986. All directors but John Mueller were present, constituting a quorum. Although Schluter said he believed the price was fair, he was the only director present at the meeting who did not vote to recommend the Investcorp deal to shareholders. Dudley Godfrey, a board member and the Company's counsel, telephoned John Mueller during the board meeting to obtain his views. Godfrey told the board that John Mueller said he did not wish to stand in the way of a deal, but was personally opposed to selling the Company. However, John Mueller could not be heard by the entire board and did not believe that he was casting his vote by phone. Thus, only two family-designated directors clearly recorded yes votes at the meeting.

Three days later, on March 24, 1986, decedent died. At the time of her death, the estate of her other son, Robert, was undergoing a Federal estate tax audit. Robert Mueller's estate included Mueller Co. shares.

At the time of decedent's death, Powers was pessimistic that the deal would go through. He believed that only the Staley branch of the family could be counted on to vote in favor of the deal. He believed that the Adolph Mueller/Schluter branch and Philip M. Mueller opposed the deal. Powers saw John Mueller, the representative of decedent's branch, as wavering.

Powers also was concerned about a defect in the March 21 meeting. John Mueller had not been "present" and could not have voted at that meeting under Illinois law because he could not hear and be heard by all directors simultaneously. Ill. Ann. Stat. ch. 32, par. 8.15(d) (Smith-Hurd 1985). The family veto provision of the Mueller Co. bylaws ostensibly required yes votes from three family-designated directors, and only two valid family yes votes were recorded at the meeting. The Company's local attorney had advised Powers in October 1985 that the family veto provision violated Illinois law and would be struck down if challenged in court, but the family veto provision had been respected by the board, n2 and Powers believed litigation on the point was inevitable and would threaten the merger. The threat was real because Investcorp had a reputation for shying away from hostile deals.

n2 The parties stipulated that "The minutes of the Mueller Co. Board meetings for the years 1981 through 1986 disclose no action of the board which did not meet the requirements of [the family veto provision]." However, those minutes reflect that the provision probably was not followed at the Mar. 21, 1986, meeting and clearly was not followed at the Nov. 19, 1985 meeting, at which the board voted to form a committee to interview investment bankers. John Mueller was not present at the November 19 meeting, and Philip Mueller voted against the resolution, leaving only two family designated directors who could have "assented to" the board's action. However, the vote to form the committee was not likely to (and did not) lead to a legal challenge, inasmuch as thereafter the entire board unanimously approved the committee's choice of Morgan Stanley as investment banker.

The doubts about the March 21 vote were cleared up at an April 4, 1986, special meeting of the board. By telephone conference call, the board ratified the vote of March 21. John Mueller voted yes, and the other directors voted the same way they had voted at the prior meeting. Schluter proposed that the board merely send the Investcorp deal to shareholders for their vote, but not recommend that shareholders vote in favor of the transaction. Schluter's motion was not seconded. Schluter also reminded the directors that they could be sued for breach of their fiduciary duty to shareholders and that the Company did not have directors and officers liability insurance. The minutes of the April 4 meeting show that the debt offerings were then expected to close on June 18, with the merger closing to occur immediately thereafter.

Schluter continued to threaten legal action to block the sale. Schluter's attorneys assailed the proxy statement as failing to disclose all material facts and accused the board of failing to discharge its fiduciary duty to shareholders. Schluter's attorneys tried to convince the Company to delay mailing the proxy statement, but the Company mailed it anyway. The proxy statement included a favorable fairness opinion from Morgan Stanley.

The directors met informally, on April 15, 1986, to discuss Schluter's criticisms, but took no action. The Company's attorney responded to Schluter's charges on April 16. Schluter's attorney replied that Schluter did not seek to block the merger, but only obtain the best price. However, it seemed to Powers that Schluter was willing to block the sale. On April 16, the Company retained special litigation counsel to prepare for the possibility of a lawsuit by Schluter.

During this period, Powers and other members of management tried to persuade shareholders to vote in favor of the merger. Powers and other members of management had attended decedent's funeral and had used the occasion to try to convince members of her branch of the family to vote for the merger. On

March 30, 1986, Powers wrote a letter to Milton Bush, coadministrator of decedent's estate, emphasizing the cyclical nature of the Company's business. In the letter, Powers relayed management's projection that housing starts would level off, with adverse effects on the Company's earnings. Powers also believed that the merger fever of the mid-1980's was at its height. Powers noted that AWWA, the nationwide standard-setting organization, might approve the design of low-cost European valves, resulting in greater competition for the Company in the municipal water distribution market, the Company's core business, and that the Company might be required to use lightweight ductile iron, used in European valves, rather than cast iron, the material of which Mueller Co. valves were made. This change would have required $ 30-40 million in capital improvements. Powers made similar arguments to the other branches of the Mueller family, but was certain only that the Staley branch would vote in favor of the transaction.

Although John Mueller had voted at the April 4 meeting in favor of recommending the Investcorp deal to shareholders, he had not decided prior to the middle of that month how he would vote the 15,196.1 shares he controlled as trustee. The decedent, who knew she would die soon, had told John Mueller during the first week of March that she opposed the sale. About 2 weeks after his mother's death, John Mueller received a letter from a friend and investment adviser, Samuel R. MacArthur of MacArthur & Co., outlining several alternative courses of action, including a public offering or recapitalization of the Company. However, MacArthur concluded by advising John Mueller to vote for the sale.

On April 10 management made an informal presentation to shareholders in an effort to convince them to vote for the merger. Schluter told shareholders that he and other Mueller Co. shareholders wished to take the Company private by matching or exceeding the Investcorp offer. But Schluter had no financing commitment, and Powers and other members of management said they would not work for Schluter. Powers also argued that the Company and the board of directors had a commitment to Investcorp under a "best efforts" clause in the merger agreement.

Another issue raised at the April 10 meeting was the disposition of family memorabilia and land used by the family but owned by the Company. John Mueller suggested that the Company donate the land, known as Mueller Heights, and some cash to a college in Decatur to establish a museum, and said he would feel better about selling the family company if the family heritage in Decatur were preserved. Investcorp agreed to John Mueller's proposal.

By April 14, John Mueller had decided to vote for the sale. On April 14, 28 shareholders, including John Mueller, entered into a voting agreement naming John Mueller, Philip M. Mueller, and Staley as voting shareholders. By the time of the shareholder meeting, the voting agreement covered more than 60,000 shares of the 119,468.83 shares outstanding.

On May 1, 1986, the day before the annual shareholder meeting, the directors held a special meeting. Schluter again asked that the shareholder vote be postponed to allow him time to put together a leveraged buyout at $ 2,250 a share. All the directors but Schluter voted against the request. The following day, the board held another special meeting to discuss the issues raised at the previous meeting. Schluter's attorney told the board that the proxy statement was incomplete and defective, that the board had a fiduciary responsibility to consider better offers, and that the board could recommend that the shareholders delay voting without violating the agreement with Investcorp. Schluter's motion to postpone the shareholder vote was not seconded.

At all times relevant to this case, the only class of Mueller Co. stock outstanding was common stock. Each share of common stock was entitled to one vote. There was no public market for the shares. On March 21, 1986, decedent's date of death, the various branches of the family held Mueller Co. stock as follows:

Name of Group	Shares	(percent)	Group Members
Schluter	30,567.67	(25.59 %)	Adolph Mueller II, John Schluter
Staley	30,100.00	(25.19 %)	A.E. Staley III
Decedent's	29,766.66	(24.92 %)	Bessie I. Mueller, John S. Mueller
Philip Mueller	26,612.50	(22.28 %)	Philip M. Mueller
Outsiders	2,422.00		(2.03 %)
Total			119,468.83

For the most part, the family shares were held in trust, with family members acting as trustees. Although John Schluter directly owned only 2.5 shares, he beneficially owned 18,971.33 shares, as to 10,800 of which he shared voting power. No Mueller Co. stock was sold or exchanged between March 21 and May 2, 1986.

On May 2, 1986, the Company's 183 shareholders held their annual meeting. Proxies for their shares were held as follows:

A.E. Staley III	61,623.89
Company management	25,786.96
John A. Schluter	22,526.26
No proxy	9,530.72
Unrepresented	1.00
Total	119,468.83

Schluter moved to postpone the meeting until June 10. Powers told the shareholders that Investcorp had waived the conditions that a valid Securities and Exchange Commission registration statement become effective for the debt financing and that the proposed merger obtain favorable review under the Hart-Scott-Rodino Act and the Investment Canada Act (formerly known as the Canadian Foreign Investment Review Act). Power also told the shareholders that financing for the deal was in place and the deal would close by May 30 because Merrill Lynch had agreed to make a "bridge loan" to Investcorp. This type of financing, which was not yet generally used, allowed Investcorp to complete the deal before the public offering of senior subordinated debentures and senior secured notes. Schluter's motion was defeated, 87,410.85 shares to 22,526.26 shares. Shareholders then approved the Investcorp transaction, with 92,761.57 shares voting in favor and 26,706.26 shares abstaining.

On May 14, the Federal Trade Commission and the Department of Justice granted early termination of the premerger notification period required by section 7A of the Clayton Act and section 803.10(b) of the Department of Justice premerger notification rules.

On May 30, the Company merged with Mueller Merger Corp., a subsidiary of Mueller Holdings Corp., an affiliate of Investcorp. Mueller Co. shareholders received $ 2,150 for each of their shares. Merrill Lynch provided a $ 177.9 million bridge loan, giving Investcorp until November 30, 1986, to raise the money in the public market. With loans from Investcorp and affiliates, the Company's management acquired 150,000 of the 1 million fully diluted shares of Mueller Holdings. Morgan Stanley received $ 2,675,000, plus expenses, as its fee.

On July 1, 1986, the registration statement for the debt offering became effective and the notes and debentures were offered to the public. The notes and debentures were delivered on July 10, raising $ 177.9 million.

On July 8, 1986, the merger of the Company and Mueller Holdings Corp. was declared unreviewable under the Investment Canada Act.

ULTIMATE FINDING OF FACT

The March 24, 1986, value of the 8,924 common shares of the Mueller Co. includable in decedent's gross estate was $ 15,170,800, or $ 1,700 a share.

OPINION

The value of decedent's gross estate is the fair market value of property includable in the gross estate. Sec. 2031. Fair market value is defined as "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 to sell and both having reasonable knowledge of relevant facts." United States v. Cartwright, 411 U.S. 546, 551 (1973); Estate of Newhouse v. Commissioner, 94 T.C. 193, 217 (1990); sec. 20.2031-1(b), Estate Tax Regs. When the facts indicate that a lawsuit could impair the value of the property, we need not decide the probable outcome of the suit. The only relevant consideration is the effect of the possibility of a suit on the market price for the shares on the valuation date. Estate of Newhouse v. Commissioner, supra at 232-233.

Our task is to determine what a willing buyer would have paid a willing seller on the date of decedent's death for a 7.5-percent equity interest in the Mueller Co. The question of fair market value is a question of fact. Estate of Newhouse v. Commissioner, supra at 217; Estate of Gilford v. Commissioner, 88 T.C. 38 (1987). Valuation issues are "inherently imprecise and capable of resolution only by a Solomon-like pronouncement." Estate of Gilford v. Commissioner, supra at 50. However, we once again intone our warning to parties before this Court that we need not reconcile or average the opinions of the experts. We may choose one approach over another, resulting in a windfall for one party and a disaster for the other. See Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 452 (1980). We continue to believe that valuation disputes are better settled than litigated.

Whatever the weaknesses of the litigation process in its application to valuation questions, we cannot simply "pick at random any number that happens to lie somewhere between the Commissioner's valuation and the taxpayer's." Akers v. Commissioner, 798 F.2d 894, 897 (6th Cir. 1986), revg. T.C. Memo. 1984-208. We therefore explain how we arrived at our valuation conclusion.

Expert Testimony

We heard expert testimony on the valuation issue, and we weigh that testimony in light of the experts' qualifications and other credible evidence. Estate of Newhouse v. Commissioner, supra at 217. But we are not bound by the opinion of any expert, and we weigh expert testimony in the exercise of sound judgment. Helvering v. National Grocery Co., 304 U.S. 282, 295 (1938); Estate of Newhouse v. Commissioner, supra at 217.

All three experts and the parties agree that the relevant valuation standards are contained in sections 20.2031-1 (valuation of gross estate generally) and 20.2031-2 (valuation of stocks and bonds), Estate Tax Regs., and Rev. Rul. 59-60, 1959-1 C.B. 237 (valuation of stock of closely held corporations). Those standards emphasize that each case should be decided by reference to the facts and circumstances knowable on the valuation date: n3

A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance. [Rev. Rul. 59-60, 1959-1 C.B. 237, sec. 3.01.]

n3 Inasmuch as decedent's personal representative did not elect the alternate valuation date under sec. 2032, the valuation date is the date of decedent's death.

Respondent's expert

Respondent presented the expert's report of Willamette Management Associates, Inc., which was prepared under the "direct supervision" of Willamette's managing director, Dr. Shannon Pratt. Kathryn Daly "managed" the report, with the assistance of Scott Beauchene. Both Dr. Pratt and Ms. Daly signed the Willamette report.

Dr. Pratt also testified on behalf of respondent. Dr. Pratt has a doctorate degree in business administration and finance from Indiana University, and is a chartered financial analyst. He is a member of the American Society of Appraisers and of several of the Society's committees, including the theory and techniques committee. He is the author of the book Valuing a Business: Analysis and Appraisal of Closely Held Companies (2d ed. 1989). His academic and professional accomplishments are disclosed by his curriculum vitae, attached to the Willamette report, and the record of his introductory testimony.

Willamette appraised Mueller Co. stock using two methods. First, Willamette figured the Company's "discounted effective merger price." Willamette surveyed various sources for public market takeovers between January 1985 and May 1986. Willamette discarded transactions that were not friendly, leaving a universe of 80 transactions. Willamette then noted that the Mueller Co.-Investcorp merger was consummated 67 days after the valuation date, so it examined the trading price of the stock of each of the target companies in its survey 67 days prior to the consummation of their respective mergers. The median discount was 3.4 percent. Willamette discounted the Mueller Co. takeover price of $ 2,150 a share by 3.4 percent and determined that the discounted effective merger price of Mueller Co. shares on the valuation date was $ 2,077 a share.

We are convinced Willamette made erroneous assumptions at nearly every step of this part of its analysis. First, Willamette figured the discount by looking back 67 days, the exact time it took the transaction to close, even though the Mueller-Investcorp acquisition agreement contemplated an outside date almost 2 months later than what turned out to be the sale date, and there was no indication on the valuation date that the period would be shortened to 67 days. On April 4, the deal was expected by management to close some time after June 18, at least 86 days after the March 24 valuation date. The announcement that the deal would close on May 30 was made at the shareholders meeting on May 2, after Investcorp secured the bridge loan commitment from Merrill Lynch. At that time bridge loans were not widely used and the availability of such a loan could not have been foreseen on the valuation date. Respondent argues that 67 days was a reasonable period because it was the midpoint between the valuation date and the outside termination date. In effect, respondent asks us to average two unreasonable assumptions and hope that we reach a reasonable result. This we decline to do.

The only legitimate use of hindsight is for the limited purpose of establishing what a reasonably well-informed investor might have believed on the valuation date. Estate of Gilford v. Commissioner, supra at 52. No reasonable investor would have believed that the Investcorp-Mueller Co. deal would close exactly 67 days after decedent's death. As we stated in Estate of Newhouse v. Commissioner, 94 T.C at 231, "it would be error to postulate a certainty that did not exist." Common sense tells us that by shortening the "expected" time for the merger to close, Willamette's hindsight approach reduced the amount of the discount from the Investcorp offer price necessary to reach the value on the valuation date, and consequently bolstered respondent's position.

Another way Willamette reduced the discount was to limit its universe to "friendly" acquisitions in which the risk of deal failure was, in our view, lower than in the Company's case. The apparent likelihood of shareholder objections required that acquisitions that were less than friendly be included in the sampling.

Willamette also, of necessity, looked only at public market transactions. We recognize that data on privately held companies is rarely available. But we believe Willamette should have adjusted its discount to reflect the shares' lack of liquidity. Those who bought the stock of the target companies in Willamette's survey on speculation that the deals would go through could have liquidated their positions quickly if the deals cratered. A potential purchaser of Mueller Co. shares would not have had that option, and would have demanded an additional discount for this risk. Nonetheless, Willamette did not adjust for the Company's lack of liquidity in determining an appropriate "discounted effective merger price." Willamette did adjust the second part of its analysis for lack of liquidity, but that discount applied only to the so-called buy-and-hold valuation. We also have concluded the amount of the discount was too small compared to the overall value reached by Willamette, amounting to just 5 percent (25 percent discount times 20 percent weighting) of the total value.

Finally and most importantly, Willamette's hindsight method caused Willamette to use a skewed statistical sample. The decedent died 3 days after the announcement of the proposed merger. Willamette, therefore, should have scoured its vast library n4 for similar tender offers for comparable companies, and looked at the price of target companies a few days after those announcements. Instead, Willamette looked only at deals that actually closed (rather than all deals that were announced) and counted back 67 days.

n4 Dr. Pratt testified:

Willamette has either the most comprehensive, or one of the most comprehensive libraries in the United States, on the subject of valuation of companies and interests of companies. It contains SEC filings, company annual reports. It contains a great deal of both national and regional economic data. It contains a great deal of industry data. It contains a large number of court cases, involving valuation disputes, which are indexed with respect to both the type of case, and the issues involved in the case. It has a key word index file by subject, for various types of things, such as, for example, arbitrage, which is one of the items in it. And it has articles from the financial literature, organized by subject matter, and indexed and so forth, as well as a lot, of course, [of] books, periodicals kept from many years back, and statistical services from which we derive valuation data.

Willamette's sample universe of mergers that actually closed is not representative of the universe of tender offers. The sample was underinclusive because tender offers relating to deals that actually failed were not included. Assume that investors make an educated guess about the likelihood that a deal that was announced 3 days ago will eventually go through. If some potential investors are good predictors, they will be able to avoid investing in the stocks of targets that will not be acquired. The price of those stocks would reflect this belief, resulting in a comparatively large discount from the offer price. These large discounts (if they existed) were excluded from the Willamette analysis, inflating the supposed value of the Mueller Co. stock.

If Willamette instead had looked at all comparable deals a few days after the deals were announced, as petitioner's expert Frederick J. Schroeder did, the potential for bias would have been eliminated. We cannot be sure of the actual effect of Willamette's sampling mistake. The correct sample and Willamette's sample might coincidentally point to the same result, but we cannot jump to that conclusion any more than we can decide this case by rolling dice. We conclude that Willamette's "discounted effective merger price" methodology is flawed not only because it relies on information (the exact day the deal would close) that could not have been known on the valuation date, but also because the methodology limited Willamette to an inappropriate sample.

The second part of Willamette's analysis was an attempt to come up with the value of a minority long-term investment in the Company, on the assumption that some investor would have been willing to make such an investment on March 24, 1986. Willamette chose three methods -- historical price-earnings multiple, historical price-cash flow multiple, and projected earnings and cash flow multiple. In the case of the historical earnings calculations, Willamette multiplied the Company's 1985 earnings per share by the average price-earnings multiple of 11 "comparable" publicly traded firms. Willamette then multiplied the Company's average earnings per share for 3 years, 1983-85, by the average multiple the comparable firms were trading at over their 1983-85 average earnings. Willamette weighted these values (70 percent 1985 earnings, 30 percent 1983-85 earnings) to come up with a weighted average:

	Mueller Earnings Per Share		Price-Earnings Multiple		Preliminary Indicated Value		Weight		Indicated Value
1985	$ 135.67	x	15.7	=	$ 2,130	x	0.7	=	$ 1,491
Avg. 1983-85	121.95	x	21.1	=	2,573	x	0.3	=	772

$ 2,263

Willamette performed the same procedure for historical cash-flow multiples:

	Mueller Cash Flow Per Share		Price-Cash Flow Multiple	Preliminary Indicated Value		Weight	Indicated Value
1985	$ 212.90	x	9.4	$ 2,001	x	0.7 =	$ 1,401
Avg. 1983-85	187.64		12.3	2,308	x	0.3 =	692
							$ 2,093

The same method was applied to 1986 projected earnings and cash-flow multiples, although the weighting was 50-50:

	Mueller Fundamental Per Share		Market Multiple	Preliminary Indicated Value		Weight	Indicated Value
'86 Earnings	$ 193.80	x	13.1 =	$ 2,539	x	0.5 =	$ 1,270
'86 Cash Flow	363.76	x	7.1 =	2,583	x	0.5 =	1,291
							$ 2,561

Willamette then took a weighted average of the weighted averages to reach an indicated fundamental value of $ 2,301 per share:

Approach	Value		Weight	Weighted Value
Past Earnings	$ 2,263	x	0.4 =	$ 905
Past Cash Flow	2,093	x	0.3 =	628
Projected 1986	2,561	x	0.3 =	768
				$ 2,301

This number was discounted by 25 percent, to $ 1,726 per share, toreflect the lack of liquidity of Mueller Co. shares.

We doubt any investor would have applied such an approach to value a minority interest in Mueller Co. on March 24, 1986. There had been two very recent definitive offers for the company. The offerors had developed well-informed opinions on the value of the Company, and the management of the Company had a substantial incentive to maximize the price offered, as did the Company's investment bankers. n5 We believe that those offers, not the mathematical manipulation of the Company's financial results, were the best evidence of the proper starting point for arriving at the Company's value.

n5 We are puzzled that Morgan Stanley's potential breakup fee ($ 3 million) approximated its actual compensation ($ 2.675 million plus expenses), thus making it indifferent, in the short term, to whether Mueller Co. was sold. However, Morgan Stanley certainly would have preferred the deal to go through to

protect its reputation and build additional business in the future. Also, Morgan Stanley did have an incentive to maximize the price paid by the acquiror, since each additional million dollars added to the acquisition price in excess of $ 260 million resulted in $ 50,000 in additional compensation. The fact that Morgan Stanley was not successful in obtaining a price greater than $ 270 million does not change the fact that it had a substantial incentive to do so.

Even if the Georgetown and Investcorp offers did not truly represent the Company's date-of-death value, Willamette's calculations are not a good alternative. Willamette, in its analysis of the Company's fundamentals, used only the most recent 3 full years prior to the Investcorp deal, 1983-85, all banner years. The year Willamette used twice, 1985, was the all-time record year for the Company. Willamette excluded 1981 and 1982 on the ground that they were recession years and might result in a "misleading" valuation. Willamette failed to explain why Mueller Co., a firm that rises and falls on economic cycles, should be analyzed only by reference to good years and not bad years. We think it would have been more appropriate to value a firm such as Mueller Co. by factoring in results from an entire business cycle, and not just a few good years. Rev. Rul. 59-60 recommends that appraisers refer to income statements covering a period of 5 years or more. Rev. Rul. 59-60, 1959-1 C.B. 237, sec. 4.02(d). Respondent's instructions to Form 706, the Federal estate tax return, have for many years required the estate to:

Apply the rules in the section 2031 regulations to determine the value of inactive stock and stock in close corporations. Submit with [Schedule B] complete financial and other data used to determine value, including balance sheets (particularly the one nearest to the valuation date) and statements of the net earnings or operating results and dividends paid for each of the 5 years immediately before the valuation date. [Form 706 Instructions 9 (Rev. July 1990); emphasis added.]

In addition, the weights assigned to the various indicated values seem to have been picked out of the air. We heard no legitimate basis for Willamette's weighting. As respondent said in Rev. Rule. 59-60:

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance. [Rev. Rul. 59-60, 1959-1 C.B. 237, sec. 7.]

Willamette's near-exclusive reliance on earnings and cash flow is precisely the error the revenue ruling warns against, especially considering the capital intensive nature of the Company's business.

To compound the problem, Willamette took a weighted average of its two methods, weighting the effective merger price at 80 percent to reflect the supposed certainty of the deal's going through, and weighting the long-term minority investment price at 20 percent. This weighted average resulted in an indicated value of $ 2,007 per share:

Approach	Value	Weight	Weighted Value
Discounted Merger	$ 2,077 x	0.8 =	$ 1,662
Minority Interest	1,726 x	0.2 =	345

$ 2,007

In addition to our problems with the constituent elements, we question the validity of this equation as a valuation tool. We cannot imagine that any prospective buyer would use such an arbitrary, artificial, and subjective approach to formulate an initial offering price or to calculate a last best offer.

We also believe that the "average of averages" is too error-prone. Assume that Mueller's financial results were reported with 100-percent accuracy. Assume also that Willamette's approach was correct and that the following elements of Willamette's calculation were believed sufficiently accurate for valuation purposes 86.7 percent of the time: the market multiples for earnings and cash flow, the weighting of current versus 3-year average results, the weighting of the various fundamental approaches in reaching the "minority value", the lack of liquidity discount, and the weighting of the minority versus merger prices. These five levels of multiplication also provide five independent opportunities for error. Even though the parameters each are sufficiently accurate 86.7 percent of the time, the final result will be sufficiently accurate only in 86.7 n5 percent of occurrences, or 49 percent of the time.

n5 We are puzzled that Morgan Stanley's potential breakup fee ($ 3 million) approximated its actual compensation ($ 2.675 million plus expenses), thus making it indifferent, in the short term, to whether Mueller Co. was sold. However, Morgan Stanley certainly would have preferred the deal to go through to protect its reputation and build additional business in the future. Also, Morgan Stanley did have an incentive to maximize the price paid by the acquiror, since each additional million dollars added to the acquisition price in excess of $ 260 million resulted in $ 50,000 in additional compensation. The fact that Morgan Stanley was not successful in obtaining a price greater than $ 270 million does not change the fact that it had a substantial incentive to do so.

We heard no testimony on the error rate in Willamette's calculations. In our own calculations, we have found that the amount of the "minority value" can be made as low as $ 1,450 (a 16-percent absolute difference) simply by reducing the market multiples by 10 percent, increasing the lack of liquidity discount by 10 percent (from 25 percent to 27.5 percent), and weighting the smaller of the elements of the weighted averages by 10 percent more (e.g., weighting the 1985 price-earnings calculation at 80 percent and the 1983-85 average price-earnings calculation at 20 percent, rather than 70-30).

Having found Willamette's analysis to be materially flawed, we turn to petitioner's objection to the Willamette report and Dr. Pratt's testimony. Petitioner assails the report and testimony as those of a "hired gun", arguing that the contractual arrangement between Willamette and respondent, and Willamette's resulting involvement in developing respondent's case, cast Willamette in the disturbing, perhaps unethical, role of advocate rather than the neutral expert required by the rules of the American Society of Appraisers and our decision in Estate of Halas v. Commissioner, 94 T.C. 570 (1990), reconsidering T.C. Memo. 1989-536. Petitioner seeks to exclude from evidence entirely the Willamette report and Dr. Pratt's testimony.

While Dr. Pratt testified, Ms. Daly, a senior associate of Willamette and a signatory with Dr. Pratt of the Willamette valuation report, sat at respondent's counsel table to provide "litigation support". The contract between respondent and Willamette in its expert role also governed Willamette's litigation support role. n6 In the latter role, Ms. Daly was not only required to help respondent's counsel understand the

vocabulary of corporate finance, but she and Dr. Pratt (who was also in the courtroom throughout the trial) were additionally responsible for analyzing the reports and testimony of petitioner's experts to aid respondent in preparing for cross-examination.

n6 Respondent resisted the Court's attempt to obtain a copy of the engagement letter. We rely on Dr. Pratt's testimony as to its contents, which are not in dispute.

We believe that Willamette's report was result-oriented and that this was reflected Dr. Pratt's testimony. As a result, Dr. Pratt's report and testimony lacked the objectivity we endorsed in Estate of Halas v. Commissioner, supra, where we held that the attorney's privilege of confidentiality does not apply to appraisers and decided that Willamette could qualify as respondent's expert over the taxpayers' objection. In Estate of Halas we observed that appraisers, by their own Code of Conduct, have third-party responsibilities -- just as certified public accountants do -- to those who rely on their opinions, and that their determinations must be independent and objective. We find here, as the Court of Appeals did in Midstate Fertilizer Co. v. Exchange Natl. Bank of Chicago, 877 F.2d 1333, 1340 (7th Cir. 1989), that Dr. Pratt

offered the Court his CV rather than his economic skills. * * * "The importance of safeguarding the integrity of the [judicial] process requires the trial * * * judge, when he believes an expert's testimony has fallen below professional standards, to say so, as many judges have done." [Citations omitted.]

See also Estate of Hall v. Commissioner, 92 T.C. 312, 338 (1989); Estate of O'Keefe v. Commissioner, T.C. Memo. 1992-210; Estate of Hatchett v. Commissioner, T.C. Memo. 1989-637; Hudspeth v. Commissioner, T.C. Memo. 1985-628, revd. on another issue 914 F.2d 1207 (9th Cir. 1990).

We overrule, however, petitioner's objection to the bifurcated role of Willamette in providing an opinion as to the value of the Mueller stock and providing, simultaneously, litigation support for respondent. Like any expert, Willamette could review, question, and comment on the expert's report and testimony for the opposing party. The conflict arose when Dr. Pratt strayed from the standard of objectivity and "cast aside his scholar's mantle and became a shill" for respondent. Midstate Fertilizer Co. v. Exchange Natl. Bank of Chicago, supra at 1340. A court may rely on one part of an expert's opinion while ignoring another. See Parker v. Commissioner, 86 T.C. 547, 562-563 (1986); Chiu v. Commissioner, 84 T.C. 722, 734 (1985). A court may rely on an expert's criticism of other experts, while disregarding his testimony in support of his report. Pittsburgh Terminal Corp. v. Commissioner, 60 T.C. 80, 89 (1973) ("Although his testimony was clearly biased in respondent's favor, respondent's expert witness demonstrated the folly of [petitioner's expert's theory]"). That is what we do here.

As a result of the foregoing analysis of Willamette's methodology and credibility, we reject most of the contents of the Willamette report and Dr. Pratt's testimony, but take account of Dr. Pratt's criticisms in our analysis of petitioner's experts' reports and testimony.

Petitioner's experts

Frederick J. Schroeder, Jr.

Frederick J. Schroeder, Jr., has been employed by First of Michigan Corp., a member of the New York Stock Exchange, since 1968. He is an executive vice president, a member of the executive committee, and cochairman of the management committee. His primary responsibility is the corporate finance department, helping corporations raise equity and debt financing in both public and private markets. He also is the person who recommends which "risk arbitrage" transactions First of Michigan participates in. He has a master's degree in business administration from Harvard University and a bachelor of arts degree from Georgetown University. n7

n7 Respondent made much of Schroeder's lack of academic credentials and his absence from the rolls of the American Society of Appraisers. The Federal Rules of Evidence, however, make clear that experts are to be judged by what they know, not where or how they learned what they know. Fed. R. Evid. 702; 28 U.S.C. app. at 767 (1988) (Notes of Advisory Committee).

Schroeder's analysis begins with the observation that, inasmuch as an acquisition proposal was under consideration on the valuation date, traditional methods of appraising a closely held corporation are not appropriate. Schroeder instead analyzed the transaction from the perspective of a risk arbitrageur.

Schroeder testified that risk arbitrage is the practice of buying the shares of a company that is the target of a takeover proposal, subject to the risk that the takeover will not be completed. To justify taking the risk, an arbitrageur typically will purchase shares only at a substantial discount from the takeover price. During 1985, many arbitrage firms earned annual returns in excess of 50 percent. This implies that, at that time, an arbitrageur who thought a transaction would be consummated 90 days in the future would try to purchase the stock at a 10.67-percent or greater discount from the offering price. With that percentage discount, the arbitrageur could redeploy his capital three times more that year, earning an aggregate return (including compounding) of 50 percent. See generally Wyser-Pratte, Merger Arbitrage, in The Mergers and Acquisitions Handbook 235 (Rock ed. 1987).

To determine the typical arbitrage discount on the valuation date, Schroeder chose four takeover transactions announced during the first quarter of 1986. In contrast to Willamette's hindsight method, Schroeder looked at the price of the targets 1 week after the announcement of the takeover. Schroeder determined that the targets' shares were trading at an average 11.75-percent discount to the takeover price.

Schroeder then examined the circumstances of the proposed takeover as of March 24, 1986. There was a possibility that Investcorp would back out because of the failure to comply with the family veto provision at the March 21 board meeting. There also was a possibility that the board would reject the proposal definitively at the April 4 meeting, since John Mueller's vote was not certain and the family veto provision required three affirmative votes, only two of which were assured. Another negative factor was that a higher offer was not probable, so all the risk appeared to be on the downside. An arbitrageur also would have had a number of other deals to invest in at that time. On the other hand, financing for the deal appeared more solid than is typical shortly after the announcement of a deal, antitrust did not seem a major concern, and Investcorp already had done a fair amount of due diligence. Schroeder decided that a risk arbitrageur would have required a 9-percent "pure" arbitrage discount, expecting the deal to complete in 90 days or so.

In addition, in Schroeder's opinion, an arbitrageur would have demanded an additional discount to account for the possibility of shareholder rejection. On March 24, 1986, John Schluter was on record as opposing the deal, and he had been influential in scuttling the 1982 recapitalization plan. Schluter might have tried to acquire additional shares to block the deal, and also might have filed a lawsuit to block the sale. In addition, the estates of decedent and her son, Robert, either were undergoing or were subject to estate tax audits, and the administrators of the estates might have voted the estates' shares against the deal in an attempt to reduce the tax liability of the estates. n8 Schroeder estimated that an arbitrageur would have required an additional 5-percent discount to account for the risk of shareholder rejection.

n8 We express no opinion on whether such a tactic would have been well founded.

Finally, an arbitrageur would have required a discount to reflect the lack of liquidity of Mueller Co.'s shares. An essential element of the arbitrageur's strategy is the ability to minimize losses and redeploy capital quickly to take advantage of new deals as they are announced. Anyone purchasing 7.5 percent of the Mueller Co.'s stock on the valuation date would not have had an assured exit route; the Company was privately held and there was no public market for its shares. If the Investcorp deal fell through, the investor would have had to wait for another buyout offer, place the shares privately, or hold the shares. Even if the Investcorp deal did close eventually, the investor would have lost access to the funds invested until the merger was consummated. Thus, the investor would not be able to bail out of the Mueller Co. investment to take advantage of more rewarding opportunities. To compensate for lack of liquidity, Schroeder estimated that an arbitrageur would require an additional 15-percent discount from the announced merger price.

In sum, Schroeder testified that an arbitrageur would be willing to pay $ 1,527 per share, a 29-percent discount from the merger price of $ 2,150 per share.

We believe Schroeder's methodology more closely represents the steps a potential investor might reason through to reach an acceptable price. However, as Dr. Pratt pointed out, there are several weaknesses in Schroeder's numerical assumptions. Schroeder used only four transactions in figuring the base arbitrage discount of 11.75 percent. We do not think one can draw valid statistical assumptions from such a small sample. Circumstantial evidence, such as the returns arbitrageurs were making at the time of the Investcorp-Mueller Co. deal, convinces us that Schroeder was in the ballpark, but we do not feel bound by his exact number. Schroeder's other numbers were not as well substantiated by objective evidence, but we believe that they were not out of line with reality. Schroeder also admitted that risk arbitrageurs in the markets for publicly held securities would not have been likely to purchase the shares, but that does not change our belief that any purchaser of the shares would have used an analysis similar to Schroeder's to arrive at an offering price that the seller of a minority interest in the company would have been willing to accept.

Albert A. Koch

Petitioner also presented the testimony of Albert A. Koch, cofounder and managing director of Equity Partners of America, Ltd., since 1987. Koch directs and assists in the valuation of businesses and negotiates mergers and acquisitions. Koch was managing partner of the Detroit office of the accounting firm Ernst & Young from 1981 to 1987. Koch is not involved in risk arbitrage in any way. He graduated with honors from Elizabethtown College.

Koch's analysis was similar to Schroeder's. Koch assessed the impact that several risks would have had on the price an investor would have been willing to pay for a 7.5-percent stake in the Company. Koch opined that the transaction price was fair, that the financing seemed solid, and that the Company had an "acceptable" ability to find another merger partner if Investcorp bowed out. Koch also believed that there was a low to moderate risk that business factors, such as general economic conditions or the loss of a Mueller Co. plant, would threaten the deal prior to closing.

On the other hand, Koch characterized the following three risks as "extremely high": that shareholders would fail to approve the deal by a two-thirds majority, that a lawsuit would block the deal, and that a buyer would be stuck with an illiquid asset if the deal failed to close. Koch stated that it was unlikely that a risk arbitrageur would be interested in such a transaction, but that a private fund operated by a large Wall Street entity might have been willing to assume the risks for a sufficiently large return. n9

n9 KKR, which bid between $ 235 million and $ 240 million for Mueller Co., operated such a fund. This does not necessarily mean KKR would have taken an arbitrage position in the Company; KKR was bidding on its own account for the entire Company.

Koch said that a buyer would have required a discount sufficient to result in a 75-percent to 150-percent annualized return. Koch assumed the transaction would take 120 days to close. Allowing for the effect of compounding three times a year (1 year/120 days), a 75-percent to 150-percent annualized return implies a discount of 21 percent to 35 percent. These discounts in turn imply a price between $ 1,400 and $ 1,700.

Turning to the "willing seller" portion of the willing buyer-willing seller formulation, Koch estimated that a seller would have demanded a price toward the higher end of his estimated spectrum, while the buyer would try to bargain for a lower price. Koch concluded that the most likely result would have been a price that was the average of the two extremes, or $ 1,550 per share.

Koch's analysis, rather than making the error of hindsight, makes the error of converting the deadline for the deal into the expected closing date. Koch assumed the deal would close 120 days after its announcement. Koch did not take into account the more probable outcome that the deal would close less than 120 days from its announcement. If we instead use a 90-day period so that the investment can be compounded four times a year, the range of discounts is 15.0 percent to 25.7 percent, or a per share price range of $ 1,597.45 to $ 1,827.50. The midpoint of these numbers is $ 1,712.48, more than $ 150 per share greater than Koch's estimate.

Koch did not adequately explain why an investor would require a 75-percent to 150-percent annualized return to buy Mueller Co. stock. Koch said that " the Mueller Co. opportunity might appeal to a limited number of investors whose threshold rate of return for ordinary investments is 40 percent to 60 percent." Koch argued that his estimate that certain significant risks were "extremely high" justified the jump in rate of return from 40-60 percent to 75-150 percent, but he did not make the connection sufficiently clear to us.

We also were disturbed by the argumentative tone of the Koch report. The report is replete with exclamation points and italicized emphasis of the major points of petitioner's argument. Having reminded respondent of the importance of objectivity in expert testimony, we see no need to repeat the

lesson here for petitioner's benefit. We simply view the Koch report with some skepticism.

Discussion

We find that none of the experts was entirely convincing. However, we are persuaded that the Schroeder approach is the most representative of the likely thought processes of a hypothetical willing buyer or seller. We agree that a buyer and a seller, each presumed to be committed to maximum economic advantage, would use the $ 2,150 takeover price as a starting point and discount the price to reflect the risks of nonconsummation and lack of liquidity.

Respondent argues that arbitrageurs are not the only category of potential purchasers of stock, and in fact are not the most likely market. Among the alternatives respondent lists are: the public market, companies contacted by Morgan Stanley who might be interested in the Company, other potential buyers not located by Morgan Stanley because there was no public announcement of the deal, a leveraged buy-out, a professional outside investor, a recapitalization, or existing shareholders.

A public offering of a minority interest in the Company does not seem to us to have been a reasonable alternative. Such an offering would have required considerable time and expense. Indeed, it seems likely that dividing a minority interest into even smaller units of ownership might further depress the value of the shares. A public offering of a larger block of stock would have had greater interest to investors in the public market, but a holder of 7.5 percent of the shares would not have had the power to launch such an undertaking. A large public offering was not under consideration at the time of decedent's death, and no reasonable buyer or seller would act on speculation that it would occur.

The also-rans in the bidding for the Company were not a likely market either, because those bidders made their offers for all the shares. There is no evidence suggesting that they were looking for a passive minority investment, with the possible exception of KKR, which operated an arbitrage fund, but which had made a lower offer for the Company in its entirety.

Respondent theorizes that companies not contacted by Morgan Stanley might have been interested in buying a 7.5-percent interest in the Company, but we heard no evidence to convince us either (1) that Morgan Stanley failed to identify any potential purchaser of the Company, or (2) that such a purchaser would have wished to acquire a 7.5-percent interest in the Company. Although there was no public announcement, Morgan Stanley had cast a wide net and the deal was not a secret. Indeed, Morgan Stanley received several unsolicited offers, none of which made a difference in the final bidding.

The alternative suggestion of a leveraged buy-out does not make sense. In effect, the Investcorp deal was a leveraged buyout, and probably the best such deal available to shareholders. Management did not appear particularly interested in mounting a competing bid, and had substantial incentives to see the Investcorp deal through to completion. Schluter's proposal was not likely to do anything but disrupt the Investcorp deal.

Respondent argued that a recapitalization was an alternative. A 7.5-percent shareholder would have had no power to effect a recapitalization of the Company, at least not without acquiring another 60 percent or so of the outstanding shares.

Finally, petitioner counters respondent's "professional investor" and "other shareholder" scenarios by pointing out that respondent has identified no individual or group of professional outside investors who would have been interested in acquiring the Company. In any event, we believe such investors would

analyze the deal much the same as we have.

We believe that respondent, and to some extent petitioner, misapprehends the willing buyer-willing seller test. We need not identify exactly who the buyer would be or even what class of investors the buyer would belong to. The "willing buyer" is supposed to be a hypothetical amalgam of potential buyers in the marketplace. Although we have, in prior opinions, identified types of hypothetical buyers, we did so only to determine which valuation approach, among several reasonable approaches, would result in the highest bid, and therefore the one most acceptable to a willing seller. See, e.g., Estate of Newhouse v. Commissioner, 94 T.C. 193, 245 (1990) ("The choice of the appropriate valuation methodology for a particular stock is, in itself, a question of fact" (emphasis added)); Perdue v. Commissioner, T.C. Memo. 1991-478 (dividing rare coin market into numismatists and "glamour" purchasers). The question is not so much "who", but "how".

We agree with Schroeder and Koch that a buyer would consider three principal adverse factors in deciding what he would be willing to pay for 7.5 percent of the Mueller Co. shares: shareholder rejection, a lawsuit, and lack of liquidity. It is also our task to find the price at which a willing seller would sell. Logically, a willing seller would sell only to the willing buyer making the highest bid. We assume that the potential buyers of the shares would bid up the price of the shares until the person who values the shares most highly -- that is, the person who is most certain that the Investcorp deal will go through, or who is most willing to take the risk that it will not -- wins the bidding. The final result is not an average of the high and low ranges (as Koch suggests) because we assume the price is determined by an "auction" in the marketplace, not the give-and-take of one-on-one negotiation.

First, there is the matter of a base arbitrage discount. This discount is the starting point -- more or less the average discount an investor would demand for a risk arbitrage investment. We believe that there were potential investors who were more risk-tolerant than the risk arbitrageur Schroeder described who would have been interested in a minority investment in the Company's stock. We therefore place a value of 6 percent, rather than 9 percent, on this base discount.

Second, a potential buyer would consider the risk that shareholders would reject the deal. It was not entirely clear at the valuation date what the outcome of a shareholder vote would be. The Company's chief executive was pessimistic that the deal would go through, and most of the shareholder blocks had not expressed an opinion. On the other hand, only Schluter had gone on record as opposing the deal. Another fact to consider is how persuasive management could be expected to be in selling the deal to shareholders. Could it have been expected on the valuation date that someone would hit on an idea that would weaken the resistance of wavering shareholders, such as John Mueller's suggestion to donate the family memorabilia to a local college?

Another factor to consider is that most of the shares were held in trust. The trustees owed a fiduciary duty to the beneficiaries to protect their economic interests. Respondent argues that if the trustees had voted against the Investcorp deal, they would have been derelict in their fiduciary duties. Although the Investcorp deal was attractive, we believe that a trustee could have voted against the deal for legitimate reasons. Besides, we are not so much concerned with the trustees' legal obligations as with what they were likely to do, even if in violation of those obligations. The trustees were primarily members of the Mueller family. We believe that it would have seemed uncertain to a prospective outside purchaser of shares that the trustees would disregard the Company's family heritage.

All these factors indicate to us that a reasonable investor might have assumed that family resistance to the sale could be overcome, but still be concerned that the deal might not win two-thirds shareholder approval. Such an investor would have demanded an additional 5-percent discount, as Schroeder suggested.

Third, the hypothetical buyer would have considered the risk that Schluter or another dissenter would file a lawsuit. We need not decide what the probable outcome of a potential lawsuit would have been in order to determine the value of the shares; we only must try to gauge how the possibility of the suit would affect the fair market value of the shares. Estate of Newhouse v. Commissioner, supra at 232-233.

We heard no testimony from two key participants in the March 21, 1986, board meeting where the merger was first voted on. Dudley Godfrey, the board member who telephoned John Mueller to obtain his views, might have shed additional light on whether John Mueller had indeed voted at that meeting. He could have testified that the phone call was audible to all directors, or that it was not. We did hear testimony from another attorney in Godfrey's law firm, Kenneth Hunt, who was at the meeting, but his recollection of events was not very clear. We also heard testimony from John Mueller and Powers on this point. Respondent argues that because Godfrey was not called, we should draw the inference that his testimony would have hurt petitioner, citing Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158 (1946), affd. on other grounds 162 F.2d 513 (10th Cir. 1947). We disagree. In Wichita Terminal Elevator, the taxpayer submitted practically no evidence. Petitioner in the instant case submitted reams of exhibits and hours of testimony. If respondent believed Godfrey's testimony would have damaged petitioner's case, respondent could have called him as a witness to impeach the recollections of Hunt, Powers, and John Mueller.

We also heard no testimony from John Schluter. Obviously, only he could state definitively what his motivations and intentions were. Respondent again suggests that we employ Wichita Terminal Elevator to draw inferences against petitioner. We again suggest that respondent could have called Schluter as an impeachment witness. In addition, we are not so sure that Schluter's testimony would have been relevant. We are here concerned not with Schluter's actual state of mind, but with the perception of his motivations and intentions by others. Other witnesses testified sufficiently about Schluter's apparent motives and intentions.

Returning to the issue of the likelihood of a lawsuit, we observe that Investcorp could have walked away from the deal if a lawsuit materialized. n10 On March 24, 1986, a reasonable investor could have surmised that a lawsuit could have raised the issue of the validity of the board action at the March 21 meeting, n11 or other issues yet to be exposed in the proxy statement. At the time of decedent's death, Schluter had not yet threatened suit, although a reasonable investor would have foreseen that possibility. After decedent's death, Schluter sent mixed signals. On the one hand, he claimed that he only wanted the best price for shareholders. On the other, he rattled his saber over nit-picky points in the proxy statement, possibly indicating that he would block the merger at any price. The Company hired special litigation counsel to prepare for the possibility that Schluter would sue.

n10 Respondent suggests that Investcorp may not have known about the family veto provision of the bylaws, and therefore Investcorp would not have even considered the option of walking away. We believe it unlikely that an acquiring company with a professional and experienced staff could spend 300 man-hours on due diligence and not read the target company's bylaws.

n11 Respondent argues that the board did in fact comply with the bylaw provision because John Mueller either did "assent" to the deal (even though he was not present at the meeting), or authorized Godfrey to vote in favor of the measure on his behalf. As to the second argument, it is hornbook law that directors may not vote by proxy. 2 Fletcher Cyc. Corp., sec. 427, at 324 (1990); Henn & Alexander, Laws of Corporations and Other Business Enterprises, sec. 208, at 565 (3d ed. 1983). In any event, we need not decide whether these arguments would have carried the day in a lawsuit. The fact that these arguments could have been made, in our view, would have increased the uncertainty over the resolution of a lawsuit, and therefore would have increased the probability of a lawsuit, rather than a settlement without litigation. This in turn would have increased the probability that Investcorp would withdraw.

A reasonable investor might have discounted the possibility of a lawsuit, or assumed that such a suit would be quickly settled or dismissed. We note that no lawsuit ever was filed. Although no one could have known on the valuation date that no suit would be filed, the fact that no suit was filed suggests the reasonableness of a belief that no suit would be filed. See Estate of Gilford v. Commissioner, 88 T.C. 38, 52 (1987). Thus, we believe that a discount of no more than 2.5 percent is in order to account for this risk.

Third, there is the problem of lack of liquidity. We assume that any rational investor would prefer a liquid to an illiquid investment. But the degree of this preference is a matter of uncertainty. Two factors lead us to believe that a lower discount than suggested by Schroeder is appropriate. First, we believe that the prospect of a quick takeover made these shares considerably more liquid. Second, part of the reason for the shareholder rejection and litigation discounts is the lack of liquidity of the shares. To the extent Schroeder's 15-percent lack of liquidity discount was not reduced to reflect the lack of liquidity components of the other discounts, it was too large. We find that a lack of liquidity discount of 7.5 percent is appropriate.

Taking all these factors into account, we believe that a discount from the takeover price of 21 percent is appropriate. This results in a per share fair market value of $ 1,700. We have therefore found that the value of the 8,924 shares of the Company includable in decedent's gross estate was $ 15,170,800.

An appropriate order will be issued.

SUPERIOR
COURT OF NEW JERSEY
APPELLATE DIVISION
DOCKET NO. A-3709-98T1
July 14, 2000

WILLIAM C. MUSTO,
Plaintiff-Appellant/Cross-Respondent,

v.

VINCENT G. VIDAS, JOHN S. DEGNAN, and SEMCOR, INC.,
a New Jersey Corporation,
Defendants-Respondents/Cross-Appellants.

Argued: April 18, 2000
Before Judges Wallace, Jr., Cuff and Lesemann.

On appeal from the Superior Court of New Jersey, Chancery Division, Burlington County.

Ira G. Megdal argued the cause for appellant/cross-respondent (Cozen & O'Connor, attorneys; Mr. Megdal, on the brief).

Anne C. Singer argued the cause for respondents/cross-appellants (Wolf, Block, Schorr and Solis-Cohen, attorneys; Ms. Singer, on the brief).

The opinion of the court was delivered by WALLACE, JR., J.A.D.

This appeal is the sequel to *Musto v. Vidas*, 281 N.J. Super. 548 (App. Div. 1995), *certif. denied*, 143 N.J. 328 (1996) (*Musto I*), wherein we held that plaintiff William Musto was an oppressed shareholder of Semcor, Inc., and that the remedy was a court-ordered buy-out of his shares pursuant to N.J.S.A. 14A:12-7(8) by the other one-third shareholders of Semcor, Inc., Vincent Vidas and John Degnan (defendants).

We remanded for the trial judge to determine the fair value of plaintiff's one-third interest. Following lengthy valuation proceedings, the trial judge valued Semcor, Inc. (Semcor) at $6,240,000 as of December 31, 1990, and plaintiff's share at $2,080,000. On December 26, 1996, the trial judge entered judgment requiring plaintiff to sell his shares in Semcor to defendants in return for $3,052,946. This amount included interest of $128,472 from January 1, 1991 through December 31, 1996, and a $155,526 credit to defendants for payments made to plaintiff pursuant to a

prior order. Subsequently, on June 18, 1997, plaintiff was awarded litigation fees and expenses in the amount of $482,088.03. Plaintiff appeals and defendants cross-appeal.

While the appeal was pending, we remanded the matter to the trial judge to consider plaintiff's motion to supplement the record regarding the sale of Semcor in June of 1998 to Advanced Communication Systems, Inc. (ACS) for approximately $40 million dollars. Following a hearing, the trial judge denied this motion. Plaintiff then filed a new notice of appeal and defendants again filed a cross-appeal.

On appeal, plaintiff contends the trial judge erred in: (1) establishing December 31, 1990 as the valuation date; (2) failing to give plaintiff an equitable adjustment for post-valuation date profits; (3) failing to apply the equitable interest rate advanced by plaintiff's expert; (4) determining he could not alter the valuation date from December 31, 1990; and (5) denying plaintiff's motion to supplement the record. In addition, plaintiff contends we should award him $96,025 for attorney's fees incurred in the appellate courts.

In the cross-appeal, defendants contend the judge erred in: (1) awarding plaintiff litigation expenses; (2) awarding prejudgment interest; (3) failing to grant two equitable adjustments to the fair value claimed by defendants; and (4) holding that the insurance provision in the shareholders' agreement survived the termination of plaintiff's shareholder status. We reject plaintiff's and defendants' various challenges and affirm.

I.

Plaintiff's primary arguments concern the selection of December 31, 1990 as the valuation date for determining fair value. Plaintiff suggests that December 31, 1996 would be a more appropriate and equitable valuation date because that date would take into account defendants' failure to distribute Semcor's profits to all the shareholders between 1991 and 1996, as well as Semcor's growth during these years. Alternatively, plaintiff urges that if December 31, 1990 remains the valuation date, then he is entitled to equitable adjustments to account for these factors.

Defendants maintain the trial judge was correct in not deviating from the presumptive valuation date set forth in the statute (the date of the filing of the complaint) because an award of post-1990 profits under any rationale would constitute an illegal double recovery since the determination of fair value is actually based

upon a company's future income stream. Defendants further assert that plaintiff would not have sought a post-1990 valuation date if Semcor's value had decreased after 1990. Defendants also claim that plaintiff is judicially estopped from contending otherwise because he had asserted as late as 1994 that December 31, 1990 was the proper valuation date.

As an initial matter, we reject defendants' judicial estoppel claim. Generally, the doctrine of judicial estoppel bars a party to a legal proceeding from arguing a position inconsistent with one previously asserted. *Bell Atlantic Network Servs., Inc. v. P.M. Video Corp*., 322 N.J. Super. 74, 94 (App. Div.), *certif. denied*, 162 N.J. 130 (1999)(citation omitted). However, the doctrine is only applicable when the party against whom it is to be applied successfully asserted the inconsistent position in the prior proceeding. *Id.* at 95. Here, plaintiff advanced December 31, 1990 as the valuation date when he was to be the purchaser of the shares, a position which we reversed in *Musto I*. Since plaintiff was not successful in his argument, and the circumstances have now changed, we find no reason to apply the doctrine of judicial estoppel.

We turn now to plaintiff's arguments addressed to the valuation date. Pursuant to N.J.S.A. 14A:12-7(8)(a), in a court- ordered buy-out:

> The purchase price of any shares so sold shall be their fair value as of the date of the commencement of the action or such earlier or later date deemed equitable by the court, plus or minus any adjustments deemed equitable by the court if the action was brought in whole or in part under paragraph 14A:12-7(1)(c).

The "date of the commencement of the action" is considered the presumptive valuation date. *See* Stuart L. Pachman, Title 14A-*Corporations, Comment to 14A:12* (1998-99)(noting that the date of the commencement of the action is the presumptive date for determining the fair value of shares which are bought out).

In *Musto I*, we instructed the trial judge with respect to the determination of the valuation date as follows:

> On remand, the trial court must again determine the valuation date . . . . The trial court found no equitable reason to deviate from [N.J.S.A. 14A:12-7(8)(a)'s] provision that the commencement date of the action be the "presumptive date" for valuation purposes and determined that December 31, 1990 was the valuation date. However, in light of our conclusion that plaintiff should not be re-employed by the corporation, the

> court ordered payment of salary to plaintiff, the passage of time since the filing of the complaint, and other factors the trial court may deem relevant, we do not foreclose the trial court from considering whether a different valuation date would be "deemed equitable."

[*Musto I, supra*, 281 N.J. Super. at 561.]

In determining to maintain December 31, 1990 as the valuation date, Judge Gottlieb stated:

> There's an assumption . . . that we're going to use December 31, [1990] here. Equitable reasons means to me that there's going to be some unfairness brought about by using December 31, [1990] that can't otherwise be addressed. [A]lthough you've given me a menu of reasons why I should deviate from December 31, [1990] and bring it closer to today, the only one that really has any intellectual appeal to me is [an equitable adjustment for post-1990 undistributed profits]. And, in that regard I find that equitably it's not sufficient to overcome the assumption that we're going to go with the filing date, because it can be addressed by another course, and that is just a matter of calculation of the adjustment for the undistributed profit plus interest.

However, Judge Gottlieb subsequently decided against an equitable adjustment for post-1990 corporate profits, stating:

> I determine that post-1990 . . . corporate profits are irrelevant for purposes of an equitable adjustment . . . . I say that because, one, another provision of the statute, which is subsection 8D says, "Interest may be allowed at the rate and from the date determined by the Court to be equitable . . . ." That's the remedy for the post-valuation date use of the money.
>
> However, the interest rate is to be set by me in the exercise of my reasoned judgment or discretion in an equitable fashion obviously, and in order to do that post-1990 financial circumstances . . . of the corporation are meaningful . . . .
>
> If, in fact, I were to allow an equitable adjustment as being participation in the post- valuation date . . . profits of the entity, then intellectually it raises an inconsistency, [because] the valuation as of December 31, 1990 not only factors in what is the present value of this and that . . . but also what is . . . the likely future course of the corporation. As long as that is factored in obtaining a value for purposes of valuation, then you can't have it duplicated by saying not only are we giving you something . . . which is

> based on, in part, the likely future course of the corporation, future earnings . . . we're also going to give you those future earnings. That can't occur. By the declaration in the statute, the provision of which I quoted for interest, that is the remedy that is to be provided.

Plaintiff claims that the trial judge erred by deviating from his original inclination to permit the equitable adjustments which should have been the law of the case.

The "law of the case" doctrine may be applied to the question of whether or not a decision made by a trial judge during one stage of the litigation is binding throughout the course of the action. *State v. Hale*, 127 N.J. Super. 407, 410-11 (App. Div. 1974). The rule is "based upon the sound policy that when an issue is once litigated and decided during the course of a particular case, that decision should be the end of the matter." *Id.* at 410 (citation omitted). As applied to rules or orders of an interlocutory nature, such as a ruling by a trial judge during one stage of the action, application of the doctrine is discretionary. *State v. Reldan*, 100 N.J. 187, 205 (1985).

Here, the trial judge's initial comments concerning equitable adjustments were not included as part of the corresponding April 19, 1996 order. In addition, the issue of post-valuation date profits had neither been briefed nor argued when the trial judge made his comments. Essentially, the trial judge made a tentative observation which he later changed. Under these circumstances, we find no reason to apply the law of the case doctrine.

In arguing that the trial judge abused his discretion by not taking the equities of the case into consideration in setting the valuation date, plaintiff relies on two recent New Jersey Supreme Court decisions, *Balsamides v. Protameen Chems., Inc.*, 160 N.J. 352 (1999) and *Lawson Mardon Wheaton, Inc. v. Smith*, 160 N.J. 383 (1999).

Balsamides involved the question of whether a judicially ordered buy-out pursuant to N.J.S.A. 14A:12-7(8) should include a marketability discount in determining the fair value of the purchaser's shares. *Balsamides, supra*, 160 N.J. at 354. The Court explained that a marketability discount accounts for a lack of liquidity in the shareholder's interest in a close corporation because there is no readily available market for the shares. *Id.* at 373. The Court held that a marketability discount should be applied in light of the equities of the case; specifically, the Court cited the fact that the seller was the oppressor and that

the purchaser should not bear the brunt of the company's illiquidity merely because he or she is the designated buyer. *Id.* at 377-79. In *Lawson Mardon Wheaton*, the issue was whether a marketability discount should be applied in determining fair value in a statutory appraisal action pursuant to N.J.S.A. 14A:11-1 to -11. The Court held that absent the presence of "extraordinary circumstances," such as where the dissenting shareholder has held out in order to exploit the transaction giving rise to the appraisal, the marketability discount should not be applied because to do so would enrich the majority shareholders and penalize the minority shareholders for taking advantage of the protection afforded by the appraisal statute and would inevitably encourage corporate "squeeze-outs." *Lawson Mardon Wheaton, supra*, 160 N.J. at 402-04.

Thus, the *Lawson Mardon Wheaton* and *Balsamides* cases demonstrate that the "equities of the case" must be considered when ascertaining fair value in oppressed shareholder actions. Specifically, the Court stated in *Balsamides*:

> In cases where the oppressing shareholder instigates the problems, as in this case, fairness dictates that the oppressing shareholder should not benefit at the expense of the oppressed . . . . The statute does not allow the oppressor to harm his partner and the company and be rewarded with the right to buy out that partner at a discount. We do not want to afford a shareholder any incentive to oppress other shareholders. What to do when it is the oppressing shareholder who is given the buy-out option is a harder question that we need not decide. The guiding principle we apply in this case and in *Lawson Mardon Wheaton* is that a marketability discount cannot be used unfairly by the controlling or oppressing shareholders to benefit themselves to the detriment of the minority or oppressed shareholders.

[*Balsamides, supra*, 160 N.J. at 382-83 (emphasis added).]

Unlike in *Balsamides* and *Lawson Mardon Wheaton*, the issue of a marketability discount, or any other discount, does not arise in this case; nor was the valuation date an issue in either of the Supreme Court cases. Beyond that, plaintiff's reliance on these cases is weakened by the fact that the "equities of the case" are taken into consideration when setting the valuation date under N.J.S.A. 14A:12-7(8)(a). This section requires that the valuation date be the date of the commencement of the action or such earlier or later date "deemed equitable" by the court, plus or minus any adjustments the court "deem[s] equitable." N.J.S.A. 14A:12-7(8)(a). We are satisfied that Judge Gottlieb considered the

"equities of the case" in reaching his ultimate determination to maintain the presumptive valuation date of December 31, 1990.

Plaintiff also argues that if December 31, 1990 is found to be the appropriate valuation date, then the trial judge erred in failing to make equitable adjustments to fair value to reflect Semcor's growth in the years following the valuation date. In this context, plaintiff does not dispute the trial judge's determination of fair value or its utilization of the income capitalization method of valuation.

There are various factors which are considered fundamental in valuing a close corporation, including: (1) the nature of the business; (2) its history; (3) the economic outlook in general; and (4) the condition and outlook of the specific industry in particular. *Lavene v. Lavene*, 162 N.J. Super. 187, 193-94 (Ch. Div. 1978) (quoting Rev. Rul. 59-60, 1959-1 C.B. 237). Generally, in valuation proceedings the corporation must be valued as a going concern, which necessitates not only examination of the corporation's historical earnings, but also consideration of the corporation's future prospects. *Universal City Studios, Inc. v. Francis I. duPont & Co.,* 334 A.2d 216, 218 (Del. 1975).

In utilizing the income capitalization method of valuation, the company's prospective income growth must be considered. *See Lavene, supra*, 162 N.J. Super. at 195 (noting that "potential future income is a major factor in valuing stocks of closely held corporations"). *See also Olson v. Olson*, 585 N.E.2d 1082, 1089 (Ill. App.)(holding that both the future economic outlook and the capitalization of future earnings are important tools for valuing a close corporation), appeal denied, 596 N.E.2d 630 (Ill. 1992); *Waller v. American Int'l Distribution Corp*., 706 A.2d 460, 463 (Vt. 1997)(stating that the income capitalization method is identical to the discounted future earnings method of valuation). Thus, if the judge had allowed an equitable adjustment to account for a company's actual growth in the years following the valuation date, he might well have accorded plaintiff a double recovery. Consequently, we find no abuse of discretion in the trial judge's denial of plaintiff's request for equitable adjustments to fair value.

Moreover, we disagree with plaintiff's contention that the Supreme Court's reversal of *Muellenberg v. Bikon Corp*., 143 N.J. 168 (1996), which we relied on in *Musto I*, should influence our decision here. Although the Supreme Court in *Muellenberg* found a minority buy-out of the majority was the appropriate remedy, it also distinguished *Musto I* in that the minority shareholder in

Muellenberg was actively involved in the operation of the company since its inception, and the company had been his only source of income for over ten years. *Id.* at 183. That is not the situation here.

In sum, we find no abuse of discretion in the trial judge maintaining the valuation date of December 31, 1990, and in refusing to make equitable adjustments for Semcor's post-valuation date profits.

II.

Plaintiff argues that the trial judge erred by not utilizing an equitable interest rate to allot him a twenty-five percent rate of return as the expected rate of return for the years subsequent to 1990, and by striking his expert's report to that effect.

Defendants argue that the term "equitable interest rate" is not "interest" as that term is used in the accepted sense; namely, a charge for the use of borrowed money. In addition, defendants claim that the term constituted a "net opinion" because the term is not recognized within the valuation field, there is no support for using company profits in setting an interest rate, and the equitable interest rate advanced was similar to the post-valuation profits previously barred by the trial judge.

In his report, plaintiff's expert, Raymond Grossman, asserted that plaintiff was entitled to an "equitable interest rate" under N.J.S.A. 14A:12-7(8)(d) to compensate him for the period after 1990 during which his Semcor investment remained in place. Grossman asserted:

> Musto is entitled to interest from the valuation in the amount deemed equitable by the Court (an Equitable Interest Rate) . . . . The Equitable Interest Rate [EIR] will be applied to the December 31, 1990 fair value of William Musto's Semcor stock in order to equitably adjust the value to ensure that it is fair as of the forthcoming buyout date. The EIR should compensate William Musto for (i) the time delay in receipt of his sale consideration, (ii) the investment risk he bore during this six-year period, and (iii) his opportunity cost of not earning comparable rates of return.
>
> [A]n appropriate EIR for William Musto is one which recognizes that [he] remained an equity investor in Semcor common stock over the post- valuation period, and as an

> investor, he remained at risk to the same market conditions as any other investor in an equity security.
>
> The EIR should be established at a fair rate which ensures that the oppressing shareholders do not benefit from their oppressive actions, at the expense of William Musto.

In determining the EIR, Grossman looked at the following sources: (1) rates of return on comparable securities over the post-valuation period; (2) the expected rate of return for an investor in Semcor as of December 31, 1990; and (3) Semcor's return on equity over the post-valuation period. Grossman determined the EIR range to be between 18% and 33%, and ultimately settled on an EIR of 25%.

In his deposition, Grossman could not identify any authoritative source which uses the term "interest" differently than as a charge for borrowed money. He indicated that the term "equitable interest rate" is different from the term "interest rate" because the former was particular to the facts of this case. Grossman was not aware of any source which defines the term "equitable interest rate." He agreed that the EIR is comparable to the annual dividend stream plaintiff was receiving prior to 1990.

In granting defendants' motion to strike that portion of Grossman's report and to bar Grossman from testifying regarding the EIR, Judge Gottlieb stated:

> I've noted as of January 1, 1991 Mr. Musto became a, in essence, creditor of the corporation, a lender to the corporation . . . . Under 8D, that is what I think the Legislature is talking about . . . .
>
> There are a multitude of other investments for which a return can be obtained, but as a matter of law, I hold that plaintiff has the characteristics of being a creditor/lender as opposed to an equity owner. Therefore, to that end Grossman's report is founded on a legal fallacy and cannot be advanced, I will . . . partly bar that.
>
> Mr. Musto's investment is not to be considered an equity investment to establish an interest rate also because equity investment and interest rate are totally intellectually incompatible.

When there is a court-ordered sale of a corporation's stock, the court may award interest "at the rate and from the date determined by the court to be equitable . . . ." N.J.S.A. 14A:12-7(8)(d). In

the absence of any explicit indication of special meaning, words of a statute are to be given their ordinary and well-understood meaning. *Levin v. Township of Parsippany-Troy Hills*, 82 N.J. 174, 182 (1980).

"Interest" is defined as "compensation fixed by agreement or allowed by law for the use or detention of money, or for the loss of money by one who is entitled to its use," and as "the amount owed to a lender in return for the use of borrowed money." Black's Law Dictionary 816 (7th ed. 1999). The term has also been defined as "an exaction for past due obligations and, in essence, is in the nature of a penalty" and is compensation for delay in payment. *Parsippany Hills Assocs. v. Rent Leveling Bd. of Parsippany-Troy Hills*, 194 N.J. Super. 34, 52 (App. Div.), *certif. denied*, 97 N.J. 643 (1984).

Here, we are satisfied the term "equitable interest rate," as utilized by Grossman, is not encompassed by these definitions. We find no evidence that the term "interest" as used in N.J.S.A. 14A:12-7(8) was intended to have a special meaning as asserted by Grossman. Consequently, we find no abuse of discretion in the trial judge's rejection of plaintiff's proposed equitable interest rate.

III.

Plaintiff argues that the trial judge erred by not granting his motion to supplement the record to take into account Semcor's mid-1998 sale to ACS for approximately $40 million. Specifically, plaintiff contends the sale is relevant as reflective of Semcor's increase in value as of December 1996, as well as the unfairness of adhering to a December 1990 valuation date.

Defendants maintain that the motion was properly denied because the sale of the corporation post-dated the valuation date by over seven years. Further, defendants claim that the sale was not newly discovered evidence as required by R. 4:50-1.

While this appeal was pending, we remanded this matter for the trial judge to consider plaintiff's motion to supplement the record as a motion pursuant to R. 4:50-1. In denying plaintiff's application, Judge Gottlieb viewed the sale of Semcor as a fortuitous event, regardless of the valuation date selected. In addition, the judge cited the policy of finality in litigation, commenting:

> It's not as if the mid-1998 sale occurred on the heels of the 1990 valuation date or, indeed, the requested [1995]

> valuation date.[1] We had, depending on which date would be selected, either a seven and a half or two and [a] half year intervening period. So, we're talking about a time interval that occurs here . . . . If we open up the new valuation date, I am also encouraging the imposition of a great inefficiency on the parties and on the court system itself.
>
> All things being considered, there has to be a balancing of the tension, if you would, between the desire to be absolutely, perfectly, right, and the desire to have a decision, right or wrong, a decision, and let the parties go on with their lives from there. The tension is resolved by the passage of time. If this sale had occurred on February 1, 1991 . . . I think it would have been meaningful. It did not.

Plaintiff points to the Supreme Court's decision in *Lawson Mardon Wheaton*, decided after Judge Gottlieb's denial of the motion, as support for his position.

Lawson Mardon Wheaton arose out of an appraisal action brought by shareholders dissenting from a corporate restructuring in 1991. *Lawson Mardon Wheaton, supra*, 160 N.J. at 389. The company offered to buy out the dissenting shareholders at $41.50 per share. *Id.* at 390. The case eventually reached the Supreme Court under the caption of *Strasenburgh v. Straubmuller*, 146 N.J. 527 (1996), shortly after the company announced an acquisition merger, wherein its stock was purchased for $63.00 per share. *Lawson Mardon Wheaton, supra*, 160 N.J. at 391. In *Strasenburgh*, the Court remanded to the trial court to consider whether to reopen the record to consider the company's recent merger "in making a just and equitable determination of the appraisal value as of 1991." *Strasenburgh, supra*, 146 N.J. at 545. On remand, the trial court declined to reopen the record. We upheld that ruling on appeal. *Lawson Mardon Wheaton, Inc. v. Smith*, 315 N.J. Super. 32 (App. Div. 1998).

The Supreme Court reversed in *Lawson Mardon Wheaton, Inc. v. Smith*, 160 N.J. 383, 404-07 (1999), holding that the trial court erred by refusing to reopen the record to consider the per share acquisition price of the company in 1996 to "gauge, assess, and determine" the fair value of the dissenters' stock on the December 1991 valuation date. The acquisition price was relevant since the company asserted that the fair value of the dissenters' stock was $41.50 per share in December 1991, while the 1996 acquisition price was $63.00 per share, even though the company's fortunes had steadily deteriorated between 1991 and 1996. *Id.* at 406. Thus, as the Court noted: "[t]he Company's own financial statements

disclose that the fair value of the Company was greater in 1991 than in 1996." *Id.* at 405. Therefore, because the company's fortunes had waned during the 1991 to 1996 period, and in light of the 1996 per share sales price, the Court questioned the company's assertion that the fair value of the dissenters' stock in 1991 was worth only $41.50 per share. *Id.* at 407.

Although *Lawson Mardon Wheaton* lends some support to plaintiff's contention, under the facts of this case, we find no abuse of discretion in Judge Gottlieb's decision not to consider the seven-year-old acquisition price. Unlike the situation in *Lawson Mardon Wheaton*, evidence of the 1998 acquisition price was not clearly shown to have aided in the assessment of the fair value of plaintiff's stock in December of 1990. Whatever the fortunes of Semcor after 1990, whether good or bad, they were due to the efforts of defendants.

Consequently, we find no abuse of discretion in the trial judge's refusal to open the judgment to permit plaintiff to supplement the record to consider the 1998 acquisition price of Semcor.

In sum, we find no error in the trial judge's refusal to open the judgment to permit plaintiff to supplement the record to consider Semcor's 1998 sale.

IV.

In plaintiff's reply brief, he challenges for the first time the trial judge's calculation of Semcor's fair value. Specifically, plaintiff questions the income capitalization approach utilized to the extent that the approach understated Semcor's expected future growth rate.

It is well-settled that introduction of a new issue by way of a reply brief is improper. *Selective Ins. Co. of Am. v. Hojnoski*, 317 N.J. Super. 331, 335 (App. Div. 1998); *Interchange State Bank v. Veglia*, 286 N.J. Super. 164, 188 (App. Div. 1995), *certif. denied*, 144 N.J. 377 (1996); *City of Elizabeth v. Elizabeth Fire Officers Ass'n*, 198 N.J. Super. 382, 384 n.2 (App. Div. 1985). Moreover, the issue raised in this matter is not one of public importance. *See Coastal Group v. Planned Real Estate Dev. Section*, 267 N.J. Super. 49, 56 (App. Div. 1993)(addressing the issue of a state agency's authority to order recission, even though improperly raised for the first time in a reply brief, because the Appellate Division considered it to be a matter of public importance); *Hojnoski, supra*, 317 N.J. Super. at 335 (addressing an apparent conflict between a statute and a regulation even

though the issue was raised for the first time in an appellate reply brief). Consequently, we will not consider this issue raised for the first time in plaintiff's reply brief. *See Veglia, supra*, 286 N.J. Super. at 188 (refusing to entertain the issue of the method by which prejudgment interest was calculated since it was improperly raised for the first time in a reply brief).

V.

In his final argument, plaintiff seeks to require defendants to reimburse him for his prior appellate costs in the appellate proceedings. Defendants maintain that plaintiff is not entitled to such fees and costs because he failed to apply for the expenses within ten days after determination of the appeal, as required by R. 2:11- 4, and because a large portion of the expenses were incurred before the Supreme Court. We agree.

By order dated June 4, 1997, Judge Gottlieb awarded plaintiff $482,088.03 for attorney's fees and other litigation costs related to trial court matters. However, the judge denied plaintiff any attorney's fees relating to his appeal because the judge did not "interpret R. 2:11-4 as authorizing this trial court to act on appellate fees, especially where the Appellate Division did not refer that question to me."

R. 2:11-4 provides in pertinent part: "An application for a fee for legal services rendered on appeal shall be made by motion supported by affidavits as prescribed by R. 4:42-9(b) and (c), which shall be served and filed within 10 days after the determination of the appeal." *In Tooker v. Hartford Accident and Indem. Co.,* 136 N.J. Super. 572, 578 (App. Div. 1975), *certif. denied*, 70 N.J. 137 (1976), we held that the trial court lacked the power to award attorney's fees and costs for legal services rendered in the Appellate Division in a prior appeal of the matter because application for such allowances should have been made in the Appellate Division. However, because the proofs were before the court and the opposing party did not challenge the reasonableness of the fee, this court relaxed the ten-day requirement of R. 2:11-4 in the interests of justice and awarded the moving party counsel fees and costs relating to the prior appeal. Ibid.

Unlike in *Tooker*, we find no compelling interests of justice warranting a relaxation of the ten-day requirement under R. 2:11-4. Moreover, we reject plaintiff's claim in his reply brief that R. 2:11-4 does not apply to interlocutory appeals.

VI.

In their cross-appeal, defendants assert that the trial judge erred in awarding counsel fees to plaintiff because the judge relied on the finding that plaintiff was an oppressed shareholder, rather than finding that defendants acted in bad faith, as required by N.J.S.A. 14A:12-7(10). Defendants further claim that they are entitled to counsel fees pursuant to N.J.S.A. 14A:12-7(10) because the trial judge found in *Musto I* that plaintiff did not act in good faith on several occasions.

Plaintiff responds by pointing out that the trial judge did not rely on N.J.S.A. 14A:12-7(10), but awarded him counsel fees pursuant to N.J.S.A. 14A:12-7(8)(d), which allows a court to award counsel fees to a selling oppressed shareholder. Plaintiff further contends that defendants are not entitled to counsel fees under N.J.S.A. 14A:12-7(10) because the trial judge did not find that he acted in bad faith.

Contrary to defendants' contention, the trial judge was not required to find that defendants acted in bad faith in order to award plaintiff counsel fees pursuant to N.J.S.A. 14A:12-7(8)(d). This section does not require the judge to find bad faith, but rather, that the judge find that shareholder oppression took place:

> If the court finds that the action was maintainable under paragraph 14A:12-7(1)(c)[any oppressive action by officers or directors], the court in its discretion may award to the selling shareholder or shareholders reasonable fees and expenses of counsel and of any experts, including accountants, employed by them.

[N.J.S.A. 14A:12-7(8)(d).]

Consequently, we find no abuse of discretion in awarding plaintiff counsel fees pursuant to N.J.S.A. 14A:12-7(8)(d).

Defendants further claim that they are entitled to counsel fees under N.J.S.A. 14A:12-7(10) because of plaintiff's bad faith. This section authorizes the award of reasonable expenses to the injured party where the court finds a party acted "arbitrarily, vexatiously, or otherwise not in good faith . . . ." N.J.S.A. 14A:12-7(10). In rejecting defendants' request for counsel fees, Judge Gottlieb stated:

> I will not subscribe to any affirmative remedy in favor of defendants pursuant to N.J.S.A. 14A:12-7(10) since to do so would be an endorsement of a windfall to some extent and would mean that I have found[,] as I have not[,] that Mr.

> Musto acted in bad faith in bringing the suit (as opposed to advancing particular positions during the case's progress).

We agree and affirm the denial of counsel fees for defendants essentially for the reasons expressed by Judge Gottlieb.

VII.

Defendants also contend the trial judge's award of $1,128,472 in prejudgment interest to plaintiff was grossly excessive and constituted an abuse of discretion. In addition, they claim there are compelling reasons for not awarding prejudgment interest at all, or at least not after March 13, 1992 when defendants formerly moved to purchase plaintiff's stock, because of their offer to pay more for plaintiff's stock than what was ultimately found to be fair value by the trial judge. Further, defendants claim that plaintiff was responsible for needless litigation. Finally, defendants contend that if interest is to be awarded, the trial judge erred in awarding the prime rate, rather than a treasury bill rate or the prejudgment interest rate established by R. 4:42-11, and in awarding compound, rather than simple, interest. Plaintiff maintains that the award of prejudgment interest was proper because defendants had use of his money from the valuation date until his shareholder status was terminated. Further, plaintiff asserts that the trial judge was correct in utilizing the prime rate as the applicable rate of interest and in awarding compound interest.

In awarding prejudgment interest in the amount of $1,128,472 running from January 1, 1991 through December 31, 1996, Judge Gottlieb stated:

> Now interest. Defendants urge that it be not available but realistically as – a cutoff as of March 1992. That is when the several motions were made which memorialized a buy-out offer of the other. I'm not going to go on with that because then that overlooks the ultimate fact and that is that defendant had the use of plaintiff's money . . . .
>
> What I have selected for the use of an interest rate payable here is the prime rate and why I have selected the prime rate is, it is most analogous to a corporate borrower and in light of Semcor's solid financial position . . . . I am not going to use the risk free rates, and by that I refer to the treasury notes, treasury bills, CDs, that sort of thing, since that would be intellectually inconsistent with my earlier determination of fair value where I said the cap rate which I have to apply . . . to the income stream or

> reasonable income in order to arrive at the formulation of value, put a certain amount in there additional for Semcor not being, "risk free."
>
> I have thought about . . . whether it should be compound or simple . . . . What I've done is try, since I'm using the prima [sic] rate . . . to figure out if it were going to ABC Bank what it would be doing in borrowing X dollars for two years, four years, whatever it is, some period longer than one year.
>
> In that marketplace, to my knowledge, it would be compounded on an annual basis at best, maybe compounded at a shorter period of time. That's why I have chosen compounding as opposed to simple. I have chosen annual as opposed to quarterly compounding only because it seems to me that in the light of the events that occurred if it had been the equivalent circumstance the lending of money to Semcor would have been on probably not a quarterly compounding basis but on an annual.

N.J.S.A. 14A:12-7(8)(d) provides in pertinent part:

> Interest may be allowed at the rate and from the date determined by the court to be equitable, and if the court finds that the refusal of the shareholder to accept any offer of payment was arbitrary, vexatious, or otherwise not in good faith, no interest shall be allowed.

Generally, the awarding of prejudgment interest is subject to the trial judge's broad discretion in accordance with principles of equity. *A.J. Tenwood Assocs. v. Orange Senior Citizens Hous. Co.*, 200 N.J. Super. 515, 525 (App. Div.), *certif. denied*, 101 N.J. 325 (1985); *Tobin v. Jersey Shore Bank*, 189 N.J. Super. 411, 414 (App. Div. 1983). We will defer to the trial judge's exercise of discretion involving prejudgment interest unless it represents a manifest denial of justice. *A.J. Tenwood, supra*, 200 N.J. Super. at 525 (citations omitted). The primary consideration in awarding prejudgment interest is that "the defendant has had the use, and the plaintiff has not, of the amount in question; and the interest factor simply covers the value of the sum awarded for the prejudgment period during which the defendant had the benefit of monies to which the plaintiff is found to have been earlier entitled." *Rova Farms Resort, Inc. v. Investors Ins. Co. of Am.*, 65 N.J. 474, 506 (1974).

Defendants claim that either no interest should be awarded or the amount awarded should be reduced because plaintiff was responsible

for the length of the litigation. We disagree. The fact that defendants may have made a buy-out offer prior to the litigation greater than the trial judge's ultimate determination of fair value does not mean that plaintiff's refusal to accept such an offer constitutes unjustified delay. As noted, the initial decision required plaintiff to buy-out defendants' interests. Thereafter, much of the delay was due to the defendants' interlocutory appeal from that initial decision. Moreover, some of the examples of delay cited by defendants were accounted for in the trial judge's reduction of plaintiff's counsel fee award. Therefore, we find no abuse of discretion in the trial judge's decision to award prejudgment interest.

Further, we reject defendants' contention that the prime rate, rather than a lower rate, is an appropriate rate. *See Tobin, supra*, 189 N.J. Super. at 416 (noting that in the context of a wrongful retention or detention of funds by a bank, the appropriate rate of prejudgment interest in such cases is usually the prime lending rate). Similarly, we find no abuse of discretion in the trial judge's decision to award compound rather than simple interest. *Borough of Wildwood Crest v. Smith,* 235 N.J. Super. 404, 407 (App. Div. 1988)(summarily finding no error in the trial court's award of compound rather than simple interest in a condemnation action).

VII.

Defendants further contend the trial judge erred in not granting two equitable adjustments to fair value; namely, an adjustment for the post-1990 compensation paid to plaintiff by Semcor according to court order, and the amount voluntarily paid by Semcor to plaintiff in 1991 as deferred compensation. Defendants claim that the judge's failure to allow for these adjustments resulted in plaintiff receiving more than fair value.

Plaintiff maintains that the compensation he received in both instances does not constitute a double recovery, but rather is separate and distinct from the amount he received for his shares.

In 1991, Semcor paid $550,000 to plaintiff--$200,000 in July and $350,000 in December. Vidas described the payments as deferred compensation for tax purposes and claimed that this was purely a voluntary decision, not done under any legal obligation. Thomas Earp, Semcor's attorney, also testified that the payments were made as deferred compensation for tax purposes.

In his initial decision, Judge Gottlieb found that the alteration of the equal compensation agreement constituted an act of shareholder oppression on the part of defendants and ordered that the compensation be "evened out" for the relevant time period. In *Musto I*, we upheld the trial judge's findings in this regard as supported by substantial credible evidence, and ultimately awarded Musto $693,000. *Musto I, supra*, 281 N.J. Super. at 561-62.

In disallowing the adjustments sought by defendants, Judge Gottlieb stated:

> [I]t was characterized by the defendants as deferred compensation. It has been argued to me that . . . that characterization[] was just a fiction in order to be able to take out of the corporation monies that year and still meet the equal compensation requirements.
>
> [I]t was called deferred compensation . . . to avoid taxes which would otherwise have had to have been paid to the State of New Jersey as a then subchapter S corporation . . . .
>
> So, the first concern that I have is the defendants have selected to go that route . . . in order to gain a tax advantage and now having obtained that tax advantage wish to disavow it. I will not permit that. I find that they are estopped from characterizing it as anything other than deferred compensation for efforts before January 1, 1991.
>
> The second basis is . . . that it was paid pursuant to the equal compensation agreement and not for reasons of distributing to plaintiff a share of the corporation.

As noted above, N.J.S.A. 14A:12-7(8)(a) authorizes a trial judge to make adjustments to fair value, either plus or minus, which the trial judge finds equitable. The fact that Semcor was not obligated to make a payment to plaintiff, but did so voluntarily, does not mean the trial judge was obligated to make an equitable adjustment to fair value to account for the payment, or that his failure to do so constitutes an abuse of discretion.

Moreover, with respect to the court-ordered payment of deferred compensation, that payment and the payment for the fair value of shares are separate and distinct remedies. As we noted in *Musto I*, with respect to the court-ordered payment of compensation:

> Such an award is akin to an award of damages to a minority shareholder as compensation for an injury suffered as a result of the oppressive conduct by the majority . . . . In view of defendants' improper conduct towards plaintiff, it is a reasonable exercise of that power for the trial court to

> award damages to plaintiff equal to Vidas's pay for 1991 and 1992.

[*Musto I, supra*, 281 N.J. Super. at 562.]

Consequently, if defendants were awarded an equitable adjustment for the court-ordered payment, the effect would be to nullify the damages awarded plaintiff for defendants' oppressive conduct. We will not grant such relief.

IX.

Defendants further contend the trial judge erred in holding that paragraph sixteen of the shareholders' agreement, dealing with a shareholder death benefit in the form of deferred compensation, survived plaintiff's termination as a shareholder of Semcor.

Paragraph sixteen of the May 1990 shareholders' agreement provides:

> Deferred Compensation. The parties acknowledge [sic] that each Shareholder serves and has served as an employee, officer, and director of SEMCOR. In consideration of each Shareholder's agreement to continue to perform services as an executive of SEMCOR, SEMCOR has agreed to pay deferred compensation to the Shareholder's family upon his death. Such deferred compensation shall be paid as follows:
>
> > A. The total amount payable as deferred compensation, with respect to each Shareholder, shall be the sum of THREE HUNDRED SIXTY THOUSAND DOLLARS ($360,000).

In a statement of reasons attached to his April 19, 1996 order, Judge Gottlieb stated with respect to the above provision:

> Defendants . . . claim . . . that since plaintiff will no longer be a shareholder, his family (upon his death) should not be entitled to the benefit. But that position overlooks the agreement's declaration that plaintiff had served the corporation and agreed to continue to serve the corporation. To deny plaintiff's position would be to (a) overlook the fact that defendants precluded plaintiff from continuing to serve the corporation; and (b) the court cannot separate the value attributable to past services from that ascribed to potential future service.

N.J.S.A. 14A:12-7(8)(f) provides in pertinent part:

> Upon entry of an order for the sale of shares under this subsection . . . the selling shareholders shall no longer have any rights or status as shareholders, officers, or

> directors, except the right to receive the fair value of their shares plus whatever other amounts as may be awarded. [(emphasis added).]

Thus, the statute expressly permits "other amounts as may be awarded," and does not require that all contractual agreements between shareholders end with the termination of shareholder status. In short, we find nothing in the statute which prohibits the award in question. That is, the trial court, as a court of equity, "has the power of devising the remedy and shaping it in order to fit the circumstances of the case and the complexities involved therein." *Musto I*, *supra*, 281 N.J. Super. at 562.

Consequently, we affirm the trial judge's holding that the death benefit provision of the shareholders' agreement remained in effect after the termination of plaintiff's status as shareholder.

Affirmed.

FOOTNOTES

1. Plaintiff had also advanced a 1995 valuation date in addition to the 1996 valuation date.

Full Text of Court Cases

Nail v. Nail

Case name: Nail v. Nail
Citation: 486 S.W.2d 761, 1972 Tex. LEXIS 244
Date of decision: November 8, 1972
Country: US
State or Federal: State
State/Jurisdiction: Texas
Court: Supreme Court
Type of action: Marital Dissolution
Judge: Steakley
SIC: 8011 Offices and Clinics of Doctors of Medicine (except mental health specialists, HMO medical centers, and ambulatory surgical and emergency centers)
NAICS: 621111 Offices of Physicians (except Mental Health Specialists)

Keywords: Marital dissolution, Personal goodwill

JUDGES:

Zollie Steakley, Associate Justice.

OPINIONBY:

STEAKLEY

OPINION:

Section 3.63 of the Texas Family Code n1 requires the Court in a decree of divorce to "order a division of the estate of the parties in a manner that the Court deems just and right . . . ." The controlling question here is whether in this divorce proceeding the accrued good will of the medical practice of the husband, a doctor of medicine specializing in ophthalmology, based as it is on his personal skill, experience and reputation, as well as upon his continuing in the practice, constitutes property that is subject to division as part of the estate of the parties. The trial court and a divided court of civil appeals considered that it was. 477 S.W.2d 395. We hold that it was not.

n1 Vernon's Texas Codes Annotated, Family Code.

The problem is posed in this manner. Petitioner, Dr. James B. Nail, Jr. and his wife, Alice J. Nail, Respondent, were married in 1945. He was subsequently licensed to practice medicine and has practiced in Wichita Falls, Texas, since 1956. His wife sued him for divorce which was granted by

judgment dated August 12, 1971. The court ordered a division of the estate of the parties and that which is questioned here is the following grant to Alice J. Nail in the decree of divorce:

"The Court finds that the value of Alice J. Nail's community interest in said medical practice, including the good will accrued thereto, to be the sum of $40,000.00. This sum shall be paid to Alice J. Nail by James B. Nail, Jr. at the rate of $400.00 per month for a period of twenty-four (24) months beginning August 1, 1971, and continuing to July 1, 1973. Beginning August 1, 1973, the monthly payments from James B. Nail, Jr. to Alice J. Nail shall be reduced to $300.00 per month and shall continue thereafter until the total sum of $40,000.00 shall have been paid by James B. Nail, Jr. to Alice J. Nail, or until the said James B. Nail, Jr. shall cease to practice medicine."

The supporting findings of fact and conclusions of law of the trial court were these:

"That except for the cruel conduct on the part of the said James Barry Nail, Jr. to Alice Jane Nail,the marriage could have continued.

"That had the marriage continued, Alice Jane Nail would have had the benefit of community income in the approximate sum of $53,000.00 per year.

"That during their marriage, James Barry Nail, Jr., completed his pre-medical education, graduated from medical school, completed his internship and his residency in opthalmology.

"That Alice Jane Nail and James Barry Nail, Jr., accumulated and now own the following community property:

(a) The house and lots located at 4502 Martinique Street, Wichita Falls, Texas;

(b) Valuable household fixtures, furnishings and appliances located in the home at 4502 Martinique Street, Wichita Falls, Texas;

(c) The medical practice of James Barry Nail, Jr.;

(d) Two automobiles; and

(e) One boat and motor.

"There are no liquid assets owned by the community estate of Alice Jane Nail and James Barry Nail, Jr.

"That the value of the assets of the medical practice of James Barry Nail, Jr., is $131,759.64, including all fixtures, furniture, equipment, and the value of the good will that has accrued thereto during the marriage of Alice Jane Nail and James Barry Nail, Jr.

"That the approximate value of Defendant's office equipment and office furniture is $735.47.

"That James Barry Nail, Jr., has an earning capacity of approximately $52,000.00 per year.

"That the earning capacity of James Barry Nail, Jr., will increase in subsequent years.

"That Alice Jane Nail is not trained for any employment.

"I conclude from a consideration of the respective ages of the parties, their earning capacities and abilities, the conduct of the Respondent toward the Petitioner, what the Petitioner could have reasonably expected to receive from a continuation of the marriage, except for the conduct of the Respondent, and

from all other factors that it is fair and equitable to grant to the Petitioner Alice Jane Nail, the following property:

(a) . . .

(b) . . .

(c) . . .

(d) A community interest in the medical practice of James Barry Nail, Jr., in the sum of $40,000.00, which said sum shall be payable at the rate of $400.00 per month for a period of 24 months beginning August 1, 1971, and continuing until July 1, 1973. Beginning August 1, 1973, the monthly payments of James Barry Nail, Jr. to Alice Jane Nail should be reduced to $300.00 per month and continue thereafter until the total of $40,000.00 shall have been paid by James Barry Nail, Jr., to Alice Jane Nail, or until the said James Barry Nail, Jr. shall cease to practice medicine; . . ."

It is to be observed that the decree of the court was not based upon a permissible agreement between the parties for support payments to the wife after divorce; nor was it in terms of a court imposed personal obligation of the husband for support of the wife after divorce that would constitute permanent alimony not sanctioned by the statutes and public policy of Texas. See Francis v. Francis, 412 S.W.2d 29 (Tex. 1967); Art. 2328b-4 § 2(f), Art. 4637, Vernon's Ann.Civ.St., and Sec. 3.59 of the Texas Family Code. Rather, the decree in the respects under attack purported to be an exercise of the discretionary powers of the trial court in effecting a just and right division of the estate of the parties.

As noted, the trial court found the value of the husband's medical practice to be $131,759.64, inclusive of fixtures, furniture, equipment and accrued good will; but the court further found the value of the furniture and equipment to be only approximately $735.47, thus leaving a valuation of accrued good will in the sum of $131,024.17. The further finding that the wife's community interest therein was $40,000.00 was derived, at least in part, from the testimony of a witness offered by the wife as an expert that the valuation of the good will of a professional practice would have "a starting point" of "multiplying one full year's billings by one or one and a half". This seems so in light of the trial court finding that the husband had an annual earning capacity of approximately $52,000, one and one-half of which would be $78,000. In any event it is apparent that the award to the wife of $40,000, payable in future monthly installments if, and so long as, the husband practiced his profession, rested upon the conclusion that the accrued good will of the husband's practice constituted property which was subject to division by the court.

Alice J. Nail asserts that the problem is solved by precedents in our State which recognize that a professional man can acquire and voluntarily sell good will. Cited are Randolph v. Graham, 254 S.W. 402 (Tex.Civ.App. 1923, writ ref'd) where it was stated that "[the] good will of a professional man may be as much an asset and a thing to be sold as that of a merchant."; Sanderfur v. Beard, 249 S.W. 274 (Tex.Civ.App. 1923, no writ) and Yeakley v. Gaston, 50 Tex. Civ. App. 405, 111 S.W. 768 (Tex.Civ.App. 1908, no writ). So it is said, the husband's medical practice with its good will was owned by the marital partners; and as such, it was property in existence at the time of the divorce that was subject to valuation and partition in a manner within the discretion of the trial court.

We have found no case in point and solution of the problem is not easy. The division of authority on the question of whether good will may exist in a profession dependent on personal qualities of the owner has been stated in this manner:

". . . It has frequently been held that good will does not adhere to a business or profession dependent solely on the personal ability, skill, integrity, or other personal characteristics of the owner. According to other decisions, however, good will may exist in a professional as well as a commercial business, and may be sold together with the estate, and, irrespective of whether there is technically a good will adherent to a business or profession dependent on personal qualities of the owner, contracts disposing thereof coupled with an agreement that the seller would not compete, if otherwise valid, are enforced. In any case, an involuntary sale cannot be made of a good will based on professional reputation. 38 C.J.S., Good Will, § 3, pp. 952-953

It is generally held that good will has no existence as property in and of itself, as a separate and distinct entity, but only as an incident of a continuing business having locality or name. 38 Am.Jur.2d, Good Will, § 3, p. 914, and cases there cited. The rule has been otherwise stated that as good will must adhere to some principal property or right, the extinction of such right operates to extinguish the good will dependent on it. 38 C.J.S., Good Will, § 4, p. 953. It has been held that good will cannot be levied upon in satisfaction of debts. Lilienthal v. Drucklieb, (Cir. 1898) 84 F. 918. It is the rule in Tennessee that there can be no forced sale or transfer of good will based upon professional reputation and standing against one not assenting. Hunt v. Street, 182 Tenn. 167, 184 S.W.2d 553 (Tenn. 1945); Slack v. Suddoth, 102 Tenn. 375, 52 S.W. 180, 45 L.R.A. 589. The distinction has been drawn that professional good will is not so much fixed or as localized as the good will of a trade, and attaches to the person of the professional man or woman as a result of confidence in his or her skill and ability. Finch Bros. v. Michael, 167 N.C. 322, 83 S.E. 458 (1914).

In any event, it cannot be said that the accrued good will in the medical practice of Dr. Nail was an earned or vested property right at the time of the divorce or that it qualifies as property subject to division by decree of the court. It did not possess value or constitute an asset separate and apart from his person, or from his individual ability to practice his profession. It would be extinguished in event of his death, or retirement, or disablement, as well as in event of the sale of his practice or the loss of his patients, whatever the cause. Cf. Busby v. Busby, 457 S.W.2d 551 (Tex. 1970), and the cases there referred to with approval, where the husband's existing entitlement to future military retirement benefits was held to constitute a vested property right. The crucial consideration was the vesting of a right when the husband reached the requisite qualifications for retirement benefits; the fact that the benefits were subject to divestment under certain conditions did not reduce the right to a mere expectancy. The good will of the husband's medical practice here, on the other hand, may not be characterized as an earned or vested right or one which fixes any benefit in any sum at any future time. That it would have value in the future is no more than an expectancy wholly dependent upon the continuation of existing circumstances. Accordingly, we hold that the good will of petitioner's medical practice that may have accrued at the time of the divorce was not property in the estate of the parties; and that for this reason the award under attack was not within the authority and discretion vested in the trial court by Section 3.63 of the Texas Family Code.

It is to be understood that in resolving the question at hand we are not concerned with good will as an asset incident to the sale of a professional practice, or that may exist in a professional partnership or corporation apart from the person of an individual member, or that may be an element of damage by reason of tortious conduct.

The judgments below are reversed and the cause is remanded to the trial court for further proceedings consistent with this opinion.

Full Text of Court Cases

Neuman v. Neuman

Case name: Neuman v. Neuman
Citation: 842 P.2d 575, 1992 Wyo. LEXIS 170
Date of decision: November 30, 1992
Country: US
State or Federal: State
State/Jurisdiction: Wyoming
Court: Supreme Court
Type of action: Marital Dissolution
Judge: Thomas
SIC: 9999 Unassignable
NAICS: 999999 Unassignable

Keywords: Marital dissolution

COUNSEL:

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Richard G. Miller, Casper, for Appellee.

JUDGES:

Before MACY, C.J., and THOMAS, CARDINE, URBIGKIT, * and GOLDEN, JJ.

* Chief Justice at time of oral argument

OPINIONBY:

THOMAS

OPINION:

THOMAS, Justice.

All of the questions raised in this appeal relate to the exercise of discretion by the trial court in effecting a division of marital property in a divorce action. The primary issue concerns the method adopted for determining the value of stock in a closely-held family corporation. Other allegations of error concern a variance between the decree entered by the trial court and the parties' stipulations; the failure of the trial court to consider tax liabilities and early withdrawal penalties in valuing retirement accounts; and the failure of the trial court to take into account a right of contribution from cotenants in determining the value of the wife's interest in real property held by her in joint tenancy with others. We hold there was no abuse of discretion on the part of the trial court with respect to any valuations. We do modify the decree of divorce to increase the value of the residence awarded to the wife to its stipulated value and, after

that adjustment, we further modify the decree by abolishing periodic payments obviously designed by the trial court to effect an equal distribution. As modified, we affirm the decree of divorce entered by the trial court.

Charles Richard Neuman (the husband) raises the following issues in expressing his dissatisfaction with the property division made by the district court:

I. Did the trial court abuse its discretion by making findings of fact and conclusions of law at variance with the parties' stipulations?

II. Did the trial court abuse its discretion under the particular facts and circumstances of this case by failing to consider tax liabilities and early withdrawal penalties when determining the value of the parties' individual retirement accounts?

III. Did the trial court abuse its discretion by failing to consider appellee's right to contribution from her cotenants when determining the value of her interests in a joint tenancy?

IV. Did the trial court properly determine the value of appellant's closely held stock?

Gretchen Ann Neuman (the wife) offers this statement of the issues in arguing to sustain the property division made by the trial court:

1. Was the trial court's division of property when viewed on an overall basis an abuse of discretion?

2. Was the trial court's valuation of appellee's joint tenancy an abuse of discretion?

3. Did the trial court err as a matter of law and abuse its discretion when it accepted appellee's expert's valuation of appellant's stock?

The husband, by his reply brief, summarizes the case in this way:

V. Is the trial court's property settlement fair and equitable when judged on an overall basis under the particular facts and circumstances of this case?

The Neumans were married on June 7, 1980, in Saratoga. By December of 1989, irreconcilable differences had arisen between them and, following a year of separation, the husband filed for a divorce on May 24, 1990. The wife filed an answer and a counterclaim in which she sought a decree of divorce, custody of their daughter, child support, and an equitable division of their properties. The trial was held on January 4, 1991, with the only matter in dispute before the court being the value, and the appropriate division, of the parties' property.Other issues including custody of their daughter, child support, medical expenses, and visitation of the daughter generally were not in dispute because they had been resolved by stipulations.

The husband and wife each brought substantial assets into the marriage. At that time, the husband owned a house in Rawlins, which was worth approximately $ 57,000, and approximately seventeen shares of Phelps-Dodge stock, a gift from his father in 1979. The wife owned an 85% interest in a cabin and lot near Moran Junction; a Merrill Lynch cash money market account; and interests in two real estate investment companies known as JMB Properties. The wife's property had been acquired with proceeds that she received from a personal injury settlement in 1974.

Before they were married, the husband and wife purchased three acres of land in the Aspen Highlands Development near Elk Mountain. During the time they were married, the Neumans purchased an additional home with the proceeds of the sale of the home owned by the husband prior to the marriage, and they acquired certificates of deposit (CDs), individual retirement accounts (IRAs), life insurance, a vehicle, household furnishings, and a significant amount of cash. The husband worked in his family's trucking business, as service manager, during the ten years of the marriage. The wife was employed as a teacher at Carbon County Child Development Center for the first two years of the marriage, but she was not employed after their daughter was born.

The Neumans had an outstanding mortgage on their home of $ 14,000 but, otherwise, they were free of debt. The husband held eighty-four shares of stock in Neuman Transit Company, Inc. (Neuman Transit), a closely-held corporation owned entirely by the Neuman family. He received sixty of those shares as gifts from his father in 1981, 1982, and 1983, and the other twenty-four shares were distributed to him in settlement of his grandmother's estate in 1988. The trial court found that the value of the husband's shares in Neuman Transit was $ 188,943.

The decree of divorce in this case was filed on March 7, 1991. The district court found a just and equitable division of the property to be as follows:

ASSETS	MR. NEUMAN	MRS. NEUMAN
Family home in Rawlins		$ 76,000.00
3 acres on Elk Mountain	$ 9,000.00	
Household furnishings		8,790.00
1984 Wagoneer		4,425.00
IRAs	28,600.00	2,597.21
Hungry 5	4,463.60	
JMB		5,270.00
Cash value of life insurance	11,608.44	
Ginnie Mae account		5,400.00
Savings		1,900.00
CDs		14,520.58
Neuman Transit stock	188,943.00	
Phelps-Dodge stock	1,000.00	
Merrill Lynch		44,430.00
3 horses	2,200.00	
Loan to Kevin	2,000.00	
Teton County home		61,666.00
	$ 247,815.04	$ 224,998.79

LIABILITIES	MR. NEUMAN	MRS. NEUMAN

Appraisals for trial	620.00	620.00
Mortgage on family home	14,000.00	
	$ 233,195.04	$ 224,378.79

As an additional settlement of their property, the husband was ordered to pay the wife the sum of $ 367.34 per month for twenty-four months. That amount comes within pennies of the disparity between the value of the property according to the decree. Each party was to bear their own attorney fees and costs.

The major issue in this case with respect to the property division is over the valuation of the stock in Neuman Transit. In addressing the husband's claim that the property division was not just and equitable and, therefore, must be held to be an abuse of the trial court's discretion, we look both to the statute and prior cases. The controlling statute in this case, Wyo. Stat. § 20-2-114 (1987), provides, in pertinent part:

In granting a divorce, the court shall make such disposition of the property of the parties as appears just and equitable, having regard for the respective merits of the parties and the condition in which they will be left by the divorce, the party through whom the property was acquired and the burdens imposed upon the property for the benefit of either party and children.

In prior cases, we have held repeatedly that the division of marital property is within the discretion of the trial court and, in the absence of a manifest abuse of that discretion, we will not disturb the result. Mair v. Mair, 823 P.2d 538 (Wyo. 1992) (citing Williams v. Williams, 817 P.2d 884 (Wyo. 1991), and Blanchard v. Blanchard, 770 P.2d 227 (Wyo. 1989)). An abuse of discretion is to be found in a result that shocks the conscience of the court and appears so unfair and inequitable that reasonable persons could not abide it. Grosskopf v. Grosskopf, 677 P.2d 814 (Wyo. 1984) (citing Paul v. Paul, 616 P.2d 707 (Wyo. 1980), and Kane v. Kane, 577 P.2d 172 Wyo. 1978)). In evaluating the question of whether a property division by the trial court is, in fact, just and equitable, we must analyze the situation from the perspective of the overall distribution of the marital assets and liabilities, rather than focusing narrowly on the effects of disposition of any one particular asset. Overcast v. Overcast, 780 P.2d 1371 (Wyo. 1989) (citing Klatt v. Klatt, 654 P.2d 733 (Wyo. 1982), and Paul). We also apply the usual rule that, on appeal, we view the evidence favorably to the successful party in the trial court, ignoring the evidence of the unsuccessful party, and affording to the successful party every reasonable inference that can be drawn from the evidence in the record. Kennedy v. Kennedy, 761 P.2d 995 (Wyo. 1988) (citing Grosskopf.

The major dispute in this case is over the method adopted by the trial court for valuing stock in Neuman Transit. Each of the parties presented an expert witness at trial to testify as to the value of the husband's stock. Pursuant to a stipulation of counsel, the trial court took the testimony of the experts in narrative form. Each of the experts offered an opinion; explained the approach utilized to arrive at his opinion; articulated the reason for selecting the approach utilized; and elaborated generally upon the reasons for the offered opinion.

The chairman of the accounting department of the University of Wyoming was called by the husband to provide an academic and theoretical guide. That witness agreed that the three primary methods of valuation of closely-held stock are book value,capitalization of earnings, and historical earnings. Later,

he testified that the comparable sales approach was a fourth method by which stock of this type commonly is valued. This witness furnished an explanation of each of the various methods of valuation.

Book value is arrived at by taking the aggregate equity of the stockholders in the company and dividing it by the number of outstanding shares. In the capitalization of earnings method, the appraiser uses the average of an accumulation of earnings, normally at least two years, and then discounts the average earnings and multiplies that by an appropriate capitalization factor. IRS Revenue Ruling 59-60 suggests the appropriate capitalization factor be somewhere between twenty and thirty. The historic earnings method represents an attempt to adjust, by price level adjustment, the historical cost statements for earnings power over the life of the entity. When asked about the comparable sales approach used by another expert witness, the Chairman of the Accounting Department said:

Well, comparable sales is probably most difficult with a closely-held corporation, you understand. Because there might not be a comparable sale of a closely-held entity.

So what we normally -- and let me broach the subject in this fashion -- normally we talk about comparable sales when we are talking about the sales of stock that are on an exchange, and we can look at those kinds of comparable companies.

This witness also said that, in valuing a closed-corporation interest in a transportation company, it sometimes is proper to compare assets, liabilities, and interests to a publicly-traded transportation company. This approach is known as common sizing. The witness discussed the advantages and disadvantages of each of the methods of valuation, concluding that to discount an average earnings figure and then capitalize that rate would most consistently achieve the most accurate results.

The valuation expert for the husband, a certified public accountant, testified utilizing a comparable sales approach and then taking a 35% discount for lack of marketability of the Neuman Transit stock, ending with an opinion of a net value of $ 69,058. This witness also used, as a second approach, the common-sizing approach pursuant to which he compared Neuman Transit with Consolidated Freightways and Yellow Freight Company, both publicly traded stocks and, after a discount of 35% plus an additional 39% discount for a loss of business within the last two weeks, he arrived at a net value of $ 73,904. The husband's witness also testified that the book value of the husband's interest in the stock minus the minority discount was $ 45,136. The trial court found that the testimony relating to a comparable sale was not reflective of the actual value of the stock in Neuman Transit. Similarly, the trial court ruled that the evidence of book value did not accurately reflect actual or market value because of the practice of maintaining its equipment rather than replacing it. The trial court also noted that using the husband's expert witness' computation for the price earnings ratio after netting out a 39% reduction for an anticipated loss of gross earnings and a 35% reduction for a minority interest resulted in a value of $ 189,908.43, a value slightly higher than the one the court adopted from the testimony of the wife's expert witness.

The wife called as her expert a witness who also was a certified public accountant and testified utilizing the capitalization of earnings approach. The wife's expert computed the capitalization of earnings based on Neuman Transit's own records for the past ten years. He then adjusted the value of the rolling stock which was almost totally depreciated and arrived at a net value of $ 188,943. This witness offered a second valuation pursuant to a modified book value approach. The wife, in her brief, referred to this as a "liquidation value," and the opinion of the expert, based on this latter method, resulted in a net value of $

247,330. The wife's witness did not apply a discount for the lack of marketability, nor did he adjust for the very recent loss of business in reaching either of his proposed figures. Neuman Transit was dealing with a $ 2 million loss of revenue which, according to the wife's witness, would cause the company to not reach a break-even profit. The witness testified that, if the company were to reach a break-even point, then it would either liquidate or it would go out and find new sources of revenue to offset the loss of revenue. It followed, in the opinion of the wife's expert, that the 39% reduction for loss of business proposed by the husband's expert was inappropriate. The wife's export also testified that the 35% minority discount for the lack of marketability the husband's expert proposed was not applicable in this instance, since it was a divorce case, and the husband was not going to sell his shares of stock.

The trial court adopted the capitalization of earnings approach used by the wife's expert witness and then valued the husband's stock at $ 188,943. The husband challenges the adoption by the court of the approach of the wife's expert claiming that the witness' methods are not in accordance with general accounting principles. Specifically, the husband states in his brief:

As will be shown, the trial court's findings of fact and conclusions of law regarding the valuation of the stock are so at variance with accepted accounting procedures and the law as it exists in our sister states that this court simply will not be able to abide them. As a result, this appeal offers this court the opportunity to decide how stock in a closely held corporation should be properly valued in divorce actions.

While forcefully stated, we are not in accord with the husband's argument. As we have noted above, the trial court is afforded substantial deference in the determination of a just and equitable disposition of the properties ofthe parties in a divorce case. In addition, the precedent and theories offered by both the husband and the wife, in their briefs and arguments together with the literature that has been developed by independent research, reveal numerous methods and factors courts may consider in arriving at a determination of the value of corporate stock.

The challenge by the husband is to both the methodology and certain assumptions relied upon by the wife's expert and later adopted by the district court to calculate the earnings of Neuman Transit. We have selected a relatively recent article as a lucid and concise summary of this problem and the various solutions. Alan S. Zipp, Divorce Valuation of Business Interests: A Capitalization of Earnings Approach, XXIII Fam. L. Q. 89 (1989). Mr. Zipp recognizes that the valuation of a closely-held business is among the more difficult problems in divorce cases, and courts can only expect a reasonable estimate of business value based upon expert testimony. The author then makes the distinction between the valuation of a business for divorce purposes and its value to a willing buyer, primarily because there is no willing buyer in the divorce, and the business will not be sold. In addition, a willing buyer is contemplating future profitability and earnings in the future when making a valuation decision while, in the divorce case, the post-divorce earnings are considered property outside the scope of the rules for distribution of marital property. The legal concept of marital property recognizes the business value as it exists at the date of divorce or separation, and income to be earned after the divorce is not part of that marital property. The capitalization of earnings approach to the valuation of stock in such cases is supported by the Zipp article.

In this case, we are persuaded that the capitalization of earnings approach utilized by the wife's expert witness, and its adoption by the district court, does not result in an abuse of discretion as the husband argues. The wife's expert expressed his preferential method for valuing a company like Neuman Transit,

which has a significant investment. That preferred method is to value the underlying assets, and then apply a calculation to account for goodwill if there is any goodwill. For our purposes, goodwill appropriately is defined as:

Business goodwill for marital property valuation purposes is the reasonable value, in the hands of the current business owner, of the average excess earnings of the business, at the valuation date, based exclusively on the historical earnings of the business and without reference to projected future earnings.

Zipp, supra, at 108.

The wife's expert applied a 15% capitalization rate, which is generally one way of valuing goodwill. The capitalization rate of 15% that the witness used is not challenged by the husband on appeal.

Before the wife's expert applied the 15% capitalization rate, he determined the value of the company's equipment by examining ten years of Neuman Transit's records. He next estimated the actual depreciation of the equipment during the ten-year period and applied this to taxable income and reached a result denominated "Adjusted Net Cash Flow" for each of the ten years. An average for the ten years then was obtained by giving more weight to the net cash flow that was generated in the last five years as opposed to the first five years. The expert witness then subtracted the actual depreciation from the net cash flow and arrived at the profit from operations, from which he subtracted 30% forincome taxes, arriving at the average annual after-tax earnings. He then applied the 15% capitalization rate to reach his final valuation of the husband's shares of stock in the amount of $ 188,943.

A method of valuation that capitalizes the historical past earnings of a business at an appropriate capitalization rate, in order to identify the value of any goodwill possessed by the business at the date of divorce or separation, is appropriate in the context of divorce proceedings because it avoids the problem of valuing a business on the basis of post-divorce earnings and profits. Zipp, supra. This method essentially is the approach that the wife's expert took in reaching his opinion as to value of the Neuman Transit stock, and his approach ultimately was adopted by the trial court. The court considered and evaluated the opinions of both experts. The deliberate nature of this consideration by the trial court is manifest by the nearly five pages of explanation contained in the findings of fact in the decree of divorce.

A trial court is free to assess expert opinion and determine fair market value in light of testimony regarding: the nature of the business, the corporation's fixed and liquid assets at the actual or book value, the corporation's net worth, the marketability of the shares, past earnings or losses and future earning potential.

Bryan v. Bryan, 222 Neb. 180, 382 N.W.2d 603, 606 (Neb. 1986) (citing Dean v. Dean, 87 Wis.2d 854, 275 N.W.2d 902, 912 (Wis. 1979)).

We accept and agree with the reasoning of the Nebraska and Wisconsin Supreme Courts. The trial court is not required to accept any one accounting method of stock valuation as more accurate than another.

The husband agrees that the capitalization of earnings method is a recognized and accepted valuation technique and even that it perhaps is the most widely-used technique for appraising and evaluating on-going businesses. This acknowledgement is in accord with the decision of the trial court as well as

recent accounting literature and case law. The husband insists, however, that the trial court cannot ignore the recent 35% reduction in Neuman Transit's gross revenue. The trial court considered that factor in its findings of fact in the divorce decree and said:

While there was testimony that the Company was going to suffer a 39% reduction in gross revenue as a result of events which had occurred two weeks prior to trial, the Court finds that any such reduction in value based thereon would be speculative and inequitable, considering the age of the Company, the past history of the earnings and the undisputed testimony that the Company was not going out of business, would continue to be in business at least until 2014. Further, a 39% reduction of gross revenue would not be a direct proportional reduction of net income as proposed by plaintiff's expert; but, instead, would cause the Company to not reach break-even point, and liquidation value, or the adjusted net book value, would be more appropriate.

This comment demonstrates that the trial court did not ignore the reduction in gross revenue. The court considered that factor, with all of the circumstances surrounding the case, and concluded that it would be speculative and inequitable to reduce the value accordingly. The approach taken is within the wide discretion afforded the trial court in the area of disposition of marital property, and we hold there was no abuse of discretion by the trial court in the valuation it made of the husband's shares of stock in Neuman Transit.

We emphasize that we do not adopt the capitalization of earnings approach as the only method to value corporate stock. Trial courts should continue to adjudicate marital property dispositions on a case-by-case basis. If we were to adopt a single bright-line method for evaluation of closely-held corporate stock, we would unnecessarily inhibit the invocation by trial courts of methods developed in the future for valuation of stock in a closely-held corporation. Furthermore, we would inhibit other methods that might be appropriate in a particular case. An examination of the literature in this area discloses that the choice of methods for valuing closely-held corporate stock has changed greatly in the past fifteen years, n1 and the capitalization of earnings approach that is the most commonly used method at this time will not necessarily be the method of choice in the future. Certainly, valuation of closely-held corporate stock will remain a battle of the experts, but those witnesses are probably in the best position to keep both counsel for the litigants and the courts current with respect to this troublesome topic.

n1 E.g., W. Terrance Schreier & O. Maurice Joy, Judicial Valuation of "Close Corporation Stock: Alice in Wonderland Revisited, 31 Okla. L. Rev. 853 (1978); MARJORIE A. O'CONNELL, GUIDE TO DIVORCE TAXATION § 12,104 (1987).

Other allegations of error presented by the husband include a variance between the decree of divorce entered by the trial court and the stipulations of the parties; the failure of the trial court to consider tax liabilities and early withdrawal penalties in connection with certain retirement accounts; and the failure of the trial court to consider a right of the wife to contribution from cotenants in its determination of the value of the wife's interest in certain property held by her in joint tenancy with others. This court has remained steadfast in holding that property awards must be viewed in their entirety and not considered on the basis of individual items. Ebeling v. Ebeling, 782 P.2d 584 (Wyo. 1989) (citing Barney v. Barney, 705 P.2d 342 (Wyo. 1985)). In light of that rule, little purpose would be served in this case by analyzing the individual assets in any attempt to calculate the precise financial effect of the divorce decree.

Financial equality is not a prerequisite of a just and equitable distribution. Ebeling (citing Blanchard, 770 P.2d 227). The district court has greatdiscretion under § 20-2-114 in making disposition of marital property to determine what is a just and equitable division. We hold that the trial court did not abuse its discretion in making the division of property in this case. In a reply brief, the husband asks this court to limit its review to a determination of whether substantial equality actually has been achieved by the trial court's division of marital estate. We are of the opinion that substantial equality was achieved.

We turn now to an area that we believe does demand further consideration. The decree of divorce must be modified because of an error that occurred in the valuation of the Rawlins home. As noted previously, it was valued at $ 76,000, and there was a mortgage of $ 14,000 on the home chargeable to the husband. The husband, in his reply brief, asserts that, even though the trial court's judgment is entitled to great deference, the appellate court should not defer to valuation errors that affect the essence of the property settlement. We are in accord. The correct value that should be attributable to the wife with respect to the family home should be the stipulated fair market value of $ 90,000.

The husband gains support for his argument from the Supreme Court of South Dakota in Warne v. Warne, 360 N.W.2d 510 (S.D. 1984). In Warne, the trial court allocated a mortgage on a house to the wife as an asset and to the husband as a debt. The purchase price of the house was $ 40,000 with $ 36,000 remaining unpaid. The trial court valued the home at $ 40,000 and awarded it to the wife debt-free, which required allocation of the $ 36,000 debt to the husband. Upon appeal by the husband, the South Dakota court held that the court did not overlook the mortgage nor fail to properly account for it. In the context of this case, the point of Warne is that the court did not award the wife only the equity in the house which was $ 4,000, but the full value of the house which was $ 40,000. The rationale articulated by the South Dakota court is persuasive:

This Court limits its review to determine whether there was an equitable division of property. The trial court has broad discretion in dividing property. Error does occur, however, when the trial court fails to properly value assets and thereby establishes a false net worth.

Warne, 360 N.W.2d at 512 (citations omitted).

While it would appear from the record that, subsequent to the decree of divorce, the mortgage on the home was paid by the husband, if the scheduled payments were met, that does not impact the division which occurred in the decree. Correction of this error results in attributing an additional $ 14,000 to the wife and increases the total assets distributed to her to $ 238,998.79.

We are satisfied that the court awarded an additional property settlement to the wife in the amount of $ 367.34 for 24 months in order to balance as perfectly as possible the disparity in the total property awarded to each. That disparity has been abrogated by crediting the wife with an additional $ 14,000 and, in fact, she now would have some $ 5,000 more than the husband received according to the decree of divorce. It is our conclusion, in light of the circumstances, that the decree of divorce should be further modified to delete the requirement for the 24 monthly payments by the husband to the wife.

We conclude that the decree should be modified to correct the technical error and to delete the periodic payments awarded to balance the division of the marital property. Except forthis correction, we conclude that there was no abuse of discretion by the trial court. We hold that, as modified, the decree of divorce entered by the district court should be affirmed.

Full Text of Court Cases

Estate of Newhouse v. Commissioner of Internal Revenue

Case name: Estate of Newhouse v. Commissioner of Internal Revenue
Date of decision: February 28, 1990
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Williams
SIC: 2711 Newspapers: Publishing, or Publishing and Printing (except Internet newspaper publishing)
NAICS: 511110 Newspaper Publishers

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JUDGES:

Williams, Judge.

OPINIONBY:

WILLIAMS

OPINION:

The Commissioner determined a deficiency in the Federal estate tax due from the estate of Samuel I. Newhouse in the amount of $ 609,519,855. The Commissioner also determined an addition to tax for fraud pursuant to section 6653(b) n1 in the amount of $ 304,759,927. The Commissioner has conceded the addition to tax for fraud.

n1 All section references are to the Internal Revenue Code of 1954 as amended and in effect at decedent's death.

After concessions, the remaining issues for our decision are: (1) The value, for purposes of the Federal estate tax, of 10 shares of class A common stock and 990 shares of class B common stock of Advance Publications, Inc., owned by Samuel I. Newhouse, Sr. (Newhouse) at the time of his death, and (2) the value, for purposes of the Federal estate tax, of 100 shares of common stock in Newhouse Broadcasting Co. owned by Newhouse at the time of his death.

FINDINGS OF FACT

Some of the facts were stipulated and are so found. Newhouse died testate on August 29, 1979. His sons, S.I. Newhouse, Jr. (S.I., Jr.), and Donald E. Newhouse (Donald), were duly appointed executors of his estate.At the time of his death, Newhouse resided in Palm Beach, Florida. The executors timely filed a Federal estate tax return on May 27, 1980, and elected to value the Newhouse estate as of February 29, 1980, the alternate valuation date.

On Schedule B of the estate tax return, the executors valued the 10 shares of class A common stock and the 990 shares of class B common stock in Advance Publications, Inc. (Advance), at $ 8,595,000 and $ 170,181,000, respectively, based on an appraisal by Chemical Bank. Also on Schedule B of the estate tax return, the executors valued the 100 shares of common stock in Newhouse Broadcasting Co. (N.B. Co.) at $ 68,300,000. In the notice of deficiency dated May 18, 1983, the Commissioner valued the 10 shares class A common stock and the 990 shares of class B common stock in Advance at $ 420,000,000 and $ 811,800,000, respectively, and valued the 100 shares of common stock in N.B. Co. at $ 91,600,000. On August 12, 1983, petitioners timely filed their petition in this case.

I. VALUE OF ADVANCE COMMON STOCK

A. Organization and Operations

Advance is a corporation organized under the laws of the State of New York that publishes newspapers and magazines.Advance's principal place of business was and always has been in New York. At the time of Newhouse's death, the officers of Advance were: Newhouse, President and Treasurer; Mitzi Newhouse, Newhouse's wife, Vice President; S.I., Jr., Vice President; Donald, Secretary.

In 1922, Newhouse and Judge Hyman Lazarus, a New Jersey lawyer, formed a partnership to acquire 51 percent of the stock of the Staten Island Advance which published a newspaper, The Staten Island Advance. In 1924, Newhouse bought Judge Lazarus' shares and soon after purchased the remaining 49 percent. Newhouse filed a Certificate of Incorporation (the certificate) for the Staten Island Advance Co., Advance's predecessor, on May 12, 1924. From the time Newhouse incorporated Advance, Newhouse's brothers Theodore (Ted) and Norman were employed at Advance, and all three brothers shared equally in the management of the business.

In 1932, Advance acquired the controlling interest in the Long Island Daily Press Publishing Co., the first of a long line of newspaper acquisitions. In 1939, Advance bought two newspaper properties in Syracuse, New York. Advance further enlarged its operations by purchasing an Oregon newspaper in 1950 and newspapers in Alabama in 1956. On February 29, 1980, Advance operated either by itself or through a wholly owned subsidiary, 50 newspapers in 22 markets as well as magazines published by Conde Nast Publications, Inc. (Conde Nast). n2 After each acquisition one of the brothers was assigned primary responsibility for the acquired property and assumed management of its operations. To provide on-site management, one of the three brothers would visit each newspaper located outside of the New York City area weekly or monthly. The visiting brother would meet with the local publisher and department heads to discuss circulation, current advertising and advertising development, accounts, compensation plans, editorial quality, production facilities, and distribution. After S.I., Jr., and Donald joined the management team, the five family members would meet frequently to discuss the operations of the out-of-town newspapers and plans for the acquisition of new properties. The topics at the family meetings included the purchase of new capital equipment, consideration of policies about purchasing newsprint, the setting of rates, and discussions of circulation techniques and distribution policies.

n2 As of Feb. 29, 1980, Advance owned and operated the following newspapers: The Staten Island Advance in New York, New York; the National News Service Co. in Washington, D.C.; The Birmingham News in Birmingham, Alabama; The Huntsville News and The Huntsville Times in Huntsville, Alabama; The Jersey Journal in Jersey City, New Jersey; The Post-Standard, The Syracuse Herald-Journal, and the Syracuse Herald-American in Syracuse, New York; The St. Louis Globe in St. Louis, Missouri; The Ann Arbor News in Ann Arbor, Michigan; The Bay City Times in Bay City, Michigan; The Flint Journal in Flint, Michigan; The Grand Rapids Press in Grand Rapids, Michigan; The Jackson Citizen Patriot in Jackson, Michigan; The Kalamazoo Gazette in Kalamazoo, Michigan; The Muskegon Chronicle in Muskegon, Michigan; The Saginaw News in Saginaw, Michigan; The Mississippi Press and The Mississippi Press Register in Pascagoula, Mississippi; The Mobile Register, The Mobile Press, and The Press-Register in Mobile, Alabama; The Star-Ledger in Newark, New Jersey; The Oregonian and the Oregon Journal in Portland, Oregon; Parade in New York, New York; The Patriot, The Evening News, and the Sunday Patriot News in Harrisburg, Pennsylvania; The Plain Dealer in Cleveland, Ohio; The Union, The News, and the Republican, in Springfield, Massachusetts; The Times-Picayune and the States Item in New Orleans, Louisiana. Advance also owned Electric Delivery System, Inc., a distribution and delivery company for the Times-Picayune and Mercury Express, Inc., a distribution and delivery company for The Birmingham News.

As of Feb. 29, 1980, Advance operated the following magazines: Vogue, Vogue Guides, Glamour, Mademoiselle, House & Garden, House & Garden Guides, Bride's, Self, Street & Smith, Analog, Vogue Patterns, and GQ in the United States; Vogue in Brazil, Australia, and Germany; Vogue, House & Garden, and Bride's & Setting Up Home in England, Vogue, Vogue Shopping, L'Uomo Vogue, Casa Vogue, Uomo Mare, Vogue Bambini, and Lei in Italy; Vogue, Vogue Beaute, Vogue Homes, Maison & Jardin, Maison, and Club Maison in France.

As of Feb. 29, 1980, Advance also owned Art Gravure and Diversified Printing, two printing companies. Advance also owned a 49-percent interest in Catawba Newsprint Co., a newsprint manufacturing company.

When there was no scheduled meeting, the five family members, who all arrived at work very early in the morning, would speak with each other by telephone before other employees had come to work. Between monthly visits they communicated by telephone with the local management of newspapers they oversaw and regularly received financial reports, advertising reports, circulation reports, and other pertinent data. Financial and operating reports from the out-of-town newspapers were shared among the five family members. The family members considered the periodic visits to the out-of-town properties and the consensus decision-making to be hallmarks of their management style. Throughout Advance's history, all major decisions were reached by unanimous agreement after discussion in which all partook. Each visiting family member would write a report on the management of the out-of-town newspaper (issues, decisions, future) that was circulated to the other family members. While no person dominated the discussions, some deference in matters relating to a particular newspaper was shown to the family member who was responsible for that newspaper. Decisions were never made by voting. The consensus style of management has been utilized throughout the time the family has managed Advance. Despite disagreements, discussions always proved fruitful and consensus was reached.

In the 1950's S.I., Jr., and Donald joined their father and uncles in the business. Working primarily under the supervision of their uncles, S.I., Jr., and Donald learned the family business from the ground up. In the beginning both Donald and S.I., Jr., attended the family management meetings as mere observers but by the mid-1960's their advice was sought by their father and uncles. After several years of learning editorial and production management, S.I., Jr., and Donald were each assigned to manage an out-of-town property. S.I., Jr., worked in the Conde Nast organization and Donald started at the Long Island and the Jersey City newspapers.

The management of Advance was eventually shared among all five of the family members. Until the last year of his life when he became too ill to travel, Newhouse supervised the newspaper properties in Newark, New Jersey; Syracuse, New York; Harrisburg, Pennsylvania; St. Louis, Missouri; New Orleans, Louisiana; and Mobile, Alabama. Ted managed the newspaper properties in Portland, Oregon; Birmingham, Alabama; Huntsville, Alabama; Springfield, Massachusetts and later the Booth divisions in Michigan. Norman was responsible for the newspaper in Cleveland, Ohio, and later for the newspapers in New Orleans and Mobile when he moved to New Orleans in the late 1960's. S.I., Jr., made periodic visits to the newspaper in Cleveland, Ohio to help Norman and managed Conde Nast; after his father became ill, he oversaw St. Louis. Donald traveled with Ted to the newspapers in Birmingham and Huntsville. After his father became ill, Donald took over supervision of the operations at Newark, Syracuse, Harrisburg, Jersey City, and Staten Island.

Throughout its history, Advance had a policy of reinvesting earnings to finance further acquisitions. Advance traditionally minimized the dividends declared. From 1973 to 1979, dividends were declared and paid at their highest historical level in the amount of $ 200 per share although in 1977, 1978, and 1979, Advance had retained earnings of $ 411,206,000, $ 503,858,000, and $ 475,969,000, respectively, and total operating income of $ 148,217,000, $ 173,947,000, and $ 159,895,000, respectively. Each shareof stock received the same amount of dividends.

B. Capital Structure

On August 26, 1924, the stock of Advance, viz, 200 shares of common stock, par value $ 100, was reclassified into 1,000 shares, no par value.

By a "Certificate of Increase of Number of Shares, Change of Previously Authorized Shares and Classification of Shares" filed August 26, 1936, Advance authorized 6,000 no-par shares divided equally among class A, class B, and class C common stock (the 1936 amendment). The right to vote for the board of directors was given to the holders of the class A stock exclusively. The class B and class C shareholders were explicitly denied the right to vote on certain matters referenced in the New York Stock Corporation Law and General Corporation Law. n3 Furthermore, the class B stock and the class C stock could be redeemed in whole or in part at the prices of $ 175 and $ 199.50 per share, respectively, after September 1, 1939, at the discretion of the board of directors. The 1936 amendment also provided for equal participation in dividends of all three classes of stock, and finally, established a liquidation preference in the Class B stock of $ 175 per share, then in the class C stock of $ 199.50 per share and ultimately in the class A stock of $ 333 per share, with the residual value to be divided equally among all classes.

n3 Specifically the Class B and the Class C shareholders were denied the right to vote:

in a proceeding for mortgaging the property and franchises of the Corporation, pursuant to Section 16 of the Stock Corporation Law; for guaranteeing the bonds of another Corporation, pursuant to Section 19 of the Stock Corporation Law; for sale of the franchises and property, pursuant to Section 20 of the Stock Corporation Law; for establishing priorities or creating preferences among several classes of stock, pursuant to Section 36 of the Stock Corporation Law; for consolidation, pursuant to Section 86 of the Stock Corporation Law; for voluntary dissolution, pursuant to Section 105 of the Stock Corporation Law; for change of name, pursuant to the General Corporation Law * * *.

On December 27, 1938, Advance filed a "Certificate of Change of All Its Previously Authorized Shares Without Par Value Issued or Unissued, (1) class 'A' Stock Into the Same Number of Shares of Common Stock, Without Par Value; (2) class 'B' Stock and class 'C' Stock Into the Same Number of Shares of Preferred Stock, Without Par Value And Reclassification of Shares" (the 1938 amendment). This amendment provided that the 6,000 shares of authorized class A, class B, and class C common stock would be reclassified to create two classes of stock: the 2,000 shares of class A would become no-par common stock and the 4,000 shares of class B and class C would become no-par preferred. The amendment further provided that the preferred shareholders would receive noncumulative dividends of $ 12 per share before any dividends would be paid to the common shareholders, and the remainder of declared dividends would be shared proportionately by the common and the preferred shareholders. The preferred shareholders were also entitled to a liquidation preference of $ 187.25 per share before payment to the common shareholders of $ 333 per share could be made. The residual value would be divided pro rata among all shareholders. The entire voting power for the election of the board of directors was reserved to the common shareholders and the voting rights of the preferred shareholders were explicitly restricted. n4 The amendment further provided that the preferred stock could be redeemed after September 1, 1944, at $ 187.25 per share at the discretion of the board of directors.

n4 The preferred was not entitled to vote:

in a proceeding for mortgaging the property and franchises of the Corporation, pursuant to Section 16 of the Stock Corporation Law; for guaranteeing the bonds of another Corporation, pursuant to Section 10 of the Stock Corporation Law; for sale of the franchise and property, pursuant to Section 20 of the Stock Corporation Law; for establishing priorities or creating preferences among the several classes of stock, pursuant to Section 86 of the Stock Corporation Law; for voluntary dissolution, pursuant to Section 105 of the Stock Corporation Law; for change of name, pursuant to the General Corporation Law * * *.

On December 27, 1949, Advance filed a "Certificate of Amendment of Certificate of Incorporation" (the 1949 amendment), which provided that the preferred and the common stock would participate proportionately in all dividends. The amendment retained the preferred's liquidation preference of $ 187.25, but abandoned the common's liquidation preference of $ 333 per share and the preferred's right to share in the residual value. The common shareholders were given exclusive right to the residual liquidation value. With one important exception, the voting rights remained substantially the same. n5 Also in 1949, Advance changed its name from Staten Island Advance Co. to Advance Publications, Inc.

n5 Prior to the 1949 amendment, the preferred shareholders had been specifically prohibited from voting on "establishing priorities or creating preferences among the several classes of stock" but this limitation was removed in the 1949 amendment.

On December 22, 1952, Advance filed another "Certificate of Amendment of Certificate of Incorporation" which provided for the transformation of the 2,000 shares of authorized common stock into 20 shares of class A common voting stock and 1,980 shares of class B common nonvoting stock (the 1952 amendment). A "Certificate of Amendment of Certificate of Incorporation" was filed on January 5, 1955, to change the number of directors.

On December 27, 1956, the last change in Advance's corporate structure was made by "Certificate of Amendment to Certificate of Incorporation" n6 (the 1956 amendment) stating that: (1) Dividends were to be shared equally between the class A common, the class B common, and the preferred shareholders, (2) and the preferred shareholders were entitled to a liquidation preference of $ 187.25 per share before the class A common and the class B common shared equally in the residual liquidation value, and (3) the limitation on the voting rights of the preferred shareholders on voluntary dissolution was removed.

n6 All future references in this opinion to "the certificate" are to the original Certificate of Incorporation as amended.

Prior to 1936, Newhouse owned 786 of the 1,000 authorized shares of Advance no-par common stock. After the 1936 amendment, Newhouse's shares were changed to 1,000 shares of class A common. At this time, 1,000 shares of class B common were issued to his wife, Mitzi Newhouse (Mitzi), and 500 shares of class C common were issued in trust for each of his sons, S.I., Jr. and Donald. After the 1938 amendment, Newhouse's class A common was exchanged for 1,000 shares of common stock, Mitzi's shares of class B common were exchanged for 1,000 shares of preferred stock and the 500 shares of class C common stock held in each trust for S.I., Jr., and Donald were exchanged for shares of preferred stock. On or about December 27, 1938, an additional 250 shares of preferred stock were issued to each trust for S.I., Jr., and Donald. In 1947, 500 shares of preferred stock apiece were issued to Ted and Norman. In 1948, the trust distributed 400 shares of preferred stock to S.I., Jr., and in 1950 the trust distributed to him an additional 350 shares of preferred stock. In 1950, the trust distributed 750 shares of preferred stock to Donald.

At the time of Newhouse's death, Newhouse still owned all the common stock andMitzi Newhouse owned 1,000 shares of preferred stock, S.I., Jr., and Donald each owned 750 shares of preferred stock and Ted and Norman each owned 500 shares of preferred stock. By will, Newhouse left 300 shares of Advance class B common stock to Mitzi.

In 1959 Advance and all of its shareholders executed separate agreements providing that at their deaths, Advance would redeem enough stock from the shareholder's estate to cover Federal estate taxes. The 1959 agreements between Advance and Ted, Norman, S.I., Jr., and Donald were superseded by a shareholders' agreement in 1974. The 1959 agreement between Advance and Mitzi was superseded in 1978 when the shareholders' agreement executed in 1974 was amended to include Mitzi's stock. The 1959 agreement between Advance and Newhouse continued in effect until the time of Newhouse's death.

On April 24, 1974, Advance, Newhouse, Ted, Norman, S.I., Jr., and Donald executed an agreement limiting the rights of any subsequent owner of the preferred stock who had not executed the agreement to dispose of their stock (the 1974 shareholders' agreement). The purpose of the 1974 shareholders' agreement was to:

make certain the continued ability of Advance to operate as a closely held corporation with a harmonious group of shareholders, and to continue its management policies and procedures which have proven successful in the past, despite change which may result from the deaths or other transfers of shares by Theodore Newhouse, Norman N. Newhouse or Samuel I. Newhouse, Sr.

Particularly, the family members were concerned with the fragmentation of closely held, family-owned companies that they felt frequently occurred in the newspaper industry.

The 1974 shareholders' agreement provided that in the event of a sale or exchange of preferred stock, Advance would first have the right to buy the stock on the same terms as offered by the prospective buyer. Furthermore, upon the determination of a majority of the board of directors, Advance was given the right to acquire all or any part of the shares of preferred stock from a shareholder upon the death of a preferred shareholder, upon an involuntary transfer of preferred shares by operation of law or otherwise, or whenever a majority of the board of directors determined in good faith that (1) the preferred shareholder had violated an agreement with Advance resulting in a materially adverse effect on Advance or its shareholders, (2) the shareholder threatened to dispute Advance over his rights as a shareholder, or (3) when it would be in Advance's interests to reduce the number of preferred shareholders. If the preferred shareholder and Advance could not agree on the purchase price, the "fair value" of the preferred shares would be determined by Chemical Bank. Chemical Bank's decision would be binding on the preferred shareholders and Advance and was not judicially reviewable except as required by New York arbitration law.

The 1974 shareholders' agreement also provided that at the deaths of Ted, Norman, S.I., Jr., and Donald, and their spouses, their personal representatives could require Advance to purchase preferred stock from the respective estates in an amount that satisfied, but did not exceed, the estate's cost for taxes, funeral expenses, and administrative expenses of the estate. On April 18, 1978, the 1974 shareholders' agreement was amended to include Mitzi Newhouse's 1,000 shares of preferred stock. n7

n7 In 1980, the 1974 shareholders' agreement was amended to include 300 shares of Class B common stock that Mitzi received under S.I., Sr.'s will.

After Newhouse's death, the estate requested Chemical Bank to determine the value of the class A common and class B common stock that Newhouse held at the date of death. In a letter dated April 29, 1980, Chemical Bank explained that, after considering financial statements for the years 1973 through 1979 and the certificate, and after visiting some of Advance's key properties, Chemical Bank concluded that the class A common stock was worth five times as much per share as the class B common stock and that the class B common stock shares were equal in value to the preferred shares. The report concluded that the value of Newhouse's class A common stock had an aggregate value of $ 8,595,000, viz, $ 859,500 per share and the class B common stock had an aggregate value of $ 170,181,000, viz, $ 171,900 per share.

C. State Law Issues

There are three basic methods for a shareholder to realize value from a corporation: (1) The redemption of stock, (2) the payment of dividends or distributions, and (3) a merger or liquidation in which stock is cashed out or exchanged for value. Consequently, the rights and privileges of the various classes of Advance stock determine the constraints on a purchaser of the Advance common stock in attempting to realize the value of his purchase. On February 29, 1980, a buyer of the Advance common stock could

have elected the board of directors. The preferred stock, however, could vote on and block corporate liquidation. On February 29, 1980, the Advance preferred stock could not be redeemed without the preferred shareholders' consent. The preferred stock could vote on any charter change that affected its class rights or gave new class rights or authorized a new class of stock. The preferred shareholders were entitled to 78 percent of all dividends declared out of current and retained earnings; the common stock was entitled to 22 percent.

The allocation of all the other rights and privileges pertaining to shareholders is unclear. The preferred shareholders might be entitled to participate equally in dividends declared from capital surplus. It is not clear whether a buyer of the Advance common stock could effect a merger to eliminate or cash out the preferred shareholders. It is also unclear what price the common shareholder would have to pay the preferred shareholders in an appraisal proceeding or a fair value proceedingunder New York law. The extent of the disagreement over the rights and privileges of the classes of Advance stock under New York law would be certain to result in litigation in the event that the common shareholder attempted to cash out the preferred stock through a merger or otherwise attempted to effect a constructive redemption or liquidation that returned less than 78 percent of the value of Advance to the preferred shareholders.

Petitioner's expert witnesses on New York law included Loeber Landau, a partner with Sullivan & Cromwell who specializes in corporate and securities law, Martin Lipton, a partner with Wachtell, Lipton, Rosen & Katz who specializes in corporate and securities law, and Robert H. Mundheim, Dean of the University of Pennsylvania Law School, whose area of expertise is corporate law. With the consent of respondent, petitioner also submitted reports without accompanying testimony from the law firm of Cravath, Swaine & Moore and from John McNally, a partner with the law firm of White & Case who specializes in corporate law.

Respondent's expert witnesses included Victor Brudney, a professor emeritus from Harvard Law School who taught finance and corporate law, Stanley Siegel, the associate dean of New York University Law School who teaches business planning, corporate finance, and tax, and John C. Coffee, Jr., a professor at Columbia University Law School who teaches corporate and securities law. With the consent of petitioner, respondent also submitted reports without testimony from Melvin A. Eisenberg, a professor of law at Boalt School of Law at the University of California at Berkeley, and James D. Cox, professor of law at Duke University.

The experts considered the relative rights and powers of the common and preferred shareholders. In preparing their reports the experts relied on the certificate, the 1974 shareholders' agreement, the New York Business Corporation Law (McKinney 1980) (the Business Corporation Law), and New York case law. The experts treated the class A common stock and the class B common stock as one block of identical shares for purposes of analyzing the relative rights of the common and the preferred stock. All the experts commenced their legal analysis from the standpoint of a prospective buyer of the common stock of Advance who would want to be able to realize value greater than his investment despitepossible hostility from the preferred shareholders.

1. Redemption

The Advance stock cannot be redeemed at the request of either the shareholders or the corporation except as permitted under the 1974 shareholders' agreement. The certificate would have to be amended to force a redemption of preferred stock. Although the certificate is silent on voting rights for amendments to the certificate, sections 804 and 801(b)(12) of the Business Corporation Law provide that an amendment to "fix, change or abolish" the "relative rights, preferences and limitations" of any shares of stock "including any provisions in respect of * * * the redemption of any shares" entitles the nonvoting shareholders to a class vote. Consequently, the preferred shareholders were entitled to a class vote on any proposed amendment to the certificate and by sheer numbers could have overruled any proposed amendment to the certificate adverse to their interests.

2. Dividends

The certificate requires that the common and the preferred shareholders participate pro rata in dividends. The common shareholder can receive only 1000/4500 or 22 percent of all dividends declared and paid out of earningswhile the preferred shareholders are entitled to 3500/4500 or 78 percent.

a. Source of Dividends

Section 4(a) of the certificate provides:

The holders of the Preferred Stock, the Class A Common Stock and the Class B Common Stock shall participate equally in proportion to the number of shares of such stock held by them respectively, whether Preferred Stock, Class A Common Stock or Class B Common Stock, in any and all dividends which may be declared and paid by the corporation out of its earnings. [Emphasis supplied.]

The experts disagreed about the common shareholder's entitlement to more than 22 percent of dividends declared from sources other than current or retained earnings such as from capital surplus. They also disagreed over whether the shareholder who forced a sale of assets would be entitled to more than 22 percent of dividends out of sales proceeds. The dispute focused in part over the characterization of the proceeds as earnings or capital surplus.

b. Stock Split or Stock Dividend

There were 1,000 shares of authorized and unissued common stock and 500 shares of authorized and unissued preferred stock on February 29, 1980. For the common shareholder to dilute the voting power of the preferred shareholders sufficiently to obtain the power to liquidate Advance, the certificate would have to be amended to authorize the issuance of new stock. Even if the common shareholder distributed all the authorized but unissued stock to himself, he would not have enough to force liquidation. Under New York law a stock split requires the approval of the shareholders. An attempt to dilute the voting power of the preferred shareholders through a stock split or a stock dividend would also require an amendment to the certificate.

New York law provides for preemptive rights to shareholders whose shares have unlimited dividend rights where the issuance of new shares would adversely affect the shareholders' dividend rights under section 622(b) of the Business Corporation Law. The experts disagreed whether a plan by the common shareholder to issue himself additional stock would give rise to preemptive rights in the preferred stock.

c. Nonpayment of Dividends

Despite the preferred shareholders' entitlement to 78 percent of declared and paid dividends, the common shareholder could, through his control over the board of directors, cease declaring dividends altogether. The experts disputed the extent that fiduciary obligations of the board to the preferred shareholders would limit their exercise of this power.

3. Liquidation or Merger

Under the terms of the certificate, the preferred shareholders are entitled to receive only $ 187.25 per share in the event of liquidation. All the experts assumed that a purchaser of the common stock would prefer liquidation as the means to extract the value of the investment and that the preferred shareholders would oppose liquidation.

a. Liquidation

Under New York law, liquidation requires a two-thirds majority. The experts agreed that as of February 29, 1980, the preferred shareholders were entitled to vote on the liquidation. Section 612(a) of the Business Corporation Law provides a vote for each share of stock of all classes of stock unless specifically denied by the certificate of incorporation. Because the right to vote on liquidation is not explicitly denied to the preferred shareholders, the statute authorizes a vote.

b. Mergers

The experts on both sides focused primarily on several possible merger transactions the common shareholder could employ to try to limit the preferred shareholders' rights. The objectives of any merger would be to dilute the preferred stock, to reduce its claim to dividends, and to eliminate the class. A vote on mergers is explicitly reserved to the common shareholders in the certificate. The possible mergers discussed were (1) the freeze-out merger, and (2) the freeze-in merger.

(1) Freeze-Out Merger

In a freeze-out merger, the common shareholder's goal is to force a merger that would require the preferred shareholders to exchange their Advance stock for cash. The common shareholder could then either retain his interest in the corporation, sell it, or liquidate it. Respondent's experts believed that the common shareholder could implement this plan because the common stock controls the election of the board of directors and has practical control over the board's decisions. The freeze-out merger would merge Advance into a corporation owned by the common shareholder or the purchaser. The common shareholder would exchange Advance common stock for the stock of the acquirer while the preferred shareholders exchanged their stock for cash. The experts disagreed about whether such a merger would be allowed over the objections of the preferred shareholders. Section 903(a)(2) n8 of the Business Corporation Law provides for a class vote if a plan for merger contains an amendment to the certificate which would entitle the shareholders of that class to vote. Business Corporation Law sections 804(a)(2) n9 and 801(b)(12) n10 provide a class vote on amendments that change or abolish the relative rights and preferences of any shares of stock. In light of these rights, the historical participation of the preferred shareholders in directing corporate affairs, their understanding that the shares were of equal value, on the one hand, and the common stock's right to elect the board of directors, approve sales of assets, and approve mergers, on the other, the experts dispute whether the preferred shareholders would have a class vote on the proposed merger, and, if they did not, whether the freeze-out merger would be allowed under New York law.

n8 Sec. 903(a)(2) provides that notwithstanding any provision in the certificate of incorporation:

the holders of shares of a class or series shall be entitled to vote and to vote as a class (on a merger) if the plan of merger * * * contains any provision which, if contained in an amendment to the certificate of incorporation, would entitle the holders of shares of such class or series to vote and to vote as a class thereon. In such case, in addition to the authorization of the merger * * * by vote of the holders of two-thirds of all outstanding shares entitled to vote thereon, the merger * * * shall be authorized by vote of the holders of a majority of all outstanding shares of each class or series.

n9 Sec. 804(a) provides a class vote on a certificate amendment that would:

(1) Exclude or limit their right to vote on any matter, except as such right may be limited by voting rights given to new shares then being authorized of any existing or new class or series.

(2) Change their shares under subparagraphs (b)(10), (11) or (12) of section 801 * * * or provide that their shares may be converted into shares of any other class or into shares of any other series of the same class, or alter the terms or conditions upon which their shares are convertible or change the shares issuable upon conversion of their shares, if such action would adversely affect such holders, or

(3) Subordinate their rights, by authorizing shares having preferences which would be in any respect superior to their rights.

n10 Secs. 801(b)(10), (11), and (12) referred to in sec. 804(a)(2) apply to certificate amendments that would:

(10) * * * reduce the par value of any authorized shares of any class with par value, whether issued or unissued.

(11) * * * change any authorized shares, with or without par value, whether issued or unissued, into a different number of shares of the same class or into the same or a different number of shares of any one or more classes or any series thereof, either with or without par value.

(12) * * * fix, change or abolish the designation of any authorized class of any series thereof or any of the relative rights, preferences and limitations of any shares of any authorized class or any series thereof, whether issued or unissued, including any provisions in respect of any undeclared dividends whether or not cumulative or any sinking fund for the redemption or purchase of any shares, or any preemptive right to acquire shares or other securities.

(2) Freeze-In Merger

In a freeze-in merger, the common shareholder exchanges his Advance stock for cash or stock in an acquiring company while the preferred shareholders retain their Advance stock. This proposal would be intended to dilute the preferred shareholders' ability to block liquidation, by authorizing and issuing at least 6,000 new shares of voting common. The Advance common stock would be traded to the acquiring company in exchange for its stock. Because the common shareholder would then hold 7,000 shares of stock, a liquidation could be accomplished over the objection of the preferred shareholders. Although the preferred shareholders would retain their stock, they would have lost their ability to influence the affairs of Advance and would be susceptible to redemption. The acquiring corporation would then be able to overpower the preferred shareholders and liquidate Advance. As with the freeze-out merger, the experts disputed whether the freeze-in merger would be allowed over the objections of the preferred.

D. Valuation Opinions

In order to demonstrate the correct value of the Advance common stock, the parties introduced the testimony of several experts. Peter Fahey and Gary Gensler, partners with the investment banking firm of Goldman Sachs & Co., prepared reports and testified for petitioner about the fair market value of the Advance common stock. n11 Petitioner also introduced the reports and testimony of Robert J. Harrity of Chemical Bank on the value of the common stock, and David Wilkofsky of Wilkofsky, Gruen Associates, Inc., on the general economic conditions of the newspaper and magazine publishing industries in 1979 and early 1980. Rupert Murdoch, the chief executive officer of The News Corp., a newspaper and magazine publishing company, and Douglas McCorkindale a vice president of Gannett Corp., a media company, both testified about the criteria a buyer would use in considering the purchase of the Advance common stock. n12 Respondent introduced the report and testimony of Joseph P. Baniewicz, a financial analyst for the Internal Revenue Service.

n11 Respondent challenged the expertise of the Goldman Sachs employees because they are "graduates of business schools with no formal education in the valuation of stock." Fahey and Gensler testified that they routinely value stock in closely held corporations in order to advise their clients on possible purchases or sales. We do not share respondent's doubt as to their qualifications.

n12 Respondent challenged the relevance of the testimony of Murdoch and McCorkindale because neither wanted to purchase the Advance stock. It is their views on the considerations warranted in analyzing the potential purchase of the Advance common stock, not whether they would in fact have purchased the stock, that interest us.

According to the experts from Goldman Sachs and Chemical Bank, there were a number of factors that would have influenced a prospective buyer of the Advance common stock. Some, such as the capital structure and uncertain relative rights and limitations of the Advance stock, were internal to Advance. Others, such as the particular economic conditions of the newspaper and magazine publishing industries and the general negative economic mood of 1979 and early 1980, were external to Advance. The size and financial strength of Advance itself, particularly in comparison with other newspaper and magazine publishing companies, would have been a consideration for a prospective willing buyer. Finally, the most likely willing buyers would have faced other concerns, suchas antitrust considerations or difficulties complying with Federal Communications Commission regulations, that would have affected the ultimate selling price.

1. General Economic Conditions

In late 1979 and early 1980, high inflation and "record high" interest rates predominated. Many economists were uncertain or pessimistic about the near future, forecasting an economic slowdown or recession. The 1979 decision of the Federal Reserve Board to manage the supply of money rather than interest rates resulted in a sharp rise in interest rates. Although the economy had experienced a period of growth after the recession of 1974-1975, in 1979 economic growth slowed again, as inflation rose rapidly and interest rates soared. The gross national product grew at an annual rate of only 1.2 percent in constant dollars in the first half of 1980; unemployment was high and was expected to rise, and oil prices were increasing.

One of the byproducts of the tightening money supply and unrestrained interest rates was a new attitude of wariness and reluctance to lend on the part of many banks and lending institutions. In late October of 1979, the Chairman of the Federal Reserve Board warned banks against making "nonproductive" takeover loans. Due to the negative economic outlook, the late 1970's experienced a decline in merger activity. Of the acquisitions for which data was disclosed, only 2 percent of the private companies acquired in the first half of 1980 were sold for more than $ 100 million.

2. Industry Economic Conditions

The economic malaise of the country affected the newspaper and magazine publishing industry. Although revenues rose, the increase was consumed by inflation. The newspaper publishing industry was considered "mature" by the late 1970's. The markets for Advance's newspapers had been fully penetrated, and newspaper circulation was expected to remain fairly constant and stable.

The newspaper and magazine publishing industry also suffered from the growing competition of television in late 1979 and early 1980. Local advertising revenues were increasingly devoted to television at the expense of newspapers, particularly evening newspapers, and, in 1980, newspaper advertising revenues were expected to decline, in real terms. The popularity of evening newspapers had begun to be displaced by the television evening news. Most of the large newspaper publishing companies were acquiring holdings in the broadcast media to diversify away from the newspaper business. Furthermore, the use of "preprints," printed advertising inserts that were slipped into the newspapers for a fee, grew in the later 1970's. The fee brought in from preprints was less than the revenue that straight advertising would have generated. The preprint publishers competed with newspaper publishers for advertising dollars.

Economic conditions discouraged advertising expenditures. Television was becoming a considerable rival for local advertising dollars and cable television was expected to continue the trend as independent television stations competed for local advertising dollars. The annual growth rate for total newspaper advertising dropped from 13.5 percent in 1979 to 6.7 percent in 1980 although retail spending growth only declined from 14.9 percent in 1979 to 10.9 percent in 1980. Furthermore, much of the growth that did occur in advertising in 1979 and 1980 came from increased use of preprints and did not significantly benefit the newspaper publishing companies.

Due to adverse economic conditions, total newspaper circulation per adult declined between 1975 and 1980 and the rate of that decline increased in 1979 and 1980. The decline in circulation was largely attributable to the decline in evening newspaper readership. Similarly, circulation revenue grew between 1975 and 1978 but then tapered off and actually declined by 5.1 percent in 1980.

The costs of newsprint and production labor rose, as the total spending on newspapers was decreasing in 1979 and 1980. Total expenditures for newsprint rose in 1979, outpacing the increase in newspaper revenues from 1979 to 1980. Although labor costs were suppressed by labor contracts predating the period of acute inflation, the labor contracts also delayed automation by requiring newspaper publishing companies to retain costly labor-intensive printing processes. Additionally, the decrease in bulk mail rates in 1978 caused an increase in direct mail advertising which, in turn, cut into newspaper advertising revenue.

The health of the magazine publishing industry also weakened in the late 1970's and early 1980. Because magazine advertising is national, magazine publishing industry conditions reflected the overall economic conditions. A slowdown in advertising expenditures began in 1979 and worsened in 1980. Magazine circulation dropped at the same time. Finally, the Wilkofsky report mentioned that in 1979 and 1980 the growth in production labor costs exceeded the growth in magazine revenues.

3. Competitive Position

Many of Advance's newspaper properties were situated in economically depressed markets that suffered from low population growth and high unemployment. Many of the markets in which Advance operated newspapers were extremely competitive. Additionally, in its 22 newspaper markets, Advance operated 10 morning newspapers, 19 evening newspapers, and 21 Sunday newspapers, so, in all but three of its markets, Advance had evening newspapers. In over half its markets Advance published no morning paper. In 1979, Advance's revenues increased by only 4.1 percent though inflation grew at the rate of 11.3 percent. Operating margins for Advance's newspaper properties declined from 21.6 percent in 1978 to 18 percent in 1979, resulting in a 13-percent decline in operating income for 1979. Furthermore, the rate of increase in total advertising linage decreased and total circulation actually decreased. For Advance's aggregate operations, operating income fell by $ 14 million from 1978 to 1979 and the operating margin decreased from 17.8 percent in 1978 to 14.8 percent in 1979.

Advance's subsidiary, Conde Nast, published seven consumer magazines that were predominantly fashion oriented. Although revenues were increasing in 1979, costs were increasing faster. Conde Nast's operating cash-flow margin declined from 14 percent in 1977 to 7.8 percent in 1979.

4. Size of Advance

As of February 29, 1980, Advance was the fourth largest newspaper and magazine publishing company in the United States. On December 31, 1979, Advance had a consolidated book value of $ 505,400,000 and retained earnings of $ 475,969,000. At that time, only seven or eight corporate acquisitions for more than $ 1 billion had ever occurred, and there had been no acquisitions of more than $ 350 million in the media industry. n13

n13 In 1976, the Herald Co., a subsidiary of Advance, acquired Booth Newspapers, Inc., for $ 304,588,598.

In early 1980, before leveraged buy-outs gained wide popularity, Advance could have borrowed an amount requiring interest obligations of not more than two-thirds of its operating income or, under the prevailing interest rate of 18 3/4 percent, $ 565 million. Because Advance had planned capital expenditures of $ 228 million, the remaining $ 337 million would be available to be distributed to the shareholders. Of this amount, only 22 percent would belong to the common shareholder.

5. Legal Uncertainty

A prospective buyer of the Advance common stock would want to know the rights of the preferred shareholders to gauge what corporate affairs the common stock could control and to project how to maximize the value of the investment. The prospective buyer would have received contradictory expert legal opinions on the relative rights and privileges of the common and preferred stock. This uncertainty would significantly depress the purchase price of the common stock. The prospective buyer would have been sure of protracted and expensive litigation. A substantial likelihood of considerable delay in

effecting plans to cash-out the preferred existed. The litigation might take between 6 and 10 years to resolve in New York courts, and substantial probability existed that any action taken by the common shareholder to defeat the claims of the preferred shareholders would be blocked. Furthermore, because interest rates in February 1980 were extraordinarily high and the size of Advance would require financing, the carrying costs of the purchase would be enormous.

6. Antitrust and FCC Difficulties

Generally, only a media business would be interested in purchasing Advance. Because only a very sizable media business could afford to buy Advance, it would be likely that some of the potential buyer's newspaper and magazine markets would overlap with some of Advance's newspaper and magazine markets. This would raise potential problems under both the antitrust laws and the Federal Communications Commission (FCC) regulations.

The operative antitrust law looks to whether a purchase might lessen competition, and the Department of Justice monitored newspaper acquisitions with particular scrutiny in 1980. A newspaper and magazine publisher that bought the Advance common stock would probably need to sell some current holdings or sell off some of Advance's assets after the purchase. As with antitrust, the FCC cross-ownership rules might require the buyer to sell certain assets.

7. Accounting Problem

The experts disagreed that, if the buyer were a corporation, the common shareholder could not report in its consolidated earnings the full amount of Advance's earnings and profits without, at a minimum, disclosing that the preferred shareholders were entitled to 78 percent of declared dividends out of those earnings. If a corporate buyer of Advance's common stock were to attribute more than 22 percent of Advance's earnings to the common stock interest, the financial statements would not comport with generally accepted accounting principles and would result in a qualified opinion on the buyer's consolidated financial statements. Such a qualified opinion would be unacceptable to users of the financial statements, including, for example, lenders, shareholders, and if the buyer's stock was publicly traded, the public.

II. VALUE OF N.B. CO. COMMON STOCK

N.B. Co. is a corporation that was organized under the laws of the State of New York in August 1944. On February 29, 1980, its principal place of business was located in Syracuse, New York. N.B. Co., either by itself or through wholly owned subsidiary corporations, operated television broadcasting, radio broadcasting, cable television, and microwave businesses. N.B. Co. operated radio and television broadcasting stations in Syracuse, New York; Elmira, New York; Birmingham, Alabama; Harrisburg, Pennsylvania; and St. Louis, Missouri. N.B. Co. operated cable television companies in many localities in New York State n14 and in Corapolis, Pennsylvania; Canonsburg, Pennsylvania; and Anniston, Alabama. N.B. Co. operated microwave stations in New York, New Hampshire, New Jersey, Ohio, Massachusetts, Vermont, Pennsylvania, and Alabama. As of February 29, 1980, N.B. Co. had contracted to sell all of its television broadcasting stations. The total value of N.B. Co. on the valuation date was $ 206,361,416.

n14 These are: Carthage, Corning, Delhi, Fulton, Malone, Massena, Ogdensburg, Oneonta, Potsdam, Rome, Sidney, Syracuse suburbs, Troy, Binghamton, Vestal/Endicott, Cooperstown, Franklin, Milford, New Berlin, Oxford, and Richfield Springs.

N.B. Co.had one class of stock authorized. As of February 29, 1980, 225 shares of voting common stock were authorized and outstanding, owned as follows:

Shareholder	No. Shares	Percentage
Petitioner	100	44.44
S.I., Jr.	60	26.67
Donald	60	26.67
Mitzi	5	2.22

In its estate tax return, petitioner valued the N.B. Co. stock at $ 68.3 million based on a valuation report prepared by Chemical Bank.

OPINION

I. VALUE OF ADVANCE COMMON STOCK

The first issue for our decision is the value of Newhouse's 10 shares of class A common stock and 990 shares of class B common stock as of February 29, 1980. A derivative issue is the value, for purposes of the marital deduction, of 300 shares of class B common stock.

Property is included in the gross estate at its fair market value, which 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 to sell and both having reasonable knowledge of relevant facts." Sec. 20.2031-1(b), Estate Tax Regs.; United States v. Cartwright, 411 U.S. 546, 551 (1973). If the property is stock that is not listed on an exchange andcannot be valued with reference to bid and asked prices or historical sales prices, the value of stock in comparable corporations engaged in the same or similar line of business must be considered. Sec. 2031(b). Also considered are the corporation's management, net worth, earnings, and ability to pay dividends. Estate of Leyman v. Commissioner, 40 T.C. 100, 119 (1963), remanded on other grounds 344 F.2d 763 (6th Cir. 1965).

The determination of the fair market value of property is a question of fact. Hamm v. Commissioner, 325 F.2d 934, 938 (8th Cir. 1963), affg. a Memorandum Opinion of this Court. At trial, we received opinion evidence testimony from many expert witnesses, and we weigh that testimony in light of the expert's qualifications as well as all the other credible evidence. Estate of Christ v. Commissioner, 480 F.2d 171, 174 (9th Cir. 1973), affg. 54 T.C. 493 (1970); Estate of Gilford v. Commissioner, 88 T.C. 38, 56 (1987). Nonetheless, we are not bound by the opinion of any expert witness and will accept or reject expert testimony in the exercise of sound judgment. Helvering v. National Grocery Co., 304 U.S. 282, 295 (1938); Estate of Hall v. Commissioner, 92 T.C. 312, 338 (1989).

Respondent's Revenue Ruling 59-60, 1959-1 C.B. 237, has been widely accepted as setting forth the appropriate criteria to consider in determining fair market value; it lists the following factors to be considered:

(a) The nature of the business and the history of the enterprise from its inception. (b) The economic outlook in general and the condition and outlook of the specific industry in particular. (c) The book value of the stock and the financial condition of the business. (d) The earning capacity of the company. (e) The dividend paying capacity. (f) Whether or not the enterprise has goodwill or other intangible value. (g) Sales of the stock and the size of the block of stock to be valued. (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter. [1959-1 C.B. at 238-239.]

Only facts reasonably known at the valuation date may serve as the basis for valuation. Estate of Gilford v. Commissioner, 88 T.C. 38, 52-53 (1987). Generally, valuations based on subsequent events whose occurrence was not foreseeable at the time of the valuation date are not helpful. Messing v. Commissioner, 48 T.C. 502, 509 (1967). n15 The willing buyer is a purely hypothetical figure and valuation does not take into account the personal characteristics of the actual recipients of the stock. Estate of Bright v. United States, 658 F.2d 999, 1006 (5th Cir. 1981). The hypothetical willing buyer and seller are presumed to be dedicated to achieving the maximum economic advantage. Estate of Curry v. United States, 706 F.2d 1424, 1429 (7th Cir. 1983). This advantage must be achieved in the context of market conditions, the constraints of the economy, and the financial and business experience of the corporation existing at the valuation date. Moreover, in valuing stock,the rights, restrictions, and limitations of the various classes of stock must be considered. n16

n15 Subsequent events affecting the character or quality of the property to be valued should be distinguished from subsequent market activity which can provide helpful comparable sales.

n16 See Estate of Anderson v. Commissioner, T.C. Memo. 1988-511. E.g., Estate of Van Horne v. Commissioner, 78 T.C. 728 (1982), affd. 720 F.2d 1114 (9th Cir. 1983).

A. State Law Issue

A willing buyer would want to know the relative rights and powers of the two classes of common stock and one class of preferred. If the rights and powers of the preferred stock are sufficient to significantly limit the ability of the common stock to control the company and its assets, then the value of the common stock will be significantly less than if the common enjoyed full and unrestricted control over corporate affairs. The parties agree that the common stock controls the board of directors and, by extension, the management of the business and that the preferred shareholders have the ability and the motivation to block a proposed liquidation.

Respondent believes that the common stock, through other means than by liquidation, could arrogate to itself substantially all of the value of Advance. Respondent proffers the "subtraction method" of valuation, i.e., value the whole of Advance, value the preferred, and the difference equates to the value of the common. Petitioner argues that the common stock does not control Advance, and the preferred is entitled to 78 percent of dividends declared out of earnings. Consequently, the preferred is worth far more than respondent believes. Moreover, petitioner argues, the extent of the common stock's rights to force the preferred out of Advance are unclear at best. With this uncertainty, the value of the common stock is substantially less than respondent determined.

1. Redemption

The certificate could be amended to allow redemption of the preferred stock only with the consent of the preferred shareholders. Respondent's experts do not dispute the power of the preferred shareholders to block an amendment that could force redemption of the preferred stock. The common shareholder cannot force the redemption of preferred stock.

2. Dividends

The experts from both sides presumed that a buyer of petitioner's common stock would want to eliminate or at least limit the preferred shareholders' rights to 78 percent of declared dividends. They discussed several ways of doing this.

a. Source of Dividends

The experts agree that all shareholders participate pro rata in dividends declared out of earnings. Respondent's experts, Coffee and Siegel, believe that the certificate's allocation of dividends among the shareholders limits the preferred shareholders to a fully participating share only from those dividends paid out of earnings or earned surplus. n17 The preferred would not, in their view, participate in distributions of capital surplus, ordinarily available as a source for dividends under New York law. n18 Siegel and Coffee concluded that the common shareholder could receive dividends paid out of capital surplus, for example, by borrowing against assets and distributing the cash to the common shareholder without sharing the distribution with the preferred shareholders.

n17 Under New York law, "earnings" is defined as the corporation's income in a current year, "earned surplus" is defined as retained and undistributed earnings from prior years, and "capital surplus" is defined as unrealized appreciation in assets.

n18 Sec. 510 of the Business Corporation Law permits a corporation to make dividend distributions in cash, property, or bonds unless to do so would make the corporation insolvent, would violate a term of the corporate charter, or would reduce the value of net assets remaining in the corporation below the value of stated capital.

Petitioner's expert, Mundheim, disagreed and opined that the certificate does not speak at all about dividends paid from sources other than earnings. Alternatively, Mundheim noted, the language could mean that no shareholder, preferred or common, could receive dividends paid out of capital surplus. Mundheim explained that under New York corporation law there is a general underlying assumption that all shares are considered equal and therefore, differences between various classes of stock must be specifically designated and will not be inferred. Mundheim concluded that because the meaning was ambiguous, a New York court would construe the certificate against the background of the general rule that classes of stock are different only to the extent the differences are explicit, and would conclude that the two classes of stock should participate pro rata as to dividends from sources other than earnings as well.

Regardless of the source of dividends, the experts on both sides agreed that a prospective buyer of the Advance common stock would want to circumvent the preferred shareholders' right to 78 percent of declared dividends. To avoid paying the major portion of dividends to the preferred shareholders, the common shareholder would have to alter the preferred shareholders' rights and privileges, but the experts disagreed about whether the common shareholder could succeed.

b. Stock Split or Stock Dividend

Mundheim also concluded that because an amendment to increase the number of shares held by the common shareholder would clearly impinge on the voting rights of the preferred stock, the preferred shareholders would be allowed to vote against the proposed amendments under sections 801(b)(12) and 804 of the Business Corporation Law. Respondent's experts agree that the common shareholder would be unable to effect a stock split or stock dividend without the consent of the preferred shareholders.

c. Preemptive Rights

Shareholders generally have preemptive rights where the issuance of new shares would adversely affect their dividend rights. Coffee, respondent's expert, argued that the preferred shareholders would not have preemptive rights to acquire unissued or treasury shares of stock pursuant to exceptions to section 622(b) of the Business Corporation Law. As of February 29, 1980, Advance had no treasury shares and if all authorized common stock were issued it would not give the common shareholder the power to liquidate Advance. Because section 622 also provides an exception for the issuance of new shares necessary for a merger or consolidation, Coffee believed that new shares could be issued to the common shareholder pursuant to a plan of merger and could dilute the preferred shareholders' control over liquidation.

Lipton, petitioner's expert, countered that Coffee's maneuver would be viewed, not as necessary to effect a merger, but as an attempt to derogate the preferred shareholder's rights. A New York court, in Lipton's view, would not permit the dilution of the preferred stock.

d. Nonpayment of Dividends

Coffee noted that the board of directors could stop paying dividends. He argued that a decision by the board of directors to curtail or cease the payment of dividends would be difficult to overturn because New York courts are highly disinclined to review a corporation's dividend policy. According to Coffee, in order to force the board of directors to pay dividends in New York, a shareholder must show that the nonpayment expressed hostility to the shareholders directly and that the failure to pay dividends was detrimental to both the shareholders and the corporation. Coffee further noted that Advance's past dividends had historically been low in relation to its earnings and that a preferred shareholder would find it particularly difficult to force a hostile board of directors (elected by the common) to pay dividends.

The Cravath, Swaine & Moore report submitted by petitioner maintained that an abrupt cessation of dividends without a demonstrable business purpose might constitute a breach of the directors' fiduciary duties. Furthermore, although the nonpayment of dividends may be burdensome to the preferred shareholders, it has an obvious correlative detriment for the common shareholder's extraction of corporate profits. n19

n19 Siegel suggests that the common shareholder might avoid the hardship of the cessation of dividends by paying himself a handsome salary but such a possibility implies that the common shareholder is an individual, not a corporation, and thus, impermissibly relies on personal characteristics of a particular willing buyer. See Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981).

The common shareholder could not force a redemption of the preferred stock and probably could not issue more stock to himself to dilute the preferred shareholders' voting power. Finally, the board of directors elected by the common shareholder might not be allowed to cease all dividends.Therefore, the

common shareholder's ability to defeat the claims of the preferred shareholders to 78 percent of earnings is subject to considerable doubt.

3. Liquidation or Merger

All of the experts considered liquidating or merging the corporation as a way to disenfranchise the preferred shareholders.

a. Liquidation

The experts proceeded on the assumption that the preferred shareholders would not agree to a liquidation because the certificate sets a liquidation preference for the preferred stock at only $ 187.25 per share. Because the preferred shareholders are entitled to vote on liquidation, they could prevent it. This assumption comports with economic reality.

b. Mergers

The experts disagreed at all points on whether the common shareholder could dispose of the preferred shareholders by freeze-out or freeze-in merger.

(1) Freeze-Out Merger

Mundheim and Landau, petitioner's experts, noted several problems with the proposed freeze-out merger, structured as an acquisition by a third-party corporation. Mundheim and Landau found a significant likelihood that, under New York law, the preferred shareholders as a class would be entitled to vote ona freeze-out merger notwithstanding the fact that the certificate expressly reserves voting power over mergers to the common shareholder. Cravath, Swaine & Moore agreed, noting that a merger that threatened to diminish the preferred shareholders' entitlement to dividends or required the preferred shareholders to exchange their stock for cash would trigger a class vote. If the proposed freeze-out merger were viewed as a forced redemption, because its effect is to abolish the rights of the preferred, a class vote would be triggered because the preferred would be entitled to vote if the forced redemption were attempted in the form of an amendment to the certificate. Lipton also observed that the freeze-out merger amounts to a de facto forced redemption which is not permitted under the certificate. He opined that the common stock could not accomplish by indirect means what is forbidden by direct means.

Landau also noted that the historical development of the rights and privileges of the two classes of stock from the original certificate through the various amendments shows that the preferred shareholders were increasingly given a participating role through the capital structure. Landau concluded that the preferred shareholders were given equal status with the common shareholders in sharing the future earnings of Advance.

Respondent's experts disagreed that the preferred shareholders would be entitled to a class vote in the event of a freeze-out merger. Coffee based his conclusion on his analysis that the statutory language refers only to situations in which the "relative rights, preferences, or limitations" of the minority shares are changed and not to the total cancellation of the stock. He argued that:

the purpose of both sections 804 and 903 is to protect continuing shareholders against a change in their legal rights, not to prevent the voting majority from cashing out another class. The danger addressed by these sections was that of being locked in under a new and different legal regime, not that of being frozen out.

Coffee noted that not only does the statute protect minority shareholders from abuse by the majority shareholder, but it also protects the majority shareholders from unreasonable minority shareholders. Brudney and Siegel echoed Coffee's reasoning in their reports.

Petitioner's experts doubted whether such a transaction could pass muster under the New York requirement of fiduciary care on the part of the board of directors toward the shareholders, especially if the merger had no business purpose. Mundheim noted "under New York law, directors and controlling shareholders, such as the holder of Advance's common stock, have broad fiduciary responsibilities and may not direct the affairs of the corporation so as to favor themselves at the expense of other shareholders." Landau agreed. Mundheim concluded that because such a merger would have no purpose other than to force out the preferred shareholders for the exclusive benefit of the common shareholder, a New York court would not uphold it. Cravath, Swaine & Moore's report stated that where the corporate structure clearly protects the preferred shareholders' right to prevent liquidation, a court would not allow the board of directors to accomplish indirectly what they could not do directly.

Mundheim determined that a freeze-out merger could violate the New York requirements of procedural and substantive fairness. The leading New York case, Alpert v. 28 Williams Street, 63 N.Y.2d 557, 483 N.Y.S.2d 667, 473 N.E.2d 19 (1984), imposes an overall equitable requirement that a freeze-out merger must have an "independent corporate purpose for the merger" and include a fair price for the shareholders who are being frozen out. Mundheim noted that the court in Alpert ruled that a fair cash-out price would be "reasonably related to the value that might be set by an appraisal proceeding" and offered five factors for determining that amount. n20 Mundheim stated that it was impossible to be sure at the date of purchase of the common stock what fair value the New York courts might set for the preferred stock. While it was unclear whether a New York court would aim for the going concern price or the liquidation price in setting fair value, he noted that under recent New York cases, fair value might not be restricted by contractual provisions. In Mundheim's view a court might look beyond the stated liquidation preference amount and historical dividends and decide that the preferred and the common stock were fundamentally equal.

n20 The five factors listed in Alpert v. 28 Williams Street, 63 N.Y.2d 557, 483 N.Y.S.2d 677, 665, 473 N.E.2d 19 (1984), are net asset value, book value, earnings, market value, and investment value.

Lipton opined without equivocation that the preferred would be entitled to 78 percent of the going concern value of the corporation because "the terms of the Preferred Stock were specifically engineered to ensure that the holders of the Preferred Stock share proportionately in whatever level of pay-out the Company as a going concern makes on its capital stock." Lipton also suggested that a court might determine that the common shareholder had breached his fiduciary duties if, in negotiating the terms of the proposed merger, the common shareholder allocated more than 22 percent of the purchase price to the common and gave the preferred shareholders less than 78 percent of the purchase price.

Respondent's experts did not believe that the proposed freeze-out merger would violate those fiduciary duties. Eisenberg noted that under New York law, preferred stock is purely a creation of contract law and that the only fiduciary duty running to a preferred shareholder is the duty to satisfy the contractual entitlements. Since the proposed merger would not violate any of the Advance preferred shareholders' existing contractual rights, he reasoned they would have no grounds to complainof unfair treatment.

Respondent's experts concluded that although the preferred shareholders were entitled to receive fair value in the event of a freeze-out merger, the courts would not be inclined to value the rights of the preferred shareholders at 78 percent of the total value of the corporation. Coffee believed that a New York court would not derive fair value by measuring the corporation's going concern value but rather would compute the weighted average of the liquidation preference, the historical dividends, the book value per share, and the recent earnings history. Furthermore, Coffee noted that even if the court disagreed with the figure offered by the common shareholder, it would simply require that a higher price be paid, still allowing the transaction to proceed.

Brudney believed that a New York court would be most influenced by the historical dividend stream in computing fair value for the preferred stock. Because Advance has historically always reinvested the bulk of its earnings and paid minimal dividends, he opined, the preferred shareholders are on notice that they are entitled to no more than a future projection of historical dividends, or "the capitalized value of an annual amount equal to the dividend paid to [the preferred shareholders] during the last several years." Siegel concluded that fair value would lie between the liquidation preference amount of $ 187.25 per share and a number representing maximum possible dividend participation in Advance as a going concern.

Finally, all the experts agree that not only would a merger have to be fair but the transaction would have to have a business purpose that would benefit Advance as a whole and not just the controlling shareholder. Nonetheless, the experts disagreed about what constitutes a valid business purpose under New York law.

If the freeze-out were perceived as little more than an attempt to dispossess the preferred shareholders as cheaply as possible, petitioner's expert, Mundheim, believed it would not be sustained by a New York court. Mundheim explained that in the proposed freeze-out "there would be no independent corporate purpose -- no improvement in management, no increase in capitalization, simply a reshuffling of the corporate structure for the exclusive benefit of the Common Stock at the expense of the to-be-ousted Preferred Stock." McNally agreed that a New York court would not consider the removal of the preferred shareholders for the sole benefit of the common shareholder to be a sufficient business purpose.

Respondent's expert, Coffee, agreed that the New York courts require a business purpose but argued that it does not have to be substantial. As a possible business purpose, Coffee suggested the need to avoid Advance's future obligation to redeem the preferred shares at the death of the shareholders, or the need to be able to redeem the preferred shares in the event of a future transfer by an existing shareholder in order to remain a closely-held corporation. Coffee also recommended the need to avoid hostility and dissension among the shareholders as a valid business reason.

(2) Freeze-In Merger

The objective of this transaction would be to dilute the preferred stock by issuing proportionately more common in the course of the merger while leaving the preferred stock in place. The dilution would have to be sufficient to give the common the ability to liquidate Advance over any objection by the preferred. Petitioner's experts, Landau and Mundheim, determined that like the freeze-out merger, the freeze-in merger would alsotrigger the class vote under sections 801(b)(12) and 804 of the Business Corporation Law. Although the freeze-in merger would appear to leave the rights and preferences of the preferred stock unchanged, Landau and Mundheim believed that a New York court would not stop at a superficial

analysis. Because the rights of the preferred would in effect be dramatically reduced by the presence of an increased number of voting common shares, the statute would impose a class vote. Respondent's experts disagree because the form of the transaction leaves the preferred shareholders untouched.

Acknowledging that there are no dispositive New York cases on this point, Mundheim warned that the freeze-in merger would be subject to the same judicial requirements of business purpose and procedural and substantive fairness, as well as fiduciary duties, as the freeze-out merger. Mundheim concluded that a New York court would not be satisfied that the transaction had a business purpose.

Respondent's expert, Siegel, stated that "There appears to be no reason why the business purpose test, as applied under New York law, would be applied more restrictively to a freeze-in than to a freeze-out."Coffee agreed that although the preferred shareholders in a freeze-in merger would have to be treated equitably and the preferred stock could not be diluted unfairly, "the burden on the plaintiffs attacking such a [freeze-in] merger would be substantially higher than in the case of a 'freeze-out' merger." Coffee and Eisenberg surmised that if the preferred shareholders were guaranteed the continuation of the historic dividend rate as a part of the terms of the merger they would have no grounds to complain of mistreatment. Coffee also suggested that if the board of directors were composed of persons who were neither shareholders nor corporate management, their actions would be substantially immunized from derivative suits by minority shareholders.

As Mundheim noted, considering the size of Advance, the purchaser would have to capitalize the acquiring corporation in the proposed merger very heavily. Furthermore, although the common shareholder would want the freeze-in to be done quickly because the Advance preferred shareholders would be entitled to 78 percent of declared dividends until the merger was approved and the carrying costs of the investment in the common would be significant,the inevitable litigation would foreclose any quick accomplishment of the merger.

(3) Waiting Out the Preferred

Respondent's expert witnesses suggested that the buyer of Advance common stock could ultimately acquire complete control by buying the preferred stock as it is transferred from the existing preferred shareholders to new owners. Coffee outlined a plan which could be employed in lieu of the mergers: first, the common shareholder would replace the board of directors, suspend the payment of all dividends, fire the family members, and issue all the authorized but unissued stock to himself in exchange for property of equal value. As the preferred shareholders died or attempted to transfer their stock to third parties, the corporation could purchase it, exercising the rights set forth in the 1974 shareholders' agreement. Then the new common shareholder would approach each remaining preferred shareholder and offer to buy his stock at a certain price, "explaining that he did not intend to acquire all the Preferred Stock, but only enough to give it two thirds voting control. The risks of being a holdout and the prospect of eventual liquidation could also be politely explained." Rather than be the last preferred shareholder holding less than one-third of the total outstanding stock and having to accept the contractual liquidation value of $ 187.25 per share, Coffee believed that, in light of the advanced ages of Norman, Ted, and Mitzi, each preferred shareholder would be willing to sell his stock to the common shareholder quickly, or, alternatively, the preferred shareholders would acknowledge the futility of resisting and agree to a common sales price.

Siegel suggested more strongly coercive techniques for ousting the preferred shareholders such as selling off Advance assets for less than the highest market value either alone or in conjunction with a third party. Siegel indicated that it might not be necessary to actually engage in such transactions because it might be enough to "vaguely and darkly threaten such tactics to maximize the pressure on the Preferred Stock's holders." Time, Siegel concluded, would be on the side of the common shareholder because three of the preferred shareholders were elderly. Coffee also opined that the 1974 shareholders' agreement makes it inevitable that ultimately the corporation will be able to acquire allof the preferred stock and that preferred shareholders would choose to sell their stock to the corporation rather than risk having to accept liquidation value of $ 187.25 per share. Coffee noted that once the shares had been reacquired by the corporation, they could be issued to the common shareholder without invoking preemptive rights which do not apply to treasury shares under New York law.

Petitioner's experts explained that a buyer of the Advance common stock would be very unsure of his rights and powers to effect the major corporate restructuring and of the rights of the preferred shareholders to block his efforts. Angered preferred shareholders would bring legal action seeking either injunctive relief or the recision of the transaction. Further obfuscating any predictable outcome of litigation, the experts disagreed on whether a New York court would entertain parol evidence of the understandings of the Newhouse family members about the relative rights and powers of shareholders or how much weight the court would give it. Lipton noted that faced with legal uncertainty of such magnitude, a buyer would insist on indemnification and other protections against the claims of the preferred shareholders. An indemnification provision would depress the value the hypothetical willing seller would receive.

Petitioner's experts believed that a buyer of the common stock who cannot also purchase the preferred stock would be in a precarious situation. The report from Cravath, Swaine & Moore described the situation as analogous to:

the relationship between a person who owns a house surrounded by someone else's land and the surrounding landowner. * * * neither the holders of the Preferred Stock nor the holders of the Class B Common Stock have an easement to realize the full value of their interests in the Company, but the holders of the Class A Common Stock have no right to that portion of value of the Company attributable to the interests of the holders of the Class B Common Stock and Preferred Stock.

Analysis

Initially we must resolve whether we need to determine the relative rights and preferences of the two classes of Advance stock. Petitioner contends that to discern what a hypothetical willing buyer would be willing to pay for the common stock we need only determine that there is substantial uncertainty among respected legal experts about the rights and powers of the classes of stock and about the extent of the common shareholder's authority over the corporate assets. Petitioner argues that this uncertainty will strongly influence the willing buyer's purchase offer. Petitioner contends that we do not need to decide whether a common shareholder would succeed or fail in eliminating the claims of the preferred shareholders, but only that the willing buyer could not be secure about his ability to do so and would offer a commensurately lower price for the stock.

Respondent counters that we must first decide whether, in fact, the common shareholder could ultimately secure complete control over the assets of Advance through any one of the methods suggested by his expert witnesses. Respondent maintains that we cannot rule on the value of the common stock without first deciding the common shareholder's rights.

The focus of a valuation inquiry, however, is on the existing facts, circumstances, and factors at the valuation date that influence a hypothetical willing buyer and willing seller in determining a selling price. We agree with petitioner that it is the likely understanding of the rights and privileges of the Advance common stock that will influence the terms of sale, not whether we resolve this dispute over New York law. Indeed, we believe that it would be error to postulate a certainty that did not exist. Any potential buyer would be investing millions of dollars in this acquisition. Such a buyer would not assume legal certainty in the face of divided legal counsel. n21

n21 We struck from evidence the valuation report of one of respondent's experts precisely because he assumed legal certainty (i.e., that respondent's legal experts were correct) where none existed. Having made this flawed assumption, his report became irrelevant. See Estate of Hall v. Commissioner, 92 T.C. 312, 338-339 (1989).

To decide the exact rights and powers of the Advance common stock under New York law, we would have to decide that a willing buyer would ignore or discount some of the expert advice we heard. We believe that we cannot, however, disregard the effect of the mixed legal advice on the hypothetical willing buyer's commitment of funds to a purchase price. Not only would our resolution of this issue not make the hypothetical willing buyer feel secure on February 29, 1980, it would distort the reality in which the fair market value must be determined.

A hypothetical willing buyer would have had the counsel of several advisers of formidable reputation: Landau & Lipton, noted corporate lawyers; Professors Coffee, Cox, Eisenberg, and Brudney and Deans Mundheim and Siegel, all affiliated with prestigious educational institutions. He could have read legal memoranda from White & Case and Cravath, Swain & Moore, well-respected law firms. The hypothetical willing seller would also have been aware of this conflicting legal advice and the uncertainty of obtaining economic dominance in Advance. Not only is the law disputed, but the experts cite substantially the same cases to support their diametrically opposed positions. Moreover, no expert's views were patently unreasonable. No willing buyer, faced with the conflicting arguments and opinions of these respected legal experts could choose which one is right. The legal uncertainty will strongly affect his decision on the value of the common stock. "[The] Court must not 'permit the positing of transactions which are unlikely and plainly contrary to the economic interest of a hypothetical buyer.'" Estate of Hall v. Commissioner, 92 T.C. at 337, citing to Estate of Curry v. Commissioner, 706 F.2d 1424, 1429 (7th Cir. 1983). To assume the correctness of the views of either respondent's or petitioner's legal experts would distort the facts in which a willing buyer would have negotiated the purchase and would result in a transaction plainly contrary to the buyer's economic interests.

In arguing that we must decide that one side or the other is right, respondent relies on several cases that are not directly applicable to the case at hand. In Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981), the parties did not dispute the proper treatment of a decedent's community property under Texas law. In Estate of Watts v. Commissioner, 823 F.2d 483 (11th Cir. 1987), the process and implication of the dissolution and liquidation of a partnership under Oregon law was clear and easily resolved. In Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970), the Government urged this Court

to overlook restrictions on stock imposed by a voting trust. Although we concluded that the voting trust restrictions would "most likely be valid," we decided that the threat of the enforcement of the voting trust restrictions would be significant in itself to a potential investor. 55 T.C. at 193-194. Two of these cases involve legal disputes capable of fairly ready determination. In the other, the actual resolution of the State law question was deemed unnecessary and supports our approach here. n22

n22 See also Estate of Mundy v. Commissioner, T.C. Memo. 1976-395 (validity of redemption provisions under Florida law were not necessary to evaluate effect of redemption provisions on prospective purchaser of restricted stock).

In this case, the State law question cannot be resolved short of actual litigation subsequent to an actual purchase. The one certainty that the willing buyer would confront, which the willing seller would also have to take into account, is that with the State law issues as difficult to resolve and as fiercely contested as the relative rights and privileges of the Advance stock, there would be litigation. It would be nonsensical to believe that the preferred shareholders would not try to vindicate their economic interests.

B. Valuation Opinions

Petitioner approached the willing buyer, willing seller test by soliciting the expert advice of investment bankers who daily counsel clients that buy and sell stock in businesses like Advance. Petitioner's experts evaluated the Advance common stock as if they were giving advice to a client, reviewing the advantages and the disadvantages that a client would face. Then, analyzing benchmark values for several approaches to selling the Advance common stock and relying on their experience and judgment, petitioner's experts determined a likely sales price. n23

n23 On brief, respondent argues that Goldman Sachs' approach only explores what a willing buyer would pay for the Advance common stock and should therefore be disregarded. What respondent has failed to see is that the highest price a willing buyer would pay is also the price that a willing seller wants.

Respondent approached the valuation of Advance very differently. Respondent's theory of valuation takes the sum of the value of the Advance's assets in excess of certain planned expenditures and certain liabilities, and reduces that sum by a value attributable to the presence of the preferred stock. The remainder represents the value of the common stock and the price that respondent believes a willing buyer would pay to a willing seller. Several portions of respondent's expert's report were stricken from the record because they were based on an assumption without foundation. Specifically, Baniewicz based his analysis on the assumption that the value of the Advance common stock would be determined by subtracting from the value of the entire company the value of the preferred stock (the subtraction method).

None of respondent's expert witnesses testified that they would have advised a willing buyer to use the subtraction method in deciding the value of the stock. None could testify that they had ever advised the use of the subtraction method in advising buyers or sellers of closely held stock in any comparable situation.

1. General and Industry Economic Conditions

The period immediately preceding the valuation date was characterized by economic gloom. The economy was in a state of near-recession with high interest rates and high inflation. The newspaper and magazine publishing industry reflected the nation's troubles. Costs were high, competition increasing, and circulation and advertising revenues at a standstill or decreasing. A willing buyer and a willing seller would be aware of these economic conditions as they negotiated their price for the Advance common stock.

Respondent's expert witness, Baniewicz, found that the prognosis for the newspaper and magazine publishing industry was not as grim as we have found it to be. Although he agreed that the economy as a whole was not robust in late 1979 and early 1980, he stated that total advertising revenues rose in 1978 and 1979 and that the percentage of total U.S. advertising that was devoted to newspaper advertising decreased only slightly. Baniewicz' revenue figures, however, were not adjusted for inflation. Because classified advertising remained strong in 1978 and 1979, Baniewicz believed that no one expected that the impact on the publishing industry of the projected 1980 recession would be serious. Baniewicz also noted that magazine circulation grew in 1978 but leveled off in 1979. He further surmised that because magazine readers tend to have higher incomes, and because that demographic segment was expected to grow in 1980, the long-term outlook for growth in the magazine publishing industry would have been positive. We have concluded that Baniewicz' findings at best represent a few isolated bright spots in an otherwise gloomy economic picture.

2. Competitive Position

In order to compare Advance's financial strength and performance in relation to others in the industry, Goldman Sachs chose eight companies whose business mixes would be meaningfully comparable to Advance. n24 Relying on data from these eight companies, Goldman Sachs concluded that because Advance's earnings were already within the range of the industry norm for large publicly held companies, Advance's historical profit was reasonably indicative that its earning capacity had been fully achieved. Goldman Sachs noted that Advance paid relatively low dividends, although there were sufficient earnings to pay considerably more. Furthermore, Goldman Sachs determined that Advance retained a high cash balance relative to comparable businesses. Advance also had $ 145 million for planned extraordinary capital expenditures at the date of valuation. Goldman Sachs' comparison shows that Advance had relatively high operating income and net income and exceptionally low long-term debt in 1979.

n24 These eight companies were: Affiliated Publications, Inc., Dow Jones & Co., Gannett Co., Knight-Ridder Newspapers, Inc., Media General, Inc., The New York Times Co., The Times Mirror Co., and The Washington Post Co.

3. Size of Advance and Legal Uncertainty

As the Chemical Bank report explained, a willing buyer's business judgment in valuing the Advance common stock would be formed in large part by the uncertainty of the common's power to defeat the preferred's claim to 78 percent of dividends:

The possibility that any speculative buyer's attempt to deny the preferred shareholders what they believed to be the fair value of their shares would fail makes it extremely unlikely that any such buyer would have risked the enormous capital required to buy the Common Stock based on such speculation * * *.

Because of the millions of dollars needed to buy the common stock of Advance, the prevailing high interest rates, and the inevitability of litigation (aside from the possibility of failure), no one would have been willing to make such a speculative investment in early 1980 at a price determined by respondent's subtraction method. Goldman Sachs believed, and we agree, that the uncertainty inherent in purchasing only the common stock combined with the enormous investment required would depress the price that any buyer would offer. Goldman Sachs explained further the effect of fiduciary duties to the preferred shareholders on any buyer's judgment on the value of the common stock: "most acquirers want the ability to enter into transactions, with affiliates or otherwise, without being challenged as to the fairness of those transactions to non-controlling shareholders."

McCorkindale, vice president of Gannett Corp., stated that Gannett would not be interested in a purchase of the Advance common stock, unless the preferred stock were also available. Gannett, he explained, generally avoided purchases of less than 100 percent of the outstanding stock. McCorkindale was also concerned that the Advance common shareholder would have fiduciary responsibilities toward the preferred shareholders. Murdoch, chief executive officer of The News Corp., agreed that the Advance common stock would not be attractive because of the existence of the preferred shareholders.

4. Antitrust and FCC Difficulties

J. Paul McGrath, a partner of Dewey, Ballantine, Bushby , Palmer & Wood, specializing in the antitrust ramifications of mergers and acquisitions, testified on behalf of petitioner. McGrath stated that any media company large enough to buy Advance would have overlapping markets and would need to divest itself of some of its holdings.

Murdoch agreed that purchasing Advance was made less desirable by "various Justice Department and Federal Communications Commission restrictions."

McCorkindale explained that if Gannett had purchased the Advance common stock, Gannett would have had several newspaper properties in overlapping markets. Furthermore, in contemplating an acquisition, McCorkindale also considers long-term anticipated expansion into new markets. Owning one ofAdvance's newspaper properties might preclude the buyer from later purchasing a competing newspaper that was more desirable.

5. Accounting Problem

The parties disagreed about how the purchaser of Advance's common stock would account for the earnings of Advance on its books. Petitioners introduced the testimony and report of Abraham Briloff, a certified public accountant and Professor Emeritus of Baruch College, and Ronald J. Murray, a certified public accountant and a partner with the accounting firm of Coopers & Lybrand.

Briloff stated that pursuant to generally accepted accounting principles, a corporate owner of the common stock interest in Advance could report in consolidated earnings only Advance's earnings and profits attributable to the common stock and no amount attributable to the preferred stock interests. Murray and Briloff agreed that a corporate owner could report only 22 percent of Advance's earnings on its consolidated financial income statement.

Contradicting the reports of Murray and Briloff, respondent introduced the report and testimony of Gustav A. Gomprecht, a certified public accountant and a retired partner of KMG Main Hurdman. Gomprecht, in his prepared report and on direct examination, concluded that the financial statements of

the buyer of Advance's common stock could include all of Advance's net income. Gomprecht based his view in part on his belief that the common shareholder could represent that, until dividends were paid out of earnings, the shareholder was entitled to all earnings. Gomprecht conceded on cross-examination that if the common shareholder included the earnings of Advance in its financial statements without at least a footnote stating that 78 percent would have to be distributed to the preferred shareholders when declared, those financial statements would be misleading.

In the end we believe that Briloff and Gomprecht came to the same conclusion. Once Advance declares a dividend from earnings, retained or current, 78 percent would be distributed to the preferred shareholders. The holder of the common stock would be entitled to no more than 22 percent, and if the buyer's financials suggested entitlement to more, they would be misleading. Given the size of Advance's earnings, it is likely that such a misstatement would be material.

6. Valuation Analyses

a. Goldman Sachs' Valuation

In valuing the Advance common stock, Goldman Sachs applied the methods it uses daily to advise buyers and sellers of stock and securities. First, Goldman Sachs assessed four benchmarks of value that a prospective buyer of Advance would consider. These benchmarks would be used to ascertain the correct value of Advance by a buyer for analytical purposes but are not determinative of the value of the common stock. The four benchmarks are: (1) The public trading market value, i.e., the value if Advance stock had been actively traded on the stock market; (2) the initial public offering value, or the net value realizable by the shareholders who first introduce Advance stock on the public stock market; (3) the possible merger market value, or the amount realized by the shareholders if they sold all their stock to one party in a private sale; and (4) the arithmetic sum value, or the sum of the values of each of the assets if sold in independent transactions.

Goldman Sachs concluded that the public trading value for Advance as of February 29, 1980, was $ 905 million. At that time the stock market indices were declining and media companies were lagging behind the market. GoldmanSachs evaluated eight businesses that were active in the media industry and comparable to Advance in business mix. n25 Advance placed near the middle of these companies in overall financial performance. Furthermore, though Advance was well managed, Goldman Sachs believed the public market would have disapproved of Advance's concentration in newspapers, particularly evening newspapers, and magazines at a time when other media companies were diversifying into television. Goldman Sachs estimated a price-earnings multiple of approximately 9.4 times earnings or $ 905 million.

n25 On brief, respondent objected to Goldman Sachs' choice of the eight comparable businesses on the grounds that Advance's unique capital structure set it apart from those eight corporations. Respondent failed at trial to introduce evidence (whether on cross or through direct examination of his own witnesses) that would suggest any lack of merit in using these businesses as comparables. Moreover, respondent's own expert, Baniewicz, used four of those businesses as comparables (Gannett Co., Knight-Ridder Newspapers, Inc., The New York Times Co., and The Times Mirror Co.) to evaluate Advance's financial position.

Goldman Sachs also determined that the initial public offering value for Advance on February 29, 1980, was $ 778 million. Ordinarily the price at the initial public offering would be subject to a discount of between 5 and 10 percent below the anticipated price once the stock is established on the market. There is an additional underwriter's gross spread discount of about 7 percent. These two discounts applied to $ 905 million produced $ 778 million. An initial public offering of all the Advance stock would have been more than 20 times larger than any initial public offering for several years preceding February 1980. The magnitude of the offering would have further lowered the realizable value.

Although Goldman Sachs decided that practically it would be difficult to arrange a merger of Advance, they determined that if there was a merger the shareholders could have realized between $ 1.1 and $ 1.2 billion. Although the merger market for small newspaper companies was flourishing around February 1980, Advance was already efficiently managed and a prospective buyer would not have believed that he could quickly and easily improve the operating margins or increase the revenue.Furthermore, the size of Advance would have daunted all but the largest prospective buyers. For these and other reasons, both Goldman Sachs and Chemical Bank could not find any comparable historical mergers by which to measure the merger value of Advance. Additionally, neither the general economic conditions nor the newspaper publishing industry were conducive to a major acquisition.

Finally, Goldman Sachs computed the arithmetic sum value of $ 1.5 billion by assuming that each of Advance's properties was sold independently. Although unlikely in a real market situation, Goldman Sachs assumed for the purposes of the report that the purchase prices realized would be unaffected by the simultaneous sale of all of the other properties. n26 After reviewing the economic conditions' effect on the value of newspaper properties, Goldman Sachs evaluated each of Advance's assets. Goldman Sachs considered the local economies and demographic pictures for each newspaper and compared the Advance advertising and circulation trends to those of other newspapers. They also considered the individual newspaper properties from the point of view of the mergers and acquisitions market.

n26 Respondent complained on brief that Goldman Sachs' arithmetic sum value represented future income potential to the exclusion of current asset value. This is due, in part, to Goldman Sachs' analysis of the newspaper properties as going concerns, in contrast to Baniewicz' liquidation value approach. Nonetheless, because Goldman Sachs and Baniewicz ultimately came very close to agreeing on the aggregate value of the newspaper properties, we do not believe that this discrepancy is worth further consideration.

The sale of all of Advance's newspaper and magazine properties at one time would have had a seriously depressing effect on the market for such properties. Furthermore, in order to avoid significant tax consequences, the sale of all of the properties would have to be accomplished within 1 year. In light of the difficulties, Goldman Sachs concluded that its arithmetic sum value was not realistic.

Keeping in mind their four benchmarks of value for Advance's entire business, Goldman Sachs then turned to a discussion of the possible types of buyers for the Advance common stock. The report contemplated four types of investors: (1) The passive investor, (2) the active investor, (3) the control investor, and (4) the public.

A passive investor would not be interested in managing Advance and would not attempt to wrest control from management. Expecting to realize value from dividends and private resale, the passive investor would not expect to extract value from Advance through liquidation, merger, or public offering. The

passive investor would consider that Advance's stock was not publicly traded which would depress expectations of resale value. Due to this illiquidity, lack of control, and the uncertainties and constraints affecting the purchase, Goldman Sachs concluded that the passive investor would have offered 30 percent less than the public trading market value of the common stock and thus only $ 141 million for the common stock.

The active investor would be inclined to pursue action, short of seeking control, that would quickly maximize the return on his investment. One course of action would be to declare a dividend of Advance's excess cash and any funds that could be obtained through borrowing. Because of the high prevailing interest rate and planned capital expenditures, the common shareholder could extract no more than $ 74 million of excess cash plus loan proceeds. Advance also had $ 145 million of excess cash which could be distributed with the loan proceeds. Because of the time and uncertainty involved in this plan of action, the active investor would pay no more than 85 percent of the amount he hoped to extract. This figure would be far less than the $ 141 million the passive investor would be willing to pay.

Alternatively, the active investor might cause the excess cash to be distributed immediately and then cause Advance to pay dividends at the highest possible level. Assuming that the active investor would insist on an after-tax yield on his investment of about 13 or 14 percent, Goldman Sachs concluded that the active investor would be willing to pay $ 150 million for the Advance common stock.

A control investor would have purchased the Advance common stock with the goal of acquiring 100 percent of the equity ownership and control of the company. A control investor would hope to realize value from his purchase by dividend distributions, by liquidation, or by merger, but Advance's unusual capital structure would prevent the latter two courses of action without eliminating the preferred stock or securing their consent. The preferred had the right to block liquidation. Because the common's power to effect a merger adverse to the preferred's interests was so uncertain, Goldman Sachs concluded that any willing buyer, as a matter of sound business judgment, would analyze the value of the common as if that option were foreclosed. Goldman Sachs' analysis is persuasive.

Goldman Sachs concluded that only another media company would be interested in acquiring Advance and that none of the major media companies would have considered buying the common stock without first eliminating the claims of the preferred shareholders. Because the control investor would assume that he could not receive anything except 22 percent of the highest level of dividends declared, he would be in the same position as the active investor and would pay no more than what the active investor would pay, viz, $ 150 million.

Goldman Sachs concluded that an underwritten public offering would be the best way to sell the Advance common stock, requiring the three different types of stock to be recapitalized into a single class. Goldman Sachs' research indicated that in approximately half of the transactions in which voting control was transferred the buyers paid a premium for control. Goldman Sachs concluded that no control premium was warranted. Goldman Sachs then determined that, after exchanging the class A common stock one for three, and the class B common and the preferred stock one for one, the offering price would be $ 25 per share subject to a 7-percent discount. The price for all the shares would be $ 778 million, and for petitioner's shares it would be $ 176 million.

Because the benchmark value for a public offering, $ 176 million, was the highest value, Goldman Sachs concluded that the value of petitioner's Advance common stock was $ 176 million on February 29, 1980.

b. Chemical Bank's Valuation

Chemical Bank applied two analytical approaches: (1) A discounted cash-flow analysis, and (2) a comparison with the financial performances of publicly traded companies in a similar line of business. Chemical Bank did not use a breakup value analysis because it believed a buyer in early 1980 could not have maximized the return on his investment by liquidating Advance and selling off its assets. Chemical Bank declined to employ acquisition multiples (information relating to mergers and acquisitions) because there were no acquisitions of publishing businesses of Advance's size and complexity between 1975 and 1980, and Chemical concluded that other acquisitions were not sufficiently similar to be meaningful.

After calculating a value for Advance as a whole, Chemical Bank derived appropriate discounts and premiums and computed a value for petitioner's Advance stock. Based on Advance's financial data from the preceding 5 years, Chemical Bank projected the future cash-flow for the next 10 years and discounted it back to 1979 in order to determine the net present value of Advance. In forecasting the future growth of Advance, Chemical Bank used a growth rate of 10 percent, which was the rate that Advance had experienced prior to the date of valuation. A discount rate for the risk of the investment of 18 or 19 percent was applied. Under the discounted cash-flow model, Chemical Bank figured that Advance was worth between $ 738 and $ 814 million.

Chemical Bank chose eight newspaper or magazine publishers and compared them to Advance by earnings, book value, cash-flow, earnings before interest and taxes, and earnings before depreciation, interest, and taxes. These comparisons revealed a range of value for Advance between $ 854 and $ 926 million.

Chemical Bank assumed a worst-case scenario for the potential buyer's consideration of realizable value, viz, that the right to 22 percent of declared dividends was the common shareholder's sole method for extracting cash from the corporation. Using the midpoint number from the range of value produced by the discounted cash-flow analysis and the comparable businesses analysis, Chemical Bank computed that the Advance common stock was worth 22 percent of $ 906 million or $ 201.31 million. Chemical Bank applied a control premium of 7 percent to the class A common shares over the class B common shares. Finally, a 15-percent discount for lack of marketability was applied. Chemical Bank valued the Advance common stock at $ 1.831 million and $ 169.422 million for the class A common stock and the class B common stock respectively, or $ 171,253,000 altogether.

c. Baniewicz' Report

Baniewicz valued all the properties owned by Advance on February 29, 1980, and derived a total value of $ 1,555,773,000. He subtracted foreseeable capital expenditures and unfunded pension liabilities and then added excess cash, arriving at a value of $ 1,505,943,000. Baniewicz' ultimate conclusion of the value of all of Advance thus agrees with the arithmetic sum value calculated by Goldman Sachs.

Baniewicz' report went on to place a value on the preferred stock and to reach a value for the common stock by subtracting the value of the preferred from the value of Advance. Cf. Rev. Rul. 83-120, 1983-2 C.B. 170. Finally, he allocated the value he determined for the common stock between the class A

common and the class B common.

The section of Baniewicz' report that discussed the value of the preferred stock was stricken from the record. The report was based on two erroneous assumptions unsupportable on this record: (1) That the preferred stock enjoyed only those rights and privileges that respondent's legal experts said it did (a best-case scenario), and (2) that a willing buyer and willing seller would have approached the valuation of the Advance common stock by determining the net value of all assets and subtracting the value of the preferred stock.

The hypothetical willing buyer is presumed to be aware of all the pertinent facts. Such a buyer would be privy to the differing legal opinions on the common shareholder's ability to defeat the claims of the preferred shareholders to 78 percent of Advance's earnings. We do not believe that a willing buyer would have chosen to ignore the legal advice of petitioner's five legal experts. A fully informed buyer would not have assumed the correctness of the advice of respondent's five legal experts. We, therefore, cannot accept Baniewicz' underlying assumptions about the rights and privileges of the preferred stock. Rather, the record makes clear that any willing buyer would have considerable uncertainty about the common shareholder's rights to confine the preferred stock's interest in Advance to less than 78 percent of the value of Advance. Because Baniewicz' report assumes a confident willing buyer, certain that the preferred shareholders' right to 78 percent of declared dividends can be defeated, who is unmoved by the warnings of petitioner's legal experts, this portion of his analysis assumed a transaction at odds with the economic interest of any buyer. Consequently, this portion of his report was not useful to us and was stricken from the record. Estate of Hall v. Commissioner, 92 T.C. 312, 338-339 (1989).

The other problem with Baniewicz' report was his use of the subtraction method for valuing the Advance common stock. Although the subtraction method may on occasion be an appropriate valuation method, some foundation for applying the subtraction method to a corporation whose capital structure is as unusual and complicated as Advance's is necessary. Respondent had to establish that the subtraction method was appropriate to valuing Advance. While Baniewicz was on the stand, respondent's counsel promised that two of his subsequent witnesses would testify that in their experience (Baniewicz had no qualifying experience on this point), a willing buyer would use the subtraction method to value the common stock in Advance. In fact, their proffered testimony fell far short and was ultimately stricken from the record as irrelevant. As a result, Baniewicz' employment of the subtraction method was not meaningful. Without the subtraction method, Baniewicz' report says nothing more than that the sum of the values of all of the assets of Advance was $ 1.5 billion.

Conclusion

The first issue we must resolve is whether the parties correctly applied the willing buyer, willing seller test to these facts. Each party accuses the other on brief of adopting a rigid formulaic analysis that does not do justice to the complexity of this factual situation. Hamm v. Commissioner, 325 F.2d 934, 940 (8th Cir. 1963).

The choice of the appropriate valuation methodology for a particular stock is, in itself, a question of fact. O'Malley v. Ames, 197 F.2d 256, 258 (8th Cir. 1952); Riss v. Commissioner, 56 T.C. 388, 430 (1971), affd. sub nom. Commissioner v. Transport Mfg. & Equipment Co., 478 F.2d 731 (8th Cir. 1973), affd. cause remanded 478 F.2d 1160 (8th Cir. 1973).

Goldman Sachs analyzed four benchmarks of value that willing buyers use to determine the value of stock to be purchased, and Chemical Bank valued Advance by utilizing discounted cash-flow and Advance's comparative position. These represent perfectly acceptable applications of the willing buyer, willing seller test. Respondent, however, failed to qualify any expert who could testify that a willing buyer and a willing seller would value the Advance common stock using the subtraction method. Moreover, in the face of the legal uncertainty confronting a willing buyer and willing seller on whether the common could limit the preferred's 78-percent interest in dividends and perhaps in the value of the whole business, we believe that no willing buyer or willing seller being fully informed would have used such a method to determine the value of the common stock. Respondent has no support for using the subtraction method.

Respondent faults petitioner for adhering inflexibly to a "joint sale" theory. Respondent characterizes petitioner's position as follows: because a third party contemplating a merger with Advance would be unsure of the common shareholder's rights to eliminate the claims of the preferred shareholders and would be highly averse to protracted and expensive litigation, the third party would not agree to the merger. Thus, the only way for the common shareholder to realize value, other than through dividend distributions, would be to effect a merger transaction with the preferred shareholders' blessing. The terms of such a merger would require that 78 percent of the value of Advance would go to the preferred shareholders, and the common shareholder could not hope to get more than 22 percent of the total value of Advance.

We do not find any merit in respondent's attacks on petitioner's "joint sale" theory, and we note that respondent misstates petitioner's theory. n27 Petitioner's theory is that a fully informed willing buyer would take into account the uncertain state of the common stock's rights in deciding what value to pay for it.

n27 Indeed it was one of respondent's experts that assumed that the willing buyer, willing seller test required the preferred shareholders to consent to the sale of all Advance stock. This testimony was stricken as fundamentally flawed.

Respondent argues that this theory is unsound for several reasons. First, respondent contends that the common shareholder would protect the third party by indemnifying it against any claims of the preferred. As noted above, however, an indemnification provision would simply allocate the risk from the third party to the common shareholder. It in no way lessens the risk itself; rather it lessens the value the seller may realize. Respondent's second argument, that corporations are not as risk averse as petitioner claims, is irrelevant because: (1) While a willing buyer may employ the corporate form to effect the acquisition, we do not assume that the willing buyer would be a corporation and, more importantly for this case, (2) it is an assertion completely without support in the record. Respondent then notes that because the preferred shareholders would immediately seek an injunction, the common shareholder and the third party buyer would not have to wait to find out if their planned defeat of the preferred's claims would work. We do not think that this would end the suspense because the outcome of the litigation is not clear to us. Respondent's fourth argument is that the preferred shareholders would settle the litigation for the capitalized value of future dividends. Obviously, they would not if they were represented by Messrs. Landau, Mundheim, or Lipton.

The foundation of respondent's approach is his view that we must resolve the question of the various legal entitlements of the common and preferred stock in his favor. Respondent's position assumes that a willing buyer would not be uncertain about his ability to dispose of the claims of the preferred shareholders. In effect, respondent argues that a willing buyer would not hesitate to pay $ 1,231,800,000, as Baniewicz suggests, for the Advance common stock because of his ability to eliminate the preferred stock. This is an astonishing proposition on this record. Noted legal experts have given contrary views in this case. Petitioner's experts' opinions were unscathed by cross-examination. Their opinions were well reasoned and persuasive. We believe the likelihood of the common shareholder's legal rights to eliminate the preferred is, at best, in equipoise. The one thing the willing buyer would not have had is certainty about the ability to eliminate the preferred at the values that respondent used in his subtraction method.

Not only is there no support in the record for the subtraction method in this case, but we conclude that it is far too simplistic a method for the valuation of the Advance common stock. An underlying fallacy in this theory of valuation is the assumption that the sum of the fair market values of the preferred stock and the common stock, each sold independently to separate buyers, must equal the net value of the entire company as a going concern. Massive amounts of credible evidence in this case indicate that this assumption is not supportable.

If all the common and preferred stock in the company were sold at one time to a single buyer, we have little doubt that the price would approach the values that the experts on both sides determined for the business as a whole. But if either class of stock is sold separately, a buyer cannot be reasonably certain of his ability to eliminate or control the other shareholders, and the price will be less than its proportionate share of the total value. Although the subtraction method may be suitable for other situations, its use is inappropriate for Advance. We conclude that the correct value of the Advance common stock on February 29, 1980, was $ 176 million.

A subissue that we must address is the value of the 300 shares of class B common stock that Newhouse left to his wife by will. Petitioners submitted Goldman Sachs' report that states that the 300 shares of class B common stock were worth $ 51,757,576. Goldman Sachs calculated this figure by allocating $ 170,800,000 (of the value of the common stock, $ 176,000,000,) to the class B and $ 5,200,000 to the class A. This allocation was derived from Goldman Sachs' initial public offering analysis. Petitioner argues that, because the stock conveyed no control and because the value of the 300 shares of class B common stock must be determined without reference to any other stock Mitzi held, the correct value was $ 51,757,576. Petitioner also submitted an analysis of the value of the class B common stock by Chemical Bank. Chemical Bank determined the value of the 300 shares of class B common stock to be $ 51,340,000.

Respondent argues that the correct value of the 300 shares of class B common stock is $ 246 million. As support for this position, respondent relies on reports that were not admitted into evidence. The figure wasderived by discounting his value for the class B stock by 33 percent for lack of control and substantial voting restrictions. Baniewicz' argument supporting his calculation allocating his figure for the total value of Advance common stock between the class A and the class B was not admitted into evidence.

We have already concluded that the combined value of class A and the class B is $ 176 million. Respondent argues that a 33-percent discount of the value of class A to reflect the differential voting rights is appropriate to find the value of the class B, but offers no evidence to support his position. We conclude that Goldman Sachs' analysis produces a reasonable and correct value for the class B stock. Goldman Sachs determined that the best way to realize the value in the Advance stock would be through a public sale. First, it would be necessary to recapitalize Advance creating a single class of common stock. Goldman Sachs determined that the preferred stock and the class B stock would be traded for equal amounts of the new stock but the class A common stock would be traded for three shares of the new stock. The value of the class A common stock was $ 5.2 million and the value of the class B was $ 170.8 million. The value of 300 shares of class B common stock was $ 51,757,576.

II. VALUE OF N.B. CO. COMMON STOCK

In the notice of deficiency, the value determined for the 100 shares of N.B. Co. stock was $ 91,600,000 which is simply 44.44 percent of $ 206,400,000. On brief, respondent argues Baniewicz' determination that a 16.67-percent "discount" would be appropriate. n28 Petitioner derives the value of $ 59,600,000 by applying a discount of 35 percent to the 44.44 percent block of stock. The sole dispute that we must resolve is whether a discount is appropriate and, if so, how large it should be.

n28 Baniewicz calculated that the value of the 100 shares would be $ 76,372,500. Respondent did not explain the discrepancy between his figure and Baniewicz' result.

Respondent's determination in the notice of deficiency, which he supported through the testimony of William B. Cate, is undeniably wrong. Ignoring discounts for lack of control and lack of marketability is contraryto long-established valuation methods well accepted by the Courts in cases presenting the value of stock in closely held corporations. Estate of Andrews v. Commissioner, 79 T.C. 938 (1982); Estate of Bright v. United States, 658 F.2d 999, 1002-1003 (5th Cir. 1981); Estate of Leyman v. Commissioner, 40 T.C. 100, 119 (1963). The discounts are conceptually distinct: (1) The discount for lack of control reflects the minority shareholders' inability to compel liquidation and inability to realize a pro rata share of the corporation's net asset value. Harwood v. Commissioner, 82 T.C. 239, 267 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986); (2) the lack of marketability discount reflects that there is no ready market for the shares of a closely held corporation. Estate of Andrews v. Commissioner, supra at 953. While the appropriate amount of discount to apply is a question of fact, Ward v. Commissioner, 87 T.C. 78, 109 (1986), it is unreasonable to argue that no discount should be considered for a minority interest in a closely held corporation.

A. Goldman Sachs' Report

Petitioner submitted a report in which Goldman Sachs determined that a willing buyer would pay a willing seller $ 59.6 million for the 100 shares of N.B. Co. common stock on February 29, 1980. In preparing the report, Goldman Sachs reviewed the corporate bylaws, the Certificate of Incorporation, and the financial statements from the preceding 5 years. Additionally, Goldman Sachs read the 1980 valuation report prepared by Chemical Bank n29 and the valuation report prepared by respondent's expert, Baniewicz.

n29 The 1980 valuation report of Chemical Bank was the basis of petitioner's claim on its estate tax return that the N.B. Co. stock was worth $ 68.3 million. For purposes of trial, however, the parties agreed to use $ 206.4 million for the value of the entire company and so petitioner discarded Chemical Bank's

1980 valuation.

Goldman Sachs concluded that the 100 shares of commonstock, representing 44.44 percent of the stock, lacked voting control. In other words, this block of stock neither controlled management nor controlled cash flow or distributions. A buyer of the 100 shares would not have the power to sell corporate assets or to register the stock with the Securities and Exchange Commission preparatory to an initial public offering. Because the stock interest had no control over corporate affairs, Goldman Sachs concluded that a buyer of the stock would hope to realize the value from his investment when the stock was initially offered to the public.

Goldman Sachs believed that a public offering was unlikely. In view of the large size of the company, a public offering would not have been feasible under market conditions at the valuation date. Moreover, while N.B. Co. had in excess of $ 25 million in cash and virtually no debt, management had expressed no interest in taking the company public. Furthermore, N.B. Co. had, as of the valuation date, arranged to sell its five television broadcasting stations that generated more than half of N.B. Co.'s revenue and planned to reinvest the proceeds in new television broadcasting stations.

Because liquidation of the corporation was unlikely, Goldman Sachs concluded that the only means of disposing of the 100 shares of N.B. Co. common stock would be through private placement. Because the 100 shares do not convey control over the company, no control premium would be warranted. The private placement investor would expect to realize value on his investment only through the receipt of dividends and the eventual resale of his shares. Goldman Sachs estimated the value of the future annual dividend income from the 100 shares at $ 889,000 based on historical dividends for 1978 and 1979. Although the corporation had the ability to pay higher dividends, the private placement investor would not have the power to compel it to do so. At the valuation date, publicly traded corporate bonds were yielding 14 and 15 percent and a buyer would not have accepted a lower rate of return on his investment from his N.B. Co. stock. Additionally, Goldman Sachs determined that in circumstances that suggest no expectation of a public offering for at least 5 years, the investor would not pay more than the total value discounted by between 33 to 55 percent. Goldman Sachs concluded that a discount of35 percent would be appropriate to the N.B. Co. common stock. Applying a discount of 35 percent to 44.44 percent of the total value of N.B. Co. of $ 206.4 million, Goldman Sachs derived a fair market value for the 100 shares of common stock of $ 59.6 million.

B. Baniewicz' Report

Baniewicz determined that the 100 shares of stock would bear a control premium because, though 44.44 percent was not a majority interest, it was the "largest outstanding ownership interest" and thus "would participate in decisions controlling the affairs of the corporation." Because the stock did not represent a majority interest, Baniewicz concluded that a 25-percent control premium, rather than a full 50-percent control premium, was warranted. In order to attain a 25-percent control premium, Baniewicz applied a 16.67-percent discount from full liquidation value of $ 206.4 million because the liquidation value included a 50-percent control premium that had to be reduced. Thus, Baniewicz' 16.67-percent discount is actually a reduced control premium.

We cannot accept respondent's position. Control means that, because of the interest owned, the shareholder can unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation's capital structure, and decide whether to liquidate, merge, or sell

assets. The owner of the 100 shares of N.B. Co. could not accomplish any of these actions. Baniewicz explained at trial that the owner of the 100 shares would have effective control because he would have the largest block of stock. Having a substantial or even the largest block of stock does not necessarily create effective control, and it certainly does not in this closely held corporation. The owner of the 100 N.B. Co. shares enjoys no attributes of control. Participating in corporate decisions is a right that any stock interest may enjoy (and which in this case the other stock interests also enjoyed), but unless that interest controls (which in a closely held corporation typically means a majority interest), a control premium is unsupportable.

We conclude that petitioner's position, as explained in the Goldman Sachs report, is reasonable and fair. The discount of 35 percent combines discounts for lack of control and lack of marketability. A combined discount of 35 percent is well within precedent. See Estate of Watts v. Commissioner, T.C. Memo. 1985-595, affd. 823 F.2d 483 (11th Cir. 1987); Drybrough v. United States, 208 F. Supp. 279 (D. Kan. 1962). n30 We conclude that the value of the 100 shares of N.B. Co. stock was $ 59,600,000 on February 29, 1980.

n30 See also Martin v. Commissioner, T.C. Memo. 1985-424.

In light of the foregoing, concessions, and the need to calculate various administration expense deductions,

Decision will be entered under Rule 155.

LEXSEE 1990 U.S. Tax Ct. LEXIS 9

Estate of Samuel I. Newhouse, Deceased, Samuel I. Newhouse, Jr. and Donald E. Newhouse, Executors, Petitioner, v. Commissioner of Internal Revenue, Respondent

Docket No. 23588-83

UNITED STATES TAX COURT

94 T.C. 193; 1990 U.S. Tax Ct. LEXIS 9; 94 T.C. No. 14

February 28, 1990

February 28, 1990, Filed

DISPOSITION:

Decision will be entered under Rule 155.

SYLLABUS:

Decedent, N, owned all of the outstanding shares of class A voting and class B nonvoting common stock in a closely held corporation, A, at his death. Other family members owned all of the outstanding shares of A's preferred stock. A's corporate charter provided that the voting common stock had exclusive rights to elect the board of directors, that all three classes of stock participated pro rata in dividends declared out of earnings, that the preferred stock had a liquidation preference, and that only the common stock could vote on plans for merger. The preferred stock was authorized by statute to vote on corporate liquidation. Both P and R submitted testimony and reports of numerous expert witnesses about the rights of A's common shareholder under State law to extract wealth from the corporation

through redemption, dividends, or merger and liquidation. The experts, whose opinions were well-reasoned, disagreed about almost every issue, and we find that a willing buyer would have been uncertain about the rights and privileges of A's common stock. N also owned 100 shares of common stock in NB, and other family members owned the remaining 125 shares of NB. Held: Where a State law issue about the relative rights and duties of different classes of stock is incapable of resolution except through actual litigation, as evidenced by the profound disagreement of several noted experts, a willing buyer would experience uncertainty about the rights of the common shareholder. The willing buyer and willing seller would take into account the likelihood of protracted and unpredictable litigation in negotiating a purchase price. Held, further, the fair market value of N's stock in A is determined. Held, further, N's interest in closely held NB, representing 44.44 percent of the voting stock, does not control NB and will not carry a control premium. Held, further, the fair market value of N's NB common stock is determined.

COUNSEL:

Albert H. Turkus, Judith A. Mather, James A. Treaner III, Bernard J. Long, Jr., Linda A. Fritts, and Richard L. Braunstein, for the petitioners.

Robert S. Shilliday, Jr., Albert L. Sandlin, and Howard P. Levine, for the respondent.

JUDGES:

Williams, Judge.

OPINIONBY:

WILLIAMS

OPINION:

The Commissioner determined a deficiency in the Federal estate tax due from the estate of Samuel I. Newhouse in the amount of $ 609,519,855. The Commissioner also determined an addition to tax for fraud pursuant to section 6653(b) n1 in the amount of $ 304,759,927. The Commissioner has conceded the addition to tax for fraud.

n1 All section references are to the Internal Revenue Code of 1954 as amended and in effect at decedent's death.

After concessions, the remaining issues for our decision are: (1) The value, for purposes of the Federal estate tax, of 10 shares of class A common stock and 990 shares of class B common stock of Advance Publications, Inc., owned by Samuel I. Newhouse, Sr. (Newhouse) at the time of his death, and (2) the value, for purposes of the Federal estate tax, of 100 shares of common stock in Newhouse Broadcasting Co. owned by Newhouse at the time of his death.

FINDINGS OF FACT

Some of the facts were stipulated and are so found. Newhouse died testate on August 29, 1979. His sons, S.I. Newhouse, Jr. (S.I., Jr.), and Donald E. Newhouse (Donald), were duly appointed executors of his estate.At the time of his death, Newhouse resided in Palm Beach, Florida. The executors timely filed a Federal estate tax return on May 27, 1980, and elected to value the Newhouse estate as of February 29, 1980, the alternate valuation date.

On Schedule B of the estate tax return, the executors valued the 10 shares of class A common stock and the 990 shares of class B common stock in Advance Publications, Inc. (Advance), at $ 8,595,000 and $ 170,181,000, respectively, based on an appraisal by Chemical Bank. Also on Schedule B of the estate tax return, the executors valued the 100 shares of common stock in Newhouse Broadcasting Co. (N.B. Co.) at $ 68,300,000. In the notice of deficiency dated May 18, 1983, the Commissioner valued the 10 shares class A common stock and the 990 shares of class B common stock in Advance at $ 420,000,000 and $ 811,800,000, respectively, and valued the 100 shares of common stock in N.B. Co. at $ 91,600,000. On August 12, 1983, petitioners timely filed their petition in this case.

I. VALUE OF ADVANCE COMMON STOCK

A. Organization and Operations

Advance is a corporation organized under the laws of the State of New York that publishes newspapers and magazines.Advance's principal place of business was and always has been in New York. At the time of Newhouse's death, the officers of Advance were: Newhouse, President and Treasurer; Mitzi Newhouse, Newhouse's wife, Vice President; S.I., Jr., Vice President; Donald, Secretary.

In 1922, Newhouse and Judge Hyman Lazarus, a New Jersey lawyer, formed a partnership to acquire 51 percent of the stock of the Staten Island Advance which published a newspaper, The Staten Island Advance. In 1924, Newhouse bought Judge Lazarus' shares and soon after purchased the remaining 49 percent. Newhouse filed a Certificate of Incorporation (the certificate) for the Staten Island Advance Co., Advance's predecessor, on May 12, 1924. From the time Newhouse incorporated Advance, Newhouse's brothers Theodore (Ted) and Norman were employed at Advance, and all three brothers shared equally in the management of the business.

In 1932, Advance acquired the controlling interest in the Long Island Daily Press Publishing Co., the first of a long line of newspaper acquisitions. In 1939, Advance bought two newspaper properties in Syracuse, New York. Advance further enlarged its operations by purchasing an Oregon newspaper in 1950 and newspapers in Alabama in 1956. On February 29, 1980, Advance operated either by itself or through a wholly owned subsidiary, 50 newspapers in 22 markets as well as magazines published by Conde Nast Publications, Inc. (Conde Nast). n2 After each acquisition one of the brothers was assigned primary responsibility for the acquired property and assumed management of its operations. To provide on-site management, one of the three brothers would visit each newspaper located outside of the New York City area weekly or monthly. The visiting brother would meet with the local publisher and department heads to discuss circulation, current advertising and advertising development, accounts, compensation plans, editorial quality, production facilities, and distribution. After S.I., Jr., and Donald joined the management team, the five family members would meet frequently to discuss the operations of the out-of-town newspapers and plans for the acquisition of new properties. The topics at the family meetings included the purchase of new capital equipment, consideration of policies about purchasing newsprint, the setting of rates, and discussions of circulation techniques and distribution policies.

n2 As of Feb. 29, 1980, Advance owned and operated the following newspapers: The Staten Island Advance in New York, New York; the National News Service Co. in Washington, D.C.; The Birmingham News in Birmingham, Alabama; The Huntsville News and The Huntsville Times in Huntsville, Alabama; The Jersey Journal in Jersey City, New Jersey; The Post-Standard, The Syracuse Herald-Journal, and the Syracuse Herald-American in Syracuse, New York; The St. Louis Globe in St. Louis, Missouri; The

Ann Arbor News in Ann Arbor, Michigan; The Bay City Times in Bay City, Michigan; The Flint Journal in Flint, Michigan; The Grand Rapids Press in Grand Rapids, Michigan; The Jackson Citizen Patriot in Jackson, Michigan; The Kalamazoo Gazette in Kalamazoo, Michigan; The Muskegon Chronicle in Muskegon, Michigan; The Saginaw News in Saginaw, Michigan; The Mississippi Press and The Mississippi Press Register in Pascagoula, Mississippi; The Mobile Register, The Mobile Press, and The Press-Register in Mobile, Alabama; The Star-Ledger in Newark, New Jersey; The Oregonian and the Oregon Journal in Portland, Oregon; Parade in New York, New York; The Patriot, The Evening News, and the Sunday Patriot News in Harrisburg, Pennsylvania; The Plain Dealer in Cleveland, Ohio; The Union, The News, and the Republican, in Springfield, Massachusetts; The Times-Picayune and the States Item in New Orleans, Louisiana. Advance also owned Electric Delivery System, Inc., a distribution and delivery company for the Times-Picayune and Mercury Express, Inc., a distribution and delivery company for The Birmingham News.

As of Feb. 29, 1980, Advance operated the following magazines: Vogue, Vogue Guides, Glamour, Mademoiselle, House & Garden, House & Garden Guides, Bride's, Self, Street & Smith, Analog, Vogue Patterns, and GQ in the United States; Vogue in Brazil, Australia, and Germany; Vogue, House & Garden, and Bride's & Setting Up Home in England, Vogue, Vogue Shopping, L'Uomo Vogue, Casa Vogue, Uomo Mare, Vogue Bambini, and Lei in Italy; Vogue, Vogue Beaute, Vogue Homes, Maison & Jardin, Maison, and Club Maison in France.

As of Feb. 29, 1980, Advance also owned Art Gravure and Diversified Printing, two printing companies. Advance also owned a 49-percent interest in Catawba Newsprint Co., a newsprint manufacturing company.

When there was no scheduled meeting, the five family members, who all arrived at work very early in the morning, would speak with each other by telephone before other employees had come to work. Between monthly visits they communicated by telephone with the local management of newspapers they oversaw and regularly received financial reports, advertising reports, circulation reports, and other pertinent data. Financial and operating reports from the out-of-town newspapers were shared among the five family members. The family members considered the periodic visits to the out-of-town properties and the consensus decision-making to be hallmarks of their management style. Throughout Advance's history, all major decisions were reached by unanimous agreement after discussion in which all partook. Each visiting family member would write a report on the management of the out-of-town newspaper (issues, decisions, future) that was circulated to the other family members. While no person dominated the discussions, some deference in matters relating to a particular newspaper was shown to the family member who was responsible for that newspaper. Decisions were never made by voting. The consensus style of management has been utilized throughout the time the family has managed Advance. Despite disagreements, discussions always proved fruitful and consensus was reached.

In the 1950's S.I., Jr., and Donald joined their father and uncles in the business. Working primarily under the supervision of their uncles, S.I., Jr., and Donald learned the family business from the ground up. In the beginning both Donald and S.I., Jr., attended the family management meetings as mere observers but by the mid-1960's their advice was sought by their father and uncles. After several years of learning editorial and production management, S.I., Jr., and Donald were each assigned to manage an out-of-town property. S.I., Jr., worked in the Conde Nast organization and Donald started at the Long Island and the Jersey City newspapers.

The management of Advance was eventually shared among all five of the family members. Until the last year of his life when he became too ill to travel, Newhouse supervised the newspaper properties in Newark, New Jersey; Syracuse, New York; Harrisburg, Pennsylvania; St. Louis, Missouri; New Orleans, Louisiana; and Mobile, Alabama. Ted managed the newspaper properties in Portland, Oregon; Birmingham, Alabama; Huntsville, Alabama; Springfield, Massachusetts and later the Booth divisions in Michigan. Norman was responsible for the newspaper in Cleveland, Ohio, and later for the newspapers in New Orleans and Mobile when he moved to New Orleans in the late 1960's. S.I., Jr., made periodic visits to the newspaper in Cleveland, Ohio to help Norman and managed Conde Nast; after his father became ill, he oversaw St. Louis. Donald traveled with Ted to the newspapers in Birmingham and Huntsville. After his father became ill, Donald took over supervision of the operations at Newark, Syracuse, Harrisburg, Jersey City, and Staten Island.

Throughout its history, Advance had a policy of reinvesting earnings to finance further acquisitions. Advance traditionally minimized the dividends declared. From 1973 to 1979, dividends were declared and paid at their highest historical level in the amount of $ 200 per share although in 1977, 1978, and 1979, Advance had retained earnings of $ 411,206,000, $ 503,858,000, and $ 475,969,000, respectively, and total operating income of $ 148,217,000, $ 173,947,000, and $ 159,895,000, respectively. Each shareof stock received the same amount of dividends.

B. Capital Structure

On August 26, 1924, the stock of Advance, viz, 200 shares of common stock, par value $ 100, was reclassified into 1,000 shares, no par value.

By a "Certificate of Increase of Number of Shares, Change of Previously Authorized Shares and Classification of Shares" filed August 26, 1936, Advance authorized 6,000 no-par shares divided equally among class A, class B, and class C common stock (the 1936 amendment). The right to vote for the board of directors was given to the holders of the class A stock exclusively. The class B and class C shareholders were explicitly denied the right to vote on certain matters referenced in the New York Stock Corporation Law and General Corporation Law. n3 Furthermore, the class B stock and the class C stock could be redeemed in whole or in part at the prices of $ 175 and $ 199.50 per share, respectively, after September 1, 1939, at the discretion of the board of directors. The 1936 amendment also provided for equal participation in dividends of all three classes of stock, and finally, established a liquidation preference in the Class B stock of $ 175 per share, then in the class C stock of $ 199.50 per share and ultimately in the class A stock of $ 333 per share, with the residual value to be divided equally among all classes.

n3 Specifically the Class B and the Class C shareholders were denied the right to vote:

in a proceeding for mortgaging the property and franchises of the Corporation, pursuant to Section 16 of the Stock Corporation Law; for guaranteeing the bonds of another Corporation, pursuant to Section 19 of the Stock Corporation Law; for sale of the franchises and property, pursuant to Section 20 of the Stock Corporation Law; for establishing priorities or creating preferences among several classes of stock, pursuant to Section 36 of the Stock Corporation Law; for consolidation, pursuant to Section 86 of the Stock Corporation Law; for voluntary dissolution, pursuant to Section 105 of the Stock Corporation Law; for change of name, pursuant to the General Corporation Law * * *.

On December 27, 1938, Advance filed a "Certificate of Change of All Its Previously Authorized Shares Without Par Value Issued or Unissued, (1) class 'A' Stock Into the Same Number of Shares of Common Stock, Without Par Value; (2) class 'B' Stock and class 'C' Stock Into the Same Number of Shares of Preferred Stock, Without Par Value And Reclassification of Shares" (the 1938 amendment). This amendment provided that the 6,000 shares of authorized class A, class B, and class C common stock would be reclassified to create two classes of stock: the 2,000 shares of class A would become no-par common stock and the 4,000 shares of class B and class C would become no-par preferred. The amendment further provided that the preferred shareholders would receive noncumulative dividends of $ 12 per share before any dividends would be paid to the common shareholders, and the remainder of declared dividends would be shared proportionately by the common and the preferred shareholders. The preferred shareholders were also entitled to a liquidation preference of $ 187.25 per share before payment to the common shareholders of $ 333 per share could be made. The residual value would be divided pro rata among all shareholders. The entire voting power for the election of the board of directors was reserved to the common shareholders and the voting rights of the preferred shareholders were explicitly restricted. n4 The amendment further provided that the preferred stock could be redeemed after September 1, 1944, at $ 187.25 per share at the discretion of the board of directors.

n4 The preferred was not entitled to vote:

in a proceeding for mortgaging the property and franchises of the Corporation, pursuant to Section 16 of the Stock Corporation Law; for guaranteeing the bonds of another Corporation, pursuant to Section 10 of the Stock Corporation Law; for sale of the franchise and property, pursuant to Section 20 of the Stock Corporation Law; for establishing priorities or creating preferences among the several classes of stock, pursuant to Section 86 of the Stock Corporation Law; for voluntary dissolution, pursuant to Section 105 of the Stock Corporation Law; for change of name, pursuant to the General Corporation Law * * *.

On December 27, 1949, Advance filed a "Certificate of Amendment of Certificate of Incorporation" (the 1949 amendment), which provided that the preferred and the common stock would participate proportionately in all dividends. The amendment retained the preferred's liquidation preference of $ 187.25, but abandoned the common's liquidation preference of $ 333 per share and the preferred's right to share in the residual value. The common shareholders were given exclusive right to the residual liquidation value. With one important exception, the voting rights remained substantially the same. n5 Also in 1949, Advance changed its name from Staten Island Advance Co. to Advance Publications, Inc.

n5 Prior to the 1949 amendment, the preferred shareholders had been specifically prohibited from voting on "establishing priorities or creating preferences among the several classes of stock" but this limitation was removed in the 1949 amendment.

On December 22, 1952, Advance filed another "Certificate of Amendment of Certificate of Incorporation" which provided for the transformation of the 2,000 shares of authorized common stock into 20 shares of class A common voting stock and 1,980 shares of class B common nonvoting stock (the 1952 amendment). A "Certificate of Amendment of Certificate of Incorporation" was filed on January 5, 1955, to change the number of directors.

On December 27, 1956, the last change in Advance's corporate structure was made by "Certificate of Amendment to Certificate of Incorporation" n6 (the 1956 amendment) stating that: (1) Dividends were to be shared equally between the class A common, the class B common, and the preferred shareholders,

(2) and the preferred shareholders were entitled to a liquidation preference of $ 187.25 per share before the class A common and the class B common shared equally in the residual liquidation value, and (3) the limitation on the voting rights of the preferred shareholders on voluntary dissolution was removed.

n6 All future references in this opinion to "the certificate" are to the original Certificate of Incorporation as amended.

Prior to 1936, Newhouse owned 786 of the 1,000 authorized shares of Advance no-par common stock. After the 1936 amendment, Newhouse's shares were changed to 1,000 shares of class A common. At this time, 1,000 shares of class B common were issued to his wife, Mitzi Newhouse (Mitzi), and 500 shares of class C common were issued in trust for each of his sons, S.I., Jr. and Donald. After the 1938 amendment, Newhouse's class A common was exchanged for 1,000 shares of common stock, Mitzi's shares of class B common were exchanged for 1,000 shares of preferred stock and the 500 shares of class C common stock held in each trust for S.I., Jr., and Donald were exchanged for shares of preferred stock. On or about December 27, 1938, an additional 250 shares of preferred stock were issued to each trust for S.I., Jr., and Donald. In 1947, 500 shares of preferred stock apiece were issued to Ted and Norman. In 1948, the trust distributed 400 shares of preferred stock to S.I., Jr., and in 1950 the trust distributed to him an additional 350 shares of preferred stock. In 1950, the trust distributed 750 shares of preferred stock to Donald.

At the time of Newhouse's death, Newhouse still owned all the common stock andMitzi Newhouse owned 1,000 shares of preferred stock, S.I., Jr., and Donald each owned 750 shares of preferred stock and Ted and Norman each owned 500 shares of preferred stock. By will, Newhouse left 300 shares of Advance class B common stock to Mitzi.

In 1959 Advance and all of its shareholders executed separate agreements providing that at their deaths, Advance would redeem enough stock from the shareholder's estate to cover Federal estate taxes. The 1959 agreements between Advance and Ted, Norman, S.I., Jr., and Donald were superseded by a shareholders' agreement in 1974. The 1959 agreement between Advance and Mitzi was superseded in 1978 when the shareholders' agreement executed in 1974 was amended to include Mitzi's stock. The 1959 agreement between Advance and Newhouse continued in effect until the time of Newhouse's death.

On April 24, 1974, Advance, Newhouse, Ted, Norman, S.I., Jr., and Donald executed an agreement limiting the rights of any subsequent owner of the preferred stock who had not executed the agreement to dispose of their stock (the 1974 shareholders' agreement). The purpose of the 1974 shareholders' agreement was to:

make certain the continued ability of Advance to operate as a closely held corporation with a harmonious group of shareholders, and to continue its management policies and procedures which have proven successful in the past, despite change which may result from the deaths or other transfers of shares by Theodore Newhouse, Norman N. Newhouse or Samuel I. Newhouse, Sr.

Particularly, the family members were concerned with the fragmentation of closely held, family-owned companies that they felt frequently occurred in the newspaper industry.

The 1974 shareholders' agreement provided that in the event of a sale or exchange of preferred stock, Advance would first have the right to buy the stock on the same terms as offered by the prospective buyer. Furthermore, upon the determination of a majority of the board of directors, Advance was given the right to acquire all or any part of the shares of preferred stock from a shareholder upon the death of a preferred shareholder, upon an involuntary transfer of preferred shares by operation of law or otherwise, or whenever a majority of the board of directors determined in good faith that (1) the preferred shareholder had violated an agreement with Advance resulting in a materially adverse effect on Advance or its shareholders, (2) the shareholder threatened to dispute Advance over his rights as a shareholder, or (3) when it would be in Advance's interests to reduce the number of preferred shareholders. If the preferred shareholder and Advance could not agree on the purchase price, the "fair value" of the preferred shares would be determined by Chemical Bank. Chemical Bank's decision would be binding on the preferred shareholders and Advance and was not judicially reviewable except as required by New York arbitration law.

The 1974 shareholders' agreement also provided that at the deaths of Ted, Norman, S.I., Jr., and Donald, and their spouses, their personal representatives could require Advance to purchase preferred stock from the respective estates in an amount that satisfied, but did not exceed, the estate's cost for taxes, funeral expenses, and administrative expenses of the estate. On April 18, 1978, the 1974 shareholders' agreement was amended to include Mitzi Newhouse's 1,000 shares of preferred stock. n7

n7 In 1980, the 1974 shareholders' agreement was amended to include 300 shares of Class B common stock that Mitzi received under S.I., Sr.'s will.

After Newhouse's death, the estate requested Chemical Bank to determine the value of the class A common and class B common stock that Newhouse held at the date of death. In a letter dated April 29, 1980, Chemical Bank explained that, after considering financial statements for the years 1973 through 1979 and the certificate, and after visiting some of Advance's key properties, Chemical Bank concluded that the class A common stock was worth five times as much per share as the class B common stock and that the class B common stock shares were equal in value to the preferred shares. The report concluded that the value of Newhouse's class A common stock had an aggregate value of $ 8,595,000, viz, $ 859,500 per share and the class B common stock had an aggregate value of $ 170,181,000, viz, $ 171,900 per share.

C. State Law Issues

There are three basic methods for a shareholder to realize value from a corporation: (1) The redemption of stock, (2) the payment of dividends or distributions, and (3) a merger or liquidation in which stock is cashed out or exchanged for value. Consequently, the rights and privileges of the various classes of Advance stock determine the constraints on a purchaser of the Advance common stock in attempting to realize the value of his purchase. On February 29, 1980, a buyer of the Advance common stock could have elected the board of directors. The preferred stock, however, could vote on and block corporate liquidation. On February 29, 1980, the Advance preferred stock could not be redeemed without the preferred shareholders' consent. The preferred stock could vote on any charter change that affected its class rights or gave new class rights or authorized a new class of stock. The preferred shareholders were entitled to 78 percent of all dividends declared out of current and retained earnings; the common stock was entitled to 22 percent.

The allocation of all the other rights and privileges pertaining to shareholders is unclear. The preferred shareholders might be entitled to participate equally in dividends declared from capital surplus. It is not clear whether a buyer of the Advance common stock could effect a merger to eliminate or cash out the preferred shareholders. It is also unclear what price the common shareholder would have to pay the preferred shareholders in an appraisal proceeding or a fair value proceedingunder New York law. The extent of the disagreement over the rights and privileges of the classes of Advance stock under New York law would be certain to result in litigation in the event that the common shareholder attempted to cash out the preferred stock through a merger or otherwise attempted to effect a constructive redemption or liquidation that returned less than 78 percent of the value of Advance to the preferred shareholders.

Petitioner's expert witnesses on New York law included Loeber Landau, a partner with Sullivan & Cromwell who specializes in corporate and securities law, Martin Lipton, a partner with Wachtell, Lipton, Rosen & Katz who specializes in corporate and securities law, and Robert H. Mundheim, Dean of the University of Pennsylvania Law School, whose area of expertise is corporate law. With the consent of respondent, petitioner also submitted reports without accompanying testimony from the law firm of Cravath, Swaine & Moore and from John McNally, a partner with the law firm of White & Case who specializes in corporate law.

Respondent's expert witnesses included Victor Brudney, a professor emeritus from Harvard Law School who taught finance and corporate law, Stanley Siegel, the associate dean of New York University Law School who teaches business planning, corporate finance, and tax, and John C. Coffee, Jr., a professor at Columbia University Law School who teaches corporate and securities law. With the consent of petitioner, respondent also submitted reports without testimony from Melvin A. Eisenberg, a professor of law at Boalt School of Law at the University of California at Berkeley, and James D. Cox, professor of law at Duke University.

The experts considered the relative rights and powers of the common and preferred shareholders. In preparing their reports the experts relied on the certificate, the 1974 shareholders' agreement, the New York Business Corporation Law (McKinney 1980) (the Business Corporation Law), and New York case law. The experts treated the class A common stock and the class B common stock as one block of identical shares for purposes of analyzing the relative rights of the common and the preferred stock. All the experts commenced their legal analysis from the standpoint of a prospective buyer of the common stock of Advance who would want to be able to realize value greater than his investment despitepossible hostility from the preferred shareholders.

1. Redemption

The Advance stock cannot be redeemed at the request of either the shareholders or the corporation except as permitted under the 1974 shareholders' agreement. The certificate would have to be amended to force a redemption of preferred stock. Although the certificate is silent on voting rights for amendments to the certificate, sections 804 and 801(b)(12) of the Business Corporation Law provide that an amendment to "fix, change or abolish" the "relative rights, preferences and limitations" of any shares of stock "including any provisions in respect of * * * the redemption of any shares" entitles the nonvoting shareholders to a class vote. Consequently, the preferred shareholders were entitled to a class vote on any proposed amendment to the certificate and by sheer numbers could have overruled any proposed amendment to the certificate adverse to their interests.

2. Dividends

The certificate requires that the common and the preferred shareholders participate pro rata in dividends. The common shareholder can receive only 1000/4500 or 22 percent of all dividends declared and paid out of earningswhile the preferred shareholders are entitled to 3500/4500 or 78 percent.

a. Source of Dividends

Section 4(a) of the certificate provides:

The holders of the Preferred Stock, the Class A Common Stock and the Class B Common Stock shall participate equally in proportion to the number of shares of such stock held by them respectively, whether Preferred Stock, Class A Common Stock or Class B Common Stock, in any and all dividends which may be declared and paid by the corporation out of its earnings. [Emphasis supplied.]

The experts disagreed about the common shareholder's entitlement to more than 22 percent of dividends declared from sources other than current or retained earnings such as from capital surplus. They also disagreed over whether the shareholder who forced a sale of assets would be entitled to more than 22 percent of dividends out of sales proceeds. The dispute focused in part over the characterization of the proceeds as earnings or capital surplus.

b. Stock Split or Stock Dividend

There were 1,000 shares of authorized and unissued common stock and 500 shares of authorized and unissued preferred stock on February 29, 1980. For the common shareholder to dilute the voting power of the preferred shareholders sufficiently to obtain the power to liquidate Advance, the certificate would have to be amended to authorize the issuance of new stock. Even if the common shareholder distributed all the authorized but unissued stock to himself, he would not have enough to force liquidation. Under New York law a stock split requires the approval of the shareholders. An attempt to dilute the voting power of the preferred shareholders through a stock split or a stock dividend would also require an amendment to the certificate.

New York law provides for preemptive rights to shareholders whose shares have unlimited dividend rights where the issuance of new shares would adversely affect the shareholders' dividend rights under section 622(b) of the Business Corporation Law. The experts disagreed whether a plan by the common shareholder to issue himself additional stock would give rise to preemptive rights in the preferred stock.

c. Nonpayment of Dividends

Despite the preferred shareholders' entitlement to 78 percent of declared and paid dividends, the common shareholder could, through his control over the board of directors, cease declaring dividends altogether. The experts disputed the extent that fiduciary obligations of the board to the preferred shareholders would limit their exercise of this power.

3. Liquidation or Merger

Under the terms of the certificate, the preferred shareholders are entitled to receive only $ 187.25 per share in the event of liquidation. All the experts assumed that a purchaser of the common stock would prefer liquidation as the means to extract the value of the investment and that the preferred shareholders would oppose liquidation.

a. Liquidation

Under New York law, liquidation requires a two-thirds majority. The experts agreed that as of February 29, 1980, the preferred shareholders were entitled to vote on the liquidation. Section 612(a) of the Business Corporation Law provides a vote for each share of stock of all classes of stock unless specifically denied by the certificate of incorporation. Because the right to vote on liquidation is not explicitly denied to the preferred shareholders, the statute authorizes a vote.

b. Mergers

The experts on both sides focused primarily on several possible merger transactions the common shareholder could employ to try to limit the preferred shareholders' rights. The objectives of any merger would be to dilute the preferred stock, to reduce its claim to dividends, and to eliminate the class. A vote on mergers is explicitly reserved to the common shareholders in the certificate. The possible mergers discussed were (1) the freeze-out merger, and (2) the freeze-in merger.

(1) Freeze-Out Merger

In a freeze-out merger, the common shareholder's goal is to force a merger that would require the preferred shareholders to exchange their Advance stock for cash. The common shareholder could then either retain his interest in the corporation, sell it, or liquidate it. Respondent's experts believed that the common shareholder could implement this plan because the common stock controls the election of the board of directors and has practical control over the board's decisions. The freeze-out merger would merge Advance into a corporation owned by the common shareholder or the purchaser. The common shareholder would exchange Advance common stock for the stock of the acquirer while the preferred shareholders exchanged their stock for cash. The experts disagreed about whether such a merger would be allowed over the objections of the preferred shareholders. Section 903(a)(2) n8 of the Business Corporation Law provides for a class vote if a plan for merger contains an amendment to the certificate which would entitle the shareholders of that class to vote. Business Corporation Law sections 804(a)(2) n9 and 801(b)(12) n10 provide a class vote on amendments that change or abolish the relative rights and preferences of any shares of stock. In light of these rights, the historical participation of the preferred shareholders in directing corporate affairs, their understanding that the shares were of equal value, on the one hand, and the common stock's right to elect the board of directors, approve sales of assets, and approve mergers, on the other, the experts dispute whether the preferred shareholders would have a class vote on the proposed merger, and, if they did not, whether the freeze-out merger would be allowed under New York law.

n8 Sec. 903(a)(2) provides that notwithstanding any provision in the certificate of incorporation:

the holders of shares of a class or series shall be entitled to vote and to vote as a class (on a merger) if the plan of merger * * * contains any provision which, if contained in an amendment to the certificate of incorporation, would entitle the holders of shares of such class or series to vote and to vote as a class thereon. In such case, in addition to the authorization of the merger * * * by vote of the holders of two-thirds of all outstanding shares entitled to vote thereon, the merger * * * shall be authorized by vote of the holders of a majority of all outstanding shares of each class or series.

n9 Sec. 804(a) provides a class vote on a certificate amendment that would:

(1) Exclude or limit their right to vote on any matter, except as such right may be limited by voting rights given to new shares then being authorized of any existing or new class or series.

(2) Change their shares under subparagraphs (b)(10), (11) or (12) of section 801 * * * or provide that their shares may be converted into shares of any other class or into shares of any other series of the same class, or alter the terms or conditions upon which their shares are convertible or change the shares issuable upon conversion of their shares, if such action would adversely affect such holders, or

(3) Subordinate their rights, by authorizing shares having preferences which would be in any respect superior to their rights.

n10 Secs. 801(b)(10), (11), and (12) referred to in sec. 804(a)(2) apply to certificate amendments that would:

(10) * * * reduce the par value of any authorized shares of any class with par value, whether issued or unissued.

(11) * * * change any authorized shares, with or without par value, whether issued or unissued, into a different number of shares of the same class or into the same or a different number of shares of any one or more classes or any series thereof, either with or without par value.

(12) * * * fix, change or abolish the designation of any authorized class of any series thereof or any of the relative rights, preferences and limitations of any shares of any authorized class or any series thereof, whether issued or unissued, including any provisions in respect of any undeclared dividends whether or not cumulative or any sinking fund for the redemption or purchase of any shares, or any preemptive right to acquire shares or other securities.

(2) Freeze-In Merger

In a freeze-in merger, the common shareholder exchanges his Advance stock for cash or stock in an acquiring company while the preferred shareholders retain their Advance stock. This proposal would be intended to dilute the preferred shareholders' ability to block liquidation, by authorizing and issuing at least 6,000 new shares of voting common. The Advance common stock would be traded to the acquiring company in exchange for its stock. Because the common shareholder would then hold 7,000 shares of stock, a liquidation could be accomplished over the objection of the preferred shareholders. Although the preferred shareholders would retain their stock, they would have lost their ability to influence the affairs of Advance and would be susceptible to redemption. The acquiring corporation would then be able to overpower the preferred shareholders and liquidate Advance. As with the freeze-out merger, the experts disputed whether the freeze-in merger would be allowed over the objections of the preferred.

D. Valuation Opinions

In order to demonstrate the correct value of the Advance common stock, the parties introduced the testimony of several experts. Peter Fahey and Gary Gensler, partners with the investment banking firm of Goldman Sachs & Co., prepared reports and testified for petitioner about the fair market value of the Advance common stock. n11 Petitioner also introduced the reports and testimony of Robert J. Harrity of Chemical Bank on the value of the common stock, and David Wilkofsky of Wilkofsky, Gruen Associates, Inc., on the general economic conditions of the newspaper and magazine publishing industries in 1979 and early 1980. Rupert Murdoch, the chief executive officer of The News Corp., a newspaper and

magazine publishing company, and Douglas McCorkindale a vice president of Gannett Corp., a media company, both testified about the criteria a buyer would use in considering the purchase of the Advance common stock. n12 Respondent introduced the report and testimony of Joseph P. Baniewicz, a financial analyst for the Internal Revenue Service.

n11 Respondent challenged the expertise of the Goldman Sachs employees because they are "graduates of business schools with no formal education in the valuation of stock." Fahey and Gensler testified that they routinely value stock in closely held corporations in order to advise their clients on possible purchases or sales. We do not share respondent's doubt as to their qualifications.

n12 Respondent challenged the relevance of the testimony of Murdoch and McCorkindale because neither wanted to purchase the Advance stock. It is their views on the considerations warranted in analyzing the potential purchase of the Advance common stock, not whether they would in fact have purchased the stock, that interest us.

According to the experts from Goldman Sachs and Chemical Bank, there were a number of factors that would have influenced a prospective buyer of the Advance common stock. Some, such as the capital structure and uncertain relative rights and limitations of the Advance stock, were internal to Advance. Others, such as the particular economic conditions of the newspaper and magazine publishing industries and the general negative economic mood of 1979 and early 1980, were external to Advance. The size and financial strength of Advance itself, particularly in comparison with other newspaper and magazine publishing companies, would have been a consideration for a prospective willing buyer. Finally, the most likely willing buyers would have faced other concerns, suchas antitrust considerations or difficulties complying with Federal Communications Commission regulations, that would have affected the ultimate selling price.

1. General Economic Conditions

In late 1979 and early 1980, high inflation and "record high" interest rates predominated. Many economists were uncertain or pessimistic about the near future, forecasting an economic slowdown or recession. The 1979 decision of the Federal Reserve Board to manage the supply of money rather than interest rates resulted in a sharp rise in interest rates. Although the economy had experienced a period of growth after the recession of 1974-1975, in 1979 economic growth slowed again, as inflation rose rapidly and interest rates soared. The gross national product grew at an annual rate of only 1.2 percent in constant dollars in the first half of 1980; unemployment was high and was expected to rise, and oil prices were increasing.

One of the byproducts of the tightening money supply and unrestrained interest rates was a new attitude of wariness and reluctance to lend on the part of many banks and lending institutions. In late October of 1979, the Chairman of the Federal Reserve Board warned banks against making "nonproductive" takeover loans. Due to the negative economic outlook, the late 1970's experienced a decline in merger activity. Of the acquisitions for which data was disclosed, only 2 percent of the private companies acquired in the first half of 1980 were sold for more than $ 100 million.

2. Industry Economic Conditions

The economic malaise of the country affected the newspaper and magazine publishing industry. Although revenues rose, the increase was consumed by inflation. The newspaper publishing industry was considered "mature" by the late 1970's. The markets for Advance's newspapers had been fully penetrated, and newspaper circulation was expected to remain fairly constant and stable.

The newspaper and magazine publishing industry also suffered from the growing competition of television in late 1979 and early 1980. Local advertising revenues were increasingly devoted to television at the expense of newspapers, particularly evening newspapers, and, in 1980, newspaper advertising revenues were expected to decline, in real terms. The popularity of evening newspapers had begun to be displaced by the television evening news. Most of the large newspaper publishing companies were acquiring holdings in the broadcast media to diversify away from the newspaper business. Furthermore, the use of "preprints," printed advertising inserts that were slipped into the newspapers for a fee, grew in the later 1970's. The fee brought in from preprints was less than the revenue that straight advertising would have generated. The preprint publishers competed with newspaper publishers for advertising dollars.

Economic conditions discouraged advertising expenditures. Television was becoming a considerable rival for local advertising dollars and cable television was expected to continue the trend as independent television stations competed for local advertising dollars. The annual growth rate for total newspaper advertising dropped from 13.5 percent in 1979 to 6.7 percent in 1980 although retail spending growth only declined from 14.9 percent in 1979 to 10.9 percent in 1980. Furthermore, much of the growth that did occur in advertising in 1979 and 1980 came from increased use of preprints and did not significantly benefit the newspaper publishing companies.

Due to adverse economic conditions, total newspaper circulation per adult declined between 1975 and 1980 and the rate of that decline increased in 1979 and 1980. The decline in circulation was largely attributable to the decline in evening newspaper readership. Similarly, circulation revenue grew between 1975 and 1978 but then tapered off and actually declined by 5.1 percent in 1980.

The costs of newsprint and production labor rose, as the total spending on newspapers was decreasing in 1979 and 1980. Total expenditures for newsprint rose in 1979, outpacing the increase in newspaper revenues from 1979 to 1980. Although labor costs were suppressed by labor contracts predating the period of acute inflation, the labor contracts also delayed automation by requiring newspaper publishing companies to retain costly labor-intensive printing processes. Additionally, the decrease in bulk mail rates in 1978 caused an increase in direct mail advertising which, in turn, cut into newspaper advertising revenue.

The health of the magazine publishing industry also weakened in the late 1970's and early 1980. Because magazine advertising is national, magazine publishing industry conditions reflected the overall economic conditions. A slowdown in advertising expenditures began in 1979 and worsened in 1980. Magazine circulation dropped at the same time. Finally, the Wilkofsky report mentioned that in 1979 and 1980 the growth in production labor costs exceeded the growth in magazine revenues.

3. Competitive Position

Many of Advance's newspaper properties were situated in economically depressed markets that suffered from low population growth and high unemployment. Many of the markets in which Advance operated newspapers were extremely competitive. Additionally, in its 22 newspaper markets, Advance

operated 10 morning newspapers, 19 evening newspapers, and 21 Sunday newspapers, so, in all but three of its markets, Advance had evening newspapers. In over half its markets Advance published no morning paper. In 1979, Advance's revenues increased by only 4.1 percent though inflation grew at the rate of 11.3 percent. Operating margins for Advance's newspaper properties declined from 21.6 percent in 1978 to 18 percent in 1979, resulting in a 13-percent decline in operating income for 1979. Furthermore, the rate of increase in total advertising linage decreased and total circulation actually decreased. For Advance's aggregate operations, operating income fell by $ 14 million from 1978 to 1979 and the operating margin decreased from 17.8 percent in 1978 to 14.8 percent in 1979.

Advance's subsidiary, Conde Nast, published seven consumer magazines that were predominantly fashion oriented. Although revenues were increasing in 1979, costs were increasing faster. Conde Nast's operating cash-flow margin declined from 14 percent in 1977 to 7.8 percent in 1979.

4. Size of Advance

As of February 29, 1980, Advance was the fourth largest newspaper and magazine publishing company in the United States. On December 31, 1979, Advance had a consolidated book value of $ 505,400,000 and retained earnings of $ 475,969,000. At that time, only seven or eight corporate acquisitions for more than $ 1 billion had ever occurred, and there had been no acquisitions of more than $ 350 million in the media industry. n13

n13 In 1976, the Herald Co., a subsidiary of Advance, acquired Booth Newspapers, Inc., for $ 304,588,598.

In early 1980, before leveraged buy-outs gained wide popularity, Advance could have borrowed an amount requiring interest obligations of not more than two-thirds of its operating income or, under the prevailing interest rate of 18 3/4 percent, $ 565 million. Because Advance had planned capital expenditures of $ 228 million, the remaining $ 337 million would be available to be distributed to the shareholders. Of this amount, only 22 percent would belong to the common shareholder.

5. Legal Uncertainty

A prospective buyer of the Advance common stock would want to know the rights of the preferred shareholders to gauge what corporate affairs the common stock could control and to project how to maximize the value of the investment. The prospective buyer would have received contradictory expert legal opinions on the relative rights and privileges of the common and preferred stock. This uncertainty would significantly depress the purchase price of the common stock. The prospective buyer would have been sure of protracted and expensive litigation. A substantial likelihood of considerable delay in effecting plans to cash-out the preferred existed. The litigation might take between 6 and 10 years to resolve in New York courts, and substantial probability existed that any action taken by the common shareholder to defeat the claims of the preferred shareholders would be blocked. Furthermore, because interest rates in February 1980 were extraordinarily high and the size of Advance would require financing, the carrying costs of the purchase would be enormous.

6. Antitrust and FCC Difficulties

Generally, only a media business would be interested in purchasing Advance. Because only a very sizable media business could afford to buy Advance, it would be likely that some of the potential buyer's newspaper and magazine markets would overlap with some of Advance's newspaper and magazine

markets. This would raise potential problems under both the antitrust laws and the Federal Communications Commission (FCC) regulations.

The operative antitrust law looks to whether a purchase might lessen competition, and the Department of Justice monitored newspaper acquisitions with particular scrutiny in 1980. A newspaper and magazine publisher that bought the Advance common stock would probably need to sell some current holdings or sell off some of Advance's assets after the purchase. As with antitrust, the FCC cross-ownership rules might require the buyer to sell certain assets.

7. Accounting Problem

The experts disagreed that, if the buyer were a corporation, the common shareholder could not report in its consolidated earnings the full amount of Advance's earnings and profits without, at a minimum, disclosing that the preferred shareholders were entitled to 78 percent of declared dividends out of those earnings. If a corporate buyer of Advance's common stock were to attribute more than 22 percent of Advance's earnings to the common stock interest, the financial statements would not comport with generally accepted accounting principles and would result in a qualified opinion on the buyer's consolidated financial statements. Such a qualified opinion would be unacceptable to users of the financial statements, including, for example, lenders, shareholders, and if the buyer's stock was publicly traded, the public.

II. VALUE OF N.B. CO. COMMON STOCK

N.B. Co. is a corporation that was organized under the laws of the State of New York in August 1944. On February 29, 1980, its principal place of business was located in Syracuse, New York. N.B. Co., either by itself or through wholly owned subsidiary corporations, operated television broadcasting, radio broadcasting, cable television, and microwave businesses. N.B. Co. operated radio and television broadcasting stations in Syracuse, New York; Elmira, New York; Birmingham, Alabama; Harrisburg, Pennsylvania; and St. Louis, Missouri. N.B. Co. operated cable television companies in many localities in New York State n14 and in Corapolis, Pennsylvania; Canonsburg, Pennsylvania; and Anniston, Alabama. N.B. Co. operated microwave stations in New York, New Hampshire, New Jersey, Ohio, Massachusetts, Vermont, Pennsylvania, and Alabama. As of February 29, 1980, N.B. Co. had contracted to sell all of its television broadcasting stations. The total value of N.B. Co. on the valuation date was $ 206,361,416.

n14 These are: Carthage, Corning, Delhi, Fulton, Malone, Massena, Ogdensburg, Oneonta, Potsdam, Rome, Sidney, Syracuse suburbs, Troy, Binghamton, Vestal/Endicott, Cooperstown, Franklin, Milford, New Berlin, Oxford, and Richfield Springs.

N.B. Co.had one class of stock authorized. As of February 29, 1980, 225 shares of voting common stock were authorized and outstanding, owned as follows:

Shareholder	No. Shares	Percentage
Petitioner	100	44.44
S.I., Jr.	60	26.67
Donald	60	26.67
Mitzi	5	2.22

In its estate tax return, petitioner valued the N.B. Co. stock at $ 68.3 million based on a valuation report prepared by Chemical Bank.

OPINION

I. VALUE OF ADVANCE COMMON STOCK

The first issue for our decision is the value of Newhouse's 10 shares of class A common stock and 990 shares of class B common stock as of February 29, 1980. A derivative issue is the value, for purposes of the marital deduction, of 300 shares of class B common stock.

Property is included in the gross estate at its fair market value, which 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 to sell and both having reasonable knowledge of relevant facts." Sec. 20.2031-1(b), Estate Tax Regs.; United States v. Cartwright, 411 U.S. 546, 551 (1973). If the property is stock that is not listed on an exchange andcannot be valued with reference to bid and asked prices or historical sales prices, the value of stock in comparable corporations engaged in the same or similar line of business must be considered. Sec. 2031(b). Also considered are the corporation's management, net worth, earnings, and ability to pay dividends. Estate of Leyman v. Commissioner, 40 T.C. 100, 119 (1963), remanded on other grounds 344 F.2d 763 (6th Cir. 1965).

The determination of the fair market value of property is a question of fact. Hamm v. Commissioner, 325 F.2d 934, 938 (8th Cir. 1963), affg. a Memorandum Opinion of this Court. At trial, we received opinion evidence testimony from many expert witnesses, and we weigh that testimony in light of the expert's qualifications as well as all the other credible evidence. Estate of Christ v. Commissioner, 480 F.2d 171, 174 (9th Cir. 1973), affg. 54 T.C. 493 (1970); Estate of Gilford v. Commissioner, 88 T.C. 38, 56 (1987). Nonetheless, we are not bound by the opinion of any expert witness and will accept or reject expert testimony in the exercise of sound judgment. Helvering v. National Grocery Co., 304 U.S. 282, 295 (1938); Estate of Hall v. Commissioner, 92 T.C. 312, 338 (1989).

Respondent's Revenue Ruling 59-60, 1959-1 C.B. 237, has been widely accepted as setting forth the appropriate criteria to consider in determining fair market value; it lists the following factors to be considered:

(a) The nature of the business and the history of the enterprise from its inception. (b) The economic outlook in general and the condition and outlook of the specific industry in particular. (c) The book value of the stock and the financial condition of the business. (d) The earning capacity of the company. (e) The dividend paying capacity. (f) Whether or not the enterprise has goodwill or other intangible value. (g) Sales of the stock and the size of the block of stock to be valued. (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter. [1959-1 C.B. at 238-239.]

Only facts reasonably known at the valuation date may serve as the basis for valuation. Estate of Gilford v. Commissioner, 88 T.C. 38, 52-53 (1987). Generally, valuations based on subsequent events whose occurrence was not foreseeable at the time of the valuation date are not helpful. Messing v. Commissioner, 48 T.C. 502, 509 (1967). n15 The willing buyer is a purely hypothetical figure and valuation does not take into account the personal characteristics of the actual recipients of the stock. Estate of Bright v. United States, 658 F.2d 999, 1006 (5th Cir. 1981). The hypothetical willing buyer and

seller are presumed to be dedicated to achieving the maximum economic advantage. Estate of Curry v. United States, 706 F.2d 1424, 1429 (7th Cir. 1983). This advantage must be achieved in the context of market conditions, the constraints of the economy, and the financial and business experience of the corporation existing at the valuation date. Moreover, in valuing stock,the rights, restrictions, and limitations of the various classes of stock must be considered. n16

n15 Subsequent events affecting the character or quality of the property to be valued should be distinguished from subsequent market activity which can provide helpful comparable sales.

n16 See Estate of Anderson v. Commissioner, T.C. Memo. 1988-511. E.g., Estate of Van Horne v. Commissioner, 78 T.C. 728 (1982), affd. 720 F.2d 1114 (9th Cir. 1983).

A. State Law Issue

A willing buyer would want to know the relative rights and powers of the two classes of common stock and one class of preferred. If the rights and powers of the preferred stock are sufficient to significantly limit the ability of the common stock to control the company and its assets, then the value of the common stock will be significantly less than if the common enjoyed full and unrestricted control over corporate affairs. The parties agree that the common stock controls the board of directors and, by extension, the management of the business and that the preferred shareholders have the ability and the motivation to block a proposed liquidation.

Respondent believes that the common stock, through other means than by liquidation, could arrogate to itself substantially all of the value of Advance. Respondent proffers the "subtraction method" of valuation, i.e., value the whole of Advance, value the preferred, and the difference equates to the value of the common. Petitioner argues that the common stock does not control Advance, and the preferred is entitled to 78 percent of dividends declared out of earnings. Consequently, the preferred is worth far more than respondent believes. Moreover, petitioner argues, the extent of the common stock's rights to force the preferred out of Advance are unclear at best. With this uncertainty, the value of the common stock is substantially less than respondent determined.

1. Redemption

The certificate could be amended to allow redemption of the preferred stock only with the consent of the preferred shareholders. Respondent's experts do not dispute the power of the preferred shareholders to block an amendment that could force redemption of the preferred stock. The common shareholder cannot force the redemption of preferred stock.

2. Dividends

The experts from both sides presumed that a buyer of petitioner's common stock would want to eliminate or at least limit the preferred shareholders' rights to 78 percent of declared dividends. They discussed several ways of doing this.

a. Source of Dividends

The experts agree that all shareholders participate pro rata in dividends declared out of earnings. Respondent's experts, Coffee and Siegel, believe that the certificate's allocation of dividends among the shareholders limits the preferred shareholders to a fully participating share only from those dividends paid out of earnings or earned surplus. n17 The preferred would not, in their view, participate in

distributions of capital surplus, ordinarily available as a source for dividends under New York law. n18 Siegel and Coffee concluded that the common shareholder could receive dividends paid out of capital surplus, for example, by borrowing against assets and distributing the cash to the common shareholder without sharing the distribution with the preferred shareholders.

n17 Under New York law, "earnings" is defined as the corporation's income in a current year, "earned surplus" is defined as retained and undistributed earnings from prior years, and "capital surplus" is defined as unrealized appreciation in assets.

n18 Sec. 510 of the Business Corporation Law permits a corporation to make dividend distributions in cash, property, or bonds unless to do so would make the corporation insolvent, would violate a term of the corporate charter, or would reduce the value of net assets remaining in the corporation below the value of stated capital.

Petitioner's expert, Mundheim, disagreed and opined that the certificate does not speak at all about dividends paid from sources other than earnings. Alternatively, Mundheim noted, the language could mean that no shareholder, preferred or common, could receive dividends paid out of capital surplus. Mundheim explained that under New York corporation law there is a general underlying assumption that all shares are considered equal and therefore, differences between various classes of stock must be specifically designated and will not be inferred. Mundheim concluded that because the meaning was ambiguous, a New York court would construe the certificate against the background of the general rule that classes of stock are different only to the extent the differences are explicit, and would conclude that the two classes of stock should participate pro rata as to dividends from sources other than earnings as well.

Regardless of the source of dividends, the experts on both sides agreed that a prospective buyer of the Advance common stock would want to circumvent the preferred shareholders' right to 78 percent of declared dividends. To avoid paying the major portion of dividends to the preferred shareholders, the common shareholder would have to alter the preferred shareholders' rights and privileges, but the experts disagreed about whether the common shareholder could succeed.

b. Stock Split or Stock Dividend

Mundheim also concluded that because an amendment to increase the number of shares held by the common shareholder would clearly impinge on the voting rights of the preferred stock, the preferred shareholders would be allowed to vote against the proposed amendments under sections 801(b)(12) and 804 of the Business Corporation Law. Respondent's experts agree that the common shareholder would be unable to effect a stock split or stock dividend without the consent of the preferred shareholders.

c. Preemptive Rights

Shareholders generally have preemptive rights where the issuance of new shares would adversely affect their dividend rights. Coffee, respondent's expert, argued that the preferred shareholders would not have preemptive rights to acquire unissued or treasury shares of stock pursuant to exceptions to section 622(b) of the Business Corporation Law. As of February 29, 1980, Advance had no treasury shares and if all authorized common stock were issued it would not give the common shareholder the power to liquidate Advance. Because section 622 also provides an exception for the issuance of new

shares necessary for a merger or consolidation, Coffee believed that new shares could be issued to the common shareholder pursuant to a plan of merger and could dilute the preferred shareholders' control over liquidation.

Lipton, petitioner's expert, countered that Coffee's maneuver would be viewed, not as necessary to effect a merger, but as an attempt to derogate the preferred shareholder's rights. A New York court, in Lipton's view, would not permit the dilution of the preferred stock.

d. Nonpayment of Dividends

Coffee noted that the board of directors could stop paying dividends. He argued that a decision by the board of directors to curtail or cease the payment of dividends would be difficult to overturn because New York courts are highly disinclined to review a corporation's dividend policy. According to Coffee, in order to force the board of directors to pay dividends in New York, a shareholder must show that the nonpayment expressed hostility to the shareholders directly and that the failure to pay dividends was detrimental to both the shareholders and the corporation. Coffee further noted that Advance's past dividends had historically been low in relation to its earnings and that a preferred shareholder would find it particularly difficult to force a hostile board of directors (elected by the common) to pay dividends.

The Cravath, Swaine & Moore report submitted by petitioner maintained that an abrupt cessation of dividends without a demonstrable business purpose might constitute a breach of the directors' fiduciary duties. Furthermore, although the nonpayment of dividends may be burdensome to the preferred shareholders, it has an obvious correlative detriment for the common shareholder's extraction of corporate profits. n19

n19 Siegel suggests that the common shareholder might avoid the hardship of the cessation of dividends by paying himself a handsome salary but such a possibility implies that the common shareholder is an individual, not a corporation, and thus, impermissibly relies on personal characteristics of a particular willing buyer. See Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981).

The common shareholder could not force a redemption of the preferred stock and probably could not issue more stock to himself to dilute the preferred shareholders' voting power. Finally, the board of directors elected by the common shareholder might not be allowed to cease all dividends.Therefore, the common shareholder's ability to defeat the claims of the preferred shareholders to 78 percent of earnings is subject to considerable doubt.

3. Liquidation or Merger

All of the experts considered liquidating or merging the corporation as a way to disenfranchise the preferred shareholders.

a. Liquidation

The experts proceeded on the assumption that the preferred shareholders would not agree to a liquidation because the certificate sets a liquidation preference for the preferred stock at only $ 187.25 per share. Because the preferred shareholders are entitled to vote on liquidation, they could prevent it. This assumption comports with economic reality.

b. Mergers

The experts disagreed at all points on whether the common shareholder could dispose of the preferred shareholders by freeze-out or freeze-in merger.

(1) Freeze-Out Merger

Mundheim and Landau, petitioner's experts, noted several problems with the proposed freeze-out merger, structured as an acquisition by a third-party corporation. Mundheim and Landau found a significant likelihood that, under New York law, the preferred shareholders as a class would be entitled to vote ona freeze-out merger notwithstanding the fact that the certificate expressly reserves voting power over mergers to the common shareholder. Cravath, Swaine & Moore agreed, noting that a merger that threatened to diminish the preferred shareholders' entitlement to dividends or required the preferred shareholders to exchange their stock for cash would trigger a class vote. If the proposed freeze-out merger were viewed as a forced redemption, because its effect is to abolish the rights of the preferred, a class vote would be triggered because the preferred would be entitled to vote if the forced redemption were attempted in the form of an amendment to the certificate. Lipton also observed that the freeze-out merger amounts to a de facto forced redemption which is not permitted under the certificate. He opined that the common stock could not accomplish by indirect means what is forbidden by direct means.

Landau also noted that the historical development of the rights and privileges of the two classes of stock from the original certificate through the various amendments shows that the preferred shareholders were increasingly given a participating role through the capital structure. Landau concluded that the preferred shareholders were given equal status with the common shareholders in sharing the future earnings of Advance.

Respondent's experts disagreed that the preferred shareholders would be entitled to a class vote in the event of a freeze-out merger. Coffee based his conclusion on his analysis that the statutory language refers only to situations in which the "relative rights, preferences, or limitations" of the minority shares are changed and not to the total cancellation of the stock. He argued that:

the purpose of both sections 804 and 903 is to protect continuing shareholders against a change in their legal rights, not to prevent the voting majority from cashing out another class. The danger addressed by these sections was that of being locked in under a new and different legal regime, not that of being frozen out.

Coffee noted that not only does the statute protect minority shareholders from abuse by the majority shareholder, but it also protects the majority shareholders from unreasonable minority shareholders. Brudney and Siegel echoed Coffee's reasoning in their reports.

Petitioner's experts doubted whether such a transaction could pass muster under the New York requirement of fiduciary care on the part of the board of directors toward the shareholders, especially if the merger had no business purpose. Mundheim noted "under New York law, directors and controlling shareholders, such as the holder of Advance's common stock, have broad fiduciary responsibilities and may not direct the affairs of the corporation so as to favor themselves at the expense of other shareholders." Landau agreed. Mundheim concluded that because such a merger would have no purpose other than to force out the preferred shareholders for the exclusive benefit of the common shareholder, a New York court would not uphold it. Cravath, Swaine & Moore's report stated that where the corporate structure clearly protects the preferred shareholders' right to prevent liquidation, a court would not allow the board of directors to accomplish indirectly what they could not do directly.

Mundheim determined that a freeze-out merger could violate the New York requirements of procedural and substantive fairness. The leading New York case, Alpert v. 28 Williams Street, 63 N.Y.2d 557, 483 N.Y.S.2d 667, 473 N.E.2d 19 (1984), imposes an overall equitable requirement that a freeze-out merger must have an "independent corporate purpose for the merger" and include a fair price for the shareholders who are being frozen out. Mundheim noted that the court in Alpert ruled that a fair cash-out price would be "reasonably related to the value that might be set by an appraisal proceeding" and offered five factors for determining that amount. n20 Mundheim stated that it was impossible to be sure at the date of purchase of the common stock what fair value the New York courts might set for the preferred stock. While it was unclear whether a New York court would aim for the going concern price or the liquidation price in setting fair value, he noted that under recent New York cases, fair value might not be restricted by contractual provisions. In Mundheim's view a court might look beyond the stated liquidation preference amount and historical dividends and decide that the preferred and the common stock were fundamentally equal.

n20 The five factors listed in Alpert v. 28 Williams Street, 63 N.Y.2d 557, 483 N.Y.S.2d 677, 665, 473 N.E.2d 19 (1984), are net asset value, book value, earnings, market value, and investment value.

Lipton opined without equivocation that the preferred would be entitled to 78 percent of the going concern value of the corporation because "the terms of the Preferred Stock were specifically engineered to ensure that the holders of the Preferred Stock share proportionately in whatever level of pay-out the Company as a going concern makes on its capital stock." Lipton also suggested that a court might determine that the common shareholder had breached his fiduciary duties if, in negotiating the terms of the proposed merger, the common shareholder allocated more than 22 percent of the purchase price to the common and gave the preferred shareholders less than 78 percent of the purchase price.

Respondent's experts did not believe that the proposed freeze-out merger would violate those fiduciary duties. Eisenberg noted that under New York law, preferred stock is purely a creation of contract law and that the only fiduciary duty running to a preferred shareholder is the duty to satisfy the contractual entitlements. Since the proposed merger would not violate any of the Advance preferred shareholders' existing contractual rights, he reasoned they would have no grounds to complainof unfair treatment.

Respondent's experts concluded that although the preferred shareholders were entitled to receive fair value in the event of a freeze-out merger, the courts would not be inclined to value the rights of the preferred shareholders at 78 percent of the total value of the corporation. Coffee believed that a New York court would not derive fair value by measuring the corporation's going concern value but rather would compute the weighted average of the liquidation preference, the historical dividends, the book value per share, and the recent earnings history. Furthermore, Coffee noted that even if the court disagreed with the figure offered by the common shareholder, it would simply require that a higher price be paid, still allowing the transaction to proceed.

Brudney believed that a New York court would be most influenced by the historical dividend stream in computing fair value for the preferred stock. Because Advance has historically always reinvested the bulk of its earnings and paid minimal dividends, he opined, the preferred shareholders are on notice that they are entitled to no more than a future projection of historical dividends, or "the capitalized value of an annual amount equal to the dividend paid to [the preferred shareholders] during the last several years."

Siegel concluded that fair value would lie between the liquidation preference amount of $ 187.25 per share and a number representing maximum possible dividend participation in Advance as a going concern.

Finally, all the experts agree that not only would a merger have to be fair but the transaction would have to have a business purpose that would benefit Advance as a whole and not just the controlling shareholder. Nonetheless, the experts disagreed about what constitutes a valid business purpose under New York law.

If the freeze-out were perceived as little more than an attempt to dispossess the preferred shareholders as cheaply as possible, petitioner's expert, Mundheim, believed it would not be sustained by a New York court. Mundheim explained that in the proposed freeze-out "there would be no independent corporate purpose -- no improvement in management, no increase in capitalization, simply a reshuffling of the corporate structure for the exclusive benefit of the Common Stock at the expense of the to-be-ousted Preferred Stock." McNally agreed that a New York court would not consider the removal of the preferred shareholders for the sole benefit of the common shareholder to be a sufficient business purpose.

Respondent's expert, Coffee, agreed that the New York courts require a business purpose but argued that it does not have to be substantial. As a possible business purpose, Coffee suggested the need to avoid Advance's future obligation to redeem the preferred shares at the death of the shareholders, or the need to be able to redeem the preferred shares in the event of a future transfer by an existing shareholder in order to remain a closely-held corporation. Coffee also recommended the need to avoid hostility and dissension among the shareholders as a valid business reason.

(2) Freeze-In Merger

The objective of this transaction would be to dilute the preferred stock by issuing proportionately more common in the course of the merger while leaving the preferred stock in place. The dilution would have to be sufficient to give the common the ability to liquidate Advance over any objection by the preferred. Petitioner's experts, Landau and Mundheim, determined that like the freeze-out merger, the freeze-in merger would alsotrigger the class vote under sections 801(b)(12) and 804 of the Business Corporation Law. Although the freeze-in merger would appear to leave the rights and preferences of the preferred stock unchanged, Landau and Mundheim believed that a New York court would not stop at a superficial analysis. Because the rights of the preferred would in effect be dramatically reduced by the presence of an increased number of voting common shares, the statute would impose a class vote. Respondent's experts disagree because the form of the transaction leaves the preferred shareholders untouched.

Acknowledging that there are no dispositive New York cases on this point, Mundheim warned that the freeze-in merger would be subject to the same judicial requirements of business purpose and procedural and substantive fairness, as well as fiduciary duties, as the freeze-out merger. Mundheim concluded that a New York court would not be satisfied that the transaction had a business purpose.

Respondent's expert, Siegel, stated that "There appears to be no reason why the business purpose test, as applied under New York law, would be applied more restrictively to a freeze-in than to a freeze-out."Coffee agreed that although the preferred shareholders in a freeze-in merger would have to be treated equitably and the preferred stock could not be diluted unfairly, "the burden on the plaintiffs attacking such a [freeze-in] merger would be substantially higher than in the case of a 'freeze-out' merger." Coffee and Eisenberg surmised that if the preferred shareholders were guaranteed the

continuation of the historic dividend rate as a part of the terms of the merger they would have no grounds to complain of mistreatment. Coffee also suggested that if the board of directors were composed of persons who were neither shareholders nor corporate management, their actions would be substantially immunized from derivative suits by minority shareholders.

As Mundheim noted, considering the size of Advance, the purchaser would have to capitalize the acquiring corporation in the proposed merger very heavily. Furthermore, although the common shareholder would want the freeze-in to be done quickly because the Advance preferred shareholders would be entitled to 78 percent of declared dividends until the merger was approved and the carrying costs of the investment in the common would be significant,the inevitable litigation would foreclose any quick accomplishment of the merger.

(3) Waiting Out the Preferred

Respondent's expert witnesses suggested that the buyer of Advance common stock could ultimately acquire complete control by buying the preferred stock as it is transferred from the existing preferred shareholders to new owners. Coffee outlined a plan which could be employed in lieu of the mergers: first, the common shareholder would replace the board of directors, suspend the payment of all dividends, fire the family members, and issue all the authorized but unissued stock to himself in exchange for property of equal value. As the preferred shareholders died or attempted to transfer their stock to third parties, the corporation could purchase it, exercising the rights set forth in the 1974 shareholders' agreement. Then the new common shareholder would approach each remaining preferred shareholder and offer to buy his stock at a certain price, "explaining that he did not intend to acquire all the Preferred Stock, but only enough to give it two thirds voting control. The risks of being a holdout and the prospect of eventual liquidation could also be politely explained." Rather than be the last preferred shareholder holding less than one-third of the total outstanding stock and having to accept the contractual liquidation value of $ 187.25 per share, Coffee believed that, in light of the advanced ages of Norman, Ted, and Mitzi, each preferred shareholder would be willing to sell his stock to the common shareholder quickly, or, alternatively, the preferred shareholders would acknowledge the futility of resisting and agree to a common sales price.

Siegel suggested more strongly coercive techniques for ousting the preferred shareholders such as selling off Advance assets for less than the highest market value either alone or in conjunction with a third party. Siegel indicated that it might not be necessary to actually engage in such transactions because it might be enough to "vaguely and darkly threaten such tactics to maximize the pressure on the Preferred Stock's holders." Time, Siegel concluded, would be on the side of the common shareholder because three of the preferred shareholders were elderly. Coffee also opined that the 1974 shareholders' agreement makes it inevitable that ultimately the corporation will be able to acquire allof the preferred stock and that preferred shareholders would choose to sell their stock to the corporation rather than risk having to accept liquidation value of $ 187.25 per share. Coffee noted that once the shares had been reacquired by the corporation, they could be issued to the common shareholder without invoking preemptive rights which do not apply to treasury shares under New York law.

Petitioner's experts explained that a buyer of the Advance common stock would be very unsure of his rights and powers to effect the major corporate restructuring and of the rights of the preferred shareholders to block his efforts. Angered preferred shareholders would bring legal action seeking either injunctive relief or the recision of the transaction. Further obfuscating any predictable outcome of

litigation, the experts disagreed on whether a New York court would entertain parol evidence of the understandings of the Newhouse family members about the relative rights and powers of shareholders or how much weight the court would give it. Lipton noted that faced with legal uncertainty of such magnitude, a buyer would insist on indemnification and other protections against the claims of the preferred shareholders. An indemnification provision would depress the value the hypothetical willing seller would receive.

Petitioner's experts believed that a buyer of the common stock who cannot also purchase the preferred stock would be in a precarious situation. The report from Cravath, Swaine & Moore described the situation as analogous to:

the relationship between a person who owns a house surrounded by someone else's land and the surrounding landowner. * * * neither the holders of the Preferred Stock nor the holders of the Class B Common Stock have an easement to realize the full value of their interests in the Company, but the holders of the Class A Common Stock have no right to that portion of value of the Company attributable to the interests of the holders of the Class B Common Stock and Preferred Stock.

Analysis

Initially we must resolve whether we need to determine the relative rights and preferences of the two classes of Advance stock. Petitioner contends that to discern what a hypothetical willing buyer would be willing to pay for the common stock we need only determine that there is substantial uncertainty among respected legal experts about the rights and powers of the classes of stock and about the extent of the common shareholder's authority over the corporate assets. Petitioner argues that this uncertainty will strongly influence the willing buyer's purchase offer. Petitioner contends that we do not need to decide whether a common shareholder would succeed or fail in eliminating the claims of the preferred shareholders, but only that the willing buyer could not be secure about his ability to do so and would offer a commensurately lower price for the stock.

Respondent counters that we must first decide whether, in fact, the common shareholder could ultimately secure complete control over the assets of Advance through any one of the methods suggested by his expert witnesses. Respondent maintains that we cannot rule on the value of the common stock without first deciding the common shareholder's rights.

The focus of a valuation inquiry, however, is on the existing facts, circumstances, and factors at the valuation date that influence a hypothetical willing buyer and willing seller in determining a selling price. We agree with petitioner that it is the likely understanding of the rights and privileges of the Advance common stock that will influence the terms of sale, not whether we resolve this dispute over New York law. Indeed, we believe that it would be error to postulate a certainty that did not exist. Any potential buyer would be investing millions of dollars in this acquisition. Such a buyer would not assume legal certainty in the face of divided legal counsel. n21

n21 We struck from evidence the valuation report of one of respondent's experts precisely because he assumed legal certainty (i.e., that respondent's legal experts were correct) where none existed. Having made this flawed assumption, his report became irrelevant. See Estate of Hall v. Commissioner, 92 T.C. 312, 338-339 (1989).

To decide the exact rights and powers of the Advance common stock under New York law, we would have to decide that a willing buyer would ignore or discount some of the expert advice we heard. We believe that we cannot, however, disregard the effect of the mixed legal advice on the hypothetical willing buyer's commitment of funds to a purchase price. Not only would our resolution of this issue not make the hypothetical willing buyer feel secure on February 29, 1980, it would distort the reality in which the fair market value must be determined.

A hypothetical willing buyer would have had the counsel of several advisers of formidable reputation: Landau & Lipton, noted corporate lawyers; Professors Coffee, Cox, Eisenberg, and Brudney and Deans Mundheim and Siegel, all affiliated with prestigious educational institutions. He could have read legal memoranda from White & Case and Cravath, Swain & Moore, well-respected law firms. The hypothetical willing seller would also have been aware of this conflicting legal advice and the uncertainty of obtaining economic dominance in Advance. Not only is the law disputed, but the experts cite substantially the same cases to support their diametrically opposed positions. Moreover, no expert's views were patently unreasonable. No willing buyer, faced with the conflicting arguments and opinions of these respected legal experts could choose which one is right. The legal uncertainty will strongly affect his decision on the value of the common stock. "[The] Court must not 'permit the positing of transactions which are unlikely and plainly contrary to the economic interest of a hypothetical buyer.'" Estate of Hall v. Commissioner, 92 T.C. at 337, citing to Estate of Curry v. Commissioner, 706 F.2d 1424, 1429 (7th Cir. 1983). To assume the correctness of the views of either respondent's or petitioner's legal experts would distort the facts in which a willing buyer would have negotiated the purchase and would result in a transaction plainly contrary to the buyer's economic interests.

In arguing that we must decide that one side or the other is right, respondent relies on several cases that are not directly applicable to the case at hand. In Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981), the parties did not dispute the proper treatment of a decedent's community property under Texas law. In Estate of Watts v. Commissioner, 823 F.2d 483 (11th Cir. 1987), the process and implication of the dissolution and liquidation of a partnership under Oregon law was clear and easily resolved. In Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970), the Government urged this Court to overlook restrictions on stock imposed by a voting trust. Although we concluded that the voting trust restrictions would "most likely be valid," we decided that the threat of the enforcement of the voting trust restrictions would be significant in itself to a potential investor. 55 T.C. at 193-194. Two of these cases involve legal disputes capable of fairly ready determination. In the other, the actual resolution of the State law question was deemed unnecessary and supports our approach here. n22

n22 See also Estate of Mundy v. Commissioner, T.C. Memo. 1976-395 (validity of redemption provisions under Florida law were not necessary to evaluate effect of redemption provisions on prospective purchaser of restricted stock).

In this case, the State law question cannot be resolved short of actual litigation subsequent to an actual purchase. The one certainty that the willing buyer would confront, which the willing seller would also have to take into account, is that with the State law issues as difficult to resolve and as fiercely contested as the relative rights and privileges of the Advance stock, there would be litigation. It would be nonsensical to believe that the preferred shareholders would not try to vindicate their economic interests.

B. Valuation Opinions

Petitioner approached the willing buyer, willing seller test by soliciting the expert advice of investment bankers who daily counsel clients that buy and sell stock in businesses like Advance. Petitioner's experts evaluated the Advance common stock as if they were giving advice to a client, reviewing the advantages and the disadvantages that a client would face. Then, analyzing benchmark values for several approaches to selling the Advance common stock and relying on their experience and judgment, petitioner's experts determined a likely sales price. n23

n23 On brief, respondent argues that Goldman Sachs' approach only explores what a willing buyer would pay for the Advance common stock and should therefore be disregarded. What respondent has failed to see is that the highest price a willing buyer would pay is also the price that a willing seller wants.

Respondent approached the valuation of Advance very differently. Respondent's theory of valuation takes the sum of the value of the Advance's assets in excess of certain planned expenditures and certain liabilities, and reduces that sum by a value attributable to the presence of the preferred stock. The remainder represents the value of the common stock and the price that respondent believes a willing buyer would pay to a willing seller. Several portions of respondent's expert's report were stricken from the record because they were based on an assumption without foundation. Specifically, Baniewicz based his analysis on the assumption that the value of the Advance common stock would be determined by subtracting from the value of the entire company the value of the preferred stock (the subtraction method).

None of respondent's expert witnesses testified that they would have advised a willing buyer to use the subtraction method in deciding the value of the stock. None could testify that they had ever advised the use of the subtraction method in advising buyers or sellers of closely held stock in any comparable situation.

1. General and Industry Economic Conditions

The period immediately preceding the valuation date was characterized by economic gloom. The economy was in a state of near-recession with high interest rates and high inflation. The newspaper and magazine publishing industry reflected the nation's troubles. Costs were high, competition increasing, and circulation and advertising revenues at a standstill or decreasing. A willing buyer and a willing seller would be aware of these economic conditions as they negotiated their price for the Advance common stock.

Respondent's expert witness, Baniewicz, found that the prognosis for the newspaper and magazine publishing industry was not as grim as we have found it to be. Although he agreed that the economy as a whole was not robust in late 1979 and early 1980, he stated that total advertising revenues rose in 1978 and 1979 and that the percentage of total U.S. advertising that was devoted to newspaper advertising decreased only slightly. Baniewicz' revenue figures, however, were not adjusted for inflation. Because classified advertising remained strong in 1978 and 1979, Baniewicz believed that no one expected that the impact on the publishing industry of the projected 1980 recession would be serious. Baniewicz also noted that magazine circulation grew in 1978 but leveled off in 1979. He further surmised that because magazine readers tend to have higher incomes, and because that demographic segment

was expected to grow in 1980, the long-term outlook for growth in the magazine publishing industry would have been positive. We have concluded that Baniewicz' findings at best represent a few isolated bright spots in an otherwise gloomy economic picture.

2. Competitive Position

In order to compare Advance's financial strength and performance in relation to others in the industry, Goldman Sachs chose eight companies whose business mixes would be meaningfully comparable to Advance. n24 Relying on data from these eight companies, Goldman Sachs concluded that because Advance's earnings were already within the range of the industry norm for large publicly held companies, Advance's historical profit was reasonably indicative that its earning capacity had been fully achieved. Goldman Sachs noted that Advance paid relatively low dividends, although there were sufficient earnings to pay considerably more. Furthermore, Goldman Sachs determined that Advance retained a high cash balance relative to comparable businesses. Advance also had $ 145 million for planned extraordinary capital expenditures at the date of valuation. Goldman Sachs' comparison shows that Advance had relatively high operating income and net income and exceptionally low long-term debt in 1979.

n24 These eight companies were: Affiliated Publications, Inc., Dow Jones & Co., Gannett Co., Knight-Ridder Newspapers, Inc., Media General, Inc., The New York Times Co., The Times Mirror Co., and The Washington Post Co.

3. Size of Advance and Legal Uncertainty

As the Chemical Bank report explained, a willing buyer's business judgment in valuing the Advance common stock would be formed in large part by the uncertainty of the common's power to defeat the preferred's claim to 78 percent of dividends:

The possibility that any speculative buyer's attempt to deny the preferred shareholders what they believed to be the fair value of their shares would fail makes it extremely unlikely that any such buyer would have risked the enormous capital required to buy the Common Stock based on such speculation * * *.

Because of the millions of dollars needed to buy the common stock of Advance, the prevailing high interest rates, and the inevitability of litigation (aside from the possibility of failure), no one would have been willing to make such a speculative investment in early 1980 at a price determined by respondent's subtraction method. Goldman Sachs believed, and we agree, that the uncertainty inherent in purchasing only the common stock combined with the enormous investment required would depress the price that any buyer would offer. Goldman Sachs explained further the effect of fiduciary duties to the preferred shareholders on any buyer's judgment on the value of the common stock: "most acquirers want the ability to enter into transactions, with affiliates or otherwise, without being challenged as to the fairness of those transactions to non-controlling shareholders."

McCorkindale, vice president of Gannett Corp., stated that Gannett would not be interested in a purchase of the Advance common stock, unless the preferred stock were also available. Gannett, he explained, generally avoided purchases of less than 100 percent of the outstanding stock. McCorkindale

was also concerned that the Advance common shareholder would have fiduciary responsibilities toward the preferred shareholders. Murdoch, chief executive officer of The News Corp., agreed that the Advance common stock would not be attractive because of the existence of the preferred shareholders.

4. Antitrust and FCC Difficulties

J. Paul McGrath, a partner of Dewey, Ballantine, Bushby , Palmer & Wood, specializing in the antitrust ramifications of mergers and acquisitions, testified on behalf of petitioner. McGrath stated that any media company large enough to buy Advance would have overlapping markets and would need to divest itself of some of its holdings.

Murdoch agreed that purchasing Advance was made less desirable by "various Justice Department and Federal Communications Commission restrictions."

McCorkindale explained that if Gannett had purchased the Advance common stock, Gannett would have had several newspaper properties in overlapping markets. Furthermore, in contemplating an acquisition, McCorkindale also considers long-term anticipated expansion into new markets. Owning one ofAdvance's newspaper properties might preclude the buyer from later purchasing a competing newspaper that was more desirable.

5. Accounting Problem

The parties disagreed about how the purchaser of Advance's common stock would account for the earnings of Advance on its books. Petitioners introduced the testimony and report of Abraham Briloff, a certified public accountant and Professor Emeritus of Baruch College, and Ronald J. Murray, a certified public accountant and a partner with the accounting firm of Coopers & Lybrand.

Briloff stated that pursuant to generally accepted accounting principles, a corporate owner of the common stock interest in Advance could report in consolidated earnings only Advance's earnings and profits attributable to the common stock and no amount attributable to the preferred stock interests. Murray and Briloff agreed that a corporate owner could report only 22 percent of Advance's earnings on its consolidated financial income statement.

Contradicting the reports of Murray and Briloff, respondent introduced the report and testimony of Gustav A. Gomprecht, a certified public accountant and a retired partner of KMG Main Hurdman. Gomprecht, in his prepared report and on direct examination, concluded that the financial statements of the buyer of Advance's common stock could include all of Advance's net income. Gomprecht based his view in part on his belief that the common shareholder could represent that, until dividends were paid out of earnings, the shareholder was entitled to all earnings. Gomprecht conceded on cross-examination that if the common shareholder included the earnings of Advance in its financial statements without at least a footnote stating that 78 percent would have to be distributed to the preferred shareholders when declared, those financial statements would be misleading.

In the end we believe that Briloff and Gomprecht came to the same conclusion. Once Advance declares a dividend from earnings, retained or current, 78 percent would be distributed to the preferred shareholders. The holder of the common stock would be entitled to no more than 22 percent, and if the buyer's financials suggested entitlement to more, they would be misleading. Given the size of Advance's earnings, it is likely that such a misstatement would be material.

6. Valuation Analyses

a. Goldman Sachs' Valuation

In valuing the Advance common stock, Goldman Sachs applied the methods it uses daily to advise buyers and sellers of stock and securities. First, Goldman Sachs assessed four benchmarks of value that a prospective buyer of Advance would consider. These benchmarks would be used to ascertain the correct value of Advance by a buyer for analytical purposes but are not determinative of the value of the common stock. The four benchmarks are: (1) The public trading market value, i.e., the value if Advance stock had been actively traded on the stock market; (2) the initial public offering value, or the net value realizable by the shareholders who first introduce Advance stock on the public stock market; (3) the possible merger market value, or the amount realized by the shareholders if they sold all their stock to one party in a private sale; and (4) the arithmetic sum value, or the sum of the values of each of the assets if sold in independent transactions.

Goldman Sachs concluded that the public trading value for Advance as of February 29, 1980, was $ 905 million. At that time the stock market indices were declining and media companies were lagging behind the market. GoldmanSachs evaluated eight businesses that were active in the media industry and comparable to Advance in business mix. n25 Advance placed near the middle of these companies in overall financial performance. Furthermore, though Advance was well managed, Goldman Sachs believed the public market would have disapproved of Advance's concentration in newspapers, particularly evening newspapers, and magazines at a time when other media companies were diversifying into television. Goldman Sachs estimated a price-earnings multiple of approximately 9.4 times earnings or $ 905 million.

n25 On brief, respondent objected to Goldman Sachs' choice of the eight comparable businesses on the grounds that Advance's unique capital structure set it apart from those eight corporations. Respondent failed at trial to introduce evidence (whether on cross or through direct examination of his own witnesses) that would suggest any lack of merit in using these businesses as comparables. Moreover, respondent's own expert, Baniewicz, used four of those businesses as comparables (Gannett Co., Knight-Ridder Newspapers, Inc., The New York Times Co., and The Times Mirror Co.) to evaluate Advance's financial position.

Goldman Sachs also determined that the initial public offering value for Advance on February 29, 1980, was $ 778 million. Ordinarily the price at the initial public offering would be subject to a discount of between 5 and 10 percent below the anticipated price once the stock is established on the market. There is an additional underwriter's gross spread discount of about 7 percent. These two discounts applied to $ 905 million produced $ 778 million. An initial public offering of all the Advance stock would have been more than 20 times larger than any initial public offering for several years preceding February 1980. The magnitude of the offering would have further lowered the realizable value.

Although Goldman Sachs decided that practically it would be difficult to arrange a merger of Advance, they determined that if there was a merger the shareholders could have realized between $ 1.1 and $ 1.2 billion. Although the merger market for small newspaper companies was flourishing around February 1980, Advance was already efficiently managed and a prospective buyer would not have believed that he could quickly and easily improve the operating margins or increase the revenue.Furthermore, the size of Advance would have daunted all but the largest prospective buyers. For these and other

reasons, both Goldman Sachs and Chemical Bank could not find any comparable historical mergers by which to measure the merger value of Advance. Additionally, neither the general economic conditions nor the newspaper publishing industry were conducive to a major acquisition.

Finally, Goldman Sachs computed the arithmetic sum value of $ 1.5 billion by assuming that each of Advance's properties was sold independently. Although unlikely in a real market situation, Goldman Sachs assumed for the purposes of the report that the purchase prices realized would be unaffected by the simultaneous sale of all of the other properties. n26 After reviewing the economic conditions' effect on the value of newspaper properties, Goldman Sachs evaluated each of Advance's assets. Goldman Sachs considered the local economies and demographic pictures for each newspaper and compared the Advance advertising and circulation trends to those of other newspapers. They also considered the individual newspaper properties from the point of view of the mergers and acquisitions market.

n26 Respondent complained on brief that Goldman Sachs' arithmetic sum value represented future income potential to the exclusion of current asset value. This is due, in part, to Goldman Sachs' analysis of the newspaper properties as going concerns, in contrast to Baniewicz' liquidation value approach. Nonetheless, because Goldman Sachs and Baniewicz ultimately came very close to agreeing on the aggregate value of the newspaper properties, we do not believe that this discrepancy is worth further consideration.

The sale of all of Advance's newspaper and magazine properties at one time would have had a seriously depressing effect on the market for such properties. Furthermore, in order to avoid significant tax consequences, the sale of all of the properties would have to be accomplished within 1 year. In light of the difficulties, Goldman Sachs concluded that its arithmetic sum value was not realistic.

Keeping in mind their four benchmarks of value for Advance's entire business, Goldman Sachs then turned to a discussion of the possible types of buyers for the Advance common stock. The report contemplated four types of investors: (1) The passive investor, (2) the active investor, (3) the control investor, and (4) the public.

A passive investor would not be interested in managing Advance and would not attempt to wrest control from management. Expecting to realize value from dividends and private resale, the passive investor would not expect to extract value from Advance through liquidation, merger, or public offering. The passive investor would consider that Advance's stock was not publicly traded which would depress expectations of resale value. Due to this illiquidity, lack of control, and the uncertainties and constraints affecting the purchase, Goldman Sachs concluded that the passive investor would have offered 30 percent less than the public trading market value of the common stock and thus only $ 141 million for the common stock.

The active investor would be inclined to pursue action, short of seeking control, that would quickly maximize the return on his investment. One course of action would be to declare a dividend of Advance's excess cash and any funds that could be obtained through borrowing. Because of the high prevailing interest rate and planned capital expenditures, the common shareholder could extract no more than $ 74 million of excess cash plus loan proceeds. Advance also had $ 145 million of excess cash which could be distributed with the loan proceeds. Because of the time and uncertainty involved in this plan of action, the active investor would pay no more than 85 percent of the amount he hoped to extract. This figure would be far less than the $ 141 million the passive investor would be willing to pay.

Alternatively, the active investor might cause the excess cash to be distributed immediately and then cause Advance to pay dividends at the highest possible level. Assuming that the active investor would insist on an after-tax yield on his investment of about 13 or 14 percent, Goldman Sachs concluded that the active investor would be willing to pay $ 150 million for the Advance common stock.

A control investor would have purchased the Advance common stock with the goal of acquiring 100 percent of the equity ownership and control of the company. A control investor would hope to realize value from his purchase by dividend distributions, by liquidation, or by merger, but Advance's unusual capital structure would prevent the latter two courses of action without eliminating the preferred stock or securing their consent. The preferred had the right to block liquidation. Because the common's power to effect a merger adverse to the preferred's interests was so uncertain, Goldman Sachs concluded that any willing buyer, as a matter of sound business judgment, would analyze the value of the common as if that option were foreclosed. Goldman Sachs' analysis is persuasive.

Goldman Sachs concluded that only another media company would be interested in acquiring Advance and that none of the major media companies would have considered buying the common stock without first eliminating the claims of the preferred shareholders. Because the control investor would assume that he could not receive anything except 22 percent of the highest level of dividends declared, he would be in the same position as the active investor and would pay no more than what the active investor would pay, viz, $ 150 million.

Goldman Sachs concluded that an underwritten public offering would be the best way to sell the Advance common stock, requiring the three different types of stock to be recapitalized into a single class. Goldman Sachs' research indicated that in approximately half of the transactions in which voting control was transferred the buyers paid a premium for control. Goldman Sachs concluded that no control premium was warranted. Goldman Sachs then determined that, after exchanging the class A common stock one for three, and the class B common and the preferred stock one for one, the offering price would be $ 25 per share subject to a 7-percent discount. The price for all the shares would be $ 778 million, and for petitioner's shares it would be $ 176 million.

Because the benchmark value for a public offering, $ 176 million, was the highest value, Goldman Sachs concluded that the value of petitioner's Advance common stock was $ 176 million on February 29, 1980.

b. Chemical Bank's Valuation

Chemical Bank applied two analytical approaches: (1) A discounted cash-flow analysis, and (2) a comparison with the financial performances of publicly traded companies in a similar line of business. Chemical Bank did not use a breakup value analysis because it believed a buyer in early 1980 could not have maximized the return on his investment by liquidating Advance and selling off its assets. Chemical Bank declined to employ acquisition multiples (information relating to mergers and acquisitions) because there were no acquisitions of publishing businesses of Advance's size and complexity between 1975 and 1980, and Chemical concluded that other acquisitions were not sufficiently similar to be meaningful.

After calculating a value for Advance as a whole, Chemical Bank derived appropriate discounts and premiums and computed a value for petitioner's Advance stock. Based on Advance's financial data from the preceding 5 years, Chemical Bank projected the future cash-flow for the next 10 years and discounted it back to 1979 in order to determine the net present value of Advance. In forecasting the

future growth of Advance, Chemical Bank used a growth rate of 10 percent, which was the rate that Advance had experienced prior to the date of valuation. A discount rate for the risk of the investment of 18 or 19 percent was applied. Under the discounted cash-flow model, Chemical Bank figured that Advance was worth between $ 738 and $ 814 million.

Chemical Bank chose eight newspaper or magazine publishers and compared them to Advance by earnings, book value, cash-flow, earnings before interest and taxes, and earnings before depreciation, interest, and taxes. These comparisons revealed a range of value for Advance between $ 854 and $ 926 million.

Chemical Bank assumed a worst-case scenario for the potential buyer's consideration of realizable value, viz, that the right to 22 percent of declared dividends was the common shareholder's sole method for extracting cash from the corporation. Using the midpoint number from the range of value produced by the discounted cash-flow analysis and the comparable businesses analysis, Chemical Bank computed that the Advance common stock was worth 22 percent of $ 906 million or $ 201.31 million. Chemical Bank applied a control premium of 7 percent to the class A common shares over the class B common shares. Finally, a 15-percent discount for lack of marketability was applied. Chemical Bank valued the Advance common stock at $ 1.831 million and $ 169.422 million for the class A common stock and the class B common stock respectively, or $ 171,253,000 altogether.

c. Baniewicz' Report

Baniewicz valued all the properties owned by Advance on February 29, 1980, and derived a total value of $ 1,555,773,000. He subtracted foreseeable capital expenditures and unfunded pension liabilities and then added excess cash, arriving at a value of $ 1,505,943,000. Baniewicz' ultimate conclusion of the value of all of Advance thus agrees with the arithmetic sum value calculated by Goldman Sachs.

Baniewicz' report went on to place a value on the preferred stock and to reach a value for the common stock by subtracting the value of the preferred from the value of Advance. Cf. Rev. Rul. 83-120, 1983-2 C.B. 170. Finally, he allocated the value he determined for the common stock between the class A common and the class B common.

The section of Baniewicz' report that discussed the value of the preferred stock was stricken from the record. The report was based on two erroneous assumptions unsupportable on this record: (1) That the preferred stock enjoyed only those rights and privileges that respondent's legal experts said it did (a best-case scenario), and (2) that a willing buyer and willing seller would have approached the valuation of the Advance common stock by determining the net value of all assets and subtracting the value of the preferred stock.

The hypothetical willing buyer is presumed to be aware of all the pertinent facts. Such a buyer would be privy to the differing legal opinions on the common shareholder's ability to defeat the claims of the preferred shareholders to 78 percent of Advance's earnings. We do not believe that a willing buyer would have chosen to ignore the legal advice of petitioner's five legal experts. A fully informed buyer would not have assumed the correctness of the advice of respondent's five legal experts. We, therefore, cannot accept Baniewicz' underlying assumptions about the rights and privileges of the preferred stock. Rather, the record makes clear that any willing buyer would have considerable uncertainty about the common shareholder's rights to confine the preferred stock's interest in Advance to less than 78 percent of the value of Advance. Because Baniewicz' report assumes a confident willing buyer, certain that the

preferred shareholders' right to 78 percent of declared dividends can be defeated, who is unmoved by the warnings of petitioner's legal experts, this portion of his analysis assumed a transaction at odds with the economic interest of any buyer. Consequently, this portion of his report was not useful to us and was stricken from the record. Estate of Hall v. Commissioner, 92 T.C. 312, 338-339 (1989).

The other problem with Baniewicz' report was his use of the subtraction method for valuing the Advance common stock. Although the subtraction method may on occasion be an appropriate valuation method, some foundation for applying the subtraction method to a corporation whose capital structure is as unusual and complicated as Advance's is necessary. Respondent had to establish that the subtraction method was appropriate to valuing Advance. While Baniewicz was on the stand, respondent's counsel promised that two of his subsequent witnesses would testify that in their experience (Baniewicz had no qualifying experience on this point), a willing buyer would use the subtraction method to value the common stock in Advance. In fact, their proffered testimony fell far short and was ultimately stricken from the record as irrelevant. As a result, Baniewicz' employment of the subtraction method was not meaningful. Without the subtraction method, Baniewicz' report says nothing more than that the sum of the values of all of the assets of Advance was $ 1.5 billion.

Conclusion

The first issue we must resolve is whether the parties correctly applied the willing buyer, willing seller test to these facts. Each party accuses the other on brief of adopting a rigid formulaic analysis that does not do justice to the complexity of this factual situation. Hamm v. Commissioner, 325 F.2d 934, 940 (8th Cir. 1963).

The choice of the appropriate valuation methodology for a particular stock is, in itself, a question of fact. O'Malley v. Ames, 197 F.2d 256, 258 (8th Cir. 1952); Riss v. Commissioner, 56 T.C. 388, 430 (1971), affd. sub nom. Commissioner v. Transport Mfg. & Equipment Co., 478 F.2d 731 (8th Cir. 1973), affd. cause remanded 478 F.2d 1160 (8th Cir. 1973).

Goldman Sachs analyzed four benchmarks of value that willing buyers use to determine the value of stock to be purchased, and Chemical Bank valued Advance by utilizing discounted cash-flow and Advance's comparative position. These represent perfectly acceptable applications of the willing buyer, willing seller test. Respondent, however, failed to qualify any expert who could testify that a willing buyer and a willing seller would value the Advance common stock using the subtraction method. Moreover, in the face of the legal uncertainty confronting a willing buyer and willing seller on whether the common could limit the preferred's 78-percent interest in dividends and perhaps in the value of the whole business, we believe that no willing buyer or willing seller being fully informed would have used such a method to determine the value of the common stock. Respondent has no support for using the subtraction method.

Respondent faults petitioner for adhering inflexibly to a "joint sale" theory. Respondent characterizes petitioner's position as follows: because a third party contemplating a merger with Advance would be unsure of the common shareholder's rights to eliminate the claims of the preferred shareholders and would be highly averse to protracted and expensive litigation, the third party would not agree to the merger. Thus, the only way for the common shareholder to realize value, other than through dividend distributions, would be to effect a merger transaction with the preferred shareholders' blessing. The

terms of such a merger would require that 78 percent of the value of Advance would go to the preferred shareholders, and the common shareholder could not hope to get more than 22 percent of the total value of Advance.

We do not find any merit in respondent's attacks on petitioner's "joint sale" theory, and we note that respondent misstates petitioner's theory. n27 Petitioner's theory is that a fully informed willing buyer would take into account the uncertain state of the common stock's rights in deciding what value to pay for it.

n27 Indeed it was one of respondent's experts that assumed that the willing buyer, willing seller test required the preferred shareholders to consent to the sale of all Advance stock. This testimony was stricken as fundamentally flawed.

Respondent argues that this theory is unsound for several reasons. First, respondent contends that the common shareholder would protect the third party by indemnifying it against any claims of the preferred. As noted above, however, an indemnification provision would simply allocate the risk from the third party to the common shareholder. It in no way lessens the risk itself; rather it lessens the value the seller may realize. Respondent's second argument, that corporations are not as risk averse as petitioner claims, is irrelevant because: (1) While a willing buyer may employ the corporate form to effect the acquisition, we do not assume that the willing buyer would be a corporation and, more importantly for this case, (2) it is an assertion completely without support in the record. Respondent then notes that because the preferred shareholders would immediately seek an injunction, the common shareholder and the third party buyer would not have to wait to find out if their planned defeat of the preferred's claims would work. We do not think that this would end the suspense because the outcome of the litigation is not clear to us. Respondent's fourth argument is that the preferred shareholders would settle the litigation for the capitalized value of future dividends. Obviously, they would not if they were represented by Messrs. Landau, Mundheim, or Lipton.

The foundation of respondent's approach is his view that we must resolve the question of the various legal entitlements of the common and preferred stock in his favor. Respondent's position assumes that a willing buyer would not be uncertain about his ability to dispose of the claims of the preferred shareholders. In effect, respondent argues that a willing buyer would not hesitate to pay $ 1,231,800,000, as Baniewicz suggests, for the Advance common stock because of his ability to eliminate the preferred stock. This is an astonishing proposition on this record. Noted legal experts have given contrary views in this case. Petitioner's experts' opinions were unscathed by cross-examination. Their opinions were well reasoned and persuasive. We believe the likelihood of the common shareholder's legal rights to eliminate the preferred is, at best, in equipoise. The one thing the willing buyer would not have had is certainty about the ability to eliminate the preferred at the values that respondent used in his subtraction method.

Not only is there no support in the record for the subtraction method in this case, but we conclude that it is far too simplistic a method for the valuation of the Advance common stock. An underlying fallacy in this theory of valuation is the assumption that the sum of the fair market values of the preferred stock and the common stock, each sold independently to separate buyers, must equal the net value of the entire company as a going concern. Massive amounts of credible evidence in this case indicate that this assumption is not supportable.

If all the common and preferred stock in the company were sold at one time to a single buyer, we have little doubt that the price would approach the values that the experts on both sides determined for the business as a whole. But if either class of stock is sold separately, a buyer cannot be reasonably certain of his ability to eliminate or control the other shareholders, and the price will be less than its proportionate share of the total value. Although the subtraction method may be suitable for other situations, its use is inappropriate for Advance. We conclude that the correct value of the Advance common stock on February 29, 1980, was $ 176 million.

A subissue that we must address is the value of the 300 shares of class B common stock that Newhouse left to his wife by will. Petitioners submitted Goldman Sachs' report that states that the 300 shares of class B common stock were worth $ 51,757,576. Goldman Sachs calculated this figure by allocating $ 170,800,000 (of the value of the common stock, $ 176,000,000,) to the class B and $ 5,200,000 to the class A. This allocation was derived from Goldman Sachs' initial public offering analysis. Petitioner argues that, because the stock conveyed no control and because the value of the 300 shares of class B common stock must be determined without reference to any other stock Mitzi held, the correct value was $ 51,757,576. Petitioner also submitted an analysis of the value of the class B common stock by Chemical Bank. Chemical Bank determined the value of the 300 shares of class B common stock to be $ 51,340,000.

Respondent argues that the correct value of the 300 shares of class B common stock is $ 246 million. As support for this position, respondent relies on reports that were not admitted into evidence. The figure wasderived by discounting his value for the class B stock by 33 percent for lack of control and substantial voting restrictions. Baniewicz' argument supporting his calculation allocating his figure for the total value of Advance common stock between the class A and the class B was not admitted into evidence.

We have already concluded that the combined value of class A and the class B is $ 176 million. Respondent argues that a 33-percent discount of the value of class A to reflect the differential voting rights is appropriate to find the value of the class B, but offers no evidence to support his position. We conclude that Goldman Sachs' analysis produces a reasonable and correct value for the class B stock. Goldman Sachs determined that the best way to realize the value in the Advance stock would be through a public sale. First, it would be necessary to recapitalize Advance creating a single class of common stock. Goldman Sachs determined that the preferred stock and the class B stock would be traded for equal amounts of the new stock but the class A common stock would be traded for three shares of the new stock. The value of the class A common stock was $ 5.2 million and the value of the class B was $ 170.8 million. The value of 300 shares of class B common stock was $ 51,757,576.

II. VALUE OF N.B. CO. COMMON STOCK

In the notice of deficiency, the value determined for the 100 shares of N.B. Co. stock was $ 91,600,000 which is simply 44.44 percent of $ 206,400,000. On brief, respondent argues Baniewicz' determination that a 16.67-percent "discount" would be appropriate. n28 Petitioner derives the value of $ 59,600,000 by applying a discount of 35 percent to the 44.44 percent block of stock. The sole dispute that we must resolve is whether a discount is appropriate and, if so, how large it should be.

n28 Baniewicz calculated that the value of the 100 shares would be $ 76,372,500. Respondent did not explain the discrepancy between his figure and Baniewicz' result.

Respondent's determination in the notice of deficiency, which he supported through the testimony of William B. Cate, is undeniably wrong. Ignoring discounts for lack of control and lack of marketability is contraryto long-established valuation methods well accepted by the Courts in cases presenting the value of stock in closely held corporations. Estate of Andrews v. Commissioner, 79 T.C. 938 (1982); Estate of Bright v. United States, 658 F.2d 999, 1002-1003 (5th Cir. 1981); Estate of Leyman v. Commissioner, 40 T.C. 100, 119 (1963). The discounts are conceptually distinct: (1) The discount for lack of control reflects the minority shareholders' inability to compel liquidation and inability to realize a pro rata share of the corporation's net asset value. Harwood v. Commissioner, 82 T.C. 239, 267 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986); (2) the lack of marketability discount reflects that there is no ready market for the shares of a closely held corporation. Estate of Andrews v. Commissioner, supra at 953. While the appropriate amount of discount to apply is a question of fact, Ward v. Commissioner, 87 T.C. 78, 109 (1986), it is unreasonable to argue that no discount should be considered for a minority interest in a closely held corporation.

A. Goldman Sachs' Report

Petitioner submitted a report in which Goldman Sachs determined that a willing buyer would pay a willing seller $ 59.6 million for the 100 shares of N.B. Co. common stock on February 29, 1980. In preparing the report, Goldman Sachs reviewed the corporate bylaws, the Certificate of Incorporation, and the financial statements from the preceding 5 years. Additionally, Goldman Sachs read the 1980 valuation report prepared by Chemical Bank n29 and the valuation report prepared by respondent's expert, Baniewicz.

n29 The 1980 valuation report of Chemical Bank was the basis of petitioner's claim on its estate tax return that the N.B. Co. stock was worth $ 68.3 million. For purposes of trial, however, the parties agreed to use $ 206.4 million for the value of the entire company and so petitioner discarded Chemical Bank's 1980 valuation.

Goldman Sachs concluded that the 100 shares of commonstock, representing 44.44 percent of the stock, lacked voting control. In other words, this block of stock neither controlled management nor controlled cash flow or distributions. A buyer of the 100 shares would not have the power to sell corporate assets or to register the stock with the Securities and Exchange Commission preparatory to an initial public offering. Because the stock interest had no control over corporate affairs, Goldman Sachs concluded that a buyer of the stock would hope to realize the value from his investment when the stock was initially offered to the public.

Goldman Sachs believed that a public offering was unlikely. In view of the large size of the company, a public offering would not have been feasible under market conditions at the valuation date. Moreover, while N.B. Co. had in excess of $ 25 million in cash and virtually no debt, management had expressed no interest in taking the company public. Furthermore, N.B. Co. had, as of the valuation date, arranged to sell its five television broadcasting stations that generated more than half of N.B. Co.'s revenue and planned to reinvest the proceeds in new television broadcasting stations.

Because liquidation of the corporation was unlikely, Goldman Sachs concluded that the only means of disposing of the 100 shares of N.B. Co. common stock would be through private placement. Because the 100 shares do not convey control over the company, no control premium would be warranted. The private placement investor would expect to realize value on his investment only through the receipt of

dividends and the eventual resale of his shares. Goldman Sachs estimated the value of the future annual dividend income from the 100 shares at $ 889,000 based on historical dividends for 1978 and 1979. Although the corporation had the ability to pay higher dividends, the private placement investor would not have the power to compel it to do so. At the valuation date, publicly traded corporate bonds were yielding 14 and 15 percent and a buyer would not have accepted a lower rate of return on his investment from his N.B. Co. stock. Additionally, Goldman Sachs determined that in circumstances that suggest no expectation of a public offering for at least 5 years, the investor would not pay more than the total value discounted by between 33 to 55 percent. Goldman Sachs concluded that a discount of35 percent would be appropriate to the N.B. Co. common stock. Applying a discount of 35 percent to 44.44 percent of the total value of N.B. Co. of $ 206.4 million, Goldman Sachs derived a fair market value for the 100 shares of common stock of $ 59.6 million.

B. Baniewicz' Report

Baniewicz determined that the 100 shares of stock would bear a control premium because, though 44.44 percent was not a majority interest, it was the "largest outstanding ownership interest" and thus "would participate in decisions controlling the affairs of the corporation." Because the stock did not represent a majority interest, Baniewicz concluded that a 25-percent control premium, rather than a full 50-percent control premium, was warranted. In order to attain a 25-percent control premium, Baniewicz applied a 16.67-percent discount from full liquidation value of $ 206.4 million because the liquidation value included a 50-percent control premium that had to be reduced. Thus, Baniewicz' 16.67-percent discount is actually a reduced control premium.

We cannot accept respondent's position. Control means that, because of the interest owned, the shareholder can unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation's capital structure, and decide whether to liquidate, merge, or sell assets. The owner of the 100 shares of N.B. Co. could not accomplish any of these actions. Baniewicz explained at trial that the owner of the 100 shares would have effective control because he would have the largest block of stock. Having a substantial or even the largest block of stock does not necessarily create effective control, and it certainly does not in this closely held corporation. The owner of the 100 N.B. Co. shares enjoys no attributes of control. Participating in corporate decisions is a right that any stock interest may enjoy (and which in this case the other stock interests also enjoyed), but unless that interest controls (which in a closely held corporation typically means a majority interest), a control premium is unsupportable.

We conclude that petitioner's position, as explained in the Goldman Sachs report, is reasonable and fair. The discount of 35 percent combines discounts for lack of control and lack of marketability. A combined discount of 35 percent is well within precedent. See Estate of Watts v. Commissioner, T.C. Memo. 1985-595, affd. 823 F.2d 483 (11th Cir. 1987); Drybrough v. United States, 208 F. Supp. 279 (D. Kan. 1962). n30 We conclude that the value of the 100 shares of N.B. Co. stock was $ 59,600,000 on February 29, 1980.

n30 See also Martin v. Commissioner, T.C. Memo. 1985-424.

In light of the foregoing, concessions, and the need to calculate various administration expense deductions,

Decision will be entered under Rule 155.

T.C. Memo. 1998-279

United States Tax Court

WILLIAM NORWALK, TRANSFEREE, ET AL.[1], Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 20686-96, 20767-96, 20772-96, 20773-96 Filed July 30, 1998

Harry J. Kaplan and John F. Hopkins, for petitioners.

LaVonne D. Lawson, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

RUWE, JUDGE: These consolidated cases involve transferee liability, deficiencies, penalties, and an addition to tax determined by respondent as follows:

William Norwalk, Transferee
docket No. 20685-96

Year	Transferee Liability
1992	$165,940

Robert DeMarta, Transferee
docket No. 20686-96

Year	Transferee Liability
1992	$505,935

DeMarta & Norwalk, CPA's, Inc.
docket No. 20767-96

Accuracy-related Penalty

Year	Deficiency	Sec. 6662
1992	$232,540	$46,508

William R. Norwalk
docket No. 20772-96

Accuracy-related Penalty

Year	Deficiency	Sec. 6662
1992	$44,088	$8,818

Robert and Patricia DeMarta

docket No. 20773-96

		Addition to Tax	Accuracy-related Penalty
Year	Deficiency	Sec. 6651(a)(1)	Sec. 6662
1992	$150,249	$7,512	$30,050

After concessions by the parties, the issues for decision are: (1) Whether DeMarta & Norwalk, CPA's, Inc. (the corporation), realized a gain of $588,297 on the distribution of its intangible assets to its shareholders in a liquidation; (2) whether the corporation is liable for depreciation recapture in the amount of $15,643 on the distribution of its tangible assets to its shareholders in a liquidating distribution in 1992; (3) whether Robert and Patricia DeMarta realized a capital gain of $505,935 on the receipt of property from the corporation in a liquidating distribution in 1992; (4) whether William R. Norwalk realized a capital gain of $165,940 on the receipt of property from the corporation in a liquidating distribution in 1992; (5) whether the corporation is entitled to a deduction, reported as consulting fees, of $40,000 for payments to the shareholders in 1992; (6) whether Robert DeMarta and William R. Norwalk are required to report such payments, in the amounts of $23,320 and $16,680, respectively, as dividend income; (7) whether Robert and Patricia DeMarta are liable for an addition to tax under section 6651(a)(1)[2] and an accuracy- related penalty under section 6662; (8) whether the corporation is liable for an accuracy-related penalty under section 6662; (9) whether William Norwalk is liable for an accuracy-related penalty under section 6662; and (10) whether Messrs. DeMarta and Norwalk are liable as transferees for the corporation's 1992 Federal income tax liability.

FINDINGS OF FACT

Some of the facts are stipulated and are incorporated herein by this reference.

At the time of the filing of the petitions in these consolidated cases, each of the individual petitioners resided in Fremont, California, and the corporate petitioner, DeMarta & Norwalk, CPA's, Inc., maintained its principal office in Fremont, California. Robert DeMarta and William Norwalk (sometimes referred to as the shareholders) are certified public accountants (C.P.A.'s) and provide accounting services on a full-time basis. Mr. DeMarta became a C.P.A. in approximately 1970, while Mr. Norwalk became a C.P.A. in 1980.

In 1985, Messrs. DeMarta and Norwalk organized DeMarta & Norwalk, CPA's, Inc., which was incorporated in California on August 14, 1985. The business of the corporation was the practice of public accounting. At all times during the corporation's existence, Messrs. DeMarta and Norwalk have been its only shareholders.

On September 3, 1985, Messrs. DeMarta and Norwalk signed separate agreements with the corporation regarding their respective ownership interests in, and rights and duties regarding, the corporation. Each agreement is entitled "Employment Agreement". The

effective date set forth on these agreements was October 1, 1985, and each provides, among other things, the following:

TERM

5. The term of employment shall be five years from the date specified in Schedule A attached to this Agreement, subject to the following conditions:

(a) This Agreement may be terminated at any time by mutual agreement in writing of the Corporation and Employee.

(b) Employee shall have the absolute right to unilaterally terminate this Agreement by providing the Board of Directors with written notice of termination and, in that case, termination shall occur upon the expiration of ninety (90) days after the date of the notice.

* * * * *

(h) Either party may terminate this Agreement after the expiration of 15 months by giving the other 30 days written notice.

RESTRICTIVE COVENANT

6. Employee agrees that during the term of this Agreement he will not engage in any other business duties or pursuits whatsoever, directly or indirectly, except activities approved in writing by the Board of Directors, directorships in companies not in competition with the Corporation, and passive personal investments. Furthermore, Employee will not, directly or indirectly, acquire, hold, or retain any interest in any business competing with or similar in nature to the business of the Corporation, and will not own or hold to any substantial degree any securities in any company competing with the Corporation.

* * * * *

DISCLOSURE OF INFORMATION

8. Employee recognizes and acknowledges that the list of the Corporation's clients, as it may exist from time to time, is a unique asset of the Corporation's business. Employee will not, during or after the term of employment, disclose the list of the Corporation's clients or any part of it to any person, firm, corporation, association, or other entity for any reason or purpose whatsoever. In the event of a breach or threatened breach by Employee of the provisions of this Paragraph, the Corporation shall be entitled to an injunction restraining Employee from disclosing, in whole or in part, the list of the Corporation's clients, or from rendering any services to any person, firm, corporation, association, or other entity to whom the list, in whole or in part, has been disclosed or is threatened to be disclosed. Nothing in this Agreement shall be construed as prohibiting the

> Corporation from pursuing any other remedies available to the Corporation for disclosure, including the recovery of damages from Employee.

* * * * *

RECORDS

> 11. On the termination of this Agreement, Employee shall not be entitled to keep or preserve records or charts of the Corporation as to any client unless a client specifically requests a different disposition of those records, and in no event shall Employee be entitled to the records of clients not served by him.

Subsequent to the term of the shareholders' respective agreements with the corporation, no other agreements between the shareholders and the corporation were entered into. Accordingly, Messrs. DeMarta and Norwalk were not bound by any covenant not to compete on June 30, 1992.

As of June 30, 1992, in addition to the shareholders, the corporation had eight employees, four of whom were accountants. No other employee of the corporation signed any employment agreement with the corporation.

On June 30, 1992, the corporation's assets were distributed to its shareholders. On that date, Mr. DeMarta held 75 percent of the corporation's stock, while Mr. Norwalk held the remaining 25 percent. Only a nominal amount of assets was left in the corporation after this distribution. This distribution constituted a complete liquidation of the corporation in 1992. The corporation did not continue to provide accounting services after June 30, 1992, and the business of the corporation did not continue. The corporation has never been dissolved.

The corporation reported the following revenues and expenditures on its Federal income tax returns for the years 1988 through 1992:

Item from returns	1988	1989	1990	1991	1992
Gross receipts	$666,185	$850,527	$938,096	$967,495	$730,989
Form 4797 gain/loss	--	(5,481)	--	--	--
Other income	--	--	480	--	194
Deductions					
Comp. of officers	168,024	187,383	177,363	197,341	74,654
Salaries & wages	249,091	343,935	377,676	381,135	218,813
Repairs	2,404	4,528	--	6,664	--
Bad debts	602	--	--	--	--

Rents	62,039	54,471	82,219	101,628	56,379
Taxes	29,245	36,732	41,200	44,283	26,048
Interest	14,563	16,421	30,993	23,622	11,162
Charitable contr.	--	--	--	--	99
Depreciation	11,516	19,019	32,371	27,190	8,045
Amortization	334	334	252	--	--
Pension plan	--	41,337	44,264	51,589	--
Bank charges	--	--	--	68	--
Meals & enter.	1,930	6,577	18,266	1,761	10,323
Books & journals	6,527	3,708	2,757	1,791	2,774
Client costs	38	118	3,997	12,331	80
Computax costs	41,897	49,762	15,228	--	--
Computer costs	3,543	15,571	14,161	11,314	--
Continuing educ.	10,273	17,447	12,524	7,807	9,408
Dues & subscript.	4,376	19,005	18,136	8,903	10,564
Insurance	26,474	42,401	49,475	45,219	29,466
Meetings	3,089	--	--	6,825	--
Per diem fees	--	--	--	15,677	--
Library service	--	--	--	1,000	--
Office expense	13,333	24,640	25,567	26,073	14,197
Employment agency	5,486	--	--	--	--
Payroll processing	767	1,067	659	--	--
Postage	4,546	6,940	6,944	7,441	7,684
Telephone	8,289	7,803	9,911	8,013	5,182
Travel	2,838	6,825	7,022	1,971	6,445
Tax processing costs	--	--	--	1,577	3,590
Advertising	1,718	2,551	1,755	4,449	4,094
Consulting fees	--	3,225	--	--	40,000
Peer review expense	--	4,952	--	--	--
Pension administration	--	700	372	270	465
Legal & professional	450	--	8,986	--	--
Supplies	--	--	10,001	--	8,492
Equipment rental	631	219	7,459	1,808	5,611
Moving expenses	--	500	4,522	--	--
Total expenses	674,023	918,171	1,004,080	997,750	553,575
Taxable income/loss	(7,838)	(73,125)	(65,504)	(30,255)	177,608

From 1988 to 1992, the shareholders received the following salaries from the corporation:

Year	Mr. DeMarta	Mr. Norwalk
1988	$98,024	$70,000
1989	107,463	79,920

1990	107,440	69,923
1991	107,440	89,901
1992	40,880	33,774

A portion of the salaries paid to Messrs. DeMarta and Norwalk was derived from bank loans guaranteed by the shareholders and from loans made to the corporation by the shareholders. At the beginning of the corporation's 1992 tax year, it had outstanding loans from shareholders of $22,533. At the end of the corporation's 1992 tax year, its liabilities included outstanding loans from the shareholders of $96,678.

In addition to their salaries from the corporation, Messrs. DeMarta and Norwalk received $23,320 and $16,680, respectively, in 1992. A total of $40,000 representing these additional amounts was deducted by the corporation as consulting fees on its 1992 Federal income tax return. Mr. Norwalk reported this additional amount as ordinary income on his 1992 Federal income tax return. Mr. DeMarta did not report any of this additional amount on his Federal income tax return.

On January 3, 1992, as reflected in the corporation's minutes, the board of directors (Messrs. DeMarta and Norwalk) authorized the distribution of the corporation's assets and liabilities to the shareholders. These corporate minutes provided the following reason for this distribution:

> Due to lack of profitability, it was decided to stop practice as Certified Public Accountants within the structure of DeMarta & Norwalk. It was further decided to distribute all available assets and liabilities to the shareholders. Each shareholder would then be able to pursue a professional practice on their own or as partners with other CPA(s).

On July 1, 1992, following the distribution of the corporation's assets, Messrs. DeMarta and Norwalk became partners of the accounting firm Ireland, San Filippo (the partnership), and transferred assets, distributed to them by the corporation, to the partnership. The partnership did not use the corporation's name. The tangible assets distributed to the shareholders included all the corporation's furniture and equipment, which the corporation reported on its 1992 Federal income tax return at a value of $59,455. These assets were contributed to the partnership at an agreed value of $59,455. The shareholders also transferred their share of the corporation's receivables to the partnership. These assets were contributed to the partnership (less liabilities assumed by the partnership) in exchange for the opening balances of the respective partnership capital accounts of Messrs. DeMarta and Norwalk. The partnership did not assume tax obligations of the corporation, nor did it assume the debts owed by the corporation to the shareholders. The opening capital account balances in the partnership for Messrs. DeMarta and Norwalk were $39,202 and $28,041, respectively.

Messrs. DeMarta and Norwalk each executed a partnership agreement when they joined the partnership. Under the terms of the partnership agreement, Messrs. DeMarta and Norwalk were treated as equal partners and subject to the same formula for allocation of

compensation. This partnership agreement also contained certain provisions restricting the partners' ability to compete with the partnership.

The partnership assumed the corporation's lease and occupied its former offices from July 1, 1992, to April 25, 1994. On April 28, 1994, after vacating these offices, the partnership subleased the space. At the time of the sublease, the remaining term of the lease was 8 months. The partnership subsidized one-third of the rent when it subleased the space.

As of June 30, 1992, other than the shareholders, the corporation employed the following persons: Barbara Bailey; Karin Laster; Beverly Hagan, C.P.A.; Thomas Tang, C.P.A.; Don Christman, C.P.A.; Jeanette Joyce, accountant; Judy Cunningham, administrator; and Joan Long, secretary. After the liquidation of the corporation, many of its former employees were subsequently employed by the partnership. By the end of October 1992, both Beverly Hagan and Thomas Tang left the partnership to set up their own separate accounting practices. When Mr. Tang left, Barbara Bailey, a computer consultant, and Karin Laster, a bookkeeper, also left the partnership to work for Mr. Tang.

When Ms. Hagan and Mr. Tang left to set up their individual practices, they each sent announcements to former clients of the corporation and to clients of the partnership informing them of their move. The partnership received at least 92 requests from former clients to have the information contained in their files made available to either Ms. Hagan or Mr. Tang. Pursuant to these client authorizations, the partnership permitted Ms. Hagan and Mr. Tang to copy the files of clients that left the partnership. Neither Messrs. DeMarta and Norwalk nor the partnership requested any compensation for any clients lost to either Ms. Hagan or Mr. Tang. Five years following the liquidation of the corporation, only about 10 percent of the accounts serviced by the corporation remained with the partnership.

OPINION

The principal issue underlying all these consolidated cases is the fair market value of the corporation's assets on the date of distribution.

CUSTOMER-BASED INTANGIBLES

Respondent contends that when the corporation was liquidated, it distributed to its shareholders "customer-based intangibles" in addition to tangible assets. Respondent describes the intangible assets at issue to include the corporation's client base, client records and workpapers, and goodwill (including going-concern- value). Respondent's position is that these intangibles were assets of the corporation that had a specific value and that when distributed to the shareholders in the liquidation, triggered taxable gain to the corporation. Liability in respect of a deficiency in the corporation's tax and penalty was then asserted by respondent against the shareholders of the corporation as transferees. Respondent also determined that the transfer of the customer-based intangibles received by the shareholders generated taxable gain to the shareholders.

Petitioners maintain that the corporation did not own the intangibles in question. Rather, petitioners argue that the accountants themselves owned the intangibles, and, thus, there was no transfer nor any corresponding taxable gain attributable to these intangibles.

Generally, gain or loss must be recognized by a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value. Sec. 336(a). Petitioners do not contend that the provisions of section 336(a) should not apply here. The corporation must recognize gain calculated as the difference between the fair market value of the distributed property and the corporation's basis in that property.

Moreover, amounts received by the shareholders in a distribution in complete liquidation of the corporation must be treated as in full payment in exchange for the corporation's stock. Sec. 331(a). The shareholders must recognize any gain on the receipt of the property in the liquidating distribution. The gain to the shareholder is computed by subtracting the shareholder's adjusted basis in the stock from the amount realized. Sec. 1001(a); sec. 1.331-1(b), Income Tax Regs. The amount realized is the sum of any money received on the distribution plus the fair market value of the property received (other than money).[3] Sec. 1001(b). This gain is reduced by the outstanding corporate liabilities assumed by the shareholders, if any. Here, the loans payable to the shareholders totaled $96,678 as of June 30, 1992.[4]

We have recognized that goodwill is a vendible asset which can be sold with a professional practice. LaRue v. Commissioner, 37 T.C. 39, 44 (1961); Watson v. Commissioner, 35 T.C. 203, 209 (1960). Goodwill is often defined as the expectation of continued patronage. Newark Morning Ledger Co. v. United States, 507 U.S. 546 (1993). In Rudd v. Commissioner, 79 T.C. 225, 238 (1982), we stated:

> The goodwill of a public accounting firm can generally be described as the intangibles that attract new clients and induce existing clients to continue using the firm. These intangibles may include an established firm name, a general or specific location of the firm, client files and workpapers (including correspondence, audit information, financial statements, tax returns, etc.), a reputation for general or specialized services, an ongoing working relationship between the firm's personnel and clients, or accounting, auditing, and tax systems used by the firm. * * *

In determining the value of goodwill, there is no specific rule, and each case must be considered and decided in light of its own particular facts. MacDonald v. Commissioner, 3 T.C. 720, 726 (1944). Moreover, in determining such value it is well established that the earning power of the business is an important factor. Estate of Krafft v. Commissioner, T.C. Memo. 1961-305. In Staab v. Commissioner, 20 T.C. 834, 840 (1953), we stated:

> Goodwill, then, is an intangible consisting of the excess earning power of a business. A normal earning power is expected of the business assets, and if the business has greater earnings, then the business may be said to have goodwill. This excess in earning power may be due to any one or more of several reasons,

> and usually this extra value exists only because the business is a going concern, being successful and profitable. Goodwill may arise from: (1) the mere assembly of the various elements of a business, workers, customers, etc., (2) good reputation, customers' buying habits, (3) list of customers and their needs, (4) brand name, (5) secret processes, and (6) other intangibles affecting earnings.

Both parties presented testimony from expert witnesses regarding the value of the corporation's intangible assets. In appraising the value of the corporation's intangibles, petitioners' expert stated: "Intangible value within a company (or goodwill value) is based upon the existence of excess earnings." After examining financial information from the corporation's Federal income tax returns, the pay history of Messrs. DeMarta and Norwalk, and Federal Government guidelines for an accountant's pay, he found that the corporation did not have excess earnings or earnings over and above a return on tangible assets. Consequently, petitioners' expert concluded that the corporation was worth the value of its tangible assets[5] and that there was no intangible or goodwill value at the time of the distribution to the shareholders. He then addressed the valuation of the corporation's client list. Recognizing that in a service-related business the client relationship is normally between the client and the professional who services that client, petitioners' expert concluded that "Without an effective non- competition agreement, the clients have no meaningful value." Recognizing that there was no restriction on the ability of the individual accountants to compete with the corporation, he concluded that the client-related goodwill and intangibles belonged to the professional accountants (individually) who serviced the clients and that a list of these clients had no material value.

We have held that there is no salable goodwill where, as here, the business of a corporation is dependent upon its key employees, unless they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become property of the corporation. Martin Ice Cream Co. v. Commissioner, 110 T.C. 189, 207 (1998) ("personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation"); Estate of Taracido v. Commissioner, 72 T.C. 1014, 1023-1024 (1979); Cullen v. Commissioner, 14 T.C. 368, 372 (1950); MacDonald v. Commissioner, supra at 727; cf. Schilbach v. Commissioner, T.C. Memo. 1991-556.[6]

We have no doubt that most, if not all, of the clients of the corporation would have "followed" the accountant who serviced that client if the accountant would have left the corporation. For instance, when Mr. Tang and Ms. Hagan left the partnership shortly after the corporation was liquidated, at least 92 clients engaged these former employees to provide future services. On the record here, it is reasonable to assume that the personal ability, personality, and reputation of the individual accountants are what the clients sought. These characteristics did not belong to the corporation as intangible assets, since the accountants had no contractual obligation to continue their connection with it. There is no persuasive evidence that the name and location of the corporation had any value other than for their connection with the accountants themselves.

The situation in the instant case is similar to that in MacDonald v. Commissioner, supra. In MacDonald, the taxpayer and his wife were the sole shareholders in an incorporated insurance agency. They subsequently liquidated the corporation, distributing all assets to the husband, who proceeded to set up an insurance agency under a name similar to the name of the liquidated corporation and solicited the clients of the corporation.

The issue presented to us in that case was whether there was any valuable goodwill passing from the corporation to the taxpayers upon liquidation of the corporation. The corporation had no exclusive right to the business of any policyholder, and without a covenant not to compete from the taxpayer, the business of the corporation had no market value. In holding that there was no goodwill passing to the taxpayers because the goodwill was solely attributable to the personal abilities of the taxpayers, we stated:

> The facts in the instant cases established that any value which this business may have had on July 31, 1941, in addition to its tangible assets, was due to the personal ability, business acquaintanceship, and other individualistic qualities of D. K. MacDonald. As one witness put it, "Mr. MacDonald was the Company." The policy of the corporation was decided by D. K. MacDonald and all employees worked under his direction and supervision. There existed no contract between the corporation and any of its employees, including D. K. MacDonald, with respect to future services. Neither the name of the corporation, its location, its agency agreements, nor its existing policies with customers had any value. If the law prevents the recognition of the personal ability and personality of D. K. MacDonald as an element of this corporation's goodwill for income tax purposes, then petitioners did not receive any goodwill as a result of their acquisition of this corporation's assets.
>
> We find no authority which holds that an individual's personal ability is part of the assets of a corporation by which he is employed where, as in the instant cases, the corporation does not have a right by contract or otherwise to the future services of that individual. . . . (MacDonald v. Commissioner, 3 T.C. at 727.]

We further held in MacDonald that there was no marketable asset embodying the goodwill of the corporation which could be sold to a third party. We recognized the possibility that a purchaser might take over the customer list of the corporation on a contingency basis. In holding that this type of an arrangement has no fair market value, we stated:

> It is true that goodwill may be the subject of exchange. Here, however, Cassatt and Company [the seller] did not undertake to transfer its goodwill to Pierce [the purchaser] in exchange for property of an ascertainable market value. On the contrary the transfer was made in consideration of Pierce's promise to share with Cassatt and Company for six years in the future any commissions which it might earn during that period from business with Cassatt customers. The receipt of such commissions was wholly contingent upon Pierce's remaining in business and obtaining business from the former Cassatt customers, neither of which it was under any obligation to do. It is settled that such a promise to make payments in the future "wholly contingent upon facts and circumstances not possible to foretell

> with anything like fair certainty" has no ascertainable fair market value. Burnet v. Logan, 283 U.S. 404, 413, 51 S. Ct. 550, 552, 75 L.Ed. 1143. (Id. at 729 (quoting Cassatt v. Commissioner, 137 F.2d 745, 748 (3d Cir. 1943), affg. 47 B.T.A. 400 (1942)).]

Therefore, for the same reasons as given in MacDonald, we hold that at the time of the corporation's liquidation it had no goodwill, either in terms of a client list or in any other form, which could be distributed to the individual shareholders or sold to a third party.

We have carefully considered the testimony of respondent's experts who testified that in their opinion a fair value of the corporation would be $870,000, of which $266,000 would represent the value of the client list and $369,000 would represent goodwill.[7] However, we conclude that their opinion regarding the intangible assets of the corporation is of no probative force in light of other evidence of record and existing case law.

Respondent's experts based their opinion as to the value of the goodwill and the client list upon an approximation of earnings that they made based upon the volume of business actually done by the corporation but using cost percentages normal to the industry, which were far less than the corporation's actual operating costs. These approximations are not in line with the actual experience of the corporation, and the record does not establish that there was any reasonable expectation that such costs could have been so reduced. See Estate of Krafft v. Commissioner, T.C. Memo. 1961-305.

More importantly, respondent's experts valued the corporation's client list and goodwill as if a covenant not to compete was in effect on the date of distribution. Respondent's expert, Mr. Kettell, testified that such a restriction is a very important factor in valuing the intangibles of the corporation. However, we have found that there were no restrictions on the corporation's employees to compete with it on the date of distribution. Nevertheless, in determining the corporation's value, respondent's experts relied upon the restrictions expressed in the partnership agreement executed by Messrs. DeMarta and Norwalk after the distribution of the corporation's assets. The parties to the partnership agreement are Messrs. DeMarta and Norwalk and the existing partners of the partnership, not the corporation. This agreement was not enforceable by the corporation and should have no bearing on the valuation of the corporation on the date that it distributed its assets.

In view of the foregoing, we conclude that there were no transferable "customer-based intangibles" belonging to the corporation independent of the abilities, skills, and reputation of the individual accountants. "Ability, skill, experience, acquaintanceship, or other personal characteristics or qualifications do not constitute goodwill as an item of property, nor do they exist in such form that they could be the subject of transfer." Providence Mill Supply Co. v. Commissioner, 2 B.T.A. 791, 793 (1925). In O'Rear v. Commissioner, 28 B.T.A. 698, 700 (1933), affd. 80 F.2d 473 (6th Cir. 1935), we stated that "it is at least doubtful whether a professional man can sell or dispose of any goodwill which may attach to his practice EXCEPT PERHAPS BY CONTRACTING TO

REFRAIN FROM PRACTICING." (Emphasis added.) Because there was no enforceable contract which restricted the practice of any of the accountants at the time of the distribution, their personal goodwill did not attach to the corporation. Any goodwill transferred to the partnership was that of the individual accountants, not the corporation. Under these circumstances, we conclude that the value of any "customer-based intangibles" that the corporation may have had was nominal. We hold that petitioners have met their burden of establishing that value is not allocable to the customer-based intangibles as determined by respondent.

TANGIBLE ASSET VALUE

Respondent increased the corporation's taxable income by $15,643 for section 1245 depreciation-recapture income, resulting from the distribution of its tangible assets to the shareholders.[8] Section 1245(a)(1) provides for the recapture of depreciation as ordinary income upon the disposition of section 1245 property. Personal property used in a trade or business is section 1245 property. Sec. 1245(a)(3)(A). Here, the amount recaptured is the amount by which the lower of the recomputed basis of the property or the fair market value of such property, exceeds the adjusted basis of the property. Sec. 1245(a)(1). Recomputed basis means the adjusted basis of the property recomputed by adding thereto all adjustments reflected in such adjusted basis on account of deductions allowed or allowable to the taxpayer for depreciation.[9] Sec. 1245(a)(2)(A).

The corporation reported an adjusted basis in its tangible assets of $59,455 on its 1992 Federal income tax return. Respondent's experts stated that the corporation's tangible assets, which were distributed to the shareholders and then transferred to the partnership, had a fair market value of $102,000. Respondent's experts arrived at their opinion by estimating the replacement cost of items listed on an asset ledger and then subtracting an amount for accumulated depreciation based upon an estimate using each item's age and useful life. The amount of depreciation was calculated using the experts' own "in house developed software."[10] However, none of the tangible assets were inspected by respondent's experts, nor did they have any actual knowledge of the nature or condition of the assets distributed.

Petitioners, on the other hand, argue that the tangible assets of the corporation had a fair market value equal to, or less than, the corporation's adjusted basis in the assets on the date of distribution. The tangible assets at issue were contributed to the partnership at an agreed value equal to the corporation's basis as reported on its 1992 Federal income tax return. Petitioners rely upon the contribution value of the tangible assets as evidence of the assets' fair market value. It is well established that the best evidence of fair market value is the amount paid for property in an arm's-length transaction at or near the relevant valuation date. Chiu v. Commissioner, 84 T.C. 722, 734 (1985). Respondent does not argue that the contribution of the tangible assets by the shareholders was other than at arm's length, and the opinions of respondent's experts do not convince us that the fair market value of the tangible assets at the time of the distribution was anything other than $59,455. Accordingly, the corporation did not realize recapture income on the distribution.

CONSULTING FEES

The corporation paid the shareholders $40,000 in addition to their salaries for 1992, which the corporation deducted as consulting fees. Respondent determined that the corporation was not entitled to the subject deduction and that the shareholders must report the amounts they received with respect to this deduction as dividend income. No documentary evidence has been presented to establish that the $40,000 deducted by the corporation was paid to the shareholders for services provided to the corporation in the year deducted. The corporation has failed to meet its burden of establishing that it is entitled to deduct the $40,000 payment to the shareholders in 1992 as consulting fees or that it should not characterize the amounts as dividends as respondent contends.

Petitioners Robert and Patricia DeMarta conceded respondent's determination in regard to this issue. Petitioner William Norwalk reported the $16,680 as business income and deducted $1,425 as business expenses. Respondent adjusted this by determining that the $16,680 was unreported dividend income and simultaneously reducing reported business income by $15,255 (the difference between the $16,680 business income and $1,425 expense) that Mr. Norwalk reported. This results in a net increase in taxable income of $1,425, which we uphold.

FAILURE TO FILE -- SECTION 6651(a)

Respondent determined that Robert and Patricia DeMarta are liable for an addition to tax under the provisions of section 6651(a). Section 6651(a) imposes an addition to tax for failure to timely file a return, unless the taxpayer establishes that such failure is due to reasonable cause and not due to willful neglect. Mr. and Mrs. DeMarta failed to file their 1992 individual tax return within the period allowed for filing. An extension to file their return was granted until October 15, 1993. According to the notice of deficiency issued to Mr. and Mrs. DeMarta, their 1992 return was filed on October 27, 1993. Petitioners have provided no evidence or argument on this issue. We find that Mr. and Mrs. DeMarta are liable for the addition to tax in accordance with section 6651(a)(1).

IMPOSITION OF ACCURACY-RELATED PENALTY -- SECTION 6662(a)

Respondent has determined that the corporation, William R. Norwalk, and Robert and Patricia DeMarta are liable for accuracy- related penalties under section 6662(a). Section 6662(a) provides that, if it is applicable to any portion of an underpayment in taxes, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which section 6662 applies. Section 6662(b)(1) provides that section 6662 shall apply to the portion of any underpayment attributable to negligence or disregard of rules or regulations. Section 6662(c) provides that the term "negligence" includes any failure this title, and the term "disregard" includes any careless, reckless, or intentional disregard of rules or regulations. Negligence is the lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances. Neely v. Commissioner, 85 T.C. 934, 947 (1985).

However, under section 6664(c), no penalty shall be imposed under section 6662(a) with respect to any portion of any underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion. The Commissioner's determination is presumptively correct and will be upheld unless the taxpayer is able to rebut the presumption. Luman v. Commissioner, 79 T.C. 846, 860-861 (1982); Bixby v. Commissioner, 58 T.C. 757, 791 (1972); Reily v. Commissioner, 53 T.C. 8, 13-14 (1969).

In the notices of deficiency issued to the corporation, William R. Norwalk, and Robert and Patricia DeMarta, respondent applied the section 6662(a) penalty to "all or part of the underpayment of tax". With regard to the $23,320 adjustment conceded by petitioners Robert and Patricia DeMarta, they have presented no evidence to show that they acted with reasonable cause or good faith.[11] Therefore, we find that the accuracy-related penalty under section 6662(a) applies to the underpayment of tax associated with this settled issue.

In regard to the $40,000 deducted by the corporation as consulting fees, we have upheld respondent's determination. After thoroughly reviewing the record in these cases, we find no persuasive evidence or argument that the corporation acted with reasonable cause or good faith with respect to this issue. On this record, we hold that the corporation negligently or intentionally disregarded rules or regulations with regard to the underpayment of tax associated with this issue. Accordingly, the accuracy-related penalty under section 6662(a) is sustained with respect to the underpayment of tax associated with this deduction by the corporation.

Mr. Norwalk reported his allocable portion of the dividend ($16,680) on his return. Even though he did not characterize this amount as a dividend, the net effect of this was de minimis. We find that any understatement attributable to this was not due to negligence. Thus, Mr. Norwalk is not liable for the accuracy-related penalty under section 6662(a).

TRANSFEREE LIABILITY

Section 6901(a)(1)(A) authorizes the assessment of transferee liability in the same manner as the taxes in respect of which the liability was incurred. This provision does not create a new liability; it merely provides a remedy for enforcing the existing liability of the transferor. Coca-Cola Bottling Co. v. Commissioner, 334 F.2d 875, 877 (9th Cir. 1964), affg. 37 T.C. 1006 (1962); Mysse v. Commissioner, 57 T.C. 680, 700-701 (1972). The Commissioner has the burden of proving all the elements necessary to establish the taxpayer's liability as a transferee except for proving that the transferor was liable for the tax. Sec. 6902(a); Rule 142(d).

The substantive questions of whether a transferee is liable for the transferor's obligation and the extent of his liability depend on State law. See Commissioner v. Stern, 357 U.S. 39, 45 (1958); Adams v. Commissioner, 70 T.C. 373, 389 (1978), affd. without published

opinion 688 F.2d 815 (2d Cir. 1982). All the transfers in the instant case occurred in California; hence, California law governs. Adams v. Commissioner, supra at 390.

Respondent contends that Messrs. DeMarta and Norwalk are liable as transferees under Cal. Corp. Code section 2009 (West 1990). That section provides creditors with a cause of action against shareholders who have received assets improperly distributed upon dissolution of a corporation. Id. Cal. Corp. Code section 2004 (West 1990) provides the proper method of distributing corporate assets in a dissolution:

> After determining that all the known debts and liabilities of a corporation in the process of winding up have been paid or adequately provided for, the board shall distribute all the remaining corporate assets among the shareholders according to their respective rights and preferences or, if there are no shareholders, to the persons entitled thereto. * * *

Therefore, in order to impose transferee liability on the shareholders under this California law, respondent must prove that the shareholders improperly distributed the assets of the corporation.

At the time the corporation was liquidated, its liabilities included outstanding loans from the shareholders of $96,678.[12] On the basis of our findings in this case, we hold that respondent has not shown that the assets the shareholders received exceeded this amount.[13] The corporate minutes signed by Messrs. DeMarta and Norwalk and dated May 1, 1992, state:

> It was resolved that the Corporation, DeMarta & Norwalk, would distribute most of its assets and liabilities to the shareholders.
>
> Each shareholder would be distributed his share of assets and liabilities (except for shareholders loans). The net asset received by each shareholder would be credited as payment toward his shareholder loan.
>
> There does not appear to be sufficient net assets to pay back the full amount of the shareholder loans and therefore there will be no assets available for distribution against stock, retained earnings or dividends.
>
> This distribution is to take place prior to June 30, 1992.

There is nothing in the record that would indicate that the receipt of the corporate assets was anything other than partial payment of this debt. Based upon the meager record presented on this issue, we do not find that the assets were improperly distributed under Cal. Corp. Code section 2004; thus, this law is not a valid basis for transferee liability in this case.

Respondent also contends that the shareholders are liable as transferees under Cal. Civ. Code section 3439.04 (West 1997), which provides:

> A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the

> obligation was incurred, if the debtor made the transfer or incurred the obligation as follows:
>
> > (a) With actual intent to hinder, delay, or defraud any creditor of the debtor.
> >
> > (b) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
> >
> > > (1) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
> > >
> > > (2) Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.

Therefore, in order to establish that Messrs. DeMarta and Norwalk are liable as transferees for the amounts they received from the corporation, respondent must prove: (1) The corporation transferred the assets with "actual intent to hinder, delay, or defraud" the Internal Revenue Service; or (2) the corporation made the transfer without receiving a reasonably equivalent value in exchange for the transfer.

Actual intent may be established from circumstances surrounding the transfer of the assets. Menick v. Goldy, 280 P.2d 844 (Cal. Ct. App. 1955); Burns v. Radoicich, 176 P.2d 77 (Cal. Ct. App. 1947). As respondent recognizes, transferee liability generally results:

> when stockholders receive corporate distributions for which they do not pay an adequate and full consideration at a time when the corporation is insolvent, or thereby becomes insolvent, or is in process of liquidation. [Lesser v. Commissioner, 47 T.C. 564, 585 (1967).]

After carefully reviewing the record, we find that respondent has not met his burden of proving either actual intent to defraud or that the shareholders received assets for which they did not pay adequate and full consideration. Accordingly, we hold that Messrs. DeMarta and Norwalk are not liable as transferees.

Decisions will be entered under Rule 155.

FOOTNOTES

1. The following cases are consolidated: Robert DeMarta, Transferee, docket No. 20686-96; DeMarta & Norwalk, CPA's, Inc., docket No. 20767-96; William R. Norwalk, docket No. 20772-96; and Robert and Patricia DeMarta, docket No. 20773-96.

2. Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the taxable year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

3. sec. 1.331-1(e), Income Tax Regs., provides that a shareholder's gain or loss on a liquidating distribution be calculated on a per-share basis. The parties have stipulated the shareholders' bases in the corporation's stock, which are used for purposes of calculating the shareholder gain on the distribution.

4. It is not clear from the record whether respondent allowed any reduction for liabilities assumed by the shareholders in making his determination.

5. Petitioners' expert expressed no opinion with respect to the value of the tangible assets of the corporation.

6. In support of his position, respondent cites Schilbach v. Commissioner, T.C. Memo. 1991-556. In Schilbach, we found that a medical practice, operating as a corporation, had goodwill despite the lack of a covenant not to compete. Schilbach is distinguishable from the instant case in that in Schilbach some of the goodwill of the medical practice was inherent in the operating entity and was not solely dependent upon the employee-shareholder's ability. Moreover, in Schilbach, we found it doubtful that the employee-shareholder would have competed with the medical practice due to his inability to obtain malpractice insurance and his physical and mental condition. We do not find that the same circumstances exist in the instant cases.

7. Respondent made no separate determination as to any going- concern-value that the corporation may have had. Moreover, respondent's experts fail to attribute any value to such an asset.

8. Neither party argues that any of the tangible assets of the corporation is other than sec. 1245 property.

9. Petitioners submitted a list of the tangible assets at issue, which reflects an approximate recomputed basis of $179,880. Because both parties contend that the fair market value of the property is less than this amount, we rely on the fair market value to determine any gain recognized from depreciation recapture.

10. "Additionally, the market approach was used as a check for some items, such as computer equipment.

11. With respect to the adjustments in the notice of deficiency issued to Robert and Patricia DeMarta, the parties filed a stipulation of settled issues with this Court on Oct. 24, 1997.

12. Loans from shareholders increased by more than $74,000 from Jan. 1 to June 30, 1992.

13. If we had upheld respondent's principal determination regarding the value of the "customer-based intangibles", there would be no question that the assets exceeded the corporate debt owed to the shareholders.

66 N.Y.2d 576 (1985)

Michael O'Brien, Respondent-Appellant, v. Loretta O'Brien, Appellant-Respondent.

Court of Appeals of the State of New York.

Argued November 11, 1985.
Decided December 26, 1985.

Albert J. Emanuelli for appellant-respondent.

Willard H. Da Silva and *Richard J. Keidel* for respondent-appellant.

Sally Weinraub, *Shirley Tolley* and *Brynne Haines* for Westchester Women's Bar Association, amicus curiae.

Chief Judge WACHTLER and Judges JASEN, MEYER, KAYE, ALEXANDER and TITONE concur with Judge SIMONS; Judges MEYER and TITONE concur in separate concurring opinions.

SIMONS, J.

In this divorce action, the parties' only asset of any consequence is the husband's newly acquired license to practice medicine. The principal issue presented is whether that license, acquired during their marriage, is marital property subject to equitable distribution under Domestic Relations Law § 236 (B) (5). Supreme Court held that it was and accordingly made a distributive award in defendant's favor.[1] It also granted defendant maintenance arrears, expert witness fees and attorneys' fees (114 Misc 2d 233). On appeal to the Appellate Division, a majority of that court held that plaintiff's medical license is not marital property and that defendant was not entitled to an award for the expert witness fees. It modified the judgment and remitted the case to Supreme Court for further proceedings, specifically for a determination of maintenance and a rehabilitative award (106 AD2d 223). The matter is before us by leave of the Appellate Division.

We now hold that plaintiff's medical license constitutes "marital property" within the meaning of Domestic Relations Law § 236 (B) (1) (c) and that it is therefore subject to equitable distribution pursuant to subdivision 5 of that part. That being so, the Appellate Division erred in denying a fee, as a matter of law, to defendant's expert witness who evaluated the license.

[1] The action was originally instituted by plaintiff husband and defendant wife asserted a counterclaim in her answer. Subsequently, the husband withdrew his complaint and reply to the counterclaim and the wife received an uncontested divorce.

Plaintiff and defendant married on April 3, 1971. At the time both were employed as teachers at the same private school. Defendant had a bachelor's degree and a temporary teaching certificate but required 18 months of postgraduate classes at an approximate cost of $3,000, excluding living expenses, to obtain permanent certification in New York. She claimed, and the trial court found, that she had relinquished the opportunity to obtain permanent certification while plaintiff pursued his education. At the time of the marriage, plaintiff had completed only three and one-half years of college but shortly afterward he returned to school at night to earn his bachelor's degree and to complete sufficient premedical courses to enter medical school. In September 1973 the parties moved to Guadalajara, Mexico, where plaintiff became a full-time medical student. While he pursued his studies defendant held several teaching and tutorial positions and contributed her earnings to their joint expenses. The parties returned to New York in December 1976 so that plaintiff could complete the last two semesters of medical school and internship training here. After they returned, defendant resumed her former teaching position and she remained in it at the time this action was commenced. Plaintiff was licensed to practice medicine in October 1980. He commenced this action for divorce two months later. At the time of trial, he was a resident in general surgery.

During the marriage both parties contributed to paying the living and educational expenses and they received additional help from both of their families. They disagreed on the amounts of their respective contributions but it is undisputed that in addition to performing household work and managing the family finances defendant was gainfully employed throughout the marriage, that she contributed all of her earnings to their living and educational expenses and that her financial contributions exceeded those of plaintiff. The trial court found that she had contributed 76% of the parties' income exclusive of a $10,000 student loan obtained by defendant. Finding that plaintiff's medical degree and license are marital property, the court received evidence of its value and ordered a distributive award to defendant.

Defendant presented expert testimony that the present value of plaintiff's medical license was $472,000. Her expert testified that he arrived at this figure by comparing the average income of a college graduate and that of a general surgeon between 1985, when plaintiff's residency would end, and 2012, when he would reach age 65. After considering Federal income taxes, an inflation rate of 10% and a real interest rate of 3% he capitalized the difference in average earnings and reduced the amount to present value. He also gave his opinion that the present value of defendant's contribution to plaintiff's medical education was $103,390. Plaintiff offered no expert testimony on the subject.

The court, after considering the life-style that plaintiff would enjoy from the enhanced earning potential his medical license would bring and defendant's contributions and efforts toward attainment of it, made a distributive award to her of $188,800, representing 40% of the value of the license, and ordered it paid in 11 annual installments of various amounts beginning November 1, 1982 and ending November 1, 1992. The court also directed plaintiff to maintain a life insurance policy on his life for defendant's benefit for the unpaid balance of the award and it ordered plaintiff to pay defendant's counsel fees of $7,000 and her expert witness fee of $1,000. It did not award defendant maintenance.

A divided Appellate Division, relying on its prior decision in *Conner v Conner* (97 AD2d 88) and the decision of the Fourth Department in *Lesman v Lesman* (88 AD2d 153, *appeal dismissed* 57 N.Y.2d 956), concluded that a professional license acquired during marriage is not marital property subject to distribution. It therefore modified the judgment by striking the trial court's determination that it is and by striking the provision ordering payment of the expert witness for evaluating the license and remitted the case for further proceedings.

On these cross appeals, defendant seeks reinstatement of the judgment of the trial court. Plaintiff contends that the Appellate Division correctly held that a professional license is not marital property but he also urges that the trial court failed to adequately explain what factors it relied on in making its decision, that it erroneously excluded evidence of defendant's marital fault and that the trial court's awards for attorneys and expert witness fees were improper.

II

The Equitable Distribution Law contemplates only two classes of property: marital property and separate property (Domestic Relations Law § 236 [B] [c], [d]). The former, which is subject to equitable distribution, is defined broadly as *"all* property acquired by either or both spouses during the marriage and before the execution of a separation agreement or the commencement of a matrimonial action, *regardless of the form in which title is held"* (Domestic Relations Law § 236 [B] [1] [c] [emphasis added]; *see*, § 236 [B] [5] [b], [c]). Plaintiff does not contend that his license is excluded from distribution because it is separate property; rather, he claims that it is not property at all but represents a personal attainment in acquiring knowledge. He rests his argument on decisions in similar cases from other jurisdictions and on his view that a license does not satisfy common-law concepts of property. Neither contention is controlling because decisions in other States rely principally on their own statutes, and the legislative history underlying them, and because the New York Legislature deliberately went beyond traditional property concepts when it formulated the Equitable Distribution Law (*see generally*, 2 Foster-Freed-Brandes, Law and the Family — New York ch 33, at 917 *et set.*[1985 Cum Supp]). Instead, our statute recognizes that spouses have an equitable claim to things of value arising out of the marital relationship and classifies them as subject to distribution by focusing on the marital status of the parties at the time of acquisition. Those things acquired during marriage and subject to distribution have been classified as "marital property" although, as one commentator has observed, they hardly fall within the traditional property concepts because there is no common-law property interest remotely resembling marital property. "It is a statutory creature, is of no meaning whatsoever during the normal course of a marriage and arises full-grown, like Athena, upon the signing of a separation agreement or the commencement of a matrimonial action. [Thus] [i]t is hardly surprising, and not at all relevant, that traditional common law property concepts do not fit in parsing the meaning of `marital property'" (Florescue, "Market Value", *Professional Licenses and Marital Property: A Dilemma in Search of a Horn*, 1982 NY St Bar Assn Fam L Rev 13 [Dec.]). Having classified the "property" subject to distribution, the Legislature did not attempt to go further and define it but left it to the courts to determine what interests come within the terms of section 236 (B) (1) (c).

We made such a determination in *Majauskas v Majauskas* (61 N.Y.2d 481), holding there that vested but unmatured pension rights are marital property subject to equitable

distribution. Because pension benefits are not specifically identified as marital property in the statute, we looked to the express reference to pension rights contained in section 236 (B) (5) (d) (4), which deals with equitable distribution of marital property, to other provisions of the equitable distribution statute and to the legislative intent behind its enactment to determine whether pension rights are marital property or separate property. A similar analysis is appropriate here and leads to the conclusion that marital property encompasses a license to practice medicine to the extent that the license is acquired during marriage.

Section 236 provides that in making an equitable distribution of marital property, "the court shall consider: * * * (6) any equitable claim to, interest in, or direct or indirect contribution made to the acquisition of such marital property by the party not having title, including joint efforts or expenditures and contributions and services as a spouse, parent, wage earner and homemaker, and *to the career or career potential* of the other party [and] * * * (9) the impossibility or difficulty of evaluating any component asset or any interest in a business, corporation or *profession"* (Domestic Relations Law § 236 [B] [5] [d] [6], [9] [emphasis added]). Where equitable distribution of marital property is appropriate but "the distribution of an interest in a business, corporation or *profession* would be contrary to law" the court shall make a distributive award in lieu of an actual distribution of the property (Domestic Relations Law § 236 [B] [5] [e] [emphasis added]). The words mean exactly what they say: that an interest in a profession or professional career potential is marital property which may be represented by direct or indirect contributions of the non-title-holding spouse, including financial contributions and nonfinancial contributions made by caring for the home and family.

The history which preceded enactment of the statute confirms this interpretation. Reform of section 236 was advocated because experience had proven that application of the traditional common-law title theory of property had caused inequities upon dissolution of a marriage. The Legislature replaced the existing system with equitable distribution of marital property, an entirely new theory which considered all the circumstances of the case and of the respective parties to the marriage (Assembly Memorandum, 1980 NY Legis Ann, at 129-130). Equitable distribution was based on the premise that a marriage is, among other things, an economic partnership to which both parties contribute as spouse, parent, wage earner or homemaker (*id.*, at 130; *see*, Governor's Memorandum of Approval, 1980 McKinney's Session Laws of NY, at 1863). Consistent with this purpose, and implicit in the statutory scheme as a whole, is the view that upon dissolution of the marriage there should be a winding up of the parties' economic affairs and a severance of their economic ties by an equitable distribution of the marital assets. Thus, the concept of alimony, which often served as a means of lifetime support and dependence for one spouse upon the other long after the marriage was over, was replaced with the concept of maintenance which seeks to allow "the recipient spouse an opportunity to achieve [economic] independence" (Assembly Memorandum, 1980 NY Legis Ann, at 130).

The determination that a professional license is marital property is also consistent with the conceptual base upon which the statute rests. As this case demonstrates, few undertakings during a marriage better qualify as the type of joint effort that the statute's economic partnership theory is intended to address than contributions toward one spouse's acquisition of a professional license. Working spouses are often required to contribute substantial income as wage earners, sacrifice their own educational or career goals and

opportunities for child rearing, perform the bulk of household duties and responsibilities and forego the acquisition of marital assets that could have been accumulated if the professional spouse had been employed rather than occupied with the study and training necessary to acquire a professional license. In this case, nearly all of the parties' nine-year marriage was devoted to the acquisition of plaintiff's medical license and defendant played a major role in that project. She worked continuously during the marriage and contributed all of her earnings to their joint effort, she sacrificed her own educational and career opportunities, and she traveled with plaintiff to Mexico for three and one-half years while he attended medical school there. The Legislature has decided, by its explicit reference in the statute to the contributions of one spouse to the other's profession or career (*see*, Domestic Relations Law § 236 [B] [5] [d] [6], [9]; [e]), that these contributions represent investments in the economic partnership of the marriage and that the product of the parties' joint efforts, the professional license, should be considered marital property.

The majority at the Appellate Division held that the cited statutory provisions do not refer to the license held by a professional who has yet to establish a practice but only to a going professional practice (*see, e.g.*, *Arvantides v Arvantides*, 64 N.Y.2d 1033; *Litman v Litman*, 61 N.Y.2d 918). There is no reason in law or logic to restrict the plain language of the statute to existing practices, however, for it is of little consequence in making an award of marital property, except for the purpose of evaluation, whether the professional spouse has already established a practice or whether he or she has yet to do so. An established practice merely represents the exercise of the privileges conferred upon the professional spouse by the license and the income flowing from that practice represents the receipt of the enhanced earning capacity that licensure allows. That being so, it would be unfair not to consider the license a marital asset.

Plaintiff's principal argument, adopted by the majority below, is that a professional license is not marital property because it does not fit within the traditional view of property as something which has an exchange value on the open market and is capable of sale, assignment or transfer. The position does not withstand analysis for at least two reasons. First, as we have observed, it ignores the fact that whether a professional license constitutes marital property is to be judged by the language of the statute which created this new species of property previously unknown at common law or under prior statutes. Thus, whether the license fits within traditional property concepts is of no consequence. Second, it is an overstatement to assert that a professional license could not be considered property even outside the context of section 236 (B). A professional license is a valuable property right, reflected in the money, effort and lost opportunity for employment expended in its acquisition, and also in the enhanced earning capacity it affords its holder, which may not be revoked without due process of law (*see*, *Matter of Bender v Board of Regents*, 262 App Div 627, 631; *People ex rel. Greenberg v Reid*, 151 App Div 324, 326). That a professional license has no market value is irrelevant. Obviously, a license may not be alienated as may other property and for that reason the working spouse's interest in it is limited. The Legislature has recognized that limitation, however, and has provided for an award in lieu of its actual distribution (*see*, Domestic Relations Law § 236 [B] [5] [e]).

Plaintiff also contends that alternative remedies should be employed, such as an award of rehabilitative maintenance or reimbursement for direct financial contributions *(see, e.g.*, *Kutanovski v Kutanovski*, 109 AD2d 822, 824; *Conner v Conner*, 97 AD2d 88,

101, *supra; Lesman v Lesman*, 88 AD2d 153, 158-159, *supra)*. The statute does not expressly authorize retrospective maintenance or rehabilitative awards and we have no occasion to decide in this case whether the authority to do so may ever be implied from its provisions (*but see*, *Cappiello v Cappiello*, 66 N.Y.2d 107). It is sufficient to observe that normally a working spouse should not be restricted to that relief because to do so frustrates the purposes underlying the Equitable Distribution Law. Limiting a working spouse to a maintenance award, either general or rehabilitative, not only is contrary to the economic partnership concept underlying the statute but also retains the uncertain and inequitable economic ties of dependence that the Legislature sought to extinguish by equitable distribution. Maintenance is subject to termination upon the recipient's remarriage and a working spouse may never receive adequate consideration for his or her contribution and may even be penalized for the decision to remarry if that is the only method of compensating the contribution. As one court said so well, "[t]he function of equitable distribution is to recognize that when a marriage ends, each of the spouses, based on the totality of the contributions made to it, has a stake in and right to a share of the marital assets accumulated while it endured, not because that share is needed, but because those assets represent the capital product of what was essentially a partnership entity" (*Wood v Wood*, 119 Misc 2d 1076, 1079). The Legislature stated its intention to eliminate such inequities by providing that a supporting spouse's "direct or indirect contribution" be recognized, considered and rewarded (Domestic Relations Law § 236 [B] [5] [d] [6]).

Turning to the question of valuation, it has been suggested that even if a professional license is considered marital property, the working spouse is entitled only to reimbursement of his or her direct financial contributions (*see*, Note, *Equitable Distribution of Degrees and Licenses: Two Theories Toward Compensating Spousal Contributions*, 49 Brooklyn L Rev 301, 317-322). By parity of reasoning, a spouse's down payment on real estate or contribution to the purchase of securities would be limited to the money contributed, without any remuneration for any incremental value in the asset because of price appreciation. Such a result is completely at odds with the statute's requirement that the court give full consideration to both direct and indirect contributions "made to the acquisition of such marital property by the party not having title, including joint *efforts* or expenditures and *contributions and services as a spouse, parent*, wage earner *and homemaker"* (Domestic Relations Law § 236 [B] [5] [d] [6] [emphasis added]). If the license is marital property, then the working spouse is entitled to an equitable portion of it, not a return of funds advanced. Its value is the enhanced earning capacity it affords the holder and although fixing the present value of that enhanced earning capacity may present problems, the problems are not insurmountable. Certainly they are no more difficult than computing tort damages for wrongful death or diminished earning capacity resulting from injury and they differ only in degree from the problems presented when valuing a professional practice for purposes of a distributive award, something the courts have not hesitated to do (*see*, *Arvantides v Arvantides*, 64 N.Y.2d 1033, *supra; Litman v Litman*, 93 AD2d 695, *affd* 61 N.Y.2d 918, *supra; Billington v Billington*, 111 AD2d 203; *Cohen v Cohen*, 104 AD2d 841, *appeal dismissed* 64 N.Y.2d 773; *Nehorayoff v Nehorayoff*, 108 Misc 2d 311). The trial court retains the flexibility and discretion to structure the distributive award equitably, taking into consideration factors such as the working spouse's need for immediate payment, the licensed spouse's current ability to pay and the income tax consequences of prolonging the period of payment (*see*, Internal Revenue Code [26 USC] § 71 [a] [1]; [c] [2]; Treas Reg [26 CFR] § 1.71-1 [d] [4]) and, once it has received evidence of

the present value of the license and the working spouse's contributions toward its acquisition and considered the remaining factors mandated by the statute (*see*, Domestic Relations Law § 236 [B] [5] [d] [1]-[10]), it may then make an appropriate distribution of the marital property including a distributive award for the professional license if such an award is warranted. When other marital assets are of sufficient value to provide for the supporting spouse's equitable portion of the marital property, including his or her contributions to the acquisition of the professional license, however, the court retains the discretion to distribute these other marital assets or to make a distributive award in lieu of an actual distribution of the value of the professional spouse's license *(see*, *Majauskas v Majauskas*, 61 N.Y.2d 481, 493, *supra)*.

III

Three additional issues remain for our consideration.

First, plaintiff notes that the statute requires the trial court to state the factors it considered and the basis for its decision in making distribution and that neither the parties nor counsel may waive that requirement (*see*, Domestic Relations Law § 236 [B] [5] [g]). He contends that the court failed to adequately do so in this case. We have held recently that while section 236 (B) (5) (g) does not require the court to analyze each of the factors stated in subdivision (5) (d) and give reasons as to each, it still must set forth all the factors it considered and the reason for its decision (*Cappiello v Cappiello*, 66 N.Y.2d 107, *supra*). Unless the trial judge reveals not only the factors he considered, but also his reasoning for the award made, intelligent review of the broad discretion entrusted to him is not possible.

The evidence before the trial court in this case supported its factual findings but its decision does not indicate what factors it considered, or the weight it attributed to them, in making the distributive award to defendant. Nevertheless, the Appellate Division has the same authority to make an award of marital property as does the trial court *(see*, *Majauskas v Majauskas*, 61 N.Y.2d 481, *supra)*, and it may effectuate the award and set forth the factors it considers determinative and the reasons for its decision or it may remit the matter to Special Term for that purpose if it is unable to do so (*see*, *Kobylack v Kobylack*, 62 N.Y.2d 399).

Plaintiff also contends that the trial court erred in excluding evidence of defendant's marital fault on the question of equitable distribution. Arguably, the court may consider marital fault under factor 10, "any other factor which the court shall expressly find to be just and proper" (Domestic Relations Law § 236 [B] [5] [d] [10]; *see*, Scheinkman, 1981 Practice Commentary, McKinney's Cons Laws of NY, Book 14, Domestic Relations Law C236B:13, pp 205-206 [1977-1984 Supp Pamphlet]). Except in egregious cases which shock the conscience of the court, however, it is not a "just and proper" factor for consideration in the equitable distribution of marital property (*Blickstein v Blickstein*, 99 AD2d 287, 292, *appeal dismissed* 62 N.Y.2d 802; *see*, *Stevens v Stevens*, 107 AD2d 987; *Pacifico v Pacifico*, 101 AD2d 709; *McMahan v McMahan*, 100 AD2d 826). That is so because marital fault is inconsistent with the underlying assumption that a marriage is in part an economic partnership and upon its dissolution the parties are entitled to a fair share of the marital estate, because fault will usually be difficult to assign and because introduction of the issue may involve the courts in time-consuming procedural maneuvers relating to collateral issues

(*see*, *Blickstein v Blickstein*, *supra*, at p 292; *McMahan v McMahan*, *supra*, at p 827). We have no occasion to consider the wife's fault in this action because there is no suggestion that she was guilty of fault sufficient to shock the conscience.

Finally, plaintiff contends that the trial court erred in allowing defendant an award of counsel fees and defendant contends the Appellate Division erred in deleting the trial court's award of expert witness fees. The decision to award either expert witness fees or attorney's fees lies, in the first instance, in the discretion of the trial court and then in the Appellate Division whose discretionary authority is as broad as the trial court's is *(see*, Domestic Relations Law § 237 [a], [c]; *Majauskas v Majauskas*, 61 N.Y.2d 481, 493-494, *supra)*. Because the Appellate Division's affirmance of the award of counsel fees cannot be characterized as an abuse of discretion as a matter of law, the issue is beyond our review (*see*, *Majauskas v Majauskas*, *supra*, at p 494; *Patron v Patron*, 40 N.Y.2d 582). Its decision to delete the award of expert fees, as a matter of law, was apparently based on the fact that the expert's testimony was directed solely to the value of plaintiff's license, evidence that was unnecessary in view of its determination that the license was not marital property. We have concluded that the license is marital property, however, and on remand the court may exercise its discretion to determine whether an award of expert fees is warranted and if so their proper amount *(see*, *Litman v Litman*, 61 N.Y.2d 918, *supra)*.

Accordingly, in view of our holding that plaintiff's license to practice medicine is marital property, the order of the Appellate Division should be modified, with costs to defendant, by reinstating the judgment and the case remitted to the Appellate Division for determination of the facts, including the exercise of that court's discretion (CPLR 5613), and, as so modified, affirmed. Question certified answered in the negative.

MEYER, J. (concurring).

I concur in Judge Simons' opinion but write separately to point up for consideration by the Legislature the potential for unfairness involved in distributive awards based upon a license of a professional still in training.

An equity court normally has power to "`change its decrees where there has been a change of circumstances"' (*People v Scanlon*, 11 N.Y.2d 459, 462, *on second appeal* 13 N.Y.2d 982). The implication of Domestic Relations Law § 236 (B) (9) (b), which deals with modification of an order or decree as to maintenance or child support, is, however, that a distributive award pursuant to section 236 (B) (5) (e), once made, is not subject to change. Yet a professional in training who is not finally committed to a career choice when the distributive award is made may be locked into a particular kind of practice simply because the monetary obligations imposed by the distributive award made on the basis of the trial judge's conclusion (prophecy may be a better word) as to what the career choice will be leaves him or her no alternative.

The present case points up the problem. A medical license is but a step toward the practice ultimately engaged in by its holder, which follows after internship, residency and, for particular specialties, board certification. Here it is undisputed that plaintiff was in a residency for general surgery at the time of the trial, but had the previous year done a residency in internal medicine. Defendant's expert based his opinion on the difference

between the average income of a general surgeon and that of a college graduate of plaintiff's age and life expectancy, which the trial judge utilized, impliedly finding that plaintiff would engage in a surgical practice despite plaintiff's testimony that he was dissatisfied with the general surgery program he was in and was attempting to return to the internal medicine training he had been in the previous year. The trial judge had the right, of course, to discredit that testimony, but the point is that equitable distribution was not intended to permit a judge to make a career decision for a licensed spouse still in training. Yet the degree of speculation involved in the award made is emphasized by the testimony of the expert on which it was based. Asked whether his assumptions and calculations were in any way speculative, he replied: "Yes. They're speculative to the extent of, will Dr. O'Brien practice medicine? Will Dr. O'Brien earn more or less than the average surgeon earns? Will Dr. O'Brien live to age sixty-five? Will Dr. O'Brien have a heart attack or will he be injured in an automobile accident? Will he be disabled? I mean, there is a degree of speculation. That speculative aspect is no more to be taken into account, cannot be taken into account, and it's a question, again, Mr. Emanuelli, not for the expert but for the courts to decide. It's not my function nor could it be."

The equitable distribution provisions of the Domestic Relations Law were intended to provide flexibility so that equity could be done. But if the assumption as to career choice on which a distributive award payable over a number of years is based turns out not to be the fact (as, for example, should a general surgery trainee accidentally lose the use of his hand), it should be possible for the court to revise the distributive award to conform to the fact. And there will be no unfairness in so doing if either spouse can seek reconsideration, for the licensed spouse is more likely to seek reconsideration based on real, rather than imagined, cause if he or she knows that the nonlicensed spouse can seek not only reinstatement of the original award, but counsel fees in addition, should the purported circumstance on which a change is made turn out to have been feigned or to be illusory.

TITONE, J. (concurring).

I join in the majority opinion by Judge Simons for the court, and, like Justice Jackson, forthrightly surrender my contrary views in *Conner v Conner* (97 AD2d 88, 105 [Titone, J. P., concurring]) to a more cogent position (*McGrath v Kristensen*, 340 US 162, 178 [Jackson, J., concurring]).

Order modified, with costs to defendant, and case remitted to the Appellate Division, Second Department, for further proceedings in accordance with the opinion herein and, as so modified, affirmed. Question certified answered in the negative.

T.C. Memo. 2003-280

UNITED STATES TAX COURT

PETER S. PERACCHIO, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 10470-01. Filed September 25, 2003.

P transferred limited partner interests in a family limited partnership (PT) to a family trust (T) pursuant to two separate transactions. In one of the transactions, P transferred a 45.47-percent limited partner interest to T for no consideration. In the other transaction, P transferred a 53.48-percent limited partner interest to T in exchange for T's promissory note in the amount of $646,764.

Held: Fair market value of the transferred PT interests determined. See sec. 2512, I.R.C.

Eric M. Nemeth, Michael J. Mulcahy, and Brian C. Bernhardt, for petitioner.

John W. Stevens, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HALPERN, Judge: By notice of deficiency dated May 25, 2001 (the notice of deficiency), respondent determined a deficiency in Federal gift tax for calendar year 1997 with respect to petitioner in the amount of $328,317. Petitioner timely filed a petition for redetermination. The dispute involves the value of interests in a family limited partnership transferred by petitioner to a family trust.

Unless otherwise noted, all section references are to the Internal Revenue Code in effect on the date of the transfers, and all Rule references are to the Tax Court Rules of Practice and Procedure. All dollar amounts have been rounded to the nearest dollar.

FINDINGS OF FACT

Some facts are stipulated and are so found. The stipulation of facts, with accompanying exhibits, is incorporated herein by this reference. At the time he filed the petition, petitioner resided in Grosse Pointe Woods, Michigan.

Formation of the Trust and the Partnership

On November 25, 1997 (the valuation date), petitioner, as settlor, and petitioner's wife, as trustee, executed a trust agreement creating the Peracchio Family Trust (the trust). On the same day, petitioner, the trust, and petitioner's son, John R. Peracchio, executed an agreement of limited partnership (the partnership agreement) with respect to Peracchio Investors, L.P.,

a Delaware limited partnership (the partnership). Petitioner contributed cash and securities with a designated value of $2,013,765 to the partnership in exchange for a 0.5-percent general partner interest and a 99.4-percent limited partner interest in the partnership, which, collectively, represented 2,013.765 partnership units. Petitioner's son contributed $1,000 to the partnership in exchange for a 0.05-percent general partner interest in the partnership, which represented one partnership unit. The trust contributed $1,000 to the partnership in exchange for a 0.05-percent limited partner interest in the partnership, which also represented one partnership unit.

Transfers of Partnership Units

Also on the valuation date, petitioner made three transfers of partnership units. Petitioner gratuitously transferred 9.0788 partnership units (representing 0.45 percent of all partnership units outstanding) to his son, to be held in the capacity of a general partner. Petitioner also gratuitously transferred 916.667 partnership units (representing 45.47 percent of all partnership units outstanding) to the trust, to be held in the capacity of a limited partner. Petitioner transferred an additional 1,077.9409 partnership units (representing 53.48 percent of all partnership units outstanding) to the trust, to be held in the capacity of a limited partner, in exchange for the trust's promissory note in the amount of $646,764. After the

foregoing transfers, the percentage ownership of the partnership was as follows:

General Partners	
Peter S. Peracchio	0.05%
John R. Peracchio	0.50%
Limited Partners	
Peter S. Peracchio	0.45%
Peracchio Family Trust	99.00%
Total	100.00%

Partnership Assets

The partnership's assets on the valuation date consisted entirely of cash and marketable securities.[1] The partnership's domestic stock portfolio on that date consisted of shares in 44 companies, with no apparent concentration in any particular industry.

Relevant Provisions of the Partnership Agreement

Among other things, the partnership agreement provides as follows:

The partnership will continue in existence until November 25, 2047 (the termination date), unless sooner terminated in accordance with the terms of the partnership agreement. No limited partner may withdraw his capital from the partnership

[1] The partnership held certain marketable securities indirectly through investment funds, including "open-end" investment funds. We understand from the expert reports received into evidence in this case that, although shares of open-end investment funds are not themselves publicly traded, a holder thereof generally can liquidate his investment at any time by tendering his shares to the fund for repurchase at a price equal to their pro rata share of the fund's net asset value (NAV).

prior to the termination date without the written consent of the general partners.

Partners may freely transfer their partnership units to or for the benefit of certain family members and charitable organizations (permitted transferees). A partner desiring to transfer his partnership units to someone other than a permitted transferee must first offer those units to the partnership on the same terms and conditions. The partnership then has 30 days to exercise its option to purchase such units. Regardless of the identity of the transferee, no transferee of partnership units can attain the legal status of a partner in the partnership without the unanimous consent of all general partners.

Limited partners have no right to participate in the management of the partnership's affairs, and partnership distributions are subject to the discretion of the general partners.

The Gift Tax Return

Petitioner timely filed Form 709, United States Gift (and Generation Skipping Transfer) Tax Return, for 1997 (the Form 709). In a statement attached to the Form 709, petitioner reported his gratuitous transfer of 9.0788 partnership units to his son at a value of $9,070. In the same statement, petitioner reported his gratuitous transfer of 916.667 partnership units to the trust at a value of $550,000. In another attachment to the Form 709, petitioner disclosed that he had determined the value

of his gratuitous transfer to the trust by (1) multiplying the number of partnership units transferred (916.677) by their designated "per unit" value of $1,000, and (2) applying a combined discount of 40 percent (for lack of control and lack of marketability) to the resulting figure.

The Notice of Deficiency

By the notice of deficiency, respondent determined a deficiency in Federal gift tax with respect to petitioner in the amount of $328,317, based primarily on an increase in 1997 taxable gifts in the amount of $797,843.[2] Specifically, respondent (1) increased the value of petitioner's gratuitous transfer to the trust from $550,000 to $916,667, and (2) determined an additional gift in the amount of $431,176, representing the amount by which, according to respondent, the value of the additional 1,077.9409 partnership units transferred by petitioner to the trust exceeded the consideration received therefor.[3]

Respondent based his determination on four alternative theories: (1) that the partnership lacks economic substance and

[2] Respondent also determined that, in preparing the Form 709, petitioner failed to account for $70,500 of taxable gifts made in prior years. Petitioner does not dispute that determination and has paid the portion of the asserted deficiency (plus interest) attributable thereto.

[3] Respondent did not adjust the value of petitioner's gratuitous transfer of 9.0788 partnership units to his son.

therefore should be disregarded for Federal gift tax purposes, (2) that the partnership agreement should be treated as a restriction on the right to sell or use property (i.e., the property underlying the transferred partnership units) which must be disregarded under section 2703(a)(2) in determining the Federal gift tax value of such property, (3) that the provision in the partnership agreement restricting a limited partner's ability to liquidate his interest by withdrawing from the partnership should be treated as an applicable restriction under section 2704(b) which must be disregarded in determining the Federal gift tax value of the transferred partnership units, and (4) that in determining the fair market value of the transferred partnership units under the general valuation rule of section 2512, no discounts for lack of control and lack of marketability are warranted. Respondent has since abandoned the first three of those four alternative theories and has modified his position with respect to the remaining theory to allow for a 4.4-percent discount for lack of control and a 15-percent discount for lack of marketability.

OPINION

I. Introduction

We must determine the fair market value, as of the date of transfer, of 45.47-percent and 53.48-percent limited partner

interests (the gifted interest and the sold interest,[4] respectively, and, collectively, the transferred interests) in Peracchio Investors, L.P. (the partnership) transferred by petitioner to the Peracchio Family Trust (the trust) in separate transactions occurring on November 25, 1997 (the valuation date). The parties agree that, because the partnership's assets on the valuation date consisted entirely of cash and marketable securities, the partnership's net asset value (NAV) on that date is the appropriate starting point for determining the fair market value of the transferred interests. The parties further agree that, in valuing the transferred interests, it is appropriate to discount each interest's pro rata share of the partnership's NAV to reflect the lack of control and lack of marketability inherent in the transferred interests. The parties disagree on the magnitude of those discounts. For purposes of reporting the value of the gifted interest on his Federal gift tax return and establishing the consideration for the sold interest, petitioner applied a combined discount of 40 percent. Respondent contends that 4.4-percent and 15-percent discounts for lack of control and lack of marketability, respectively, are appropriate, yielding a combined discount (applying the separate discounts serially) of 18.74 percent.

[4] We use the term "sold interest" solely for descriptive convenience (i.e., without regard to the proper characterization, for Federal gift tax purposes, of petitioner's transfer of that interest).

Petitioner bears the burden of proof.[5] Rule 142(a)(1).

II. Law

Section 2501(a) imposes a tax on the transfer of property by gift. Section 2512(a) provides that, if a gift is made in property, the value of the property on the date of the gift is considered the amount of the gift. Section 25.2512-1, Gift Tax Regs., provides that the value of property for Federal gift tax purposes is "the price at which such 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." The willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the donor and the donee. Estate of Newhouse v. Commissioner, 94 T.C. 193, 218 (1990) (citing Estate of Bright v.

[5] Petitioner does not raise the applicability of sec. 7491(a), which operates to shift the burden of proof to the Commissioner in certain circumstances. See Rule 142(a)(2). However, petitioner argues for the first time in his posttrial reply brief that, under general principles of Federal tax law, respondent bears the burden of proof on the ground that the notice of deficiency is arbitrarily excessive and without foundation. As petitioner did not timely raise that issue, we decline to consider it. See, e.g., Graham v. Commissioner, 79 T.C. 415, 423 (1982) ("It is well settled that this Court will not consider issues raised for the first time on brief when to do so prevents the opposing party from presenting evidence or arguments that might have been presented if the issue had been timely raised.").

United States, 658 F.2d 999, 1006 (5th Cir. 1981)).[6] The hypothetical willing buyer and willing seller are presumed to be dedicated to achieving the maximum economic advantage. Estate of Newhouse, supra at 218.

III. Expert Opinions

A. Introduction

In this case, the parties rely exclusively on expert testimony to establish the appropriate discounts to be applied in determining the fair market value of the transferred interests. Of course, we are not bound by the opinion of any expert witness, and we may accept or reject expert testimony in the exercise of our sound judgment. Helvering v. Natl. Grocery Co., 304 U.S. 282, 295 (1938); Estate of Newhouse v. Commissioner, supra at 217. Although we may largely accept the opinion of one party's expert over that of the other party's expert, see Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 452 (1980), we may be selective in determining what portions of each expert's opinion, if any, to accept, Parker v. Commissioner, 86 T.C. 547, 562 (1986). Finally, because valuation necessarily involves an approximation, the figure at which we arrive need not be directly traceable to specific testimony if it is within the range of

[6] Although the cited cases involved the Federal estate tax, it is well settled that the Federal estate tax and the Federal gift tax, being in pari materia, should be construed together. See, e.g., Shepherd v. Commissioner, 283 F.3d 1258, 1262 n.7 (11th Cir. 2002) (citing Harris v. Commissioner, 340 U.S. 106, 107 (1950)), affg. 115 T.C. 376 (2000).

values that may be properly derived from consideration of all the evidence. Estate of True v. Commissioner, T.C. Memo. 2001-167 (citing Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo. 1974-285).

B. Petitioner's Experts

Petitioner offered Timothy R. Dankoff and Charles H. Stryker as expert witnesses to testify concerning the value of the transferred interests. Mr. Dankoff is a partner in Plante & Moran, LLP, an accounting and management consulting firm. He is accredited as a senior appraiser by the American Society of Appraisers and has been involved in business valuation activities since 1986. Mr. Stryker is a partner in the valuation and appraisal group of BDO Seidman, LLP, an accounting and consulting firm. He has been performing valuation services for approximately 25 years. The Court accepted Mr. Dankoff and Mr. Stryker as experts in valuation and received into evidence as their expert testimony their respective written analyses regarding the value of the transferred interests.

In his written report, Mr. Dankoff concludes that, based on a 7.7-percent minority interest discount and a 35-percent marketability discount, the fair market values of the gifted interest and the sold interest on November 30, 1997 (5 days after the valuation date), were $550,000 and $646,764, respectively. Mr. Stryker concludes in his written report that, based on a 5-

percent minority interest discount and a 40-percent marketability discount, the fair market value of the gifted interest on the valuation date was $522,609. Mr. Stryker did not separately calculate the fair market value of the sold interest.

C. Respondent's Expert

Respondent offered Francis X. Burns as an expert witness to testify concerning the value of the transferred interests. Mr. Burns is managing director of InteCap, Inc., a financial consulting firm that specializes in valuation services. He has been performing valuation services for approximately 15 years and has testified as an expert in several valuation cases. The Court accepted Mr. Burns as an expert in valuation and received into evidence as his expert testimony his written analysis regarding the value of the transferred interests.

In his written report, Mr. Burns concludes that, based on a 4.4-percent minority interest discount and a 15-percent marketability discount, the fair market values of the gifted interest and the sold interest on the valuation date were $742,071 and $872,794, respectively.

IV. Discussion

A. Net Asset Value of the Partnership

Mr. Dankoff's firm valued the assets petitioner contributed to the partnership (the contributed assets) at $2,013,765. In his written report, Mr. Dankoff acknowledges that such figure

(upon which petitioner's other expert, Mr. Stryker, relied as well)[7] is based on values reported in brokerage account statements as of November 30, 1997 (5 days after the valuation date). Respondent's expert, Mr. Burns, concludes in his written report that the value of the contributed assets on the valuation date was $2,008,370.[8] We accept Mr. Burns's conclusion in that regard.[9] Taking into account the $2,000 in cash contributed by the other partners of the partnership, we conclude that the partnership's NAV on the valuation date was $2,010,370.

B. Minority Interest (Lack of Control) Discount

1. Introduction

Pursuant to the partnership agreement, a hypothetical buyer of all or any portion of the transferred interests would have limited control of his investment. For instance, such holder (1) would have no say in the partnership's investment strategy, and (2) could not unilaterally recoup his investment by forcing the partnership either to redeem his interest or to undergo a complete liquidation. The parties agree that the hypothetical

[7] Mr. Stryker also inappropriately added approximately $640 of interest earned by the partnership in December 1997.

[8] Mr. Burns actually identifies that figure as the partnership's NAV. In doing so, he overlooks the $2,000 contributed by the other partners, which the parties have stipulated.

[9] Although the parties stipulated that, for purposes of the notice of deficiency, respondent relied on the valuation of the contributed assets by Mr. Dankoff's firm, the parties did not stipulate the accuracy of that figure.

"willing buyer" of a transferred interest would account for such lack of control by demanding a reduced sales price; i.e., a price that is less than the interest's pro rata share of the partnership's NAV.

2. Comparison to Closed End Investment Funds

a. Overview

Each expert witness determined a minority interest discount for the transferred interests by reference to shares of publicly traded, closed end investment funds, which typically trade at a discount relative to their share of fund NAV.[10] The idea is that, since such shares (by definition) enjoy a high degree of marketability, those discounts must be attributable, at least to some extent, to a minority shareholder's lack of control over the investment fund.[11]

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[10] We understand from the expert reports received into evidence in this case that, unlike a shareholder of an open-end fund (and similar to a holder of a limited partner interest in the partnership), a shareholder of a closed end fund cannot obtain the liquidation value of his investment (i.e., his pro rata share of the fund's NAV) at will by tendering his shares to the fund for repurchase.

[11] That there are other factors involved in the pricing of closed end fund shares is evidenced by the fact that shares of some funds trade at a premium relative to their share of fund NAV. In his written report, Mr. Burns suggests that positive pricing factors include heightened investor interest in the specific attributes of a fund, while additional negative pricing factors (i.e., in addition to lack of control) include fund management fees and administration fees. Absent any further refinement of the data contained in the record, we assume that, within each sample of closed end funds we consider in our analysis, such positive factors and additional negative factors

(continued...)

Both Mr. Dankoff and Mr. Burns determine a minority interest discount factor for each type of investment held by the partnership, based (to the extent possible) on discounts observed in shares of closed end funds holding similar assets.[12] They then determine their respective minority interest discounts for the transferred interests by calculating the weighted average of such factors, based on the partnership's relative holdings of each asset type. That is an approach we have previously followed in the context of investment partnerships, see McCord v. Commissioner, 120 T.C. 358, 376-387 (2003), and we shall do so again here.

b. Partnership Asset Categories

Both Mr. Dankoff and Mr. Burns divide the assets of the partnership into five basic categories: cash and money market funds, U.S. Government bond funds, municipal bonds, domestic equities, and foreign equities. We utilize those categories in our analysis, except that we divide the "municipal bonds" category into "national" and "Michigan" subcategories.

[11](...continued)
roughly offset each other.

[12] Although petitioner's other expert, Mr. Stryker, purports to derive his minority interest discount from discounts observed in shares of closed end funds, his methodology is comparatively both imprecise (his 5-percent discount is not statistically derived from observed discounts) and incomplete (he considers only domestic equity funds). For those reasons, we give no weight to that portion of Mr. Stryker's testimony.

c. Partnership Assets in Each Category

In his written report, Mr. Burns includes a list of partnership investments (and their values as of the valuation date) by asset category. That list, as modified by the aforementioned refinement of the "municipal bonds" category and two additional classification changes[13] (as well as the addition of $2,000 to the "Cash and Money Market Funds" category to reflect contributions by partners other than petitioner, see supra note 8), yields the following profile of partnership assets as of the valuation date:

Asset Type	FMV	Percentage
Cash & money market funds	$883,622	44.0
U.S. Government bond funds	7,988	0.4
State & local bonds (MI)	41,750	2.1
Natl. Muni bond funds	101,145	5.0
Domestic equities	877,179	43.6
Foreign equities	98,686	4.9
Total	$2,010,370	100.0

d. Date of Price/NAV Data

Both Mr. Dankoff and Mr. Burns obtain their closed end fund data from tables prepared by Lipper Analytical Services (Lipper) and published in Barron's. However, Mr. Dankoff relies on data as of October 24, 1997, while Mr. Burns utilizes data as of

[13] Because "money market fund" is a term of art, see 17 C.F.R. sec. 270.2a-7(b) and (c) (1997), we have also reclassified "Fidelity MI Muni Money Market" and "Short Term Income Fund-Govt." (listed by Mr. Burns as a municipal bond fund and a U.S. Government bond fund, respectively) as money market funds, which is how they are classified in brokerage statements introduced into evidence.

November 21, 1997. Absent any explanation from Mr. Dankoff as to why it would be more appropriate for us to use his less contemporaneous data, we utilize Mr. Burns' price and NAV data in our analysis.

e. Samples of Closed End Funds

i. Cash and Money Market Funds

Both Mr. Dankoff and Mr. Burns implicitly recognize the lack of an appropriate sample of closed end funds from which to derive a minority interest discount factor for the "cash and money market funds" asset category. In his written report, Mr. Dankoff assigns a 5-percent discount factor to that asset category and notes that such figure is "[j]udgmentally determined recognizing the relative risk/return tradeoff of this asset category vis a vis U.S. Government Bond Funds". Mr. Burns assigns a 2-percent discount factor to the "cash and money market funds" asset category, noting without further explanation that such figure is an estimate. While we find neither expert persuasive on this issue, we utilize a 2-percent discount factor in our analysis on the grounds that (1) respondent has effectively conceded that a discount factor of up to 2 percent would be appropriate, and (2) petitioner has failed to carry his burden of persuading us that a figure in excess of 2 percent would be appropriate.

ii. U.S. Government Bond Funds[14]

Mr. Burns' written report includes a copy of the aforementioned Lipper closed end fund table published in the November 24, 1997, edition of Barron's (the Lipper table). That table lists 13 funds under the heading "U.S. Gov't Bond Funds" and contains NAV data for 12 of those funds.[15] Mr. Dankoff winnows that sample to seven unidentified funds, apparently on the basis of "outliers and asset homogeneity with the subject assets". Mr. Dankoff offers no data in support of his refinement of the sample, and we see no obvious "outliers" in the group. Accordingly, we include in our sample (as did Mr. Burns) all 12 of the funds for which NAV data is set forth in the Lipper table.

iii. State and Local Bonds (Michigan)

The Lipper table lists five Michigan funds under the heading "Single State Muni Bond". We include in our sample (as did Mr. Dankoff, apparently) all five of those funds.[16]

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[14] The partnership's lone investment in U.S. Government bonds on the valuation date was itself in the form of shares of a closed end investment fund, Putnam Intermediate Government (PGT). While it may be more appropriate under these circumstances simply to utilize that fund's price-to-NAV discount in our analysis (rather than a discount derived from a sample of funds), the record does not contain that information.

[15] See supra note 14.

[16] Although Mr. Dankoff does not identify the funds included in his sample, he does indicate that his sample contains five funds. Mr. Burns did not create a separate sample of single State funds invested in Michigan-based obligations.

iv. National Municipal Bond Funds

The Lipper table lists 99 funds under the heading "National Muni Bond Funds" and contains NAV data for 81 of those funds. As we see no obvious outliers in the data, we include all 81 of those funds in our sample.[17]

v. Domestic Equities

The Lipper table lists 24 funds under the heading "General Equity Funds" and 21 funds under the heading "Specialized Equity Funds". Mr. Dankoff apparently included both types of funds in his sample, which is comprised of 44 funds. Mr. Burns, on the other hand, limited his sample to general equity funds. As referenced in our findings of fact, the partnership's domestic stock portfolio was widely diversified on the valuation date. We therefore follow Mr. Burns' lead and limit our sample to general equity funds. We further limit our sample by excluding two funds from the Lipper table which were trading at unusually high premiums relative to the other domestic equity funds listed in that table.[18]

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[17] We cannot deduce from the record whether Mr. Burns included all 81 of those funds in his sample. However, we note that the average discount of Mr. Burns's sample (3.3 percent) is very close to the average discount of our sample (3.4 percent).

Mr. Dankoff did not create a separate sample of national municipal bond funds.

[18] Shares of "MFS Special Val" (MFV) and "NAIC Growth" (GRF) were trading at premiums of 27.3 percent and 51.3 percent, respectively. No other general equity fund listed in the Lipper

(continued...)

vi. Foreign Equities

The Lipper table lists 91 funds under the heading "World Equity Funds" and contains NAV and price data for 89 of those funds.[19] Unlike Mr. Burns, we exclude from our sample three funds from the Lipper table which were trading at unusually high premiums relative to the other foreign equity funds listed in that table.[20]

f. Representative Discount Within the Range of Sample Fund Discounts

Mr. Dankoff calculates the mean (average) discount and the median (midpoint) discount with respect to each of his fund samples. In each instance, the median discount is greater than the mean discount. Mr. Dankoff opts to use the median, rather than the mean, discount with respect to each sample for purposes of determining a minority interest discount factor for each

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[18](...continued)
table was trading at a premium greater than 11.1 percent.

By contrast, discounts among general equity funds listed in the Lipper table showed less variation, ranging from 2.1 percent to 26.4 percent and averaging 12.8 percent.

[19] Mr. Dankoff inexplicably derives his sample from the "World Income Funds" (global bond funds) listed by Lipper.

[20] Shares of "Thai Capital" (TC), "Malaysia" (MF), and "Thai" (TTF) were trading at premiums of 35.1 percent, 36 percent, and 55.7 percent, respectively. No other world equity fund listed in the Lipper table was trading at a premium greater than 21.9 percent.

By contrast, discounts among world equity funds listed in the Lipper table showed less variation, ranging from 1.6 percent to 31.3 percent and averaging 16.8 percent.

corresponding asset category of the partnership. At trial, he testified that medians "in my opinion are often more relevant [than means] because it takes outliers out of the equation". However, Mr. Dankoff's written report suggests that he may have accounted for outliers (by excluding them from his samples) prior to determining sample medians: "After adjusting for outliers and asset homogeneity with the subject assets, we then calculated a weighted average median discount". In any event, Mr. Dankoff eventually conceded at trial that "I don't think I have a good reason as to why one was better than the other, and I think either one [median or mean] could have been used." Because it seems more straightforward to us to account for obvious outliers by excluding them from the samples in question, we utilize the mean discount from each of our samples as the minority interest discount factor for each corresponding asset category of the partnership.

g. Minority Interest Discount Factor for Each Asset Category

Based on the methodology described above, we conclude that the appropriate minority interest discount factors for the partnership asset categories are as follows:

Asset Type	Discount Factor
Cash & money market funds	2.0%
U.S. Government bond funds	6.9%
State & local bonds (MI)	3.5%
Natl. Muni bond funds	3.4%

Domestic equities	9.6%
Foreign equities	13.8%

3. Determination of the Minority Interest Discount

The minority interest discount factors determined above yield a weighted average discount of 6.02 percent, determined as follows:

Asset Type	Percent of NAV	Percent Disc. Factor	Percent Weighted Average
Cash & money market funds	44.0	2.0	0.88
U.S. Government bond funds	0.4	6.9	0.03
State and local bonds (MI)	2.1	3.5	0.07
Natl. Muni bond funds	5.0	3.4	0.17
Domestic equities	43.6	9.6	4.19
Foreign equities	4.9	13.8	0.68
Discount			6.02

Rounding to the nearest percentage point, we conclude that the appropriate minority interest discount for the transferred interests is 6 percent.

C. Marketability Discount

1. Introduction

The parties agree that, to reflect the lack of a ready market for the transferred interests, an additional discount should be applied to the partnership’s NAV (after applying the minority interest discount) for purposes of determining the fair market value of those interests. Such a discount is commonly referred to as a “marketability discount”. The parties disagree on the appropriate magnitude of that discount in the context of the transferred interests.

2. Analyses of Petitioner's Experts

a. General Approach

Both Mr. Dankoff and Mr. Stryker start with a benchmark discount or range of discounts and then determine, based on the factors we analyzed in Mandelbaum v. Commissioner, T.C. Memo. 1995-255, affd. without published opinion 91 F.3d 124 (3d Cir. 1996), whether the marketability discount for the transferred interests should be greater than, less than, or equal to (or within) the benchmark discount (or range of discounts). Because we are unpersuaded by either expert's determination of the appropriate benchmark (starting point), we give little weight to their respective analyses.

b. Mr. Dankoff's Analysis

In his written report, Mr. Dankoff states that, in Mandelbaum v. Commissioner, supra, the Tax Court "established a benchmark lack of marketability discount range of 35% to 45%". He subsequently states that he analyzed the factors we reviewed in Mandelbaum "as they relate to the subject Partnership in order to determine whether the Partnership's lack of marketability discount should be above, below or within the range indicated by the benchmark range of 35% to 45%." Thus, although Mr. Dankoff refers to numerous empirical studies elsewhere in his report, he derives his quantitative starting point (35 percent to 45 percent) from the Mandelbaum case.

To the extent Mr. Dankoff believes that the benchmark range of discounts we utilized in Mandelbaum v. Commissioner, supra, is controlling in this or any other case, he is mistaken.[21] Nothing in Mandelbaum suggests that we ascertained that range of discounts for any purpose other than the resolution of that case. To the contrary, we specifically stated that we were using the upper and lower limits of that range "as benchmarks of the marketability discount for the shares at hand." (Emphasis added.) If, instead, Mr. Dankoff simply believes that such range of discounts is equally appropriate under the facts of this case, he offers no justification whatsoever for that view. We believe he would be hard pressed to do so; the entity at issue in Mandelbaum, an established operating company, bears little resemblance to the partnership.[22]

[21] Petitioner's counsel indeed asserts in his posttrial brief that Mandelbaum v. Commissioner, T.C. Memo. 1995-255, affd. without published opinion 91 F.3d 124 (3d Cir. 1996), "sets a benchmark for lack of marketability discounts in the range of 35% to 45%", suggesting his belief that the Court in Mandelbaum established a legal standard in that regard to be followed in subsequent cases.

[22] Petitioner indeed states in his posttrial reply brief that "Petitioner did not rely on the factual basis of Mandelbaum or claim that the instant case should be similarly decided based on factual similarities".

c. Mr. Stryker's Analysis

In his written report, Mr. Stryker cites a series of empirical studies known as restricted stock studies,[23] which, according to him, "center around a 30% marketability discount for transfers of restricted stock." After analyzing the factors we reviewed in Mandelbaum v. Commissioner, supra,[24] Mr. Stryker concludes that "a discount of 40% was applicable to the freely traded value of Peracchio's interests. (10 percentage points higher than the private placement studies.)" Thus, Mr. Stryker derives his quantitative starting point (30 percent) from restricted stock studies.

While restricted stock studies certainly have some probative value in the context of marketability discount analysis, see, e.g., McCord v. Commissioner, 120 T.C. at 390-393, Mr. Stryker makes no attempt whatsoever to analyze the data from those studies as they relate to the transferred interests. Rather, he simply lists the average discounts observed in several such studies, effectively asking us to accept on faith the premise

[23] Restricted stock studies (also referred to by Mr. Stryker as private placement studies) compare the private-market price of restricted shares of public companies (i.e., shares that, because their issuance was not registered with the Securities and Exchange Commission (SEC), generally cannot be sold in the public market for a certain period of time without SEC registration) with the coeval public-market price of such companies' unrestricted shares.

[24] Mr. Stryker also considers factors discussed in Rev. Rul. 77-287, 1977-2 C.B. 319, which are generally subsumed within the Mandelbaum factors.

that the approximate average of those results provides a reliable benchmark for the transferred interests. Absent any analytical support, we are unable to accept that premise, particularly in light of the fundamental differences between an investment company holding easily valued assets (such as the partnership) and the operating companies that are the subject of the restricted stock studies.

3. Analysis of Respondent's Expert

Unfortunately, Mr. Burns does not offer a satisfactory alternative to the inadequate analyses of petitioner's experts. Following a brief analysis of six factors "that may influence the size of the marketability discount", he concludes in his written report:

> It is reasonable to assume that a negotiation between buyer and seller would initially focus on a discount for lack of marketability in the range of 5% to 25%. A discount above this range would not be justified for a conservatively-managed partnership holding highly liquid marketable securities and cash investments; while a discount below the range would ignore the costs and effort that might be required to find a willing buyer. I believe that a fair outcome of such a negotiation between buyer and seller would entail an adjustment of approximately 15% to reflect marketability concerns.

In his testimony at trial, Mr. Burns confirmed that the lower limit of his suggested range of discounts (5 percent) represents the typical sales commission charged by brokers of interests in private limited partnerships. However, he also testified that an additional discount (unspecified in degree)

would be warranted to account for the admittedly thin nature of that secondary market. Regarding his suggested upper limit of 25 percent, Mr. Burns essentially testified that such figure derives from his attempt "to extricate somehow * * * from the restricted stock studies" the portion of the observed discount level which, in his opinion, readily translates to the transferred interests. Given the lack of quantitative evidence in support of that attempt, as well as Mr. Burns's tacit acknowledgment that the lower limit of his suggested range of discounts is understated, we are not persuaded by his opinion that the appropriate range of marketability discounts for the transferred interests is 5 to 25 percent. We are even less impressed by his arbitrary selection of the midpoint of that range (15 percent) as his suggested discount.

4. Determination of the Marketability Discount

Having expressed our dissatisfaction with the experts' respective analyses, we must nevertheless determine an appropriate marketability discount for the transferred interests. As noted above, respondent's expert states in his written report that a marketability discount above 25 percent would not be justified for an entity with the characteristics of the partnership. We treat that statement as a concession that a marketability discount of up to 25 percent (rather than the arbitrarily selected 15 percent) would be appropriate for the

transferred interests. Because petitioner has failed to carry his burden of persuading us that a figure in excess of 25 percent would be appropriate, we utilize a 25-percent marketability discount for purposes of determining the fair market value of the transferred interests.

D. Valuation Conclusion

We conclude that the fair market values of the gifted interest and the sold interest on the valuation date were $644,446 and $757,972, respectively, determined as follows:[25]

Total NAV	$2,010,370
1 percent of NAV	20,104
Less: 6-percent minority interest discount	(1,206)
Marketable value	18,898
Less: 25-percent marketability discount	(4,725)
FMV of 1-percent interest	14,173
FMV of 45.47-percent interest	644,446
FMV of 53.48-percent interest	757,972

To reflect the foregoing,

Decision will be entered under Rule 155.

[25] For ease of computation, we determine the fair market value of a 1-percent interest.

Full Text of Court Cases

Piscopo v. Piscopo

Case name: Piscopo v. Piscopo
Citation: 232 N.J. Super. 559, 557 A.2d 1040, 1989 N.J. Super. LEXIS 169
Date of decision: May 1, 1989
Country: US
State or Federal: State
State/Jurisdiction: New Jersey
Court: Court of Appeals
Type of action: Marital Dissolution
Judge: Ashbey
Experts: Irwin Marks, C.P.A.
SIC: 7389 Business Services, NEC (tobacco sheeting service)
NAICS: 561499 All Other Business Support Services

Keywords: Marital dissolution

COUNSEL:

Francis W. Donahue argued the cause for appellant, cross-respondent (Skoloff & Wolfe, attorneys, Francis W. Donahue, of counsel, Francis W. Donahue and Phyllis S. Klein, on the brief).

Charles C. Abut argued the cause for respondent, cross-appellant (Lowen & Abut, attorneys, Louis J. Lamatina, on the brief).

JUDGES:

King, Brody and Ashbey. The opinion of the court was delivered by Ashbey, J.A.D.

OPINIONBY:

ASHBEY

OPINION:

This is an appeal from the provisions of a judgment of divorce between plaintiff entertainer and comedian Joseph and defendant Nancy Piscopo. The novel issue raised by the trial judge's holding is that the marital property included plaintiff's "celebrity goodwill." See Piscopo v. Piscopo, 231 N.J. Super. 576, 580-581 (Ch.Div.1988).

At trial plaintiff claimed that the goodwill attributed to his celebrity status was not an asset subject to equitable distribution. On appeal he concedes that celebrity goodwill could be a distributable marital asset. His argument is personal, that his reputation as a celebrity could not be related to probable future

earnings, but only to possible future earnings. Defendant asserts that the goodwill associated with plaintiff's status as a celebrity is an intangible but quantifiable asset recognizable by analogy to well-accepted New Jersey caselaw, and therefore an equitably distributable marital asset.

Irwin Marks, C.P.A., was appointed by the trial judge to value plaintiff's business and pension interests and to calculate the value, if any, of celebrity goodwill and the actual disposable income of plaintiff. Marks had experience as an accountant for famous entertainment personalities. He rendered two reports and testified at trial.

Marks found that substantially all of plaintiff's earned income flowed through Piscopo Productions, Inc., with plaintiff's compensation from the corporation determined at the end of each year. n1 Marks said the valuation of plaintiff's business was analogous to valuing any other professional corporation. He used three out of five years of income from which to derive an average adjusted net income of $ 288,150 and average adjusted gross receipts of $ 635,452.

n1 Piscopo Productions, Inc., as the trial judge noted, was actually owned: plaintiff: 51%; defendant: 48%; plaintiff's father: 1%. Two other business entities, "Joe Piscopo West" and "Little Joey Music," were not treated separately by the accountant, based upon the manner in which plaintiff had designated them for accounting and tax purposes.

Marks had never valued the business of a show business personality. He had familiarized himself with publications and with custom of the trade, which was to take a percentage of the celebrity's average gross earnings and to apply an appropriate discount. He calculated plaintiff's celebrity goodwill by taking 25% of his average gross earnings over the three year period. He applied no further discount. He said that by using the figure of 25%, he had already discounted the applicable percentage based upon his experience and training. n2 Marks attributed to plaintiff's celebrity goodwill a value of $ 158,863.

n2 Plaintiff's supplemental answers to interrogatories listed the fair market value of Piscopo Productions at a value which his accountant read to be at least $ 205,000. Plaintiff's case information statement listed the value of Piscopo Productions at $ 115,000. His accountant was unable to explain these values, although neither was intended to include goodwill.

Under N.J.S.A. 2A:34-23, the court may "effectuate an equitable distribution of the property, both real and personal, which was legally and beneficially acquired by them or either of them during the marriage." n3 While no New Jersey case has held that celebrity goodwill is a form of "property" to be distributed within the meaning of the statute, goodwill is a legally protected interest. J. B. Liebman & Co., Inc. v. Leibman, 135 N.J.Eq. 288, 292 (Ch.1944); In re Hall, 99 N.J.L. 1, 2 (Sup.Ct.1923), aff'd 100 N.J.L. 405 (E. & A. 1924).

n3 This statute has been recently amended. See L. 1988, c. 153, § 4.

In the context of equitable distribution, the leading case holding that goodwill is a distributable asset is Dugan v. Dugan, 92 N.J. 423 (1983). In Dugan the Supreme Court held that the goodwill attributed to the solely owned professional corporation of a lawyer was subject to equitable distribution,despite the fact that ethical considerations prevented plaintiff from selling his practice. The Court said that business goodwill existed although the business depended entirely upon the skill of one person and had no book value. Id. at 429. The Court defined goodwill as "essentially reputation that will probably generate future business." Ibid. The Court said further:

. . . [goodwill] does not exist at the time professional qualifications and a license to practice are obtained. A good reputation is earned after accomplishment and performance. Field testing is an essential ingredient before goodwill comes into being. Future earning capacity per se is not goodwill. However, when that future earning capacity has been enhanced because reputation leads to probable future patronage from existing and potential clients, goodwill may exist and have value. When that occurs the resulting goodwill is property subject to equitable distribution. [Id. at 433].

The trial judge in this case analogized the celebrity goodwill of plaintiff to the professional goodwill of Dugan. Piscopo v. Piscopo, 231 N.J. Super. at 580 (slip opinion at 5). Plaintiff distinguishes Dugan on the ground that a successful professional has a reliable future income, whereas show business is volatile. The Dugan Court said, however, that the valuation of goodwill is not measured by future earnings, but by past earning capacity and the probability that such past earnings will continue. Dugan v. Dugan, 92 N.J. at 433.

Contrary to plaintiff's contention, "the possible" earnings which the Dugan Court distinguished from "probable" earnings referred to earnings from a new license or degree untested in the marketplace. Plaintiff's record of past earning was undisputed. It was also undisputed that whatever plaintiff had achieved as a celebrity had taken place during the marriage. While the trial judge recognized that it would be difficult to value plaintiff's celebrity goodwill, that difficulty would not affect its includability in the marital estate. n4 Id. at 435.

n4 The issue of valuation is moot. While the trial judge's published opinion deferred valuation, at oral argument we were advised that the parties stipulated $ 98,708.60 as the value of plaintiff's celebrity goodwill.

The trial judge said:

. . . The Court cannot countenance the anomaly that would result if one branch of Chancery vigorously protected plaintiff's person and business from another's "unjust enrichment by the theft of [his] goodwill," Ali v. Playgirl, Inc., 447 F.Supp. 723, 729 (S.D.N.Y.1978), while another branch deprived a spouse from sharing in that very same protectible interest. [Piscopov. Piscopo, 231 N.J. Super. at 579 (slip opinion at 4)].

The trial judge also cited authority in which a person's name and likeness had been recognized as a property right and given legal protection. Estate of Presley v. Russen, 513 F.Supp. 1339, 1359 (D.N.J.1981); Canessa v. J.I. Kislak, Inc., 97 N.J. Super. 327, 339 (Law Div.1967). Piscopo v. Piscopo, 231 N.J. Super. at 579 (slip opinion at 4).

In her opinion, the trial judge also cited a New York case, Golub v. Golub, 139 Misc.2d 440, 527 N.Y.S.2d 946 (Sup.Ct.1988), where the court ruled on a similar question. The financial issues there stemmed from the divorce of actress and model Marisa Berenson. The New York court recognized her earning potential as an asset and held that her spouse was entitled to a share of its value. Unlike plaintiff, Berenson had established a successful modeling and acting career before the marriage, but during the course of the marriage her earnings appreciated, due, in part, as the court found, to the husband's efforts. (The husband was an attorney.) The court held that this increase in value was marital property subject to equitable distribution (the court did not use the term "goodwill"). The New York court said:

. . . There seems to be no rational basis upon which to distinguish between a degree, a license, or any other special skill that generates substantial income. In determining the value of marital property, all such income generating assets should be considered if they accumulated while the marriage endured. If one spouse has sacrificed and assisted the other in an effort to increase that other spouse's earning capacity, it should make no difference what shape or form that asset takes so long as it in fact results in an increase earning capacity. . . .

The noncelebrity spouse should be entitled to a share of the celebrity spouse's fame, limited, of course, by the degree to which that fame is attributable to the noncelebrity spouse. The source of the fame must still be traced to the marital efforts. [139 Misc.2d at 446-447, 527 N.Y.S.2d at 950 (citation omitted)]. n5

n5 Our review of the Golub record indicates that the court awarded no equitable distribution for any portion of the celebrity goodwill. That portion of the opinion was omitted from publication. A somewhat similar result was reached in Getz v. Getz, N.Y.L.J., Mar. 2, 1989, at 28-29 (N.Y.Sup.Ct.1989).

The court-appointed accountant in the case before us calculated the value of plaintiff'scorporation by including plaintiff's goodwill and the trial judge also so allocated the goodwill in her oral opinion. In her published opinion, however, and in the final judgment of divorce, the trial judge separately listed the asset.

Plaintiff contends, and we agree, that NewYork law differs materially from ours and from that of other states because in New York the value of a license alone is considered marital property. n6 Plaintiff's reliance on Lynn v. Lynn, 91 N.J. 510 (1982), and on Mahoney v. Mahoney, 91 N.J. 488 (1982), however, is misplaced. We accept the accountant's analysis which conforms to ours and to that of the majority of states concerning the value in a marital estate of a business which is based upon personal competence. n7 Plaintiff had such a business, the earnings of which were undisputed, and which he conceded had value.

n6 See O'Brien v. O'Brien, 66 N.Y.2d 576, 489 N.E.2d 712, 498 N.Y.S.2d 743 (Ct.App.1985); McGowan v. McGowan, 142 A.D.2d 355, 535 N.Y.S.2d 990 (App.Div.1988); cf. Annotation, "Spouse's professional degree or license as marital property for purposes of alimony, support, or property settlement," 4 A.L.R.4th 1294, 1295-1301 (1981 & Supp.1988) (collected cases); Rubin v. Rubin, 230 Neb. 919, 434 N.W.2d 329 (Sup.Ct.1989) (medical degree is not distributable asset); Hoak v. Hoak, 370 S.E.2d 473 (W.Va.Sup.Ct.1988) (professional degree earned during marriage is not marital property subject to equitable distribution).

n7 See Annotation, "Accountability of good will of professional practice in actions arising from divorce or separation," 52 A.L.R.3d 1344, 1344-1346 (1973 & Supp.1988) (collected cases); 24 Am.Jur.2d, Divorce and Separation, § 899 at 881-882; Molloy v. Molloy, 158 Ariz. 64, 761 P.2d 138 (Ct.App.1988) (husband's interest in law firm's goodwill is distributable asset); Buckl v. Buckl, 373 Pa.Super. 521, 542 A.2d 65 (Super.Ct.1988) (value of husband's portion of goodwill in architectural firm is subject to equitable distribution); Peerenboom v. Peerenboom, 147 Wis.2d 547, 433 N.W.2d 282 (Ct.App.1988) (goodwill of dental practice is distributable asset to the extent it is marketable and exceeds value of practice's assets and husband's skills and services); but see Antolik v. Harvey, Haw.App. , 761 P.2d 305 (Ct.App.1988) (true goodwill, that which is not dependent upon voluntary continued presence of professional, is distributable asset).

We agree with the Family Part that the goodwill value of plaintiff's business was a distributable marital asset and affirm that part of the judgment.

[Here the court disposed of other issues on appeal.]

75 Md. App. 113 (1988)
540 A.2d 833

LEO PRAHINSKI
v.
MARGARET E. PRAHINSKI.

No. 1187, September Term, 1987.

Court of Special Appeals of Maryland.

May 6, 1988.
Certiorari Granted September 2, 1988.

Cheryl Lynn Hepfer (Meehan, Kovach and Hepfer, P.A., on the brief), Upper Marlboro, for appellant.

Marvin E. Perlis, Silver Spring, for appellee.

Argued before MOYLAN, BLOOM and POLLITT, JJ.

BLOOM, Judge.

Leo Prahinski appeals from a judgment of the Circuit Court for Prince George's County severing the bonds of matrimony between him and appellee, Margaret Prahinski. Although the divorce aspect of the case was uncontested, appellant is aggrieved by those portions of the judgment that distributed certain marital property between the parties and granted a substantial monetary award in addition to indefinite alimony. Specifically, appellant contends:

1. The trial court erred in its valuation of the appellant's business.
2. The trial court erred in awarding indefinite alimony to appellee and in making that award the trial court failed to consider the required statutory factors.
3. The trial court erred in requiring that alimony payments begin after the payment of a monetary award representing the business value; and
4. The trial court erred in the distribution of marital assets and likewise failed to consider the required statutory factors.

In her brief, appellee presents us with a fifth issue. But since she failed to file a cross-appeal pursuant to Md. Rule 1012g, she may not raise this issue on appeal. *See, Joseph H. Munson Co. v. Sec. of State,* 294 Md. 160, 168, 448 A.2d 935 (1982), *aff'd,* 467 U.S. 947, 104 S.Ct. 2839, 81 L.Ed.2d 786 (1984). Consequently, we will address only those issues that were presented by appellant.

Background

The parties met as college students at the University of Maryland. They were married in 1965, at which time appellee, who had completed her freshman year, decided to discontinue her education in order to maintain the family home and, eventually, to raise the parties' two children.[1] Appellant completed his undergraduate studies and continued his education in law school. In 1971, appellant started his own law practice. Appellee worked with appellant in that practice; she was, as appellant acknowledged, legal secretary, office manager, and a "Gal Friday, doing anything and everything necessary. She was very helpful." Initially, appellant's practice was varied in that he handled negligence cases, estate and will work, some collection work, and domestic relations cases. As appellant testified, he "was dying for [the] Lawyer Referral Service to call with cases."

In 1974, appellant handled his first real estate settlement; by 1977 or 1978 real estate settlement work became a major portion of his practice. As that aspect of the practice grew, appellee's involvement in the practice also grew. Appellant testified that at the time of the trial his practice was probably 95 to 97% settlement work with the remaining percentage being wills work and the giving of legal advice to clients on a variety of matters.

In 1983, appellant became involved with another woman. The parties separated in March 1984. Appellee continued to work for appellant at his law office until October 1986, at which time appellant insisted that she leave the office because of the pending divorce litigation. During the separation, appellee remained in the family home while appellant resided in a house in Montgomery County.

Appellee filed for divorce on November 14, 1986. Hearings were held on July 1, 2, and 6, 1987. At the conclusion of the July 6 hearing, the court granted the parties an absolute divorce, holding the property disposition, monetary award, and alimony issues under advisement. By written order dated July 7, 1987, and filed July 10, 1987, the court incorporated its oral order of absolute divorce, provided for the distribution of marital assets, and granted a monetary award and indefinite alimony. It is from that order that this appeal was taken.

Business Evaluation

A major issue in this case is the evaluation of the husband's business. The court found it to be worth $300,000, which consisted entirely of goodwill since the tangible physical assets were worth less than the liens thereon and the business bank accounts were separately valued. The court granted appellee a monetary award of $150,000, specifically designated as one-half of the value of the business, payable, with interest, at the rate of $3,000 per month. Appellant's first, and principal, argument on appeal is that the evaluation and, therefore, the monetary award based thereon are erroneous.

The threshold consideration of the business evaluation issue is what is the nature of appellant's business. Appellant contends that his business is a law practice that specializes in real estate settlements; appellee contends that it is a title business. The trial court, agreeing with appellee, found appellant's business to be a title business and not a law

[1] At the time of the divorce, the children were emancipated and thus no child custody issues were presented.

practice, and valued it as such. We believe that finding to be clearly erroneous. Md. Rule 1086. On the basis of the evidence presented, appellant's business is unquestionably a law practice and not a title company.

A law practice specializing in real estate transactions and a title business are essentially similar in the functions they perform and the services they provide. Both examine land records and approve titles to real estate; both prepare deeds, mortgages and other documents deemed necessary or appropriate to effectuate transfers of title to realty and the securing of liens thereon; both conduct settlements and collect and disburse funds in connection with sales and mortgages of real estate; both either issue to, or obtain for, the purchaser or mortgagee title insurance. An attorney may conduct such business in his own name, as an attorney, or he may opt to do so as, and under the name of, a title company. A title company need not be owned by an attorney, but a title company may need to have an attorney on its staff or be associated with one, since, in certain Maryland counties, a deed, mortgage, or deed of trust cannot be recorded "unless it bears a certification that the instrument has been prepared by an attorney admitted to practice before the Court of Appeals, under his supervision, or by or on behalf of one of the parties named in the instrument." *See,* Md. Real Prop.Code Ann. § 3-104(f) (1988 Repl.Vol.). Whether operated as a law practice or title company, it would appear that the real estate settlement business can produce substantial income.[2]

Despite the similarities, the practice of law, even one dedicated almost exclusively to real estate transactions, is not merely the operation of a title company, and a title company is not a law practice. The difference is not so much in the nature of the "finished product" — an insured title or mortgage — delivered to the client, but in the nature of the responsibility assumed by the provider, particularly in the eyes of the client. The client of the title company may expect no more than the finished product; the client of the attorney has every reason to expect and rely upon the attorney's professional expertise, advice and counsel in addition to the product he could obtain from a title company. The difference may be largely in the perception of the client, but it is that perception, and the professional reputation attached thereto, that would cause the client to choose an attorney rather than a title company to provide the service.

In the case *sub judice,* when appellant began his law practice in 1971, he held himself out to the public, as he continues to do, as "Leo F.X. Prahinski, Attorney at Law." According to his testimony, as his skills in conducting settlements grew realtors began to return to him for settlements. When asked why realtors returned, appellant testified that "they can count on me to help if a problem comes up in getting a case settled, and they bring [cases] to my office because they know [the transactions] will settle." Appellant further testified that he often gave legal advice at settlements and explained each party's obligation under the contracts and the law. Finally, appellant testified that he frequently gave legal advice to people, drafted wills, answered legal questions, occasionally handled a negligence case, and handled legal matters relating to real estate other than settlements. None of this evidence was contradicted; to a large extent it was corroborated.

[2] In 1986, when refinancing of home mortgages became attractive as the result of falling interest rates, appellant earned over $200,000 in settlement work.

Appellee relies heavily on the fact that much of the work done at the business was done by appellant's staff[3] rather than by appellant. That is not unusual in law practices, in many of which non-lawyers—student law clerks, paralegals, and secretaries—do much of the research and clerical work, which the attorney reviews and then adds his professional imprimatur to create a legal end product. According to the evidence, that is precisely what occurred in appellant's office. Appellant's staff did clerical work and initial research. Appellant, applying his professional judgment, would then review their work, conduct the settlement, and certify the settlement forms, pursuant to Md. Real Prop.Code Ann., § 3-104(f), thereby taking full professional responsibility for the work done by his staff as well as by himself.

The only evidence to the effect that appellant's business was a title business rather than a law practice came from appellee's expert witness. That witness, a certified public accountant, was accepted by the court as an expert in the field of accounting and appraising service businesses. The witness's expertise did not, however, include the classification of businesses. And since a title business and a law practice are both service businesses, with considerable similarity between them, the expert's testimony that appellant's business was a title and escrow business should be scrutinized carefully. In one sense, the witness was correct; the bulk of appellant's business or practice resembled that of a title business with an in-house counsel. But the witness's opinion that he was valuing a title company ignores the fact that appellant rendered legal advice on matters other than real estate settlements and held himself out to the public as an attorney, not as a title company. To a large extent, the witness's opinion that appellant's business was not the practice of law was based upon his own admittedly limited experience in attending real estate settlements, at which, he claimed, he never heard legal advice asked for or given. All of the other evidence being entirely to the contrary, the testimony of appellee's expert witness that appellant's practice was a title company business cannot make it so. As we recently noted in *Ziegler v. Kawasaki Heavy Industries, Ltd.,* 74 Md. App. 613, 539 A.2d 701 (1988), quoting *Bernstein v. Reforzo,* 37 Md. App. 724, 732, 379 A.2d 181 (1977), *cert. granted,* 282 Md. 738 (1978), *appeal dismissed,* May 18, 1978, an expert opinion has "no greater value than the facts on which it is based." Slip op. at 18. In this case it has no value at all, since the facts upon which the opinion was based simply do not support the opinion, and the witness lacked the expertise adequately to evaluate those facts. The court should not have accepted the witness's opinion as to the nature of appellant's practice; in so doing it made a factual finding that was clearly erroneous. Md. Rule 1086.

Having held that the expert witness wrongly characterized appellant's practice as a title company, we turn now to the valuation of that practice.

A law practice, like a title company, is a service business; and whatever classification he assigned to it, appellee's expert was valuing a service business, a subject on which he did qualify as an expert.

[3] The fact that appellant had non-lawyers working for him did not transform his business from that of a law practice to a title business. Rule 5.3 of the Maryland Rules of Professional Conduct, permits non-lawyer assistants so long as the lawyer maintains proper supervision over the non-lawyer assistants. *See* 306 Md. LXXVII for the text of Rule 5.3. In the case *sub judice* there is no indication that appellant did not practice in accordance with Rule 5.3.

Appellant testified that the law practice had tangible assets of $11,000, but was burdened by $13,000 in liabilities. This evidence was not controverted, and appellee's expert conceded that the law practice had no "tangible assets entering into [the] net worth" of appellant's practice. Nevertheless, the expert placed a value of $450,000 on the business, which the court, for some unexplained reason, reduced to $300,000, on the basis of which it granted appellee a monetary award of $150,000.

There being no tangible assets, the expert's evaluation and the court's finding of value were based entirely on an intangible asset, "goodwill." Appellant contends that goodwill is not marital property. In the alternative, he contends that if goodwill is marital property, then it was improperly valued in the instant case. Before considering appellant's contentions, we shall examine the nature of goodwill.

Goodwill is an intangible property asset commonly defined as:

> [T]he advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement, which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.

J. Story, *Commentaries on the Law of Partnership as a Branch of Commercial and Maritime Jurisprudence,* § 99, at 139 (Boston 1841). The Court of Appeals recognized this definition in *Brown v. Benzinger,* 118 Md. 29, 35, 84 A. 79 (1912). In *Hagan v. Dundore,* 187 Md. 430, 442, 50 A.2d 570 (1947), the Court of Appeals noted that "goodwill" had been variously defined, from Lord Eldon's terse definition of "the probability that the old customers will resort to the old place," Cruttwell v. Lye, 17 Ves.Jr. 335, 346, 34 Eng.Rep. 129, 134 (ch. 1810), to "the goodwill of a business comprises those advantages which may inure to the purchaser from holding himself out to the public as succeeding to an enterprise which has been identified in the past with the name and repute of his predecessor." *Knoedler v. Boussod,* 47 F. 465, 466 (S.D.N.Y. 1891), *aff'd.,* 55 F. 895 (2nd Cir.1893).

The preceding characterizations of goodwill raise the question of when is goodwill, specifically professional goodwill, an asset with value and therefore property to be included in an equitable distribution pursuant to Md. Fam.Law Code Ann. § 8-201 *et seq. See also, Archer v. Archer,* 303 Md. 347, 493 A.2d 1074 (1985) (only items imbued with the traditional indicia of "property," *i.e.,* transferable, assignable, devisable, subject to conveyance, sale, pledge or inheritance, are proper subjects of equitable distribution). The key issue as to the professional goodwill of a sole proprietorship, as in the case *sub judice,* has to do with the value, if any, which can be attributed to it, causing it to be subject to equitable distribution.

Whether professional goodwill can be marital property susceptible to valuation and distribution as such has been the subject of many articles. *See, e.g.,* Parkman, *The Treatment of Professional Goodwill in Divorce Proceedings,* 18 Fam.L.Q. 213 (1984); Family Law Comment, *The Recognition and Valuation of Professional Goodwill in the Marital Estate,* 66 Marg.L.Rev. 697 (1983); Note, *Treating Professional Goodwill As Marital*

Property in Equitable Distribution States, 58 *N.Y.U.L.Rev.* 554 (1983); Foster, *Equitable Distribution of Professional Degrees, Licenses and Goodwill,* 1 Fairshare 9 (Jan. 1983); Raggio, *Professional Goodwill and Professional Licenses as Property Subject to Distribution Upon Dissolution of Marriage,* 16 *Fam.L.Q.* 147 (1982); Kennedy & Thomas, *Putting A Value on: Education and Goodwill,* 2 *Fam.Advoc.* 3 (1979); Lurvey, *Professional Goodwill on Marital Dissolution: Is It Property or Another Name for Alimony?,* 52 *Cal.St.B.J.* 27 (1977). *See also, Accountability for Goodwill of Professional Practice in Actions Arising from Divorce or Separation,* 52 A.L.R.3d 1344 (1973). The courts have been as active as the commentators in addressing the question of professional goodwill in an equitable distribution. *See, e.g., Wilson v. Wilson,* 294 Ark. 194, 741 S.W.2d 640 (1987); *Wisner v. Wisner,* 129 Ariz. 333, 631 P.2d 115 (Ct.App. 1981), *harmonized, Mitchell v. Mitchell,* 152 Ariz. 317, 732 P.2d 208 (1987) (*en banc*); *In re Marriage of Foster,* 42 Cal. App.3d 577, 117 Cal. Rptr. 49 (1974); *In re Marriage of Nichols,* 43 Colo. App. 383, 606 P.2d 1314 (1979); *In re Marriage of White,* 98 Ill. App.3d 380, 53 Ill.Dec. 786, 424 N.E.2d 421 (1981), *appeal after remand,* 151 Ill. App.3d 778, 104 Ill.Dec. 424, 502 N.E.2d 1084 (1986); *Powell v. Powell,* 231 Kan. 456, 648 P.2d 218 (1982); *Heller v. Heller,* 672 S.W.2d 945 (Ky. Ct. App. 1984); *In re Marriage of Hull,* 712 P.2d 1317 (Mont. 1986); *Taylor v. Taylor,* 222 Neb. 721, 386 N.W.2d 851 (1986); *Hurley v. Hurley,* 94 N.M. 641, 615 P.2d 256 (1980), *limited overruling on other grounds, Ellsworth v. Ellsworth,* 97 N.M. 133, 637 P.2d 564 (1981); *Weaver v. Weaver,* 72 N.C. App. 409, 324 S.E.2d 915 (1985); *Goger v. Goger,* 27 Or. App. 729, 557 P.2d 46 (1976); *Nail v. Nail,* 486 S.W.2d 761 (Tex. 1972); *In re Marriage of Fleege,* 91 Wash.2d 324, 588 P.2d 1136 (1979) (*en banc*); *Holbrook v. Holbrook,* 103 Wis.2d 327, 309 N.W.2d 343 (1981). The specific issue of the professional goodwill of an attorney's practice in a divorce situation has also been addressed by some courts. *See, e.g., In re Marriage of Fenton,* 134 Cal. App.3d 451, 184 Cal. Rptr. 597 (1982); *Dugan v. Dugan,* 92 N.J. 423, 457 A.2d 1 (1983) (goodwill of a law practice is subject to distribution); *Beasley v. Beasley,* 359 Pa.Super. 20, 518 A.2d 545 (1986), *allocatur denied,* 516 Pa. 631, 533 A.2d 90 (1987) (professional goodwill of a law practice operated as a sole proprietorship is not marital property). Since Maryland has not heretofore addressed the question of professional goodwill relative to an equitable distribution, we deem it appropriate to examine the cases from our sister states and analyze how they have handled this question. Before we do so, however, we should consider whether the fact that appellant's business is a law practice affects the determination of its goodwill value for purposes of equitable distribution.

In *Archer v. Archer, supra,* the Court of Appeals held that a medical degree or license was not marital property, but merely reflected the possibility of future earnings. 303 Md. at 357, 493 A.2d 1074. The *Archer* rationale, of course, is equally applicable to a law degree and a license to practice law. Insofar as such degrees and licenses reflect future earnings, they should be treated as considerations affecting alimony and not as marital property. *See, Archer v. Archer,* 303 Md. at 359, 493 A.2d 1074. Nevertheless, when the opportunity provided by the license or degree is exercised, goodwill *may* come into existence, and if it does, it should be differentiated from earning capacity. True goodwill reflects not simply a *possibility* of future earnings, but a *probability* based on existing circumstances. That is what distinguishes it from the professional license or degree, to which is attached a mere prospect of enhanced future earnings that are too remote and speculative for the degree or license itself to be deemed property. *Archer,* 303 Md. at 357,

493 A.2d 1074. Unlike the license and the degree, goodwill is a marketable and transferable asset. *See Dugan v. Dugan, supra,* 457 A.2d at 6.

There may be some degree of likelihood that goodwill exists as a valuable asset of a law firm; it is doubtful that the practice of a sole practitioner enjoys any marketable goodwill. A principal attribute of goodwill of any business, trade, or profession is its firm or trade name. There are law firms bearing the names of long deceased partners.[4] Presumably, the right to use the firm name, which is a major part of the goodwill of the firm, is a valuable asset. But the sole practitioner, practicing under his own name, as is the case with appellant here, does not have a trade name that is transferable. No one but appellant can practice law under the name "Leo F.X. Prahinski, Attorney-at-law." His trade name is not a saleable, transferable commodity.

After a divorce, a lawyer's law practice will continue to benefit from whatever goodwill it may have had during the marriage. If, in fact, goodwill exists, it would be inequitable to ignore the contribution of the attorney's spouse to the development of that goodwill during the marriage. If it does exist, therefore, goodwill is an asset to be valued and considered in equitable distribution. Obviously, equitable distribution does not require that all property be part of some monetary award, but the attorney's spouse is entitled to have *true* goodwill, as distinguished from future earnings, considered as any other property acquired during the marriage. Accordingly, a number of jurisdictions have held that professional goodwill is property subject to distribution. *See, e.g., In re Marriage of Lopez,* 38 Cal. App.3d 93, 113 Cal. Rptr. 58 (1974); *Dugan v. Dugan,* 92 N.J. 423, 457 A.2d 1 (1983); *In re Marriage of Kaplan,* 23 Wash. App. 503, 597 P.2d 439 (1979).

There is considerable doubt, based on ethical considerations, that the goodwill of a law practice can be sold or transferred. *See,* Maryland State Bar Assoc., Inc. Committee on Ethics, Opinion 81-55 (1981) (citing *Validity of Contract for Sale of "Goodwill" of Law Practice,* 79 A.L.R.3d 1243 (1977)). Even so, such goodwill may be proven to exist and to be a real element of economic worth. Its valuation would present difficulty, but the fact that ethically it could not be sold should not necessarily eliminate goodwill as an element of value to be considered by the court in making an equitable distribution. *See, Stein v. Stein,* 66 N.J. 340, 331 A.2d 257 (1975); *Levy v. Levy,* 164 N.J. Super. 542, 397 A.2d 374 (1978). That even true goodwill cannot *ethically* be sold may adversely affect but not necessarily eliminate its value as property, capable of being transferred, devised, or inherited. Therefore, if there is true goodwill in an attorney's practice, separable from his individual future earning capacity, then a value can be placed on it. Whether, in this case, appellant's law practice has true goodwill is the question which we now address.

[4] The Comment to Rule 7.5 of the Maryland Rules of Professional Conduct states that: "A firm may be designated by the names of all or some of its members, *by the names of deceased* or retired members where there has been a continuing succession in the firm's identity or by a trade name such as the `ABC Legal Clinic.'" 13 Md. Reg. 11 (May 23, 1986) (part II) at 45 (emphasis added). *Cf.* 13 Md. Reg. 11 (May 23, 1986) (part II) at 3 (comment by Judge Cole where he stated that he did not concur in the adoption of the emphasized portion of the Comment to Rule 7.5 because of his belief that it is "false and misleading for a firm to state as a part of the firm name the name of a lawyer who has been deceased for a period in excess of five years.")

Essentially, three positions have been taken relative to professional goodwill as marital property. Currently, the majority view is that professional goodwill is a business asset with a determinable value and is thus marital property. *See, e.g., Wisner v. Wisner,* 129 Ariz. 333, 631 P.2d 115 (Ct.App. 1981), *harmonized, Mitchell v. Mitchell,* 152 Ariz. 317, 732 P.2d 208 (1987) (*en banc*); *In re Marriage of Foster,*42 Cal. App.3d 577, 117 Cal. Rptr. 49 (1974); *In re Marriage of Nichols,* 43 Colo. App. 383, 606 P.2d 1314 (1979); *In re Marriage of White,* 98 Ill. App.3d 380, 53 Ill.Dec. 786, 424 N.E.2d 421 (1981), *appeal after remand,* 151 Ill. App.3d 778, 104 Ill.Dec. 424, 502 N.E.2d 1084 (1986); *Heller v. Heller,* 672 S.W.2d 945 (Ky. Ct. App. 1984); *In re Marriage of Hull,* 712 P.2d 1317 (Mont. 1986); *Dugan v. Dugan,*92 N.J. 423, 457 A.2d 1 (1983); *Hurley v. Hurley,* 94 N.M. 641, 615 P.2d 256 (1980), *limited overruling on other grounds, Ellsworth v. Ellsworth,* 97 N.M. 133, 637 P.2d 564 (1981); *Weaver v. Weaver,* 72 N.C. App. 409, 324 S.E.2d 915 (1985); *Goger v. Goger,* 27 Or. App. 729, 557 P.2d 46 (1976); *In re Marriage of Fleege,* 91 Wash.2d 324, 588 P.2d 1136 (1979). The Courts that have found such goodwill to be marital property have generally adopted a method of evaluation involving the capitalization of excess earnings. For example, in ***Dugan v. Dugan, supra,*** the New Jersey Supreme Court suggested a capitalization of excess earnings method as follows:

> 1. Ascertain what a professional of comparable experience, expertise, education and age would be earning as an employee in the same general locale;
> 2. Determine and average the professional's net income before federal and state income taxes for a period of years, preferably five;
> 3. Compare the actual average with the employee norm; and
> 4. Multiply the excess by a capitalization factor.

92 N.J. at 439-40, 457 A.2d at 9-10. *See also,* Internal Revenue Service, Rev.Rule. 68-609, 1968 — 2 C.B. 327. The Internal Revenue Service Rule was the method utilized by appellee's expert witness in the case *sub judice.* He testified that it is the method permitted by the Internal Revenue Service to determine fair market value of intangible assets based upon excess earnings. When only a capitalization of excess earnings method of evaluation is applied to a professional practice, the value determined, characterized as "professional goodwill," represents nothing more than an entity's future earning capacity; it is not necessarily an asset that may be sold, transferred, or assigned. *See Taylor v. Taylor, supra,* 386 N.W.2d at 857-58. The capitalization of excess earnings approach, therefore, according to Professor Parkman, does nothing more than place "a value on an individual's reputation, which is something possessed by everyone." Parkman, *supra,* 18 *Fam.L.Q.* at 219. Since professional reputation is a factor that affects one's ability to obtain future earnings, it is clearly a relevant factor for alimony. Whether it should be a factor in an equitable distribution is not so clear. To the extent that professional reputation may be deemed to be "uniquely personal to the holder," it would not be marital property. *See Unkle v. Unkle,* 305 Md. 587, 596, 505 A.2d 849 (1986).

Some courts, taking a second approach, have held that professional goodwill is not property and thus cannot be marital property. *See e.g., Powell v. Powell,* 231 Kan. 456, 648 P.2d 218 (1982); *Beasley v. Beasley,* 359 Pa.Super. 20, 518 A.2d 545, *allocatur denied,* 516 Pa. 631, 533 A.2d 90 (1987); *Nail v. Nail,* 486 S.W.2d 761 (Tex. 1972); *Holbrook v. Holbrook,* 103 Wis.2d 327, 309 N.W.2d 343 (1981). Illustrative of the reasoning for this is the Wisconsin Supreme Court's statement that:

> [t]he concept of professional goodwill evanesces when one attempts to distinguish it from future earning capacity. Although a professional business's good reputation, which is essentially what its goodwill consists of, is certainly a thing of value, we do not believe that it bestows on those who have an ownership interest in the business an actual separate property interest. The reputation of a law firm or some other professional business is valuable to its individual owners to the extent that it assures continued substantial earnings in the future. It cannot be separately sold or pledged by the individual owners. The goodwill or reputation of such a business accrues to the benefit of the owners only through increased salary.

103 Wis.2d at 350, 309 N.W.2d at 354. This approach ignores that probability that "goodwill" as a business asset can be separate and distinct from reputation and thus valuable as an intangible property, whereas the first approach blurred the distinction between goodwill and the mere prospect for future earnings.

At least two courts have taken a third approach, somewhat between the two stated above. *See, e.g., Wilson v. Wilson,* 294 Ark. 194, 741 S.W.2d 640 (1987); *Taylor v. Taylor,* 222 Neb. 721, 386 N.W.2d 851 (1986). They have held:

> (1) Where goodwill is a marketable business asset distinct from the personal reputation of a particular individual, as is usually the case with many commercial enterprises, that goodwill has an immediately discernible value as an asset of the business and may be identified as an amount reflected in a sale or transfer of a business.
> (2) If the goodwill depends on the continued presence of a particular individual, such good will, by definition, is not a marketable asset distinct from the individual.

Wilson, 741 S.W.2d at 647; *Taylor,* 222 Neb. at 731, 386 N.W.2d at 858.

We believe this third approach to be a sound one, as it recognizes the difference between true goodwill and an individual's reputation, which may be characterized as the ability to obtain future earnings masquerading as goodwill. This approach also has an advantage of being more flexible than either of the other two. Of the three it is the one most consistent with the holdings that in any calling the existence of goodwill and its value, if any, are questions of fact. *See, Wilson v. Wilson,* 741 S.W.2d at 647; *Taylor v. Taylor, supra,* 386 N.W.2d at 859; *In re Marriage of Foster,* 42 Cal. App.3d 577, 117 Cal. Rptr. 49 (1974); *Levy v. Levy,* 164 N.J. Super. 542, 397 A.2d 374 (1978). *See also,* B. Goldberg, *Valuation of Divorce Assets,* § 8.3 (1984). That is, whether an asset is true goodwill or merely the reputation of an individual enhancing his prospects for future earnings should be determined, on a case by case basis, by the trier of fact.

We shall adopt the view expressed in the third approach as the one that correctly distinguishes true goodwill from personal reputation and recognizes the former as property. Accordingly, we hold that for professional goodwill to be marital property it must be a business asset having a value independent of the continued presence or reputation of any particular individual. That is, it must be shown to be an asset distinct from, and thus not dependent on, the reputation or continued presence of the individual professional.

In the case *sub judice,* the appellee did not and could not make such a showing. Appellant is a sole practitioner. Were he to terminate his activity, the lights would go out and the value of his practice would be extinguished. The practice itself is non-transferable. A lawyer's clients cannot be sold; the right to represent them can only be transferred with their express consent; they have the absolute right to select their own future representation. Aside from the tangible physical property, which in this case is worth less than the liens burdening it, there is nothing of value in appellant's law practice that he can legitimately transfer to a purchaser of his practice. Perhaps because of the nature of appellant's practice, there is no evidence that there are any accounts receivable that might be assigned to a purchaser.

Appellee's expert witness conceded that his evaluation of the goodwill of appellant's practice or business was based upon the assumption that if appellant were to sell his practice he would have to agree not to compete with the purchaser. When questioned as to whether the absence of such an agreement not to compete would have a dramatic effect on his valuation, the witness acknowledged that it would. The fact that such a non-competition clause was an essential factor in the expert's valuation *sub judice* clearly establishes that what the expert referred to as "goodwill" was in reality the appellant's reputation. The value of the business was entirely dependent either on appellant continuing in the practice or agreeing not to compete if he sold it.[5] Therefore, the goodwill associated with appellant's law practice is of the type entirely dependent upon appellant's reputation and not true goodwill, *i.e.,* an independent asset of the business. It is simply *not* a marketable asset severable from appellant, and the value assigned to this "goodwill" is in reality a calculation of appellant's future earnings. As noted *supra,* the prospect for future earnings is a proper consideration for alimony, ***Brodak v. Brodak,*** 294 Md. 10, 28, 447 A.2d 847 (1982), but it is not marital property subject to equitable distribution. *See, Archer v. Archer,* 303 Md. at 357-59, 493 A.2d 1074. Therefore, the trial court erred in treating appellant's law practice, which had no assets other than its supposed goodwill, as marital property.

We deem it appropriate to emphasize that our decision with respect to goodwill in this case should not be taken as a holding or even an implication that goodwill, as a saleable or marketable asset, may never exist in a professional practice. *See,* Parkman, *supra,* 18 Fam.L.Q. at 215-21. It is difficult to imagine how the law practice of a sole practitioner can enjoy goodwill that is severable from the reputation of the practitioner himself, but if a party were to produce appropriate evidence establishing the salability or marketability of professional goodwill as a distinct and separate asset of the business, then such true goodwill would be deemed to be property that could be considered in the equitable distribution of marital property. In the instant case, however, there was no such evidence; therefore, the granting of a monetary award based upon an evaluation of goodwill as marital property subject to equitable distribution was reversible error.

The law practice was not totally devoid of marital property assets. There was a substantial business bank account upon which a monetary award might be based. As to that, the court will undoubtedly take into account Mrs. Prahinski's work in her husband's practice that contributed to the accumulation of that asset.

[5] Such a clause in the case of an attorney would not be possible because of ethical considerations. *See,* Maryland Rules of Professional Conduct, Rule 5.6, at 306 Md. LXXIX.

Indefinite Alimony[6]

The trial court granted appellee indefinite alimony of $1,000 per month, to commence when appellant had completed his payments of the monetary award which represented the value of appellant's business.[7] Maryland Fam. Law Code Ann. § 11-106(c) permits a court to grant indefinite alimony under certain conditions. In the case *sub judice,* the trial court found that "the incomes of the parties following the divorce will be unconscionably disparate even after the [appellee] shall have made as much progress toward self-support as can reasonably be expected...." This finding comports with Md. Fam. Law Code Ann. § 11-106(c)(2), which states that the "court may award alimony for an indefinite period, if the court finds that even after the party seeking alimony will have made as much progress toward becoming self-supporting as can be reasonably expected, the respective standards of living of the parties will be unconscionably disparate." A trial court's finding and award of alimony is not to be disturbed on appeal unless the court exercised its discretion arbitrarily or its judgment was clearly wrong. *Brodak v. Brodak,* 294 Md. at 28-29, 447 A.2d 847. Having reviewed the evidence, we are not persuaded that the trial judge abused her discretion or exercised it arbitrarily or erroneously in awarding indefinite alimony. There was certainly sufficient evidence to support her finding that there is a gross disparity in earnings and incomes between the parties, which may be expected to continue indefinitely. Considering the efforts expended by appellee to further her husband's career and the circumstances surrounding the breakup of the marriage, we would be hard put to find error, arbitrariness, or abuse in the determination that continuation of such disparity would be unconscionable.

Despite our holding that on the basis of the evidence an award of permanent alimony was not improper, we are required to set aside this award for two reasons. First, it was ordered to begin *in futuro,* based upon certain assumptions as to the probable state of each party's finances after appellant had paid off the monetary award. This was erroneous as a matter of law. *See, Unkle v. Unkle,* 305 Md. 587, 597-98, 505 A.2d 849 (1986). Second, our holding that the monetary award must be vacated and remanded, because it was based on an improper valuation of the so-called "goodwill" of appellant's law practice as marital property, requires us to vacate the award of alimony as well. As we noted in *Campolattaro v. Campolattaro,* 66 Md. App. 68, 75, 502 A.2d 1068 (1986), "alimony and a monetary award are significantly interrelated and largely inseparable. The decision to award one or both must be made after a consideration of them in their mutual context." Here, the trial court specifically based its alimony award upon the monetary award, making the former

[6] In this argument and the one concerning the equitable distribution *infra,* appellant questions whether the trial court considered the statutory factors as required by the Family Law Code. In response to this argument, we note that the trial court's order recites "that all of the required statutory factors regarding alimony, marital property, and monetary award hav[e] been considered and made part of the record." This language is sufficient for us to conclude that the trial court considered the required statutory factors. *See, Campolattaro v. Campolattaro,* 66 Md. App. 68, 502 A.2d 1068 (1986). Furthermore, a trial court is not required to articulate each step in its thought process, *Bangs v. Bangs,* 59 Md. App. 350, 475 A.2d 1214 (1984), and a recitation that the trial court considered the statutory factors is sufficient.

[7] Because we have already held that the valuation of appellant's business was error, the award of that value and its payment schedule were reversed. Contingent on that award was the court's order for payment of alimony. Because the monetary award is no longer present, the court's order requiring that appellant begin alimony payment after the payment of the monetary award is reversed. As such, we need not reach appellant's third contention of trial court error.

contingent upon the latter. Furthermore, whether an award of alimony, either as to amount or duration, is error can only be determined in light of all the factors in the case, including a monetary award. *See Cotter v. Cotter,* 58 Md. App. 529, 473 A.2d 970 (1984). The remand on the issue of the monetary award will in all probability necessitate an alimony reconsideration. For these reasons, the award of indefinite alimony is also vacated and remanded for reconsideration.

On remand, the court will, of course, consider appellant's future earning capacity in its determination of alimony. *Brodak v. Brodak,* 294 Md. at 28, 447 A.2d 847. Appellee's expert witness apparently calculated appellant's anticipated future earnings as the value of the business. As we indicated *supra,* those expected future earnings should be considered in an alimony award rather than in an equitable distribution. The court may wish to take into account, as an equitable factor in awarding alimony, appellee's contribution to appellant's business and its effect, if any, in enhancing the growth of his reputation and thus his prospects for future earnings. Md.Fam.Law Code Ann., § 11-106(b).

Distribution of Marital Assets

Maryland's equitable distribution system involves a three-step process. The first is the determination of whether property is marital or separate. Md.Fam.Law Code Ann. § 8-203. *See also,* Md.Fam.Law Code Ann. § 8-201(e) (definition of marital property). Once property is determined to be marital, the second step is the placing of a value on that property. Md.Fam.Law Code Ann. § 8-204. The third step involves an adjustment of the equities and the rights of the parties which may require the court to grant a monetary award. Md.Fam.Law Code Ann. § 8-205. The Maryland courts have no authority to transfer the ownership of personal or real property from one party to the other. Md.Fam.Law Code Ann. § 8-202(a)(3). *See also, Ward v. Ward,* 48 Md. App. 307, 426 A.2d 443 (1981). With this law in mind, we now turn to the equitable distribution made by the court in the case *sub judice.*

Apparently, appellant does not contest the trial court's handling of steps one and two. What he contends is that the court erred in distribution of the marital assets under step three. We shall examine his assertions of error relative to the items of property he asserts were distributed incorrectly.

The court found all of the parties' property to be marital and stated that "the marital property of the parties is divided as follows:

Husband		Wife	
Greenacres	$ 50,000	Glen Ave.	$ 93,000
Cadillac	13,000	Toyota	6,962
Sailboat	20,000	Oldsmobile	200
IRA	4,000	IRA	4,000
1/2 Keogh	65,000	1/2 Keogh	65,000
1/2 Business	150,000	1/2 Business	150,000
Office Furn.	10,200	Household Furn.	2,000
1/2 Norwich	$ 13,500	1/2 Norwich	$ 13,500
1/2 Fontana	16,200	1/2 Fontana	16,200

Cash in Accts.	46,000	LMF	37,500
	$387,900		$388,362"

In this division, the court gave no consideration (except for the business and the rental properties) to its own findings as to how the properties were titled. In effect, the above division attempts to transfer the ownership of some of the property from one party to another (more accurately, from both parties jointly to one of them), which is forbidden by Md.Fam.Law Code Ann. § 8-202(a)(3). The property erroneously allocated included:

> *Glen Ave. Property,* the family home, which is titled in both parties as tenants by the entirety.
> *Sailboat,* also titled in both parties as tenants by the entirety.
> *A one-half Interest in LMF Partnership,* owned by the parties as tenants by the entirety.

By awarding the sailboat to appellant and the family home and the interest in the LMF partnership to appellee, instead of partitioning those properties by ordering that they be sold and the proceeds distributed to the parties, the court improperly transferred ownership of the property. Md.Fam.Law Code Ann. § 8-202(a)(3). Consequently, these contested provisions of the judgment must be vacated and remanded for a proper equitable distribution.

The parties also held as tenants by the entirety two rental properties identified as "Norwich Road" and "Fontana Drive." The court found these properties to be marital property and ordered that they be sold with the proceeds being evenly divided between the parties. Appellant asserts that this distribution was erroneous because the court failed to consider appellant's testimony that he made substantial contributions of cash to maintain the properties during the parties' separation whereas appellee made no contributions. Therefore, appellant argues, instead of ordering that the proceeds of the rental properties be distributed evenly, the court should have provided for reimbursement to appellant of his cash contributions to the properties. We disagree.

The cash that appellant testified he expended to maintain the properties after the parties separated was money acquired during the marriage. Property acquired during a separation and prior to divorce is marital property. *Campolattaro v. Campolattaro,* 66 Md. App. at 81, 502 A.2d 1068; *Cotter v. Cotter,* 58 Md. App. at 537, 473 A.2d 970; *Gravenstine v. Gravenstine,* 58 Md. App. 158, 177, 472 A.2d 1001 (1984). Accordingly, the funds that appellant used to maintain the rental properties were as much marital property as the real estate upon which those funds were expended. Ordering an equal distribution of the proceeds of sales of the rental properties, therefore, was not error.

Appellant also contests the distribution of the two automobiles to appellee. The court found that the Oldsmobile was titled in appellee's name; therefore, the award of the Oldsmobile to appellee was proper. The other automobile, a 1983 Toyota, was also awarded to appellee, despite the fact, as noted by the court, that there was no evidence as to how that vehicle was titled. Since we are remanding the case for proper distribution of the parties' properties, the trial court, upon remand, should receive evidence as to how the Toyota is titled in order

that it may be distributed properly. *See,* Md.Transp.Code Ann. § 13-101.1 (each vehicle in Maryland requires a certificate of title).

The parties' household furnishings were distributed to the appellee. There being no evidence presented as to title or ownership of this property, there is nothing to rebut the presumption that the parties acquired and own the household furnishings as tenants by the entireties. *See, Bender v. Bender,* 282 Md. 525, 534, 386 A.2d 772 (1978). Consequently, unless the parties can agree upon a distribution, either of them may require a sale in lieu of partition. Md.Fam.Law Code Ann., § 8-202(b)(2).

Appellant complains that the court failed to include certain jewelry in the distribution. During the trial, appellee testified that she possessed jewelry worth approximately $5,000, some of which she had received as gifts from appellant, some as gifts from her mother, and some as payment for services rendered by appellee and appellant. The trial court made no findings on this evidence. On remand, the court should make a factual determination as to ownership of the jewelry and whether any of it is marital property, in order that it may be distributed, or if appropriate, considered in connection with the granting of a monetary award.

Appellant has not contested the transfer of any other property. Nevertheless, since the court's distribution is fraught with error, a remand for redistribution of many of the items may well result in upsetting the balance of equities that the trial court attempted to create. We deem it necessary, therefore, to vacate the entire distribution of property to allow the trial court to start with a clean slate in making an equitable distribution of the parties' property. In so doing, we remind the court that it cannot transfer title, Md.Fam.Law Code Ann. § 8-202(a)(3); if it concludes that distribution of property in accordance with title would be inequitable, it has the authority to grant a monetary award to either party in order to adjust that inequity.[8]

Conclusion

The judgment of the Circuit Court for Prince George's County is affirmed as to the decree of absolute divorce but reversed and remanded for further proceedings as to distribution of property, grant of a monetary award, and alimony.

JUDGMENT AFFIRMED IN PART AND REVERSED IN PART, AND REMANDED FOR FURTHER PROCEEDINGS CONSISTENT WITH THIS OPINION.

COSTS TO BE PAID BY APPELLEE.

[8] Appellant asserts that the trial court erred in failing to consider the parties' debts in making the distribution. Because we are vacating the distribution for other reasons, we need not address that issue here. On remand, however, the court should consider the testimony concerning the marital debts prior to making any distribution. *See* *Schweizer v. Schweizer,* 301 Md. 626, 434 A.2d 267 (1984); *Green v. Green,* 64 Md. App. 122, 494 A.2d 721 (1985).

Full Text of Court Cases

Prahinski v. Prahinski

Case name: Prahinski v. Prahinski
Citation: 321 Md. 227, 582 A.2d 784, 1990 Md. LEXIS 183
Date of decision: December 6, 1990
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Daniel F. Thomas (Thomas & Kalichman, on brief), Daniel F. Thomas, Baltimore, for respondent.

JUDGES:

Eldridge, Cole, Rodowsky, McAuliffe, Adkins, Blackwell, JJ. and Charles E. Orth, Jr., Judge of the Court of Appeals, (retired) Specially Assigned, JJ. Murphy, C.J., Eldridge, Cole, Rodowsky, McAuliffe, Chasanow and Charles E. Orth, Jr., Judge of the Court of Appeals, (retired), Specially Assigned, JJ. Dissenting Opinion by Rodowsky, J., in which Murphy, C.J. and Eldridge, J. join. Chief Judge Murphy and Judge Eldridge join in the views expressed in this dissenting opinion.

OPINIONBY:

COLE

OPINION:

In this case we must determine whether the goodwill of a solo law practice is a value includable as marital property for purposes of calculating a monetary award upon divorce.

The facts are neither complicated nor in dispute. Margaret and Leo F. X.Prahinski were married on March 20, 1965. Margaret discontinued her education after her freshman year in college in order to maintain the family home. Leo continued his formal education and eventually obtained a law degree. In

1971, Leo started his own law practice. Margaret became his secretary, and as the law practice grew, so did Margaret's responsibilities in the office. Gradually, the focus of the practice shifted to real estate settlements and Margaret's position evolved into that of office manager.

Leo became involved with another woman in 1983. The parties separated thereafter, and Margaret filed for divorce on November 14, 1986. The Circuit Court for Prince George's County granted an absolute divorce, and on July 10, 1987, the court filed a written order determining what was marital property, providing for distribution of marital assets, and granting both a monetary award and indefinite alimony. Included in the monetary award was one-half of the value of the law practice.

Leo appealed to the Court of Special Appeals claiming that the trial court erred in considering his law practice to be marital property consisting totally of goodwill and dividing the value thereof equally between the parties. Leo also questioned the proprietyof setting the amount of alimony at a time far in advance of when the alimony payments were to commence.

The Court of Special Appeals, 75 Md.App. 113, 540 A.2d 833 (1988), held that the value of the practice consisted entirely of the reputation of Leo F. X. Prahinski, Attorney-at-Law, and was therefore personal to him. As such, the value of the practice was not marital property and could not be subject to distribution as part of the monetary award. The intermediate appellate court left open the possibility that goodwill in a solo practice could be marital property if it could be shown that the goodwill was severable from the reputation of the practitioner. Additionally, the Court of Special Appeals held that it was improper for alimony to be set now when the payments were not to begin until some future time because it would be impossible to predict the economic circumstances of the parties on the date when alimony was to begin. Furthermore, that court held that alimony should take into consideration the monetary award. Since that award must be recalculated, that court declaredthe previous alimony calculation was invalid. The intermediate appellate court, therefore, remanded the case to the trial court for proper calculation of both the monetary award and alimony. Margaret petitioned this Court for certiorari which we granted in order to address the important issue involved.

We set forth several sections of the Maryland Code (1984, 1989 Cum.Supp.) Family Law Article which we believe impact upon our disposition of this case.

Section 8-201(e) provides:

(e) Marital property. -- (1) "Marital Property" means the property, however titled, acquired by 1 or both parties during the marriage.

(2) "Marital property" does not include property:

(i) acquired before the marriage;

(ii) acquired by inheritance or gift from a third party;

(iii) excluded by valid agreement; or

(iv) directly traceable to any of these sources.

Section 8-203 -- Marital Property. -- Determination. (a) Time of court action. -- In a proceeding for an annulment or an absolute divorce, if there is a dispute as to whether certain property is marital property, the court shall determine which property is marital property:

(1) when the court grants an annulment oran absolute divorce[.]

Section 8-205 provides in pertinent part

(a) Grant of award. -- Subject to the provisions of subsection (b) of this section, after the court determines which property is marital property, and the value of the marital property, the court may transfer ownership of an interest in a pension, retirement, profit sharing, or deferred compensation plan from 1 party to either or both parties, grant a monetary award, or both, as an adjustment of the equities and rights of the parties concerning marital property, whether or not alimony is awarded.

(b) Factors in determining amount and method of payment or terms of transfer. -- The court shall determine the amount and the method of payment of a monetary award, or the terms of the transfer of the interest in the pension, retirement, profit sharing, or deferred compensation plan, or both, after considering each of the following factors:

(1) the contributions, monetary and nonmonetary, of each party to the wellbeing of the family;

(2) the value of all property interests of each party;

(3) the economic circumstances of each party at the time the award is to be made;

(4) the circumstances that contributed tothe estrangement of the parties;

(5) the duration of the marriage;

(6) the age of each party;

(7) the physical and mental condition of each party;

(8) how and when specific marital property or interest in the pension, retirement, profit sharing, or deferred compensation plan, was acquired, including the effort expended by each party inaccumulating the marital property or the interest in the pension, retirement, profit sharing, or deferred compensation plan, or both;

(9) any award of alimony and any award or other provision that the court has made with respect to family use, personal property or the family home; and

(10) any other factor that the court considers necessary or appropriate to consider in order to arrive at a fair and equitable monetary award or transfer of an interest in the pension, retirement, profit sharing, or deferred compensation plan, or both.

Under the above provisions, it seems to us that trial courts are required first to determine which property is marital, what the value of this marital property is, and then to apply the ten factors in § 8-205(b) to determine what monetary award represents an "adjustment of the equities and rights of the parties"in the marital property.

Margaret argues that the value of the practice should be considered marital property, and therefore subject to a monetary award to compensate her for her contributions thereto. She insists that the majority of the work handled by the practice did not require an attorney, and that she contributed the overwhelming majority of the time and effort which made the practice successful. To deny her an

equitable share of the goodwill inherent in the practice, she claims, would frustrate the purpose of the monetary award statute, which seeks to adjust the rights of the parties based upon their contributions during the marriage.

Specifically, Margaret contends that goodwill is a form of property which the practice acquired during the marriage; hence it fits the definition of marital property, no matter whose name is on the business. She further urges this Court to adopt the position that the professional goodwill of a sole proprietorship is valuable property to be included in the marital estate.

Leo maintains that his vocation has always been a solo law practice. As such, any intangible value assigned to the business is a result of his personal reputation as an attorney. The only way that goodwill could be considered marital property, he argues, is if the goodwill had a value independent of the continued presence or reputation of the sole practitioner. He contends that he is the only person who can practice under the name "Leo F.X. Prahinski, Attorney-at-law." He claims he could not sell his practice and its intangible assets to anyone; therefore, he concludes that the goodwill is personal to him and should not be considered marital property.

The characterization of goodwill and its relationship to a business is crucial to the determination of this issue. In Hagan v. Dundore, 187 Md. 430, 50 A.2d 570 (1946), we examined the sale of a partnership interest. In so doing, we took notice of the definitions of goodwill applied by other jurisdictions. One such definition states: "The goodwill of a business comprises those advantages which may inure to the purchaser from holding himself out to the public as succeeding to an enterprise which has been identified in the past with the name and repute of his predecessor." Id. at 442, 50 A.2d at 576 (quoting Knoedler v. Boussod, 47 F. 465, 466 (S.D.N.Y. 1891), aff'd, 55 F. 895 (2d Cir.1893)) (emphasis added). According to this definition, goodwill can exist in those situations in which a business has successive owners, each one benefitting from the management of the business by the preceding owners.

Goodwill exists, however, in businesses that are still in the hands of their founders and which may never be sold. We took notice of such a situation in Brown v. Benzinger, 118 Md. 29, 84 A. 79 (1912), where we quoted Lord Eldon's definition of goodwill as "the probability that the old customers will resort to the old place." Id. at 35, 84 A. at 81 (quoting Cruttwell v. Lye, 34 Eng.Rep. 129, 134 (Ch. 1810)). Such a definition provides for the presence of goodwill in a business even if no monetary value has ever been placed on it.

In Brown, the Court was confronted with the sale of a "business conducted by [the vendor] as surgeon chiropodist." 118 Md. at 31,84 A. at 79. That opinion makes clear that as long ago as 1912, this Court considered the goodwill involved in a profession to be different from the goodwill involved in a commercial business. Examining the decisions from other jurisdictions, the Brown court noted that in the context of a non-competition agreement in the sale of a business, the goodwill of a professional practice had been held to be personal to the practitioner. The Court specifically observed that there was a distinction

between the sale of the good will of a trade or business of a commercial character where the location is an important feature of the business, and the sale of an established practice and good will of a person engaged in a profession or calling where the income therefrom is the immediate or direct result of his labor and skill and where integrity, skill, ability and other desirable personal qualities follow the person and not the place.

Id. at 36, 84 A. at 81 and cases cited therein.

Having recognized the existence of goodwill in the above noted situations, we must now determine whether goodwill can exist in the particular circumstances of the instant case. Although the trial court found that the business was predominantly a title company and treated it as such, both parties' arguments to this Court are based on the Court of Special Appeals' holding that the business was a sole proprietorship, and in particular a solo law practice. It should be noted that neither party is contesting the status of the license to practice law. n1 What is being contested is the existence of goodwill in a practice established once the professional license has been obtained.

n1 As we held in Archer v. Archer, 303 Md. 347, 493 A.2d 1074 (1985), "a professional degree or license does not possess any of the basic characteristics of property within the ambit of marital property." Id. at 357, 493 A.2d at 1079.

Because the question of whether professional goodwill is marital property is one of first impression in Maryland, we found it beneficial to review the decisions of the courts of other states which have addressed the issue. This review revealed three positions. The view most often followed treats goodwill as marital property in all cases. n2 Thenext largest group considers goodwill to be personal to the practitioner, and therefore not marital property. n3 Finally, a small group of states requires a case-by-case examination to determine how goodwill should be treated. n4 It is interesting to note that the classification of a jurisdiction as a community property state or anequitable distribution state is not determinative of its treatment of goodwill.

n2 Rostel v. Rostel, 622 P.2d 429, 430-32 (Alaska 1981), rev'd on other grounds, 749 P.2d 343 (Alaska 1988); Wisner v. Wisner, 129 Ariz. 333, 631 P.2d 115 (1981); In re Marriage of Foster, 42 Cal.App.3d 577, 117 Cal.Rptr. 49 (1974); Golden v. Golden, 270 Cal.App.2d 401, 75 Cal.Rptr. 735 (1969); Mueller v. Mueller, 144 Cal.App.2d 245, 301 P.2d 90 (1956); In re Marriage of Nichols, 43 Colo.App. 383, 606 P.2d 1314 (1979); Wright v. Wright, 469 A.2d 803 (Del.Fam.Ct.1983); In re Marriage of Kapusta, 141 Ill.App.3d 1010, 96 Ill.Dec. 234, 491 N.E.2d 48 (1986); Porter v. Porter, 526 N.E.2d 219 (Ind.App.1988); Heller v. Heller, 672 S.W.2d 945 (Ky.Ct.App.1984); Rethman v. Rethman, 429 Mich. 868, 413 N.W.2d 679 (1987); Kowalesky v. Kowalesky, 148 Mich.App. 151, 384 N.W.2d 112, app. den., 425 Mich. 876 (1986); Roth v. Roth, 406 N.W.2d 77 (Minn. Ct.App.1987); Hanson v. Hanson, 738 S.W.2d 429 (Mo.1987); Taylor v. Taylor, 736 S.W.2d 388 (Mo.1987); In re Marriage of Hull, 219 Mont. 480, 712 P.2d 1317 (1986); Dugan v. Dugan, 92 N.J. 423, 457 A.2d 1 (1983); Hurley v. Hurley, 94 N.M. 641, 615 P.2d 256 (1980), overruled on other grounds by Ellsworth v. Ellsworth, 97 N.M. 133, 637 P.2d 564 (1981); Dorton v. Dorton, 77 N.C.App. 667, 336 S.E.2d 415 (1985); Jondahl v. Jondahl, 344 N.W.2d 63 (N.D.1984); Goger v. Goger, 27 Or.App. 729, 557 P.2d 46 (1976); Sorensen v. Sorensen, 769 P.2d 820 (Utah 1989); Gardner v. Gardner, 748 P.2d 1076 (Utah 1988); In re Marriage of Fleege, 91 Wash.2d 324, 588 P.2d 1136 (1979).

n3 Powell v. Powell, 231 Kan. 456, 648 P.2d 218 (1982); Pearce v. Pearce, 482 So.2d 108 (La.1986); Beasley v. Beasley, 359 Pa.Super. 20, 518 A.2d 545 (1986); Wood v. Wood, 378 S.E.2d 59 (S.C.App.1989); Smith v. Smith, 709 S.W.2d 588 (Tenn.Ct.App.1985); Austin v. Austin, 619 S.W.2d 290 (Tex.Civ.App.1981); Geesbreght v. Geesbreght, 570 S.W.2d 427 (Tex.Civ.App.1978); Nail v. Nail, 486 S.W.2d 761 (Tex.1972); Holbrook v. Holbrook, 103 Wis.2d 327, 309 N.W.2d 343 (1981).

n4 Richmond v. Richmond, 779 P.2d 1211 (Alaska 1989); Wilson v. Wilson, 294 Ark. 194, 741 S.W.2d 640 (1987); Antolik v. Harvey, 7 Haw.App. 313, 761 P.2d 305 (1988); Taylor v. Taylor, 222 Neb. 721, 386 N.W.2d 851 (1986).

The view that the goodwill of a solo practice should be considered as marital property was early on set forth in the California decisions of Mueller v. Mueller, 144 Cal.App.2d 245, 301 P.2d 90 (1956) and Golden v. Golden, 270 Cal.App.2d 401, 75 Cal.Rptr. 735 (1969).

In Mueller, the husband was the sole owner of a dental laboratory which employed six people. The wife sought to have the value of the business divided at the time of the divorce. The husband argued that the goodwill of the business was wholly dependent upon his personal skill and ability. The court examined the business and concluded that the business was too old and too large to be dependent solely upon the owner for its goodwill, 144 Cal.App.2d at 251, 301 P.2d at 95, and held that the value of this business was to be divided between the parties. Furthermore, the Mueller court examined the argument that goodwill cannot arise in a professional business depending upon the personal skill and ability of a particular person. Even though unnecessary to its decision, the court stated that this argument was based on the definition of goodwill set forth by Lord Eldon, and the better, more modern, view is that the skill and learning acquired by a professional has intangible value which may be transferred. Id. at 251, 301 P.2d at 94-95. This left open the possibility that professional goodwill could also be divided upon divorce.

The court in Golden used the opening left by Mueller to hold that professional goodwill was marital property. The husband in Golden was a sole practicing physician. The wife sought a division of the value of the practice when the couple was divorced. The court, looking to Mueller, 270 Cal.App.2d at 405, 75 Cal.Rptr. at 737, set forth the holding that "the better rule is that, in a divorce case, the good will of the husband's professional practice as a sole practitioner should be taken into consideration in determining the award to the wife." Id.

The Golden court distinguished a divorce from the dissolution of a partnership, in which it might be difficult to determine the correct share upon distribution.

[I]n a matrimonial matter, the practice of the sole practitioner husband will continue, with the same intangible value as it had during the marriage. Under the principles of community property law, the wife, by virtue of her position of wife, made to that value the same contribution as does a wife to any of the husband's earnings and accumulations during marriage. She is as much entitled to be recompensed for that contribution as if it were represented by the increased value of stock in a family business.

Id. at 405, 75 Cal.Rptr. at 738 (emphasis added).

Although the California court used community property law to give the wife credit for the increase in the goodwill value during the marriage, the non-monetary contribution aspect of equitable distribution principles tends to accomplish the same result. Note, Treating Professional Goodwill as Marital Property in Equitable Distribution States, 58 N.Y.U.L.Rev. 554, 558 (1983).

The New Jersey case of Dugan v. Dugan, 92 N.J. 423, 457 A.2d 1 (1983) presents a situation which is quite similar to the instant case, but in that case the court held that the goodwill of a solo law practice was marital property. The husband was an attorney who operated his practice as a wholly-owned professional corporation. New Jersey and Maryland both place the following limitations on the practice

of law: (1) sole practitioners cannot sell their law practices, id. at 436, 457 A.2d at 8, (2) restrictive covenants prohibiting competition by the transferor of the practice are not allowed, and (3) clients may not be sold between practices. Regarding domestic relations law, both Maryland and New Jersey are equitable distribution states, and neither treats a professional degree or license to practice as property. See Lynn v. Lynn, 91 N.J. 510, 453 A.2d 539 (1982).

The New Jersey court began its analysis by looking at the various definitions of goodwill used in other states. Its conclusion was that goodwill exists and is a legally protected interest. 92 N.J. at 429, 457 A.2d at 4. Next the court examined the relationship between goodwill and "going concern value." Goodwill was found to be closely related to reputation, and the definition settled on by the New Jersey court was that goodwill "is equivalent to the excess of actual earnings over expected earnings based on a normal rate of return on investment." Id. at 431, 457 A.2d at 5.

Examining the relationship between goodwill and earning capacity (as that relates to a medical degree), the court found a difference between the two:

Future earning capacity per se is not goodwill. However, when that future earning capacity has been enhanced because reputation leads to probable future patronage from existing and potential clients, goodwill may exist and have value. When that occurs the resulting good will is property subject to equitable distribution.

Id. at 433, 457 A.2d at 6.

Having distinguished goodwill from earning capacity and having found goodwill subject to equitable distribution, the court went on to state its rationale for the decision:

After divorce, the law practice will continue to benefit from that goodwill as it had during the marriage. Much of the economic value produced during an attorney's marriage will inhere to the goodwill of the law practice. It would be inequitable to ignore the contribution of the non-attorney spouse to the development of that economic resource. An individual practitioner's inability to sell a law practice does not eliminate existence of goodwill and its value as an asset to be considered in equitable distribution. Obviously, equitable distribution does not require conveyance or transfer of any particular asset. The other spouse, in this case the wife, is entitled to have that asset considered as any other property acquired during the marriage partnership.

Id. at 434, 457 A.2d at 6 (emphasis added).

The view that professional goodwill is personal to the practitioner and is not marital property is articulated by the Texas court in Nail v. Nail, 486 S.W.2d 761 (Tex.1972). Despite the fact that Texas, like California, is a community property state, the Nail court held that the goodwill built up by a medical practice was personal to the husband doctor. The court determined that the goodwill was based on the husband's personal skill, experience, and reputation. Because the goodwill was not an asset separate and apart from the doctor, it would be extinguished if he died, retired, or became disabled. Because of the personal nature of this asset, it was not considered by the court as an earned or vested property right at the time of the divorce, and did not qualify as property subject to division in a divorce proceeding. Id. at 764.

Taylor v. Taylor, 222 Neb. 721, 386 N.W.2d 851 (1986), sets forth the middle ground between the two extremes. The trial court found that the husband's professional medical corporation contained no goodwill which was subject to distribution upon divorce. On appeal, the Nebraska Supreme Court affirmed that finding. In so doing, however, the appellate court noted that in proper circumstances, professional goodwill might exist as a salable or marketable business asset. Id. at 732, 386 N.W.2d at 858-59. Whether such a situation existed would be a question of fact. If the goodwill was found to be saleable or marketable, the court could divide that goodwill as a marital asset. The court stated that the essential factor which would determine the goodwill to be personal would be its dependence upon the continued presence of the individual. Id. at 731, 386 N.W.2d at 858. See also, Richmond v. Richmond, 779 P.2d 1211 (Alaska 1989) and Antolik v. Harvey, 7 Haw.App. 313, 761 P.2d 305 (1988).

Taylor, therefore, provides for a case-by-case analysis to determine whether goodwill in a particular situation should be considered marital property. Unlike the Texascourt, Taylor does not rule out the possibility that a professional solo practice might contain such goodwill. And unlike the California cases, it allows for distinctions between those situations where goodwill is truly personal and where it is indeed marital property. It was this rationale which the Court of Special Appeals found persuasive. 75 Md.App. at 133, 540 A.2d at 843.

After reviewing these three alternatives and the rationale of their respective supporting cases, we are of the opinion that the goodwill of a solo law practice is personal to the individual practitioner. Goodwill in such circumstances is not severable from the reputation of the sole practitioner regardless of the contributions made to the practice by the spouse or employees. In order for goodwill to be marital property, it must be an asset having a separate value from the reputation of the practitioner.

We are not convinced that the goodwill of a solo law practice can be separated from the reputation of the attorney. It is the attorney whose name, whether on the door or stationery, is the embodiment of the practice. We are cognizant that in this computer age many law practices, and in Leo's practice in particular, much of the research and "form" work is done by nonlawyers. In the final analysis, however, it is the attorney alone who is responsible for the work that comes out of the office. Rule of Professional Conduct 5.3(c). In the instant case, the responsibility is solely Leo's, and no amount of work done by Margaret will shift the responsibility to her. The attorney's signature or affidavit places his seal of approval on the work being done and makes the attorney liable for its accuracy and authenticity. This professional assurance is what might have convinced some clients to use Leo F.X. Prahinski, Attorney-at-Law, instead of going to a title company to have their settlements completed. The assurance would end should Leo somehow remove himself from the practice. Therefore, the goodwill generated by the attorney is personal to him and is not the kind of asset which can be divided as marital property.

Because the instant case involves the practice of law,special considerations arise which might not be present in other professional practices. In Brown v. Benzinger, 118 Md. 29, 84 A. 79 (1912), we quoted with approval from Yeakley v. Gaston, 50 Tex.Civ.App. 405, 111 S.W. 768 (1908) where the court said, "the sale of goodwill by a professional carries with it the obligation that he will abstain from practice in the future in the territory from which he binds himself to withdraw." It is clear that an attorney, as distinguished from other professionals, may not covenant to abstain from the practice of law, and therefore, may not sell his or her goodwill. The ABA/BNA Lawyer's Manual on Professional Conduct § 91:801 states:

because of [the] ethical proscriptions, authorities have generally prohibited a lawyer's sale of his or her goodwill. [Citing], Geffen v. Moss, 53 Cal.App.3d 215, 125 Cal.Rptr. 687 (1975); Detroit Bank and Trust Co. v. Coopes, 93 Mich.App. 459, 287 N.W.2d 266 (1979); Lake County Bar Association v. Patterson, 64 Ohio St.2d 163, 413 N.E.2d 840 (1980);In re Laubenheimer [113 Wis.2d 680], 335 N.W.2d 881 [624] (Wis.1983); ABA Formal Opinion 266 (June 2, 1945); see also Sterett, The Sale of a Law Practice, 121 U.Pa.L.Rev. 306 (1972); Annot. 79 ALR 3d 1243 (1981).

Other professions do not have the prohibition against the sale of goodwill. Brown v. Benzinger, supra (sale of her practice "including goodwill" by a "surgeon chiropodist"); Warfield v. Booth, 33 Md. 63 (1870) (sale of a physician's practice including goodwill); Spaulding v. Benenati, 57 N.Y.2d 418, 456 N.Y.S.2d 733, 442 N.E.2d 1244 (1982) (goodwill of a dentist is a saleable asset); Dwight v. Hamilton, 113 Mass. 175 (1873) (goodwill of a physician is a saleable asset).

Since a lawyer's goodwill is not a saleable asset, it has no commercial value. The methods for valuing the marketable goodwill of a profession or business would not be applicable to an attorney's nonmarketable goodwill. The fact that a lawyer's goodwill cannot be sold by the lawyer isanother factor in our determination that it is not marital property.

Of equal importance is the fact that Maryland lawyers are governed by the Rules of Professional Conduct, which deal specifically with situations in which lawyers and nonlawyers work together.

Rule 5.4 provides in pertinent part:

(b) A lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law.

* * *

(d) A lawyer shall not practice with or in the form of a professional corporation or association authorized to practice law for profit if:

(1) a nonlawyer owns any interest therein, except that a fiduciary representative of the estate of a lawyer may hold the stock or interest of the lawyer for a reasonable time during administration;

(2) a nonlawyer is a corporate director or officer thereof; or

(3) a nonlawyer has the right to direct or control the professional judgment of the lawyer.

This rule clearly prohibits Leo from making Margaret a partner in his law practice. In fact, the practice was set up as "Leo F.X. Prahinski, Attorney-at-Law" and there is no indication that Rule 5.4(d) was not followed. Because Margaret cannot be a partner in the practice, she cannot claim a partner's interest in the practice upon her divorce from her lawyer husband.

Under these circumstances the non-lawyer spouse has no interest in the lawyer-spouse's practice and therefore the goodwill of the practice may not be included as marital property. We hold that a non-lawyer spouse cannot be a partner (silent or otherwise) in the practice of law in Maryland.

We have noted, as did the Court of Special Appeals, that the circuit court included the value of the goodwill of the legal practice of Leo F.X. Prahinski as a part of the marital property. The alimony and the monetary award were both calculated with the value being a factor. This was error. Therefore, the entitlements of the spouse must be recalculated. n5

n5 We have not addressed the other issues certified for review and need not do so because of the disposition we make in this case.

JUDGMENT OF THE COURT OF SPECIAL APPEALS AFFIRMED. PETITIONER TO PAY THE COSTS.

DISSENTBY:

RODOWSKY

DISSENT:

RODOWSKY, Judge, dissenting.

I respectfully dissent. By mixing the Marital Property Act, Family Law Article § § 8-201 through 8-205, with the Rules of Professional Conduct, principally Rule 5.6(a), without giving effect to the purpose of either ingredient, the Court has produced an inequitable result. Although the spouse of a person engaged as a sole proprietor in a trade or business may receive an equitable award in the value of the goodwill of that proprietorship, and although the spouse of a person engaged as a sole practitioner in a profession, other than law, may receive an equitable award in the value of the goodwill of that professional practice, the Court holds that the spouse of a person engaged as a sole practitioner in the legal profession cannot even be considered for an equitable award in the value of the goodwill of that law practice because, solely in the latter instance, goodwill is not marital property.

Archer v. Archer, 303 Md. 347, 493 A.2d 1074 (1985), held that there is no marital property in a license to practice medicine. But there this Court said:

"Our cases have generally construed the word 'property' broadly, defining it as a term of wide and comprehensive signification embracing '"everything which has exchangeable value or goes to make up a man's wealth -- every interest or estate which the law regards of sufficient value for judicial recognition."' Deering v. Deering, 292 Md. 115, 125, 437 A.2d 883 (1981); Diffendall v. Diffendall, 239 Md. 32, 36, 209 A.2d 914 (1965). In Bouse v. Hutzler, 180 Md. 682, 686, 26 A.2d 767 (1942), we said that the word 'property,' when used without express or implied qualifications, 'may reasonably be construed to involve obligations, rights and other intangibles as well as physical things.' 'Goodwill,' for example, has been characterized as a legally protected valuable property right. Schill v. Remington Putnam Co., 179 Md. 83, 88-89, 17 A.2d 175 (1941)."

303 Md. at 356, 493 A.2d at 1079.

Indeed, the majority opinion acknowledges that "[t]he view most often followed treats goodwill as marital property in all cases." Opinion at 234 (footnote omitted). Thus, if a brain surgeon or a house painter were to divorce, most courts would permit the spouse to show both goodwill in the solo practice or sole proprietorship and the value thereof. This is consistent with the policy of Maryland's Marital Property Act

"that nonmonetary contributions within a marriage should be recognized in the event that a marriage is dissolved; that a spouse whose activities do not include the production of income may nevertheless have contributed toward the acquisition of property by either or both spouses during the marriage; that when a marriage is dissolved, the property interests of the spouses should be adjusted fairly and equitably, with careful consideration given to both monetary and nonmonetary contributions made by the

respective spouses; and that the accomplishment of these objectives necessitates that there be a departure from the inequity inherent in Maryland's old 'title' system of dealing with the marital property of divorcing spouses."

Archer v. Archer, 303 Md. at 351-52, 493 A.2d at 1076-77.

The Court nevertheless holds that the majority rule in this country does not apply here because "the goodwill of a solo law practice is personal to the individual practitioner. . . . In order for goodwill to be marital property, it must be an asset having a separate value from the reputation of the practitioner." Opinion at 239. "Because the instant case involves the practice of law, special considerations arise which might not be present in other professional practices." Opinion at 240.

Although today's holding is clearly limited to solo legal practitioners, the holding seems to rest, at least in part, on equating goodwill with professional reputation and then denying marital property in a professional reputation. In my view that does not distinguish attorneys and brain surgeons from house painters for marital property purposes. Where services are involved a reputation for competently rendering the particular service is a component of goodwill whether we deal with a trade, a business or a profession. The nonmonetary support rendered by the spouse while the service provider was expending the time and effort required for quality performance, and thereby was building the reputation, is precisely the type of contribution within a marriage which the General Assembly intended be recognized under the Marital Property Act.

If, on the other hand, both the rationale and the holding of the majority opinion are limited to solo legal practitioners, then it seems to be principally because, under the majority's reasoning, "an attorney, as distinguished from other professionals, may not covenant to abstain from the practice of law, and therefore, may not sell his or her goodwill." Opinion at 240. Rule 5.6, entitled "Restrictions on Right to Practice," subsection (a), prohibits a lawyer from participating in offering or making "[a] partnership or employment agreement that restricts the rights of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement[.]" The rationale underlying the prohibition "is that such covenants impinge upon the right of future clients to free choice of counsel." G. Hazard, Jr. & W. Hodes, The Law of Lawyering: A Handbook on the Model Rules of Professional Conduct 486 (1985). The freedom of choice of future clients is in no way diminished by recognizing a spouse'smarital property interest in the goodwill of a solo law practice.

The only effect of the Rules of Professional Conduct on the problem before us is to complicate valuation. Because a solo law practice, unlike a medical practice or accounting practice, cannot be sold directly, valuation of a law practice might require comparisons to be drawn to other professions, particularly if a multiplier of some part of the net earnings of the law practice must be used. See Dugan v. Dugan, 92 N.J. 423, 439-40, 457 A.2d 1, 9-10 (1983) (multiplier to be applied to excess of average annual net income from practice over annual salary available in same general locale to attorney of comparable experience, expertise, education and age).

Finally, it is at least interesting to note that experienced counsel for the respondent did not even urge the majority holding. Recognizing the inequity of denying marital property in the goodwill of a professional practice while allowing marital property in the goodwill of sole proprietorships, trades and businesses, counsel urged that goodwill which ultimately rested on personal reputation not be included in marital property in the case of any trade, business or profession.

Rapid-American Corp. v. Harris

603 A.2d 796 (1992)

RAPID-AMERICAN CORPORATION and McCrory Parent Corp., Respondents Below, Appellants/Cross-Appellees, v. David HARRIS, Leeburn Securities Limited, Cede & Co., Curt Rothschild, Naomi Weiss, Bastion Management Ltd., Bastion Fund-1980 L.P., Sea Venture International L.P., Cordoba Investment Ltd., and 398737 Ontario Ltd., Petitioners Below, Appellees/Cross-Appellants.

Supreme Court of Delaware.

Submitted: May 21, 1991.

Decided: January 23, 1992.

William O. LaMotte, III and Robert J. Valihura, Jr., Morris, Nichols, Arsht & Tunnell, Wilmington, Jeffrey R. Mann (argued), Tab K. Rosenfeld (Rubin, Baum, Levin, Constant & Freidman, New York City, of counsel), for appellants/cross-appellees.

Stuart B. Young and Bruce L. Silverstein, Young, Conaway, Stargatt & Taylor, Wilmington, Eliot Lauer (argued), Benard V. Preziosi, Jr. (Curtis, Mallet-Prevost, Colt & Mosle, New York City, of counsel), for appellees/cross-appellants.

Before CHRISTIE, C.J., HORSEY and MOORE, JJ.

MOORE, Justice.

This consolidated appeal challenges the results of a statutory appraisal of Rapid-American Corporation ("Rapid") which awarded certain dissenting shareholders $51.00 per share. On January 31, 1981, Rapid and R.K. Holding Corporation merged into Kenton Corporation ("Kenton"). After the merger, Rapid was transformed into a privately-held corporation. Meshulam Riklis and his family acquired 60% of Rapid through his controlling interest in Kenton. Carl H. Lindener, Riklis' partner, obtained the other 40% of Rapid's shares through his controlling interest in American Financial Corporation ("AFC").

Appellees and cross-appellants ("Harris"), owned 58,400 shares of Rapid before the merger. Harris brought a statutory appraisal action pursuant to 8 Del.C. § 262, contesting the merger consideration. The merger price included cash and securities worth approximately $28.00 per share. After a trial in the Court of Chancery, the court awarded Harris $51.00 per share plus simple interest. See *Harris v. Rapid American Corp.,* Del.Ch., C.A. No. 6462, Chandler, V.C., slip op. at 43, 1990 WL 146488 (Oct. 2, 1990).

Rapid now challenges the trial court's decision to award Harris $51.00 per share. It claims that the results of the appraisal are unrealistic because the $51.00 award represents a 200% premium over Rapid's unaffected market price at the time of the merger. Rapid maintains that the trial court's error was the result of its decision to adopt Harris' valuation technique. Rapid claims that Harris' appraisal methodology violated Delaware law.

Harris further claims that the trial court erred when it failed to include a "control premium" in its valuation of Rapid. Harris argues that the inclusion of a "control premium" was necessary to compensate Rapid's shareholders for their 100% ownership in three operating subsidiaries. Harris also challenges the award of simple interest. He urges us to adopt a "rule" presumptively requiring the trial court to award only compound interest pursuant to 8 Del.C. § 262(i).

After carefully examining the record, we affirm the trial court's decision to adopt Harris' valuation technique. Harris' methodology does not contravene Delaware law. We also affirm the trial court's decision to award Harris simple interest. The unambiguous statutory language of 8 Del.C. § 262(i) gives a court broad discretion to award either compound or simple interest. We reject any attempt to artificially fashion a "rule" upsetting the legislature's clear intent.

Finally, we reverse the denial of a "control premium" to Harris. We find that the trial court had an affirmative duty to consider the nature of the enterprise as an element of its valuation. Rapid, as a parent company owning a 100% interest in three valuable subsidiaries, was entitled to an adjustment of its inherent value as a going concern to reflect the economic reality of its structure at the corporate level. The valuation technique the trial court applied artificially discounted Rapid's ownership interest in its subsidiaries and deprived all of Rapid's shareholders of fair value.

We decline, however, to consider Harris' claim that the inclusion of the "control premium" merited an adjustment of Rapid's fair value to $73.28 per share. Instead we remand this case back to the Court of Chancery for a recalculation of Rapid's fair value. The trial court should consider the "control premium," together with all traditional "relevant factors," to determine if Harris is entitled to anything more than his original $51.00 per share award.

I.

The underlying facts of this case are not in serious dispute. Rapid was a publicly-held conglomerate receiving 99% of its net sales and most of its operating profits from three wholly-owned subsidiaries. These subsidiaries included the McCrory Corporation ("McCrory"), Schenley Industries, Inc. ("Schenley"), and McGregor-Duniger, Inc. ("McGregor"). Rapid and each subsidiary had a full and distinct set of executives and operating officers. All of the subsidiaries maintained independent financial reports and records.

McCrory was Rapid's largest subsidiary. It was responsible for over half of Rapid's net sales and operating profits. McCrory was basically a retailing company owning such well-known subsidiaries and divisions as Lerner Shops, McCrory, and J.J. Newberry Stores. McCrory also held interests in other retailing and merchandising operations.

Schenley, Rapid's second largest subsidiary, was a distiller, importer and distributor of alcoholic spirits. It generated approximately 25% of Rapid's net sales and operating profits. Finally, McGregor was Rapid's smallest subsidiary. A clothing manufacturer and distributor, it generated less than 1% of Rapid's net sales and operating profits.

Rapid, as a whole, was burdened with a significant amount of debt before the merger. It was capitalized with close to 75% in long-term and short-term debt. Prior to the merger, Rapid carried the debt at market value instead of its face amount and book value. Apparently, the market value of Rapid's debt was deeply discounted because it was subject, at that time, to a significantly low rate of interest. At the parent level, Rapid also held certain valuable assets including a substantial art collection.

A.

The merger transaction leading to the appraisal began in 1974. At that time, Riklis, Rapid's CEO and Chairman, began to purchase Rapid's shares in the open market through his interests in Kenton and AFC. Rapid also contemporaneously began to repurchase large blocks of its own shares. The repurchase program ultimately *800 increased Riklis' control of Rapid's outstanding shares.

On April 11, 1980, Rapid announced that it had agreed to merge with Kenton into a newly reformed Rapid-American corporation. On the eve of the merger, Kenton and AFC controlled 46.5% of Rapid's outstanding stock. After the merger was effectuated on January 31, 1981, Rapid's shareholders received a compensation package worth approximately $28. The compensation included $45 principal in a newly-issued 10% sinking fund subordinated debenture, $3 in cash and an additional $.25. This nominal cash fee represented settlement consideration for certain pending derivative suits.

Rapid employed an independent Transaction Review Committee ("TRC") to evaluate the merger price. The TRC retained Bear Stearns & Co. to provide financial advice. The TRC also employed Standard Research Consultants ("SRC") to determine, among other things, the fairness of the proposed transaction to Rapid's shareholders. Arthur H. Rosenbloom, SRC's head consultant and expert witness at trial, led the investigation. The examination continued for approximately six months. SRC ultimately concluded that the $28.00 compensation package was fair to Rapid's shareholders.

SRC's valuation technique considered Rapid on a consolidated basis. It evaluated Rapid based on an analysis of earnings and dividends. Harris, slip op. at 7. SRC calculated price/earnings ratios for each subsidiary and adjusted its figures to include certain dividend ratios. It figured each subsidiaries' contribution to the parent's operating

income for a set period of time to calculate Rapid's ultimate value. SRC then tested its figures against various established financial ratios of similarly situated corporations. Id.

Harris retained Willamette Management Associates, Inc. ("WMA") to evaluate the merger consideration. In contrast to SRC's technique, WMA separately evaluated each of Rapid's subsidiaries. WMA reasoned that its "segmented" approach to valuation was particularly appropriate because of the difficulty of finding a conglomerate comparable to Rapid.

The trial court carefully considered both the SRC and WMA analyses. The court rejected SRC's approach, ruling that WMA's "segmented" comparative valuation was more reliable. The court specifically noted that after considering the "voluminous" record, WMA's methodology was "by far the most reliable analysis presented in this appraisal action." *Harris,* slip op. at 21. The court found that SRC's evaluation suffered from a number of defects including its failure to consider that Rapid had adjusted its accounting techniques during the relevant time period. Id. at 7-18. The court also faulted SRC for its decision not to treat Rapid on a debt-free basis. Id. Finally, the court explicitly rejected SRC's valuation, and held that it violated Delaware law. Id. at 16. The court found that SRC's valuation technique "determined the value of [Harris'] shares as freely trading minority shareholders instead of considering Harris' proportionate (1.5%) [sic] interest in Rapid as a going concern...." Id.

The court adopted a modified version of WMA's valuation technique in a highly detailed, forty-three page opinion. It then ruled that Rapid's fair value at the time of the merger was $51.00 per share. See id. at 43. The trial court also awarded Harris 12.75% simple interest. Id.

B.

The Court of Chancery adopted WMA's comparative analysis. Id. at 19. It examined each of Rapid's subsidiaries as a separate entity. Id. It then compared the subsidiaries to a group of comparable publicly-traded companies. Id.

WMA examined the financial statements of the subsidiaries and the comparables to develop certain pricing multiples. Id. at 20 These multiples were based on revenues, pre-interest and tax earnings, earnings "before depreciation, amortization, interest and taxes [and] tangible book value of invested capital...." Id. WMA specifically treated each subsidiary and comparable on a debt-free basis in an effort to factor out the vagaries of "managerial discretion" and to treat the companies on a "level playing field." Id. The analysis yielded a market value of invested capital for each segment. Id. The trial court also considered an average of the subsidiaries' financials for the five years preceding the merger, but placed special emphasis on the twelve months before the merger. Id. at 20-21. After calculating the market value of invested capital for each segment, the court subtracted out the market value of all senior debt and preferred equity to calculate the value of each segment's common equity. Id. at 13, 21. The trial court also considered "various parent-level" factors. Id.

The Vice Chancellor rejected WMA's inclusion of a "control premium" in its final evaluation of each Rapid subsidiary. Id. at 21-22. It found that the addition of a "control premium" violated Delaware law. Id. at 29, 35, 38. The court reasoned that the "control premium" contravened the proscription against weighing factors affecting valuation "at the shareholder level." Id. at 29.

II.

We now turn to the merits of Rapid's appeal. Rapid launches a complex and detailed attack on the trial court's decision to award Harris $51.00 per share. Despite its breadth, Rapid's argument ultimately reduces to one fundamental point. It maintains that the trial court erroneously relied on WMA's "segmented" valuation technique instead of employing SRC's methodology.

Rapid first claims that its valuation did not violate Delaware law and was more reliable than Harris' computation. It then proposes that WMA's valuation contravened Delaware law and improperly neglected to consider certain specific aspects of Rapid's financial structure. Rapid makes four specific arguments. It contends that: (1) WMA's valuation incorrectly included a "control premium"; (2) WMA's valuation was erroneously based upon a "break-up" or liquidation value of Rapid's subsidiaries; (3) WMA only valued Rapid's subsidiaries and did not consider the value of the parent; and finally (4) WMA's valuation techniques only treated Rapid's debt at its market value and not at its book value.

Harris argues that WMA's technique was not violative of Delaware law. He maintains that WMA's valuation methodology was inherently more reliable.

A.

We first note that the parties dispute the applicable standard of review. Rapid urges us to exercise de novo plenary review.

Rapid contends that the trial court committed legal error when it ruled that SRC's valuation contravened Delaware law. Rapid claims that the court misinterpreted the trial testimony of its expert, Rosenbloom, that SRC quantified Rapid as its "value to the minority shareholder representing a freely traded minority interest, with neither premium for control nor discount for lack of marketability or minority interest." Rapid also argues that the WMA analysis suffers from a number of fundamental defects. It concludes that the trial court must have contravened Delaware appraisal law by adopting WMA's supposedly flawed technique.

Harris maintains that we can only examine the record for an abuse of discretion. He characterizes the trial court's decision to adopt the modified WMA approach as a mixed question of law and fact. Harris concludes that the trial court's ultimate decision reflected a choice between the competing views of experts.

1.

We agree with Harris' assessment of the issues presented in this aspect of Rapid's appeal. Rapid's claim that the trial court committed legal error is unconvincing for two reasons. First, Rapid only argues that the court mistakenly thought that the SRC valuation applied a minority discount at the shareholder level. It only quarrels with the Vice Chancellor's interpretation of trial testimony. Rapid does not recognize that Delaware law entrusts the assessment of trial witnesses in an appraisal action to the discretion of the fact-finder. See *Kahn v. Household Acquisition Corp.,* Del.Supr., 591 A.2d 166, 175 (1991); *Alabama By-Products Corp. v. Neal,* Del.Supr., 588 A.2d 255, 258-59 (1991); *Cavalier Oil Corp. v. Harnett,* Del. Supr., 564 A.2d 1137, 1146 (1989). We can only examine the trial judge's alleged failure to "understand" expert trial testimony in this case for an abuse of discretion. Id.

Second, Rapid implies that the court rejected its valuation solely because of the Vice Chancellor's supposed misinterpretation of Rosenbloom's testimony. Rapid's argument is somewhat disingenuous. The trial court explicitly stated that it rejected SRC's valuation for "several reasons." *Harris,* slip op. at 18. The court also noted that it accepted the WMA method because SRC's valuation did not treat Rapid on a debt free basis or make a LIFO/FIFO adjustment. Id. at 19.

Rapid's objection to the trial court's adoption of WMA's valuation also attacks the application of law to the facts. It does not follow, however, that a trial court commits legal error every time it adopts a view of the evidence contrary to that held by the losing party.

2.

It is well-settled that we accord "a high level of deference" to a trial court's determination of value in a statutory appraisal proceeding. See *Kahn,* 591 A.2d at 175; *Alabama By-Products,* 588 A.2d at 258-59; *Cavalier,* 564 A.2d at 1146. It is frequently the case in appraisal proceedings that valuation disputes become a battle of experts. Id. We have noted that the trial judge, as finder of fact in appraisal cases, enjoys the unique opportunity to examine the record and assess the demeanor and credibility of witnesses. Id. Accordingly, we will overturn an appraisal decision only if the trial court abused its discretion. Id. A court abuses its discretion in an appraisal proceeding when its factual findings do not have record support and its valuation is not the result of an orderly and logical deductive process. See *Alabama By-Products,* 588 A.2d at 259 (citing *Levitt v. Bouvier,* Del.Supr., 287 A.2d 671, 673 (1972)).

B.

We now turn to the specific merits of Rapid's appeal to determine whether the trial court abused its discretion. We first consider Rapid's claim that the court's "segmented" valuation technique violated Delaware law because it supposedly assessed Rapid's

value on a liquidation basis instead of considering it as a going concern.[1] Rapid argues that the court's valuation approach was identical to the liquidation technique rejected in *Bell v. Kirby Lumber Corp.,* Del.Ch., 395 A.2d 730 (1978), modified, Del.Supr., 413 A.2d 137 (1980).

1.

We start with a brief overview of the law. It is now "axiomatic" that in a statutory appraisal proceeding, the dissenting shareholders are entitled to receive "fair value" representing their "proportionate interest in a going concern." Cavalier, 564 A.2d at 1144 (quoting *Tri-Continental Corp. v. Battye,* Del.Supr., 74 A.2d 71, 72 (1950)). The court must consider "all relevant factors" to determine "fair value" exclusive of "post-merger events or other possible business combinations." See 8 Del.C. § 262(h); *Kahn,* 591 A.2d at 174; *Alabama By-Products,* 588 A.2d at 257-58; *Cavalier,* 564 A.2d at 1144; *Weinberger v. UOP, Inc.,* Del.Supr., 457 A.2d 701, 713 (1983).

Bell best illustrates the law. Kirby Lumber Corporation ("Kirby"), the company subject to the appraisal in Bell, was a manufacturing concern primarily engaged in the production of lumber and plywood. *Bell,* 395 A.2d at 732. Kirby also held a vast acreage of timberland. Id. at 733. Kirby harvested the timber on a "sustained yield" basis to maintain a steady and constant supply of natural resources for its wood production operations. Id.

The dissenting shareholders argued that the court should have evaluated Kirby on its acquisition value. Id. at 735-36. They claimed that Kirby's natural resources were much more valuable than its worth as an on-going concern. Id. The dissenters thus maintained that the court should have set Kirby's "fair value" at the price a third party would have paid for the company instead of relying on an evaluation of earnings or market price. Id.

The trial court rejected the dissenters' argument. Id. at 736. It reasoned that the liquidation value incorrectly assumed that Kirby would not have continued in its pre-merger form as an on-going concern. Id. This Court affirmed. *Bell,* 413 A.2d at 142. We agreed that the dissenters' liquidation approach violated the statute and improperly failed to consider Kirby's value apart from its acquisition value. Id.

2.

We find nothing in the record to convincingly support the claim that the court's "segmented" valuation technique was either identical or even similar to the liquidation approach rejected in Bell. The modified WMA valuation explicitly considered Rapid's subsidiaries as going concerns. See *Harris,* slip op. at 34-35. It placed special emphasis on financial data cumulated from operating results and not liquidation values. Id. at 19-22.

[1] We consider the merits of Rapid's critique of the trial court's "controlling person/control premium" analysis infra at Part III.

The "segmented" technique itself also did not manifest a liquidation analysis. Instead, the "segmented" approach best mirrored economic reality. Indeed, even Riklis admitted that "Rapid's value is best found in the sum of its parts." Id. at 10.

Riklis is right. The record fully supports our conclusion that the "segmented" valuation did not involve consideration of Rapid's break-up value. Instead, the court independently valued Rapid's three major subsidiaries according to their value as going concerns. There was no abuse of discretion.

3.

Rapid also challenges the trial court's decision not to consider its inherent value as a parent within WMA's "segmented" accounting technique. The record, however, indicates that WMA not only considered Rapid's parent-level financials, but that the trial court explicitly decided to exclude them. The court, after considering the record, held:

> I accept petitioner's determination that Rapid's parent-level revenues, assets and expenses amounted to a wash ... [p]etitioners' determination that these assets and expenses effectively cancel each other out is reasonable and has not been contradicted by respondents' evidence.

Harris, slip op. at 42.

Our review of the record also indicates that there was no need to add Rapid's parent-level considerations to its "fair value." The parent-level financial data is inconclusive and does not significantly affect the trial court's analysis. Again, there was no abuse of discretion.

4.

Rapid finally contests WMA's evaluation of its debt. Rapid faults the trial court for its decision to net out its debt to facilitate the "segmented" comparative analysis. Rapid also argues that the trial court artificially inflated Rapid's fair value when the court calculated equity value by subtracting the market value and not the higher book value of its debt. Rapid concludes that the court should not have considered its debt at market value because the discount between market and book value is only relevant upon an acquisition and liquidation. Rapid's argument is not persuasive.

Initially we note that Rapid did not explicitly object at trial to WMA's debt-free valuation. The court found that "[r]espondents have not objected to Willamette's debt-free valuation." Harris, slip op. at 13. Rapid's appeal of this valuation issue therefore is barred under Supreme Court Rule 8. In any event, the court did not abuse its discretion when it adopted WMA's debt-free approach.

The face value of Rapid's debt at the time of the merger was $652,589,000, while the contemporaneous market value of the same debt was $356,154,000. The court was

free to consider the realities of the market place in its evaluation of Rapid's intrinsic value. See, e.g., *Alabama By-Products,* 588 A.2d at 258; *Cavalier,* 564 A.2d at 1142-43; *Weinberger,* 457 A.2d at 713. In view of the well-established principle that a court can consider "all relevant factors" affecting value, there was no abuse of discretion in taking account of the market value of Rapid's debt.

5.

In sum, we find that the trial court did not abuse its discretion when it adopted a modified form of the WMA "segmented" valuation approach to determine the "fair value" of Rapid's shares before the merger. The "segmented" technique considered each subsidiary as a going concern. It did not attempt to ascertain Rapid's liquidation value.

The trial court also explicitly considered Rapid on its parent level. After considering the voluminous trial record, the court was convinced that the parent-level considerations were a "wash" and did not significantly impact Rapid's ultimate value. Finally, the court properly considered Rapid's debt at its market value. Far from constituting an abuse of discretion, the trial court's analysis of the debt issue reflected a proper consideration of market realities.

Accordingly, we affirm these three aspects of the trial court's decision.

III.

We now consider the merits of Harris' cross-appeal. The trial court determined the publicly traded equity ("PTE") value of Rapid's shares after adopting WMA's "segmented" comparative valuation technique. See Harris, slip op. at 22-38. The court, however, refused to add a "control premium" to the PTE for each of Rapid's operating subsidiaries. The court, citing Cavalier, reasoned that adding a "control premium" violated 8 Del.C. § 262 because it contravened the general proscription against weighing any additional factors affecting valuation "at the shareholder level." Id. at 29, 35, 38.

Harris claims that the trial court's decision to exclude a "control premium" constituted legal error. He argues that the court should have considered and valued Rapid's 100% interest in its subsidiaries. Harris maintains that WMA's valuation technique only compared its subsidiaries' PTE's with the individual shares of similar corporations trading in the market. He notes that the market price of these comparable corporations are discounted and do not reflect a control premium. Harris concludes that the trial court effectively treated Rapid as a minority shareholder in its wholly-owned subsidiaries. Harris contends that the trial court gave the new, privately-held Rapid, a windfall at his expense.

Rapid claims that the trial court did not commit error. Rapid, citing to Cavalier and Bell, argues that the addition of a control premium violates Delaware law because it takes into account Rapid's liquidation value. In sum, Rapid assumes that it could not realize a

"control premium" unless it was sold to a third party. Rapid also argues that Harris only owned 1.2% of its outstanding shares and factually was not entitled to realize a "control premium."

A.

In this respect the trial court's decision implicated a question of law. We review such matters de novo to determine whether the trial court "erred in formulating or applying legal precepts." *Gilbert v. El Paso Co.,* Del.Supr., 575 A.2d 1131, 1142 (1990); Cavalier, 564 A.2d at 1141. After reviewing the entire record, we conclude that the trial court misinterpreted applicable legal precepts by erroneously omitting the "control premium."

B.

A stock appraisal is a statutory remedy. See *Alabama By-Products,* 588 A.2d at 256; *Cede & Co. v. Technicolor, Inc.*, Del. Supr., 542 A.2d 1182, 1186 (1988); *Weinberger,* 457 A.2d at 714. The statute contemplates that a reviewing court must exclude from its calculations "any element of value arising from the accomplishment or expectation of the merger or consolidation...." 8 Del.C. § 262(h).

This Court, in accordance with the statutory mandate, has consistently held that a dissenting stockholder in an appraisal action is only entitled to "that which has been taken from him [or, in other words] his proportionate interest in a going concern." Tri-Continental, 74 A.2d at 72; see also *Cavalier,* 564 A.2d at 1144; *Cede,* 542 A.2d at 1186; *Weinberger,* 457 A.2d at 714. Two distinct but related concepts emerge from the statutory scheme. First, a court cannot assign value to any "speculative" events arising out of the merger or consolidation. See *Cavalier,* 564 A.2d at 1144; *Cede,* 542 A.2d at 1187; *Weinberger,* 457 A.2d at 714. Second, the court must value the dissenter's proportionate interest in the corporation as a "going concern" taking into account all other "relevant factors" affecting value. Id. See *Bell,* 413 A.2d at 142. In accordance with this principle, a court cannot adjust its valuation to reflect a shareholder's individual interest in the enterprise. As *Cavalier* succinctly states:

> The dissenting shareholder's proportionate interest is determined only after the company as an entity has been valued. In that determination the [trial court] is not required to apply further weighing factors at the shareholder level, such as discounts to minority shares for asserted lack of marketability.

564 A.2d at 1144 (emphasis added).

Rapid, in apparent agreement with the trial court, seizes upon *Cavalier*, and argues that the phrase "such as" similarly prohibits a court from adding "a control premium" at the shareholder level. Rapid indicates that adding a control premium at the shareholder level violates this Court's decision in *Bell*. It reasons that a control premium typically only "arises out" of the merger and is not part of Rapid's going-concern value.

We disagree with the trial court's characterization of the "control premium" in this case as an impermissible shareholder level adjustment. Its reliance on *Cavalier* and *Bell* is misplaced. The "control premium" Harris urged the trial court to adopt represented a valid adjustment to its valuation model which "applied a [bonus] at the company level against all assets...." *Cavalier,* 564 A.2d at 1144.

C.

Weinberger recognized that there is no one exclusive means of assigning value to a Delaware corporation for purposes of an appraisal. 457 A.2d at 713-14. It interpreted the statutory language "all relevant factors" to include a multitude of non-speculative considerations. Id. 8 Del.C. § 262(h). Of course, one of the most important factors to consider is the very "nature of the enterprise" subject to the appraisal proceeding. Id.; see *Cavalier,* 564 A.2d at 1144-45; *Tri-Continental,* 74 A.2d at 72, 73.

Tri-Continental recognized that a court had the authority to discount the value of the enterprise at the corporate level. 74 A.2d at 76. The company appraised in Tri-Continental was a leveraged closed-end mutual fund. Id. at 73. The court understood that the shares of a leveraged closed-end mutual fund ordinarily trade at a discount of its underlying assets. Id. at 76. The court concluded:

> [T]he full value of the corporate assets to the corporation is not the same as the value of those assets to the common stockholder because of the factor of discount. To fail to recognize this conclusion... is to fail to face the economic facts and to commit error.

Id. (Emphasis added).

Cavalier also recognized the importance of assigning a realistic market value to the appraised corporation. 564 A.2d at 1144. Cavalier claimed that the *Tri-Continental* decision authorized shareholder level discounts to devalue the shares of the minority dissenters. The Court rejected that argument. It correctly interpreted *Tri-Continental* as standing for the proposition that an appraisal valuation must include consideration of the unique nature of the enterprise. Id. It drew the important distinction between assigning value at the corporate level and the shareholder level. Id. Cavalier authorized corporate level discounting as a means of establishing the intrinsic value of the enterprise. Id. at 1144. The court, however, rejected shareholder level discounting. It found that an appraisal explicitly considering the minority discount at the shareholder level both injects speculative elements into the calculation, and more importantly:

> [F]ail[s] to accord to a minority shareholder the full proportionate value of his shares [which] imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder, a clearly undesirable result.

Id. at 1145.

Rapid misses the fundamental point that Harris was not claiming a "control premium" at the shareholder level. Harris urged the trial court to add a premium at the parent level to compensate all of Rapid's shareholders for its 100% ownership position in the three subsidiaries. WMA's valuation technique arrived at comparable values using the market price of similar shares. These shares presumptively traded at a price that discounted the "control premium."

The trial court's decision to reject the addition of a control premium within the WMA valuation model placed too much emphasis on market value. Indeed, the Court of Chancery long ago rejected exclusive reliance upon market value in an appraisal action. See *Chicago Corp. v. Munds,* Del. Ch., 172 A. 452, 455 (1934); see also *Tri-Continental,* 74 A.2d at 72. *Munds,* referring to the 1929 market crash, found:

> The experience of recent years is enough to convince the most causal observer that the market in its appraisal of values must have been woefully wrong in its estimates at one time or another within the interval of a space of time so brief that fundamental conditions could not possibly have become so altered as to affect true worth.

172 A. at 455. *Munds* continued:

> [I]f the market quotations are lower than what all the relevant facts that bear on value show it to have been worth, he should not be compensated according to the market's estimate.

Id. at 456.

Munds' succinct evaluation of the market has lost none of its lustre. Recent price changes in the stock market dramatically illustrate the defects of an overstated reliance on market price to determine a corporation's intrinsic value in an appraisal proceeding. Cf. Application of Del. Racing Assoc., Del.Supr., 213 A.2d 203, 211 (1965) (emphasizing importance of considering market value in appraisal but nonetheless rejecting exclusive reliance on market price). While we do not fault the WMA valuation methodology, we do find that the trial court's decision to exclude the control premium may have inadvertently altered the reliability of its findings.

Rapid was a parent company with a 100% ownership interest in three valuable subsidiaries. The trial court's decision to exclude the control premium at the corporate level practically discounted Rapid's entire inherent value. The exclusion of a "control premium" artificially and unrealistically treated Rapid as a minority shareholder. Contrary to Rapid's arguments, Delaware law compels the inclusion of a control premium under the unique facts of this case.[2] Rapid's 100% ownership interest in its

[2] We are fully aware of the Court of Chancery's decision in *Cede & Co. v. Technicolor, Inc.,* Del. Ch., Civ.A. No. 7129, Allen, C. 1990 WL 161084 (Oct. 19, 1990), which explicitly rejected the inclusion of a "control premium" in a calculation of the intrinsic value of dissenting shares. Id. at 50-52 & n. 41. We note that *Cede* is factually distinguishable and did not consider a corporate level "control premium." We now express no view on the particular merits of the trial court's holding in *Cede,* a case in which an appeal is now pending before this Court.

subsidiaries was clearly a "relevant" valuation factor and the trial court's rejection of the "control premium" implicitly placed a disproportionate emphasis on pure market value. See *Weinberger,* 457 A.2d at 712-13; *Munds,* 172 A. at 456.

We also reject Rapid's implicit claim that the inclusion of a "control premium" violates our decision in Bell. Rapid seems to contend that a "control premium" is only payable when the corporation is liquidated. It concludes that the addition of a "control premium" incorrectly inflates Rapid's worth to an acquisition value instead of pricing its inherent value as a going concern.

We reject Rapid's arguments because Bell is easily distinguishable on its facts. Unlike Bell, the WMA valuation technique did not assume that an acquiror would liquidate Rapid. WMA's valuation technique added the "control premium" to reflect market realities. Rapid may have had a different value as a going concern if the court had considered that it enjoyed a 100% interest in its three major subsidiaries.

We recognize that the term "control premium" may be misleading here. The past decade has proven that an acquiror is often willing to pay a "control premium" in return for a majority interest in a corporation. Nonetheless, the WMA valuation technique utilized the control premium as a means of making its valuation more realistic. Under the circumstances presented here, the trial court was under a duty to assess the value of Rapid's full ownership in its subsidiaries.

Harris also argues that the control premium increases Rapid's fair value to $73.28 per diluted share, and urges us to adopt that sum on appeal. The trial court explicitly rejected the control premium without analysis. It now must reconsider that action. There is no basis for us to adopt Harris' claimed valuation.

Accordingly, we reverse the Court of Chancery and remand. The court must consider the "control premium," together with all other traditional valuation elements, and determine what, if any, additional value is to be ascribed to Harris' stock above the $51.00 per share initial finding.

IV.

We next turn to the second and final aspect of Harris' cross-appeal. Harris claims that the trial court abused its discretion by awarding him 12.75% simple interest. The trial court, after considering Harris' arguments, decided "not to depart from this Court's standard practice of allowing only simple interest." *Harris,* slip op. at 43. Harris now claims that the trial court abused its discretion in awarding only simple interest because it did not state a rationale for its ruling. Harris claims that the trial court ignored the recently amended language in 8 Del.C. § 262(i) which provides that "[i]nterest may be simple or compound, as the Court may direct." Id.

Harris, citing to two decisions from other jurisdictions, *In re Valuation of Common Stock of McLoon Oil Co.*, Me.Supr., 565 A.2d 997, 1007-08 (1989), and *Sarrouf v. New*

England Patriots Football Club, Inc., Supr., 397 Mass. 542, 492 N.E.2d 1122, 1128-29 (1986), urges this Court to adopt a "rule" presumptively awarding compound interest in every appraisal case. Harris claims that the Court should adopt this "rule" for three basic reasons. First, he argues that dissenting shareholders, unlike other investors, are deprived of their investment during the pendency of the appraisal proceeding. Harris concludes that no "prudent investor" would select a long term investment paying only simple interest. Second, he maintains that the respondent corporation has the unfair use of the dissenter's resources during the appraisal proceeding and, unlike a commercial bank, should not be allowed to pay only simple interest. Finally, Harris argues that awarding simple interest only encourages investors to settle appraisal cases, and prevents them from legitimately vindicating their rights under the statute.

Rapid claims that the trial court did not abuse its discretion. Extrapolating from *Felder v. Anderson, Clayton & Co.,* Del. Ch., 159 A.2d 278, 286 (1960), Rapid suggests that Delaware law now provides that courts presumptively award simple interest in an appraisal case unless the dissenters *808 prove that the respondent corporation either prolonged the appraisal in bad faith, or somehow acted inequitably in relation to the valuation.

A.

We note that 8 Del.C. § 262(i) vests the trial court with the discretion to decide whether to award simple or compound interest. We review the trial court's decision to award Harris simple interest for an abuse of discretion. See *Kahn,* 591 A.2d at 175; *Alabama By-Products,* 588 A.2d at 258-59; *Cavalier,* 564 A.2d at 1146. After carefully viewing the record in this case, we do not find any abuse of discretion by the trial judge's award of simple interest.

B.

We recognize that no Delaware case has ever explicitly considered the factors which determine whether a court should award either compound or simple interest.[3] The starting point of any analysis, however, must begin with the statutory corporation law. When the law is clear, our analysis usually ends with the statute itself. See, e.g., *Staar Surgical Co. v. Waggoner,* Del. Supr., 588 A.2d 1130, 1137 n. 2 (1991); *Alabama By-Products Corp.,* 588 A.2d at 258 n. 1.

The recent amendment to the appraisal statute is clear and precise. It provides:

> The Court shall direct the payment of the fair value of the shares, together with interest, if any, by the surviving or resulting corporation to the stockholders entitled thereto. Interest may be simple or compound, as the Court may direct.

[3] See, e.g., *Cede,* slip op. at 70-82; *Pinson v. Campbell-Taggart, Inc.,* Del.Ch., C.A. No. 7499, Jacobs, V.C., 1989 WL 17438 (Feb. 28, 1989); *Charlip v. Lear Siegler, Inc.,* Del.Ch., C.A. No. 5178, Walsh, V.C., 1985 WL 11565 (July 2, 1985).

8 Del.C. § 262(i) (emphasis added). We reject both Harris' and Rapid's arguments because 8 Del.C. § 262(i) clearly gives the trial court absolute discretion to determine the form of interest it will award in a statutory appraisal action.

Harris' argument turns the permissive language of the statute into a mandatory requirement necessitating the award of compound interest in all cases. The arguments Harris raises in support of his "rule" could apply in every successful statutory appraisal action. The General Assembly certainly recognized this fact when it amended the statute in 1987. The legislature easily could have eliminated the provision mentioning simple interest and mandated an award of only compound interest. Harris' "rule" thus strips the statute of its clear and unambiguous meaning.

Rapid's "extrapolation" of the dictum in *Felder* is no more convincing. Indeed, Rapid's "bad faith" analysis intrudes on the purpose of an appraisal action. We have repeatedly emphasized that a statutory appraisal action is merely a method for dissenting shareholders to receive an independent judicial evaluation of the fair value of their shares. *Alabama By-Products,* 588 A.2d at 256; *Cede,* 542 A.2d at 1186; *Weinberger,* 457 A.2d at 714. We have recognized that allegations of fraud and bad faith have a limited place in a statutory appraisal action. See *Alabama By-Products,* 588 A.2d at 258 & n. 1 (court can consider claims of bad faith to assess credibility of trial witnesses).

A derivative suit alleging bad faith and a statutory appraisal are two distinct causes of action. Id.; see *Cede,* 542 A.2d at 1187; *Rabkin v. Philip A. Hunt Chemical Corp.,* Del.Supr., 498 A.2d 1099, 1107-08 (1985). Rapid's argument upsets this dichotomy. It requires the court to explicitly consider allegations of bad faith to adjust the amount of the award. We have clearly ruled that the purpose of an appraisal action is not to punish the respondent corporation. See *Tri-Continental,* 74 A.2d at 72. The court must only award interest to fairly compensate dissenting shareholders for their losses incurred during the pendency of an appraisal. There is no punitive aspect of an appraisal proceeding.

Under 8 Del.C. § 262(i) the trial court is vested with the clear discretion to award either simple or compound interest. It must take into account "all relevant factors" in reaching its decision. While not exhaustive, some of these factors can include the considerations enumerated in 8 Del.C. § 262(h). See 8 Del.C. § 262(h) ("[i]n determining the fair rate of interest, the Court may consider ... the rate of interest which the surviving or resulting corporation would have to pay to borrow money during the pendency of the proceeding.")

The trial court had the opportunity to fully consider the merits of Harris' claim in post-trial briefing. It also had the opportunity to hear expert testimony and evaluate the credibility and demeanor of witnesses throughout this lengthy trial. In view of the trial court's broad powers under 8 Del.C. § 262(i), there clearly was no error or abuse of discretion in awarding Harris simple interest.

Based on the foregoing, the judgment of the Court of Chancery is AFFIRMED IN PART AND REVERSED IN PART. The matter is REMANDED to the Court of Chancery for further proceedings consistent herewith.

114 T.C. No. 9

UNITED STATES TAX COURT

ESTATE OF CHARLES E. REICHARDT, DECEASED,
WILLIAM D. REICHARDT, INDEPENDENT EXECUTOR, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 1224-98. Filed March 1, 2000.

Decedent (D) had two children, C and W. On June 17, 1993, D formed a revocable family trust (the trust) and a family limited partnership (the partnership). The trust was the general partner of the partnership. D, C, and W were named cotrustees, but only D performed any functions as trustee.

D transferred his residence and all of his other property (except for his car, personal property, and some cash) to the partnership through the trust. D's transfer was not a bona fide sale for full and adequate consideration. On Oct. 22, 1993, D gave C and W each a 30.4-percent interest in the limited partnership. D retained possession and enjoyment of and the right to income from the property he transferred to the partnership until he died on Aug. 21, 1994.

Held: The fair market value at D's date of death of assets D transferred to the partnership is included in D's gross estate. See sec. 2036(a), I.R.C.

Rex B. Cruse, Jr., and S. Jeffrey Gately, for petitioner.

Deborah H. Delgado, T. Richard Sealy III, and James G. MacDonald, for respondent.

COLVIN, Judge: Respondent determined that petitioner is liable for a deficiency in gift tax of $161,494 for gifts made by decedent in 1993 and a deficiency in estate tax of $358,771. After concessions,[1] the issue for decision is whether assets that decedent transferred to the partnership are included in his gross estate under section 2036(a). We hold that they are, and that the fair market value of those assets was $1,634,654 when decedent died.[2]

[1] Respondent no longer contends that (1) the partnership is a sham or that (2) the duty of consistency or sec. 2703(a)(2) applies here. Petitioner's motion to shift the burden of proof regarding those theories is moot.

[2] In light of this holding, we need not decide whether, as respondent contends, (1) the assets transferred to the partnership are included in decedent's gross estate under sec. 2038, (2) any "applicable restriction" in the partnership agreement is disregarded under sec. 2704(b), (3) lapsed liquidation rights are included in decedent's gross estate under sec. 2704(a), or (4) decedent did not make another gift to his children in 1994.

Unless stated otherwise, section references are to the Internal Revenue Code. Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

A. Decedent and His Family

Decedent was married to Jessie Glenn Reichardt (Mrs. Reichardt). They had two children, Carolyn A. Reichardt Foose (Carolyn Foose) and William D. Reichardt (William Reichardt). Mrs. Reichardt died at age 77 on December 6, 1991. Decedent lived at 214 Encino, Alamo Heights, San Antonio, Texas (214 Encino), when he died on August 21, 1994.

B. Mrs. Reichardt

1. Mrs. Reichardt's Inheritance

Mrs. Reichardt graduated from Rice University in Houston, Texas. Her father died in 1971. Mrs. Reichardt handled her own business affairs. Mrs. Reichardt inherited from her father an undivided one-half interest in several parcels of real property in Kleberg and Nueces Counties, Texas, and various securities. Mrs. Reichardt's sister, Ruth Welch (Welch), inherited the other one-half interest in the property.

Mrs. Reichardt's uncle, Jessie Dennett, died in 1973. Mrs. Reichardt inherited from Jessie Dennett a one-half undivided interest in real property in Kleberg County, Texas, and a one-

third undivided interest in real property in San Patricio and Cameron Counties, Texas. Welch inherited the other one-half interest in the Kleberg County property. Welch and Mrs. Reichardt's cousin, Ella Gordan, also each inherited one-third interests in the San Patricio and Cameron Counties property. The Cameron and San Patricio Counties property remained in the name of the Estate of Jessie Dennett through the time of trial in this case. Mrs. Reichardt and Welch managed Mrs. Reichardt's separate property.

Mrs. Reichardt and her children knew that Mr. Reichardt was involved with another woman (not identified in the record). Mrs. Reichardt considered filing for divorce (at a time not specified in the record) but never did so.

When she died, Mrs. Reichardt's separate property included undivided interests in 22 parcels of real property in four Texas counties and some securities. Her community property included four checking accounts, a note receivable from Bruce Graham (Graham) dated November 23, 1987 (the Graham note), stock and bonds, two cars, the residence at 214 Encino, and three rental properties on Routt Street (the Routt rental property) in San Antonio.

2. Mrs. Reichardt's Will

In her will, Mrs. Reichardt left decedent all of her community property and a life interest in her separate property.

Mrs. Reichardt authorized decedent to sell, lease, or otherwise dispose of any of the property subject to the life interest on terms that he deemed advisable, without requiring him to account for or replace any of it. Her will provided that decedent would lose his life interest in her separate property if he remarried. Mrs. Reichardt left the remainder interest to her children and appointed decedent and their children as joint independent coexecutors.

3. Probate of Mrs. Reichardt's Estate

On May 17, 1993, decedent signed and filed an inventory in the probate court for his wife's estate without consulting his children. Decedent reported that Mrs. Reichardt's estate included $744,597.50 in separate property and $612,648.50 in community property (a total of $1,357,246). Decedent mistakenly reported that her estate included no real estate in Nueces County, Texas, and that some securities were both community and separate property.

In November 1993, Thomas L. Goade (Goade), a real estate appraiser retained by Mrs. Reichardt's estate, concluded that, as of September 15, 1993, her estate had $411,178.50 in community assets and $775,986.67 in separate assets (a total of $1,187,165.17). On November 30, 1993, decedent and his children, as coexecutors, filed an amended inventory using the asset values provided by Goade.

C. Decedent’s Decision To Form a Family Limited Partnership

William Reichardt met with John R. Hannah (Hannah), a certified public accountant, and asked about post mortem estate planning for his mother’s estate. Hannah recommended that the children and decedent form a family limited partnership. Decedent, who had just been diagnosed with terminal cancer, and William Reichardt met with Hannah on June 5, 1993, to discuss Mrs. Reichardt's estate.

On June 17, 1993, decedent signed his will and a durable power of attorney and formed a revocable living trust called the Reichardt Family Trust (the trust) and a family limited partnership called Reichardt Partners, Ltd. (the partnership). Decedent appointed himself and his children as cotrustees and authorized each trustee to act on behalf of the trust. The trust instrument provided that decedent was entitled to receive the net income of the trust, which was to be paid at least annually, and that he was entitled to use the corpus of the trust for his support, maintenance, health, and general welfare. The trust instrument provided that the trust property and accumulated income would be divided into as many equal shares as the number of his children when decedent died.

The trust was the partnership's only general partner.

On June 21, 1993, the Texas secretary of state approved and recorded the certificate of the partnership.

D. Transfer of Assets to the Trust and Partnership

Decedent transferred all of his property (except for his car, personal effects, and a small amount of cash[3]) to the partnership. Decedent signed deeds individually and on behalf of Mrs. Reichardt's estate transferring his and the estate's interest in 214 Encino, the Routt rental property, and the Nueces and Kleberg Counties property to the trust. He also signed deeds as trustee transferring those interests in that property to the partnership. Decedent deposited $20,540 of partnership funds in his personal checking accounts in July and August 1993. Decedent transferred to the trust, which then transferred to the partnership, (1) investment accounts at Rauscher Pierce Refsnes, Inc. (Rauscher Pierce), on June 29, 1993, and Smith Barney Shearson, Inc. (Smith Barney), on August 16, 1993, (2) the Graham note on August 12, 1993, and (3) $32,871.78 in cash on August 13, 1993.[4] Before and after the transfers, decedent's children let him control the two investment accounts, the note receivable, and the cash.

Decedent individually, and with William Reichardt and Carolyn Foose as coexecutors of Mrs. Reichardt's estate, transferred the Graham note which had been Mrs. Reichardt's and

[3] Decedent had $2,389 in his personal checking account when he died.

[4] Decedent transferred the cash directly to the partnership.

decedent's community property from Mrs. Reichardt's estate to the trust. On August 12, 1993, decedent, as trustee, conveyed the Graham note from the trust to the partnership.

On August 13, 1993, decedent transferred $32,871.78 from his two personal accounts at Frost National Bank in San Antonio to a new partnership account at that bank. Decedent received at least $20,540 of the $32,871.78 from rental income from property he had transferred to the partnership.

The Estate of Jessie Dennett made no payments to Mrs. Reichardt's estate or to decedent from rent receipts or property sales distributions in 1993 and 1994 from any of the real property in Cameron County. The Estate of Jessie Dennett paid $30,000 to Mrs. Reichardt's estate on June 19, 1995, as its share of the proceeds from the sale of some real property. This amount was deposited in the partnership's bank account.

Decedent lived at 214 Encino before and after he transferred it to the trust and to the partnership. He paid no rent to the trust or the partnership to use that residence.

E. Decedent's Gift of Limited Partnership Interests to His Children

On October 22, 1993, decedent gave each of his children a 30.4-percent interest in the partnership.[5]

[5] Petitioner contends that decedent's children received assignee interests. We need not decide whether they received limited partnership interests or assignee interests because,

(continued...)

F. Management of the Partnership Assets

Decedent controlled and managed, or allowed the coowners to control and manage, the partnership assets in the same manner both before and after he transferred them to the partnership. He used the same brokers and managers before and after he transferred the property. No one except decedent signed partnership checks and documents. Welch managed the Kleberg County property before and after October 22, 1993, and August 21, 1994. The executors for the Estate of Jessie Dennett managed the Cameron County property before and after October 22, 1993, and August 21, 1994. Decedent's relationship to the partnership assets did not change when he conveyed them to the trust and partnership.

Hannah's firm made adjusting entries in the partnership's accounting records in an attempt to classify items of income and expense between decedent and the partnership. The difference between cash on hand in the partnership account and the amount in the general journal was $8,116 in 1993 and $13,507 in 1994. Hannah's firm assumed that these were the amounts of decedent's personal expenses that the partnership paid in those years.

[5](...continued)
under sec. 2036(a), decedent's gross estate includes the assets that he conveyed to the trust and partnership.

G. Tax Returns

The partnership filed income tax returns (Forms 1065, U.S. Partnership Return of Income) for 1993, 1994, 1995, 1996, and 1997. The trust filed income tax returns (Form 1041, U.S. Fiduciary Income Tax Return) for 1994, 1995, 1996, and 1997.

In March 1994, decedent and his children, as executors, filed a Federal estate tax return for Mrs. Reichardt's estate in which they reported a gross estate of $1,092,290. Hannah prepared the return.

Decedent filed a Federal gift tax return for 1993 on April 15, 1994. In it, he reported that he had given a 30.4-percent interest in the partnership to each of his two children and that each gift had a value of $310,000 as of October 22, 1993.

After decedent died, petitioner obtained an appraisal of decedent’s estate and the 1993 gifts. On Schedule F of the estate tax return, petitioner reported that, when decedent died, his gross estate included a 36.46-percent limited partnership interest in the partnership which had a fair market value of $346,000, and a 1-percent general partnership interest in the partnership which had a fair market value of $13,000.

OPINION

A. Section 2036(a)

A decedent’s gross estate includes the value of property interests transferred by the decedent during his or her lifetime

(other than a bona fide sale for full and adequate consideration) if the decedent retained for life the possession or enjoyment of the property, or the right to the income from the property. See sec. 2036(a).[6] Respondent determined and contends that assets that decedent conveyed to the partnership are includable in his estate under section 2036(a). Petitioner contends that section 2036(a) does not apply because decedent did not retain enjoyment (i.e., economic benefits) of the transferred property and that the transfer was for full and adequate consideration.

B. Whether Decedent's Gross Estate Includes Assets Held by the Partnership When Decedent Died

We must decide whether section 2036(a) applies to the following property: (1) Decedent's residence at 214 Encino and the Routt rental property; (2) a one-half interest in property in

[6] Sec. 2036 provides as follows:

> SEC. 2036(a). General Rule.--The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death--
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Kleberg and Nueces Counties; (3) a one-third interest in the Cameron and San Patricio property; (4) investment accounts at Rauscher Pierce and Smith Barney Shearson; (5) the Graham note; and (6) cash; i.e., all of the property alleged to have been in the partnership when decedent died (the transferred property).

1. Whether Decedent Retained Possession, Enjoyment, or the Right to the Income From the Transferred Property During His Lifetime

For purposes of section 2036(a), a transferor retains the enjoyment of property if there is an express or implied agreement at the time of the transfer that the transferor will retain the present economic benefits of the property, even if the retained right is not legally enforceable. See Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971); Estate of McNichol v. Commissioner, 265 F.2d 667, 671 (3d Cir. 1959), affg. 29 T.C. 1179 (1958); Estate of Spruill v. Commissioner, 88 T.C. 1197, 1225 (1987); Estate of Rapelje v. Commissioner, 73 T.C. 82, 86 (1979); Estate of Honigman v. Commissioner, 66 T.C. 1080, 1082 (1976); Estate of Gilman v. Commissioner, 65 T.C. 296, 306-307 (1975), affd. 547 F.2d 32 (2d Cir. 1976); sec. 20.2036-1(a), Estate Tax Regs. (last sentence).

In deciding whether there was an implied agreement, we consider all of the facts and circumstances surrounding the transfer and subsequent use of the property. See Estate of Spruill v. Commissioner, supra; Estate of Rapelje v.

Commissioner, supra at 86-87. Petitioner bears the burden (which is especially onerous for transactions involving family members) of proving that an implied agreement or understanding between decedent and his children did not exist when he transferred the property at issue to the trust and to the partnership. See Estate of Skinner v. United States, 316 F.2d 517, 520 (3d Cir. 1963); Estate of Rapelje v. Commissioner, supra at 86; Estate of Hendry v. Commissioner, 62 T.C. 861, 872 (1974).

Petitioner contends that decedent and his children did not have an implied agreement that decedent could continue to use the property after he conveyed it to the partnership. Petitioner contends that the partnership was formed (a) to curtail decedent's enjoyment of the property transferred to the limited partnership, (b) to prevent him from taking imprudent actions with regard to the property and to settle family disharmony regarding the assets, and (c) to give the children more control over the assets.

a. Whether Decedent Curtailed His Enjoyment of the Transferred Property

Decedent did not curtail his enjoyment of the transferred property after he formed the partnership. Nothing changed except legal title. Decedent managed the trust which managed the partnership. Decedent was the only trustee to sign the articles of limited partnership, the deeds, the transfer of lien, and any document which could be executed by one trustee on behalf of the

trust. Decedent was the only trustee to open brokerage accounts or sign partnership checks. He did not open any accounts for the trust.

Decedent commingled partnership and personal funds. He deposited some partnership income in his personal account. He used the partnership's checking account as his personal account. He lived at 214 Encino without paying rent before or after he transferred it to the trust and to the partnership. Decedent's relationship to the assets at issue remained the same after he transferred them. If a decedent's relationship to assets remains the same after a transfer as it was before a transfer, the value of the assets may be included in the decedent's gross estate. See sec. 2036(a)(1); Guynn v. United States, supra; Estate of Hendry v. Commissioner, supra at 874; Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242. Here, nothing changed after decedent transferred his interests in the property to the trust and the partnership, except legal title.

Petitioner contends that decedent had no relationship to any of the real property except for 214 Encino and the Routt rental property because Welch and the Estate of Jessie Dennett managed those properties. We disagree. Section 2036 applies not only if a transferor retains possession or enjoyment of property, but also if a transferor retains the right to income from the property. See sec. 2036(a)(1). We believe that decedent and his

children had an implied agreement that decedent could retain for his lifetime the right to the income from all of the real property that the partnership had when decedent died. Thus, decedent did not curtail his enjoyment of the transferred property after he transferred it to the trust and partnership.

Decedent's estate tax return states that when decedent died he had personal property, a car, and $2,389 cash, and he was owed a $429 Federal income tax refund and a $733 medical refund. Decedent apparently conveyed nearly all of his assets to the trust and partnership.[7] This suggests that decedent had an implied agreement with his children that he could continue to use those assets. Cf. Estate of Paxton v. Commissioner, 86 T.C. 785, 810 (1986).

b. Whether Decedent Transferred Property to the Trust and Partnership To Prevent Decedent From Treating the Property Imprudently, To Settle Family Disharmony, and To Give Children Control Over Assets

Petitioner contends that decedent formed the partnership to prevent him from treating the transferred property imprudently. We disagree because decedent controlled the partnership, and he had the power to act alone on behalf of the trust which was the

[7] Based on the estate tax return for decedent's estate and Hannah's records, respondent alleges that decedent gave about 98 percent of his property to the partnership. Petitioner's only response was that respondent's allegation is not based on the record and is "unsupported by calculations." Respondent's 98-percent estimate appears to be reasonable.

partnership's sole general partner. He alone (1) executed the articles of limited partnership, the deeds, and the transfer of lien; (2) opened the brokerage accounts; and (3) signed all of the partnership checks.

Petitioner emphasizes that decedent's children were concerned that he would give Mrs. Reichardt's property to his lady friend. Despite that, Mrs. Reichardt's will gave decedent the power to consume all of her separate property in which she gave him a life interest. Mrs. Reichardt was sophisticated and capable. We do not think she would have given him such broad power if she had the concern that petitioner alleges. In addition, decedent did not do what petitioner says his children suspected he would do. The facts suggest that this argument of petitioner's is, at best, overstated.

Petitioner also alleges that decedent formed the trust and partnership to give his children control over the assets while he was living. The facts suggest otherwise. Decedent's children, as cotrustees, could have taken, but did not take, actions related to the trust or exercise control over the assets while decedent lived.

c. Fiduciary Duties

Petitioner contends that decedent's fiduciary duties as a general partner and trustee precluded him from retaining enjoyment of the assets. We disagree. Decedent's fiduciary

duties did not deter him from continuing to possess and enjoy the house in which he lived or the other assets he conveyed to the partnership. Decedent's children, as cotrustees, did nothing to preclude him from doing so. This suggests that decedent and his children had an implied agreement to allow decedent to continue to enjoy partnership property throughout his life.

Petitioner points out that decedent's children could have revoked his management powers. However, they did not. This suggests that they and decedent had an implied agreement that he could continue to possess, enjoy, and retain the right to income from all of the property that he conveyed.

Decedent used at least $8,116 of partnership funds in 1993 for personal purposes and $13,507 in 1994. Petitioner contends that, at the end of 1993 (before decedent died) and 1994 (after decedent died), Hannah's firm prepared yearend adjusting entries which reclassified items of income and expense as relating to decedent and the partnership. Petitioner contends that the adjusting entries show there was no implied agreement for decedent to continue to enjoy partnership property.

We disagree. The 1993 yearend and 1994 post mortem adjusting entries made by Hannah's firm were a belated attempt to undo decedent's commingling of partnership and personal accounts. There is no evidence that the partnership or decedent transferred

any funds to the other as a result of the adjusting entries.[8] After-the-fact paperwork by decedent's C.P.A. does not refute that decedent and his children had agreed that decedent could continue to use and control the property during his life.

d. Conclusion

We conclude that decedent and his children had an implied agreement that decedent could continue to possess and enjoy the assets and retain the right to the income from the assets that he conveyed to the partnership during his lifetime.

2. Whether Decedent Transferred Property to the Partnership in a Bona Fide Sale for Full and Adequate Consideration

Section 2036(a) does not apply if the transfer of property was part of a bona fide sale in exchange for full and adequate consideration. A bona fide sale is an arm's-length business transaction between a willing buyer and a willing seller. See Wheeler v. United States, 77 AFTR 2d 96-1405, 96-1411, 96-1 USTC par. 60,226 (W.D. Tex. 1996) (value of homestead is included in decedent's gross estate under section 2036(a) in part because there was no bona fide sale among family members).

[8] Petitioner did not establish the accuracy of the records that Hannah's firm used to prepare the adjusting entries. The parties stipulated that the adjusting entries summarized other underlying records but not that the underlying records are accurate or complete. Petitioner does not identify all of the records on which the summary was based. One of the underlying records that petitioner produced is another summary that is extremely vague, e.g., $8,116 "Various C.E. Reichardt". Petitioner's reliance on the adjusting entries is misplaced.

Petitioner contends that decedent received full and adequate consideration because he received partnership interests, family disputes were settled, and his children became involved in family assets. We disagree. Decedent's children gave nothing to decedent or the partnership when he transferred property to the trust and the partnership, and they did not involve themselves in the partnership.

Petitioner contends that decedent's children gave consideration to the partnership in the form of their remainder interests. We disagree for reasons stated in paragraph B-4, below.

Petitioner contends that decedent sold the transferred property to the partnership in exchange for partnership interests as consideration. We disagree. Petitioner did not sell the transferred property to the partnership. See Wheeler v. United States, supra.

3. Comparison of This Case to Schauerhamer v. Commissioner

Petitioner contends that this case is distinguishable from Schauerhamer v. Commissioner, T.C. Memo. 1997-242. We held in Schauerhamer that property transferred to three family limited partnerships was included in the transferor's estate under section 2036(a). This case is similar to Schauerhamer in that, in both cases, the decedents and their children had implied agreements for the decedents to use property that they had

transferred to family limited partnerships established for the benefit of family members. In Schauerhamer, the children testified that they intended the decedent's relationship with the transferred assets to remain the same after the transfer. Here, the objective evidence (described above) shows that there was an implied agreement that the decedent could continue to enjoy the property, the children did not deny that there was such an agreement, and we have so found. The decedents in both Schauerhamer and the instant case commingled funds. Petitioner cites no significant distinction between Schauerhamer v. Commissioner, supra, and this case.

4. Whether Interests in the Cameron, San Patricio, Nueces, and Kleberg Counties Property Held by the Partnership Are Not Subject to Section 2036 Because Decedent Never Owned Those Interests

Petitioner contends that Mrs. Reichardt's interests in the Cameron, San Patricio, Nueces, and Kleberg Counties property are not subject to section 2036 because they passed directly from her estate to the partnership and decedent never owned any interest in them. We disagree.

The interests in the Cameron, San Patricio, Nueces, and Kleberg Counties property were Mrs. Reichardt's separate property. Under her will, a life interest in that property vested in decedent under Texas law when Mrs. Reichardt died. See Tex. Prob. Code Ann. sec. 37 (West Supp. 1999). Decedent's life interest included the power to consume all of Mrs. Reichardt's

interest in the property. There are no deeds transferring the Cameron and San Patricio Counties property to the trust and partnership. Thus, the only way interests in those properties could reach the partnership is for decedent to have used the power to consume to convey all of Mrs. Reichardt's interest in those properties to the partnership.

Decedent transferred his interest in the Nueces and Kleberg Counties property to the trust and partnership when he signed deeds on behalf of himself as an individual. Petitioner contends that the deeds establish that Mrs. Reichardt's interest in the Nueces and Kleberg Counties property passed directly from Mrs. Reichardt's estate to the trust and therefore is not included in decedent's estate under section 2036. We disagree. Mrs. Reichardt's interest in the Nueces and Kleberg Counties property vested in decedent as provided under Texas law. See Tex. Prob. Code Ann. sec. 37 (West Supp. 1999).

Petitioner contends that decedent's children gave their remainder interests in Mrs. Reichardt's separate property to the partnership, and thus decedent did not own those interests. We disagree. Decedent's children testified vaguely and unconvincingly about whether they contributed their remainder interests to the partnership. There is no documentary evidence that they did so. We believe that they could not have done so because decedent consumed all of Mrs. Reichardt's separate

property, leaving no remainder for the children. See Hudspeth v. Hudspeth, 756 S.W.2d 29, 31 (Tex. App. 1988) (life tenant may destroy any contingent interests held by remaindermen if testator expressly gives life tenant power to completely dispose of corpus); Calvert v. Thompson, 339 S.W.2d 685 (Tex. App. 1960) (same). No document shows that decedent transferred only a life interest in any asset to the trust or partnership.

We conclude that decedent owned and gave to the trust and partnership during his lifetime all of the interests in the Cameron, San Patricio, Nueces, and Kleberg Counties property that had belonged to Mrs. Reichardt when she died.[9] Thus, those property interests are subject to section 2036.

5. Conclusion

We conclude that section 2036(a) applies to all of the property that decedent transferred to the partnership.

C. Amount Included in Decedent's Estate Under Section 2036(a)

To decide the amount included in decedent's estate under section 2036(a), we must decide the value on the date of decedent's death of the property that decedent transferred to the partnership. James R. Parks (Parks), petitioner's expert who

[9] Decedent's life interest in the Cameron and San Patricio Counties property included the power to convey that property to the partnership. Decedent did so even though that property remained in the name of the Estate of Jessie Dennett. See Logan v. Logan, 156 S.W.2d 507, 512 (Tex. 1941); King v. Evans, 791 S.W.2d 531 (Tex. App. 1990).

adopted Goade's estimates for real property, and Francis X. Burns (Burns), respondent's expert, disagree about the value of some of the partnership assets when decedent died.

The following summarizes the parties' positions and our holding about the values of the partnership assets on August 21, 1994, before discounts.

	Estimate by		
Assets	Goade & Parks	Burns	Conclusion
Bexar County land	$378,900	$421,000	$378,900
Kleberg County land	212,017	235,575	212,017
Nueces County land	78,750	87,500	78,750
Cameron County land	42,239	0	42,239
San Patricio County land[1]	-0-	--	-0-
Rauscher Pierce	672,345	672,345	672,345
Smith Barney	119,902	119,465	[2]119,465
Note receivable	140,594	140,594	140,594
Cash	26,072	26,072	26,072
Liabilities	(35,728)	(35,728)	(35,728)
Totals	1,635,091	1,666,823	1,634,654

[1] Goade estimated that the San Patricio County property had no value because most of it was under water most of the year. Burns did not include the San Patricio County property in his report.

[2] Burns listed the value of each security in the Smith Barney portfolio. In his report, Parks stated a total for Smith Barney, but no information on specific securities because he found them to be unavailable. We accept Burns' estimate.

Parks used the estimates of Goade, a professional real estate appraiser, as the values for the real property. Goade applied a 10-percent fractional interest discount. Burns concluded that no fractional interest discount should be applied to the real property values. Goade is a qualified real estate

appraiser; Burns admitted in his testimony that he is not. We accept Goade's appraisal.

We conclude that the value of the assets (less liabilities) that decedent transferred to the partnership through the trust is $1,634,654. This value is included in decedent's estate under section 2036(a).

To reflect the foregoing and concessions of the parties,

Decision will be entered under Rule 155.

56 T.C.M. (CCH) 1033 (1989)
T.C. Memo. 1989-13.

Estate of Ruben Rodriguez, Deceased, Zoila P. Rodriguez, person in possession and administratrix, et al.[1]

v.

Commissioner.

Docket No. 46423-86, 48430-86, **20276-87**.

United States Tax Court.

Filed January 10, 1989.

William E. Frantz and Donald B. DeLoach, 3390 Peachtree Rd. N.E., Atlanta, Ga. for the petitioners. John B. Grattan, 3390 Peachtree Rd. N.E., Atlanta, Ga., for the petitioners in Docket Nos. 48430-86 and **20276-87** only. Julie M. T. Foster, for the respondent.

1034 *1034 ## Memorandum Findings of Fact and Opinion

WILLIAMS, Judge:

In these consolidated cases the Commissioner determined a deficiency of $215,208 in Federal estate tax due from the estate of Ruben **Rodriguez**.

The Commissioner also determined a deficiency in petitioners' Federal income tax of $128,903.67 for the taxable year 1982 and an addition to tax of $12,890.37 pursuant to section 6661.[2] The Commissioner further determined a deficiency in petitioner Zoila **Rodriguez**' Federal income tax of $137,873.69 for the taxable year 1983 and an addition to tax of $34,468.42 pursuant to section 6661.

These cases were consolidated for purposes of trial, briefing and opinion. The estate tax deficiency is attributable in part to respondent's determination that the value of a building used by decedent's corporation is includable in decedent's estate. The Federal income tax deficiencies arise out of the same determination, viz, that decedent rather than the corporation owned the building.

The issues we must decide are: (1) whether the property used as the principal place of business of decedent's corporation is includable in decedent's gross estate pursuant to section 2033; because of our resolution of this issue, we do not reach the question of the value of that property, (2) whether certain mortgage payments are includable in petitioners' income as constructive dividends, (3) whether petitioners are liable for additions to tax pursuant to 6661, (4) the value for Federal estate tax purposes of decedent's stock in his corporation, and (5) whether the entire value of a certificate of deposit decedent owned jointly with his wife and his wife's mother is includable in decedent's gross estate pursuant to section 2040.

Findings of Fact

Some of the facts have been stipulated and are so found. Ruben **Rodriguez** ("decedent") died intestate on June 7, 1982, survived by his wife, Zoila **Rodriguez** ("petitioner"), two minor children of their marriage and four adult children from previous marriages. Decedent resided in Atlanta, Georgia at his death. The administratrix, Zoila **Rodriguez**, timely filed the estate tax return. On the date that each petition was filed, Zoila **Rodriguez**, as an individual and as administratrix, resided in Atlanta, Georgia.

Decedent purchased an existing company, Maria Tortilla, Inc., in 1970 and renamed it Los Amigos Tortilla Manufacturing ("Los Amigos"). Los Amigos is a corn and flour tortilla manufacturing business providing "shells" used by Mexican styled restaurants for tacos, burritos, etc. Decedent and petitioner incorporated Los Amigos on August 11, 1972. Los Amigos was a closely held corporation from the date of its incorporation until decedent's death. Its securities were not registered with the Securities and Exchange Commission and were not regularly traded in any market. Decedent was President of Los Amigos until his death, and petitioner was Secretary/Treasurer.

On the date of decedent's death, Los Amigos' outstanding stock consisted of 10,000 shares of common stock, 7,000 (70 percent) of which was owned by decedent and 3,000 (30 percent) of which was owned by petitioner. Decedent's estate tax return reported the fair market value of decedent's 7,000 shares of common stock in Los Amigos as $500,000 or $71.42 per share. In his statutory notice, respondent determined that the fair market value of decedent's stock at the date of his death was $823,000.

Prior to his death, decedent had been in the tortilla manufacturing business for approximately thirty years. From 1972, the year Los Amigos was incorporated, until his death in 1982, decedent was in charge of the entire operation of Los Amigos. His duties included overseeing purchasing, manufacturing, sales, distribution, personnel matters, quality control and equipment maintenance. He worked at least two shifts and was at the Los Amigos plant during most of its operating hours. Petitioner also worked at Los Amigos, but her duties involved only in-house bookkeeping.

On September 28, 1976, the decedent purchased property located at 251 Armour Drive, N.E., Atlanta, Georgia ("Armour Drive property") which consisted of 1.865 acres improved with a building used as an office and warehouse. Decedent purchased the Armour Drive property for Los Amigos' operations, and it has been Los Amigos' principal place of business since 1976. The Armour Drive property was purchased for a cost of $275,000. The closing statement reflects that the decedent purchased the property in his own name and paid $50,000 as a down payment, plus closing costs. On September 28, 1976, the decedent executed a Deed to Secure Debt to the seller in the amount of $225,000 and received a Warranty Deed from the seller. The decedent was solely and personally liable on the purchase money note and security deed for the purchase balance. No corporate resolution specifically authorized either the corporation to purchase the Armour Drive property or the decedent to acquire the property for the corporation.

Decedent had no expertise in real estate matters at the time he purchased the Armour Drive property. The sellers of the Armour
1035 Drive property *1035 refused to sell the property to Los Amigos because they considered the corporation too much of a credit risk. Instead, they required decedent's personal liability. The sale, therefore, was closed in decedent's name.

Pursuant to decedent's instructions, Los Amigos' certified public accountant placed the Armour Drive property on the corporation's books as a corporate asset. The accountant listed the down payment decedent had made on the property as a liability owed to decedent. The accountant also designated the remaining indebtedness owed on the mortgage secured by the Armour Drive property as a liability owed to the sellers on the corporate books. Los Amigos subsequently paid the liability owed decedent for the down payment.

The Armour Drive property was titled in the decedent's name from the date of purchase throughout his lifetime and at the date of his death. Decedent and Los Amigos consistently treated the Armour Drive property as a corporate asset. Los Amigos treated the Armour Drive property as a corporate asset on its books and records from 1976 until the time of the trial. From January 1977 through December 1986, Los Amigos made all monthly mortgage payments for the Armour Drive property. The January 1977 mortgage payment was in the amount of $2,881.99; February 1977 through December 1986 mortgage payments were in the amount of $1,881.99 (principal and interest). During the years 1976 through 1986, Los Amigos deducted depreciation and interest paid on the mortgage note for the Armour Drive property on its corporate income tax returns. Los Amigos paid and deducted the property taxes on the Armour Drive property on its corporate income tax returns from 1977 through 1986. During the years 1976 through 1986, Los Amigos paid all the insurance premiums related to the Armour Drive property. Los Amigos also made and paid for all of the improvements to the building located on the Armour Drive property during the relevant years.

From the purchase of the property in 1976 through decedent's death in 1982, there was no lease agreement between the decedent and Los Amigos for the Armour Drive property. Los Amigos did not pay rent and claimed no deduction for rent for

these years. Subsequent to decedent's death through 1986, there was no lease agreement between petitioner and Los Amigos for the Armour Drive property. Los Amigos did not pay any rent and claimed no deduction for rent for these years.

Decedent did not claim deductions for depreciation, property tax or interest with respect to the Armour Drive property on his 1976 through 1982 joint Federal income tax returns. Petitioner did not report the Armour Drive property as property owned by decedent at the date of death on decedent's estate tax return.

On July 26, 1982, petitioner's attorney, S. Andrew Shuping, Jr., filed an Application for Twelve Month's Support with the Fulton County Probate Court on behalf of petitioner. Shuping also was attorney for Los Amigos and knew for two or three years prior to decedent's death that the Armour Drive property was titled in decedent's name. On September 7, 1982, the Fulton County Probate Court entered a Final Order granting the Application for Twelve Month's Support. The Order included the Armour Drive property. On September 9, 1982, attorney Shuping recorded the Certificate of Order of Year's Support.

Los Amigos' income before taxes for the years 1978 through 1986 was as follows:

Year	*Income (loss)*
1978	$ 82,045
1979	108,456
1980	249,677
1981	239,619
1982	378,315
1983	87,378
1984	(182,848)
1985	(522,536)
1986	171,439

At the date of decedent's death, Los Amigos was the owner and beneficiary of a life insurance policy (face amount $250,000) on the life of the decedent. One-half of the life insurance was payable to creditors on a machinery debt at his death.

After decedent's death, petitioner became president of Los Amigos. During the period immediately after decedent's death, petitioner received numerous inquiries from customers, suppliers and others about whether Los Amigos would continue to offer the same quality product, service and price that it had offered during decedent's management of the company. Los Amigos suffered a decline in business after decedent's death. Los Amigos lost the flour tortilla account of Del Taco Mexican Cafes after decedent's death because the flour tortillas were breaking and cracking. Del Taco Mexican Cafes was one of Los Amigos' principal customers during 1981 and 1982 for corn and flour tortillas and the largest account that was lost. Although Del Taco gave Los Amigos the opportunity to correct the flour tortilla problem, Los Amigos was unable to perform to acceptable standards under petitioner's management. Los Amigos' failure to perform was a consequence of decedent's death. Del Taco then gave the account to another company, and paid thirty percent more for the product previously produced by Los Amigos prior to decedent's death.

1036 *1036 At decedent's death, he jointly owned a certificate of deposit. C&S National Bank issued Certificate of Deposit No. S 0854399 in the face amount of $50,000 to decedent, petitioner, and Rosa Perez who is petitioner's mother.

Opinion

The first issue we must decide is whether the Armour Drive property is includable in decedent's gross estate. Decedent purchased the property in his name in 1976 after the sellers refused to sell it to Los Amigos. Thereafter, Los Amigos used the property in its business, consistently treating the property as a corporate asset. At his death, decedent still held legal title to the property.

Petitioners contend that the beneficial ownership of the property was owned by Los Amigos on the date of decedent's death. Petitioners argue that decedent purchased the Armour Drive property only because the sellers would not sell to Los Amigos

and that decedent merely held bare, legal title to the property as the trustee of an implied resulting trust in favor of Los Amigos. Respondent argues that decedent owned the Armour Drive property legally and beneficially and the property, therefore, is includable in decedent's gross estate pursuant to section 2033.

Section 2033 provides that the value of the gross estate includes the value of all property to the extent of the decedent's interest at the time of his death. The regulations pursuant to section 2033 also provide that the "gross estate includes property beneficially owned by the decedent at the time of his death." Sec. 20.2033-l(a), Estate Tax Regs.

Georgia law applies to determine what interest decedent had in the property on the date of his death. *Commissioner v. Estate of Bosch* [67-2 USTC ¶ 12,472], 387 U.S. 456 (1967). The pertinent Georgia statute provides as follows:

> Trusts are either express or implied. Express trusts are those trusts created and manifested by agreement of the parties. Implied trusts are those trusts which are inferred by law from the nature of the transaction or the conduct of the parties.

Ga. Code Ann. sec. 53-12-22 (1982). The statute further describes the circumstances that give rise to an implied trust:

> A trust is implied:
>
> (1) Whenever the legal title is in one person but the beneficial interest, either from the payment of the purchase money or from other circumstances, is either wholly or partially in another;
>
> (2) Where, from any fraud, one person obtains the title to property which rightly belongs to another;
>
> (3) Where, from the nature of the transaction, it is manifest that it was the intention of the parties that the person taking the legal title should have no beneficial interest; or
>
> (4) Where a trust is expressly created but uses either are not declared, are ineffectually declared, extend only to a part of the estate, or fail from any cause, in which case a resulting trust is implied for the benefit of the grantor or testator or his heirs.

Ga. Code Ann. sec. 53-12-26 (1982).

Because this case does not involve fraud or an express trust, only the first and third statutory classifications are relevant. Generally, trusts arising under the first and third categories in the statute are resulting trusts. *Hancock v. Hancock,* 205 Ga. 684, 54 S.E.2d 385, 389 (1949).

An implied resulting trust arises because of the mutual intention of the parties to create the trust. *Hall v. Higgison,* 222 Ga. 373, 149 S.E.2d 808, 810 (1966); see *Estate of Spruill v. Commissioner* [Dec. 43,904], 88 T.C. 1197, 1222-1224 (1987). After reviewing the statute and Georgia case law thereunder, the Georgia Supreme Court stated in 1982:

> circumstances may be offered as evidence of an intention (whether or not expressly articulated by each party) that title shall vest in one and beneficial ownership in the other. The scope of such evidence includes all of the facts and circumstances surrounding the transaction. The ultimate inquiry is whether there was, in truth, a mutual understanding, *not* whether such an understanding was expressed in plain and unambiguous terms. [Emphasis in original.]

Harrell v. Harrell, 249 Ga. 170, 290 S.E.2d 906, 907 (1982).

Decedent paid the down payment and personally signed the note for the Armour Drive property because the sellers required his personal liability. Pursuant to decedent's instructions, Los Amigos entered the property on its books as a corporate asset. The corporation repaid decedent for the down payment on the property and made all mortgage payments. In addition, Los Amigos paid all insurance premiums, property taxes and building improvement costs on the property. Los Amigos also deducted depreciation, interest paid on the mortgage note and property tax on its corporate income tax returns. Decedent did not claim deductions for depreciation, interest or property tax on his Federal income tax returns with respect to the Armour Drive property.

1037 Decedent did not lease *1037 the property to Los Amigos, and Los Amigos did not claim any deductions for rent on its corporate income tax returns.

In short, Los Amigos and decedent consistently treated the Armour Drive property as a corporate asset throughout the years at issue. Holding title as petitioner did is, moreover, a common practice to secure the liability of the beneficial owner. Under the facts and circumstances of this case, we find that decedent and Los Amigos mutually understood that while legal title would remain in decedent, beneficial ownership would vest in Los Amigos.

In *Estate of Spruill v. Commissioner* [Dec. 43,904], 88 T.C. 1197 (1987), a case decided under Georgia law, decedent held legal title at his death to the homesite of his daughter and her husband. Decedent had constructed their homesite and conveyed it to them for $20,000. The daughter and her husband were unable to obtain a loan for the purchase price; they conveyed the property back to the decedent who borrowed $20,000 and used the property as security to obtain the loan. Decedent's daughter and her husband paid decedent until decedent told them no more payments were necessary. The daughter asked decedent to deed her the property, but decedent told her he would take care of it in his will. We found that decedent and his daughter mutually understood at the time the daughter conveyed the property back to decedent that she was to retain beneficial ownership of the homesite. 88 T.C. at 1215.

Similarly, in the present case, decedent purchased the Armour Drive property solely for use in Los Amigos' business. Decedent did not exercise control over the property except through his authority as a corporate officer; Los Amigos used and controlled the property as a corporate asset. Decedent had legal title as security for Los Amigos' debt to him for the purchase price. Pursuant to decedent's instructions, Los Amigos' accountant reported the Armour Drive property as beneficially owned by Los Amigos for both book and tax purposes. We find a mutual understanding between decedent and Los Amigos at the time decedent purchased the property that decedent was to have bare legal title and Los Amigos was to have beneficial ownership of the Armour Drive property. The evidence in this case supports the finding of a resulting trust under Georgia law.

Respondent argues that petitioner took an inconsistent position with respect to the ownership of the property in the probate court. There petitioner asserted that the decedent owned the Armour Drive property in order to set aside the property for her year's support. Petitioner's position here, however, is not inconsistent: the Georgia state probate court determines the passage of legal title at death; petitioner, therefore, properly listed all property to which decedent held legal title in the probate court proceeding. Beneficial ownership, not legal title, governs the Federal estate tax consequences here. Inclusion of the asset in the probate court and exclusion from the gross estate for Federal estate tax purposes are entirely consistent in this case.

Respondent also contends that under Georgia law, petitioners must show the existence of a resulting trust by clear and convincing evidence. We do not find it necessary to decide this issue. Petitioners have provided sufficient evidence of a resulting trust whether the standard is by the preponderance of the evidence or by clear and convincing evidence. *Estate of Spruill v. Commissioner,* 88 T.C. at 1218 n. 18.

We conclude that decedent held the property in an implied resulting trust for the benefit of Los Amigos. The property, therefore, is not includable in decedent's gross estate.

Because of our holding, petitioner need not include in her income any part of the mortgage payments made by Los Amigos. These were not constructive dividends. Furthermore, petitioners are not liable for the additions to tax pursuant to section 6661 which respondent determined because of petitioners' failure to report as constructive income Los Amigos' mortgage payments. Petitioners properly reported their transactions with Los Amigos, and the property was properly excluded from decedent's gross estate. It was an asset owned by Los Amigos and not by decedent.

We next must determine the fair market value of decedent's stock in Los Amigos at decedent's death. Decedent owned 70 percent of the Los Amigos stock at the time of his death. Petitioners' expert witness, who assumed Los Amigos owned the Armour Drive property, appraised the fair market value of the stock at trial at $332,700. Respondent's expert witness, who assumed that decedent owned the Armour Drive property, valued the stock at $823,000.

Property includable in the gross estate must be valued. Sec. 2031(a). Value is generally the fair market value at the time of decedent's death. Sec. 20.2031-l(b), Estate Tax Regs. Fair market value 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." Sec. 20.2031-1(b), Estate Tax Regs.; *Estate of Hecksher v. Commissioner* [Dec. 33,023], 63 T.C. 485, 490 (1975). Subsequent events are relevant to determining the fair market value at the date of death if the events were reasonably foreseeable at the valuation date. *Ithaca Trust Co. v. United States* [1 USTC ¶ 386], 279 U.S. 151, 155 (1929); *Estate of Gilford v. Commissioner* [Dec. 43,622], 88 T.C. 38, 52 (1987).

Valuation of closely held stock for tax purposes is imprecise; each case turns on its own particular facts. *Hamm v.*
1038 *Commissioner* [64-1 USTC ¶ 12,206], 325 F.2d 934, 938 (8th Cir. 1963), affg. a Memorandum Opinion of this *1038 Court, cert. denied 377 U.S. 993 (1964); *Messing v. Commissioner* [Dec. 28,532], 48 T.C. 502, 512 (1967). Valuation is "necessarily an approximation arrived at by the trial court" after considering all the relevant factors. *Anderson v. Commissioner* [58-1 USTC ¶ 9117], 250 F.2d 242, 249 (5th Cir. 1957), affg. on the valuation issue a Memorandum Opinion of this Court [Dec. 21,874(M)], cert. denied 356 U.S. 950 (1958). Valuation of closely held stock is a "question of judgment rather than mathematics." *Hamm v. Commissioner, supra* at 940.

Petitioners and respondent each presented one expert witness at trial who valued decedent's 70 percent interest in Los Amigos. Petitioners' expert witness, Glen A. Hultquist concluded the stock was worth $332,700.[3] Respondent's expert witness, Philip J. Schneider, appraised the stock at $823,000.

Both experts considered the following factors from Revenue Ruling 59-60, 1959-1 C.B. 237, 238, in determining the fair market value of Los Amigos:

> (a) The nature of the business and the history of the enterprise from its inception. (b) The economic outlook in general and the condition and outlook of the specific industry in particular. (c) The book value of the stock and the financial condition of the business. (d) The earning capacity of the company. (e) The dividend-paying capacity. (f) Whether or not the enterprise has goodwill or other intangible value.

Expert witnesses' opinions are supposed to aid the court in understanding an area requiring specialized training, knowledge or judgment. As the trier of fact, we are not, however, bound by the experts' opinions. *Silverman v. Commissioner* [76-2 USTC ¶ 13,148], 538 F.2d 927, 933 (2d Cir. 1976), affg. a Memorandum Opinion of this Court [Dec. 32,831(M)]; *Chiu v. Commissioner* [Dec. 42,027], 84 T.C. 722, 734 (1985). One expert may be persuasive on one particular element of valuation while another expert may provide more incisive help on some other element of valuation. *Parker v. Commissioner* [Dec. 42,966], 86 T.C. 547, 562 (1986); *Estate of Gallo v. Commissioner* [Dec. 42,241(M)], T.C. Memo. 1985-363. Consequently, using our best judgment, we may adopt some portions and reject other portions of expert testimony. *Helvering v. National Grocery Co.* [38-2 USTC ¶ 9312], 304 U.S. 282 (1938).

In valuing the Los Amigos stock for trial, Hultquist combined an income and a book value approach. Under the income approach, Hultquist adjusted pre-tax income to account for the loss of the decedent, the key man in the business. The earnings as adjusted were $210,000. He capitalized the adjusted earnings using a 30 percent capitalization rate.[4] Hultquist next determined the book value of Los Amigos. He used the book value method because thirteen companies he examined in the food industry were sold at a percentage of book value. He adjusted the book value based on one of the thirteen sales, the only company he found truly comparable, at 80 percent of book value. Hultquist used a weighted average of the resulting amounts from the income and book value approaches, 40 percent for the income approach and 60 percent for the book value approach. Hultquist discounted the weighted average by 35 percent for lack of marketability. Seventy percent of the result was the value of decedent's 70 percent stock interest, $332,700.

Respondent's expert witness, Schneider, used only an income approach. Schneider first adjusted Los Amigos' income as if decedent owned the Armour Drive property rather than Los Amigos. He then used a 28.46 percent capitalization rate to determine the value of the corporation. Schneider noted that although normally he would adjust the capitalization rate to account for the loss of a key man, he did not adjust the rate here because of the $250,000 life insurance policy on decedent. Also, he testified that decedent's salary would pay for a replacement. Seventy percent of the corporation's value, $823,000, was the value respondent used in his deficiency notice.

Both experts used a capitalization of earnings method in determining their appraised value of Los Amigos. We accept as

appropriate the use of the capitalization of earnings method. See *Central Trust Co. v. United States* [62-2 USTC ¶ 12,092], 305 F.2d 393, 404 (Ct. Cl. 1962); *Estate of Huntsman v. Commissioner* [Dec. 33,976], 66 T.C. 861, 876 (1976).

We reject, however, Hultquist's adjustment to value based on a percentage of book value. The businesses that were sold at a percentage of book value, as petitioners' expert found, were not comparable with one exception. We find that petitioners have not shown that using the book value method to adjust the value determined by the capitalized earnings method is appropriate in this case. We agree with respondent's expert that the appropriate valuation approach to use in this case is the capitalization of earnings unadjusted by book value. We also believe the capitalization rate of 28.46 percent used by respondent's expert was appropriate.

Nevertheless, we do not agree with respondent's expert that no adjustment for the loss of a key man is necessary in this case.
1039 Respondent *1039 argues that an adjustment is inappropriate because Los Amigos maintained $250,000 of insurance on decedent's life. Also, respondent's expert witness testified that he did not make any allowance for the value of decedent as a key man because his replacement cost was equal to his salary. These arguments understate the importance of decedent to Los Amigos and the adverse effect his death had on business. We agree with petitioners that an adjustment is necessary to account for the loss of decedent.

The evidence shows that decedent was the dominant force behind Los Amigos. He worked long hours supervising every aspect of the business. At the time of his death, Los Amigos' customers and suppliers were genuinely and understandably concerned about the future of the business without decedent. In fact, Los Amigos soon lost one of its largest accounts due to an inability to maintain quality. The failure was due to decedent's absence from operations. Profits fell dramatically without decedent to run the business. No one was trained to take decedent's place.

Capitalizing earnings is a sound valuation method requiring no adjustment only in a case where the earning power of the business can reasonably be projected to continue as in the past. Where, as in this case, a traumatic event shakes the business so that its earning power is demonstrably diminished, earnings should properly be adjusted. See *Central Trust Co. v. United States,* 305 F.2d at 403. An adjustment to earnings before capitalizing them to determine the company's value rather than a discount at the end of the computation is appropriate to reflect the diminished earnings capacity of the business. We adopt petitioners' expert's adjustment to earnings for the loss of the key man.

The final adjustment to value remaining in issue is a discount for lack of marketability. Respondent contends that any discount for lack of marketability is offset by a control premium for decedent's 70 percent interest. Petitioners, on the other hand, discounted the value by 35 percent for lack of marketability.

Respondent has confused the discount for lack of marketability with a discount for minority interest. A discount for lack of marketability is warranted in this case because no established market exists for unlisted, closely held stock. *Estate of Piper v. Commissioner* [Dec. 36,315], 72 T.C. 1062, 1085 (1979).

Respondent's argument that a control premium offsets the discount for lack of marketability is unfounded in the present case. Both parties valued decedent's 70 percent interest beginning with the value of 100 percent of the company. A "control premium" should be added to value determined from sales of minority interests.

Petitioners, however, have not met their burden of proof that the appropriate discount is 35 percent. Based on the facts and circumstances in this case, we find that the proper discount for lack of marketability is 10 percent. Consequently, the value of decedent's interest in Los Amigos at the date of his death was $465,000 ($378,000 (capitalized $210,000 earnings at 28.46 percent) × 90 percent (10 percent discount for lack of marketability) × 70 percent (ownership interest) = 465,000).

The final issue remaining is whether the entire value of a $50,000 certificate of deposit ("CD") owned jointly by decedent, petitioner and petitioner's mother, is includable in decedent's gross estate. Petitioners contend that only $30,000 should be included in the estate because petitioner's mother, Rosa Perez ("Perez") provided adequate and full consideration in the amount of $20,000 toward the purchase of the CD. Petitioners assert that Perez had loaned decedent $20,000 prior to the time decedent purchased the CD and that decedent made Perez a joint tenant on the CD in consideration of the $20,000 loan. Respondent argues that the entire $50,000 is includable in decedent's gross estate pursuant to section 2040. Section 2040[5]

1040 *1040 requires inclusion of jointly owned property in decedent's estate to the extent of decedent's interest in the property. Petitioners have the burden of proof to show if any part of the $50,000 should be excluded from decedent's gross estate. Petitioners concede that the joint ownership was not a "qualified joint ownership" pursuant to section 2040(b).

Petitioners must show that Perez provided $20,000 consideration for her interest in the CD. To support their position, petitioners submitted the following evidence: (1) the CD showing that decedent, petitioner and Perez were joint owners; (2) petitioner's testimony that Perez loaned decedent $20,000; and (3) petitioner's testimony that decedent placed Perez' name on the CD in consideration for the $20,000 loan. Petitioners did not, however, call Perez to testify. Nor did they present tangible evidence of the loan transaction such as cancelled checks or loan documents. Petitioners did not explain these failures. The failure of a party to introduce evidence within its possession and which, if true, would be favorable to him, gives rise to a presumption that if produced it would be unfavorable. *Wichita Terminal Elevator Co. v. Commissioner* [Dec. 15,171], 6 T.C. 1158 (1946), affd. [47-1 USTC ¶ 9253] 162 F.2d 513 (10th Cir. 1947). We find that on this issue petitioners have not sustained their burden of proof that respondent's determination is incorrect. We hold, therefore, that the entire $50,000 value of the CD is includable in decedent's gross estate.

Decisions will be entered under Rule 155.

[1] Cases of the following petitioners are consolidated with this case: Ruben **Rodriguez**, Deceased and Zoila **Rodriguez**, docket No. 48430-86, Zoila **Rodriguez**, docket No. **20276-87**.

[2] All section references are to the Internal Revenue Code of 1954 as in effect at the date of the decedent's death or for the years at issue, as appropriate, unless otherwise indicated.

[3] Hultquist initially valued the stock at $500,000 in a two-page report used on decedent's estate tax return.

[4] Both Hultquist and respondent's expert used a study by Ibottson and Sinquefield to arrive at a capitalization rate of 28.46 percent. Hultquist rounded the 28.46 percent rate up to 30 percent "because of the unique business conditions" of Los Amigos.

[5] SEC. 2040. JOINT INTERESTS.

(a) GENERAL RULE. — The value of the gross estate shall include the value of all property to the extent of the interest therein held as joint tenants with right of survivorship by the decedent and any other person, or as tenants by the entirety by the decedent and spouse, or deposited, with any person carrying on the banking business, in their joint names and payable to either or the survivor, except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than an adequate and full consideration in money or money's worth: Provided, That where such property or any part thereof, or part of the consideration with which such property was acquired, is shown to have been at any time acquired by such other person from the decedent for less than an adequate and full consideration in money or money's worth, there shall be excepted only such part of the value of such property as is proportionate to the consideration furnished by such other person:

* * *

(b) CERTAIN JOINT INTERESTS OF HUSBAND AND WIFE. —

(1) INTERESTS OF SPOUSE EXCLUDED FROM GROSS ESTATE. — Notwithstanding subsection (a), in the case of any qualified joint interest, the value included in the gross estate with respect to such interest by reason of this section is one-half of the value of such qualified joint interest.

(2) QUALIFIED JOINT INTEREST DEFINED. — For purposes of paragraph (1), the term "qualified joint interest" means any interest in property held by the decedent and the decedent's spouse as —

(A) tenants by the entirety, or

(B) joint tenants with right of survivorship, but only if the decedent and the spouse of the decedent are the only joint tenants.

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49 T.C.M. (CCH) 214 (1984)
T.C. Memo. 1984-626.

Estate of Myrtle M. Sawade, deceased, Louise C. (Dewey) Hornstein, Executor; Myrtle M. Sawade Revocable Living Trust (executed May 17, 1977), Louise C. (Dewey) Hornstein, Trustee, as Transferee; Dinan E. Hornstein, Kathleen H. Rivero, and Louise C. (Dewey) Hornstein A/K/A Dewey C. Hornstein, as Transferees

v.

Commissioner.

Docket No. **23656-82**.

United States Tax Court.

Filed December 3, 1984.

215 *215 John L. Sullivan, 611 Olive St., St. Louis, Mo., for the petitioners. James A. Kutten, for the respondent.

Memorandum Findings of Fact and Opinion

KÖRNER, Judge: Respondent determined a deficiency in the Federal estate tax of the Estate of Myrtle M. **Sawade**, against the Myrtle M. **Sawade** Revocable Trust, and against the Trust remaindermen as transferees in the amount of $131,216.37. After concessions, the issues for decision are: (1) Whether the distribution of 19,910 shares of Baldor Electric Company stock to the beneficiaries of the Myrtle M. **Sawade** Revocable Living Trust occurred (thus fixing their valuation date), within the meaning of section 2032(a),[1] when the successor trustee instructed her stock-broker to effect the transfer, or when the shares were transferred on the corporation's books; (2) whether petitioners are entitled to a blockage discount for certain shares of Baldor Electric Company. If yes, whether the blocks consist of two blocks of 19,910 and 9,540 shares, or of four blocks of 6,637, 6,637, 6,636 and 9,540 shares; (3) whether the valuation of three certificates of deposit should include the accrued interest thereon; and (4) whether the estate properly valued 320 acres of real estate in Fergus County, Montana.

Findings of Fact

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioner Louise C. (Dewey) Hornstein is the Executrix of the Estate of Myrtle M. **Sawade** (hereinafter the "Estate"), and successor trustee of the Myrtle M. **Sawade** Revocable Living Trust (hereinafter the "Trust"). She resided in St. Louis, Missouri, at the time the petition in this case was filed. Petitioners Dinan E. Hornstein and Kathleen H. Rivero resided in St. Louis, Missouri, and Miami, Florida, respectively, at the time the petition was filed.

I.

On May 19, 1977, Myrtle M. **Sawade**, as grantor, created the Trust. The Trust document provided that the grantor was to retain the lifetime right to the income of the Trust. The grantor appointed her sister, Louise C. (Dewey) Hornstein, as successor trustee.

The Trust document provided that, upon the grantor's death, the successor trustee was authorized, in her sole discretion, to expend such sums of the principal of the Trust's estate as she deemed proper to pay the following expenses of Myrtle M. **Sawade**: (1) Expenses of her last illness and funeral; (2) debts; (3) expenses of administration of her estate; and (4) all taxes, including Federal estate taxes. All actions of the successor trustee in the exercise of the above-mentioned powers were to be conclusive and binding on all parties in interest. The document provided, further, that all other provisions providing for the distribution of trust property after the death of the grantor were subject to the right of the successor trustee to withhold, in whole or in part, such transfer of assets

pending a determination by her of the actions to be taken regarding the payment of the expenses. The beneficiaries, other than the grantor, had no power to assign, transfer, encumber or otherwise anticipate or dispose of any interest, either principal or income, they may have had in the property held in the trust estate. Any such assignment, transfer, encumbrance or other attempted anticipation or disposition was to be void and of no effect. The remaining trust property after the payment of the expenses, was to be transferred to the remaindermen: Louise C. (Dewey) Hornstein, Dinan E. Hornstein, and Kathleen H. Rivero, free of trust. The grantor reserved the
216 right to revoke the trust during her lifetime. Myrtle M. **Sawade** (hereinafter the "decedent") died on October 10, *216 1978, in St. Louis, Missouri, without having revoked the Trust.

Louise C. (Dewey) Hornstein, Dinan E. Hornstein, Kathleen H. Rivero, and the decedent each maintained separate brokerage accounts at Newhard, Cook, and Company (hereinafter "Newhard") in St. Louis, Missouri. After her death, Myrtle M. **Sawade's** account became the account for the Trust.

On October 26, 1978, an inventory was taken of the items contained in safe deposit box number 1830 in decedent's name at the Chippewa Bank, formerly Chippewa Trust Company, in St. Louis, Missouri. Amongst the items contained therein were Baldor Electric Company (hereinafter "Baldor") stock certificates number S932 and CU6721, representing ownership of 20,204 and 19,910 shares, respectively, owned by the Trust. On the same day, the two Baldor stock certificates, totaling 40,114 shares, were handed to John P. Cummings, a stockbroker employed by Newhard, who deposited them in the Trust's account.

The following letter was executed on October 30, 1978, by Louise C. (Dewey) Hornstein, as successor trustee, and hand delivered to John P. Cummings on the same day:

Mr. John P. Cummings Vice-President Newhard, Cook & Co. 300 North Broadway St. Louis, Missouri 63102 Re: *Trust Estate of Myrtle **Sawade***

Dear Mr. Cummings:

I have heretofore delivered to you as my agent two certificates representing ownership of the trust estate in Baldor Electric Company, being Certificate No. CU6721 for 19,910 shares and Certificate No. S932 for 20,204 shares.

Please accept this letter, which I have personally dated, as my irrevocable instructions to you, as the Successor Trustee of the trust estate of Myrtle **Sawade**, to effect delivery of 19,910 shares of Baldor Electric Company stock now held by you as my agent to the following persons in the shares indicated:

To Dewey C. Hornstein SS#XXX-XX-XXXX 10 Plaza Square Apt. 314 St. Louis, Mo. 63103—6,636 shares *To Kathleen H. Rivero* SS#XXX-XX-XXXX 1408 S.E. Bayshore Dr. Apt. 1204 Miami, Florida 33131—6,637 shares *To Dinan E. Hornstein* SS#XXX-XX-XXXX 1809 Wyoming Street St. Louis, Mo. 63118—6,637 shares Very truly yours, /s/ Louise C. (Dewey) Hornstein Dated: October 30, 1978

On November 13, 1978, Louise C. (Dewey) Hornstein executed a stock assignment (stock power of attorney) to Newhard in blank (as to the distributees) for Baldor stock certificates number S932 and CU6721 as "Louise C. Hornstein, Successor Trustee."

Newhard sent a letter, dated November 14, 1978, to the Stock Transfer Department of Mercantile Trust Company (hereinafter "Mercantile") in St. Louis, Missouri, the stock transfer agent for Baldor, requesting that it transfer the 40,114 shares owned by the Trust as follows:

(a) Stock certificate number CU6721 was to be distributed between Louise C. (Dewey) Hornstein, Kathleen H. Rivero, and Dinan E. Hornstein. New stock certificates were to be issued; Louise C. (Dewey) Hornstein was to receive 6,636 shares of stock, Kathleen H. Rivero was to receive 6,637 shares of stock, and Dinan E. Hornstein was to receive 6,637 shares of stock.

(b) The 20,204 shares of Baldor stock, represented by stock certificate number S932, were to be reregistered in the name of "Louise C. Hornstein, Successor Tstee. U/A Dtd. 5/17/77 M/B Myrtle M. **Sawade**."

The Stock Transfer Department of Mercantile returned the stock certificates to Newhard on November 16, 1978, stating that the certificates were returned without the requested action being performed since an inheritance tax waiver from the State of Missouri was needed before Mercantile would process the requested transfer.

On December 19, 1978, Newhard sent a letter to the Stock Transfer Department of Mercantile requesting that the 40,114 shares of

Baldor owned by the Trust be transferred in an identical manner as set forth in Newhard's directions in their November 14, 1978 letter to Mercantile. Newhard's November 19, 1978 letter included a Missouri inheritance tax waiver. The shares were transferred on the books of the corporation, according to Newhard's directions, on December 20, 1978. The corresponding reregistered stock
217 certificates were sent to Newhard and transferred out of the Trust's account and into the individual *217 brokerage accounts of Louise C. (Dewey) Hornstein, Dinan E. Hornstein and Kathleen H. Rivero, to the extent of 19,910 shares; the remaining 20,204 shares went into the Trust's account.

The Estate timely elected to value all the property included in the gross estate under the alternate valuation method in section 2032. The 19,910 shares of Baldor stock represented by stock certificate number CU6721 were valued as of October 30, 1978, the date on which Louise C. (Dewey) Hornstein, acting as successor trustee, executed the letter instructing Newhard to effect delivery of the Baldor stock to the remaindermen.

Respondent determined that the shares of Baldor stock transfererd to the three individual distributees during the six-month alternate valuation period should have been valued on December 20, 1978, the date the stock was transferred on the books of the corporation by the stock transfer agent, and increased the taxable estate by $117,164.38, due to the difference in the value of the stock on that date, as compared to October 30, 1978.

II.

On or about June 3, 1977, Myrtle M. **Sawade** transferred 157 shares apiece of Baldor stock as a gift to Louise C. (Dewey) Hornstein, Dinan E. Hornstein, and Kathleen H. Rivero, for a total of 471 shares. In May 1978, the stock of Baldor split two-for-one. On or about September 6, 1978, Myrtle M. **Sawade** transferred 98 shares of Baldor stock to each of the above-mentioned donees, for a total of 294 shares. None of the above shares were sold or otherwise disposed of by the respective donees prior to April 10, 1979.

The Trust sold 11,900 shares of Baldor stock in 41 separate sale transactions during the six-month alternate valuation period, and 3,504 shares thereafter. The following chart reflects the date, number of shares and price per share of the shares sold by the Trust. The chart also reflects the market volume, high, low, and closing price for the corresponding sale dates:

	Summary of **Sawade** Trust Sales		Market Performance During Corresponding Sale Dates			
Sale Date	Number of shares sold	Price per per share	Volume	High	Low	Close
1/31/1979	100	$26	6,200	26½	26	26
1/31/1979	1,600	26½	6,200	26½	26	26
2/1/1979	500	26	1,300	26	25½	25½
2/12/1979	1,100	24	3,700	24½	24	24 3/8
2/16/1979	1,500	24	3,100	24 3/8	24	24 3/8
2/16/1979	800	24 1/8	3,000	24 3/8	24	24 3/8
2/16/1979	100	24 3/8	3,000	24 3/8	24	24 3/8
2/20/1979	200	24½	6,300	24 5/8	24	24 3/8
2/20/1979	200	24 5/8	6,300	24 5/8	24	24 3/8
2/21/1979	1,000	24 5/8	5,400	25¼	24 1/8	25 1/8
2/21/1979	1,000	25	5,400	25¼	24 1/8	25 1/8
2/21/1979	400	25¼	5,400	25¼	24 1/8	25 1/8
2/22/1979	500	25	2,700	25	24 5/8	25
2/28/1979	500	25	1,000	25	24¾	24¾
3/ 5/1979	400	25	1,000	25	24¾	25
3/ 6/1979	100	25¼	1,900	25¼	24 7/8	25
3/ 7/1979	500	25	1,100	25¼	25	25¼
3/ 7/1979	400	25¼	1,100	25¼	25	25¼
3/ 8/1979	500	25¼	1,100	25½	25¼	25½
3/ 9/1979	500	25½	4,100	25 5/8	25 1/8	25¼

Subtotal	11,900[2]					
4/11/1979	500	31¼	1,300	31 3/8	31	31
4/12/1979	500	30½	2,800	30½	30 1/8	30¼
4/19/1979	500	29 1/8	1,100	29¼	29	29
4/20/1979	500	29	2,200	29¼	28½	28 5/8
4/27/1979	500	28	600	28¼	28	28 1/8
5/ 2/1979	500	28 3/8	800	28 3/8	28 3/8	28 3/8
5/ 3/1979	4	28 1/8	5,000	28 3/8	28	28¼
5/ 3/1979	500	28¼	5,000	28 3/8	28	28¼
Subtotal	3,504[3]					
Grand total	15,404					

218 *218 The gross estate of Myrtle M. **Sawade** thus included:

(a) 1,236 shares that were transferred by the decedent without consideration during the three-year period ending on the date of her death, under section 2035. These 1,236 shares consisted of 471 shares transferred on June 3, 1977, subsequently split two-for-one, and the September 6, 1978 transfer of 294 shares; and are to be valued as of April 10, 1979.[4]

(b) Also included in the gross estate were 11,900 shares of Baldor stock that were sold by the Trust during the alternate valuation period in 41 separate transactions; these shares are to be valued at each sale's respective price under section 2032(a)(1).[5]

(c) The gross estate also included 19,910 shares of Baldor stock transferred to the Trust remaindermen as described above.[6]

(d) The gross estate further included 8,304 shares of Baldor stock that were not disposed of during the six-month alternate valuation period. These shares are to be valued at the end of said six-month period, April 10, 1979, under section 2032(a)(2).[7]

Baldor stock was traded on the American Stock Exchange during the years 1978 and 1979. The following chart reflects the weekly volume of Baldor stock traded during 1978:

Week ended 1978	Volume
1/ 6	11,300
1/13	16,600
1/20	5,400
1/27	3,600
2/ 3	2,600
2/10	12,400
2/17	2,800
2/24[8]	2,300
3/ 3	2,800
3/10	9,200
3/17	16,100
3/24[9]	2,600
3/31	3,700
4/ 7	5,800
4/14	15,700
4/21	4,700
4/28	17,600

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5/ 5 .....  19,900
5/12 .....  16,700
5/19 .....   7,700
5/26 .....   7,300
6/ 2[10] ...   3,700
6/ 9 .....  33,400
6/16 .....  26,100
6/23 .....  17,500
6/30 .....   5,900
7/ 7 .....   5,900
7/14 .....  11,800
7/21 .....   9,400
7/28 .....  12,100
8/ 4 .....  23,500
8/11 .....  20,100
8/18 .....   7,800
8/25 .....  11,700
9/ 1 .....  15,700
9/ 8[11] ...   7,800
9/15 .....  16,600
9/22 .....  18,500
9/29 .....   6,400
10/ 6 .....  13,200
10/13 .....  11,200
10/20 .....  39,800
10/27 .....  16,000
11/ 3 .....  38,300
11/10 .....  11,000
11/17 .....  16,700
11/24[12] ..  11,000
12/ 1 .....   9,300
12/ 8 .....  15,700
12/15 .....   9,400
12/22 .....  22,800
12/29 .....  17,700
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A total of 682,500 shares of Baldor stock were traded during 1978.

The following chart illustrates the weekly volume of Baldor stock traded during 1979:

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Week ended
     1979            Volume

1/ 5 .............   9,600
1/12 .............  12,700
1/19 .............  11,600
1/26 .............   5,000
2/ 2 .............  12,100
2/ 9 .............   5,700
2/16 .............   9,900
2/23[13] ......  16,600
3/ 2 .............   5,400
3/ 9 .............   9,200
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3/16 7,900
3/23 6,000
3/30 17,700
4/ 6 15,600
4/13[14] 11,300
4/20 8,500
4/27 9,800
5/ 4 15,000
5/11 12,600
5/18 9,300
5/25 24,900
6/ 1[15] 27,300
219 *219 6/ 8 9,500
6/15 20,400
6/22 10,300
6/29 15,100
7/ 6[16] 14,600
7/13 15,500
7/20 6,000
7/27 6,400
8/ 3 26,800
8/10 5,700
8/17 9,000
8/24 16,900
8/31 10,600
9/ 7[17] 3,900
9/14 4,600
9/21 5,600
9/28 31,900
10/ 5 24,600
10/12 30,100
10/19 35,500
10/26 18,400
11/ 2 67,600
11/19 13,200
11/16 20,300
11/23[18] 7,100
11/30 11,700
12/ 7 14,600
12/14 12,700
12/21 20,100
12/28 2,700
12/31 1,100

A total of 756,200 shares of Baldor stock were traded in 1979.

The monthly number of shares of Baldor stock traded, and the monthly high and low prices for the years 1978 and 1979 were as follows:

1978	Volume	High	Low
January	37,100	26¾	21 1/8
February	22,000	26 7/8	24 5/8

March	32,300	29 5/8	25¾
April	43,800	33 7/8	28 5/8
May	54,800	39½	34
June	93,100	39	19½
July[19]	44,200	26	20 1/8
August	72,700	32 7/8	25 3/8
September	50,400	34	29 1/8
October	101,500	32¼	20¾
November	63,200	26	20¾
December	67,400	28¾	22½
1978			
January[20] ...	45,800	26 3/8	23½
February[21] ..	41,000	26	24
March[22]	42,600	29 3/8	24¾
April[23]	48,500	3¾	28
May[24]	82,600	30¾	25
June	58,500	30 7/8	29
July	66,900	30 3/8	27¾
August	44,600	32¼	27½
September[25] .	46,000	31½	21¼
October	142,900	24 3/8	17½
November	85,600	18¾	17¼
December[26] ..	51,200	20½	18¼

On December 20, 1978, the mean between the highest and lowest selling prices was $25.1875.[27] The mean between the highest and lowest quoted selling prices was $30.875 on April 10, 1979.[28]

Petitioners valued the 19,910 shares of Baldor stock represented by stock certificate number CU6721 as of October 30, 1978, the date on which the successor trustee hand delivered the letter to her broker instructing him to effect delivery of the shares to the remaindermen. The shares were valued at $19.3125 per share,[29] for a total of $384,318.75. The 8,304 shares of Baldor stock that were not disposed of at the end of the six-month alternate valuation period were valued as of this date, April 10, 1979, at $28.375 per share,[30] for a total of $235,626.

Respondent determined that the appropriate valuation date for the 19,910 shares that were transferred to the remaindermen was
220 December 20, 1978, the date on which the shares were transferred on the books *220 of the issuing corporation. Respondent also determined that the appropriate value was the mean between the highest and lowest selling price on December 20, 1978, $25.1875, for a total of $501,483.13. Respondent accordingly increased the taxable estate by $117,164.38. Respondent agreed with petitioners that the 8,304 shares that were in the Estate at the end of the alternate valuation period were to be valued as of April 10, 1979. Respondent determined that the value of each share of Baldor stock on April 10, 1979, was $30.875, the mean between the highest and lowest selling price on that date, for a total of $256,386. Respondent accordingly increased the taxable estate by $20,760.[31]

III.

Decedent held three certificates of deposit at the Chippewa Bank, each with a face value of $10,000. At the time of her death the accrued, but unpaid, interest on all three certificates of deposit was $56.28.

A certificate of deposit at the Chippewa Bank may be cashed in before maturity, but a penalty of six month's interest is applied. If the owner of a certificate of deposit dies, however, the estate can either cash in the certificate of deposit, without penalty, and receive the face value of the certificate plus the entire accrued interest, or roll over the certificate of deposit into a new certificate issued in the name of the estate or an heir, without penalty.

IV.

At the time of her death, the decedent owned 320 acres of real estate in Fergus County, Montana. There were no structures on the property.

In Montana, property is classified and valued by the local government (and by private appraisers) according to its highest and best use. The highest and best use of the instant real estate is for grazing. Grazing land is classified by Fergus County numerically 1G through 6G, according to the average inches of yearly rainfall, type of vegetation that grows on it, quality of the soil, and water rights. Class 1G is the best and 6G is the worst; 6G is practically desert.

The real estate in issue is classified 4G, which is considered very poor land; only sparse grass and a lot of sage brush can be found on it. Approximately 50 acres of 4G grazing land are required to support an animal for about four months. There are no streams running through the property, nor are there any wells on the property, and no water rights exist. The average annual precipitation in the area is 10 inches of rainfall. Several ranchers in Fergus County have built small dams in ditches to catch rainfall runoff, thus creating a small reservoir. No such dams can be constructed on the instant land, as there is no creek to dam up, and the land is flat.

The nearest road leading to the property is a dirt trail about two or three miles away. The nearest paved road is west of the property, at a place called Bohemian Corners, twenty miles away. To get to the decedent's property one has to take a gravel road from Bohemian Corners, to a ranch owned by one Stier, and cut across his property. The **Sawade** property has no right of way over Stier's property. Roy, Montana, the nearest town, is approximately twenty-eight miles away.

Most of the land surrounding the property belongs to the Crooked Creek State Grazing Cooperative, a semi-governmental agency that leases grazing rights to its members. The other two properties adjoining the instant land belong to private persons. The total assessed value of the property (for local tax purposes) was $805, approximately $2.52 an acre, in 1978, and $806 in 1983.

Petitioners relied on an expert appraisal valuing the land at $50 an acre, or $16,000 total, in including the value of the land as part of the gross estate at the alternate valuation date.

Respondent determined in his statutory notice of deficiency that the fair market value of the real estate was $70 an acre on April 10, 1979, and correspondingly increased the taxable estate by $6,400.

Ultimate Findings of Fact

1. The alternate valuation date for 19,910 shares of decedent's stock in Baldor is December 20, 1978, the date on which the shares were transferred on the books of the issuing corporation.

221 2. The value of 19,910 shares of decedent's Baldor stock which are to be *221 valued at December 20, 1978, is $25.1875 per share. The value of 9,540 shares of said stock which are to be valued at April 10, 1979, is $30.875 per share.

3. The value, includable in the gross estate, of decedent's three certificates of deposit includes the accrued interest thereon.

4. The fair market value of decedent's 320 acres of grazing land located in Fergus County, Montana, was $16,000 at the alternate valuation date.

Opinion

I.

The alternate valuation date issue

The Estate elected to value the gross estate under the alternate valuation method of section 2032.[32] Section 2032 provides in pertinent part:

> SEC. 2032. ALTERNATE VALUATION.
>
> (a) General.—The value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate as follows:
>
> (1) In the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date of distribution, sale, exchange, or other disposition.
>
> (2) In the case of property not distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date 6 months after the decedent's death.
>
> * * *

The phrase "distributed, sold, exchanged, or otherwise disposed of" comprehends all possible ways by which property ceases to form a part of the gross estate. Section 20.2032-1(c)(1), Estate Tax Regs. The term "distributed" means the first to occur of the following: (i) The entry of an order or decree of distribution, if the order or decree subsequently becomes final; (ii) The segregation or separation of the property from the estate or trust so that it becomes unqualifiedly subject to the demand or disposition of the distributee; or (iii) The actual paying over or delivery of the property to the distributee. Section 20.2032-1 (c)(2), Estate Tax Regs.

The issue for resolution is whether a segregation or separation of 19,910 shares of Baldor stock from the Trust occurred, so that they became unqualifiedly subject to the demand or disposition of the distributees, when the successor trustee hand delivered a letter to Mr. Cummings instructing him to effect delivery of the shares to the distributees.[33]

In *Hertsche v. United States* [65-2 USTC ¶ 12,325], 244 F. Supp. 347 (D. Or. 1965), affd. per curiam [66-2 USTC ¶ 12,424], 366 F. 2d 93 (9th Cir. 1966), the District Court held that the value of some shares of stock distributed by the executor pursuant to a probate court order was determinable as of the date of the order directing distribution, not the date of physical delivery. The validity of section 20.2032-1(c) was upheld. In interpreting the word "distributed" as used in section 2032(a)(1), the District Court stated:

> The shifting of the economic benefits of the property rather than the formal delivery is sufficient for the purposes of taxation. [*Hertsche,* 244 F. Supp. at 350.]

In *Estate of Prell v. Commissioner* [Dec. 28,438], 48 T.C. 67 (1967) the executors of the estate assigned and delivered certain shares of stock to the residuary legatees on August 9, 1960. On the same day the legatees signed receipts for the stock and the stock certificates were delivered to a local stock brokerage house for forwarding to the issuing corporation so that the ownership of the shares of stock could be transferred on the corporation's books. On August 15, 1960, the corporation transferred the ownership of the shares on its stock transfer books and issued new stock certificates to the legatees. Under Ohio probate law, an executor could not distribute the assets of the estate until certain conditions were met, one of which was the expiration of six months from the date of the executor's appointment. The executors argued that the first date that the stock could have been legally delivered to the legatees, October 5, 1960, was the appropriate date for alternate valuation purposes. In rejecting the taxpayer's argument, this Court noted that the Ohio statute was intended to protect claimants of the estate; there was no evidence that there were any present or prospective claimants of the estate. This Court cited *Hertsche, supra,* and held that the word "distribution," as used in section 2032
222 and as defined in section 20.2032-1, Income Tax Regs., relates *222 to the shifting of the economic benefits of the property transferred, rather than to technicalities of state law. *Estate of Prell v. Commissioner,* 48 T.C. at 70. The alternate valuation date was held to be August 9, 1960, the date on which the stock was assigned and delivered to the legatees.

The relevant question then becomes: When were the economic benefits of the Baldor Electric Company stock transferred to the Trust remaindermen in this case?

Upon the death of the grantor-trustee, legal title to the trust properties passed to the successor trustee; the equitable title remained in the remaindermen.[34] *Watson v. Hardwick,* 231 S.W. 964 (Mo. 1921); *Garland v. Smith,* 164 Mo. 1, 64 S.W. 188 (1901); *McDaniel Title Co.v. Lemons,* 626 S.W. 2d 686 (Mo. App. 1981); *Penney v. White,* 594 S.W. 2d 632 (Mo. App. 1980). The remaindermen's interest was not certain as to any specific dollar value or specific property; the trustee had the power, in her sole discretion, to expend the principal of the Trust to pay certain items. The actions of the trustee in exercise of this power would be conclusive and binding on the remaindermen. The remaindermen could not pursue an action in state court to compel the successor trustee to transfer the stock. The death of the decedent, therefore, did not operate as a consolidation of the right to the economic benefits of the stock in the remaindermen.

In her letter dated October 30, 1978, Louise C. (Dewey) Hornstein, acting as successor trustee, instructed John P. Cummings, a stockbroker at Newhard, "to effect delivery" of 19,910 shares of Baldor stock, *held by him as her agent,* meaning that delivery had not been completed and was to be completed in the future.

A naked contract of agency—that is, one not coupled with an interest—may be revoked by the principal at any time, at least before performance by the agent, thereby terminating the agent's authority to act in the principal's behalf. *Chamberlain v. Grisham,* 360 Mo. 655, 230 S.W. 2d 721 (1950); *Berberet v. Myers,* 240 Mo. 58, 144 S.W. 824 (1912). This is so even if the agency agreement provides that the agency is irrevocable. *Kilpatrick v. Wiley,* 197 Mo. 123, 95 S.W. 213 (1906). The only exception to the rule is that a principal may not summarily revoke the authority of his agent in those cases where the agent has acquired with the authority conferred an interest in the subject matter of the agency. But an interest sufficient to render the agency irrevocable must be an interest in the thing itself or in the property which is the subject of the agency, and a mere interest in the results or proceeds of the execution of the authority as by way of compensation is not enough. *Meyer v. Pulitzer Pub. Co.,* 156 Mo. App. 170, 136 S.W. 5 (1911).

In any case where the agency is revoked by the principal, if it appears that the agent, induced by his appointment, has in good faith incurred expense and devoted time and labor in the matter of the agency without having had a sufficient opportunity to recoup from the undertaking, the principal will be required to compensate the agent. *Want v. Century Supply Company,* 508 S.W. 2d 515 (Mo. App. 1974). This is the agent's sole recourse. *Clarkson v. Standard Brass Mfg. Co.,* 237 Mo. App. 1018, 170 S.W. 2d 407 (1943). The right of the principal cannot otherwise be questioned. *Berberet, supra.*

Neither John P. Cummings nor Newhard had any interest in the 19,910 shares of Baldor stock. The statement in the October 30, 1978 letter to John P. Cummings that the instructions therein contained were irrevocable was ineffective under Missouri law. The above-mentioned letter did not constitute a distribution of the stock, as the successor trustee had the power to revoke her instructions at any time; she did not validly relinquish her right to transfer legal title of the stock to anyone other than the remaindermen.

Missouri law is determinative of when a distribution occurred.[35] A purchase includes taking by gift or any other voluntary transaction creating an interest in property. Section 400.1-201(32), Mo. Ann. Stat. (Vernon 1965). The acts of the successor trustee seeking to
223 transfer stock to the distributees are a voluntary transaction *223 which can create an interest in property within the meaning of the statute.

The execution of a stock assignment to Newhard for the two stock certificates, by the successor trustee on November 13, 1978, did not constitute a transfer of the shares of stock. An endorsement of a security, whether special or in blank, does not constitute a transfer until delivery of the security on which it appears, or if the endorsement is on a separate document, until delivery of both the document and the security. Section 400.8-309, Mo. Ann. Stat. (Vernon 1965). Delivery requires that the security be "in form to be negotiated by the purchaser." Section 400.8-314 Mo. Ann. Stat. (Vernon 1965). Thus, it must be at least endorsed and "any other requisite which may be necessary to obtain registration of the transfer of the security," such as a Missouri inheritance tax waiver, satisfied.[36] Sections 400.8-316, 400.8-401, Mo. Ann. Stat. (Vernon 1965). Section 400.8-313(1) provides, in pertinent part, that delivery to a purchaser occurs when: (a) he or a person designated by him acquires possession of a security; or (b) his broker acquires possession of a security specially endorsed to or issued in the name of the purchaser; or (c) his broker sends him confirmation of the purchase and also by book entry or otherwise identifies a specific security in the broker's possession as belonging to the purchaser; or (d) with respect to an identified security to be delivered while still in the possession of a third person when that person acknowledges that he holds for the purchaser; or (e) appropriate entries on the books of a clearing corporation are made under section 400.8-320.

We do not have here the situation described in section 400.8-313(1)(a), Mo. Ann. Stat. (Vernon 1965), since the remaindermen did not acquire possession of the stock prior to the transfer of the shares on the books of the issuing corporation, and Mr. Cummings was acting as an agent of the successor trustee when he obtained possession of the two stock certificates, not as the broker of the remaindermen.[37] Section 400.8-313(1)(b) is similarly not applicable here as the certificates obtained by the broker were not specially endorsed in the name of the distributees, nor did he take possession as the broker of the transferees until the transaction was completed, when the shares were taken out of the Trust's account and into the individual transferees' accounts.

Nor does section 400.8-313(1)(c) establish a date of distribution, as the shares were never identified by Newhard as belonging to the remaindermen, but stayed in the Trust's account until they were re-registered in the names of the distributees and received by Newhard on December 29, 1978.

Section 400.8-313(1)(d), Mo. Ann. Stat. (Vernon 1965), generally applies to margin trading, where the securities are pledged to secure the remainder of the purchase price not advanced by the purchaser. 3 Anderson, *Uniform Commercial Code,* 762 (1971). When Newhard received the reregistered stock certificates on December 29, 1978, it held the new certificates for the remaindermen, but this is not the delivery date, since the stock was earlier transferred on the books of the corporation.

We hold that the Baldor stock was distributed to the remaindermen on December 20, 1978, the date on which the shares of stock
224 were transferred on the books of the corporation.[38] Such date is accordingly *224 to be used as the alternate valuation date for 19,910 shares of Baldor stock.[39]

Petitioners argue that in *Prell* we held "the empty form of a receipt evidencing a momentary physical fact and not a true delivery of possession [to constitute a distribution under section 2032(a), and that this] should bolster the fact pattern of this case where the fiduciary took all possible steps within her control to effect distribution as of a specific date." In *Prell, supra,* the stock transfers were completed before the stock transfers were recorded on the stock transfer books of the issuing corporation. The distribution was completed upon the executor's endorsement of the shares and physical delivery of the stock certificates to the legatees, followed by the signing of receipts by the legatees acknowledging delivery therefor. The regulations clearly state that the actual delivery of the property to the distributees constitutes a distribution. Section 20.2032-1(c) (2)(iii), Estate Tax Regs. Neither the statute nor the regulations require that the distribution take any specified amount of time.

There was no segregation or separation of the property here from the Trust prior to the transfer of the stock on the books of the corporation, constituting delivery of the property to the remaindermen.

On this issue we hold for respondent.

II.

The blockage discount issue

The second issue for resolution is whether petitioners are entitled to a blockage discount in valuing the 19,910 shares of Baldor stock transferred to the remaindermen and the 9,540 shares that had not been disposed of on April 10, 1979; and if yes, whether section 2032 contemplates a transactional approach requiring that the distribution of 6,636 shares to Louise C. (Dewey) Hornstein; 6,637 shares to Dinan E. Hornstein; and 6,637 shares to Kathleen H. Rivero be considered as separate transactions for purposes of the blockage discount analysis.

Petitioners' position is that the introduction of two blocks of stock consisting of 19,910 and 9,540 shares, respectively, into the market would have depressed the market price of the stock. This argument is based on the theory of blockage. Petitioners' expert, Elmer Jarret, a trader for Newhard, testified that a 1 to 1½ point discount should be applicable for blocks of 19,910 and 9,540 shares on October 30, 1978, and April 10, 1979, respectively. Mr. Jarret's opinion on a blockage discount was based upon the assumption that the entire amount of each block would be sold on the respective valuation dates, as if each entire block were dumped on the market in one transaction at one time on each valuation date. Mr. Jarret did not consider the alternative of disposing of the stock in small amounts over a reasonable period of time, nor was he aware of the number of Baldor shares outstanding.

Respondent contends that a blockage discount is not proper and that the shares of Baldor stock should be valued at the mean between the highest and lowest selling prices on the respective valuation dates. Respondent argues that for purposes of our analysis, four different blocks of stock must be considered, consisting of: 6,636 shares transferred to Louise C. (Dewey) Hornstein; 6,637 shares transferred to Dinan E. Hornstein; 6,637 shares transferred to Kathleen H. Rivero; and 9,540 shares that had not been
225 disposed of at the end of the alternate valuation period, *225 on April 10, 1979. Respondent argues, in support of his contention, that section 2032 requires a transactional approach.

When the executor elects the alternate valuation method in section 2032, the value of every item of property includable in the decedent's gross estate is the fair market value thereof at the appropriate valuation date. Section 20.2031-1(b), Estate Tax Regs.

Generally, if there is a market for stock, in a stock exchange, in an over-the-counter market, or otherwise, the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share. Section 20.2031-2(b)(1), Estate Tax Regs.; *Rogers v. Helvering* [39-2 USTC ¶ 9742], 107 F. 2d 394 (2d Cir. 1939); affg. [Dec. 8848] 31 B.T.A. 994 (1935); *Estate of*

Damon v. Commissioner [Dec. 28,678], 49 T.C. 108 (1967).

Under certain circumstances, however, the value of a share of stock determined on the basis of selling or bid and asked prices does not reflect its fair market value. The size of the block of stock may be a factor to consider in determining whether the bid and asked prices reflect the fair market value of stock. Section 20.2031-2(e), Estate Tax Regs., explicity recognizes this in providing that:

> * * *
>
> In certain exceptional cases, the size of the block of stock to be valued in relation to the number of shares changing hands in sales may be revelant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. Complete data in support of any allowance claimed due to the size of the block of stock being valued shall be submitted with the return. On the other hand, if the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value.

The reasoning on which this theory of valuation is based is that a large block of stock cannot ordinarily be marketed and turned into cash as readily as a few shares; also, that where there is only a limited market for a stock, offering a large block of the stock depresses the market and lowers the price that can be obtained. The conclusion that flows from this premise is that evidence of sales of small blocks of stock is not a criterion of the value of a large block of the same stock. *Phipps v. Commissioner,* 127 F. 2d 214 (10th Cir. 1942), cert. denied 317 U.S. 645 (1942).

Blockage is not a law of economics, a principle of law or a rule of evidence. If the value of a given number of shares is influenced by the size of the block, this is a matter of evidence and not of doctrinaire assumption. *Safe Deposit & Trust Co. of Baltimore v. Commissioner* [Dec. 9549], 35 B.T.A. 259 (1937), affd. 95 F. 2d 806 (4th Cir. 1938). Blockage is not a rule of law, but a question of fact. *Estate of Christie v. Commissioner* [Dec. 32,546(M)], T.C. Memo. 1974-95. There is no presumption of blockage. *Maytag v. Commissioner* [51-1 USTC ¶ 10,800], 187 F. 2d 962 (10th Cir. 1951). Only those shares remaining in the estate on the alternate valuation date are considered for blockage discount. Section 2032; *Estate of Van Horne v. Commissioner* [Dec. 38,964], 78 T.C. 728 (1982), affd. 720 F. 2d 1114 (9th Cir. 1983), cert. denied ___ U.S. ___ (May 14, 1983). Petitioners bear the burden of proof. Rule 142(a); *Welch v. Helvering* [3 USTC ¶ 1164], 290 U.S. 111 (1933).

As a threshold requirement for consideration of evidence of the price at which shares could be sold outside the usual market, it must be shown that actual sales on the market, at or near the valuation date, are not representative of the value of the stock held because of the disproportion between the volume of market sales and the block of stock to be valued. *Estate of Van Horne v. Commissioner, supra.* The taxpayers must affirmatively show that the block is so big in comparison with the amounts of the stock which have been traded in on the exchange where it is listed that it could not be sold on such market at its quoted prices within a reasonable time by skilled brokers following prudent practices for liquidation. *Helvering v. Maytag,* 125 F. 2d 55 (8th Cir. 1942); *Mott v. Commissioner* [43-2 USTC ¶ 10,077], 139 F. 2d 317 (6th Cir. 1943); *Graff v. Munford,* 150 F. 2d 825 (2d Cir. 1945).

In valuing a block of stock, we are not required to assume that the entire block was dumped on the market at one time on the
226 valuation date. Rather, the inquiry must be directed to the effect upon the *226 market based on the assumption that the block was being fed out into the market during a reasonable period of time. *Estate of Van Horne v. Commissioner, supra,* 78 T.C. at 742. What is a reasonable period of time depends on all the facts and circumstances.

In *Bankers Trust Co.v. United States,* the Court of Claims made the following statement:

> While a large block of shares dumped on the market at one moment will ordinarily depress the market price for a time, *Seas Shipping Co.v. Commissioner, supra,* 371 F. 2d at 530, the courts which have considered the blockage issue have concluded that the problem should be treated in terms of whether the market could have absorbed the shares within a reasonable period of time. *Richardson v. Commissioner,* 151 F. 2d 102 (C.A. 2, 1945), cert. denied 326 U.S. 66 S. Ct. 490, 90 L. Ed. 485 (1946); *White Farm Equipment Co., supra,* 61 T.C. at 215. In those cases in which either a blockage discount has been allowed or the market price disregarded entirely because too large a block was involved, the number of shares being valued was very much greater than the total shares traded in a year. See, *e.g.,*

> *Amerada Hess Corp., supra,* 517 F. 2d at 89, 91 (665,000 shares being valued; 440,000 traded during entire year); *Moore-McCormack Lines, Inc., supra,* 44 T.C. at 760 (300,000 shares being valued; 166,000 traded during entire year). *Bankers Trust Co.v. United States,* 518 F. 2d 1210, 1221-1222 (Ct. Cl. 1975), cert. denied 424 U.S. 966 (1976). [40]

Applying the above-mentioned case to the facts of this case, we are persuaded that respondent must prevail on this issue. A total of 682,500 and 756,200 shares of Baldor stock were traded in 1978 and 1979, respectively. (The number of shares traded during 1979 is reduced to 746,796 if the 15,404 shares sold by the Trust is not taken into account.) Even assuming, arguendo, that for purposes of section 2032 we only have two blocks of stock consisting of 19,910 and 9,540 shares (to be valued at December 20, 1978, and April 10, 1979, respectively), the number of shares here involved is far below the total number of shares traded in the respective years, and is even less than the total shares traded in the respective months and weeks involved, as our findings of fact show. The Trust's sale of 11,900 shares of Baldor stock during the 5½ week period between January 31, 1979, and March 9, 1979, showed that a large block could be sold in smaller units over a reasonable period of time without depressing the market.

Petitioners have failed to favor us with any evidence relating to the condition of the corporation which was the issuer of the stock in question. We are not advised as to its worth, its present, past or prospective earnings or even the number of shares outstanding. In short, this record leaves us with only the volume of shares traded and the quoted bid and asked prices upon which to make our determination of the value of the stock in controversy.

We do have the conclusory opinion of petitioners' witness, a stockbroker, that a blockage discount of 1 to 1½ points was appropriate for a block of 19,910 shares; and that a block of 9,540 also required a discount of 1 to 1½ points. However, we cannot give much weight to that opinion inasmuch as it is based upon an incorrect definition of blockage, viz., that the shares in question are to be valued as all dumped on the market at the same time. Petitioners have failed to sustain their burden of proof. As was stated in *Estate of McKitterick* [Dec. 11,222], 42 B.T.A. 130, 137 (1940):

> Failure of the record to disclose that the market was so inactive on or about the critical date [valuation date] that it would have been impossible to dispose of the stock * * * in a reasonably short period of time thereafter, prevents the application of the so-called blockage theory. * * *

Upon the record before us, we conclude that the fair market value of the Baldor shares of stock was $25.1875 on December 20, 1978, and $30.875 on April 10, 1979.

In view of our holding that petitioners are not entitled to a blockage discount in valuing the shares of Baldor stock, we find it unnecessary to determine whether section 2032 requires a transactional approach.

On this issue we hold for respondent.

III.

The accrued interest issue

227 The third issue for resolution is whether the valuation of three certificates of deposit *227 should include $56.28 of interest accrued thereon.

Section 2031 provides that the value of the gross estate of the decedent is determined by including the value of all property at the relevant valuation date. Section 20.2031-4, Estate Tax Regs., provides:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. * * *

In *Jeschke v. United States,* ___ F. Supp. ___ (D. Kan. 1984), 53 AFTR 2d 84-1644, 84-1 USTC ¶ 13,562 (appeal pending, 10th Cir. October 26, 1984), the District Court held that the interest accrued was includable on the Federal estate tax return under sections 2031, 2033, and 2040.

At the time of his death, Emil J. Jeschke, owned 334 certificates of deposit in the face amount of $460,000.00. Each certificate was issued jointly in the name of the decedent, one of his children, his grandchildren, his great-grandchildren, or his wife. The accrued interest on these certificates of deposit was not reported on Form 706. In rejecting the taxpayer's argument that accrued interest should not be included in the gross estate since the estate had no right to receive it, the District Court stated:

> Rev. Rul. 79-340, 1979-2 C.B. [320] is particularly instructive on this issue. This ruling dealt with the value of certificates of deposit for estate tax purposes, when the certificates of deposit were redeemable before maturity without penalty upon the death of the owner. This is exactly the situation we have here. Value, according to the ruling, includes the value of the accrued interest to the date of death. This is so, because the certificates of deposit are worth no less than the most valuable right inherent in their ownership, and because these certificates may be redeemed at death without forfeiture of interest, their value includes the par value plus accrued interest to date of death. Revenue rulings do not have the force of law, but they are official interpretations by the Service and should be given weight. *Macey's Jewelry Corp. v. United States* [68-1 USTC ¶15,782], 387 F. 2d 70, 72 (5th Cir. 1967).

We have found that the value of the certificates includes the interest accrued.

On this issue we hold for respondent.

IV.

The real estate valuation issue

The final issue for resolution is the fair market value of 320 acres of grazing land located in Fergus County, Montana, on April 10, 1979, the end of the six-month alternate valuation period.

Fair market value is a question of fact to be resolved from a consideration and weighing of all the relevant evidence in the record. *Kaplan v. Commissioner* [Dec. 27,248], 43 T.C. 663 (1965). Section 20.2031-1(b), Estate Tax Regs., provides that the value of every item in the gross estate is the fair market value, defined as follows:

> The fair market value 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 to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

Respondent determined, in his statutory notice of deficiency, that the fair market value of the real estate was $22,400.00 ($22,400 ÷ 320 = $70.00 an acre). The deficiency determinations of the statutory notice of deficiency carry with them a presumption of correctness. *Welch v. Helvering, supra;* Rule 142(a). Petitioner bears the burden of overcoming this presumption. Respondent relies on this presumption of correctness in asserting that the fair market value of the property is $22,400.

Petitioners submitted evidence, through an appraiser whom we consider qualified, sufficient to overcome the presumption of correctness attached to the determination in respondent's statutory notice of deficiency. The burden of going forward then shifted to respondent. Respondent's "evidence" regarding the fair market value of the land in issue is limited to the following notation on page two of the explanation of items accompanying the statutory notice of deficiency:

> It is determined that the fair market value at the alternate valuation date, of the property shown on Schedule A was
228 $22,400.00 instead of $16,000 reported on *228 the estate tax return. Therefore, the taxable estate is increased $6,400.

Respondent did not introduce the report of an appraiser or the testimony of any witness in support of the higher valuation figure.[41]

On this issue we hold for petitioners.

To reflect the foregoing,

Decision will be entered under Rule 155.

[1] All statutory references herein are to the Internal Revenue Code of 1954, as in effect in the years in issue, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure.

[2] This subtotal represents sale transactions during the six-month alternate valuation period.

[3] This subtotal represents sale transactions after the six-month alternate valuation period.

[4] The parties agree as to the valuation date, but not as to the correct value.

[5] The parties agree as to both the valuation dates and values.

[6] The parties disagree both as to the correct valuation date and values.

[7] The parties agree as to the valuation date, but not as to the correct value.

[8] 2/20/1978 was a holiday. No shares were traded on that date.

[9] 3/24/1978 was a holiday. No shares were traded on that date.

[10] 5/29/1978 was a holiday. No shares were traded on that date.

[11] 9/4/1978 was a holiday. No shares were traded on that date.

[12] 11/23/78 was a holiday. No shares were traded on that date.

[13] 2/19/1979 was a holiday. No shares were traded on that date.

[14] 4/13/1979 was a holiday. No shares were traded on that date.

[15] 5/28/1979 was a holiday. No shares were traded on that date.

[16] 7/4/1979 was a holiday. No shares were traded on that date.

[17] 9/3/1979 was a holiday. No shares were traded on that date.

[18] 11/22/1979 was a holiday. No shares were traded on that date.

[19] On July 6, 1978, Baldor stock split two-for-one.

[20] A total of 1,700 shares of Baldor stock were sold by the Trust during this month.

[21] The Trust sold 7,800 shares of Baldor stock during this month.

[22] Sales of Baldor stock by the Trust totaled 2,400 shares during this month.

[23] A total of 2,500 shares of Baldor stock were sold by the Trust during this month.

[24] The Trust sold 1,004 shares of Baldor stock during this month.

[25] On September 24, 1979, Baldor stock split three-for-one.

[26] A total of 15,404 shares of Baldor stock were sold by the Trust during the year 1979; 11,900 of these 15,404 shares were sold during the 5½ week period between January 31, 1979, and March 9, 1979.

[27] The actual computation is as follows: 25¾ (high) + 25 5/8 (low) = 50.375 ÷ 2 = 25.1875.

[28] The actual computation is as follows: 31 (high) + 30¾ (low) = 61.750 ÷ 2 = 30.875.

[29] This figure is the mean between the highest and lowest selling prices on October 30, 1978, (23¼ (high) + 20 3/8 (low) = 43.625 ÷ 2 = 21.8125), less a 2.5 point discount for blockage (21.8125 - 2.5 = 19.3125).

[30] This figure is the mean between the highest and lowest selling prices on April 10, 1979, (31 (high) + 30¾ (low) = 61.75 ÷ 2 = 30.875), less a 2.5 point discount for blockage (30.875 - 2.5 = 28.375). The 1,236 previously gifted shares that were not disposed of by the donee during the alternate valuation period were not included in the gross estate. Petitioners have stipulated that these shares of stock should have been included in the gross estate, but contend that a 2.5 point blockage discount is appropriate in valuing the shares. Thus, a total of 9,540 shares are to be valued as of April 10, 1979.

[31] Respondent further determined that the 1,236 shares of previously gifted stock were to be included in the gross estate and valued as of April 10, 1979, at $30.875 per share, for a total of $38,161.50. Respondent accordingly increased the taxable estate by $38,161.50.

[32] Generally, all property interests includable in the gross estate are valued on the date of the decedent's death. Sec. 2031(a).

[33] There was no order or decree of distribution.

[34] Ordinarily, the legal title to the trust property does not vest automatically in the persons beneficially entitled on termination of the trust, but remains in the trustee until he makes a conveyance or distribution of it. 4 *Scott on Trusts,* sec. 345 (3d ed. 1967).

[35] The Missouri Uniform Commercial Code was adopted at the 1963 Regular Session of the General Assembly, and became effective on July 1, 1965, applicable to transactions entered into and events occurring after July 1, 1965. The 1977 amendments to the Uniform Commercial Code have not been adopted.

[36] Sec. 400.8-401, Mo. Ann. Stat. (Vernon 1965), provides in pertinent part:

400.8-401 Duty of issuer to register transfer

(1) Where a security in registered form is presented to the issuer with a request to register transfer, the issuer is under a duty to register the transfer as requested if

* * *

(d) any applicable law relating to the collection of taxes has been complied with; and

* * *

We find the requirement under Missouri law that an inheritance tax waiver be submitted in order for the shares of stock to be transferred by the stock transfer agent by a corporation not to be a technicality of state law. Petitioners do not argue otherwise. Cf. *Estate of Prell v. Commissioner* [Dec. 28,438], 48 T.C. 67 (1967).

[37] Petitioners argue that the stockbroker was acting as the individual agent of all of the remaindermen, based on the fact that all of the remaindermen maintained individual accounts at Newhard. On this record, it is clear that Newhard was acting as the agent of the successor trustee, not the remaindermen, in effecting the stock transfer.

[38] Petitioners argue that the "[t]rustee should not be compelled to merely place the stock in the stream of commerce for eventual transfer at the whim and convenience of a stock transfer clerk in a large stock transfer institution with the date of transfer to be determined by such variables as the illness of employees on a particular day or shifts in mood as to work habits." This contention is without merit. The delays criticized by petitioners are those of the executor-successor trustee, and not of Newhard or the stock transfer agent.

[39] Compare *Richardson v. Commissioner* [Dec. 41,608(M)], T.C. Memo. 1984-595. In *Richardson,* taxpayer, the beneficial owner of 1,442 shares of Babcock & Wilcox stock held under a living trust with the First Trust Company of Montana (Trust Company), sent a letter dated August 11, 1977, to the Trust Company withdrawing the stock from the living trust and requesting that the stock be delivered to the First National Bank & Trust Company of Helena, Montana (Bank), which was instructed as to the disposition of such stock by letter sent on the same day. The stock was donated to eight different charities. United Technologies made a tender offer to the shareholders of Babcock & Wilcox of $48 per share. A new tender offer at a price of $55 per share was made by J. Ray McDermott & Co., followed by a final offer of $62.50 per share, in response to which the 1,442 shares of Babcock & Wilcox were delivered to J. Ray McDermott on August 22, 1977, by the Bank. The transfer of the tendered shares on the books of Babcock & Wilcox, and issuance of new stock certificates, took place on September 16, 1977. This Court held that the gift of the stock to the eight charities was completed upon the Bank's tender of the stock to J. Ray McDermott & Co. *Londen v. Commissioner* [Dec. 27,600], 45 T.C. 106 (1965), distinguished. The facts of this case are clearly distinguishable. Furthermore, in *Richardson,* taxpayer's letter to the Trust Company, followed by the Bank's actions in furtherance of taxpayer's directives created an irrevocable trust under Montana law. No such situation is present here.

[40] See *Wheeler v. Commissioner* [Dec. 35,198 (M)], T.C. Memo. 1978-208. *Wheeler* involved the valuation of 32,029 shares of restricted, unregistered stock. The average trading volume during the first five months of the valuation year was in excess of 10,000 shares per month. This Court held that a blockage discount was inappropriate in view of the fact that the market was able to absorb the shares within a reasonable period of time.

[41] Respondent cites *Whitt v. Commissioner* [Dec. 40,108(M)], T.C. Memo. 1983-262, in support of his position. *Whitt* involved the valuation of 343 acres of land. The sole evidence introduced by the taxpayers was a deed by which five of the heirs sold their one-sixth interest in the land to the sixth heir. The Court held that the deed was relevant evidence as to the fact that the land had been sold, not to the effect that the sale was freely negotiated. This was deemed insufficient to contradict the testimony of the expert and his appraisal, introduced by respondent. The facts of this case are clearly distinguishable.

Schecter v. Watkins

395 Pa. Superior Ct. 363 (1990)

577 A.2d 585

Benjamin C. SCHECTER, M.D., Appellant, v. Donald R. WATKINS, M.D., Edward S. Konwinski, M.D. and Surgical Associates of Bradford.

Supreme Court of Pennsylvania.

Argued August 23, 1989.

Filed June 20, 1990.

Robert Gawlas, Wilkes-Barre, for appellant.

William J. Kubiak, Bradford, for appellees.

Before CAVANAUGH, BROSKY and ROWLEY, JJ.

BROSKY, Judge.

This is an appeal from the judgment entered on a jury verdict in favor of appellees and against appellant after denial of post-trial motions.

Appellant raises the following issues on appeal: (1) whether the trial court erred in granting appellees a compulsory non-suit on appellant's breach of contract action and denied his points for charge; (2) whether the trial court erred in refusing certain points for charge regarding appellant's "freeze-out" claim in favor of its own instructions; (3) whether the trial court erred in prohibiting appellant from presenting testimony that he owned an interest in Surgical Associates and in ruling, instead, that no stock option existed; (4) whether the trial court erred in refusing to permit appellant to read certain admissions made by appellees, in permitting appellant to read only portions of certain admissions of appellees and in failing to charge the jury concerning the effect of the admissions; (5) whether the trial court erred in denying appellant's Motion in limine at trial concerning acts of misconduct occurring prior to the renewal of his employment contract and in refusing to permit appellant to read into the record various admissions; and (6) whether the trial court erred in refusing to allow appellant to present evidence and argument relative to his claim for punitive damages and whether the court incorrectly instructed the jury on this claim. We affirm.

Appellant, Benjamin C. Schecter, M.D., was employed as a surgeon in Bradford, Pennsylvania, by Surgical Associates of Bradford (Associates). The appellees are Donald R. Watkins, M.D., Edward S. Konwinski, M.D., and Associates, which

terminated the employment of appellant at a meeting of the Board of Directors on August 10, 1984.[1] Appellant filed an action alleging, inter alia, breach of his written employment contract with appellees. At the time of his termination, Dr. Schecter was recovering from a bout with alcoholism at the Marworth Facility, which is part of the Geisinger Medical Center. At issue are two provisions of this contract, Paragraph Three and paragraph Five. These two provisions read as follows:

> 3. TERM OF EMPLOYMENT. The term of this Agreement shall be one (1) year from the date set forth unless either party shall give ninety (90) days notice of their intention to terminate the agreement prior to the end of the term. This Agreement shall otherwise terminate at any time if the Employee should cease to be authorized to practice medicine in the Commonwealth of Pennsylvania, if he should die or become permanently disabled or if the Employer and Employee should mutually so agree in writing. At any time after six (6) months from the date herein, Employer and Employee may renegotiate the term of this Agreement. * * * * * * 5. DISABILITY. A. In the event of the inability of the Employee to perform his duties pursuant to this contract for a period of up to six (6) successive months due to sickness or accident his full salary shall continue to be paid by the Employer during such period. In the event such disability continues beyond six (6) months he shall be compensated to the extent that the disability income insurance shall provide. The term disability shall be defined in accordance with the definition as contained in those contracts recited in paragraph C. In determining periods of disability, periods of disability shall be counted as successive if the Employee has not returned to work for at least one (1) month between such periods of disability. B. * * * C. * * *

Dr. Schecter argues that appellees' termination of his employment with Associates is in breach of Paragraph Five of the employment contract, above, because he was wrongfully terminated due to an illness, i.e., alcoholism. Dr. Schecter maintains that Paragraph Five prohibits termination on account of illness because its terms provide for continuation of salary payments during the disability period and, if necessary, the payment of disability insurance income. Appellees counter that Dr. Schecter's termination was in accordance with Paragraph Three of the contract. At the end of Dr. Schecter's presentation of evidence at trial, appellees moved for and were granted a non-suit on the breach of contract claim.[2] The rule regarding the entry of a non-suit has been oft-stated.

The entry of a non-suit is reserved for the clearest of cases. The plaintiff must be given the benefit of all the evidence and the reasonable inferences therefrom. All conflicts in evidence must be resolved in favor of the plaintiff. Viewing the evidence in this manner, if the trier could not reasonably conclude that the cause of action has been established,

[1] Doctors Watkins and Konwinski are officers as well as employees of Associates.

[2] The parties, both at trial and in their respective appellate briefs and the court at trial and in its Opinion filed in support of its order denying post-trial motions, refer to the dismissal of the breach of contract claim interchangeably as a non-suit or a demurrer to the evidence. Since in modern practice the demurrer has been virtually superseded by the compulsory non-suit, the procedures are, in effect, identical. *Vernon D. Cox & Co., Inc. v. Giles,* 267 Pa.Super. 411, 406 A.2d 1107, n. 2 (1979).

then a non-suit is proper. *Morena v. South Hills Health System,* 501 Pa. 634, 462 A.2d 680 (1983). Grounds exist for the entry of a non-suit if the plaintiff has failed to introduce sufficient evidence to maintain the cause of action. In that event, it becomes the duty of the court to determine, prior to sending the case to the jury, whether the plaintiff has met his evidentiary burden. Id.

The court concluded at the close of Dr. Schecter's case that the latter had not presented evidence upon which his breach of contract claim could be sustained. Our review of the trial transcript supports the trial court's ruling.

At trial, Dr. Schecter attempted to introduce and did, in fact, introduce evidence that alcoholism is an illness and, from that premise, attempted to prove that his discharge was in breach of Paragraph Five of the contract. Dr. Schecter presented evidence in the nature of testimony from health care personnel at the Marworth Center to this effect. He also presented evidence that this was the official position of the American Medical Association (AMA) and the Pennsylvania Medical Society (PMS). According to these organizations, fellow physicians had the responsibility to help each other on the road to recovery from alcoholism by encouraging the recovering alcoholic physician to once again become a productive member of the profession. Dr. Schecter attempted to demonstrate that appellees' termination of his employment with Associates was not in keeping with the position espoused by these professional organizations and, therefore, effected a breach of Paragraph Five of the employment contract.

Appellees have never contested that alcoholism is an illness. However, by the introduction of evidence to this effect, Dr. Schecter attempted to demonstrate that appellees' termination of him was because of his alcoholism and, therefore, constituted a breach of the terms of Paragraph Five of the employment contract. Dr. Schecter attempted to show that the official position of the AMA and the PMS was binding upon appellees to support his breach of contract claim. In addition, Dr. Schecter introduced evidence through the testimony of Dr. Colangelo, the president of the Marworth Center, that an individual who has lost employment because of alcoholism has a lesser chance of recovery. In short, the only evidence introduced by Dr. Schecter at trial to support his breach of contract claim was that alcoholism is an illness, that both the AMA and the PMS recognized this to be so and that appellees disregarded this position as well as that of the health care personnel at the Marworth facility.

At trial, appellees denied that Associates had terminated Dr. Schecter because of his alcoholism. At the meeting of August 10, 1984, Associates decided to terminate Dr. Schecter. According to the minutes of that meeting, as testified to by appellee, Dr. Watkins, Associates decided to terminate Dr. Schecter's employment under Paragraph Three of the contract. The termination was to be effective ninety days after notice to Dr. Schecter pursuant to the terms of Paragraph Three of the employment contract. According to the minutes, "Doctor Schecter [would] be discharged for reason of his material failure to perform and satisfy the terms and convenants [sic] set forth in

paragraphs one, two and three of said employment agreement." N.T. 62.[3] Nothing in the minutes of the meeting of Associates held on August 10, 1984, nor any other testimony adduced in the presentation of Dr. Schecter's case, specifically indicates as the reason for his termination his illness.

Dr. Schecter presented evidence at trial that Dr. Watkins, an appellee here, was previously stricken with coronary disease, was not dismissed because of this and continued to receive his salary, as well. Dr. Schecter urged at trial and now urges on appeal that illness due to coronary disease is no different from illness because of alcoholism in terms of continuing his salary and employment with Associates under the terms of Paragraph Five of the agreement. Appellees counter, however, that Associates was not dissatisfied with the services of Dr. Watkins, and, consequently, that physician was not terminated.

Although Dr. Schecter relies solely on Paragraph Five of the agreement to support his claim of breach, a fair reading of this paragraph indicates that it is not a term of employment clause. This paragraph provides for contingent financial security in the event an employed physician of Associates is unable to work because of illness or accident. This paragraph, according to its terms, would support a breach of contract action only if Dr. Schecter had remained an employee of Associates and then only if Associates had refused to pay the salary of Dr. Schecter for the specified period during his disability or if it had not maintained a contract of disability insurance on him or if the disability insuror had refused to compensate him according to the terms of the policy.

Paragraph Three of the agreement, however, is a term of employment clause and is specifically labeled as such. This paragraph provides for a term of employment of one year from the date set forth in the agreement unless either party to the agreement gives ninety days' notice of intent to terminate prior to the end of the one-year term.[4] Unlike the employment-at-will situation, the contract here in question was an express one limiting Associates' ability to discharge its employees. An employment contract of definite duration cannot be legally terminated by an employer prior to its expiration date. *Dorn v. Stanhope Steel, Inc.,* 368 Pa.Super. 557, 534 A.2d 798, appeal denied, 518 Pa.

[3] The minutes of the August 10, 1984 meeting disclose some doubt as to whether the subject employment contract, which was dated July 1, 1980, was still in force at the time Associates decided to notify Dr. Schecter that he would be terminated. This is because Paragraph Three of the employment contract provided that the duration of the agreement would be for one year from July 1, 1980. Each year subsequent to July 1, 1980, Associates held a meeting on June 30, renewing the contract for another year and increasing the salaries of the physicians employed by Associates. However, no meeting was held in 1984 until August 10. Because of the possibility that the employment contract was not in effect at the time of the August 10, 1984 meeting, Associates "elect[ed] to terminate Doctor Schecter's employment relationship with the corporation effective immediately because of his failure to provide services and meet the standards expected of him and set forth in the employment agreements heretofore in effect." N.T. 62. At trial, however, all parties agreed that the employment contract had been renewed and was in effect at the time of the August 10, 1984 meeting. Even under this contingency, however, Dr. Schecter's employment was not terminated because of his illness.

[4] Other reasons for termination contained in Paragraph Three are lack of authority to practice medicine, death, permanent disability or a mutual agreement in writing to terminate. These conditions do not require the ninety days' notice, nor are they applicable to the case at bar.

656, 544 A.2d 1342 (1988). An employer may not terminate an employee for the duration of the contract period absent just cause. *Greene v. Oliver Realty, Inc.,* 363 Pa.Super. 534, 526 A.2d 1192 (1987). The employment contract at issue here, however, expressly permits termination at the behest of either party to the contract prior to the end of the contract period without a showing of any cause.

In his Reply Brief, Dr. Schecter, in effect, concedes this point:

> If Defendants [appellees here], as they have contended from the very beginning of this litigation, could at any time terminate the employment relationship upon ninety (90) days [sic] notice, then they needed no justification for doing so; they needed only to show that the Contract allowed them to terminate on ninety (90) days [sic] notice and that they provided DR. SCHECTER with such notice.

At 8; emphasis supplied. Dr. Schecter does not argue that he was not given the requisite ninety-day notice of termination, nor does he argue that the terms of the employment contract were not the result of an arms' length bargained-for exchange. He admitted at trial that the language of the contract was clear and that the contract was not one of adhesion. At trial, counsel for Dr. Schecter stated the following:

> MR. LEVINSON: I object to the question as being irrelevant. The language of the contract speaks for itself. We have the document in evidence, [sic] I don't see there's any relevance concerning negotiations or terms of the contract.
>
> N.T. 145.
>
> MR. LEVINSON: Counsel agrees it was a contract negotiated at arms length, [sic] it's not a contract of adhesion.
>
> N.T. 146.

With regard to this issue, we find as follows: (1) Paragraph Five of the employment agreement is not a term of *employment clause. We have discussed the nature and purpose of this clause, above; (2) Paragraph Three of the employment agreement is a term of employment clause. As discussed above, it sets forth the duration of the term of employment and the circumstances under which the employee may terminate or may be terminated. It does not require cause for termination on the part of either the employer or the employee; (3) Dr. Schecter has not alleged or proven at trial any breach of Paragraph Three of the employment agreement. Specifically, Dr. Schecter has neither alleged nor proven that he was terminated without the requisite ninety-days' notice prior to the end of the contractual term, the only condition of termination applicable to him under the circumstances. Nor has he alleged or proven that the ninety-day termination provision is unconscionable, adhesive or was not bargained for. In short, Dr. Schecter failed to introduce any evidence at trial which the fact finder could

consider as giving rise to a breach of the subject employment agreement. We therefore conclude that the grant of the non-suit with respect to this claim was proper.[5]

Dr. Schecter's next challenge is to the jury charge on his claim of "freeze-out". He contends that his points for charge on this claim were correct and that the trial court's charge was erroneous and confusing. We disagree.

It is now well-settled that in reviewing a challenge to a jury charge, an appellate court will scrutinize the entire charge against the evidence presented to determine if prejudicial error has occurred. This court will not reverse on the basis of isolated inaccuracies if the charge as a whole was not erroneous and did not prejudice the complaining party. *Nobel C. Quandel Co. v. Slough Flooring, Inc.,* 384 Pa.Super. 236, 558 A.2d 99 (1989). We have reviewed the charge relating to Dr. Schecter's "freeze-out" claim, in particular, as well as the entire charge, generally, according to the aforementioned standard. From this reading, we are satisfied that the charge was accurate and sufficiently covered Dr. Schecter's requested points for charge on this issue.

The term "freeze-out", also known as and referred to by the trial court as a "squeeze-out", is defined in Black's Law Dictionary as follows:

> Action taken by persons in control of corporation resulting in termination of a shareholder's interest, and term implies a purpose to enforce a liquidation or sale of other stockholder's shares, not incident to some other wholesome business goal…. The use of corporate control vested in the statutory majority of shareholders from the enterprise or to reduce to relevant insignificance their voting power or claims on corporate assets. It implies a purpose to force upon the minority shareholder a change which is not incident to any other business goal of the corporation….

At 599. The trial court explained the concept of "freeze-out" to the jury as follows:

> The question you must decide is whether Doctor [sic] Watkins and Konwinski acted together to use their majority power to act without legal justification to do things which were intended to and did harm the plaintiff's economic position as a shareholder. Did they in other words freeze out another owner, did they breach their duty of loyalty and fairness so that they themselves would be economically benefited.

N.T. 690. Upon request for clarification, the trial court further explained the theory of "freeze-out":

[5] Dr. Schecter also makes the related argument that the trial court erroneously refused his Points for Charge relating to the breach of contract claim. The trial court stated that since it granted a non-suit to this claim, the points for charge on that issue were irrelevant. Although we agree that the points for charge were properly not given, a more accurate statement of the law is that a trial court must refuse to give a requested point which has no application to the facts or which assumes the existence of evidence not in the record. *Holland v. Zelnick,* 329 Pa.Super. 469, 478 A.2d 885 (1984).

> In order for the plaintiff to win you must be satisfied … that … the defendants used their ownership position to freeze out or force out Doctor Schecter unjustifiably and that as a result, he was economically harmed. To determine whether or not a freeze out has occurred, you have to examine the entire course of dealings between the parties. Did the defendants have good reason to do what they did. Or did they engage in a course of conduct with the intent of forcing the plaintiff out of the business and financially harming him…. If you determine that what the defendants did was motivated by an unethical or unfair or improper motive, then you may conclude that a freeze out has occurred. If however you determine that what they did was properly motivated, then a freeze out has not occurred.

Id., 712-713. This charge not only comports with the legal definition of "freeze-out" but is also substantially similar to the definitional charge requested by Dr. Schecter.

Any mention of damages on Dr. Schecter's claim for breach of the employment contract which was requested in connection with the points for charge on damages for the "freeze-out" claim was properly disallowed as the former claim was not before the jury. However, the court did instruct on damages relative to the "freeze-out" claim as follows:

> Now I have told you that whether or not Doctors Watkins and Knowinski and Surgical Associates of Bradford broke the employment contract is not an issue for you to decide. You may, however, take into account all of the circumstances surrounding the corporations' [sic] decision to discharge Doctor Schecter and in deciding whether or not he was frozen out. [Y]ou must be satisfied … that the plaintiff's [sic] used their ownership position to freeze out or force out Doctor Schecter unjustifiably and did so for their own economic benefit. If you decide that they did freeze out Doctor Schecter, then you must decide how much money, if any, they should pay Doctor Schecter to reimburse him for the loss he incurred due to their action.

At 690-91.

As part of his challenge to the jury charge, Dr. Schecter alleges that the court gave no instruction relative to the personal liability of Doctors Watkins and Konwinski, as officers of Associates, as requested in Point for Charge number fifteen. Using the aforementioned standard of reviewing a jury charge for errors or omissions, we conclude that the charge was not derelict in this regard. Throughout the jury charge, the trial court mentioned the potential liability of both Doctors Watkins and Konwinski to Doctor Schecter.

As his final challenge to the jury instructions, Dr. Schecter claims that the trial court erroneously, inadequately and in a confusing manner instructed the jury on the method of determining the fair value of Dr. Schecter's stock in Associates. According to Dr. Schecter, this instruction permitted the jury to consider any factor that body deemed appropriate in determining the fair value of the stock. Dr. Schecter avers that the trial

court failed to instruct the jury in the manner requested by his Point for Charge number sixteen. The charge as given by the court reads as follows:

> The law says that if he was frozen out he's entitled to be paid the fair value of his stock. What fair value is, how much money, is for you to decide. You have heard several factors which bear on this testified to and argued. They include for example book value, asset value, earnings and profit trends, absence of a covenant not to compete, the agreement of allocation of accounts receivable between Doctor Watkins and Doctor Konwinski and the market value of the shares. You may consider any such factor you think is appropriate in deciding what Doctor Schecter's twenty-five shares are worth.

Id., 691-92. In *In re Watt & Shand,* 452 Pa. 287, 304 A.2d 694 (1973), our Supreme Court explained that in determining the fair value of a minority holder's stock, "consideration must be given to all factors and elements which reasonably might enter into the fixing of value." 452 Pa. at 292, 304 A.2d at 698. The court then listed some of the factors which must be considered, viz: asset value, market value and price, management and its policies, earnings, dividends, valuation of assets, reserves for contingencies, tax liabilities, future earnings and projected business. We find that the court charged substantially according to the language of Watt which Dr. Schecter had cited as authority for his requested point. Therefore, Dr. Schecter's claim that the jury was impermissibly informed that it could consider any factor in the context of assessing fair valuation of his stock is unfounded.[6]

In his next issue, Dr. Schecter complains that he was improperly prohibited from presenting testimony and argument that he owned or was entitled to one-third of the stock of Associates. He also alleges that the court erred in concluding as a matter of law that no option existed to permit him to purchase additional stock to complete his one-third share. At trial, Dr. Schecter and Dr. Watkins both testified that Dr. Schecter, upon joining Associates, purchased twenty-five shares of the corporation. At several annual meetings of Associates, he was made an offer to purchase and asked if and when he would purchase the remaining shares, thus bringing him up to ownership parity with Doctors Watkins and Konwinski. Dr. Schecter, throughout his tenure with Associates, informed the corporation that he was financially unable to purchase the remaining shares.

At a meeting held on November 14, 1984, Associates resolved to ratify the withdrawal of its offer to Dr. Schecter to purchase any additional shares of stock. At trial, Dr. Schecter admitted that he never made demand upon Associates to exercise his option to purchase the remaining shares prior to the meeting of November 14, 1984. Dr. Schecter, despite his testimony, attempted to show that by letter of October 30, 1984, through his then counsel, Mr. Roth, he made a demand to purchase the remaining shares of stock which would then place him on parity with his colleagues at Associates. However, the court instructed the jury to disregard any indication that Dr. Schecter had

[6] Dr. Schecter, as part of this issue, reiterates his argument on the breach of contract claim. This matter has been discussed elsewhere in this Opinion.

made the demand because of the uncertainty surrounding the representation made in the letter. The court similarly disallowed any reference to this letter as representing a demand to purchase the outstanding shares when Mr. Wick, the secretary of Associates, was examined concerning his knowledge of Dr. Schecter's demand. The purpose of representing this letter to be a demand by Dr. Schecter to purchase the outstanding stock was to demonstrate that Associates had withdrawn its offer to purchase only after Dr. Schecter had attempted to exercise that right. Based upon this testimonial background, we conclude that Dr. Schecter's complaint that the trial court prohibited him from presenting evidence that he owned or was entitled to the remaining stock is lacking in factual basis.

The trial court held as a matter of law that Dr. Schecter had no right to acquire the additional stock because it did not construe the language of Paragraph Four of the employment agreement, which addresses the purchase of stock, as an option to sell or purchase. An option contract is a contract to keep an offer open. However, the option arises and exists only if and unless the optionee elects to exercise the option by unequivocally accepting the offer. *Warner Bros. Theatres, Inc. v. Proffitt,* 329 Pa. 316, 198 A. 56 (1938). Moreover, if an option is not exercised within the time set forth in the contract, it necessarily expires. *Western Savings Fund Society v. SEPTA,* 285 Pa.Super. 187, 427 A.2d 175 (1981). Two notable commentators have stated that while "time is of the essence in an option contract … this means only that the option cannot be exercised after the offer has lapsed." J. Calamari and J. Perillo, The Law of Contracts, at 91 (2d ed. 1977).

Based upon the foregoing principles of law, we conclude that an option to purchase the stock did exist but that its purported acceptance was, as a matter of law, at least untimely, if not equivocal. As noted above, Dr. Schecter, by his own admission, never accepted the offer to purchase during any contractual period of the employment agreement, although Associates periodically reminded him of his right under the agreement to elect to purchase the stock. The trial court ruled that the letter of October 30, 1984, which purportedly contained a demand to purchase under the agreement was, at best, equivocal.[7]

However, an even more compelling reason exists to hold that Dr. Schecter's option to purchase the outstanding shares of Associates was not valid even if acceptance of the offer to purchase had been unequivocal. Paragraph Four of the employment agreement, which is entitled "Compensation", addresses the purchase of stock as follows: "After the first year, should employment continue [sic] Employee shall have the right from time to time to purchase capital common stock of the corporation, the number of shares so purchased to be mutually agreed upon by Employer and Employee." (Emphasis supplied). Associates, at a meeting held on August 10, 1984, voted to terminate Dr. Schecter's employment relationship with it. As we stated elsewhere, Dr. Schecter does not argue that he did not receive notice of this meeting or of the ultimate decision of Associates to terminate his employment relationship with it. On November 14, 1984,

[7] Although the trial court admitted this letter as an exhibit, we have not been able to examine its contents because it does not appear of record.

Associates, by written resolution, ratified the withdrawal of its offer to Dr. Schecter to purchase any additional shares of Associates.[8] As noted elsewhere, Paragraph Three of the employment agreement provides for a ninety-day notice of termination. The November 14, 1984 ratification of the withdrawal of the offer and the November 8, 1984 letter to Dr. Schecter notifying him of the said withdrawal both occurred after the ninety-day notification of termination. Thus, withdrawal of the offer was proper because Dr. Schecter at that time was no longer an employee of Associates.

Additionally, because the trial court ruled that the terms of the letter of October 30, 1984 purporting to accept the offer to purchase were uncertain, the option to purchase expired by operation of the terms of the contract, in any event, ninety days after Dr. Schecter was notified on August 10, 1984, that he would be terminated. See Western Savings, supra, and Calamari & Perillo, supra. Therefore, no error occurred here.[9]

Next, Dr. Schecter maintains that the trial court erred in denying his motion in limine to preclude evidence of his misconduct prior July 1, 1984, the date on which the renewal of his employment contract became effective through June 30, 1985. The misconduct referred to is Dr. Schecter's behavior due to the effects of alcoholism.

Dr. Schecter initially argues that evidence of his behavior prior to July 1, 1984, prejudiced him before the jury and may have influenced the jury to bring in a verdict against him. The basis for Dr. Schecter's suit against appellees was that the latter had unjustly terminated him because of his bout with alcoholism. Dr. Schecter testified at trial that he recognized that he had been an active alcoholic for thirty years prior to obtaining treatment, that he had gone to the Marworth facility for initial evaluation in 1983 and was told then that he had a problem with alcohol, that he knew in the early 1970's that he had had a drinking problem, that he had this problem when he was hired by and all through his tenure with Associates and that Doctors Konwinski and Watkins had approached him about this problem as early as 1980 or 1981. Dr. Schecter also testified concerning an incident report which was filed against him in October 1983 concerning his behavior in the emergency room at Bradford Hospital. He stated that this incident resulted in a letter of January 4, 1984, from the hospital administrator that such behavior would not be tolerated. In short, Dr. Schecter presented the very evidence which he sought to have excluded by the Motion. Therefore, in light of his testimony, Dr. Schecter can hardly complain that the denial of the motion in limine was prejudicial to him.

[8] The minutes of this meeting indicate that Dr. Schecter was actually notified of withdrawal of the offer by letter dated November 8, 1984. Dr. Schecter does not dispute this.

[9] Dr. Schecter also appends to this issue two inconsistent arguments, viz: that a directed verdict should have been granted on the issue that he had the option to purchase additional stock and that whether he had the option to purchase the stock was a jury question. He also raises the contention that it was error to refuse Dr. Schecter's request to read the deposition testimony of Doctors Watkins and Konwinski into the record concerning the stock option. The former two arguments have not been included as part of or suggested by the Statement of Question relating to the issue under discussion. See Pa.R.App.P. 2116(a). The latter will be addressed as part of another issue, infra.

Alternatively, Dr. Schecter contends that even if evidence of his behavior prior to July 1, 1984, were relevant, appellees waived their defense of discharge on the basis of Dr. Schecter's problem with alcohol because Associates continued to renew Dr. Schecter's employment contract each year with concomitant salary increases. However, at trial, Doctors Watkins and Konwinski denied that they had discharged Dr. Schecter because he was an alcoholic. The minutes of the meeting of August 10, 1984, introduced as evidence at trial, gave as the reason for Dr. Schecter's termination breach of Paragraphs One, Two and Three of the employment agreement. The Doctors also testified that Associates discharged Dr. Schecter in accordance with the terms of Paragraph Three of the agreement. Hence this argument is also meritless.

Dr. Schecter's next complaint is that the trial court erroneously refused to permit him to read into the record various admissions made by Doctors Watkins and Konwinski in their depositions. These admissions refer to the stock purchase option and the breach of contract issue. Specifically with respect to the latter, Dr. Schecter wished to read into evidence Dr. Watkins' admission that he agreed that alcoholism is an illness. We have reviewed the deposition testimony to which Dr. Schecter refers and find that it is virtually identical to the testimony given by this witness at trial. The trial court properly refused to allow these admissions to be read into the record since the evidence was merely cumulative to that already presented. We have exhaustively discussed the substance of the breach of contract and stock purchase issues elsewhere in this Opinion and will not repeat it here.

Dr. Schecter also argues that an admission of Dr. Watkins in his deposition concerning a conversation with Mrs. Schecter should have been read into evidence as being relevant to the "freeze-out" claim, the claim for punitive damages and to impeach Dr. Watkins' testimony. That deposition testimony merely refers to a conversation between Dr. Watkins and Mrs. Schecter concerning Dr. Schecter's departure for Marworth and Dr. Watkins' concern for the future well-being of Dr. Schecter and Associates. We have reviewed this deposition testimony and are unable to ascertain how it relates to the "freeze-out" claim, the claim for punitive damages or in what respect it could be used to impeach Dr. Watkins. This argument constitutes a mere recital of bald allegations to that effect.

Dr. Schecter's last allegation of trial error relates to the court's refusal to admit into evidence the AMA and PMS standards on alcoholism and alcohol-impaired physicians because admission of these standards would be relevant to an award of punitive damages on the "freeze-out" claim. Dr. Schecter alleges that punitive damages were awardable on the basis that Dr. Watkins' and Dr. Konwinski's deviation from the aforesaid AMA and PMS standards constituted outrageous conduct and reckless indifference to Dr. Schecter's rights. Dr. Schecter also maintains that the trial court erroneously instructed the jury that it could award punitive damages only if it found that Dr. Schecter was entitled to compensatory damages in excess of one thousand eight hundred eighty-two dollars and seventy-two cents, representing the amount which he paid for the initial twenty-five shares of stock of Associates. The trial court's charge does not support the interpretation suggested by Dr. Schecter. The trial court merely stated

the amount which Dr. Schecter paid for the twenty-five shares of stock and then instructed the jury that it could award punitive damages if it determined that Dr. Schecter had suffered a financial loss as a result of a "freeze-out".

The purpose of punitive damages is to punish for outrageous conduct done in reckless disregard of another's rights. The aim of punitive damages is deterrence of similar conduct. *Kirkbride v. Lisbon Contractors, Inc.,* 521 Pa. 97, 555 A.2d 800 (1989), on remand, 385 Pa.Super. 292, 560 A.2d 809 (1989). Punitive damages must arise out of liability on the cause of action because they are an element of damages flowing therefrom. Thus, if no actual damages are sustained, an award of punitive damages is not appropriate. Id. Dr. Schecter's arguments, then, are moot in light of the jury's rendition of a verdict of non-liability in favor of appellees.

Judgment affirmed.

CAVANAUGH, J., concurs in the result.

T.C. Memo. 2004-160

UNITED STATES TAX COURT

MARK W. SENDA AND MICHELE SENDA, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17298-02. Filed July 12, 2004.

Daniel V. Conlisk, James R. Dankenbring, and James Robert Loranger, for petitioners.

Thomas C. Pliske, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: Respondent determined deficiencies of $185,572, $276,321, and $25,674 in petitioners' Federal gift taxes for 1998, 1999, and 2000, respectively.

After concessions by respondent, the issue for decision is whether petitioners' transfers of stock to two family limited

partnerships, coupled with petitioners' transfers of limited partnership interests to their children (or in trust therefor), constitute indirect gifts of the stock to the children (or to the trusts) within the meaning of section 2511.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulated facts are incorporated in our findings by this reference. Petitioners resided in Lake St. Louis, Missouri, at the time that they filed their petition in this case.

General Background

Petitioners have three minor children, Mark R. Senda, Janell N. Senda, and Ross J. Senda (collectively, the children).

On May 29, 1996, Mark W. Senda (petitioner) attended a seminar in Chicago, Illinois, on tax planning regarding the tax benefits of forming a family limited partnership (FLP). The seminar, Executive Tax/Financial Planning Seminar, was sponsored by Arthur Andersen, LLP, and Fraser Stryker Meusey Olson Boyer & Bloch, P.C., an Omaha, Nebraska, law firm. On December 30, 1996, petitioners formed, but did not fund, an FLP under Illinois law.

At the end of 1996 or beginning of 1997 and in 1998, petitioner received approximately $5-6 million worth of MCI WorldCom stock (stock) after MCI WorldCom acquired two companies where petitioner was successively employed.

The Mark W. Senda Family Limited Partnership

Sometime in 1998, petitioner met with James R. Dankenbring (Dankenbring), his attorney, to discuss in more detail the advantages of forming an FLP as a vehicle to hold investment assets and to serve as a means of making gifts. On or about April 1, 1998, petitioners signed the Mark W. Senda Family Limited Partnership Agreement (SFLP I Agreement). On June 3, 1998, the secretary of state of Missouri issued a certificate of limited partnership for the Mark W. Senda Family Limited Partnership (SFLP I). The partnership interests, as set forth in the SFLP I Agreement, were initially held as follows:

Partner	Percentage	Interest
Mark W. Senda, Trustee, or his successors in trust, under the Mark W. Senda Revocable Trust dated Nov. 20, 1996, and any amendments thereto	10.0	General
Mark W. Senda, Trustee, or his successors in trust, under the Mark W. Senda Revocable Trust dated Nov. 20, 1996, as amended thereto	89.8397	Limited
Michele Senda	0.1303	Limited
Mark W. Senda, as trustee for Mark R. Senda	0.010	Limited
Mark W. Senda, as trustee for Ross J. Senda	0.010	Limited
Mark W. Senda, as trustee for Janell N. Senda	0.010	Limited

Although the children's partnership interests were purportedly held for them in trust, there was no written trust agreement at the time of the transfers reflecting that the children were beneficiaries of any trust for which petitioner was the trustee. The children, as limited partners, reported income/losses from SFLP I on their individual tax returns. Trusts for the benefit of the children and of which petitioner was trustee have never filed tax returns.

On December 28, 1998, petitioners contributed to SFLP I 28,500 shares of stock in exchange for their partnership interests. Petitioners transferred the stock from their joint brokerage account to the brokerage account of SFLP I. Both accounts were held at Salomon Smith Barney. The children (or

trusts therefor) purportedly contributed oral accounts receivable in exchange for their partnership interests. The accounts receivable, however, were never reduced to writing, had no terms for repayment, and had not been paid as of the time of trial.

By fax dated December 28, 1998, petitioners informed their accountant that they had transferred stock to SFLP I and sought advice as to what percentage of partnership interests they should transfer to the children. On that same day, petitioner gave to each child (or trust therefor) a 29.94657-percent limited partnership interest in SFLP I. Michele Senda (Senda) gave to each child (or trust therefor) a 0.0434-percent limited partnership interest in SFLP I. The certificates of ownership reflecting these transfers were not prepared and signed until several years thereafter.

The SFLP I Agreement provides that the general partner shall prepare or have prepared annual financial statements. It further provides that, not less than annually, all partners shall meet to discuss the financial condition of the partnership. SFLP I has never had annual financial statements prepared or held partnership meetings. The only books and records maintained by petitioner, as general partner, were brokerage account statements and partnership tax returns. The 1998 Form 1065, U.S. Partnership Return of Income, for SFLP I was signed by the tax return preparer on October 8, 1999.

Senda & Associates, L.P.

Sometime in 1999, Dankenbring advised petitioner that, if petitioner wished to transfer additional property in partnership form to the children, he should form a second FLP instead of recapitalizing SFLP I.

On December 2, 1999, the secretary of state of Missouri issued a certificate of limited partnership for Senda & Associates, L.P. (SFLP II). On December 4, 1999, Robert Brendell signed, as trustee, the irrevocable trusts (trusts) for the benefit of each child. Petitioner and Senda, however, did not sign the trusts as "trustmakers" until May 1 and 11, 2000, respectively. Although the trusts also list Citicorp Trust South Dakota (Citicorp) as trustee, a representative of Citicorp never signed the trusts.

On December 17, 1999, petitioners signed the SFLP II Partnership Agreement (SFLP II Agreement). The partnership interests, as set forth in the SFLP II Agreement, were initially held as follows:

Partner	Percentage	Interest
Mark W. Senda, Trustee, or his successors in trust, under the Mark W. Senda Revocable Trust dated Feb. 23, 1998, and any amendments thereto	1.0	General
Mark W. Senda, Trustee, or his successors in trust, under the Mark W. Senda Revocable Trust dated Feb. 23, 1998, and any amendments thereto	97.97	Limited
Michele Senda	1.0	Limited
Citicorp Trust South Dakota and Robert Brendell, Trustees of the Mark R. Senda Irrevocable Trust	0.01	Limited
Citicorp Trust South Dakota and Robert Brendell, Trustees of the Ross J. Senda Irrevocable Trust	0.01	Limited
Citicorp Trust South Dakota and Robert Brendell, Trustees of the Janell N. Senda Irrevocable Trust	0.01	Limited

On December 20, 1999, petitioners contributed to SFLP II 18,477 shares of stock in exchange for their partnership interests. Petitioners transferred the stock from their joint brokerage account to the brokerage account of SFLP II. Both accounts were held at Salomon Smith Barney. Trusts for the children purportedly contributed oral accounts receivable in exchange for their partnership interests. The accounts receivable, however, were never reduced to writing, had no terms for repayment, and had not been paid as of the time of trial. On that same day, petitioner gave to each child, in trust, a 17.9-percent limited partnership interest in SFLP II. The

certificates of ownership reflecting these transfers were not prepared and signed until several weeks after the transfers.

By fax dated December 22, 1999, petitioners informed their accountant that they had transferred stock to SFLP II and sought advice as to the percentage of partnership interests they should transfer to the children to maximize their annual gift tax exclusions and use all of their remaining unified credits.

On January 31, 2000, petitioner gave to each child, in trust, an additional 4.5-percent limited partnership interest in SFLP II.

The SFLP II Agreement provides that petitioner, as general partner, shall keep the financial statements of the partnership for the most recent 3 fiscal years. SFLP II has never had annual financial statements prepared. The only books and records maintained by petitioner, as general partner, were brokerage account statements and partnership tax returns. The 1999 Form 1065 for SFLP II was signed by the tax return preparer on August 30, 2000.

Petitioner paid all legal fees and filing costs with respect to SFLP I and SFLP II. The partnerships did not reimburse those costs to petitioner, nor were those costs a liability of the partnerships.

Gift Tax Returns and the Notice of Deficiency

Petitioners filed Forms 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for 1998, 1999, and 2000. On those returns, petitioners reported split gifts of $462,379, $183,792, and $14,307.71 for 1998, 1999, and 2000, respectively. Those amounts reflect the discounted values of the partnership interests transferred to the children, which were calculated by multiplying, for each year in issue, the value of the property petitioners contributed to the partnerships, as reported on the Forms 709, by the percentage of the partnership interests transferred to the children. Petitioners then applied lack of marketability and minority interest discounts and subtracted the annual exclusion amount for each child.

In the notice of deficiency, respondent determined that the fair market value of the property transferred to the children was $1,798,647, $791,826, and $164,103 for 1998, 1999, and 2000, respectively. Those amounts reflect the value of the property that petitioners contributed to the partnerships without lack of marketability and minority interest discounts.

Valuation Discounts

The parties stipulate that, if we conclude (1) that the partnership interests, rather than the underlying assets, should be valued for gift tax purposes and (2) that discounts should be

applied to the net asset value of the partnership assets, the following discounts should apply:

Partnership	Date of Transfer	Minority Discount	Marketability Discount	Combined Discount
SFLP I	12/28/98	5.88%	35%	38.82%
SFLP II	12/20/99	15.44	35	45.0
SFLP II	1/31/00	17.12	35	46.13

There is no dispute as to the value of the stock without any discount.

OPINION

Section 2501 imposes a tax on the transfer of property by gift during the taxable year. This tax is imposed whether the transfer is in trust or otherwise and whether the gift is direct or indirect. See sec. 2511. A gift of property is valued as of the date of the transfer. See sec. 2512(a). The gift is measured by the value of the property passing from the donor, rather than by the value of the property received by the donee or upon measure of enrichment to the donee. See sec. 25.2511-2(a), Gift Tax Regs.

The fair market value of the transferred property is the "price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Sec. 25.2512-1, Gift Tax Regs. Where property is transferred for less than adequate and full consideration in

money or money's worth, the amount of the gift is the amount by which the value of the property transferred exceeds the value of the property received. See sec. 2512(b).

Petitioners contend that they made gifts of limited partnership interests and that the partnerships have economic substance and are valid under Missouri law. Thus, they argue that the partnerships may not be disregarded for Federal tax purposes and that the stipulated discounts apply in determining the value of the gifts. Petitioners further contend that, because they did not shift economic value to the children when they contributed the stock to the partnerships, they did not make gifts on formation of the partnerships.

Respondent does not dispute that the partnerships are valid under Missouri law or that the partnerships have economic substance. Respondent contends, however, that petitioners' transfers of the stock to the partnerships, coupled with the transfer of limited partnership interests to the children, were indirect gifts of the stock to the children. Accordingly, respondent argues that the stock, and not the partnership interests, should be valued for gift tax purposes. Respondent argues that "the transitory allocations to petitioners' capital accounts, if such allocations even occurred at all, were merely steps in integrated transactions intended to pass the stock to the petitioners' children in partnership form."

We need not discuss the burden of proof. We decide this case on the preponderance of the evidence. Whether the children's interests were held in valid trusts or not is not material to our decision.

Section 25.2511-1(h)(1), Gift Tax Regs., provides that a transfer of property by a taxpayer to a corporation represents a gift by the taxpayer to the other shareholders of the corporation to the extent of their proportionate interests in the corporation. In Shepherd v. Commissioner, 115 T.C. 376, 389 (2000), affd. 283 F.3d 1258 (11th Cir. 2002), we applied the principle that, like a transfer of property to a corporation, a transfer of property to a partnership for less than full and adequate consideration may represent a gift to the other partners.

In Shepherd, the taxpayer transferred real property and stock to a newly formed family partnership in which he was a 50-percent owner and his two sons were each 25-percent owners. Id. at 380-381. Rather than allocating contributions to the capital account of the contributing partner, the partnership agreement provided that any contributions would be allocated pro rata to the capital accounts of each partner according to ownership. Id. at 380. Because the contributions were reflected partially in the capital accounts of the noncontributing partners, the value of the noncontributing partners' interests

was enhanced by the contributions of the taxpayer. Accordingly, we held that the transfers to the partnership were indirect gifts by the taxpayer to his sons of undivided 25-percent interests in the real property and stock. Id. at 389. The Court of Appeals for the Eleventh Circuit affirmed our decision for the reasons stated in our Opinion.

Petitioners' transfers of stock in the instant case are similar to the transfer of property in Shepherd. In both cases, the value of the children's partnership interests was enhanced by their parents' contributions to the partnerships. Petitioners attempt to distinguish Shepherd by referring to our statement in that case that "not every capital contribution to a partnership results in a gift to the other partners, particularly where the contributing partner's capital account is increased by the amount of his contribution". Id. at 389. Petitioners argue that, in the instant case, petitioners' capital accounts were increased by the amount of their contributions. Petitioners further argue that, under Estate of Jones v. Commissioner, 116 T.C. 121 (2001), it is irrelevant that the contributions of the stock to the partnerships and the transfers of the partnership interests to the children occurred on the same day.

In Estate of Jones, the taxpayer contributed property to the partnerships and received continuing limited partnership interests in return. All of the contributions of property were

properly reflected in the capital accounts of the taxpayer. Id. at 128. In the instant case, however, it is unclear whether petitioners' contributions of stock were ever reflected in their capital accounts. On cross-examination, petitioner testified with respect to SFLP I as follows:

> Q And, at that same time, certainly the same day, you transferred the partnership interests, limited partnership interests from yourself and Michele to the children, correct?
>
> A Yes, sir.
>
> Q And when did you do that? On December 28?
>
> * * * * * * *
>
> A Well, keep in mind that these things have been weeks in the making. So the fact that they triggered at a particular day or on a particular day may or may not be relevant.
>
> The fact that that happened during that day, I couldn't tell you if it happened at 1:00, 3:00 or 5:00. If that's what you're asking me.
>
> Q That was what I was asking you. The transfer of the limited partnership interests, how did that occur on December 28, 1998?
>
> A How did that occur? Tell me where you're going. I'm not sure.
>
> * * * * * * *
>
> Q So how did you transfer it from yourself to the children?
>
> A How did I transfer? I'm not certain what the right, what you're looking for here.

It is apparent from petitioner's evasive testimony and from the total record that petitioners were more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged form than they were with the formalities of FLPs. Indeed, petitioner, as general partner, did not maintain any books or records for the partnerships other than brokerage account statements and partnership tax returns. Those tax returns were prepared months after the transfers of the partnership interests. Thus, they are unreliable in deciding whether petitioners transferred the partnership interests to the children before or after they contributed the stock to the partnerships. The same is true of the certificates of ownership reflecting the transfers of the partnership interests, which were not prepared until at least several weeks after the transfers. The informality is not surprising, inasmuch as petitioners alone, individually, or on behalf of their minor children were united in purpose and acted without restraint by any adverse interest. As a result, however, petitioners have presented no reliable evidence that they contributed the stock to the partnerships before they transferred the partnership interests to the children. At best, the transactions were integrated (as asserted by respondent) and, in effect, simultaneous.

Petitioners argue that there is sufficient evidence showing that they first funded the partnerships and then transferred the partnership interests to the children and direct our attention to the letters that they faxed to their accountant after they had funded the partnerships. Those faxes, however, establish only that petitioners had funded the partnerships. They do not show what the partnership ownership interests were immediately before the funding or how the stock was allocated among the partners' capital accounts at the time of the funding. Moreover, the fax seeking advice with respect to the SFLP II partnership interests was dated 2 days after petitioners had allegedly transferred the partnership interests to the children.

On this record, we conclude that the value of the children's partnership interests was enhanced upon petitioners' contributions of stock to the partnerships. Accordingly, we hold that petitioners' transfers of stock to SFLP I and SFLP II on December 28, 1998, and December 20, 1999, respectively, were indirect gifts of the stock to the children for purposes of sections 2501 and 2511. Respondent has conceded that the January 31, 2000, gifts were gifts of partnership interests and not gifts of stock. The gift tax thus shall be determined on the value of the stock rather than on the value of the partnership interests transferred.

We have considered the other arguments of the parties, and they are either without merit or need not be addressed in view of our resolution of the issue.

To reflect the foregoing and respondent's concessions,

Decision will be entered under Rule 155.

United States Court of Appeals
FOR THE EIGHTH CIRCUIT

No. 05-1118

Mark W. Senda and Michele Senda,	*	
	*	
Appellants,	*	
	*	Appeal from the United States
v.	*	Tax Court.
	*	
Commissioner of Internal Revenue	*	
	*	
	*	
Appellee.	*	

Submitted: September 12, 2005
Filed: January 6, 2006

Before MELLOY, BEAM, and BENTON, Circuit Judges.

BENTON, Circuit Judge.

Mark W. Senda and his wife, Michele Senda, received a notice from the Commissioner of Internal Revenue for deficiencies in gift tax. Reviewing their petition, the tax court[1] found deficiencies of $185,572 for 1998 and $276,321 for 1999. *See* ***Senda v. Comm'r***, 2004 WL 1551275 (T.C. Memo. 2004-160). The Sendas appeal under Section 7482 of the Internal Revenue Code. This court affirms.

[1]The Honorable Judge Mary Ann Cohen, United States Tax Court.

I.

In the spring of 1998, the Sendas created the Mark W. Senda Family Limited Partnership. Mark Senda – as trustee of his revocable living trust – was the general partner with a 10 percent interest, as well as a limited partner with a 89.8397 percent interest. Michele Senda owned a limited interest of 0.1303 percent. According to the partnership agreement, each of their three children had a limited interest of 0.01 percent – held in (an oral) trust with Mark Senda as trustee. The children reported partnership income/losses on their individual tax returns.

On December 28, 1998, in exchange for their interests, the Sendas transferred 28,500 shares of MCI WorldCom stock, then worth about $2 million, to the partnership. The children's trusts, according to Mark Senda, contributed oral accounts receivable (reported at $200) in exchange for their interests – which were unpaid at the time of trial. On their gift-tax return for 1998, the Sendas reported that on December 28, they gave all their limited interests equally to their three minor children.

By December 17, 1999, the Sendas formed a second partnership, Senda & Associates, L.P. Mark Senda's revocable trust was the general partner with a 1.0 percent interest, as well as a limited partner with a 97.97 percent interest. Michele Senda owned a 1.0 percent limited interest. Irrevocable (written) trusts for each child held limited interests of 0.01 percent each.

On December 20, 1999, in exchange for their interests, the Sendas transferred 18,477 shares of MCI WorldCom stock, then worth about $1.5 million, to this partnership. The children's trusts, according to Mark Senda, gave oral accounts receivable (reported at $148) in exchange for their interests – which were unpaid at the time of trial. On their gift-tax return for 1999, the Sendas reported that on

December 20, they gave a total of 53.7 percent limited interest in Senda & Associates, L.P., equally to the trusts for the three children.

The Sendas' essential claim is that they made gifts of partnership interests. The Commissioner says they made indirect gifts of stock. At stake is the value of the gifts. The Sendas value the partnership interests by multiplying the value of the stock by the percentage of interests transferred, and then discounting by (stipulated) lack-of-marketability and minority-status factors. The Commissioner values the gifts at the full undiscounted value of the stock.

II.

The Internal Revenue Code taxes the transfer of property by gift, whether "direct or indirect." 26 U.S.C. §§ 2501(a)(1), 2511(a). The Code "is clear and admits of but one reasonable interpretation: transfers of property by gift, by whatever means effected, are subject to the federal gift tax." ***Dickman v. Comm'r***, 465 U.S. 330, 334 (1984). "Thus, any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax." **Treas. Reg. (26 C.F.R.) § 25.2511-1(c)(1).**

A.

According to the Sendas, the tax court should have shifted the burden of proof to the Commissioner on the indirect-gift issue, under Tax Court Rule 142(a)(1). The Commissioner concedes he did not raise this issue in the notice of deficiency, but claims it is not a "new matter." This court reviews de novo whether an issue is a new matter in the tax court. *See* ***Blodgett v. Comm'r***, 394 F.3d 1030, 1040 (8th Cir. 2005).

"A new position taken by the Commissioner is not necessarily a 'new matter' if it merely clarifies or develops the Commissioner's original determination without

requiring the presentation of different evidence, being inconsistent with the Commissioner's original determination, or increasing the amount of the deficiency." ***Id.*** Here, indirect-gift analysis did not require new evidence, did not increase the 1998 and 1999 deficiencies, and was consistent with the value determinations in the deficiency. Thus, the indirect-gift issue was not a new matter, and the burden of proof was on the Sendas. *See* ***Clajon Gas Co. v. Comm'r*** , 354 F.3d 786, 789 (8th Cir. 2004).

B.

The tax court found that the Sendas "presented no reliable evidence that they contributed the stock to the partnerships before they transferred the partnership interests to the children." This sequence is critical, because a contribution of stock *after* the transfer of partnership interests is an indirect gift to the partners (to the extent of their proportionate interest in the partnership). *See* ***Shepherd v. Comm'r***, 283 F.3d 1258, 1261 (11th Cir. 2002), *affirming* ***Shepherd v. Comm'r***, 115 T.C. 376, 388 (2000); *cf.* **Treas. Reg. (26 C.F.R.) § 25.2511-1(h)(1)** (rule for corporations).

The Sendas attack the factual and credibility findings of the tax court. This court reviews tax court decisions in the same manner and to the same extent as decisions of the district court in civil actions tried without a jury. 26 U.S.C. § 7482(a)(1). Factual determinations are reviewed for clear error. *See* ***Estate of Schuler v. Comm'r***, 282 F.3d 575, 578 (8th Cir. 2002). This court upholds factual findings unless "left with a definite and firm conviction" that the tax court committed a mistake. ***Estate of Ford v. Comm'r***, 53 F.3d 924, 926-27 (8th Cir. 1995)(quoting ***Estate of Plamer v. Comm'r***, 839 F.2d 420, 423 (8th Cir. 1988)). Findings of credibility are nearly unreviewable. *See* ***Blodgett***, 394 F.3d at 1035.

The tax court's key findings are:

> It is apparent from petitioner's evasive testimony and from the total record that petitioners were more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged form than they were with the formalities of FLPs. Indeed, petitioner, as general partner, did not maintain any books or records for the partnerships other than brokerage account statements and partnership tax returns. Those tax returns were prepared months after the transfers of the partnership interests. Thus, they are unreliable in deciding whether petitioners transferred the partnership interest to the children before or after they contributed the stock to the partnerships. The same is true of the certificates of ownership reflecting the transfers of the partnership interests, which were not prepared until at least several weeks after the transfers. The informality is not surprising, inasmuch as petitioners alone, individually, or on behalf of their minor children were united in purpose and acted without restraint by any adverse interest. As a result, however, petitioners have presented no reliable evidence that they contributed the stock to the partnerships before they transferred the partnership interests to the children. At best, the transactions were integrated (as asserted by respondent) and, in effect, simultaneous.

Senda v. Comm'r, T.C. Memo. 2004-160, p. 15.

The Sendas object to these findings, pointing to evidence that they contributed the stock before transferring the partnership interests. First, they rely on their gift-tax returns, the partnership's income-tax returns, and the partnership certificates of ownership. The tax court did not clearly err in ruling these after-the-fact documents unreliable. Second, the Sendas emphasize two letters faxed to tax advisors, one about each partnership, asking what percents of partnership interests should be gifted in order to obtain the best tax treatment. These letters are not conclusive. The first letter is dated the same day as the transfer of stock to the first partnership, and thus does not indicate any specific order of events. The second letter is dated two days after the second stock transfer, although the Sendas' return says they transferred the

partnership interests two days earlier, the same day as the stock transfer. Significantly, the testimony of Mark Senda – that his business practice is to execute documents and transactions "as of" a certain date – undercuts the reliability of the dates on the letters. On this record, the tax court did not clearly err in its factual and credibility findings.

C.

In an alternative tack, the Sendas argue that it is "irrelevant" whether the stock transfer was before or after the gift of partnership interests. They say:

> If the Sendas had made their capital contributions after they made the transfers of their limited partnership interest, the contributions would still have been allocable to the capital accounts associated with the partnership interests retained by the Sendas. Therefore, it was impossible under the terms of the partnership agreements for the Sendas to transfer their capital accounts without transferring the corresponding partnership interests.

The Sendas believe this also distinguishes the *Shepherd* case – which the tax court follows – where the partnership agreement allocated additional contributions pro rata among the partners' accounts. *See* ***Shepherd***, 115 T.C. at 380, 389; 382 F.3d at 1261.

The Sendas overlook the ultimate finding of the tax court. Immediately after concluding that they did not meet their burden of proving that the stock transfers preceded the gifts, the tax court finds: "At best, the transactions were integrated (as asserted by respondent) and, in effect, simultaneous." The tax court recognizes that even if the Sendas' contribution would have first been credited to their accounts, this formal extra step does not matter.

In some situations, formally distinct steps are considered as an integrated whole, rather than in isolation, so federal tax liability is based on a realistic view of the entire transaction. *See* ***Comm'r v. Clark***, 489 U.S. 726, 738 (1989). This step-transaction doctrine is "impliedly included in the gift tax statute itself." *See* ***Sather v. Comm'r,*** 251 F.3d 1168, 1174 (8th Cir. 2001). This court's very first case referencing the gift tax held that the events were "steps in one transaction." ***Oberwinder v. Comm'r***, 147 F.2d 255, 259 (8th Cir. 1945).

Whether several transactions should be considered integrated steps of a single transaction is a fact question which this court reviews for clear error, in the absence of a controlling statute, regulation, or constitutional question. *See* ***Sather,*** 251 F.3d at 1173; ***Dobson v. Comm'r***, 320 U.S. 489, 502 (1943). The general characterization of a transaction for tax purposes is a question of law, subject to de novo review. *See* ***IES Indus., Inc. v. United States,*** 253 F.3d 350, 351 (8th Cir. 2001)(*quoting* ***Frank Lyon Co. v. United States***, 435 U.S. 561, 581 n. 16 (1978)).

The key findings, quoted above, show that the transactions here were integrated and simultaneous. These findings are amply supported. For example, as to the first partnership, Mark Senda testified on cross-examination:

> Q. And, at that same time, certainly the same day, you transferred the partnership interests, limited partnership interests from yourself and Michele to the children, correct?
>
> A. Yes, sir.
>
> Q. And when did you do that? On December 28?
>
> A. When did I do that?
>
> Q. Yes, sir.

A. Well, keep in mind that these things have been weeks in the making. So the fact that they triggered at a particular day or on a particular day may or may not be relevant.

The fact that that happened during that day, I couldn't tell you if it happened at 1:00, 3:00 or 5:00. If that's what you're asking me.

Q. That was what I was asking you. The transfer of the limited partnership interests, how did that occur on December 28, 1998?

A. How did that occur? Tell me where you're going. I'm not sure.

....

Q. So how did you transfer it from yourself to the children?

A. How did I transfer? I'm not certain what the right, what you're looking for here.

Q. Did you just decide that today's the day I'm transferring the interest?

A. My wife and I, with counsel and advice, that happened to be the same day, yes, sir, that all occurred.

The tax court did not clearly err in finding that the Sendas' transfers were integrated steps in a single transaction. Moreover, the general characterization of the transaction is correct as a matter of law.

D.

The Sendas pose two other questions of law (or at least mixed questions of law and fact), which this court reviews de novo. *See* ***Clajon Gas Co.***, 354 F.3d at 789. First, they claim that the tax court ignores Missouri law that an entity (here, the limited partnerships) may not be disregarded "merely because of technical

deficiencies in the documentation or timing of certain transactions, " citing *Fairbanks v. Chambers*, 665 S.W.2d 33, 37 (Mo. App. 1984).

"State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." ***Morgan v. Comm'r***, 309 U.S. 78, 80 (1940). This approach balances the legitimate and traditional interest of the State in creating and defining property interests, and the necessity for uniform administration of the Internal Revenue Code. ***Aquilino v. United States***, 363 U.S. 509, 513 (1960).

The tax court does not violate these established rules in this case. It does not ignore the existence of the family limited partnerships, the transfers to and within them, or the capital provisions of the partnership agreements. To the contrary, the tax court recognizes these facts, and then applies federal law on indirect gifts and step transactions in order to determine how they are taxed.

Finally, the Sendas assert that in gift-tax cases, the step-transaction doctrine is limited to identifying the transferor or transferee. This assertion is refuted by this court's reciprocal-trust cases of *Sather* and *Schuler*: "The application of the reciprocal trust doctrine is not limited only to identifying the true transferor or transferee, but also applies to determining the nature of the property transferred." ***Schuler***, 282 F.3d at 578, *citing* ***Sather***, 251 F.3d at 1174. More generally as to issues beyond reciprocal trusts, such a limitation would contradict the expansive sweep of the gift-tax law itself, which taxes any "indirect" gift. *See* 26 U.S.C. 2511(a); ***Dickman***, 465 U.S. at 335. "The terms 'property,' 'transfer,' 'gift,' and 'indirectly' are used in the broadest and most comprehensive sense." ***Jewett v. Comm'r***, 455 U.S. 305, 309 (1982); ***Smith v. Shaughnessy***, 318 U.S. 176, 180 (1943). In sum, the Sendas' proposed limitation would be contrary to the precedent of the Supreme Court, which calls the step-transaction doctrine "well-established"

and "expressly sanctioned." *See* ***Clark***, 489 U.S. at 738; *cf.* ***Lannan v. Kelm***, 221 F.2d 725, 736 (8th Cir. 1955)("The idea that for purposes of taxation we are concerned with the substance and not the form appears to be well established, especially in regard to intra-family transactions").

III.

The judgment of the tax court is affirmed.

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607 A.2d 1213 (1992)

In the Matter of the Appraisal of SHELL OIL COMPANY.

Supreme Court of Delaware.

Submitted: February 4, 1992.
Decided: May 26, 1992.

Richard L. Sutton, William O. LaMotte, III and Robert J. Valihura, Jr., Morris, Nichols, Arsht & Tunnell, Wilmington (Rory O. Millson (argued), Cravath, Swaine & Moore, New York City, of counsel), for appellants.

Clark W. Furlow, Smith, Katzenstein & Furlow, Thomas P. Preston and John L. Olsen, Duane, Morris & Heckscher and Lawrence C. Ashby, Ashby & Geddes, Wilmington (H. Lee Godfrey (argued), and Kenneth E. McNeil, Susman Godfrey, Houston, Tex., and Edward M. Selfe, Bradley, Arant, Rose & White, Birmingham, Ala., of counsel), for appellees.

Before MOORE, WALSH, JJ., and TAYLOR, Judge (sitting by designation pursuant to Del. Const. art. IV, § 12).

1215 *1215 WALSH, Justice:

This is an appeal from a decision of the Court of Chancery in an appraisal action brought pursuant to 8 *Del.C.* § 262. Petitioners below-appellees ("petitioners"), former minority shareholders of respondent below-appellant **Shell Oil** Company ("**Shell**"), sought an appraisal of the fair value of **Shell's** common stock on June 7, 1985, the date shareholders were cashed out at $58 per share. The cash out resulted from a short-form merger effectuated by **Shell's** 94.6 percent majority stockholder, respondent below-appellant **Shell** Petroleum, Inc. (f/k/a SPNV Holdings, Inc.) ("Holdings"),[1] as required by a court approved settlement of an earlier class action.

The Court of Chancery determined that the fair value of the shareholders' stock was $71.20 per share at the time of the merger. The court further found that the shareholders were entitled to simple interest at a rate of 10 percent per annum per share. In this appeal, **Shell** challenges the Court of Chancery's fair value determination and the shareholders cross-appeal the Court of Chancery's award of simple interest rather than semi-annual compounding of interest.

We have carefully reviewed the record in this case and have concluded that there is sufficient evidence to support the findings of the Court of Chancery. Accordingly, the decision of the Court of Chancery is affirmed.

I

The events leading up to the privatization of **Shell** and the extensive litigation it spawned are described in detail elsewhere. *See Joseph v. **Shell Oil** Co.,* Del.Ch., 482 **A.2d** 335 (1984) (tender offer materials failed to satisfy disclosure requirements); *Joseph v. **Shell Oil** Co.,* Del.Ch., C.A. Nos. 7450 and 7699-NC, Hartnett, V.C. (April 19, 1985) (approving proposed settlement of class action); *Selfe v. Joseph,* Del.Supr., 501 **A.2d** 409 (1985) (affirming class action settlement); *Simon v. SPNV Holdings, Inc.,* Del.Ch., C.A. No. 8395-NC, Hartnett, V.C. (Oct. 28, 1987; reversed Nov. 2, 1987) (denying defendant's motion to dismiss claims of material nondisclosure in merger materials); *Smith v. SPNV Holdings, Inc.,* Del.Ch., C.A. No. 8395-NC, Hartnett, V.C., 1989 WL 44049 (April 26, 1989) (denying defendant's motion for summary judgment on disclosure claims); *Smith v. **Shell** Petroleum, Inc.,* Del.Ch., C.A. No. 8395-NC, Hartnett, V.C., 1990 WL 84218 (June 19, 1990) (holding that defendant failed to adequately disclose all material facts prior to cash-out merger); *In the **Matter** of the Appraisal of **Shell Oil** Co.,* Del.Ch., C.A. No. 8080, Hartnett, V.C., 1990 WL 201390 (Dec. 11, 1990) (hereinafter *Appraisal of **Shell,*** slip op.); ***Shell** Petroleum, Inc. v. Smith,* Del.Supr., 606 **A.2d** 112 (1992) (affirming the Court of Chancery's award of damages for material misstatements in connection with the cash-out merger). Much of this background is only tangentially related to the issues raised in this appeal. We will therefore summarize it briefly.

Prior to the merger which precipitated these proceedings, **Shell** was a publicly traded **oil** and gas company with substantial

assets throughout the world. It was, however, only one component of a much larger natural resources conglomerate, Royal Dutch Petroleum Company ("Royal Dutch"). Royal Dutch controlled, either directly or through subsidiary holdings, over 70 percent of **Shell's** outstanding shares.

During the early 1980's, Royal Dutch began considering the acquisition of **Shell's** minority shares. To that end, it retained in 1984, the investment banking firm of Morgan Stanley & Co. ("Morgan Stanley") to prepare an estimate of the value of **Shell** stock. Morgan Stanley opined that a share of **Shell** stock was worth $53. Royal Dutch thereafter proposed to **Shell's** Board of Directors that **Shell** merge with Royal Dutch for a consideration of $55 cash for each share of **Shell** stock.

1216 *1216 In response to this offer by its majority stockholder, **Shell's** board appointed an independent committee comprised of six outside directors to consider the offer. The committee retained the firm of Goldman Sachs & Co. ("Goldman Sachs") as its financial advisor and commissioned a study of the fair value of **Shell** stock. In the resulting study, Goldman Sachs concluded that $80 to $85 per share was a range of "high confidence" and that $70 per share was the lowest price it could say was fair. The committee thereupon recommended that the **Shell** Board reject the Royal Dutch offer.

Royal Dutch then commenced a tender offer for any and all shares at a price of $58 per share with the announced intention of effectuating a freeze-out merger after completion of the offer. It completed the offer in 1984, increasing its holdings in **Shell** to 94.6 percent. However, Royal Dutch's planned short-form merger was enjoined during the pendency of litigation which continued to call into question the propriety of the tender offer. *See Selfe v. Joseph,* Del.Supr., 501 **A.2d** 409 (1985). As a result of the decision in *Joseph,* Royal Dutch was required to pay an additional $2 per share to all those shareholders who had tendered into its offer as well as increase the merger consideration from $58 to $60 for the benefit of shareholders not electing the appraisal remedy at the back-end of the transaction. *See Joseph,* 501 **A.2d** at 410.

II

After the merger was complete, 1,005,081 shares qualified for appraisal under 8 *Del.C.* § 262. The Court of Chancery conducted an appraisal hearing which lasted seven days. The parties offered extensive evidence, primarily through competing experts, respecting the value of **Shell** shares as of the date of the merger.

Petitioners' chief witness was Kurt Wulff ("Wulff"), a chemical engineer and graduate of the Harvard Business School. Wulff's experience in the **oil** and gas field spanned twenty years and included financial analysis and asset valuation. To arrive at a fair value for **Shell** shares, he employed three different approaches. First, he offered what he called a Present Value of Equity Analysis. Essentially, this approach entailed a determination of the liquidation value of **Shell's** upstream assets, such as **oil** and gas reserves and exploratory acreage, and the valuation of **Shell's** downstream assets, such as its **Oil** Products and Chemical Products divisions, on a return on investment basis. Wulff concluded that under this method a share of **Shell** stock on June 7, 1985 was worth $100 on a buyer's tax cost basis and $89 on a seller's tax cost basis.

Second, Wulff offered what he termed a Comparative Deal market Analysis. This methodology involved comparing the results yielded by Wulff's Present Value of Equity Analysis with share prices reflected in similar transactions in the **oil** and gas industry, such as DuPont's purchase of Conoco and Chevron's acquisition of Gulf **Oil**. After comparing the transaction at issue here with seventeen other industry acquisitions, Wulff fixed the fair value of a share of **Shell** stock on the merger date at approximately $106.

Wulff's final valuation standard he referred to as a Trading Market Analysis. This inquiry rests on the assumption that the stock of corporations such as **Shell** trade on the open market at a discount from their fair value. To compensate for the effect of merger speculation, Wulff constructed a hypothetical price he believed **Shell** would have traded for on the open market in 1985 had no offer been made in 1984. To this price he added a premium calculated from the premiums over market price obtained by shareholders when other **oil** companies, such as Gulf and Conoco, were acquired. Depending on which comparable was selected, Wulff found a range in value from $92 to $143 per share.

Shell's expert, Morgan Stanley, also took a three pronged approach in its valuation of **Shell**. It first offered a liquidation study using a discounted cash flow of **Shell's** upstream assets and an estimate of the value of **Shell's** downstream assets based

1217 largely on a trading market analysis. *1217 This methodology yielded a valuation of $57.50 per share at the time of merger.

Next, Morgan Stanley offered what it called a Merger Market Analysis. This technique is similar to Wulff's Comparative Deal Market Analysis in that it involved a comparison of **Shell** to other similar companies which had experienced acquisition. Morgan Stanley concluded that this method suggested a fair value of $60 per share.

Finally, Morgan Stanley offered its own Trading Market Analysis based on a calculation of what **Shell** stock would have traded for had there been no merger offer. The quest here was to determine an "unaffected stock price." This was done simply by comparing the price of **Shell** stock to other domestic and international **oil** and gas companies which had not gone through change of control or restructuring transactions in the relevant time period. The conclusion of this analysis was that **Shell** was worth $43 to $45 per share on June 7, 1985.

III

In an extensive opinion, the Vice-Chancellor addressed the merits and deficiencies of the competing value studies. He found neither of the trading market analyses particularly convincing. He assigned no weight to Wulff's Trading Market Analysis due to numerous flaws in the method used to arrive at the price range of $92 to $143. Of particular significance, the court found that Wulff improperly relied, as a basic premise, on the proposition that **Shell** stockholders were entitled to a premium over **Shell's** value. *Cf.* *Cavalier **Oil** Corp. v. Harnett,* Del.Supr., 564 **A.2d** 1137, 1144 (1989). As for Morgan Stanley's Trading Market Analysis, the court concluded that Morgan Stanley's finding that **Shell** stock in June of 1985 would have experienced no change from its January, 1984 price notwithstanding a substantial rise in the market price of other **oil** stocks during the same period, was "highly illogical." This rejection was consistent with the court's earlier finding that **Shell** was "a superior company to most of those studied by Morgan Stanley and should have been priced above the median." *Appraisal of **Shell,*** slip op. at 55. The court therefore afforded Morgan Stanley's Trading Market Analysis very little weight.

The Vice Chancellor also assigned little weight to the proffered techniques based on comparing the **Shell** transaction to other similar "deals." Although he found Wulff's Comparative Deal Market Analysis to be "an acceptable method for evaluating a corporation like **Shell**," Wulff's conclusions were found to be "of little use" because of a number of "inconsistencies and biases in favor of the party paying for the analysis." *Id.* at 32. Specifically, the court viewed Wulff's reliance on the buyer's tax cost basis of his Present Value of Equity Analysis to be a fatal flaw. The Vice Chancellor therefore concluded that Wulff's Deal Market comparisons were "less valid" than his Present Value of Equity Analysis.

Morgan Stanley's Merger Market Analysis fared little better. The Vice Chancellor found, *inter alia,* that Morgan Stanley's calculations were often too "pessimistic" and that Morgan Stanley failed to accord sufficient weight to **Shell's** more valuable domestic reserves, as opposed to its less valuable foreign reserves. The court concluded that the Morgan Stanley's Merger Market Analysis was "less valid" than its Liquidation Value Analysis.

As to the parties' liquidation value techniques, the court found both to be valid methodologies but somewhat flawed in their application. The court characterized Wulff's Present Value of Equity Analysis as "a sufficiently accurate and accepted technique to be entitled to considerable weight in determining the fair value of the shares." *Id.* at 18. However, it noted numerous instances where Wulff made assumptions "based on acceptable, but speculative, factors" and implied that many of these assumptions were "justifiable," yet "optimistic."

Similarly, the court found Morgan Stanley's Liquidation Analysis to be an acceptable valuation technique although it had a
1218 tendency toward understatement. The court commented that "in preparing its estimate [Morgan Stanley] obviously made *1218 hundreds of assumptions as to the value of a particular asset. In most instances it chose the lower, rather than the higher, value.... It is therefore clear that Morgan Stanley's Liquidation Analysis is substantially flawed." *Id.* at 53.

After reviewing the valuation evidence in its effort to fix the fair value of **Shell** stock on the date of the merger, the Court of Chancery expressed some dissatisfaction with the lack of objectivity in the presentations. The court noted that it was "obvious... that the dynamics of this litigation and the economic interest of the parties contributed to the wide differences in the expert opinions" but the court nonetheless believed it was limited "to the record as established by the parties." *Id.* at 80. On balance,

however, the court accepted Wulff's Present Value of Equity Analysis ($89) and Morgan Stanley's Liquidation Value Analysis ($57.50) as the most credible methodologies.

The court finally settled on Wulff's Present Value of Equity Analysis as entitled to the greatest weight. However, because of certain flaws in Wulff's data which tended to skew the result upward, the court applied a twenty percent discount to the $89 figure, producing a fair value for **Shell** stock of $71.20.

The court gave no explanation for its choice of twenty percent as a discount factor. However, it did conclude that portion of its opinion with the following sentence:

> For purposes of information only, it is noted that this figure [$71.20] is not far from the $70 per share "low" value arrived at by Goldman Sachs in 1984 when it prepared an estimate of value for the Independent Committee of **Shell** appointed to consider the offer of Holdings.

Id. at 83. The court then awarded the dissenting shareholders simple interest at a rate of 10 percent per year.

In this appeal both parties express dissatisfaction with the Vice Chancellor's ruling. **Shell** argues that the $71.20 finding is erroneous in three respects. First, it contends the court's valuation determination is essentially a liquidation finding. Second, it claims the trial court erred by giving no weight to the market and earnings values of **Shell** shares. Finally, **Shell** argues that, to the extent either measure of value is relevant, the court erred in selecting Wulff's Present Value of Equity Analysis over Morgan Stanley's Liquidation Value Analysis in light of the court's specific findings which seemingly favor Morgan Stanley's approach.

Petitioners cross appeal a different aspect of the Vice-Chancellor's decision. They contend the court erred in awarding simple rather than compound interest because the only evidence in the record concerning interest supported compounding on a semi-annual basis. They argue it was error for the court to make a finding for which there was no record support.

IV

The legal standards which govern an appraisal of minority shares after a freeze-out merger are not disputed by the parties. Once a shareholder perfects his right to appraisal under 8 *Del.C.* § 262(d), the Court of Chancery is required to determine the "fair value" of his shares, "exclusive of any element of value arising from the accomplishment or expectation of the merger," by considering "all relevant factors." 8 *Del.C.* § 262(h). Fair value, in an appraisal context, measures "that which has been taken from [the shareholder], *viz.,* his proportionate interest in a going concern." *Tri-Continental Corp. v. Battye,* Del.Supr., 74 **A.2d** 71, 72 (1950). In the appraisal process the corporation is valued "as an entity," *Cavalier **Oil** Corp. v. Harnett,* Del.Supr., 564 **A.2d** 1137, 1144 (1989), not merely as a collection of assets, *Bell v. Kirby Lumber Corp.,* Del.Supr., 413 **A.2d** 137 (1980), or by the sum of the market price of each share of its stock, *Chicago Corp. v. Munds,* Del.Ch., 172 A. 452 (1934). Moreover, the corporation must be viewed as an on-going enterprise, occupying a particular market position in the light of future prospects. *See Application of Delaware Racing,* Del.Supr., 213 **A.2d** 203 (1965).

1219 *1219 The appraisal quest at the Court of Chancery level admits of a broad latitude. As this Court ruled in *Weinberger v. UOP, Inc.,* Del.Supr., 457 **A.2d** 701 (1983), the parties to an appraisal action must be afforded the opportunity to present evidence of fair value consisting of "any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court." *Id.* at 713. Thus, the scope of the Chancellor's inquiry into fair value is limited only by the appraisal statute's express exclusion "of any element of value arising from the accomplishment or expectation of the merger," 8 *Del.C.* § 262(h), and the Delaware Rules of Evidence. *Weinberger,* 457 **A.2d** at 713.

At the appellate level, when this Court reviews a Court of Chancery determination pursuant to Section 262, we impart a "high level of deference" to that court's findings. *Kahn v. Household Acquisition Corp.,* Del.Supr., 591 **A.2d** 166, 175 (1991). Recognizing that the Court of Chancery, over time, has developed an expertise in cases of this type, we will accept the court's findings if supported by the record and the product of an orderly and logical deductive process. *Levitt v. Bouvier,* Del.Supr., 287 **A.2d** 671 (1972). We will reverse those findings only when they are clearly wrong and the doing of justice requires us to do so. *Id.*

Shell first argues that the Court of Chancery erred by according 100 percent weight to Wulff's Present Value of Equity Analysis. It claims this was improper because that analysis, in effect, reflected a liquidation value, contrary to Delaware law, which precludes the use of liquidation value as the sole measure of the fair value of appraised shares. *See* *Bell v. Kirby Lumber Corp.,* Del.Supr., 413 **A.2d** 137 (1980). As **Shell** interprets the court's findings, the Vice Chancellor selected the result yielded by one valuation method, to the exclusion of other approaches and then arbitrarily discounted that value to account for perceived defects in the underlying study. Since Wulff's Present Value of Equity approach is premised on the value of **Shell** stock it remains, even when discounted, the argument runs, a liquidation approach which ignores "going concern" value.

We believe this argument mischaracterizes the trial court's findings. Our review of the court's opinion suggests that while the Vice Chancellor gave "considerable weight" to Wulff's Present Value of Equity Analysis he did not accept it, at face value, as a liquidation study. *See Appraisal of **Shell,*** slip op. at 62. Although the court considered the Present Value of Equity technique to be a "variation" of Morgan Stanley's Liquidation Value Analysis, it did not conclude that Wulff's technique produced a liquidation value.

Even if it be assumed, *arguendo,* that Wulff's Present Value of Equity Analysis is a thinly disguised liquidation study, it was considered as merely part of the total body of valuation evidence presented. At trial, the court was offered six valuation techniques, three from each side and it made discriminating judgments concerning them. As previously noted, it found that Wulff's Present Value of Equity Analysis, "although seriously flawed, must be given considerable weight." It further determined that Wulff's Comparative Deal Market Analysis because of a number of inconsistencies was "entitled to less consideration in determining the fair value of **Shell's** stock than is petitioner's Present Value of Equity Analysis." And finally, it found Wulff's Trading Market Analysis to be "entitled to no weight."

As for **Shell's** evidence, the court found Morgan Stanley's Liquidation Value Analysis to be "substantially flawed" but concluded that it was one of "the two most creditable methodologies presented." It described Morgan Stanley's Merger Market Analysis as flawed and "less valid than [Morgan Stanley's] Liquidation Value Analysis." Finally, the court concluded that the result obtained from Morgan Stanley's Trading Market Analysis was "highly illogical" and was therefore "less valid than is its Liquidation Value Analysis."

1220 Far from relying solely on Wulff's Present Value of Equity Analysis, the Vice *1220 Chancellor credited, albeit in varying degrees, each technique offered except Wulff's Trading Market Analysis, which he rejected because of its premise that **Shell** stock should command a premium over market value. In discounting the Present Value of Equity result, the court was recognizing, tacitly at least, that **Shell's** evidence, which tended to undervaluation, was entitled to some consideration. When so viewed, the court's final figure of $71.20 is clearly supportable and not the product of a liquidation analysis alone.

Shell also argues that the Vice Chancellor's selection of a discount factor was arbitrary. We do not agree. The parties had presented reams of evidence on valuation, most of which was biased to favor the position of the presenter. The competing "bottomline" valuation figures were poles apart. Unless the court slavishly adopted the position of one party, the ultimate determination of value, of necessity, was to be selected from a broad range of values. Here the final value chosen ($71.20) is very close to the mid-way mark between the two values the court found to be most credible, $89.00 (Present Value of Equity) and $57.50 (Morgan Stanley's Liquidation Value).

The trial court's selection of $71.20 per share was also verified by comparison with another view not directly tendered by the parties. The Goldman Sachs opinion, prepared in 1984 for **Shell's** Independent Committee, fixed $70 as at the low end of the range of fairness.[2] That independent assessment imparted an inference of reasonableness to the court's finding. When a court is faced with a lack of reliable direct evidence of value, or when doubt exists as to the accuracy of its findings, it is appropriate for the court, as a fact-finder, to test its conclusions against other evidence in the record before it. *Kahn,* 591 **A.2d** at 175. Given our standard of review, we cannot say the trial court's resulting conclusion was not the product of an orderly and logical deductive process.

Shell next argues that the trial court erred by giving no weight to the trading value of **Shell's** stock. It contends that instead of totally rejecting Morgan Stanley's Trading market Analysis, the court should have adjusted the input to that analysis in order to reach a fair result.

Initially, we note that the Vice Chancellor considered substituting data from other models into Morgan Stanley's Trading Market Analysis. However, it concluded that, in this case, that device was "not an acceptable alternative ... because of the difficulty of interchanging data from differing models." *Appraisal of **Shell*** at 82. Given our standard of review and the Court of Chancery's long-earned expertise in these matters, we cannot say this conclusion was clearly wrong. At any rate, **Shell's** argument mischaracterizes the court's findings. The Vice Chancellor did not "totally reject" Morgan Stanley's Trading Market Analysis. It simply found its result to be "highly illogical" and that it was "less valid" than the Liquidation Value Analysis. As we stated above, it is clear that the trial court relied on almost all of the evidence offered, including Morgan Stanley's Trading Market Analysis. Again, we cannot say that the court's treatment of that analysis was improper.

Finally, **Shell** contends the trial court erred by according any weight to Wulff's Present Value of Equity Analysis since that technique is not "generally accepted in the financial community," as required by our decision in *Weinberger,* 457 **A.2d** at 713. As a corollary to this argument it asserts that the trial court erred in favoring Wulff's equity analysis to Morgan Stanley's much sounder valuation study. We disagree.

This argument is somewhat disingenuous. In essence, **Shell** claims that a method of valuation it labels "liquidation analysis," is not generally accepted in the financial community, while at the same time tendering its own liquidation analysis. As we noted
1221 above, Wulff's Present Value of Equity approach consisted of determining the liquidation value of **Shell's** upstream *1221
assets and the return on investment value of **Shell's** downstream assets. The trial court specifically determined this to be an acceptable valuation technique and indeed noted that this approach was "really a variation of the Liquidation Analysis used by [Morgan Stanley]."

Liquidation value is one factor relevant to a fair value inquiry and an acceptable technique, with others, upon which the Court of Chancery can rely. *See Kirby Lumber,* 413 **A.2d** at 142-3. Liquidation value cannot, however, be viewed as a substitute for, or interchangeable with, fair value. We do not view Wulff's technique as a pure liquidation value analysis, however, because it entailed a consideration of cash flow characteristics, future growth potential and industry recognition of the strength of **Shell's** downstream assets. These considerations point to more than just the reflective value of **Shell's** physical assets. Nothing in the record suggests that the trial court's decision to accept a method of valuation so similar to **Shell's** own plainly acceptable method was clearly wrong. *Levitt v. Bouvier,* Del.Supr., 287 **A.2d** 671, 673 (1972).

Shell also argues that specific findings of the trial court regarding the relative persuasiveness of the evidence required preference of Morgan Stanley's liquidation value technique. It claims that the trial court's findings favored Morgan Stanley's valuation of **Shell's** reserves and exploratory acreage, in contrast to what it claims is a lack of any findings regarding Wulff's valuation of **Shell's** downstream assets. **Shell** argues that, given the implications of these findings (and lack thereof), it was error for the court to totally reject Morgan Stanley's valuations.

We find this argument to be unpersuasive in two respects. First, the trial court clearly gave at least some weight to each of Morgan Stanley's techniques. Second, the argument ignores our standard of review.

The trial court made numerous conclusions as to the acceptability and weight of all the evidence presented. It also made specific findings comparing the persuasiveness of the various techniques. Even if we were to conclude that the court should have favored Morgan Stanley over Wulff, we would not reverse the trial court on that ground alone because the initial choice is not ours to make. The discretion to weigh the evidence belongs to the Court of Chancery with our review one of abuse of that discretion. *Delaware Racing,* 213 **A.2d** at 207. In this case, each party's valuation evidence was replete with deficiencies and so susceptible to bias that indiscriminate endorsement of either would have been indefensible, even though technically supported by the record. As **Shell's** primary expert rather candidly admitted at trial, "Valuation is an art rather than a science." So too is the weighing of evidence in the appraisal process. More than anything else, this emphasizes the broad discretion which the Court of Chancery must have in fixing values. The Vice Chancellor's conclusions are amply supported by the record and the product of an orderly and logical deductive process. We therefore decline to disturb them.

V

Petitioners have also appealed from the Vice Chancellor's awarding of simple interest because the record contains no evidence

to support such an award. They contend that both experts who testified on the interest question adopted a compounding approach.

The decision to award simple or compound interest at a particular rate is within the sound discretion of the Court of Chancery. 8 *Del.C.* § 262(i); *Rapid-American Corp. v. Harris,* Del.Supr., 603 **A.2d** 796, 807 (1992). Of course, an award made arbitrarily or capriciously would be an abuse of that discretion. *Pitts v. White,* Del.Supr., 109 **A.2d** 786, 788 (1954).

In the present case, **Shell's** expert, Robert Case, of Morgan Stanley, espoused an interest rate of 7.7 percent while Petitioners expert, John Beyers, testified that the interest rate should be 10 to 10½ percent compounded semi-annually. Although the
1222 parties are now in disagreement over *1222 whether Case also recommended a compounding of interest, the record reflects that Case's ultimate position was at least neutral on the question. The Petitioners did not argue in the trial court that there was no record support for the award of simple interest and, indeed, the Vice Chancellor reviewed Case's testimony as reflecting a position in favor of "7.6% to 7.7%, simple interest." *Appraisal of **Shell,*** slip op. at 84. Although the Vice Chancellor found Case's testimony "less credible" than Beyers' because he had earlier opined in favor of a semi-annual compounded interest rate, it was clearly within his discretion to accept Case's recommendation of simple interest while at the same time fixing the interest rate near the figure recommended by Beyers.

In view of the trial court's opportunity to hear the expert testimony and evaluate the credibility and demeanor of the witnesses, we are not inclined to disturb the discretion exercised here in the awarding of simple interest. *Rapid-American* at 809.

VI

Although our affirmance of the Court of Chancery's appraisal determination resolves the merits of this appeal, we take the occasion to comment upon a recurring theme in recent appraisal cases — the clash of contrary, and often antagonistic, expert opinions on value. The presentation of widely divergent views reflecting partisan positions in appraisal proceedings adds to the burden of the Court of Chancery's task of fixing value. Such extremes may result in the court's rejection of both opinions in favor of a middle position. *See, e.g., Kahn v. Household Acquisition Corp.,* 591 **A.2d** at 172. As the trial court noted in this case: "one thing is clear from the evidence in this trial whether consciously or unconsciously, the opinions expressed by the expert witnesses significantly reflected the desires of their clients." *Appraisal of **Shell,*** slip op. at 13. We impute no impropriety to the participants in this or other appraisal litigation in their efforts to advance their respective positions. That is to be expected in an adversarial system. But if the Court is limited to the biased presentation of the parties, it is often forced to pick and choose from a limited record without the benefit of objective analysis and opinion. To compensate for this handicap, the Court of Chancery should consider, in a proper case, appointing its own expert witness.

Apparently, no Delaware Court has ever appointed a neutral expert witness upon its own initiative. However, federal courts have not hesitated to make such appointments. Those courts derive their authority to do so from their inherent power and from the express language of Rule 706 of the Federal Rules of Evidence. The Advisory Committee to the federal rules has noted that "[t]he inherent power of a trial judge to appoint an expert of his own choosing is virtually unquestioned." Fed. R.Evid. 706 advisory committee's note. The Third Circuit Court of Appeals has also noted that "the inherent power of a trial judge to appoint an expert of his own choosing is clear." *United States v. Green,* 3rd Cir., 544 F.2d 138, 145 (1976).

While the Court of Chancery rules do not contain a parallel to Federal Rule 706, this Court has held that even in the absence of a parallel federal rule, the spirit and purpose of the federal rules have always been within the inherent power of our courts. *See Cebenka v. Upjohn Co.,* Del. Supr., 559 **A.2d** 1219, 1225 (1989). Accordingly, we believe that the Court of Chancery has the inherent authority to appoint neutral expert witnesses. There is, of course, no requirement that the court do so. For example, the court need not appoint an expert when "additional experts would ... add more divergence and opinion differences." *Georgia-Pacific Corp. v. United States,* 640 F.2d 328, 334, 226 Ct.Cl. 95 (1980). The procedural steps mandated by Federal Rule 706 offer helpful guidelines where such an appointment is contemplated.

Federal Rule 706 requires the court to "enter an order to show cause why expert witnesses should not be appointed." Fed.
1223 R.Evid. 706(a). The order to show cause may be entered on the court's own initiative *1223 or on the motion of any party. *See Lightfoot v. Walker,* S.D.Ill., 486 F.Supp. 504, 506 (1980). The expert should be appointed sufficiently in advance of trial as to

permit opportunity for hearings on the appointment, consent of the expert, notification of duties, research by the expert, and a communication by the expert to the parties informing them of his findings.

The selection of the expert is solely within the discretion of the trial judge. The trial judge may appoint an expert of his own choosing or seek a list of nominations from the parties. *See* *Gates v. United States,* 10th Cir., 707 F.2d 1141, 1144 (1983). Once an expert has been retained by the Court of Chancery, the court should communicate with the expert in writing, filing a copy of the correspondence with the clerk or at a conference in which the parties have an opportunity to participate. *See* Fed.R.Evid. 706(a). Appellate review of the trial court's appointment of an expert or lack thereof proceeds under an abuse of discretion standard.

The court appointed expert is subject to the same standards which govern other expert witnesses under the Delaware Rules of Evidence. The expert must advise the parties of all findings and submit to depositions. Once trial commences, it is incumbent upon the trial judge to arrange for the court's expert witness to testify if neither party calls him as a witness. The court's expert must be subject to cross-examination by both parties, even if one party chose to call him as its witness. Finally, the court's expert should be reasonably compensated by the parties in such proportion and at such intervals as the trial court determines. [3]

We do not mandate the use of court appointed experts in any case, leaving such determination to the discretion of the trial judge, but we believe the time has come for the Court of Chancery to avail itself of such a practice whenever it believes that a more objective presentation of evidence is required, particularly in valuation matters. Finally, we suggest that the Court of Chancery consider the adoption of a rule, modeled after Federal Rule 706, which will implement its inherent authority in this area.

[1] Because their interests are the same, **Shell** and Holdings will hereafter be referred to collectively as "**Shell**."

[2] This opinion is contained in the record to this proceeding.

[3] While we express the hope that the use of such an expert will bring greater reason and clarity to the appraisal process, nothing we say here should be construed as requiring the trial court to accept the findings, conclusions or opinions of that expert. Such an appointment has no effect whatever in limiting the Court of Chancery's broad discretion in fixing fair value of corporate stock in an appraisal action.

Stern v. Stern

66 N.J. 340 (1975)

331 A.2d 257

SUSANNE H. STERN, PLAINTIFF-RESPONDENT, v. MILTON H. STERN, DEFENDANT-APPELLANT.

The Supreme Court of New Jersey.

Argued October 21, 1974.

Decided January 23, 1975.

Mr. Monroe Ackerman argued the cause for appellant (Messrs. Rudd and Ackerman, attorneys; Mr. Neil Braun, on the brief).

Mr. Everett M. Scherer argued the cause for respondent (Messrs. Riker, Danzig, Scherer and Brown, attorneys; Mr. Scherer, of counsel; Mr. Thomas C.C. Humick, on the brief).

The opinion of the Court was delivered by MOUNTAIN, J.

In this matrimonial action plaintiff, Susanne H. Stern, was granted a divorce on the ground of adultery from her husband, the defendant, Milton H. Stern. The court likewise awarded the plaintiff alimony and child support and effected an equitable distribution of property pursuant to N.J.S.A. 2A:34-23. 123 N.J. Super. 566 (Ch. Div. 1973).[1] The Appellate Division affirmed. 128 N.J. Super. 198 (1974). We granted certification at the instance of the defendant. 65 N.J. 568 (1974).

There is no challenge to the grant of a divorce. Defendant does, however, contend that the amounts of alimony and child support are excessive and that the trial judge acted improperly in the manner in which he identified and thereafter allocated marital assets between the spouses.

We perceive no error either in the amount of alimony or of child support. In respect to each of these awards the determination of the court below finds ample support in the record. The nature of the property that the trial court was called upon to examine in

[1] In the Chancery Division the cause is entitled *S.C. v. A.C.* While we continue to believe that the use of initials in order to disguise the true identity of litigants serves a legitimate end where the interests of minor children are concerned, as well as upon other miscellaneous but rare occasions, we do not approve a resort to this practice where the effort is to throw the protective cloak of anonymity over a successful and well-known member of the bar, as would appear to have been the case here.

effecting distribution, and the manner in which the allocation of these assets was made, do present issues which this Court has not heretofore considered.

Defendant was ordered to pay to the plaintiff $36,000 annually as alimony and $4,000 a year as support of a minor child. Additionally, by way of distribution of marital property, he was directed to pay the plaintiff $100,000 in forty equal consecutive quarterly installments.[2]

Defendant is a partner in a very successful, well-known and highly respected law firm. As an attorney his personal earning capacity is thoroughly proven. He concedes that his partnership interest is an asset eligible for distribution pursuant to N.J.S.A. 2A:34-23. He objects, however chiefly upon two particular grounds to the property distribution made by the trial judge. First, he disputes the inclusion and method of valuation of certain assets in determining partnership worth; secondly, he contests the propriety of considering his earning capacity as being a separately identified and distinct item of property, and as such eligible for apportionment under the statute.

We first consider the latter objection. In undertaking the statutory allocation of marital assets, the trial judge included, apparently as a separate item of property, defendant's earning capacity. The opinion states,

His ability [earning capacity] is an amorphous asset of this marriage in the absence of other assets. It consists of natural ability, undergraduate and postgraduate education, marriage to the daughter of a man of high standing and lucrative income in the area of his professional activity, entree' to his office and ultimate partnership, subsequent management of the firm, with advancement in the esteem of his professional peers. [123 N.J. Super. at 568]

We agree with defendant's contention that a person's earning capacity, even where its development has been aided and enhanced by the other spouse, as is here the case, should not be recognized as a separate, particular item of property within the meaning of N.J.S.A. 2A:34-23.[3] Potential earning capacity is doubtless a factor to be considered by a trial judge in determining what distribution will be "equitable" and it is even more obviously relevant upon the issue of alimony. But it should not be deemed property as such within the meaning of the statute.

As we have indicated, defendant readily concedes that his partnership interest is an asset that has been acquired during marriage and that it qualifies and is eligible for

[2] Plaintiff, by agreement of the parties, was to become sole owner of the marital dwelling and its contents, but defendant was to receive compensation from the plaintiff for one-half its value of $52,400. This payment of $26,200, from plaintiff to defendant, to be made over a ten-year period, will result in reducing defendant's annual payments to plaintiff to the sum of $7,380.

[3] In at least one community property state, a court has rejected the notion that a college and law school education, though financed in part by the other spouse, may be considered a separate community asset. *Todd v. Todd,* 272 Cal. App. 2d 786, 78 Cal. Rptr. 131 (Ct. of App. 1969). But see Comment, The Interest of the Community in a Professional Education, 10 *Cal. West. L. Rev.* 590 (1974).

equitable distribution. He disputes, however, the manner in which this property interest has been valued and objects to the size of the share allocated to the plaintiff.

Placing a precise or even an approximately accurate value upon an interest in a professional partnership, when the partner whose interest is in question intends to continue as a member of the firm is no easy matter. Circumstances preclude our customary resort to market value. Some other method of determining worth must be employed. Here the terms of the partnership agreement are of help. There appear in this document four quite distinct payment plans applicable with respect to a partner who withdraws from the firm, becomes disabled, dies or retires. Of these, probably the most accurate and certainly the most useful for present purposes is the formula for the calculation and payment of a partner's interest to his personal representative upon death. In such an event, according to the articles of partnership, his estate is to receive the then value of his capital account, readily determinable from the partnership books, together with a fixed sum appearing after the partner's name on a schedule appended to the partnership agreement. This schedule is revised quarterly. It is obviously intended to reflect those elements of partnership worth other than the member's capital account. The testimony reveals that these payments, occasioned by death, are to be funded with the proceeds of life insurance on the lives of the several partners, the policies being owned by and the proceeds payable to the firm. The amount appearing after defendant's name on the schedule attached to the copy of the partnership agreement which was received in evidence was $167,500. We think the trial court would be justified in adding to this sum the value of defendant's capital account and treating the total as the presumptive value of defendant's partnership interest in the firm. We say presumptive value only, because either plaintiff or defendant will be entirely at liberty to challenge the figure so determined as not being reflective of true value.

Generally speaking the monetary worth of this type of professional partnership will consist of the total value of the partners' capital accounts,[4] accounts receivable, the value of work in progress, any appreciation in the true worth of tangible personalty over and above book value, together with good will,[5] should there in fact be any; the total so arrived at to be diminished by the amount of accounts payable as well as any other liabilities not reflected on the partnership books. Once it is established that the books of the firm are well kept and that the value of partners' interests are in fact periodically and carefully reviewed, then the presumption to which we have referred should be subject to effective attack only upon the submission of clear and convincing proofs.[6]

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[4] This partnership keeps its books on a cash basis.

[5] The good will of a law firm, for ethical reasons, may not be sold or transferred for a valuable consideration. N.J. Advisory Committee on Professional Ethics, Opinion 48, 87 N.J.L.J. 459 (1964); Opinion 80, 88 *N.J.L.J.* 460 (1965). It may, however, in a given case, be possible to prove that it does exist and is a real element of economic worth. Concededly, determining its value presents difficulties. Rev. Rul. 609, 1968-2 Cum. Bull. 327.

[6] Generally, a requirement that a presumption may only be rebutted by a degree of proof stronger than that usually required upon a civil issue, should be supported by some policy consideration. In re Weeks, 29 N.J. Super. 533, 538 (App. Div. 1954). Here we are moved to express the rule in these terms in an effort to simplify as much as possible the submission of proofs in matrimonial actions involving the issue

Defendant offers a number of objections to the consideration of partnership accounts receivable in connection with the proposed equitable distribution. Most of his argument rests upon the mistaken assumption that the court is directing the apportionment of the accounts themselves. This is not the case. The accounts receivable are not the subject matter of any proposed distribution; they are being examined and valued simply as one element to be included in determining the entire worth of defendant's partnership interest. It is the latter asset that is being allocated between the parties.

The further contention is made that if accounts receivable are to be considered at all, then their value should be diminished by the estimated amount of federal income tax that defendant will be required to pay in respect of these accounts, or some part thereof, as they reach him in the form of later partnership distributions. This argument also misconceives the purpose for which the accounts receivable are being considered to fix a total value of defendant's partnership interest. The value of the latter asset is in no way diminished by the fact that defendant may thereafter be called upon to pay an income tax resulting in substantial part from his receipt of income from the partnership. The fact that he will pay a tax on these receipts may be a relevant consideration when considering whether a distribution is equitable and it is clearly relevant with respect to the determination of alimony, but it does not affect the value of defendant's interest in the law firm.

Finally, it is urged that the accounts receivable should be excluded from consideration because they are not a property interest that has "vested" in the defendant. What we have already said would seem an adequate answer to this argument. We take the opportunity, however, to suggest that the concept of vesting should probably find no significant place in the developing law of equitable distribution. The notion of a vested interest came into being in a feudal society and was intimately associated with the medieval concept of seisin. Holdsworth, *An Historical Introduction to the Land Law,* (1927) 68; Jenks, *A Short History of English Law,* (4th ed. 1928) 84-5. It has played an important part in the development of the law of future interests, and early assumed a crucial role in the portion of that law dealing with the rule against perpetuities. On the other hand and in a quite different context the phrase, "vested rights," is occasionally used to denote something to which constitutional guaranties may apply. 1 Simes and Smith, *The Law of Future Interests* (2nd ed. 1956) sec. 136, 116-18; *Rothman v. Rothman,* 65 N.J. 219, 225 (1974). These now customary usages of the concept of vesting are clearly in no way relevant to the question of effecting an equitable distribution upon the occasion of a divorce. Our statute requires, in order that property be available for distribution incident to a divorce, that it shall have been acquired during marriage. There is no reference to vesting. With only this brief word upon the subject, which is not really before us, we leave for another day any further discussion of the important and possibly difficult question as to what future interests may qualify as "property" within the meaning of N.J.S.A. 2A:34-23.

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of property distribution. We are also mindful of the inherent likelihood that such figures, derived from the firm's books and agreement of partnership, will be substantially accurate.

Subject to what immediately follows, those portions of the judgment below that pertain to the award of alimony and child support are affirmed; those portions pertaining to the distribution of marital assets are vacated and set aside and the case is remanded for further proceedings consistent with this opinion and with the opinions of this Court in *Chalmers v. Chalmers,* 65 N.J. 186 (1974); *Painter v. Painter,* 65 N.J. 196 (1974) and *Rothman v. Rothman,* supra, 65 N.J. 219 (1974), all of which were decided subsequent to the entry of the judgment from which this appeal was taken and which in some respects announced rules contrary to those followed by the trial judge in this case.[7] The amount of alimony may be reviewed should the trial judge, on remand, conclude that his then disposition of the issue of equitable distribution requires some change in this award.

For affirmance in part and reversal and remandment in part Chief Justice HUGHES and Justices JACOBS, HALL, MOUNTAIN, SULLIVAN, PASHMAN and CLIFFORD 7.

Opposed None.

[7] For instance, before the trial court, certain gifts received during marriage were excluded as being ineligible for equitable allocation. This Court adopted a contrary view in *Painter v. Painter,* supra, 65 N.J. at 214.

Estate of Stone v. Commissioner

T.C. Memo. 2003-309

UNITED STATES TAX COURT

ESTATE OF EUGENE E. STONE, III, DECEASED, C. RIVERS STONE, E.E. STONE, IV, MARY STONE FRASER & ROSALIE STONE MORRIS, CO-PERSONAL REPRESENTATIVES, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

ESTATE OF ALLENE W. STONE, DECEASED, C. RIVERS STONE, INDEPENDENT EXECUTOR, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 13647-01, 14195-01. Filed November 7, 2003.

John W. Porter, Stephanie Loomis-Price, and Robert E. August, for petitioners.

J. Craig Young, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CHIECHI, Judge: Respondent determined deficiencies in Federal estate tax (estate tax) with respect to the Estate of

Eugene Earle Stone, III (Mr. Stone's estate), and the Estate of Allene W. Stone (Ms. Stone's estate) in the amounts of $3,268,401 and $741,809, respectively. The only issue remaining for decision in the case of Mr. Stone's estate is whether certain assets owned by each of five family limited partnerships (Five Partnerships) are includible in his gross estate under section 2036(a)(1).[1] We hold that none of the assets owned by any of the Five Partnerships is includible in Mr. Stone's gross estate under section 2036(a)(1). There are two issues remaining for decision in the case of Ms. Stone's estate. The first issue is whether certain assets owned by each of the Five Partnerships are includible in her gross estate under section 2036(a)(1). We hold that none of the assets owned by any of the Five Partnerships is includible in Ms. Stone's gross estate under section 2036(a)(1). The second issue is whether certain assets owned by one of the Five Partnerships is includible in Ms. Stone's gross estate under section 2044. We hold that none of the assets owned by that partnership is includible in Ms. Stone's gross estate under section 2044.

FINDINGS OF FACT

Many of the facts have been stipulated and are so found

[1]Unless otherwise indicated, all section references are to the Internal Revenue Code in effect on the respective dates of the deaths of Eugene Earle Stone, III (Mr. Stone), and Allene W. Stone (Ms. Stone). All Rule references are to the Tax Court Rules of Practice and Procedure.

except as discussed below.

Mr. Stone was a resident of South Carolina at the time of his death on June 5, 1997. Ms. Stone was a resident of South Carolina at the time of her death on October 16, 1998.

Mr. and Ms. Stone had four children (children): Eugene Earle Stone, IV, C. Rivers Stone, Rosalie Stone Morris (Ms. Morris), and Mary Stone Fraser (Ms. Fraser). At the time the respective petitions in these consolidated cases were filed, Eugene Earle Stone, IV, C. Rivers Stone, and Ms. Fraser resided in South Carolina, and Ms. Morris resided in Georgia.

In 1933, Mr. and Ms. Stone founded several successful ventures in the apparel industry. Thereafter, at a time before 1976 not disclosed by the record, those ventures became Stone Manufacturing Co. (Stone Manufacturing), a global manufacturer and distributor of apparel, located in Greenville, South Carolina. At least as early as the 1980s, Stone Manufacturing focused on sports apparel and in particular soccer apparel.

In 1939, Mr. Stone purchased approximately 60 acres of real property known as Cherrydale (Cherrydale property), located in Greenville County, South Carolina, for the purpose of relocating the manufacturing facilities of Mr. and Ms. Stone's apparel-industry business to that property. Shortly after purchasing the Cherrydale property, Mr. and Ms. Stone began to use it, except for the Cherrydale residence discussed below, as the location for

the operations of that business.[2]

Around 1950, after having made the repairs necessary to make it habitable, Mr. and Ms. Stone along with their children (collectively, the Stone family) began residing in the house situated on the Cherrydale property, which had been built in the 1840s. (We shall refer to the house and the approximately four acres of surrounding land on the Cherrydale property where the Stone family began residing around 1950 as the Cherrydale residence.)

From at least as early as 1994 until their respective deaths, Mr. Stone lived in North Carolina on a 582.672-acre parcel of land located on certain real property known as Cedar Mountain (Cedar Mountain property),[3] and Ms. Stone lived in a villa in The Cypress of Hilton Head (Cypress villa) on Hilton Head Island, South Carolina.

By the late 1980s or the early 1990s, the Cherrydale residence had begun to deteriorate, although the Cherrydale property was still being used as the location for Stone Manufacturing's

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[2]Although not altogether clear from the record, it appears that at some time after Mr. Stone purchased the Cherrydale property he transferred that property, except for the Cherrydale residence discussed below, to Stone Manufacturing.

[3]Mr. and Ms. Stone's Cedar Mountain property, located in Little River Township, N.C., north of Greenville, S.C., consisted at least as early as 1994 of a 582.672-acre parcel, a 1054.415-acre parcel, and a .338-acre parcel, which they accumulated over approximately a 50-year period. During that time, Mr. and Ms. Stone carried out their vision of developing the Cedar Mountain property by, inter alia, building various lakes and bridges and at least one residence on that property.

operations. Because those operations were in such close proximity to the Cherrydale residence, Mr. Stone and Stone Manufacturing decided that that residence could serve as a place to house out-of-town business visitors to its facilities. To that end, in late summer 1995, renovation work commenced on the Cherrydale residence and was completed in the fall of 1997. During that renovation, the Cherrydale residence was uninhabitable.

In 1976, Mr. Stone formed Stones, Inc., as a holding company of Stone Manufacturing and owned 100 percent of the common stock of that holding company. (For convenience, we shall sometimes refer to Stones, Inc., and Stone Manufacturing, separately and collectively, as the Company.) From 1976 until April 1997, Mr. Stone owned a preferred stock interest in Stones, Inc.

On December 30, 1976, Mr. Stone made a gift of 2,250 shares, or 50 percent, of the common stock of Stones, Inc., to each of two trusts (collectively, the trusts) that he established, one for the benefit of his children and one for the benefit of his grandchildren. At the time the trusts were formed, Stones, Inc., owned 83.4 percent of the common stock of Stone Manufacturing. At that time, C. Rivers Stone, who became president of Stone Manufacturing shortly before Mr. Stone established the trusts,[4]

[4]C. Rivers Stone, who as a teenager began working for Stone Manufacturing during the summers, remained president of Stone Manufacturing until around 1999 when he stopped working for the Company.

and John J. Brausch (Mr. Brausch), a senior executive officer of Stone Manufacturing, were trustees of the trusts.

At least as early as April 28, 1992, Stones, Inc., owned 83.4 percent, each of the children owned 4.1 percent, and Ms. Stone owned the remaining .2 percent of the common stock of Stone Manufacturing. At least as early as that date, Eugene Earle Stone, IV, who became a vice president of Stone Manufacturing in 1978 and became its chief executive officer in 1982,[5] C. Rivers Stone, and Mr. Brausch, all of whom were also officers and directors of Stones, Inc., were trustees of the trusts.

At all relevant times, Ms. Morris and her husband, Charles H. Morris (Mr. Morris), were involved in the newspaper business in Savannah, Georgia. Ms. Fraser and her husband, Charles Fraser (Mr. Fraser), were, along with C. Rivers Stone, involved in the development of Sea Pines Plantation located on Hilton Head Island, South Carolina. At no relevant time were Ms. Morris and Ms. Fraser involved in the day-to-day affairs of the Company.

At least as early as around the late 1980s, Mr. Stone and Ms. Stone were serving as directors of the Company, but they were no longer involved in the day-to-day affairs of its business. At least as early as the last six months of 1995, Mr. Stone and Ms. Stone were in control of their respective assets, but they no

[5]Eugene Earle Stone, IV, remained chief executive officer of Stone Manufacturing at all relevant times.

longer were interested or actively involved in managing those assets and wanted their children to become actively involved in the management of those assets.

During the 1980s, Stone Manufacturing, which employed about 4,000 people, acquired from Umbro, an internationally known manufacturer and distributor of soccer apparel, the right to distribute Umbro's products within the United States. In late 1991, Stone Manufacturing began discussions regarding the possibility of acquiring from Umbro the right to distribute Umbro's products internationally. On April 28, 1992, Stone Manufacturing and the owners of Umbro signed a purchase agreement under which Stone Manufacturing agreed to acquire the right to distribute Umbro's products internationally.

On April 28, 1992, Ms. Morris, Ms. Fraser, and their respective children filed a petition (petition) in a Probate Court in South Carolina (Probate Court) against Eugene Earle Stone, IV, C. Rivers Stone, and Mr. Brausch, as trustees of the trusts, and against the children of C. Rivers Stone, as beneficiaries of one of the trusts. (We shall refer to that litigation as the litigation among the children and to all the parties in that litigation as the parties in the litigation among the children.) Eugene Earle Stone, IV, discussed the litigation among the children with his parents, but neither Ms. Stone nor Mr. Stone was or became a party in that litigation.

The petition in the litigation among the children included claims against the trustees for an accounting, breach of trust, breach of fiduciary duties, abuse of discretion, negligence, and self-dealing and sought the removal of Eugene Earle Stone, IV, C. Rivers Stone, and Mr. Brausch as trustees of the trusts. The petition alleged in part as follows:

> 1. Petitioners are beneficiaries of a certain Agreement and Declaration of Trust, dated December 30, 1976 and entered by and between Respondents, E.E. Stone, IV, C. Rivers Stone, and John J. Brausch, as Trustees, (Hereinafter "Trustees") for two Trusts established and funded by Eugene E. Stone, III. * * *.
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> * * * * * * *
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> 9. As Trustees of the two Trusts, Respondents, Trustees, control 100% of the shares of Stones, Inc.
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> * * * * * * *
>
> 11. In their positions as Trustees, Respondents control, and have controlled since the inception of the Trusts on December 30, 1976, and for a period of six-teen (16) years, the election and appointment [sic] officers and directors of Stone Manufacturing Company, Inc., by virtue of their control of all of the stock of Stones, Inc. and, by reason thereof, 83.4% of shares of stock of Stones [sic] Manufacturing Company, Inc.
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> * * * * * * *
>
> 16. Respondents', Trustees', control of the companies has allowed them to appoint themselves as directors and officers of Stone Manufacturing Company, Inc.
>
> 17. E.E. STONE, IV, C. RIVERS STONE and JOHN BRAUSCH are the officers and directors for Stones, Inc.
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> * * * * * * *
>
> 21. Respondent Trustees, for sixteen (16) years

> have failed to manage the Trusts' assets in a fashion designed to generate income for the Trusts in an amount sufficient to enable the Trustees to distribute directly to all adult beneficiaries (and to the parent/guardians of beneficiaries who are minors) income in an amount sufficient to meet the "standard" as set forth in Article II and Article III as the 1976 Declaration of Trust to each and every beneficiary each year, such "standard" being stated in such 1976 Trust as follows:
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> (1) "reasonable health care"
>
> (2) "support in his or her accustomed manner of living"
>
> (3) "maintenance"
>
> Since 1976, the Trustees have produced no income whatsoever to the Trusts from Trust investments and have made no distributions to the beneficiaries to meet the "standard" for such annual distributions as quoted above.
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> * * * * * * *
>
> 26. Notwithstanding the substantial net earnings of Stone Manufacturing Company, Inc., * * * the Directors have neglected, failed and refused to ever declare a dividend for distribution of profits to shareholders.
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> * * * * * * *
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> 28. While Respondents, E.E. STONE, IV and C. RIVERS STONE, as officers and directors of Stone Manufacturing Company, Inc., have taken and received substantial income and benefits for themselves, from Stone Manufacturing Company, Inc., they have, in their positions as Trustees, withheld and denied any similar income and benefits to the shareholders of the company and the beneficiaries of the Trusts.

On April 28, 1992, Ms. Morris, Ms. Fraser, and their respective children filed a motion in the Probate Court for immediate restraining orders precluding Eugene Earle Stone, IV, C. Rivers

Stone, and Mr. Brausch from taking certain actions as trustees of the trusts. On April 28, 1992, the Probate Court granted that motion.

Around May 7, 1992, Stone Manufacturing filed a motion to intervene in the litigation among the children. By order dated June 18, 1992, the Probate Court made Stone Manufacturing a party in that litigation.

On a date not disclosed by the record between April 28 and July 22, 1992, Stones, Inc., became a party in the litigation among the children.

On July 22, 1992, Ms. Morris, Ms. Fraser, and their respective children filed in the Probate Court what was identified as an amended complaint (amended complaint). The amended complaint sought, inter alia, to enjoin Eugene Earle Stone, IV, C. Rivers Stone, and Mr. Brausch, as trustees of the trusts, from, inter alia, purchasing from Umbro the right to distribute Umbro's products internationally. As grounds for granting such an injunction, the amended complaint alleged that any such purchase would necessitate the incurrence of considerable debt by Stone Manufacturing and delay the payment to the trusts of any dividends from the Company.

On September 13, 1993, C. Rivers Stone filed a petition in the Probate Court (C. Rivers Stone's petition). C. Rivers Stone's petition alleged in part as follows:

Your petitioner, C. Rivers Stone, would respectfully show unto the court:

1. That he is a Respondent in the * * * action which is pending before this Court.

* * * * * * *

5. That E.E. Stone, IV, is a Director and Chief Executive officer of Stone Manufacturing Company.

* * * * * * *

7. That E.E. Stone, IV, has never been properly named or elected as a director of Stones, Inc.

8. That on Friday, September 10, 1993, E.E. Stone, IV called a meeting of Stones, Inc., and proposed that the Board of Stone Manufacturing Company be reduced from five directors to three directors and that E.E. Stone, IV vote the stock on behalf of Stones, Inc.

9. That proper notice was not given to the directors of this proposed change of the Directors and for E.E. Stone, IV to vote the stocks of Stones, Inc. as required by law and by the Company's by-laws.

10. That the Petitioner, C. Rivers Stone, is a Director and President of Stones, Inc., and as president has always voted the stock of Stone Manufacturing Company.

* * * * * * *

16. That the Petitioner is informed and believes that E.E. Stone, IV is not a properly elected Trustee of the children's trust or the grandchildren's trust.

* * * * * * *

19. That the moves undertaken by E.E. Stone, IV with the cooperation of John J. Brausch * * * are to take total and complete control of the Trustees and thereby totally control and dominate the family corporations.

* * * * * * *

> 22. That the Petitioner believes that he will be removed as President and Director of Stone Manufacturing with great loss in salary and will cause him irreparable harm.
>
> * * * * * * *
>
> WHEREFORE, having fully petitioned the Court, the Petitioner, C. Rivers Stone, prays that the Court issue its Order restraining E.E. Stone, IV, John J. Brausch, Stone Manufacturing Company and Stones, Inc. from:
>
> 1. Withdrawing or reducing the compensation of the Petitioner, C. Rivers Stone * * *
>
> 2. Removing the Petitioner, C. Rivers Stone, as President of Stone Manufacturing Company and Stones, Inc.;
>
> 3. Removing the Petitioner, C. Rivers Stone, as a Director of Stone Manufacturing Company and Stones, Inc.; and
>
> 4. Allowing E.E. Stone, IV from voting the stock on behalf of Stones, Inc.

On September 13, 1993, C. Rivers Stone filed a motion (C. Rivers Stone's motion) in the Probate Court seeking an immediate restraining order, as requested in C. Rivers Stone's petition, against Eugene Earle Stone, IV, Mr. Brausch, Stone Manufacturing, and Stones, Inc. On September 13, 1993, the Probate Court granted C. Rivers Stone's motion.

The parties in the litigation among the children attempted to minimize any publicity about that litigation. However, that litigation was hotly contested and became very bitter.[6] As a

[6]The litigation among the children was so contentious that even Ms. Morris and Ms. Fraser, who, along with their respective (continued...)

result, the local business community, including the customers and the suppliers of the Company and the financial institutions that dealt with it, as well as the Company's employees, became aware of that litigation and concerned about its impact on them. The litigation among the children resulted in total legal fees for the parties in that litigation of between $2 million and $3 million.

Throughout the course of the litigation among the children, the children had certain concerns regarding Mr. Stone's assets and Ms. Stone's assets (the children's concerns regarding Mr. Stone's and Ms. Stone's assets), which presented potential grounds for additional litigation among the children. The children's concerns regarding Mr. Stone's and Ms. Stone's assets included concerns relating to (1) the management of those assets (a) during their parents' lives, which became a very serious concern at least as early as the last six months of 1995 when their parents no longer were interested or actively involved in managing such assets, and (b) after their parents died; (2) certain charitable gifts that Mr. Stone had made, including a gift to Furman University in December 1994 for the design and

[6](...continued)
children, had filed the petition instituting that litigation, disagreed on certain matters, as is evidenced by the fact that at a time not disclosed by the record Ms. Morris, but not Ms. Fraser, sought to settle that litigation as it pertained to Ms. Morris and her children.

construction of a permanent soccer facility to be named the Eugene E. Stone, III, Soccer Stadium; (3) Ms. Stone's living arrangements; and (4) the use of Ms. Stone's credit cards.

With respect to the children's concerns relating to the management during their parents' lives and thereafter of their parents' respective assets, Eugene Earle Stone, IV, had a particular interest in managing, and maintaining the value of, the preferred stock of Stones, Inc. C. Rivers Stone was very interested and involved in real estate development[7] and had a particular interest in managing Mr. Stone's real property known as Piney Mountain (Piney Mountain property).[8] Ms. Morris, who had substantial expertise in business and financial matters, had a particular interest in managing certain of her parents' stocks and securities, including at least some of Mr. Stone's preferred stock in Stones, Inc. Ms. Fraser, who had developed a deep attachment to her parents' Cedar Mountain property, had a partic-

[7]C. Rivers Stone pursued on a fulltime basis his strong interest in real estate development after he stopped serving as president of Stone Manufacturing around 1999. C. Rivers Stone's first exposure to real estate development was at the age of 13 when he helped his father build two 50-acre lakes on the Cedar Mountain property. At the time of the trial in the instant cases, C. Rivers Stone had been involved in five major real estate development projects.

[8]Mr. Stone's Piney Mountain property, located in Greenville, S.C., consisted at least as early as 1994 of approximately 370 acres, which he accumulated over approximately 20 to 30 years. During that time, Mr. and Ms. Stone maintained a vision as to how the Piney Mountain property should be developed. C. Rivers Stone shared that vision.

ular interest in managing that property and envisioned that it would be used some day as a site for religious activities.[9] All of the children had a particular interest in the Cherrydale residence, which had been the site of their home starting around 1950 and thereafter while they were living with their parents and which Mr. Stone and the Company decided could serve as a place to house out-of-town business visitors to Stone Manufacturing's operating facilities located on the Cherrydale property.

Mr. Stone and Ms. Stone found their children's desires to become actively involved during their parents' lives in managing certain assets that their parents owned to be consistent with their own wishes. That is because, as discussed above, at least as early as the last six months of 1995 Mr. Stone and Ms. Stone, although in control of their respective assets, no longer were interested or actively involved in managing those assets. As a result, the prospect of having their children become actively involved in the management of their respective assets was very appealing to Mr. Stone and Ms. Stone. To that end, Mr. Stone and Ms. Stone encouraged their children to attempt to come to an agreement among themselves as to the particular assets that each child wanted to become actively involved in managing. Mr. and Ms. Stone believed that any such agreement, if one could be

[9]When Ms. Fraser was a child, she spent a lot of time at, and developed a strong connection to, the Cedar Mountain property.

reached, would be of assistance to them in deciding which of their respective assets they wanted each of their children to become actively involved in managing.

The parties in the litigation among the children engaged in extensive discussions to settle that litigation and to resolve the children's concerns regarding Mr. Stone's and Ms. Stone's assets so as to avoid any future litigation as to such concerns. Those parties intended and agreed that any agreements that they were able to reach were to be comprehensive and to cover every possible issue that might arise among them as to those matters. On June 3, 1994, the parties in the litigation among the children and their respective attorneys executed a plan (1994 plan for settlement) to settle that litigation and to resolve the various issues relating to the children's concerns regarding Mr. Stone's and Ms. Stone's assets. Ms. Stone and Mr. Stone were not parties to the 1994 plan for settlement, and neither of them signed that document.

With respect to the issues relating to the trusts, the 1994 plan for settlement provided in part as follows:

> I. TRUSTS
>
> The existing trusts will remain as two (2) trusts administered by three (3) independent, qualified Trustees.
>
> A. THREE TRUSTEES TO ADMINISTER EXISTING TRUSTS
>
> There will be three independent, qualified Trustees ("Trustees") who shall administer the two existing trusts ("Existing Trusts") in accordance with the terms of the

1976 Trust Agreement, as clarified by this Plan for Settlement. The term "independent" for purposes of the two existing trusts (Children's and Grandchildren's trust) shall mean a person who:

(1) is not related by blood or marriage to any child, grandchild or spouse;
(2) is not and has not been employed by such child, grandchild or spouse, or any company which has employed such child, grandchild or spouse;
(3) is not now and has not been engaged in any common business effort with such child, grandchild or spouse;
(4) has not acted as attorney or accountant for such child, grandchild or spouse or any company which has employed such child, grandchild or spouse; and,
(5) agrees never to do business with or purchase stock in the Company.
(6) has sole allegiance to the management of the Trust in accordance with the written provision of the Trust Agreement, as clarified by this Plan for Settlement, and to the impartial protection of the interest of the beneficiaries.

The term "qualified" shall mean a person who has been active in a senior management role in a for-profit business within the last three (3) years.

Any action taken by the Trustees of the Existing Trusts shall require majority vote and contemporaneous minutes of such action shall be circulated to the adult beneficiaries.

* * * * * * *

B. SELECTION OF TRUSTEES

Each child shall anonymously nominate one independent, qualified trustee candidate. The Probate Court shall select the three Trustees from the four nominated. * * *

* * * * * * *

H. RESIGNATION AS TRUSTEES

E.E. Stone, IV, C. Rivers Stone, and John Brausch will resign as trustees to facilitate the implementation of this Article I, effective with the selection of and acceptance by the Trustees of the Existing Trusts.

With respect to the issues relating to the children's concerns regarding Mr. Stone's and Ms. Stone's assets, the 1994 plan for settlement provided in part as follows:

VI. ESTATE ISSUES

The four children and John Brausch shall cooperate in an attempt to have E.E. Stone, III, and Allene W. Stone make the following changes in their respective estate plans:

A. PREFERRED STOCK

E.E. Stone, III, would convey or assign directly or indirectly equally to each of the four children, the right to one-fourth (1/4) of the dividends from * * * [his] preferred stock for a period of fifteen (15) years (which time period is set forth herein to allow a proper valuation) and make an immediate donation of his preferred stock to the Stone Foundation, such assignment(s) to be effectuated in a tax efficient manner. There would be no further charitable donation under his will. The Company [defined in the 1994 plan for settlement as Umbro International, Inc., the name of the company resulting from a proposed merger of Stones, Inc., and Stone Manufacturing] shall be entitled to call the preferred stock any time.

B. TESTAMENTARY TRUSTS

There would be no trusts for descendants under E.E. Stone, III or Allene W. Stone's wills. After E.E. Stone, III's death, the portion of his estate not going to Allene W. Stone, after payment of estate taxes, will be distributed equally and directly to each of the four children or that Child's designated beneficiaries. After Allene W. Stone's

death, the remaining E.E. Stone, III/Allene W. Stone estate after estate taxes would be distributed equally to the four children or that Child's designated beneficiaries.

C. FAMILY SETTLEMENT AGREEMENT

The Children and Grandchildren (or their guardians ad litem) and the Stone Foundation (if necessary) shall execute a Family Settlement Agreement (pursuant to S.C. Code § 62-3-1101 et seq.) which provides for a division inter se [sic], in the manner set forth in * * * [other parts of this agreement] in the event E.E. Stone, III, or Allene W. Stone fail to change or maintain their Wills in the same manner.

* * * * * * *

F. POWERS OF ATTORNEY

All existing powers of attorney for E.E. Stone, III and Allene W. Stone will be revoked and new, limited, permanent powers of attorney executed that have been pre-approved by all four children to provide management of parents' monthly cash needs, management of the maintenance of houses, cars, health care, etc., of both parents. All accounts relative to the parents will be audited by the Trustees' accounting firm.

* * * * * * *

H. ARBITRATION

The Children shall use their best efforts to agree on the allocation of the property of the estate of E.E. Stone, III and Allene W. Stone.

It is agreed that Rivers Stone shall receive Piney Mountain from the estate of E.E. Stone, III and Allene W. Stone provided, however, Rivers Stone shall not be entitled to receive more than one-fourth of the total value of the net estates after estate taxes.

It is further agreed that Mary Fraser shall receive one-half (½) of the Cedar Mountain property from the estate of E.E. Stone, III

> and Allene W. Stone; Rosalie Morris and E.E. Stone, IV shall each receive one-fourth (¼) of Cedar Mountain. Notwithstanding the foregoing, neither Mary Fraser, Jack Stone [Eugene Earle Stone, IV], nor Rosalie Morris shall be entitled to receive more than one-fourth (¼) of the total value of the net estates after estate taxes. The parties will use their best efforts to agree on the dimensions and appurtenances to the same prior to the final Court approval of the settlement.
>
> * * * * * * *
>
> Any disagreement over the provisions in this Section VI shall be submitted to binding arbitration before the American Arbitration Association or before an arbitrator appointed by the Probate Court of South Carolina.
>
> * * * * * * *
>
> VII. IMPLEMENTATION AND JURISDICTION
>
> * * * * * * *
>
> B. CONTINUING JURISDICTION
>
> The Probate Court * * * shall maintain continuing jurisdiction to resolve any disputes which shall arise during the implementation and enforcement of this settlement agreement. * * *

The 1994 plan for settlement also provided in part as follows:

> THE FOUR CHILDREN UNDERSTAND THAT ANY RESOLUTION OF THE ESTATE ISSUES MUST INCLUDE A COMPLETELY DEFINITIVE APPROACH TO THE DIVISION OF THE ASSETS OF THE PARENT'S [sic] ESTATES. THE SETTLEMENT SHALL NOT BE FINALIZED UNTIL THE CHILDREN HAVE DETERMINED THE WILLINGNESS OF THEIR FATHER TO ADDRESS THESE ESTATE ISSUES AND ANY CHILD MAY REFUSE TO FINALIZE THE AGREEMENT IF E.E. STONE, III REFUSES TO MAKE THE CHANGES TO HIS ESTATE PLAN PROVIDED FOR HEREIN. * * *

The parties in the litigation among the children included the

above-quoted paragraph in the 1994 plan for settlement because the children were concerned about whether their parents would treat them, as a group, fairly when they decided how to divide their respective assets among their children. As reflected in the above-quoted paragraph, the children intended and agreed that they would not settle and resolve any of the issues involved in the litigation among the children and the children's concerns regarding Mr. Stone's and Ms. Stone's assets unless their parents agreed to make changes to their respective estate plans that were consistent with the provisions of the 1994 plan for settlement relating to such concerns.

In the summer of 1994, Mr. Stone retained David A. Merline (Mr. Merline) to prepare a will for him. Ms. Stone did not retain Mr. Merline; at all relevant times she had her own counsel.

After execution of the 1994 plan for settlement, issues arose with respect to the scope of the authority of the three independent, qualified trustees whom, according to the 1994 plan for settlement, the Probate Court was to select from the four candidates nominated by the children. Issues also arose with respect to whether such three independent, qualified trustees would be fully indemnified in the event of any further litigation against such trustees by any of the children. Because of the unresolved issues relating to the scope of authority and indemni-

fication of the trustees and the fact that the litigation among the children was so hotly contested and bitter, the children were unable to find candidates who were willing to serve as independent trustees of the trusts, and the 1994 plan for settlement did not result in settlement and dismissal of the litigation among the children.

During a period of time starting at least as early as 1994 that is not disclosed by the record, C. Rivers Stone was a member of three organizations: the Young Presidents Organization, the World Presidents Organization, and the Chief Executive Organization (collectively, Management Organizations). At the respective membership meetings of those organizations, various members discussed, inter alia, certain problems that they were having and other members suggested different ways of dealing with such problems. C. Rivers Stone had very close friends who were also members of the Management Organizations and who were aware of the litigation among the children and the children's concerns regarding Mr. Stone's and Ms. Stone's assets. At certain of the respective meetings of those organizations, the members discussed that litigation and those concerns and various ways of dealing with them. Sometime during 1995, certain members of the Management Organizations who were friends of C. Rivers Stone suggested that the children utilize family limited partnerships as a way of resolving the litigation among the children and the children's

concerns regarding Mr. Stone's and Ms. Stone's assets. During that year, C. Rivers Stone informed Mr. Stone, Ms. Stone, and C. Rivers Stone's siblings about that suggestion, and the Stone family became very interested in exploring it.

The primary reason why the Stone family became very interested in exploring the use of family limited partnerships was to resolve the children's concerns regarding Mr. Stone's and Ms. Stone's assets. The Stone family wanted to explore whether such concerns could be resolved by: (1) Actively involving each of the children in the management of certain of their parents' assets during their parents' lives by giving each child the opportunity, through ownership of a general partnership interest in a different family limited partnership, to manage such assets in which such child was interested; and (2) actively involving all of the children in the management of certain of their parents' other assets during their parents' lives by giving all of them the opportunity, through ownership of general partnership interests in a fifth family limited partnership, to manage such assets in which they all were interested. Another very important reason why the Stone family desired to explore the use of family limited partnerships was to settle and bring an end to the litigation among the children. Finally, the Stone family also wanted to explore the use of family limited partnerships as a way to help avoid disputes among the children regarding the ultimate

division of their parents' respective assets after their parents died, although that was not the primary reason for the Stone family's interest in exploring the use of such types of partnerships.

On August 16, 1995, Ms. Fraser and C. Rivers Stone filed a motion in the Probate Court for the following relief:

> **(a) The appointment of an arbitrator to divide the Cedar Mountain Property;**
> **(b) To appoint receivers for the Stone Trusts and the Stone Corporations;**
> **(c) To compel compliance with the * * * [1994 plan for settlement]; and**
> **(d) For other related relief.**

During the last six months of 1995, Mr. Merline and Mr. Stone discussed the suggestion of C. Rivers Stone's friends regarding the use of family limited partnerships as a means of dealing with the litigation among the children and the children's concerns regarding Mr. Stone's and Ms. Stone's assets. Mr. Merline pointed out to Mr. Stone that the use of family limited partnerships also had potential transfer tax benefits. Mr. Merline explained to Mr. Stone that if Mr. Stone and Ms. Stone were to decide to use family limited partnerships, any assets that he and Ms. Stone decided to transfer to such partnerships would no longer be available to them for their own unfettered, personal use. Instead, as explained to Mr. Stone by Mr. Merline, any assets that he and Ms. Stone decided to transfer to such partnerships would belong to such partnerships and would be

subject to the respective partnership agreements for such partnerships.

On March 28, 1996, the parties in the litigation among the children and their respective attorneys executed an amendment to the 1994 plan for settlement (1996 amendment to the 1994 plan for settlement). At the time they executed that 1996 amendment, the parties in the litigation among the children contemplated signing a third settlement agreement in which they would amend and restate both the 1994 plan for settlement and the 1996 amendment to that plan, which, as discussed below, they did. Ms. Stone and Mr. Stone were not parties to the 1996 amendment to the 1994 plan for settlement, and neither of them signed that document.

With respect to the issues relating to the trusts, the 1996 amendment to the 1994 plan for settlement did not change any of the provisions of that plan relating to such issues.

With respect to the issues relating to the children's concerns regarding Mr. Stone's and Ms. Stone's assets, the 1996 amendment to the 1994 plan for settlement provided in part as follows:

> 3. CEDAR MOUNTAIN DIVISION
>
> In implementation of * * * [the paragraph of] the June 3, 1994 Plan of Settlement [requiring arbitration of any disputes among the children regarding section VI of that plan], the parties agree as follows:
>
> (i) The parties agree to the two-page Cedar Mountain division map * * * which has been signed by * * * [the children].

(ii) The deeds to 1,054.415 acres [of the Cedar Mountain property] from E.E. Stone III to the Mary Fraser Limited Partnership will reserve for the 1,054.415-acre tract a * * * qualified road right-of-way and utility permanent easements through the adjacent 582.672-acre Life Estate Tract following the route of the existing roads * * *.

* * * * * * *

(iv) The parties * * * agree to the * * * Piney Mountain [and] Cedar Mountain * * * land appraisals.

4. Family Settlement Estate Planning: The New Limited Partnerships Plan for the Estate.

The parties shall use their reasonable best efforts to encourage E.E. Stone III and Allene W. Stone to establish the five Family Limited Partnerships contemplated by the New Plan for Mr. and Mrs. Stone's estate.

Based upon an analysis of Mr. and Mrs. Stone's assets and expenses, the Children agree to use their reasonable best efforts to encourage Mr. Stone to transfer $1,600,000 of his preferred stock in Stones, Inc. to the Mary Fraser and Rosalie Morris Family Limited Partnerships, in accordance with the "Family Limited Partnership" distribution schedule (the "Chart")[10] hand dated April 12, 1996 * * *.

In the event that assets remaining in E.E. Stone, III's and Allene W. Stone's Limited Partnership (the "Parents' L.P.") as shown in column 7 of the Chart, together with column 8, 9, and 10 and assets of E.E. Stone, III, as managed by E.E. Stone, IV, are not sufficient to pay (a) Mr. and Mrs. Stone's health, maintenance, and other reasonable (1995 standard) expenses; together with (b) estate taxes and expenses of administration payable after their deaths, the deficit shall first be offset by contributions of Jack

[10]The "Chart" identified in the 1996 amendment to the 1994 plan for settlement is not attached to the Court's copy of that amendment and is not otherwise part of the record in these cases.

> Stone equal to any future gifts made from such column 8, 9, and 10 assets in the Exhibit "A" Chart, before calling on the other three children for parental care contributions, with each Child agreeing to contribute a pro rata share of any remaining shortfall from either personal assets, or * * * assigned income rights from his or her respective Limited Partnership Interests. Provided however, that any further gifts made from such assets now shown on the chart shall first be offset by contributions of Jack Stone Family Limited Partnership.
>
> * * * * * * *
>
> In order to protect Mary Fraser on the Cedar Mountain Division, a provision will be included in the Family Settlement Agreement recognizing the Children's agreement that Mary Stone Fraser or her Limited Partnership will receive the 1,045.415-acre * * * parcel * * * and that the remainder interest in the remaining 582.672 acres will be given to one or more 501-C-3 charitable organizations recommended by Mary Fraser which are mutually agreeable to Mr. Stone and the other Children, with Mr. Stone retaining a life estate in the 582.672 acres. The Children shall use their reasonable best efforts to encourage Mr. Stone to convey the 582.672-acre Cedar Mountain property remainder interest according to the foregoing provision.
>
> The Family Settlement Agreement will acknowledge that in the event Mr. Stone executes a new Will, Codicil or other agreement which does not conform to the distribution outlined in the Chart, the Children nonetheless agree to abide by the terms of such distribution in the Chart as a Family Settlement Agreement pursuant to SC Code Sec. 62-3-1101, et seq.; and * * * to include whatever provisions are necessary to preserve any applicable marital deductions.

The 1996 amendment to the 1994 plan for settlement also provided in part as follows:

> 9. The Family Estate Plan set forth herein represents a compromise by the parties. There shall be no implementation of the Family Estate Plan * * * unless and until there is an agreement between the parties [in the litigation among the children] to an Amended and Restated Plan for Settlement.

After execution of the 1996 amendment to the 1994 plan for settlement, the children entered into intense negotiations regarding the particular assets that each child wanted their parents to transfer to a family limited partnership in which such child, as well as each of their parents, would hold a partnership interest.

Between the last six months of 1995 and April 1997, Mr. Merline met with Mr. Stone approximately a dozen times to discuss the use of family limited partnerships, the status of the children's negotiations, and why each child had an interest in certain of the respective assets of Mr. Stone and Ms. Stone. Around April 1996, Mr. Stone and Ms. Stone decided to proceed with forming five family limited partnerships. To that end, at Mr. Stone's request, Mr. Merline drafted five partnership agreements (draft partnership agreements) and circulated those draft partnership agreements among Mr. Stone, Ms. Stone, the children, and their respective attorneys. The children and their respective attorneys, inter alia, made comments on the draft partnership agreements that Mr. Merline had sent them and suggested changes to those agreements. The primary reason for the changes suggested by the children to the draft partnership agreements was the desire of the children to ensure that their parents, and in particular Mr. Stone, would not be unduly influenced by anyone to act in a manner inconsistent with each child's interest in

managing particular assets of their parents during their parents' lives and thereafter.

Mr. Stone agreed with certain of the children's comments and certain of their suggested changes to the draft partnership agreements that Mr. Merline had prepared for Mr. Stone, and Mr. Merline made changes to those draft partnership agreements in order to incorporate such comments and suggested changes. For example, one new provision incorporated into all five of the draft partnership agreements prevented anyone who obtained a power of attorney on behalf of Mr. Stone from using that power of attorney to vote any general partnership interest that Mr. Stone was to receive in each of the proposed five family limited partnerships. Another example was a new provision included only in the draft partnership agreement for the proposed partnership in which C. Rivers Stone was to hold a general partnership interest and in the draft partnership agreement for the proposed partnership in which Ms. Fraser was to hold a general partnership interest. That new provision required the unanimous consent of all the prospective general partners of each such prospective partnership in order to authorize such partnership to sell, transfer, assign, exchange, lease, convey, subdivide, partition, or encumber certain of the Piney Mountain property in the case of the proposed partnership in which C. Rivers Stone was to own a general partnership interest and certain of the Cedar Mountain

property in the case of the proposed partnership in which Ms. Fraser was to own a general partnership interest.

On May 9, 1996, Mr. Stone and Eugene Earle Stone, IV, as both general partners and limited partners, and Ms. Stone, as a limited partner, executed a partnership agreement for a limited partnership that the Stone family intended to name The Eugene E. Stone, III, Limited Partnership (ES3LP).

On May 9, 1996, Mr. Stone and Eugene Earle Stone, IV, as both general partners and limited partners, and Anne M. Stone,[11] as a general partner, executed a partnership agreement for a limited partnership that the Stone family intended to name The E.E. Stone, IV, Limited Partnership (ES4LP).

On May 9, 1996, Mr. Stone, C. Rivers Stone, and Charles Rivers Stone, Jr.,[12] as both general partners and limited partners, and Frances O. Stone,[13] as a limited partner, executed a partnership agreement for a limited partnership that the Stone family intended to name The C. Rivers Stone Limited Partnership (CRSLP).

On May 9, 1996, Mr. Stone and Ms. Morris, as both general partners and limited partners, Mr. Morris, as a general partner,

[11]Anne M. Stone is the spouse of Eugene Earle Stone, IV.

[12]Charles Rivers Stone, Jr., is the son of C. Rivers Stone.

[13]Frances O. Stone is the daughter of C. Rivers Stone.

and Charles H. Morris, Jr.,[14] and Ms. Morris as custodian for Rosalie S. Morris, II,[15] as limited partners, executed a partnership agreement for a limited partnership that the Stone family intended to name The Rosalie Stone Morris Limited Partnership (RSMLP).

On May 9, 1996, Mr. Stone, Ms. Fraser, Wyman Fraser Davis (Ms. Davis),[16] and Laura Lawton Fraser Arnal (Ms. Arnal),[17] as both general partners and limited partners, executed a partnership agreement for a limited partnership that the Stone family intended to name The Mary Stone Fraser Limited Partnership (MSFLP).

Each of the partnership agreements for the Five Partnerships set forth the following purposes of each such partnership:

> to consolidate the management of certain property of the family of EUGENE E. STONE, III (the "Family"); to make a profit; to avoid the division of the property of the Family which is in the Partnership in order to promote the greater sales potential of the property; to avoid potential expensive litigation and disputes over the property of the Family by defining the roles and rights of Family members in the property, and providing procedures to resolve disputes; to restrict the transfer of interests in the property to non-Family members; to establish protection of Family interests from interference and disruption resulting from claims by poten-

[14]Charles H. Morris, Jr., is the son of Ms. Morris.

[15]Rosalie S. Morris, II, is the daughter of Ms. Morris.

[16]Wyman Fraser Davis, also known as Mary Wyman Stone Fraser Davis, is the daughter of Ms. Fraser.

[17]Ms. Arnal is the daughter of Ms. Fraser.

> tial creditors of any Family member; to establish a combined investment policy for the Partnership; to reduce the mechanics and costs of administration of investments; * * * to facilitate the administration and reduce the costs associated with the probate of the estates of Family members; * * * to provide flexibility in business and estate planning not available through trusts, corporations or other business entities; to reduce transaction costs and multiple deeds in transferring property among Family members; * * * and acquiring, financing, developing, subdividing, managing, improving, operating, leasing, mortgaging, refinancing, pledging, selling or otherwise dealing with the Partnership Property * * *.

Each of the partnership agreements for the Five Partnerships provided that distributions to partners may be made from each such partnership only after, inter alia, determining whether the financial condition of each such partnership permitted such distributions. Each of the partnership agreements for the Five Partnerships further provided that all distributions to the partners of each such partnership must, "Unless otherwise agreed by all the Partners in writing, * * * be made simultaneously to each of the Partners and must be made in proportion to the Partners' Partnership Units."

The children understood that Mr. Stone and Ms. Stone would make the ultimate decision as to which, if any, of their parents' respective assets their parents would transfer to each of the Five Partnerships. In this connection, although Mr. Stone and Ms. Stone agreed to form the Five Partnerships, they did not intend to transfer all of the respective assets that they owned to such partnerships in exchange for partnership interests. That

was because they wanted to retain sufficient assets to enable them to maintain their respective accustomed standards of living. To that end, Mr. and Ms. Stone retained certain accountants to advise them as to what assets they should retain, and not transfer, to each of the Five Partnerships. In order to formulate such advice, those accountants performed various cashflow analyses and appraisals, using different assumptions regarding the respective life expectancies of Mr. Stone and Ms. Stone and the anticipated returns on their respective investments. The accountants retained by Mr. Stone and Ms. Stone recommended that they retain, and not transfer, to the Five Partnerships total assets that would yield a monthly total cashflow of between $12,000 and $15,000.

The Stone family intended and agreed that all the partners of each of the Five Partnerships were to receive respective partnership interests in each such partnership that were proportionate to the fair market value of the assets that such partners respectively transferred to such partnership. To that end, during the period May 1996 through March 1997, before any of the partners of each of the Five Partnerships transferred any assets to such partnership, the process (prefunding process) of identifying, describing, and obtaining various appraisals of the respective assets of Mr. Stone and Ms. Stone took place. That process was critical to enabling Mr. Stone, Ms. Stone, and the

children to make decisions about what assets to transfer to each of the Five Partnerships. During the prefunding process, various disputes arose regarding, inter alia, the appraisals of certain assets and the desire of Ms. Fraser, which her three siblings strongly opposed, that Mr. and Ms. Stone make Anne Logan Ministries a charitable beneficiary of certain of the Cedar Mountain property. Those disputes took time to resolve, and, in the case of the disputes regarding the appraisals of certain assets of Mr. Stone and Ms. Stone, new appraisals had to be obtained. Until resolution of all of the disputes that arose during the prefunding process, (1) the parties in the litigation among the children did not enter into the third settlement agreement that they contemplated when they executed the 1996 amendment to the 1994 plan for settlement, and (2) the partners of each of the Five Partnerships were not able to determine what assets were to be transferred to each such partnership.

On October 15, 1996, Mr. Stone and Eugene Earle Stone, IV, as general partners, filed a certificate of limited partnership for ES3LP with the Secretary of State of South Carolina (S.C. Secretary of State), thereby forming ES3LP under the laws of that State.

On October 15, 1996, Mr. Stone, Eugene Earle Stone, IV, and Anne M. Stone, as general partners, filed a certificate of limited partnership for ES4LP with the S.C. Secretary of State,

thereby forming ES4LP under the laws of the State of South Carolina.

On October 15, 1996, Mr. Stone, C. Rivers Stone, and Charles Rivers Stone, Jr., as general partners, filed a certificate of limited partnership for CRSLP with the S.C. Secretary of State, thereby forming CRSLP under the laws of the State of South Carolina.

On October 15, 1996, Mr. Stone, Ms. Morris, and Mr. Morris, as general partners, filed a certificate of limited partnership for RSMLP with the S.C. Secretary of State, thereby forming RSMLP under the laws of the State of South Carolina.

On October 15, 1996, Mr. Stone, Ms. Fraser, Ms. Davis, and Ms. Arnal, as general partners, filed a certificate of limited partnership for MSFLP with the S.C. Secretary of State, thereby forming MSFLP under the laws of the State of South Carolina.

On January 31, 1997, Mr. Stone was diagnosed with cancer of the gallbladder. Prior to that time, Mr. Stone had been in good health, did not have any known serious health problems, and was active and alert. After Mr. Stone was diagnosed with cancer, it was the doctors' prognosis that he would live a period of months.

By late March 1997, Mr. and Ms. Stone had become satisfied that the amount of assets that their accountants had recommended they retain, and not transfer to, each of the Five Partnerships was sufficient to enable them to maintain their respective

accustomed standards of living, and they decided to follow their accountants' recommendations. By that time, all of the disputes that arose during the prefunding process had been resolved, and Mr. Stone, Ms. Stone, and the other partners of each of the Five Partnerships had agreed on the identities and the values of the assets that they would transfer to each such partnership. Eugene Earle Stone, IV, had a particular interest in managing, and maintaining the value of, the preferred stock of Stones, Inc., and it was decided that approximately $1 million[18] of such stock, as well as certain other property, was to be transferred to ES4LP. C. Rivers Stone had a particular interest in managing Mr. Stone's Piney Mountain property, and it was decided that various parcels of that property totaling 366.097 acres, as well as certain other property, were to be transferred to CRSLP.[19] Ms.

[18]The record does not disclose the precise value of each of the assets transferred to each of the Five Partnerships as of the date of each such transfer to each such partnership. However, the record establishes the precise value of each of the assets owned by each such partnership on the respective dates of the deaths of Mr. Stone and Ms. Stone. The parties agree that, after the gifts by Mr. Stone of certain partnership interests in ES4LP, CRSLP, RSMLP, and MSFLP (described below) to Eugene Stone, IV, C. Rivers Stone, Ms. Morris, and Ms. Fraser, respectively, all the partners of each of those four partnerships (as well as ES3LP) received, as the Stone family intended and agreed, respective percentage interests in each such partnership that were proportionate to the fair market value of the assets that such partners respectively transferred to each such partnership.

[19]The parties stipulated that a one-percent interest in each of various parcels totaling 366.949 acres of the Piney Mountain property was transferred from Mr. Stone to C. Rivers Stone and

(continued...)

Morris had a particular interest in managing certain of her parents' stock and securities, including at least some of Mr. Stone's preferred stock in Stones, Inc., and it was decided that various stock and securities, including approximately $642,000 of such preferred stock, as well as certain other property, was to be transferred to RSMLP. Ms. Fraser had a particular interest in managing her parents' Cedar Mountain property, and it was decided that the 1054.415-acre parcel of that property, as well as certain other property, was to be transferred to MSFLP. All of the children had a particular interest in the Cherrydale residence, and it was decided that that property, as well as certain other property, was to be transferred to ES3LP.

On April 4, 1997, Mr. Stone, as both a general partner and a limited partner, Eugene Earle Stone, IV,[20] C. Rivers Stone, Ms. Morris, and Ms. Fraser, as general partners, and Ms. Stone, as a limited partner, executed an amended and restated partnership

[19](...continued)
that Mr. Stone and C. Rivers Stone transferred to CRSLP their respective interests in those 366.949 acres of that property. Those stipulations are clearly contrary to the deeds relating to such transfers, and we shall disregard such stipulations. See Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181, 195 (1989). Those deeds show that a total of 366.097 acres of various parcels of the Piney Mountain property was the subject of such transfers.

[20]As of Apr. 4, 1997, Eugene Earle Stone, IV, was no longer both a general partner and a limited partner of ES3LP; he was only a general partner.

agreement for ES3LP.[21] The purpose of that amended and restated partnership agreement was to make C. Rivers Stone, Ms. Morris, and Ms. Fraser general partners of ES3LP.

On April 5, 1997, the parties in the litigation among the children and their respective attorneys executed two documents[22] dated as of March 31, 1997, the purpose of which was to settle that litigation and to resolve the issues relating to the children's concerns regarding Mr. Stone's and Ms. Stone's assets (collectively, the 1997 amended and restated plan for settlement). The 1997 amended and restated plan for settlement amended and restated the 1994 plan for settlement and the 1996 amendment to that plan. Ms. Stone was not a party to the 1997 amended and restated plan for settlement, and she did not sign those documents. Mr. Stone signed the 1997 amended and restated plan for settlement--trusts and estate only in his capacity as a preferred stockholder of Stones, Inc.[23] Mr. Stone signed the 1997 amend

[21]On Apr. 11, 1997, Mr. Stone, Eugene Earle Stone, IV, C. Rivers Stone, Ms. Morris, and Ms. Fraser, as general partners, filed a first amendment to the certificate of limited partnership for ES3LP with the S.C. Secretary of State, which reflected the amended and restated partnership agreement for ES3LP executed on Apr. 4, 1997.

[22]The two documents were referred to as "Amended and Restated Plan for Settlement-Trusts and Estate" (1997 amended and restated plan for settlement--trusts and estate) and "Amended and Restated Plan for Settlement-Company (1997 amended and restated plan for settlement--Company).

[23]It was necessary for Mr. Stone to sign the 1997 amended
(continued...)

ment and restated plan for settlement--Company only in his capacity as a preferred stockholder of Stones, Inc.[24]

With respect to the issues relating to the trusts, the 1997

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[23](...continued)
and restated plan for settlement--trusts and estate in his capacity as a preferred stockholder of Stones, Inc., because that document provided:

> E.E. Stone, III will convey or assign directly or indirectly the preferred stock * * * to the Limited Partnerships [ES4LP, RSMLP, and MSFLP] created as part of the New Plan for Estate in accordance with the Chart referenced in paragraph III.H. The preferred stock shall be changed to eliminate its voting rights, or, if not so changed at the time of the conveyance or assignment, then the Children and Grandchildren shall use their reasonable best efforts to persuade E.E. Stone, III, in his capacity as General Partner of the respective Limited Partnerships, to consent to these changes.

[24]It was necessary for Mr. Stone to sign the 1997 amended and restated plan for settlement--Company in his capacity as a preferred stockholder of Stones, Inc., because that document provided:

> The Company shall offer to exchange the preferred stock in Stones [Inc.] currently held by E.E. Stone, III for new preferred stock in Stones [Inc.] which shall be classified as non-voting stock in all events ("New Preferred Stock"). * * *
>
> The Company shall have the right beginning in 1999 and for each year thereafter to redeem New Preferred Stock equal to 20% of the New Preferred Stock outstanding on January 1, 1999 on a pro rata basis until all New Preferred Stock has been redeemed. The New Preferred Stock if redeemed by the Company, in its sole discretion, shall be redeemed based on a 1996 appraised value of the preferred stock by Houlihan, Lokey, which estimates the value of the 5,100 shares of preferred stock at $4,462,500, so that the redemption price of any redeemed share shall at all times be $875.00 per share plus any dividends declared but not yet paid.

amended and restated plan for settlement--trusts and estate provided in part as follows:

> II. TRUST ISSUES
>
> A. EXISTING TRUSTS
>
> (a) Administrative Transfer to New Trusts
>
> The existing trusts established by the 1976 Agreement and Declaration of Trust ("Existing Trusts") will remain in existence as two (2) trusts. Upon receipt by the parties of a favorable Private Letter Ruling * * * the Probate Court shall release * * * [documents relating to the administrative division of the Trusts] from escrow, and thereby administratively establish eleven New Trusts * * *.
>
> It is the intent of the parties that the release of the Trust-related Plan Documents implements the Trust-related aspects of the settlement and that no further action by the parties shall be necessary to effect the administrative division of the two Existing Trusts into eleven New Trusts (as defined herein), the installation of the New Trustees (as defined herein) and the funding of these New Trusts or that any such action be ministerial and not discretionary in nature.
>
> The failure of a beneficiary to identify an Independent Trustee who has executed the Certification and Acceptance and is willing to serve over his or her New Trust shall not delay the release or implementation of the Trust-related Plan Documents. In the event an Independent Trustee selected by a beneficiary cannot be installed over a New Trust at the time the Probate Court releases the Trust-related Plan Documents from escrow, that beneficiary's New Trust shall be administered by the Existing Trustees until such time as that beneficiary

> obtains an Independent Trustee who is willing to serve as the Independent Trustee of that beneficiary's New Trust on the terms and conditions set forth in the Amended Plan and Trust-related Plan Documents.

* * * * * * *

> (b) For purposes of this Amended Plan, a Trustee of a New Trust is "qualified" if he or she is a capable and responsible individual; a Trustee of a New Trust is "Independent" if that individual is not related by blood or marriage to any Child or Grandchild (hereinafter "Independent Trustee"). * * *

* * * * * * *

H. UNDERSTANDING OF DISTRIBUTION PROVISIONS

> The distributions from the New Trusts shall be in accordance with the provision of the Existing Trusts. In this respect, there has been a legitimate dispute as to the interpretation of the Existing Trust provisions. The parties acknowledge that the language, intent and circumstances relating to the Existing Trusts are such that any income received or generated by the New Trusts shall be distributed in accordance with the distribution standards and provisions of the 1976 Trust Agreement, as restated in the New Trusts. * * *

With respect to the issues relating to the children's concerns regarding Mr. Stone's and Ms. Stone's assets, the 1997 amended and restated plan for settlement--trusts and estate provided in part as follows:

III. ESTATE ISSUES

A. GENERAL

> It is contemplated that prior to the release of the Amended Plan and Plan Docu-

ments from escrow,[25] the estate matters set forth in this Section will have been agreed to by E.E. Stone, III and Allene W. Stone and all documents necessary to fully fund the Family Limited Partnerships and to otherwise implement the Estate Section of the Amended Plan will have been executed and placed in escrow * * *. The parties understand that E.E. Stone, III and Allene W. Stone have the right to make such estate decisions as they deem appropriate. In the event they do not adopt the estate plan set forth in this Section, the Amended Plan shall not be effective unless and until an alternative estate plan is agreed to.

B. TESTAMENTARY TRUSTS

There shall be no trusts for descendants under the Wills of E.E. Stone, III or Allene W. Stone. After the death of the first of E.E. Stone, III or Allene W. Stone, the portion of the estate not going to the surviving spouse shall, after payment of estate taxes and expenses of administration, be distributed equally and directly to each of the four Children or that Child's estate, provided, however, that the decedent's interest in each of the Children's Limited Partnerships shall be distributed directly to the Child for whose Partnership such interest is held. After the death of the surviving spouse, the assets remaining in the estate of E.E. Stone,

---

[25]With respect to the "escrow" referred to in paragraph A of section III of the 1997 amended and restated plan for settlement--trusts and estate, that plan provided in part as follows:

> Executed copies of * * * [this amended plan] and all documents specified therein ("Plan Documents") shall be placed in escrow with the Probate Court. * * * [this amended plan] and Plan Documents shall not be effective unless and until they are released from escrow by the Probate Court * * *.

As discussed below, on Apr. 5, 1997, the Probate Court entered an order approving the 1997 amended and restated plan for settlement.

III and/or Allene W. Stone shall, after payment of estate taxes and expenses of administration, be distributed equally to the four Children or that Child's estate, subject, however, to the provision that the decedent's interest in each of the Children's Limited Partnerships shall be distributed directly to the Child for whose Partnership such interest is held.

C. FAMILY SETTLEMENT AGREEMENT

The Children and Grandchildren (or their guardians ad litem) and the Stone Foundation (if necessary) have executed a Family Settlement Agreement (pursuant to S.C. Code § 62-3-1101 et seq.) which provides for a division inter se [sic] of the estates of E.E. Stone, III and Allene W. Stone in the manner set forth in this Section III in the event E.E. Stone, III or Allene W. Stone fail to maintain their Wills in the same manner. The Family Settlement Agreement acknowledges that in the event E.E. Stone, III executes a new Will, Codicil or other agreement which does not conform to the distribution outline in the "Stone Family Limited Partnership Distribution Schedule" dated April 3, 1997 and attached hereto as Exhibit "J" ("the Chart") and in this Amended Plan, the Children nonetheless agree (a) the distribution outlined in such Chart and in this Amended Plan is fair and equitable; (b) to abide by the terms of such distribution as a Family Settlement Agreement pursuant to South Carolina Code § 62-3-1101, et seq.; and (c) to include whatever provisions are necessary to preserve any applicable marital deductions. * * *

* * * * * * *

E. STONE FOUNDATION

The Stone Foundation shall be divided into four separate, equal, and entirely independent foundations with each Child (and/or designee) as one of the trustees(s) of one separate foundation, but with 20% of the required income to be distributed by E.E. Stone, III to his favorite church, and/or

other charities during his lifetime. The parties shall take all steps necessary to establish and fund the four foundations within ten (10) business days of the entry of the Escrow Order.

* * * * * * *

H. NEW PLAN FOR ESTATES

* * * * * * *

In the event that assets remaining in the Parents' L.P. [ES3LP] as shown in column G,[26] together with assets listed in column H and other assets of E.E. Stone, III are not sufficient to pay health, maintenance, and other reasonable (1995 standard) expenses for E.E. Stone, III and Allene W. Stone, the deficit shall [be] borne equally by assets in the four Children's Limited Partnerships. If the assets in the residuary estate of E.E. Stone, III and the Parents' L.P. are insufficient to pay estate tax or expenses of administration payable after their deaths, any remaining estate tax or expenses of administration shall be borne equally by assets in the four Children's Limited Partnerships.

* * * * * * *

The Children shall use their reasonable best efforts to encourage E.E. Stone, III, to agree to the following: (a) to rent the Cherrydale house to Stone Manufacturing Co. until it is sold to Stone Manufacturing Co. for its fair market value as determined by a competent appraiser (which appraisal shall include, among other things the cost of the rennovation [sic] and the new furniture and fixtures) agreed to by the Buyer and Seller and (b) to revise his Will accordingly. Upon the * * * death of E.E. Stone, III, the nec-

[26]It is not clear from the record the columns to which paragraph H of section III of the 1997 amended and restated plan for settlement--trusts and estate referred.

essary portion of the proceeds from the life insurance policy maintained on E.E. Stone, III, by Stone Manufacturing Co. shall be reserved and used by Stone Manufacturing Co. to consumate [sic] the purchase of the Cherrydale house.

[I.] CEDAR MOUNTAIN DIVISION

The division of Cedar Mountain for purposes of the Chart and the Mary Fraser Limited Partnership shall be as follows:

(1) The parties agree to the two-page Cedar Mountain division map * * * which has been signed by * * * [the children]. * * *

(2) The deeds to 1,054.415 acres from E.E. Stone, III, to the Mary Fraser Limited Partnership will reserve for the 1,054.415-acre tract a * * * qualified road right-of-way and utility permanent easements through the adjacent 582.672-acre Life Estate Tract following the route of the existing roads * * *.

(3) A provision shall be included in the Family Settlement Agreement acknowledging the Children's agreement that the Mary Fraser Limited Partnership shall receive the Mary Fraser Parcel, and that the remainder interest in the Life Estate Parcel shall be given to Ann [sic] Logan Ministries, Inc., a 501(c)(3) charitable organization, with E.E. Stone, III, retaining a life estate in the Life Estate Parcel.

* * * * * * *

L. MAINTENANCE OF PARENTS

The four Children, shall jointly bear the responsibility for the financial maintenance of E.E. Stone, III and Allene W. Stone during their lives, utilizing the assets

> available to the parents ("Parental Assets") for such maintenance in the same or better manner as in recent years. * * *
>
> * * * Mary Stone Fraser shall be delegated responsibility for the management of the care for Allene W. Stone, supported by others. Allene W. Stone may be moved with Mary Fraser, including to the residence of E.E. Stone, III if he is ever incapacitated and unable to occupy the residence * * *.

The 1997 amended and restated plan for settlement--trusts and estate further provided in part as follows:

IV. IMPLEMENTATION AND JURISDICTION

* * * * * * *

B. CONTINUING JURISDICTION

> The Probate Court * * * shall maintain continuing jurisdiction to resolve any Trust-related disputes which shall arise during the implementation and enforcement of this settlement agreement. The parties will seek to have a hearing on the Amended Plan as soon as practicable after its execution.

Neither Mr. and Ms. Stone nor the children anticipated that their parents would need any financial assistance during their parents' respective lives. As discussed above, after consulting with their accountants, Mr. Stone and Ms. Stone retained, and did not transfer to the Five Partnerships, total assets that they believed would enable them to maintain their respective accustomed standards of living. Nonetheless, the parties in the litigation among the children included paragraphs H and L of section III in the 1997 amended and restated plan for settlement--trusts and estate in order to address and resolve the possibil-

ity that their parents might need financial assistance during their parents' respective lives. Those paragraphs reflected the children's agreement that, in the unlikely event that the total assets held by ES3LP and the total assets owned by Mr. Stone and Ms. Stone were insufficient to enable them to maintain their respective accustomed standards of living, the children, as a group, would share equally in providing for the maintenance of their parents at such standards of living through distributions of equal amounts from ES4LP, CRSLP, RSMLP, and MSFLP, respectively.

The parties in the litigation among the children also addressed in paragraph H of section III of the 1997 amended and restated plan an issue relating to estate taxes and estate administration expenses payable after Mr. Stone and Ms. Stone died. Those parties resolved that issue by agreeing in that paragraph that, in the event the total assets in Mr. Stone's residuary estate and the total assets owned by ES3LP were not sufficient to pay estate taxes and estate administration expenses owing as a result of their parents' respective deaths, the children, as a group, would share equally in paying any such taxes and expenses through distributions of equal amounts from ES4LP, CRSLP, RSMLP, and MSFLP, respectively.

The 1997 amended and restated plan for settlement--Company provided in part as follows:

PREAMBLE

This "Amended and Restated Plan for Settlement-Company" sets forth the provisions of the parties' settlement relating to Stones, Inc. ("Stones") and Stone Manufacturing Co. ("SMC") (and their subsidiaries) and amends and restates the Plan for Settlement dated June 3, 1994 and the First Amendment dated as of March 28, 1996 among the same parties.

I. EFFECT OF THE AMENDED PLAN

(a) Executed copies of this Amended and Restated Plan for Settlement - Company and all documents specified herein ("Plan Documents") shall be placed in escrow with the Probate Court and shall not be effective unless and until they are released from escrow by the Probate Court * * *.

II. COMPANY

A. GENERAL

Stones and SMC may be merged * * * provided such merger does not violate the provisions of any agreement for borrowed money to which Stones or SMC is a party, but no merger is required. In the event the merger does occur, any reference contained in this Amended Plan to the "Company", its Board, its officers, its shareholders, its Common Stock and its obligations shall refer to the surviving entity of the merger, its Board, its Nominating Committee, its officers, its shareholders, its Common Stock and its obligations. In the event the merger does not occur and Stones and SMC continue to exist as separate entities, except to the extent otherwise provided herein, any reference contained in this Amended Plan to the "Company", its Board, its Nominating Committee, its officers, its shareholders, its Common Stock and its obligations shall refer to each of Stones and SMC separately, as to its own Board, its Nominating Committee, its officers, its shareholders, its Common Stock and its obligations.

* * * * * * *

C. BOARD OF DIRECTORS - SELECTION OF DIRECTORS

E.E. Stone, IV and C. Rivers Stone shall both be selected as initial members of the Board. At least three members of the Board shall be independent outside directors; provided, however, that the Board initially may be comprised solely of management representatives * * * prior to the proposed initial public offering of equity securities ("IPO") of Stones, SMC or the surviving entity of the merger * * *.

* * * * * * *

IV. OWNERSHIP OF COMPANY

A. MERGER OF STONES AND SMC

Stones and SMC may be merged * * *. The shareholders agree to vote their stock in favor of any such merger that is recommended by the Board.

* * * * * * *

B. SHARE EXCHANGE

The shares of Common Stock of SMC, now held by E.E. Stone, IV, C. Rivers Stone, Mary Stone Fraser and Rosalie Stone Morris, the shares of Common Stock of Stones, held by the Existing Trusts * * * may be exchanged or otherwise changed to align their shares * * * at the Stones corporate level in a transaction recommended by the Board. * * *

* * * * * * *

The shareholders agree to vote their stock in favor of a share exchange consistent with this provision that is recommended by the Board and to exchange their shares as required.

* * * * * * *

I. PREFERENTIAL RIGHT TO SELL COMMON STOCK

The New Trusts for Mary Stone Fraser, Mary Wyman Stone Fraser Davis and Laura Lawton Stone Fraser Arnal (the "Fraser New Trusts"), the New

Trusts for Rosalie Stone Morris, Charles Hill Morris, Jr., and Rosalie Morris (the "Morris New Trusts"), and the New Trusts for Chris Stone, Frances Stone and Rosalie Stone shall have the right (but not the obligation) to dispose of their entire holding of Common Stock in the IPO and in a subsequent offering, should they choose to do so. Mary Stone Fraser and Rosalie Stone Morris shall have the right to sell their directly owned shares in either the initial or subsequent offering.
* * *

J. SALE OF THE COMPANY

The Board, with the approval of the shareholders * * * may effect a sale of the Company or other sale involving all of the stock or substantially all of the assets of the Company upon such terms and conditions as shall be determined by the Board.

* * * * * * *

M. DIVIDEND PAYMENTS

(a) To the extent actually permitted under all financing arrangements to which SMC is a party, SMC shall pay a dividend to the shareholders in 1997 of $1 million for fiscal year 1996 to shareholders of record as of December 31, 1996. * * *

(b) Mandatory dividends on all Common Stock of SMC shall be determined, and to the extent permitted under all financing arrangements to which SMC is a party paid to the shareholders as soon as practicable after the end of each fiscal year in which consolidated net after-tax earnings * * * for that year exceed $5 million * * *.

* * * * * * *

VII. IMPLEMENTATION AND JURISDICTION

* * * * * * *

B. CONTINUING JURISDICTION AND FURTHER ASSURANCES

The parties agree to take whatever additional

> actions and execute whatever additional documents are reasonably necessary to accomplish the provisions hereof * * *. The Probate Court * * * shall maintain exclusive continuing jurisdiction to resolve any disputes which shall arise during the implementation and enforcement of the Amended Plan and the Company-related Plan Documents. The parties will seek to have a hearing on the Amended Plan as soon as practicable after its execution.

Because, as discussed above, the Probate Court continued to retain jurisdiction over any issues relevant to the litigation among the children, the parties in that litigation submitted the 1997 amended and restated plan for settlement to the Probate Court for approval. Until and unless the Probate Court approved that plan, none of the partnerships was to be funded. On April 5, 1997, the Probate Court entered an order approving the 1997 amended and restated plan for settlement, finding it to be fair and equitable to all of the parties to that plan and consistent with South Carolina law.

On April 5, 1997, the children and their respective children entered into a family settlement agreement, as provided for in the 1997 amended and restated plan for settlement--trusts and estate. That agreement provided in part as follows:

> WHEREAS, in furtherance of an estate plan which has been developed for Mr. and Mrs. Stone, the parties to this Family Settlement Agreement entered into an Amended and Restated Plan For Settlement, (the "Plan") [the 1997 amended and restated plan for settlement], * * *
>
> WHEREAS, pursuant to the Plan, the Family persuaded Mr. and Mrs. Stone to execute new Wills, (collectively the "New Wills") [Mr. Stone's will executed

on April 5, 1997, discussed below, and Ms. Stone's will executed on May 3, 1997, discussed below] * * *.

WHEREAS, being mindful that Mr. and Mrs. Stone could subsequently execute other wills or codicils and revoke or amend the New Wills, the Family has agreed, pursuant to the Plan, to enter into this Family Settlement Agreement, the terms and provisions of which are consistent with the New Wills and the Plan, and which is intended to resolve the * * * [litigation among the children and the children's concerns regarding Mr. Stone's and Ms. Stone's assets] as it relates to any future will contest concerning the proper disposition of Mr. Stone's estate and Mrs. Stone's estate upon their respective deaths.

* * * * * * *

2. Terms of Family Settlement Agreement include those of the Plan and New Wills. If either Mr. or Mrs. Stone executes any subsequent will or codicil, or otherwise effectively revokes the New Wills, which would cause a distribution from their estates to the Family in a manner inconsistent with the Plan or the New Wills, then that portion of their estates which was left to the Family under the subsequent will or codicil shall pass to the Family according to the provisions of the Plan and the New Wills [Mr. and Ms. Stone's New Wills] as set forth in Exhibits A, B and C and this Family Settlement Agreement. * * *

3. State Law to Govern. This Family Settlement Agreement shall be construed, regulated and governed by and in accordance with the laws of the State of South Carolina, notwithstanding the residence in any other jurisdiction of any member of the Family.

On April 5, 1997, Mr. Stone executed his last will and testament (Mr. Stone's will). Mr. Stone's will provided in part as follows:

(1) Prior Wills. I hereby revoke all other wills and codicils heretofore made by me.

(2) Debts, Expenses and Mortgages. I direct my Personal Representative to pay my legal debts, my

funeral expenses, any unpaid expenses of my last illness, and the cost of a suitable tombstone or marker for my grave. Such debts and expenses shall first be paid out of and charged against the EUGENE E. STONE, III LIMITED PARTNERSHIP, or any proceeds received by my estate from any individual retirement account or deferred compensation. In the event these sources of funds are insufficient to pay such debts and expenses, then such remaining debts and expenses shall be paid out of and charged equally against the limited partnerships established by me for my children. In the event there are insufficient assets in a limited partnership established by me for a child of mine to pay an equal amount of such remaining debts and expenses, then the child of mine who received or receives an interest in such limited partnership, or such child's estate, as the case may be, shall be responsible for the payment of an equal amount of any such remaining debts and expenses. * * *

(3) Taxes. * * *

(a) Except as provided * * * below, I direct that all estate, generation-skipping transfer, inheritance, transfer, succession, death, or similar taxes which may be assessed or imposed upon or with respect to any interest in a limited partnership established by me for a child of mine which is included in my gross estate for the purpose of such taxes * * * shall be paid out of and charged against such limited partnership, and shall not be charged against the marital deduction. In the event there are insufficient assets in a limited partnership established by me for a child of mine to pay such taxes, then the child of mine who received or receives an interest in such limited partnership, or such child's estate, as the case may be, shall be responsible for the payment of any such remaining taxes.

(b) Except as provided in Paragraph (3)(c) below, I direct that any taxes which may be assessed or imposed by Section 2035(c) of the Internal Revenue Code, as amended, or corresponding provision of state law, including any interest or penalties thereon, as a result of any

gift tax paid or payable with respect to any interest in any limited partnerships established by me for my children which were the subject of any gifts made by me during my lifetime, shall be paid out of and charged equally against such limited partnerships, and shall not be charged against the marital deduction. In the event there are insufficient assets in a limited partnership established by me for a child of mine to pay an equal amount of such taxes, then the child of mine who received a gift of an interest in such limited partnership, or such child's estate, as the case may be, shall be responsible for the payment of an equal amount of any such remaining taxes.

(c) In the event the Internal Revenue Service or any other taxing authority changes the value attributable to (i) any assets I have contributed to a limited partnership established by me for a child of mine * * * then I direct that all gift, estate, generation-skipping transfer, inheritance, transfer, succession, death, or similar taxes which may be assessed or imposed as a result of such change in value, * * * shall be paid out of and charged against the limited partnership that received such contribution * * * and shall not be charged against the marital deduction. In the event there are insufficient assets in a limited partnership established by me for a child of mine to pay such taxes, then the child of mine who received such gift, or whose limited partnership received such contribution, or such child's estate, as the case may be, shall be responsible for the payment of any such remaining taxes.

(d) I direct that all other estate, generation-skipping transfer, inheritance, transfer, succession, death, or similar taxes, including any interest or penalties thereon, payable by reason of my death * * * or assessed or imposed with respect to my estate, or any part thereof, whether or not passing under this will, or any codicil thereto, including all policies of insurance on my life, all

> bequests and devises, all transfers made by me during my lifetime, all jointly held property, all pension and profit-sharing benefits, deferred compensation benefits and individual retirement accounts, and all powers, rights, or other interests in property included in my gross estate for the purpose of such taxes, shall first be paid out of and charged against my residuary estate. In the event there are insufficient assets in my residuary estate to pay such taxes, then such remaining taxes shall be paid out of and charged equally against the limited partnerships established by me for my children. In the event there are insufficient assets in a limited partnership established by me for a child of mine to pay an equal amount of such remaining taxes, then the child of mine who received or receives an interest in such limited partnership, or such child's estate, as the case may be, shall be responsible for the payment of an equal amount of any such remaining taxes. * * *

* * * * * * *

(4) Specific Bequests. I hereby make the following specific bequests:

(a) I give, devise and bequeath all of my tangible personal effects * * * to my children * * *.

(b) If my wife * * * survives me, I give, devise and bequeath any interest that I may own at the time of my death in the EUGENE E. STONE, III LIMITED PARTNERSHIP, or its successor, and any proceeds, net of taxes, received by my estate from any individual retirement account or deferred compensation * * * to be held in the ALLENE WYMAN STONE TRUST * * *. If my wife * * * does not survive me, then I give, devise and bequeath any interest that I may own at the time of my death in * * * [ES3LP] to my children * * *.

(c) I give, devise and bequeath any interest that I may own at the time of my death in the C. RIVERS STONE LIMITED PARTNERSHIP, or its successor, to my son, C. RIVERS STONE, if he survives me, to be his absolutely, but if he does not survive me, to my said son's

estate.

(d) I give, devise and bequeath any interest that I may own at the time of my death in the E.E. STONE, IV LIMITED PARTNERSHIP, or its successor, to my son, E.E. STONE, IV, if he survives me, to be his absolutely, but if he does not survive me, to my said son's estate.

(e) I give, devise and bequeath any interest that I may own at the time of my death in the MARY STONE FRASER LIMITED PARTNERSHIP, or its successor, to my daughter, MARY S. FRASER, if she survives me, to be hers absolutely, but if she does not survive me, to my said daughter's estate.

(f) I give, devise and bequeath any interest that I may own at the time of my death in the ROSALIE STONE MORRIS LIMITED PARTNERSHIP, or its successor, to my daughter, ROSALIE S. MORRIS, if she survives me, to be hers absolutely, but if she does not survive me, to my said daughter's estate.

* * * * * * *

(5) Allene Wyman Stone Trust. THE ALLENE WYMAN STONE TRUST shall be held, managed, invested and reinvested, administered and distributed upon the following terms and conditions and for the following uses and purposes:

(a) If my wife * * * survives me, then * * * my Trustee shall pay all of the net income from this trust, at least quarterly, to or for the benefit of my wife * * * for and during the term of her life. * * *

(b) Upon the death of my wife * * * the remaining principal of this trust shall be distributed to my children. * * *

(c) My Personal Representative shall, in its discretion, determine whether to elect under Section 2056(b)(7) of the Internal Revenue Code * * * to qualify any specific portion or all of this trust for the estate tax marital deduction. * * *

* * * * * * *

(e) * * * It is my intention that my wife under the provisions of this trust have substantially that degree of beneficial enjoyment of this trust during her lifetime which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust, and my Trustee shall not exercise its discretion in a manner which is not in accord with this expressed intention. It is also my intention that my Trustee shall invest this trust so that it will produce for my wife during her lifetime an income which is consistent with the value of the trust property and with its preservation. Therefore, non-income producing property shall not be held as a part of this trust for more than a reasonable period of time without the approval of my wife. In addition, my wife may require my Trustee at any time to either make any nonproductive property of this trust productive or to convert such nonproductive property to productive property within a reasonable period of time. It is expressly provided that my Trustee shall not in the exercise of its discretion make any determination inconsistent with the foregoing.

* * * * * * *

(8) Powers of * * * Trustee. In addition to such powers as my * * * Trustee may have by law, I authorize each of them, in their discretion, to exercise the following powers, which at all times shall be exercised in a fiduciary capacity for the benefit of the beneficiaries herein: * * * to sell, exchange, grant options and dispose of said property, real, personal, tangible or intangible at such prices and on such terms as they deem proper; * * * to invest and reinvest in any kind of property, real, personal, tangible or intangible, including, but not limited to, common trust funds, stocks, options, futures, contracts, rights, warrants, puts, calls, bonds, notes, mortgages, general or limited partnership interests, limited liability companies, savings accounts and certificates of deposit, and similar liquid funds, mutual funds, real estate, and stock of any corporate fiduciary serving hereunder or

> the holding company of such corporate fiduciary; * * * to make distributions in cash or in kind, * * * to continue and operate any business owned by me at my death in the form either of a sole proprietorship, partnership, limited liability company or corporation, and to do any and all things deemed needful or appropriate by my * * * Trustee, including the power to incorporate or form the business and to put additional capital into the business, for such time as they shall deem advisable, without liability for loss resulting from the continuance or operation of the business except for their own negligence; * * * and to do all other acts which in their discretion may be necessary or appropriate for the proper and advantageous management, investment and distribution of my estate or any trust hereunder, all of which may be done without order of or application to any court. Notwithstanding any provision in this will to the contrary, any duty or power granted to my * * * Trustee shall be absolutely void to the extent that the right to perform such duty, or to exercise such power, or the performance or exercise thereof would in any way cause my estate to lose all or any part of the tax benefits afforded by the marital deduction or any exemption allowed pursuant to the generation-skipping transfer tax provisions under either federal or state laws * * *.
>
> * * * * * * *
>
> (15) * * * Trustee. * * * I * * * nominate, constitute and appoint my children * * * as Co-Trustees of all trusts created in this will. * * *

On May 3, 1997, Ms. Stone executed her last will and testament (Ms. Stone's will). Ms. Stone's will provided as follows:

> I, ALLENE WYMAN STONE, a resident of and domiciled in Greenville County, South Carolina, do hereby make, publish and declare this writing to be and contain my Last Will and Testament, hereby revoking any and all other Wills or Codicils to Wills at any time heretofore made by me.
>
> **ITEM I**
>
> I direct that all of my just debts, secured and unsecured, be paid as soon as practicable after my

death; however, I direct that my Personal Representative may cause any debt to be carried, renewed and refinanced from time to time upon such terms and with such securities for its repayment as my Personal Representative may deem advisable taking into consideration the best interest of the beneficiaries hereunder.

ITEM II

I direct that all estate, inheritance, succession, death or similar taxes (except generation-skipping transfer taxes) assessed with respect to my estate herein disposed of, or any part thereof, or on any bequest or devise contained in this my Last Will and Testament (which term wherever used herein shall include any codicil hereto), or on any insurance upon my life or on any property held jointly by me with another or on any transfer made by me during my lifetime or on any other property or interest in property included in my estate shall be paid out of my residuary estate and shall not be charged against the marital deduction. In the event there are insufficient assets in my residuary estate which are not selected for the marital deduction to my estate taxes, then my Personal Representative may charge any such remaining tax payments against the marital deduction. Notwithstanding the foregoing, if any such tax (including any interest or penalties thereon) is imposed on property includible in my gross estate by reason of Section 2044 of the Internal Revenue Code, as amended, or corresponding provision of state law, I direct my Personal Representative to recover such tax as provided in Section 2207A of the Internal Revenue Code, as amended, or corresponding provision of state law.

ITEM III

* * * * * * *

* * * I give and devise all of my tangible personal effects and household effects of every kind * * * to my children * * *, in equal shares * * *.

* * * * * * *

ITEM IV

If my husband * * * survives me, I give, devise

> and bequeath any interest that I may own at the time of my death in * * * [ES3LP] to be held in trust pursuant to the terms of Item V of this Will. If my husband * * * does not survive me, then I give, devise and bequeath any interest that I may own at the time of my death in * * * [ES3LP] * * * to my children * * *, in equal shares * * *.
>
> * * * * * * *

ITEM VI

> I give, devise and bequeath all the rest, residue and remainder of my property of every kind and description * * * to my children * * *.

On June 14, 1997, Ms. Stone executed a first codicil to Ms. Stone's will (Ms. Stone's codicil). Ms. Stone's codicil deleted Item II and Item IV of Ms. Stone's will and replaced them with the following new Item II and Item IV:

ITEM II

> I direct that all estate, inheritance, transfer, succession, death, or similar taxes, including any interest or penalties thereon, payable by reason of my death, or assessed or imposed with respect to my estate, or any part thereof, whether or not passing under this Will, or any codicil thereto, shall be paid as follows:
>
> (a) Except as provided * * * below, I direct that all estate, generation-skipping transfer, inheritance, transfer, succession, death, or similar taxes which may be assessed or imposed upon or with respect to any interest in a limited partnership established for a child of mine which is included in my gross estate for the purpose of such taxes * * * shall be paid out of and charged against such limited partnership. In the event there are insufficient assets in a limited partnership established for a child of mine to pay such taxes, then the child of mine who received or receives an interest in such limited partner-

ship, or such child's estate, as the case may be, shall be responsible for the payment of any such remaining taxes.

(b) Except as provided in subparagraph (c) below, I direct that any taxes which may be assessed or imposed by Section 2035(c) of the Internal Revenue Code, as amended, or corresponding provision of state law, including any interest or penalties thereon, as a result of any gift tax paid or payable with respect to any interest in any limited partnerships established for my children which were the subject of any gifts made by me during my lifetime, shall be paid out of and charged equally against such limited partnerships. In the event there are insufficient assets in a limited partnership established for a child of mine to pay an equal amount of such taxes, then the child of mine who received a gift of an interest in such limited partnership, or such child's estate, as the case may be, shall be responsible for the payment of an equal amount of any such remaining taxes.

(c) In the event the Internal Revenue Service or any other taxing authority changes the value attributable to (i) any assets I have contributed to a limited partnership established for a child of mine * * * then I direct that all gift, estate, generation-skipping transfer, inheritance, transfer, succession, death or similar taxes which may be assessed or imposed as a result of such change in value, * * * shall be paid out of and charged against the limited partnership that received such contribution, or was the subject of such gift, as the case may be. In the event there are insufficient assets in a limited partnership established for a child of mine to pay such taxes, then the child of mine who received such gift, or whose limited partnership received such contribution, or such child's estate, as the case may be, shall be responsible for the payment of any such remaining taxes.

(d) I direct that all other estate, generation-

> skipping transfer, inheritance, transfer, succession, death, or similar taxes, including any interest or penalties thereon, payable by reason of my death * * * or assessed or imposed with respect to my estate, or any part thereof, whether or not passing under this Will, or any codicil thereto, including all policies of insurance on my life, all bequests and devises, all transfers made by me during my lifetime, all jointly held property, all pension and profit-sharing benefits, deferred compensation benefits and individual retirement accounts, and all powers, rights, or other interests in property included in my gross estate for the purpose of such taxes, shall first be paid out of and charged against my residuary estate. In the event there are insufficient assets in my residuary estate to pay such taxes, then such remaining taxes shall be paid out of and charged equally against the limited partnerships established for my children. In the event there are insufficient assets in a limited partnership established for a child of mine to pay an equal amount of such remaining taxes, then the child of mine who received or receives an interest in such limited partnership, or such child's estate, as the case may be, shall be responsible for the payment of an equal amount of any such remaining taxes. * * *

ITEM IV

I hereby make the following specific bequests:

(a) I give, devise and bequeath any interest that I may own at the time of my death in the EUGENE E. STONE, III LIMITED PARTNERSHIP, or its successor, to my children * * * in equal shares * * *.

(b) I give, devise and bequeath any interest that I may own at the time of my death in the C. RIVERS STONE LIMITED PARTNERSHIP, or its successor, to my son, C. RIVERS STONE, if he survives me, to be his absolutely, but if he does not survive me, to my said son's estate.

> (c) I give, devise and bequeath any interest that I may own at the time of my death in the E.E. STONE, IV LIMITED PARTNERSHIP, or its successor, to my son, E.E. STONE, IV, if he survives me, to be his absolutely, but if he does not survive me, to my said son's estate.
>
> (d) I give, devise and bequeath any interest that I may own at the time of my death in the MARY STONE FRASER LIMITED PARTNERSHIP, or its successor, to my daughter, MARY S. FRASER, if she survives me, to be hers absolutely, but if she does not survive me, to my said daughter's estate.
>
> (e) I give, devise and bequeath any interest that I may own at the time of my death in the ROSALIE STONE MORRIS LIMITED PARTNERSHIP, or its successor, to my daughter, ROSALIE S. MORRIS, if she survives me, to be hers absolutely, but if she does not survive me, to my said daughter's estate.

On April 8, 1997, Mr. Stone gave to each of the children an undivided .25-percent interest in the Cherrydale residence. On April 8, 1997, Mr. Stone gave to Eugene Earle Stone, IV, an undivided one-percent interest in 11.603 acres of land located on Keith Drive, in Greenville County, South Carolina (Keith Drive property). On April 8, 1997, Mr. Stone gave to C. Rivers Stone an undivided one-percent interest in each of various parcels totaling 366.097 acres of the Piney Mountain property. On April 8, 1997, Mr. Stone gave to Ms. Morris an undivided one-percent interest in a 4.263-acre parcel and an undivided one-percent interest in a .333-acre parcel of the Piney Mountain property. On April 8, 1997, Mr. and Ms. Stone gave to Ms. Fraser, an

undivided one-percent interest in the 1054.415-acre parcel of the Cedar Mountain property.

Around the middle of September 1998, Mr. Stone's estate filed on behalf of the deceased Mr. Stone Form 709, United States Gift (& Generation-Skipping Transfer) Tax Return, for the taxable year 1997 (1997 gift tax return), in which the above-described gifts, as well as certain other gifts including those discussed below, were reported.

In April 1997, the partners of ES3LP made bona fide, arm's-length transfers to that partnership, as follows. On April 9, 1997, Mr. Stone transferred to ES3LP the interest that he owned in the Cherrydale residence and certain other property in exchange for both general and limited partnership interests, and the children transferred to ES3LP the respective interests that they owned in the Cherrydale residence in exchange for general partnership interests.[27] At a time not disclosed by the record in April 1997, Ms. Stone transferred certain property that she owned to ES3LP in exchange for a limited partnership interest. When the partners of ES3LP formed and funded that partnership, they contemplated and intended that ES3LP operate as a joint enterprise for profit for the management of its assets and that the children contribute their services in providing such manage-

[27]Although not altogether clear from the record, it appears that each of the children also transferred certain other property to ES3LP in exchange for a general partnership interest.

ment.

Neither Mr. Stone nor Ms. Stone intended to, or did, live at the Cherrydale residence after Mr. Stone and the children transferred their respective interests in that residence to ES3LP. If Mr. Stone or Ms. Stone had desired to live at the Cherrydale residence after Mr. Stone and the children transferred their respective interests in the Cherrydale residence to ES3LP, the children, as the other partners of ES3LP, would not have objected, provided that Mr. Stone or Ms. Stone, as the case may be, used personal funds to pay rent to ES3LP.

After the partners of ES3LP transferred the respective assets that they owned to ES3LP in exchange for certain partnership interests, the children actively managed the assets of ES3LP, as Mr. and Ms. Stone intended. In this connection, during 1998, after renovation of the Cherrydale residence was completed in the fall of 1997, ES3LP rented it to, and received rental income from, Stone Manufacturing, which used that residence to house a management team that it decided to retain in order to assist the Company in addressing certain economic difficulties that it was having.[28] In addition, the respective partnership

[28]In Form 1065, U.S. Partnership Return of Income (partnership return), that ES3LP filed for 1998, ES3LP reported gross rents of $34,650 from Stone Manufacturing for the rental of the Cherrydale residence. Neither before nor after Mr. Stone and the children transferred their respective interests in the Cherrydale residence to ES3LP did Mr. Stone or Ms. Stone report any rental

(continued...)

returns that ES3LP filed for 1998 and 1999 reflected that ES3LP made investment decisions to sell some of its assets, including certain stock that it purchased on May 7, 1997, and that it sold approximately two years later for a substantial gain.[29] ES3LP also hired advisors and accountants who at all times were different from those of ES4LP, CRSLP, RSMLP, and MSFLP. At no time did the partners of ES3LP, including Mr. Stone and Ms. Stone, commingle the assets that ES3LP owned with their respective personal assets. At all times, ES3LP was respected by the Stone family as a separate entity.

In April 1997, the partners of ES4LP made bona fide, arm's-length transfers to that partnership, as follows. On April 9,

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[28](...continued)
income from that residence in any Federal income tax return. In Form 1040, U.S. Individual Income Tax Return (Form 1040), that Mr. and Ms. Stone filed jointly for their taxable year 1995 (1995 joint return), they reported "Rents received" from "various" rental properties totaling $92,798. The depreciation schedules attached to the 1995 joint return identify those "various" rental properties as properties other than the Cherrydale residence. In Mr. and Ms. Stone's joint returns for their taxable years 1996 (1996 joint return) and 1997 (1997 joint return), they reported "Rents received" from "various" rental properties totaling $99,435 and $34,440, respectively. The respective depreciation schedules attached to the 1996 joint return and the 1997 joint return identify those "various" rental properties as properties other than the Cherrydale residence and as the same properties from which Mr. and Ms. Stone reported rents in the 1995 joint return. In Form 1040 that Ms. Stone filed for the taxable year 1998 (Ms. Stone's 1998 return), Ms. Stone did not report any rental income.

[29]Although not altogether clear from the record, it appears that ES3LP reinvested the proceeds from the sale of its assets.

1997, Mr. Stone transferred to ES4LP some of his preferred stock of Stones, Inc., his interest in the Keith Drive property, and certain other property, and Eugene Earle Stone, IV, transferred to ES4LP his interest in the Keith Drive property, in exchange for both general and limited partnership interests.[30] At a time not disclosed by the record in April 1997, Anne M. Stone transferred certain property that she owned to ES4LP in exchange for a general partnership interest. On April 15, 1997, Ms. Stone transferred certain property that she owned to ES4LP in exchange for a limited partnership interest. When the partners of ES4LP formed and funded that partnership, they contemplated and intended that ES4LP operate as a joint enterprise for profit for the management of its assets and that Eugene Earle Stone, IV, contribute his services in providing such management.

After the partners of ES4LP transferred the respective assets that they owned to ES4LP in exchange for certain partnership interests, Eugene Earle Stone, IV, began actively managing the assets of ES4LP, as Mr. and Ms. Stone intended. In this connection, Eugene Earle Stone, IV, on behalf of ES4LP, managed, and made investment decisions with respect to, ES4LP's assets. The respective partnership returns that ES4LP filed for

[30]Although not altogether clear from the record, it appears that Eugene Earle Stone, IV, also transferred certain other property to ES4LP in exchange for general and limited partnership interests.

1997 and 1999 reflected that ES4LP sold certain of its stock for substantial gains.[31] Eugene Earle Stone, IV, also hired on behalf of ES4LP advisors and accountants who at all times were different from those of ES3LP, CRSLP, RSMLP, and MSFLP. At no time did the partners of ES4LP, including Mr. Stone and Ms. Stone, commingle the assets that ES4LP owned with their respective personal assets. At all times, ES4LP was respected by the Stone family as a separate entity.

In April 1997, the partners of CRSLP made bona fide, arm's-length transfers to that partnership, as follows. On April 9, 1997, Mr. Stone transferred to CRSLP his interest in each of various parcels totaling 366.097 acres of the Piney Mountain property and certain other property, and C. Rivers Stone transferred to CRSLP his interest in each of those parcels, in exchange for both general and limited partnership interests.[32] At a time not disclosed by the record in April 1997, Charles R. Stone, Jr., transferred certain property that he owned to CRSLP in exchange for both limited and general partnership interests, and Frances O. Stone transferred certain property that she owned to CRSLP in exchange for a limited partnership interest. On

[31]Although not altogether clear from the record, it appears that ES4LP reinvested the proceeds from the sale of its stock in 1997 and 1999 in certain real estate.

[32]Although not altogether clear from the record, it appears that C. Rivers Stone also transferred certain other property to CRSLP in exchange for general and limited partnership interests.

April 15, 1997, Ms. Stone transferred property that she owned to CRSLP in exchange for a limited partnership interest. When the partners of CRSLP formed and funded that partnership, they contemplated and intended that CRSLP operate as a joint enterprise for profit for the management of its assets and that C. Rivers Stone contribute his services in providing such management.

After the partners of CRSLP transferred the respective assets that they owned to CRSLP in exchange for certain partnership interests, C. Rivers Stone began actively managing the assets of CRSLP, as Mr. and Ms. Stone intended. In this connection, C. Rivers Stone, on behalf of CRSLP, began a major project to convert CRSLP's Piney Mountain property into a high-end real property development which was to be known as Montebello and which was to consist of over 1,000 houses, with, inter alia, clubhouses for meetings and weddings, as well as shopping centers. In addition, the partnership return that CRSLP filed for 1997 reflected that CRSLP made investment decisions to sell certain of its stock for a substantial gain.[33] Moreover, the respective partnership returns that CRSLP filed for 1997, 1998, and 1999 reflected that CRSLP rented various real properties that it owned (other than the Piney Mountain property) from which it

[33]Although not altogether clear from the record, it appears that CRSLP reinvested the proceeds from the sale of its stock in, inter alia, certain real estate.

received and reported rental income. C. Rivers Stone also hired on behalf of CRSLP advisors and accountants who at all times were different from those of ES3LP, ES4LP, RSMLP, and MSFLP. At no time did the partners of CRSLP, including Mr. Stone and Ms. Stone, commingle the assets that CRSLP owned with their respective personal assets. At all times, CRSLP was respected by the Stone family as a separate entity.

In April 1997, the partners of RSMLP made bona fide, arm's-length transfers to that partnership, as follows. On April 9, 1997, Mr. Stone transferred to RSMLP certain of his stock and securities, including some of his preferred stock of Stones, Inc., his interest in the 4.263-acre parcel and the .333-acre parcel of the Piney Mountain property, and certain other property, and Ms. Morris transferred to RSMLP her interest in each of those parcels, in exchange for both general and limited partnership interests.[34] At a time not disclosed by the record in April 1997, Mr. Morris transferred certain property that he owned to RSMLP in exchange for a general partnership interest, and Charles H. Morris, Jr., and Rosalie S. Morris, II, transferred certain property that they owned to RSMLP in exchange for limited partnership interests. On April 15, 1997, Ms. Stone transferred certain property, including certain of her stock and securities,

[34]Although not altogether clear from the record, it appears that Ms. Morris also transferred certain other property to RSMLP in exchange for general and limited partnership interests.

that she owned to RSMLP in exchange for a limited partnership interest. When the partners of RSMLP formed and funded that partnership, they contemplated and intended that RSMLP operate as a joint enterprise for profit for the management of its assets and that Ms. Morris contribute her services in providing such management.

After the partners of RSMLP transferred the respective assets that they owned to RSMLP in exchange for certain partnership interests, Ms. Morris began actively managing the assets of RSMLP, as Mr. and Ms. Stone intended. In this connection, Ms. Morris, on behalf of RSMLP, began actively managing its real estate holdings. She also transferred certain of RSMLP's securities from a brokerage account that it had in Greenville, South Carolina, to a brokerage account that she opened for it in Savannah, Georgia, where she was living. In addition, the respective partnership returns that RSMLP filed for 1997, 1998, and 1999 reflected that RSMLP made investment decisions to sell certain of its stock for substantial gains.[35] Those partnership returns also reflected that RSMLP rented certain of its real property from which it received and reported rental income. Ms. Morris also hired on behalf of RSMLP advisors and accountants who at all times were different from those of ES3LP, ES4LP, CRSLP,

[35]Although not altogether clear from the record, it appears that RSMLP reinvested the proceeds from the sale of its stock.

and MSFLP. At no time did the partners of RSMLP, including Mr. Stone and Ms. Stone, commingle the assets that RSMLP owned with their respective personal assets. At all times, RSMLP was respected by the Stone family as a separate entity.

In April 1997, the partners of MSFLP made bona fide, arm's-length transfers to that partnership, as follows. On April 9, 1997, Mr. Stone transferred to MSFLP his interest in the 1054.415-acre parcel of the Cedar Mountain property and certain other property, and Ms. Fraser transferred to MSFLP her interest in that property,[36] in exchange for both general and limited partnership interests.[37] On the same date, Ms. Stone transferred to MSFLP the interest that she owned in the 1054.415-acre parcel of the Cedar Mountain property in exchange for a limited partnership interest. At a time not disclosed by the record in April 1997, Ms. Davis and Ms. Arnal transferred certain property that they owned to MSFLP in exchange for both general and limited

[36]The record is not clear as to why the deed reflecting the transfer to MSFLP of Ms. Fraser's interest in the 1054.415-acre parcel of the Cedar Mountain property showed Ms. Fraser and her husband Mr. Fraser as the grantors, while the deed reflecting the transfer by Mr. Stone and Ms. Stone to Ms. Fraser of such interest in that parcel showed the grantee only as Ms. Fraser. We presume that applicable State law required that not only Ms. Fraser but also her husband Mr. Fraser be reflected as grantors on the deed when Ms. Fraser transferred to MSFLP her interest in the 1054.415-acre parcel of the Cedar Mountain property.

[37]Although not altogether clear from the record, it appears that Ms. Fraser also transferred certain other property to MSFLP in exchange for general and limited partnership interests.

partnership interests. When the partners of MSFLP formed and funded that partnership, they contemplated and intended that MSFLP operate as a joint enterprise for profit for the management of its assets and that Ms. Fraser contribute her services in providing such management.

After the partners of MSFLP transferred the respective assets that they owned to MSFLP in exchange for certain partnership interests, Ms. Fraser began actively managing the assets of MSFLP, as Mr. and Ms. Stone intended. In this connection, Ms. Fraser, on behalf of MSFLP, began actively managing MSFLP's Cedar Mountain property, which included maintaining the roads and lakes that Mr. Stone had built on that property. In addition, the respective partnership returns that MSFLP filed for 1998 and 1999 reflected that MSFLP made investment decisions to sell certain of its stock for substantial gains.[38] Ms. Fraser also hired on behalf of MSFLP advisors and accountants who at all times were different from those of ES3LP, ES4LP, CRSLP, and RSMLP. At no time did the partners of MSFLP, including Mr. Stone and Ms. Stone, commingle the assets that MSFLP owned with their respective personal assets. At all times, MSFLP was respected by the Stone family as a separate entity.

The respective assets that Mr. Stone and Ms. Stone retained,

[38]Although not altogether clear from the record, it appears that MSFLP reinvested the proceeds from the sale of its stock.

and did not transfer in April 1997 to each of the Five Partnerships, were sufficient to maintain their respective accustomed standards of living. Mr. and Ms. Stone did not transfer to any of the Five Partnerships the 582.672-acre parcel of the Cedar Mountain property on which Mr. Stone was living in April 1997.[39] Ms. Stone did not transfer to any of the Five Partnerships the Cypress villa on Hilton Head Island in which she was living in April 1997.

Sometime after the respective bona fide, arm's-length transfers of assets in April 1997 to each of ES4LP, CRSLP, RSMLP, and MSFLP in exchange for partnership interests, the Stone family realized that there had been an inadvertent, improper valuation of certain of such assets (valuation errors). Those valuation errors resulted in each of the children's having received a total partnership interest in each such partnership in which such child had a partnership interest that was larger (unintended excessive partnership interest) than the Stone family intended and agreed each should have received had the correct valuation been used. The Stone family did not intend or agree that a partner of any of ES4LP, CRSLP, RSMLP, and MSFLP (or ES3LP) was to receive a larger

[39]On Apr. 8, 1997, Mr. and Ms. Stone gave to Anne Logan Ministries, Inc., a charity, the remainder interest in the 582.672-acre parcel of the Cedar Mountain property on which Mr. Stone was living, and Mr. Stone retained a life estate in that parcel. When Mr. Stone died, he had an ownership interest only in the .338-acre parcel of the Cedar Mountain property.

total partnership interest in each such partnership than such partner should have received based on the value of the property that such partner transferred to any such partnership. In order to correct the unintended consequences of the valuation errors, Mr. Stone made a gift as of April 9, 1997, to each of the children of the unintended excessive partnership interest in each of ES4LP, CRSLP, RSMLP, and MSFLP that each such child had received, as follows:

Donee's Name	Description of Gift	Value of Gift
Eugene Earle Stone, IV	281 General Partner Units in ES4LP	$10,095
Eugene Earle Stone, IV	1 Limited Partner Unit in ES4LP	36
C. Rivers Stone	1.02 General Partner Units in CRSLP	50
Ms. Morris	136 General Partner Units in RSMLP	6,426
Ms. Morris	1 Limited Partner Unit in RSMLP	47
Ms. Fraser	34 General Partner Units in MSFLP	1,489
Ms. Fraser	1 Limited Partner Unit in MSFLP	44
Total Value of Gifts		$18,187

After the foregoing gifts were made as of April 9, 1997,[40] all the partners of each of the Five Partnerships received, as the Stone family intended and agreed, respective percentage interests in each such partnership that were proportionate to the

[40]The above-described gifts were reported in the 1997 gift tax return filed on behalf of the deceased Mr. Stone.

fair market value of the assets that such partners respectively transferred to each such partnership, and the respective assets that the partners of each such partnership transferred to each such partnership were credited to the respective capital accounts of such partners. Upon the termination or dissolution of each of the Five Partnerships, the partners of each such partnership were entitled to distributions from each such partnership in amounts equal to their respective capital accounts.

After the partners of ES3LP made bona fide, arm's-length transfers of the respective assets that they owned to that partnership in exchange for certain partnership interests, the respective partnership interests owned by the partners of ES3LP in April 1997 were as follows:

Partner	General Partner Interests	Limited Partner Interests
Mr. Stone	1.001%	68.972%
Ms. Stone	--	29.027%
Eugene Earle Stone, IV	.250%	--
C. Rivers Stone	.250%	--
Ms. Morris	.250%	--
Ms. Fraser	.250%	--

At the time of Mr. Stone's death on June 5, 1997, Mr. Stone held the same percentage partnership interests in ES3LP that he owned in April 1997. At the time of Ms. Stone's death on October 16, 1998, Ms. Stone held the same percentage partnership interest in ES3LP that she owned in April 1997.

After the partners of ES4LP made bona fide, arm's-length transfers of the respective assets that they owned to that partnership in exchange for certain partnership interests, the respective partnership interests owned by the partners of ES4LP in April 1997 were as follows:

Partner	General Partner Interests	Limited Partner Interests
Mr. Stone	1.003%	93.874%
Ms. Stone	--	4.120%
Eugene Earle Stone, IV	1.000%	.001%
Anne M. Stone	.002%	--

At the time of Mr. Stone's death on June 5, 1997, Mr. Stone held the same percentage partnership interests in ES4LP that he owned in April 1997. At the time of Ms. Stone's death on October 16, 1998, Ms. Stone held the same partnership interest in ES4LP that she owned in April 1997.

After the partners of CRSLP made bona fide, arm's-length transfers of the respective assets that they owned to that partnership in exchange for certain partnership interests, the respective partnership interests owned by the partners of CRSLP in April 1997 were as follows:

Partner	General Partner Interests	Limited Partner Interests
Mr. Stone	1.002%	97.483%
Ms. Stone	--	.510%
C. Rivers Stone	1.000%	.001%
Charles R. Stone, Jr.	.001%	.001%
Frances O. Stone	--	.002%

At the time of Mr. Stone's death on June 5, 1997, Mr. Stone held the same percentage partnership interests in CRSLP that he owned in April 1997. At the time of Ms. Stone's death on October 16, 1998, Ms. Stone held the same partnership interest in CRSLP that she owned in April 1997.

After the partners of RSMLP made bona fide, arm's-length transfers of the respective assets that they owned to that partnership in exchange for certain partnership interests, the respective partnership interests owned by the partners of RSMLP in April 1997 were as follows:

Partner	General Partner Interests	Limited Partner Interests
Mr. Stone	1.003%	94.29725%
Ms. Stone	--	3.6935%
Ms. Morris	1.000%	.001%
Mr. Morris	.00175%	--
Charles H. Morris, Jr.	--	.00175%
Rosalie S. Morris, II	--	.00175%

At the time of Mr. Stone's death on June 5, 1997, Mr. Stone held the same percentage partnership interests in RSMLP that he owned in April 1997. At the time of Ms. Stone's death on October 16, 1998, Ms. Stone held the same partnership interest in RSMLP that she owned in April 1997.

After the partners of MSFLP made bona fide, arm's-length transfers of the respective assets that they owned to that partnership in exchange for certain partnership interests, the

respective partnership interests owned by the partners of MSFLP in April 1997 were as follows:

Partner	General Partner Interests	Limited Partner Interests
Mr. Stone	1.003%	90.141%
Ms. Stone	--	7.851%
Ms. Fraser	1.000%	.001%
Ms. Davis	.001%	.001%
Ms. Arnal	.001%	.001%

At the time of Mr. Stone's death on June 5, 1997, Mr. Stone held the same percentage partnership interests in MSFLP that he owned in April 1997. At the time of Ms. Stone's death on October 16, 1998, Ms. Stone held the same partnership interest in MSFLP that she owned in April 1997.

On June 5, 1997, Mr. Stone died at the age of 89. On that date, pursuant to Mr. Stone's will, The Allene Wyman Stone Trust (AWS Trust) was formed. Pursuant to that will, (1) the 1.001 percent general partnership interest and the 68.972 percent limited partnership interest in ES3LP that Mr. Stone held on the date of his death, (2) all the assets on that date in his individual retirement account (Mr. Stone's retirement account),[41] and (3) his right on that date to certain deferred compensation from Stone Manufacturing were transferred to that trust. (We shall sometimes refer to the assets in Mr. Stone's retirement account

[41]On the date of Mr. Stone's death, the assets in Mr. Stone's retirement account consisted of numerous corporate stocks and securities and a Government bond.

and his right to certain deferred compensation from Stone Manufacturing as certain other property.) Ms. Stone did not transfer any property to ES3LP in exchange for the general and limited partnership interests in ES3LP held by the AWS Trust as of June 5, 1997, the date of Mr. Stone's death.[42]

On August 5, 1997, after Mr. Stone died, Ms. Morris, and Mr. Morris, as general partners, filed a first amendment to the certificate of limited partnership for RSMLP with the S.C. Secretary of State. The purpose of that amendment was to remove Mr. Stone as a general partner of RSMLP.

On August 5, 1997, after Mr. Stone died, Ms. Fraser, Ms. Davis, and Ms. Arnal, as general partners, filed a first amendment to the certificate of limited partnership for MSFLP with the S.C. Secretary of State. The purpose of that amendment was to remove Mr. Stone as a general partner of MSFLP.

On August 7, 1997, after Mr. Stone died, C. Rivers Stone, and Charles Rivers Stone, Jr., as general partners, filed a first amendment to the certificate of limited partnership for CRSLP with the S.C. Secretary of State. The purpose of that amendment was to remove Mr. Stone as a general partner of CRSLP.[43]

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[42]As discussed above, it was Mr. Stone who transferred certain property to ES3LP in exchange for the general and limited partnership interests that, pursuant to his will, were transferred to the AWS Trust.

[43]On Oct. 1, 1998, C. Rivers Stone, as a general partner, (continued...)

On October 1, 1997, after Mr. Stone died, Eugene Earle Stone, IV, and Anne M. Stone, as general partners, filed a first amendment to the certificate of limited partnership for ES4LP with the S.C. Secretary of State. The purpose of that amendment was to remove Mr. Stone as a general partner of ES4LP.

On January 8, 1998, after Mr. Stone died, Eugene Earle Stone, IV, C. Rivers Stone, Ms. Morris, and Ms. Fraser, as general partners, filed a second amendment to the certificate of limited partnership for ES3LP with the S.C. Secretary of State. The purpose of that amendment was to remove Mr. Stone as a general partner of ES3LP.

After Mr. Stone's death, all the respective partners of each of ES4LP, CRSLP, RSMLP, and MSFLP agreed to make a distribution from each such partnership in order to pay the portion of the Federal estate tax and any applicable State estate tax (State estate tax) (collectively, Federal and State estate taxes) with respect to Mr. Stone's estate that was attributable to the inclusion in that estate of the total partnership interest in each such partnership held by Mr. Stone on the date of his death. After Mr. Stone's death, the partners of ES3LP did not agree to,

[43](...continued)
filed a second amendment to the certificate of limited partnership for CRSLP with the S.C. Secretary of State. The purpose of that amendment was to remove Charles Rivers Stone, Jr., as a general partner of CRSLP. The record does not disclose why Charles Rivers Stone, Jr., withdrew as a general partner of CRSLP.

and did not, make any distributions from that partnership to pay any Federal and State estate taxes with respect to Mr. Stone's estate.[44]

At a time not disclosed by the record after Mr. Stone's death, Ernst & Young, LLP (E&Y), prepared a document entitled "Estate of E.E. Stone, III Allocation of Estate Tax" (E&Y's Estate tax allocation schedule). That document showed for each of ES4LP, CRSLP, RSMLP, and MSFLP the amount of Federal and State estate taxes that each such partnership was to pay in 1998 and

[44]None of the Federal and State estate taxes with respect to Mr. Stone's estate was attributable to Mr. Stone's total 69.973 percent partnership interest in ES3LP. As discussed above, that partnership interest was transferred along with certain other property to the AWS Trust with respect to which, as discussed below, an election under sec. 2056(b)(7) was made.

Because of Mr. Stone's death in 1997, in that year, as reflected in the partnership return that ES3LP filed for 1997, ES3LP opened a capital account for his estate (Mr. Stone's estate's capital account in ES3LP), and the balances in Mr. Stone's capital account in ES3LP as a general partner and a limited partner were transferred to Mr. Stone's estate's capital account in ES3LP. The partnership return that ES3LP filed for 1997 reflected that ES3LP did not make distributions during that year to any of its other partners. Because of Ms. Stone's death in 1998, in that year, as reflected in the partnership return that ES3LP filed for 1998, ES3LP opened a capital account for her estate (Ms. Stone's estate's capital account in ES3LP), and the balance in Ms. Stone's capital account in ES3LP as a limited partner was transferred to Ms. Stone's estate's capital account in ES3LP. The partnership return that ES3LP filed for 1998 reflected that ES3LP did not make distributions during that year to any of its other partners. The partnership return that ES3LP filed for 1999 reflected that ES3LP made pro rata distributions during that year to its partners totaling $567,172, as follows: $396,867 to Mr. Stone's estate, $164,633 to Ms. Stone's estate, and $1,418 to each of the children. The record does not disclose the purpose or use of those distributions.

the amount of Federal and State estate taxes and interest that each such partnership was to pay in 1999, which were attributable to the inclusion in Mr. Stone's estate of the total partnership interest in each such partnership held by Mr. Stone on the date of his death. E&Y's Estate tax allocation schedule provided as follows:

	ES4LP	CRSLP	RSMLP	MSFLP
1998 Federal estate tax	$496,642.00	$80,000.00	$599,333.00	$461,597.00
1998 State estate tax	133,029.00	20,000.00	160,536.00	123,642.00
1998 TOTAL Federal and State estate taxes	$629,671.00	$100,000.00	$759,869.00	$585,239.00
1999 Federal estate tax and interest	$371,336.72	$1,000,641.91	$571,597.34	$514,194.67
1999 State estate tax and interest	98,545.00	268,474.00	151,871.00	136,704.00
1999 TOTAL Federal and State estate taxes and interest	$469,881.72	$1,269,115.91	$723,468.34	$650,898.67
GRAND TOTAL	$1,099,552.72	$1,369,115.91	$1,483,337.34	$1,236,137.67

On March 5, 1998, the Internal Revenue Service (IRS) received a total of $1,698,074 in payments for the anticipated estate tax with respect to Mr. Stone's estate. Those payments consisted of a $60,502 check drawn on the bank account of Mr. Stone's estate,[45] a $496,642 check drawn on ES4LP's bank account,

[45]The estate tax of $60,502 paid by Mr. Stone's estate was attributable to the inclusion in his estate of all the property that he owned on the date of his death except for his properties, including his partnership interest in ES3LP, to be held by the (continued...)

an $80,000 check drawn on CRSLP's bank account, a $599,333 check drawn on RSMLP's bank account, and a $461,597 check drawn on MSFLP's bank account. In 1998, State estate tax totaling $437,207 was paid with respect to Mr. Stone's estate. Of that total amount of State estate tax paid in 1998, ES4LP paid $133,029, CRSLP paid $20,000, RSMLP paid $160,536, and MSFLP paid $123,642.[46] The funds used to pay Federal and State estate taxes in 1998 with respect to Mr. Stone's estate consisted of non pro rata distributions to or on behalf of his estate by each of ES4LP, CRSLP, RSMLP, and MSFLP.

The partnership return that ES4LP filed for 1998 reflected that ES4LP made distributions during that year to its partners totaling $639,807 (i.e., $639,288 to Mr. Stone's estate, $418 to Ms. Stone, and $101 to Eugene Earle Stone, IV).[47]

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[45](...continued)
AWS Trust for the benefit of Ms. Stone and except for his respective partnership interests in ES4LP, CRSLP, RSMLP, and MSFLP bequeathed to Eugene Earle Stone, IV, C. Rivers Stone, Ms. Morris, and Ms. Fraser, respectively.

[46]The record discloses that ES4LP paid $133,029 to the S.C. Department of Revenue on Mar. 15, 1998. The record does not disclose the date on which CRSLP, RSMLP, and MSFLP made State estate tax payments with respect to Mr. Stone's estate.

[47]The only other distribution reflected in ES4LP's partnership return for 1998 was because of Ms. Stone's death in that year. The partnership return that ES4LP filed for 1998 reflected that ES4LP opened a capital account for Ms. Stone's estate (Ms. Stone's estate's capital account in ES4LP), and the balance in Ms. Stone's capital account as a limited partner was transferred to Ms. Stone's estate's capital account in ES4LP.

(continued...)

ES4LP's balance sheet for 1998 included a schedule entitled "Eugene E. Stone IV Limited Partnership, Transaction Detail by Date, January through December 1998" (ES4LP's 1998 transaction schedule). ES4LP's 1998 transaction schedule reflected a check dated March 15, 1998, payable to the IRS, in the amount of $496,642 and a check dated March 15, 1998, payable to the S.C. Department of Revenue, in the amount of $133,029.[48]

The partnership return that CRSLP filed for 1998 reflected that CRSLP did not make distributions during that year to any of its partners.[49] However, CRSLP's "Trial Balance Worksheet--Ac

[47](...continued)
Because of Mr. Stone's death in 1997, in that year, as reflected in the partnership return that ES4LP filed for 1997, ES4LP opened a capital account for his estate (Mr. Stone's estate's capital account in ES4LP), and the balances in Mr. Stone's capital accounts in ES4LP as a general partner and a limited partner were transferred to Mr. Stone's estate's capital account in ES4LP. The partnership return that ES4LP filed for 1997 showed that ES4LP made distributions during that year to Eugene Earle Stone, IV, totaling $8,754 and that, except for the above-discussed transfer to Mr. Stone's estate's capital account in ES4LP, it did not make distributions during that year to any of its other partners.

[48]The $496,642 distribution and the $133,029 distribution on behalf of Mr. Stone's estate shown in ES4LP's 1998 transaction schedule, when totaled, equal the total amount of Federal and State estate taxes with respect to Mr. Stone's estate (i.e., $629,671) that E&Y's Estate tax allocation schedule reflected as payable by ES4LP in 1998.

[49]Although not reflected as a distribution in CRSLP's partnership return for 1998, because of Ms. Stone's death in that year, as reflected in the partnership return that CRSLP filed for 1998, CRSLP opened a capital account for Ms. Stone's estate (Ms. Stone's estate's capital account in CRSLP), and the balance in
(continued...)

counts" for 1998 (CRSLP's 1998 trial balance worksheets) reflected the following adjustments to an account identified as "C. Rivers Stone-Draws": $510, $26,390, $66,721, $6,063, $316, and $100,000, or a total of $200,000 of adjustments to that account. CRSLP's 1998 trial balance worksheets included a schedule entitled "C. Rivers Stone LLP '98, Montebello Actual Expenses (2/9/99)" (CRSLP's 1998 Montebello expense schedule). CRSLP's 1998 Montebello expense schedule reflected in pertinent part the following entries:

Vendor	March 1998	1998 Totals
Estate Taxes	$0	$0
Estate Taxes: AW Stone 4 Lots	510	510
Estate Taxes: Commercial	26,390	26,390
Estate Taxes: Residential	66,721	66,721
Estate Taxes: Securities	6,063	6,063
Estate Taxes: Tulip Street Rental	316	316

The foregoing amounts, which total $100,000,[50] are identical to

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[49](...continued)
Ms. Stone's capital account as a limited partner was transferred to Ms. Stone's estate's capital account in CRSLP.

Because of Mr. Stone's death in 1997, in that year, as reflected in the partnership return that CRSLP filed for 1997, CRSLP opened a capital account for his estate (Mr. Stone's estate's capital account in CRSLP), and the balances in Mr. Stone's capital accounts in CRSLP as a general partner and a limited partner were transferred to Mr. Stone's estate's capital account in CRSLP. The partnership return that CRSLP filed for 1997 showed that CRSLP did not make distributions during that year to any of its other partners.

[50]The $100,000 expenditure shown in CRSLP's 1998 Montebello expense schedule equals the total amount of Federal and State estate taxes with respect to Mr. Stone's estate that E&Y's Estate
(continued...)

five of the six adjustments to "C. Rivers Stone--Draws" that were reflected in CRSLP's 1998 trial balance worksheets.

The partnership return that RSMLP filed for 1998 reflected that RSMLP made distributions during that year to Mr. Stone's estate of $759,869.[51]

The partnership return that MSFLP filed for 1998 reflected that MSFLP made distributions during that year to its partners totaling $654,239 (i.e., $585,239 to Mr. Stone's estate[52] and

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[50](...continued)
tax allocation schedule reflected as payable by CRSLP in 1998.

[51]The $759,869 distribution to Mr. Stone's estate shown in RSMLP's 1998 partnership return equals the total amount of Federal and State estate taxes with respect to Mr. Stone's estate that E&Y's Estate tax allocation schedule reflected as payable by RSMLP in 1998.

The only other distribution reflected in RSMLP's partnership return for 1998 was because of Ms. Stone's death in that year. The partnership return that RSMLP filed for 1998 reflected that RSMLP opened a capital account for Ms. Stone's estate (Ms. Stone's estate's capital account in RSMLP), and the balance in Ms. Stone's capital account as a limited partner was transferred to Ms. Stone's estate's capital account in RSMLP.

Because of Mr. Stone's death in 1997, in that year, as reflected in the partnership return that RSMLP filed for 1997, RSMLP opened capital accounts for his estate (Mr. Stone's estate's capital accounts in RSMLP), and the balances in Mr. Stone's capital accounts in RSMLP as a general partner and a limited partner were transferred to Mr. Stone's estate's capital accounts in RSMLP. The partnership return that RSMLP filed for 1997 showed that RSMLP did not make distributions during that year to any of its other partners.

[52]The $585,239 distribution to Mr. Stone's estate shown in MSFLP's 1998 partnership return equals the total amount of Federal and State estate taxes with respect to Mr. Stone's estate
(continued...)

$69,000 to Ms. Fraser).[53]

Financial statements for MSFLP for 1998 (MSFLP's 1998 financial statements) reflected as an expense $585,239[54] of "Estate Taxes".

On September 15, 1998, Mr. Stone's estate filed Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (Mr. Stone's estate tax return). Mr. Stone's estate tax return reported as part of the value of Mr. Stone's gross estate, inter alia, date-of-death values claimed for Mr. Stone's respective partnership interests in ES3LP, ES4LP, CRSLP, RSMLP, and

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[52](...continued)
that E&Y's Estate tax allocation schedule reflected as payable by MSFLP in 1998.

[53]The only other distribution reflected in MSFLP's partnership return for 1998 was because of Ms. Stone's death in that year. The partnership return that MSFLP filed for 1998 reflected that MSFLP opened a capital account for Ms. Stone's estate (Ms. Stone's estate's capital account in MSFLP), and the balance in Ms. Stone's capital account as a limited partner was transferred to Ms. Stone's estate's capital account in MSFLP.

Because of Mr. Stone's death in 1997, in that year, as reflected in the partnership return that MSFLP filed for 1997, MSFLP opened capital accounts for his estate (Mr. Stone's estate's capital accounts in MSFLP), and the balances in Mr. Stone's capital accounts in MSFLP as a general partner and a limited partner were transferred to Mr. Stone's estate's capital accounts in MSFLP. The partnership return that MSFLP filed for 1997 showed that MSFLP did not make distributions during that year to any of its other partners.

[54]The $585,239 expense reflected in MSFLP's 1998 financial statements equals the total amount of Federal and State estate taxes with respect to Mr. Stone's estate that E&Y's estate tax allocation schedule reflected as payable by MSFLP in 1998. See supra note 52.

MSFLP and certain other property to be held by the AWS Trust pursuant to Mr. Stone's will. In Mr. Stone's estate tax return, the co-personal representatives[55] of Mr. Stone's estate made a qualified terminable interest property (QTIP) election under section 2056(b)(7) with respect to the AWS Trust. Consequently, although the claimed respective date-of-death values of Mr. Stone's partnership interests in ES3LP and certain other property to be held by that trust were reported in Mr. Stone's estate tax return as part of Mr. Stone's estate, Mr. Stone's estate claimed a deduction in that return under section 2056(a) for such respective values of such partnership interests and such certain other property. Mr. Stone's estate tax return showed net estate tax of $4,031,260, prior payments of $1,698,074, and a balance due of $2,333,186.

On March 10, 1999, the IRS received $2,524,858.57 (March 10, 1999 payment) in payment of the estate tax shown due (i.e., $2,333,186) in Mr. Stone's estate tax return and interest.[56] Of that total amount of estate tax and interest paid in 1999, ES4LP paid $371,336.72, CRSLP paid $1,000,641.91, RSMLP paid $571,597.34, and MSFLP paid $514,194.67. In 1999, State estate

[55]All of the children are co-personal representatives of Mr. Stone's estate.

[56]The March 10, 1999 payment included interest because Mr. Stone's estate applied for and received an extension of time within which to pay the balance of the estate tax due with respect to Mr. Stone's estate.

tax and interest totaling $655,594 were paid with respect to Mr. Stone's estate. Of that total amount of State estate tax and interest paid in 1999, ES4LP paid $98,545, CRSLP paid $268,474, RSMLP paid $151,871, and MSFLP paid $136,704. The funds used to pay Federal and State estate taxes and interest in 1999 with respect to Mr. Stone's estate consisted of non pro rata distributions to or on behalf of his estate.

The partnership return that ES4LP filed for 1999 reflected that ES4LP made distributions during that year to its partners totaling $529,254, as follows: $469,882 to Mr. Stone's estate,[57] $47,749 to Ms. Stone's estate, $11,602 to Eugene Earle Stone, IV, and $21 to Anne M. Stone.

ES4LP's balance sheet for 1999 included a schedule entitled "Eugene E. Stone IV Limited Partnership, General Ledger, As of December 31, 1999" (ES4LP's 1999 general ledger). ES4LP's 1999 general ledger reflected a check dated March 4, 1999, payable to Eugene E. Stone, III, in the amount of $469,881.72.[58] Another schedule (capital accounts schedule) included as part of ES4LP's

[57]The $469,882 distribution to Mr. Stone's estate shown in ES4LP's 1999 partnership return equals the total amount of Federal and State estate taxes and interest with respect to Mr. Stone's estate that E&Y's Estate tax allocation schedule reflected as payable by ES4LP in 1999.

[58]The $469,881.72 check reflected in ES4LP's 1999 general ledger and rounded to $469,882 equals the total amount of Federal and State estate taxes and interest with respect to Mr. Stone's estate that E&Y's estate allocation schedule reflected as payable by ES4LP in 1999. See supra note 57.

balance sheet for 1999 showed, inter alia, the capital accounts of the partners of ES4LP. The capital accounts schedule reflected cash distributions during 1998 and 1999 from ES4LP to Mr. Stone's estate of $629,671[59] and $469,882, respectively. That schedule also reflected negative adjustments to the respective capital accounts of the remaining partners of ES4LP in such amounts that all of the partners of ES4LP were shown to have received pro rata partnership distributions during 1998 and 1999. The capital accounts schedule reclassified such negative adjustments as loans made to ES4LP from all of its partners, except Mr. Stone's estate.

The partnership return that CRSLP filed for 1999 reflected that CRSLP did not make distributions during that year to any of its partners. Schedule L, Balance Sheets per Books, of the partnership return that CRSLP filed for 1999 reflected a yearend asset of $1,369,116 identified as "Other investments". A statement attached to that return explained that such "Other investments" was an amount of $1,369,116 "Due From C. Rivers Stone".

CRSLP's trial balance worksheets for 1999 reflected the following entries:

[59]As a result of bookkeeping entries, the $639,288 non pro rata distribution during 1998 from ES4LP to Mr. Stone's estate that was reflected in ES4LP's 1998 partnership return was reflected in the capital accounts schedule as a distribution to that estate of $629,671.

Description	Prior Year Balance	Current Year Balance	Adjustments	Adjusted Balance
C.R. Stone-Estate Taxes	$100,000	$100,000	[1]$1,269,115.91	$1,369,115.91

[1]The $1,269,115.91 expenditure reflected in CRSLP's 1999 Montebello expense schedule with respect to Mr. Stone's estate equals the amounts of Federal and State estate taxes and interest with respect to Mr. Stone's estate that E&Y's Estate tax allocation schedule reflected as payable by CRSLP in 1999.

A schedule entitled "C. Rivers Stone LLP '99, Montebello Actual Expenses (1/20/00)" (CRSLP's 1999 Montebello expense schedule) reflected in pertinent part the following entries:

Vendor	C/F	March 1999	1999 Totals	Grand Totals
Estate Taxes	$100,000	$1,269,115.91	$1,269,115.91	$1,369,115.91
First Trust-Est. Tax Loan	0	[1]	534,980.73	534,980.73
South Trust-Estate Tax Loan	0	[2]	14,837.39	14,837.39

[1]The 1999 Montebello expense schedule reflected various entries on the line entitled "First Trust-Est. Tax Loan" for each of the months February through December 1999. Those entries, when totaled, equaled the "1999 Totals" reflected on that line.

[2]The 1999 Montebello expense schedule reflected various entries on the line entitled "South Trust-Estate Tax Loan" for each of the months April through July 1999. Those entries, when totaled, equaled the "1999 Totals" reflected on that line.

The partnership return that RSMLP filed for 1999 reflected that RSMLP made distributions during that year to Mr. Stone's estate of $1,041,871[60] and did not make distributions during that year to any of its other partners.

[60]The $1,041,871 distribution to Mr. Stone's estate shown in RSMLP's 1999 partnership return exceeds the total amount of Federal and State estate taxes and interest with respect to Mr. Stone's estate (i.e., $723,468.34) that E&Y's Estate tax allocation schedule reflected as payable by RSMLP in 1999.

The partnership return that MSFLP filed for 1999 reflected that MSFLP made distributions during that year to Mr. Stone's estate totaling $805,693[61] and did not make distributions during that year to any of its other partners.

A 1999 profit and loss statement for MSFLP (MSFLP's 1999 profit and loss statement) reflected an expense of $805,692.67[62] for "Tax: Fed".

On October 16, 1998, Ms. Stone died at the age of 86. Pursuant to Mr. Stone's will, upon the death of Ms. Stone, any assets remaining in the AWS Trust were to be distributed equally to the children.

On the date of Ms. Stone's death, the AWS Trust held a 69.973 percent limited partnership interest in ES3LP,[63] the assets

[61]The $805,693 distribution to Mr. Stone's estate shown in MSFLP's 1999 partnership return exceeds the total amount of Federal and State estate taxes and interest with respect to Mr. Stone's estate (i.e., $650,899) that E&Y's Estate tax allocation schedule reflected as payable by MSFLP in 1999.

[62]The $805,692.67 expense reflected in MSFLP's 1999 profit and loss statement and rounded to $805,693 exceeds the total amount of Federal and State estate taxes and interest with respect to Mr. Stone's estate (i.e., $650,899) that E&Y's Estate tax allocation schedule reflected as payable by MSFLP in 1999. See supra note 61.

[63]On June 5, 1997, the date of Mr. Stone's death, Mr. Stone held a 1.001 percent general partnership interest and a 68.972 percent limited partnership interest in ES3LP. Both of those interests were transferred to the AWS Trust pursuant to Mr. Stone's will. The parties stipulated that on Oct. 16, 1998, the date of Ms. Stone's death, the AWS Trust held a 69.973 percent limited partnership interest in ES3LP. We presume that after Mr.

(continued...)

on that date in Mr. Stone's retirement account, and the right on that date to Mr. Stone's deferred compensation from Stone Manufacturing. The respective identities and values of the assets owned by ES3LP on the date of Mr. Stone's death on June 5, 1997, were not the same as the respective identities and values of the assets owned by that partnership on the date of Ms. Stone's death on October 16, 1998. Moreover, the respective identities and values of the assets in Mr. Stone's retirement account on the date of Mr. Stone's death on June 5, 1997, were not the same as the respective identities and values of the assets in that retirement account on the date of Ms. Stone's death on October 16, 1998. In addition, the present value on the date of Ms. Stone's death of Mr. Stone's right to deferred compensation from Stone Manufacturing was less than the present value of his right to such compensation on the date of his death.

On July 20, 1999, the IRS received $875,000 (July 20, 1999 payment) in payment of the anticipated estate tax with respect to Ms. Stone's estate.

On January 20, 2000, Ms. Stone's estate filed an estate tax return (Ms. Stone's estate tax return). Pursuant to section 2044, Ms. Stone's estate tax return reported as part of the value

[63](...continued)
Stone's death Mr. Stone's general partnership interest in ES3LP was converted pursuant to the partnership agreement of ES3LP into a limited partnership interest.

of her gross estate the date-of-death values claimed for all the assets held by the AWS Trust as of October 16, 1998, the date of Ms. Stone's death (i.e., the claimed fair market value on that date of the 69.973 limited partnership interest in ES3LP, the claimed fair market value on that date of all the assets in Mr. Stone's retirement account on that date, and the claimed present value on that date of the deferred compensation from Stone Manufacturing that remained to be paid as of that date).

Ms. Stone's estate tax return also reported as part of the value of her gross estate the claimed value as of the date of Ms. Stone's death of her limited partnership interest in each of the Five Partnerships.[64] Ms. Stone's estate tax return showed net

[64]E&Y was retained to provide opinions on the fair market value on the date of Ms. Stone's death of her limited partnership interest in each of ES4LP, CRSLP, RSMLP, and MSFLP. E&Y based those opinions on, inter alia, the assumptions that, as of the date of Ms. Stone's death, ES4LP, CRSLP, RSMLP, and MSFLP had the following respective liabilities for "an estate tax payable" with respect to Mr. Stone's estate:

Partnership	Erroneous Assumptions Relied on by E&Y Regarding Estate Tax Liability
ES4LP	$469,882
CRSLP	1,269,116
RSMLP	723,468
MSFLP	650,899

The parties agree that neither the Federal estate tax nor the State estate tax with respect to Mr. Stone's estate was a liability of ES4LP, CRSLP, RSMLP, or MSFLP and that, as of Oct. 16, 1998, ES4LP, CRSLP, RSMLP, and MSFLP had the following total liabilities:

(continued...)

estate tax of $861,972, a prior payment of $875,000, and an overpayment of $13,028.

Respondent commenced examinations of Mr. Stone's estate tax return and Ms. Stone's estate tax return after July 22, 1998. Mr. Stone's estate and Ms. Stone's estate cooperated with reasonable requests by respondent for witnesses, information, documents, meetings, and interviews.

On September 7, 2001, respondent issued a notice of deficiency (notice) to Mr. Stone's estate. In that notice, respondent determined, inter alia, to increase by $8,491,090 the value attributable to Mr. Stone's respective partnership interests in ES3LP, ES4LP, CRSLP, RSMLP, and MSFLP reported in SCHEDULE F, Other Miscellaneous Property Not Reportable Under Any Other Schedule (Schedule F), of Mr. Stone's estate tax return. In support of that determination, respondent relied on seven alternative grounds, including the substance over form doctrine, the economic substance doctrine, section 2036(a)(1) which was respon-

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[64](...continued)

Partnership	Total Liabilities
ES4LP	$0
CRSLP	2,428,389
RSMLP	0
MSFLP	0

dent's third alternative ground, and respondent's gift theory.[65] With respect to respondent's alternative ground under section 2036(a)(1), respondent determined in the notice that

> the decedent retained until the time of his death the possession or enjoyment * * * [of], or right to the income from, the assets he contributed to the * * * [Five Partnerships] within the meaning of Internal Revenue Code Section 2036. * * *

On November 13, 2001, respondent issued a notice to Ms. Stone's estate. In that notice, respondent determined to increase (1) by $688,385 the value attributable to Ms. Stone's respective partnership interests in ES3LP, ES4LP, CRSLP, RSMLP, and MSFLP and (2) by $959,463 the value attributable to the partnership interest in ES3LP held by the AWS Trust, which were reported in Schedule F of Ms. Stone's estate tax return. In support of those determinations, respondent relied on six alternative grounds, including the substance over form doctrine, the economic substance doctrine, and section 2036(a)(1) which was respondent's third alternative ground. With respect to respon-

[65]With respect to respondent's alternative gift theory, respondent determined in the notice that

> if it is determined that the value of the decedent's [Mr. Stone's] interests is other than that as determined above, then, for purposes of determining the amount of adjusted taxable gifts, it is determined that the decedent made indirect gifts in 1997 of proportionate amounts of the property the decedent transferred to * * * [ES3LP, ES4LP, CRSLP, MSFLP, and RSMLP] within the meaning of Internal Revenue Code Sections 2501 and 2511.

dent's alternative ground under section 2036(a)(1), respondent determined in the notice that

> the decedent retained until the time of her death the possession or enjoyment of, or right to the income from, the assets he [sic] contributed to the * * * [Five Partnerships] within the meaning of Internal Revenue Code Section 2036. * * *

OPINION

Respondent has abandoned all of the various alternative determinations in the respective notices issued to Mr. Stone's estate and Ms. Stone's estate (collectively, the estates) except section 2036(a)(1).[66] According to respondent,

> The only issue remaining for decision is whether section 2036(a)(1) applies to include the value of the assets Decedents [Mr. Stone and Ms. Stone] transferred to the Stone LPs [ES3LP, ES4LP, CRSLP, RSMLP, and MSFLP], rather than of interests in the partnerships, in their gross estates.

However, as discussed below, on brief respondent also relies on section 2044 at the time of Ms. Stone's death, and section 2036(a)(1) at the time of Mr. Stone's death, in support of respondent's position that "the pro rata net asset value of the

[66]With respect to the alternative economic substance doctrine that respondent advanced in the respective notices issued to Mr. Stone's estate and Ms. Stone's estate, respondent stipulated as follows:

> Respondent does not contest the validity under state law of * * * ES3LP * * * ES4LP * * * CRSLP * * * RSMLP * * * and * * * MSFLP * * *.
>
> Respondent does not contest the economic substance of ES3LP, ES4LP, CRSLP, RSMLP, and MSFLP.

69.973% interest in ES3LP held by the AWS Trust at her [Ms. Stone's] death is * * * included in Mrs. Stone's gross estate."

In addition to the foregoing substantive disputes regarding sections 2036(a)(1) and 2044, the parties disagree over whether the burden of proof has shifted to respondent under section 7491(a). The parties' disagreements under section 7491(a) relate to the application in the instant cases of the term "credible evidence" in section 7491(a)(1) and the factual issue or issues with respect to which Mr. Stone's estate and Ms. Stone's estate must introduce credible evidence in order for the burden of proof regarding any such issue or issues to shift to respondent. We need not and shall not address those disagreements under section 7491(a)(1). That is because resolution of the issues presented under sections 2036(a)(1) and 2044 does not depend on who has the burden of proof.

Section 2036(a)(1)

In order to resolve the parties' dispute under section 2036(a)(1),[67] we must consider the following three factual issues

[67]Sec. 2036(a)(1) provides:

SEC. 2036. TRANSFERS WITH RETAINED LIFE ESTATE.

(a) General Rule.--The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he

(continued...)

presented in each of the instant cases:

(1) Was there a transfer of property by the decedent?

(2) If there was a transfer of property by the decedent, was such a transfer other than a bona fide sale for an adequate and full consideration in money or money's worth?

(3) If there was a transfer of property by the decedent that was other than a bona fide sale for an adequate and full consideration in money or money's worth, did the decedent retain possession or enjoyment of, or the right to income from, the property transferred?

Transfer of Property by the Decedent

Mr. Stone's estate concedes that Mr. Stone made a transfer of property to each of the Five Partnerships in exchange for the general and limited partnership interests in each such partnership that he owned on the date of his death. Ms. Stone's estate concedes that Ms. Stone made a transfer of property to each of the Five Partnerships in exchange for the limited partnership

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[67](...continued)
has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death--

(1) the possession or enjoyment of, or the right to the income from, the property * * *

interest in each such partnership that she owned on the date of her death. In light of the foregoing concessions by Mr. Stone's estate and by Ms. Stone's estate, we hold that Mr. Stone and Ms. Stone each made a transfer of property under section 2036(a). We shall address below whether such respective transfers were other than bona fide sales for adequate and full consideration in money or money's worth under that section.

Ms. Stone's estate disputes, and does not concede, that Ms. Stone made a transfer of property to ES3LP in exchange for the 69.973 percent partnership interest in that partnership that the AWS Trust held on the date of her death. Respondent agrees with Ms. Stone's estate.[68] In light of respondent's concession, we hold that Ms. Stone did not make a transfer of property under section 2036(a) with respect to the 69.973 percent partnership interest in ES3LP that the AWS Trust held on the date of her death.[69]

[68]According to respondent, "it is irrelevant that Mrs. Stone made no § 2036(a) transfer with respect to that [69.973 percent] interest [in ES3LP]." That is because, as indicated above, respondent relies on sec. 2044 at the time of Ms. Stone's death, and sec. 2036(a)(1) at the time of Mr. Stone's death, to support respondent's position that 69.973 percent of the assets of ES3LP on the date of Ms. Stone's death is includible in her gross estate.

[69]We shall address below respondent's argument under sec. 2044.

Transfer Other Than a Bona Fide Sale for an Adequate and Full Consideration in Money or Money's Worth

Section 2036(a) excepts from its application any transfer of property otherwise subject to that section which is "a bona fide sale for an adequate and full consideration in money or money's worth". The foregoing exception is limited to a transfer of property where the transferor "has received benefit in full consideration in a genuine arm's length transaction". Estate of Goetchius v. Commissioner, 17 T.C. 495, 503 (1951).

It is respondent's position that the respective transfers of property by Mr. Stone and Ms. Stone to each of the Five Partnerships were not bona fide sales for adequate and full consideration in money or money's worth under section 2036(a). In support of that position, respondent relies principally on Estate of Harper v. Commissioner, T.C. Memo. 2002-121.[70] According to respondent, there is no evidence

> in the record indicating that Decedents intended to conduct a joint enterprise for the mutual profit of their children and themselves * * *.
>
> Further, a transfer is a sale for adequate and full consideration only if that received in exchange is "an adequate and full equivalent reducible to a money value." Treas. Reg. § 20.2036-1(a) (cross-referencing Treas. Reg. § 20.2043-1(a)). The average 43-percent valuation discounts claimed on Decedents' estate tax returns, and the stipulated discounts to be applied in

[70]Respondent also relies on Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000), and Estate of Thompson v. Commissioner, T.C. Memo. 2002-246, which are factually similar to Estate of Harper v. Commissioner, T.C. Memo. 2002-121.

> valuing Decedents' limited partner interests in the event the Court concludes that section 2036(a)(1) is not applicable, show that Petitioners admittedly do not consider interests in the Stone LPs to be the "full equivalent reducible to a money value" of the proportionate amount of the underlying assets Decedents contributed to the partnerships. * * * As in Estate of Harper, Decedents' transfers to the Stone LPs were simply a mere recycling of value and form of ownership. * * *

It is the estates' position that the respective transfers of property by Mr. Stone and Ms. Stone to each of the Five Partnerships were bona fide sales for adequate and full consideration in money or money's worth under section 2036(a). In support of that position, the estates argue:

> Because Mr. and Mrs. Stone received pro rata partnership interests in return for the contributions made to the Partnerships * * *, and because the contributions were properly credited to each partner's capital account * * *, there was no donative transfer made in connection with the creation of the Partnerships. * * * Because no donative transfer occurred when the Partnerships were formed § 2036(a) does not apply. * * *
>
> * * * * * * *
>
> In Harper, the Court's finding of no bona fide sale for adequate and full consideration was based upon the conclusion that the creation of the partnerships was not "motivated primarily by legitimate business concerns," and constituted only "unilateral" value recycling. * * * In [Estate of] Thompson [v. Commissioner, T.C. Memo. 2002-46], the Court's finding was based on its conclusion that "the transactions were not motivated by the type of legitimate business concerns that furnished 'adequate consideration' as described in Estate of Harrison v. Commissioner [T.C. Memo. 1987-8] and Estate of Michelson v. Commissioner [T.C. Memo. 1978-371]." * * * In these [instant] cases, however, the creation of the [Five] Partnerships was motivated by substantial business purposes and their creation and funding resulted from substantial arm's-length negotia-

> tions. * * * The creation of the [Five] Partnerships did not constitute "value recycling," and Mr. and Mrs. Stone received full and adequate consideration for their transfers to the partnerships. [Fn. ref. omitted.]

On the record before us, we agree with the estates' position and reject respondent's position. The instant cases are distinguishable from Estate of Harper v. Commissioner, supra, and other cases factually similar to Estate of Harper[71] on which respondent relies, and respondent's reliance on such cases is misplaced. Unlike the transfers involved in Estate of Harper and those other cases, we have found on the record in the instant cases that the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships, as well as the respective transfers of assets by the other partners to each such partnership,[72] were bona

[71]See supra note 70.

[72]All the partners of each of the Five Partnerships transferred to each such partnership respective assets such partners owned. We reject respondent's contention that, because certain of the assets that the children respectively transferred to one or more of the Five Partnerships were assets that they received as gifts from Mr. Stone, the children did not make transfers to one or more of such partnerships that should be recognized for purposes of determining the applicability of sec. 2036(a)(1) to such transfers. Mr. Stone gave certain property to each of the children, which they then transferred to one or more of the Five Partnerships in return for partnership interests. Mr. Stone reported the gifts that he made to the children in his 1997 gift tax return. The children owned the assets that he gave them when they respectively transferred such assets to one or more of such partnerships. In this connection, we note that respondent abandoned the alternative substance over form doctrine advanced in the respective notices issued to Mr. Stone's estate and Ms. Stone's estate.

fide, arm's-length transfers.

On the record before us, we reject respondent's contention that, because Mr. Stone and Ms. Stone did not actively participate in the negotiations by the children, the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships were not bona fide, arm's-length transfers. Each member of the Stone family was represented by his or her own independent counsel and had input into the decision-making as to how each of the Five Partnerships was to be structured and operated and what property was to be transferred to each such partnership. The Stone family understood that Mr. Stone and Ms. Stone would not be bound by any agreements that the children were able to reach as a result of the children's negotiations and that Mr. Stone and Ms. Stone would make the ultimate decision as to which, if any, of their respective assets to transfer to each of the Five Partnerships. In this connection, although Mr. Stone and Ms. Stone agreed to form the Five Partnerships, they did not intend to, and did not, transfer all their respective assets to such partnerships. Instead, they retained sufficient assets to enable them to maintain their respective accustomed standards of living. Mr. Stone and Ms. Stone did not accept the children's recommendations resulting from the children's negotiations regarding the structure, funding, and operation of the Five Partnerships without thought, comment, or question. For example, it

was Mr. Merline, Mr. Stone's attorney, who drafted proposed partnership agreements for the Five Partnerships. Mr. Merline discussed with Mr. Stone the children's and their respective attorneys' suggested changes to those proposed agreements. Only after Mr. Stone agreed to certain of those suggested changes did Mr. Merline revise the proposed partnerships agreements to reflect the changes to which Mr. Stone agreed.

The record also establishes that the respective transfers at issue did not constitute gifts by Mr. Stone and Ms. Stone, respectively, to the other partners of each of the Five Partnerships.[73] In addition, the record shows that those transfers were motivated primarily by investment and business concerns relating to the management of certain of the respective assets of Mr. Stone and Ms. Stone during their lives[74] and thereafter and the resolution of the litigation among the children.

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[73]Respondent properly does not contend that the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships were gifts by them to the other partners of each such partnership. See Estate of Jones v. Commissioner, 116 T.C. 121, 127-128 (2001); Estate of Michelson v. Commission, T.C. Memo. 1978-371. In this connection, respondent asserted in the notice issued to Mr. Stone's estate an alternative gift theory which respondent has since abandoned. Respondent did not assert any alternative gift theory in the notice issued to Ms. Stone's estate.

[74]At least as early as the last six months of 1995, Mr. Stone and Ms. Stone were in control of their respective assets. However, they no longer were interested or actively involved in managing those assets and wanted their children to become actively involved in the management of those assets.

Unlike the decedent in Estate of Harper and other cases factually similar to that case, the record in the instant cases establishes that Mr. Stone and Ms. Stone did substantially more than "change the form in which he [and she] held his [and her] beneficial interest in the contributed property." Estate of Harper v. Commissioner, T.C. Memo. 2002-121. The record in the instant cases shows that the Five Partnerships had economic substance and operated as joint enterprises for profit through which the children actively participated in the management and development of the respective assets of such partnerships during their parents' lives (and thereafter). When the partners of ES3LP formed and funded that partnership, they contemplated and intended that ES3LP operate as a joint enterprise for profit for the management of its assets and that the children contribute their services in providing such management. After ES3LP was funded in April 1997, the children actively managed the assets of that partnership, as Mr. Stone and Ms. Stone intended. When the partners of ES4LP formed and funded that partnership, they contemplated and intended that ES4LP operate as a joint enterprise for profit for the management of its assets and that Eugene Earle Stone, IV, contribute his services in providing such management. After the funding of ES4LP in April 1997, Eugene Earle Stone, IV, began actively managing the assets of ES4LP, as Mr. Stone and Ms. Stone intended. When the partners of CRSLP formed and funded

that partnership, they contemplated and intended that CRSLP operate as a joint enterprise for profit for the management of its assets and that C. Rivers Stone contribute his services in providing such management. After the funding of CRSLP in April 1997, C. Rivers Stone began actively managing the assets of that partnership, as Mr. Stone and Ms. Stone intended. When the partners of RSMLP formed and funded that partnership, they contemplated and intended that RSMLP operate as a joint enterprise for profit for the management of its assets and that Ms. Morris contribute her services in providing such management. After the funding of RSMLP in April 1997, Ms. Morris began actively managing the assets of that partnership, as Mr. Stone and Ms. Stone intended. When the partners of MSFLP formed and funded that partnership, they contemplated and intended that MSFLP operate as a joint enterprise for profit for the management of its assets and that Ms. Fraser contribute her services in providing such management. After the funding of MSFLP in April 1997, Ms. Fraser began actively managing the assets of that partnership, as Mr. Stone and Ms. Stone intended.

On the record in the instant cases, we find that, unlike the transfers involved in Estate of Harper and other cases factually similar to that case, the respective transfers at issue by Mr. Stone and Ms. Stone did not constitute "circuitous 'recycling' of

value".[75]

On the record before us, we further find that the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships were for adequate and full consideration in money or money's worth. We have found that such transfers were not, and respondent does not claim that they were, gifts by Mr. Stone and Ms. Stone, respectively, to the other partners of each such partnership. We have also found, and respondent agrees and/or does not dispute, that after all the partners of each of the Five Partnerships transferred to each such partnership certain of their respective assets and after certain gifts were made by Mr. Stone in April 1997 to correct the unintended consequences of certain inadvertent valuation errors:[76] (1) All partners of

[75]Although not cited by the parties in the instant cases because they filed their respective briefs prior to the issuance of Estate of Strangi v. Commissioner, T.C. Memo. 2003-145, Strangi insofar as it relates to sec. 2036(a)(1) is similar to Estate of Harper v. Commissioner, T.C. Memo. 2002-121, and is distinguishable from the instant cases. On the facts presented, Strangi found, as Estate of Harper did on the facts presented there, that "there has been merely a 'recycling' of value through partnership or corporate solution." Estate of Strangi v. Commissioner, supra. In so concluding, Strangi found that the arrangement involved in that case "patently fails to qualify as the sort of functioning business enterprise that could potentially inject intangibles that would lift the situation beyond mere recycling." Id.

[76]Respondent properly does not contend that Mr. Stone's gifts to correct the unintended consequences of certain inadvertent valuation errors are factors to be considered in determining whether the transfers at issue were bona fide sales for adequate and full consideration in money or money's worth under sec.

(continued...)

each of the Five Partnerships held respective partnership interests in each such partnership that were proportionate to the fair market value of the assets that such partners respectively transferred to each such partnership; (2) the respective assets that the partners of each such partnership transferred to each such partnership were properly credited to the respective capital accounts of such partners; and (3) upon the termination or dissolution of each of the Five Partnerships, the partners of each such partnership were entitled to distributions from each such partnership in amounts equal to their respective capital accounts. Under the circumstances presented in the instant cases, we find that Mr. Stone and Ms. Stone, as well as the other partners of each of the Five Partnerships, received in exchange for their respective transfers of assets to each such partnership respective partnership interests in each such partnership that were adequate and full equivalents reducible to a money value. See secs. 20.2036-1(a), 20.2043-1(a), Estate Tax Regs.; see also Estate of Goetchius, 17 T.C. at 503.

Respondent nonetheless argues that, because Mr. Stone and Ms. Stone received respective partnership interests in each of the Five Partnerships the value of which, taking into account appropriate discounts, was less than the value of the respective

[76](...continued)
2036(a).

assets that they transferred to each such partnership, they did not receive adequate and full consideration for the assets transferred. Respondent's argument in effect reads out of section 2036(a) the exception for "a bona fide sale for an adequate and full consideration in money or money's worth" in any case where there is a bona fide, arm's-length transfer of property to a business entity (e.g., a partnership or a corporation) for which the transferor receives an interest in such entity (e.g., a partnership interest or stock) that is proportionate to the fair market value of the property transferred to such entity and the determination of the value of such an interest takes into account appropriate discounts. We reject such an argument by respondent that reads out of section 2036(a) the exception that Congress expressly prescribed when it enacted that statute.

Respondent's argument about the discounted values of the partnership interests at issue also ignores the fact that each of the Five Partnerships was created, funded, and operated as a joint enterprise for profit for the management of its assets in which there was a genuine pooling of property and services. We have found that, when the partners of each of the Five Partnerships formed and funded each such partnership, they contemplated and intended that each such partnership operate as a joint enterprise for profit for the management of its assets and that the children contribute services in providing such management in the

case of ES3LP and that Eugene Earle Stone, IV, C. Rivers Stone, Ms. Morris, and Ms. Fraser contribute services in providing such management in the case of ES4LP, CRSLP, RSMLP, and MSFLP, respectively. As Mr. Stone and Ms. Stone intended, after the funding of ES3LP, the children actively participated in the management of the assets of that partnership, and after the funding of ES4LP, CRSLP, RSMLP, and MSFLP, Eugene Earle Stone, IV, C. Rivers Stone, Ms. Morris, and Ms. Fraser, respectively, actively participated in the management of the assets of such partnerships.

Based upon our examination of the entire record before us, we find that the respective transfers of assets by Mr. Stone and Ms. Stone to each of the Five Partnerships were bona fide sales for adequate and full consideration in money or money's worth under section 2036(a).[77]

Possession or Enjoyment of, or
Right to Income from, the Transferred Property

We have found that the respective transfers of assets by Mr.

[77]Although not altogether clear, respondent appears to take the position that, where a decedent has made a bona fide transfer of property for which the decedent has received an adequate and full consideration in money or money's worth and with respect to which the transferor has retained possession or enjoyment of, or the right to income from, such property, the exception in sec. 2036(a) for "a bona fide sale for an adequate and full consideration in money or money's worth" may never apply to such a transfer. We reject any such position. That position, like respondent's position about the discounted values of the partnership interests at issue, in effect reads out of sec. 2036(a) the exception that Congress expressly prescribed when it enacted that statute.

Stone and Ms. Stone to each of the Five Partnerships were bona fide sales for adequate and full consideration in money or money's worth under section 2036(a). Consequently, we need not and shall not address the third factual issue presented under section 2036(a)(1).

Ultimate Holdings

Based upon our examination of the entire record before us, we hold that none of the assets owned by any of the Five Partnerships (1) on the date of Mr. Stone's death is includible under section 2036(a)(1) in his gross estate and (2) on the date of Ms. Stone's death is includible under section 2036(a)(1) in her gross estate.

Section 2044

Respondent argues that, because section 2036(a)(1) requires the inclusion in Mr. Stone's gross estate of 69.973 percent of the assets of ES3LP on the date of his death, section 2044 requires the inclusion in Ms. Stone's gross estate of 69.973 percent of the assets of ES3LP on the date of her death.[78] We have rejected respondent's position that section 2036(a)(1) requires the inclusion in Mr. Stone's gross estate of 69.973 percent of

[78]Respondent did not raise sec. 2044 in the notice issued to Ms. Stone's estate or in the answer. We conclude that respondent's reliance on sec. 2044 raises a new issue that respondent advances for the first time on brief. However, the estates do not object to, and we find no prejudice to the estates as a result of, respondent's raising that issue for the first time on brief.

the assets of ES3LP on the date of his death. Consequently, we need not and shall not address the argument that respondent advances under section 2044. On the record before us, we hold that none of the assets owned by ES3LP on the date of Ms. Stone's death is includible under section 2044 in her gross estate.

We have considered all of the respective contentions and arguments of the estates and of respondent that are not discussed herein, and we find them to be without merit, irrelevant, and/or moot.

To reflect the foregoing and the concessions of the parties,

Decisions will be entered under Rule 155.

Full Text of Court Cases

Estate of Strangi v. Commissioner (I)

Case name: Estate of Strangi v. Commissioner (I)
Citation: 115 T.C. 478, 115 T.C. No. 35, 2000 U.S. Tax Ct. LEXIS 89
Date of decision: November 30, 2000
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Cohen
SIC: 6733 Trusts, Except Educational, Religious, and Charitable (managers)
NAICS: 525920 Trusts, Estates, and Agency Accounts
357

Keywords: Estate tax, Fair market value (FMV), Gift tax

Counsel: Norman A. Lofgren and G. Tomas Rhodus, for petitioner. Deborah H. Delgado, Gerald L. Brantley, Sheila R. Pattison, and William C. Sabin, Jr., for respondent.

Judges: Cohen, opinion; Chabot; Laro; Foley; Wells, concurring; Parr, dissenting; Ruwe, dissenting; Beghe, Renato, dissenting

Opinion by: Cohen

On December 1, 1998, respondent determined a $ 2,545,826 deficiency in the Federal estate tax of the estate of Albert Strangi, Rosalie Gulig, independent executrix. In the alternative, respondent determined a Federal gift tax deficiency of $ 1,629,947.

After concessions by the parties, the issues for decision are (alternatively): (1) Whether the Strangi Family Limited Partnership (SFLP) should be disregarded for Federal tax purposes because it lacks business purpose and economic substance; (2) whether the SFLP is a restriction on the sale or use of property that should be disregarded pursuant to section 2703(a)(2); (3) whether the transfer of assets to SFLP was a taxable gift; and (4) if SFLP is not disregarded, the fair market value of decedent's interest in SFLP at the date of death.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect as of the date of decedent's death, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulated facts are incorporated in our findings by this reference. Albert Strangi (decedent) was domiciled in Waco, Texas, at the time of his death, and his estate was administered there. Rosalie Strangi Gulig (Mrs. Gulig) resided in Waco, Texas, when the petition in this case was filed.

Decedent was a self-made multimillionaire. He married Genevieve Crowley Strangi (Genevieve Strangi) in the late 1930's and had four children -- Jeanne Strangi, Albert T. Strangi, John Strangi, and Mrs. Gulig, collectively referred to herein as the Strangi children. In 1965, the marriage between decedent and Genevieve Strangi was terminated by divorce, and decedent remarried Irene Delores Seymour (Mrs. Strangi). Mrs. Strangi had two daughters from a previous marriage, Angela Seymour and Lynda Seymour.

In 1975, decedent sold his company, Mangum Manufacturing, in exchange for Allen Group stock, and he and Mrs. Strangi moved to Fort Walton Beach, Florida. Mrs. Gulig married Michael J. Gulig (Mr. Gulig) in 1985. Mr. Gulig was an attorney in Waco, Texas, with the law firm of Sheehy, Lovelace and Mayfield, P.C. Mr. Gulig has done a substantial amount of estate planning and is proficient in that field.

On February 19, 1987, decedent and Mrs. Strangi executed wills that named the Strangi children, Angela Seymour, and Lynda Seymour as residual beneficiaries in the event that either decedent or Mrs. Strangi predeceased the other. These wills were prepared by the law offices of Tobolowsky, Prager & Schlinger in Dallas, Texas. Mrs. Strangi also executed the Irene Delores Strangi Irrevocable Trust (the Trust). Decedent was designated as the executor of Mrs. Strangi's will and as the trustee of the Trust.

Mrs. Strangi's will provided that her personal effects were to be left to decedent and that life insurance proceeds, employee benefits, and the residuary of her estate should be distributed to the Trust. The first codicil to Mrs. Strangi's will provided that property she owned in Dallas, Texas, should be distributed to the Jeanne Strangi Brown Trust. The Trust provided that lifetime distributions would be made to Mrs. Strangi and that, upon her death, (1) her property in Florida should be distributed to Angela Seymour and Lynda Seymour, (2) $ 50,000 should be distributed to Mrs. Strangi's sister, and (3) the residuary should be distributed to decedent provided that he survived her.

In 1987 and 1988, Mrs. Strangi suffered a series of serious medical problems. In 1988, decedent and Mrs. Strangi moved to Waco, Texas. Sylvia Stone (Stone) was hired as decedent's housekeeper. She also provided assistance with the care of Mrs. Strangi. On July 19, 1988, decedent executed a power of attorney, naming Mr. Gulig as his attorney in fact.

On July 31, 1990, decedent executed a new will, naming his children as the sole residual beneficiaries if Mrs. Strangi predeceased him. This will also named Mrs. Gulig and Ameritrust Texas, N.A. (Ameritrust), as coexecutors of decedent's estate. On December 27, 1990, Mrs. Strangi died in Waco, Texas. Her will was admitted to probate in Texas and was not contested.

In May 1993, decedent had surgery that removed a cancerous mass from his back. That summer, Mr. Gulig took decedent to Dallas to be examined by a physician in the neurology department of Southwest Medical School. Decedent was then diagnosed with supranuclear palsy, a brain disorder that would gradually reduce his ability to speak, walk, and swallow. In September 1993, decedent had prostate surgery.

FORMATION OF LIMITED PARTNERSHIP

After decedent's prostate surgery, Mr. Gulig took over the affairs of decedent pursuant to the 1988 power of attorney. Mr. Gulig consulted a probate judge regarding concerns he had about decedent's affairs. On August 11, 1994, Mr. Gulig attended a seminar in Dallas, Texas, provided by Fortress Financial Group, Inc. (Fortress). Fortress trains and educates professionals on the use of family limited partnerships as a tool to (1) reduce income tax, (2) reduce the reported value of property in an estate, (3) preserve assets, and (4) facilitate charitable giving. The Fortress Plan recommends contributing assets to a family limited partnership with a corporate general partner being created for control purposes. The Fortress Plan also suggests that shares of stock of the corporate general partner or an interest in the family limited partnership be donated to a charity. To facilitate the plan, Fortress licenses the use of copyrighted limited partnership agreements and shareholders' agreements.

Following the Fortress seminar, on August 12, 1994, Mr. Gulig, as decedent's attorney in fact, formed SFLP, a Texas limited partnership, and its corporate general partner, Stranco, Inc. (Stranco), a Texas corporation. Mr. Gulig handled all of the details of the formation, executing the limited partnership agreement and shareholders' agreement using Fortress documents, as well as drafting articles of incorporation and bylaws for Stranco.

The partnership agreement provided that Stranco had the sole authority to conduct the business affairs of SFLP without the concurrence of any limited partner or other general partner. Thus, limited partners could not act on SFLP's behalf without the consent of Stranco. The partnership agreement also allowed SFLP to lend money to partners, affiliates, or other persons or entities.

Mr. Gulig filed the SFLP certificate of limited partnership and the Stranco articles of incorporation with the State of Texas. He also drafted asset transfer documents, dated August 12, 1994, assigning decedent's interest in specified real estate, securities, accrued interest and dividends, insurance policies, annuities, receivables, and partnership interests (referred to collectively herein as the contributed property) to SFLP for a 99- percent limited partnership interest in SFLP. All of the contributed property was reflected in decedent's capital account. The fair market value of the contributed property was $ 9,876,929. Approximately 75 percent of that value was attributable to cash and securities.

Mr. Gulig invited decedent's children to participate in SFLP through an interest in Stranco, the corporate general partner of SFLP. Decedent purchased 47 percent of Stranco for $ 49,350, and Mrs. Gulig purchased the remaining 53 percent of Stranco for $ 55,650 on behalf of Jeanne Strangi, John Strangi, Albert T. Strangi, and herself. To purchase the Stranco shares, Jeanne Strangi, John Strangi, and Albert T. Strangi each executed unsecured notes dated August 12, 1994, to Mrs. Gulig, with a face amount of $ 13,912.50 and interest at 8 percent. Stranco contributed $ 100,333 to SFLP in exchange for a 1-percent general partnership interest. Subsequently, as a result of the downward adjustment of the value of decedent's contributed property, Stranco's capital contribution was reduced on its books by $ 1,000 to $ 99,333, and a receivable was recorded indicating $ 1,000 due from SFLP.

Decedent and the Strangi children made up the initial board of directors of Stranco, and Mrs. Gulig served as president. On August 17, 1994, the Strangi children and Mr. Gulig met to execute the Stranco shareholders' agreement, bylaws, and a Consent of Directors Authorizing Corporate Action in Lieu of Organizational Meeting that was effective as of August 12, 1994. They also executed a Unanimous Consent of Directors in Lieu of Special Meeting to employ Mr. Gulig to manage the day-to-day affairs of SFLP and Stranco, dated August 12, 1994. Stranco never had formal meetings. All corporate actions were approved by unanimous consent agreements in lieu of actual meetings. On August 18, 1994, McLennan Community College Foundation accepted a gift of 100 Stranco shares from decedent's children "in honor of their father".

From September 1993 until his death, decedent required 24- hour home health care that was provided by Olsten Healthcare (Olsten) and supplemented by Stone. During this time, Stone injured her back. This injury resulted in Stone's having back surgery, and SFLP paid for the surgery. On October 14, 1994, decedent died of cancer at the age of 81.

On December 7, 1994, Peter Gross, an attorney from the law firm of Prager & Benson, P.C., as a representative of decedent's estate, requested that Texas Commerce Bank (TCB), successor in interest to Ameritrust, resign as coexecutor of decedent's estate. The Strangi children also requested that TCB decline to serve as coexecutor and agreed to indemnify TCB for claims related to the estate if it declined to serve as coexecutor. Accordingly, TCB declined to serve as coexecutor of decedent's estate and renounced its right to appoint a successor coindependent executor. When decedent's will was admitted to probate on April 12, 1995, Mrs. Gulig was appointed as the sole executor of decedent's estate.

Angela Seymour consulted two attorneys regarding the validity of Mrs. Strangi's will during 1994. She never intended to contest decedent's will, and, ultimately, no claim or will contest was filed against decedent's estate.

PARTNERSHIP ACTIVITIES

Following the formation of SFLP, various distributions were made by SFLP to decedent's estate and the Strangi children. When distributions were made, corresponding and proportionate distributions were made to Stranco either in cash or in the form of adjusting journal entries. In July 1995, SFLP distributed $ 3,187,800 to decedent's estate for State and Federal estate and inheritance taxes. Also in 1995 and in 1996, SFLP distributed $ 563,000 to each of the Strangi children. The distributions were characterized as distributions to decedent's estate.

In May 1996, SFLP divided its primary Merrill Lynch account into four separate accounts in each of the Strangi children's names, giving them control over a proportionate share of the partnership assets. The partnership also extended lines of credit to John Strangi, Albert T. Strangi, and Mrs. Gulig for $ 250,000, $ 400,000, and $ 100,000, respectively. In January 1997, SFLP increased John Strangi's line of credit to $ 350,000 and Albert T. Strangi's line of credit to $ 650,000. In November 1997, SFLP advanced to decedent's estate $ 2.32 million to post bonds with the Internal Revenue Service and the State of Texas in connection with the review of decedent's estate tax return. In 1998, SFLP made distributions of $ 102,500 to each of the Strangi children. The Strangi children had received $ 2,662,000 in distributions from SFLP as of December 31, 1998.

ESTATE TAX RETURN

On January 16, 1996, decedent's Form 706, United States Estate (and Generation Skipping Transfer) Tax Return (estate tax return), was filed by Mr. Gulig. On the estate tax return, decedent's gross estate was reported as $ 6,823,582. This included a $ 6,560,730 fair market value for SFLP. For purposes of the estate tax return, SFLP was valued by Appraisal Technologies, Inc., on an "ongoing business", "minority interest basis". The valuation report arrived at a value before discounts and then applied minority interest discounts totaling 33 percent for lack of marketability and lack of control.

The estate tax return also indicated that decedent had $ 43,280 in personal debt and other allowable deductions totaling $ 107,108, leaving a reported taxable estate of $ 6,673,194. The estate tax return reported a transfer tax due of $ 2,522,088. The property that was held by SFLP as of the date of death had increased in value to $ 11,100,922 due to the appreciation of

securities, particularly the Allen Group stock.

OPINION

We must decide whether the existence of SFLP will be recognized for Federal estate tax purposes. Respondent argues that, under the business purpose and economic substance doctrines, SFLP should be disregarded in valuing the assets in decedent's estate. Petitioner contends that the business purpose and economic substance doctrines do not apply to transfer tax cases and that SFLP had economic substance and business purpose.

Taxpayers are generally free to structure transactions as they please, even if motivated by tax-avoidance considerations. See Gregory v. Helvering, 293 U.S. 465, 469, 79 L. Ed. 596, 55 S. Ct. 266 (1935); Yosha v. Commissioner, 861 F.2d 494, 497 (7th Cir. 1988), affg. Glass v. Commissioner, 87 T.C. 1087 (1986). However, the tax effects of a particular transaction are determined by the substance of the transaction rather than by its form. In Frank Lyon Co. v. United States, 435 U.S. 561, 583-584, 55 L. Ed. 2d 550, 98 S. Ct. 1291 (1978), the Supreme Court stated that "a genuine multiple-party transaction with economic substance * * * compelled or encouraged by business or regulatory realities, * * * imbued with tax-independent considerations, and * * * not shaped solely by tax avoidance features" should be respected for tax purposes. "[T]ransactions which have no economic purpose or substance other than the avoidance of taxes will be disregarded." Gregory v. Helvering, supra at 469-470; see also Merryman v. Commissioner, 873 F.2d 879 (5th Cir. 1989), affg. T.C. Memo 1988-72.

Family partnerships must be closely scrutinized by the courts because the family relationship "so readily lends itself to paper arrangements having little or no relationship to reality." Kuney v. Frank, 308 F.2d 719, 720 (9th Cir. 1962); accord Frazee v. Commissioner, 98 T.C. 554, 561 (1992); Harwood v. Commissioner, 82 T.C. 239, 258 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986); Estate of Kelley v. Commissioner, 63 T.C. 321, 325 (1974); Estate of Tiffany v. Commissioner, 47 T.C. 491, 499 (1967); see also Helvering v. Clifford, 309 U.S. 331, 336-337, 84 L. Ed. 788, 60 S. Ct. 554 (1940). Family partnerships have long been recognized where there is a bona fide business carried on after the partnership is formed. See, e.g., Drew v. Commissioner, 12 T.C. 5, 12-13 (1949). Mere suspicion and speculation about a decedent's estate planning and testamentary objectives are not sufficient to disregard an agreement in the absence of persuasive evidence that the agreement is not susceptible of enforcement or would not be enforced by parties to the agreement. Cf. Estate of Hall v. Commissioner, 92 T.C. 312, 335 (1989).

The estate contends that there were "clear and compelling" nontax motives for creating SFLP, including the provision of a flexible and efficient means by which to manage and protect decedent's assets. Specifically, the estate argues that its business purposes for forming SFLP were (1) to reduce executor and attorney's fees payable at the death of decedent, (2) to insulate decedent from an anticipated tort claim and the estate from a will contest (by creating another layer through which creditors must go to reach assets conveyed to the partnership), and (3) to provide a joint investment vehicle for management of decedent's assets. We agree with respondent that there are reasons to be skeptical about the nontax motives for forming SFLP.

We are skeptical of the estate's claims of business purposes related to executor and attorney's fees or potential tort claims. Mr. Gulig testified that, on various social occasions, he consulted with a former probate judge about decedent's anticipated estate. Those consultations, however, were not related in time or purpose to the formation of SFLP. In our view, the testimony about consultation is similar to the evidence described in Estate of Baron v. Commissioner, 83 T.C. 542, 555 (1984), affd. 798 F.2d 65 (2d Cir. 1986), to wit, the "'consultation' was mere window dressing to conceal tax motives."

We are not persuaded by the testimony that SFLP was formed to protect assets from will contests by Angela or Lynda Seymour or from a potential tort claim by Stone. The Seymour claims were stale when the partnership was formed, and they never materialized. There was no direct corroboration that Stone was injured by decedent while she was caring for him or any indication that Stone ever threatened litigation.

We also do not believe that a "joint investment vehicle" was the purpose of the partnership. Mr. Gulig took over control of decedent's affairs in September 1993, under the 1988 power of attorney, and Mr. Gulig continued to manage decedent's assets through his management responsibilities in Stranco. Petitioner concedes, in disputing respondent's alternative claim of gift tax liability, that "directly or indirectly, the Decedent ended up with 99.47% of the Partnership, having put in essentially 99.47% of the capital."

The formation and subsequent control of SFLP were orchestrated by Mr. Gulig without regard to "joint enterprise". He formed the partnership and the corporation and then invited Mrs. Gulig's siblings, funded by her, to invest in the corporation. The Strangi children shared in managing the assets only after and to the extent that the Merrill Lynch account was fragmented in accordance with their respective beneficial interests.

The nature of the assets that were contributed to SFLP supports the conclusion that management of those assets was not the purpose of SFLP. There were no operating business assets contributed to SFLP. Decedent transferred cash, securities, life insurance policies, annuities, real estate, and partnership interests to SFLP. The cash and securities approximated 75 percent of the value of the assets transferred. No active business was conducted by SFLP following its formation.

The actual control exercised by Mr. Gulig, combined with the 99-percent limited partnership interest in SFLP and the 47- percent interest in Stranco, suggest the possibility of including the property transferred to the partnership in decedent's estate under section 2036. See, e.g., Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000). Section 2036 is not an issue in this case, however, because respondent asserted it only in a proposed amendment to answer tendered shortly before trial. Respondent's motion to amend the answer was denied because it was untimely. Applying the economic substance doctrine in this case on the basis of decedent's continuing control would be equivalent to applying section 2036(a) and including the transferred assets in decedent's estate. As discussed below, absent application of section 2036, Congress has adopted an alternative approach to perceived valuation abuses.

SFLP was validly formed under State law. The formalities were followed, and the proverbial "i's were dotted" and "t's were crossed". The partnership, as a legal matter, changed the relationships between decedent and his heirs and decedent and actual and potential creditors. Regardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent's assets, and we do not disregard it in this case.

SECTION 2703(a)(2)

Section 2703(a) provides as follows:

SEC. 2703. (a) General Rule. -- For purposes of this subtitle, the value of any property shall be determined without regard to --

(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.

Noting that a right or restriction may be implicit in the capital structure of an entity, see sec. 25.2703-1(a)(2), Gift Tax Regs., respondent argues that section 2703(a)(2) applies to disregard SFLP for transfer tax purposes. Respondent further argues that the SFLP agreement does not satisfy the "safe harbor" exception in section 2703(b).

Respondent's brief states:

Congress recognized substantial valuation abuse in the law as it existed prior to the enactment of I.R.C. sec. 2036(c) in 1987. In 1990 Congress replaced section 2036(c) with a new Chapter 14, including sections 2701 through 2704, which sets out special valuation rules for transfer tax purposes. It intended these new sections to target transfer-tax valuation abuses in the intra-family transfers more effectively while relieving taxpayers of section 2036(c)'s broad sweep. It wanted to value property interests more accurately when they were transferred, instead of including previously transferred property in the transferor's gross estate. "Discussion Draft" Relating to Estate Valuation Freezes: Hearing Before the House Comm. on Ways and Means, 101st Cong. 2d Sess. 102 (April 24, 1990) [House hearing]; Estate Freezes: Hearing on "Discussion Draft" Before the Subcomm. on Energy and Agricultural Taxation and Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance, 101st Cong. 1233 (June 27, 1990) [Senate hearing].

The new special valuation rules in Chapter 14 departed substantially from the hypothetical willing buyer-willing seller standard. The Treasury Department recognized that valuing nonpublicly traded assets in family transactions for transfer tax purposes presented a significant problem. It testified to Congress that applying the hypothetical standard of a willing buyer-willing seller to family transactions allowed significant amounts to escape taxation. Senate hearing at 15.

Congress enacted section 2703(a) to address abusive intra-family situations. Section 2703(a)(1) addresses burdening a decedent's property with options to purchase at less than fair market value. Section 2703(a)(2), which applies to this case, addresses other restrictions that reduce the value of a decedent's property for estate tax purposes but not in the hands of the beneficiary. Congress contemplated that the section would apply to "any restriction, however created," including restrictions implicit in the capital structure of a partnership or contained in a partnership agreement, articles of incorporation, corporate bylaws or a shareholders' agreement. Informal Senate Report on S. 3209, 101st Cong., 2d Sess. (1990),136 Cong. Rec.

S15777 (October 18, 1990). Thus, it intended the word "restriction" in section 2703(a)(2) to be read as broadly as possible. See Treas. Reg. sec. 25.2703-1 (a lease from a father to son will to be disregarded for transfer tax valuation purposes because it is not similar to arm's-length transactions among unrelated parties. [Fn. ref. omitted.]

Respondent next argues that the term "property" in section 2703(a)(2) means the underlying assets in the partnership and that the partnership form is the restriction that must be disregarded. Unfortunately for respondent's position, neither the language of the statute nor the language of the regulation supports respondent's interpretation. Absent application of some other provision, the property included in decedent's estate is the limited partnership interest and decedent's interest in Stranco.

In Kerr v. Commissioner, 113 T.C. 449 (1999), the Court dealt with a similar issue with respect to interpretation of section 2704(b). Sections 2703 and 2704 were enacted as part of chapter 14, I.R.C., in 1990. See Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, 104 Stat. 1388. However, as we indicated in Kerr v. Commissioner, supra at 470-471, and as respondent acknowledges in the portion of his brief quoted above, the new statute was intended to be a targeted substitute for the complexity, breadth, and vagueness of prior section 2036(c); and Congress "wanted to value property interests more accurately when they were transferred, instead of including previously transferred property in the transferor's gross estate." Treating the partnership assets, rather than decedent's interest in the partnership, as the "property" to which section 2703(a) applies in this case would raise anew the difficulties that Congress sought to avoid by repealing section 2036(c) and replacing it with chapter 14. We conclude that Congress did not intend, by the enactment of section 2703, to treat partnership assets as if they were assets of the estate where the legal interest owned by the decedent at the time of death was a limited partnership or corporate interest. See also Estate of Church v. United States, 2000 U.S. Dist. LEXIS 714, 85 A.F.T.R.2d (RIA) 804, 2000-1 U.S. Tax Cas. (CCH) P60,369 (W.D. Tex. 2000). Thus, we need not address whether the partnership agreement satisfies the safe harbor provisions of section 2703(b). Respondent did not argue separately that the Stranco shareholders' agreement should be disregarded for lack of economic substance or under section 2703(a).

GIFT AT THE INCEPTION OF SFLP

Respondent determined in the statutory notice and argues in the alternative that, if the partnership is recognized for estate tax purposes, decedent made a gift when he transferred property to the partnership and received in return a limited partnership interest of lesser value. Using the value reported by petitioner on the estate tax return, if decedent gave up property worth in excess of $ 10 million and received back a limited partnership interest worth approximately $ 6.5 million, he appears to have made a gift equal to the loss in value. (Petitioner now claims a greater discount, as discussed below.) In analogous circumstances involving a transfer to a corporation, the Court of Appeals in Kincaid v. United States, 682 F.2d 1220 (5th Cir. 1982), held that there was a taxable gift and awarded summary judgment to the Government. The Court of Appeals rejected the discounts claimed by the taxpayer, stating that no business person "would have entered into this transaction, * * * [thus] the 'moving impulse for the * * * transaction was a desire to pass the family fortune on to others'". Id. at 1225 (quoting Robinette v. Helvering, 318 U.S. 184, 187-188, 87 L. Ed. 700, 63 S. Ct. 540 (1943)). The Court of Appeals in Kincaid concluded that, while there may have been business reasons for the taxpayer to transfer land to a family corporation in exchange for stock, "there was no business purpose, only a donative one, for Mrs. Kincaid to accept less value in return than she gave up." 682 F.2d at 1226.

In this case, the estate claims that the assets were transferred to SFLP for the business purposes discussed above. Following the formation of SFLP, decedent owned a 99-percent limited partnership interest in SFLP and 47 percent of the corporate general partner, Stranco. Even assuming arguendo that decedent's asserted business purposes were real, we do not believe that decedent would give up over $ 3 million in value to achieve those business purposes.

Nonetheless, in this case, because we do not believe that decedent gave up control over the assets, his beneficial interest in them exceeded 99 percent, and his contribution was allocated to his own capital account, the instinctive reaction that there was a gift at the inception of the partnership does not lead to a determination of gift tax liability. In a situation such as that in Kincaid, where other shareholders or partners have a significant interest in an entity that is enhanced as a result of a transfer to the entity, or in a situation such as Shepherd v. Commissioner, 115 T.C. No. 30, (2000) (slip. op. at 21), where contributions of a taxpayer are allocated to the capital accounts of other partners, there is a gift. However, in view of decedent's continuing interest in SFLP and the reflection of the contributions in his own capital account, he did not transfer more than a minuscule proportion of the value that would be "lost" on the conveyance of his assets to the partnership in exchange for a partnership interest. See Kincaid v. United States, supra at 1224. Realistically, in this case, the disparity between the value of the assets in the hands of decedent and the alleged value of his partnership interest reflects on the credibility of the claimed discount applicable to the partnership interest. It does not reflect a taxable gift.

VALUATION OF DECEDENT'S LIMITED PARTNERSHIP INTEREST

For the reasons stated above, resolution of this case requires that we determine the fair market value of decedent's limited partnership interest in SFLP. For reasons stated above and below, we do not believe that the discounts claimed by petitioner in this case are reasonable.

Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. See United States v. Cartwright, 411 U.S. 546, 551, 36 L. Ed. 2d 528, 93 S. Ct. 1713 (1973); sec. 20.2031-1(b), Estate Tax Regs. Under the hypothetical willing buyer-willing seller standard, decedent's interest cannot be valued by assuming that sales would be made to any particular person. See Estate of Bright v. United States, 658 F.2d 999, 1001 (5th Cir. 1981). On the other hand, transactions that are unlikely and plainly contrary to the economic interest of a buyer or seller are not reflective of fair market value. See Estate of Curry v. United States, 706 F.2d 1424, 1429 (7th Cir. 1983); Estate of Newhouse v. Commissioner, 94 T.C. 193, 232 (1990); Estate of Hall v. Commissioner, 92 T.C. 312, 337 (1989); Estate of O'Keeffe v. Commissioner, T.C. Memo 1992-210.

The trier of fact determining fair market value must weigh all relevant evidence and draw appropriate inferences. See Hamm v. Commissioner, 325 F.2d 934, 938 (8th Cir. 1963), affg. T.C. Memo 1961-347; Estate of Andrews v. Commissioner, 79 T.C. 938 (1982). Reviewing the facts of this case, at the date of death, decedent owned a 99-percent limited partnership interest in SFLP and a 47- percent interest in Stranco, the 1-percent owner and general partner of SFLP. Approximately 75 percent of the partnership's value consisted of cash and securities. It is unlikely and plainly contrary to the interests of a hypothetical seller to sell these interests separately and without regard to the liquidity of the underlying assets. SFLP was not a risky business or one in which the continuing value of the assets depended on continuing operations.

Each of the parties in this case presented expert valuation testimony. The experts agreed that the appropriate methodology was the "net asset value" approach. Each expert determined and applied a minority interest discount and a marketability discount to the net asset value of the partnership assets.

Both petitioner's expert and respondent's expert determined that a 25-percent lack of marketability discount was appropriate. Only respondent's expert, however, considered decedent's ownership of Stranco stock. We agree with respondent that the relationship between the limited partnership interest and the interest in Stranco cannot be disregarded. The entities were created as a unit and operated as a unit and were functionally inseparable.

In valuing decedent's 99-percent limited partnership interest on the date of death, respondent's expert applied an 8- percent minority interest discount and a 25-percent marketability discount, to reach a combined (rounded) discount of 31 percent. Respondent's expert valued decedent's 47-percent interest in Stranco by applying a 5-percent minority interest discount and a 15-percent marketability discount, to reach a combined (rounded) discount of 19 percent. Petitioner's expert applied a 25-percent minority interest discount and a 25-percent marketability discount, resulting in an effective total discount of 43.75 percent to the partnership. He did not value petitioner's interest in Stranco because he believed that the relationship was irrelevant. In our view, his result is unreasonable and must be rejected.

Respondent's expert selected the lower minority interest discount after considering the effective control of the limited partnership interest and the interest in Stranco and considering the detailed provisions of the partnership agreement and the shareholders' agreement. He examined closed-end funds, many of which are traded on major exchanges, and determined the range of discounts from net asset value for those funds. He selected a discount toward the lower end of the range. His analysis was well documented and persuasive. As respondent notes, normally a control premium would apply to an interest having effective control of an entity.

Petitioner argues that consideration of the stock interest in Stranco in valuing the limited partnership interest is erroneous because the shareholders' agreement granted the corporation and the other shareholders the right to purchase a selling shareholder's stock. While the shareholders' agreement may be a factor to be considered in determining fair market value, it does not persuade us that a hypothetical seller would not market the interest in the limited partnership and the interest in the corporation as a unit or that a transaction would actually take place in which only the partnership interest or the stock interest was transferred. Under the circumstances, the shareholders' agreement is merely a factor to be taken into account but not to be given conclusive weight. Cf. Estate of Hall v. Commissioner, 92 T.C. 312, 335 (1989); Estate of Lauder v. Commissioner, T.C. Memo 1994-527.

In view of our rejection of respondent's belated attempt to raise section 2036 and respondent's request that we disregard the partnership agreement altogether, we are constrained to accept the evidence concerning discounts applicable to decedent's interest in the partnership and in Stranco as of the date of death. We believe that the result of respondent's expert's discounts

may still be overgenerous to petitioner, but that result is the one that we must reach under the evidence and under the applicable statutes.

We have considered the other arguments of the parties, and they do not affect our analysis. To reflect the foregoing and the stipulated adjustments,

Decision will be entered under Rule 155.

Reviewed by the Court.

CHABOT, WHALEN, COLVIN, HALPERN, CHIECHI, and THORNTON, JJ., agree with this majority opinion.

LARO, J., concurs in this opinion.

* * * * *

WELLS, C.J., concurring: Respectfully, although I concur in the result reached by the majority in the instant case, I wish to express my disagreement with the majority's application of the economic substance doctrine. The majority rejects the alleged business purposes underlying the formation of the disputed partnership but then concludes that the partnership "had sufficient substance to be recognized for tax purposes", majority op. p. 16, because the partnership was validly formed under State law, which altered the legal relationships between the decedent and others.

I believe that the majority's stated reasons for holding that the partnership had substance misapplies the economic substance doctrine. In cases such as ACM Pshp. v. Commissioner, 157 F.3d 231 (3d Cir. 1998), affg. in part and revg. in part on another issue T.C. Memo 1997-115, where the economic substance doctrine is applied to deny income tax benefits, the doctrine is applied regardless of the validity of the partnership under State law. Because the majority has rejected the alleged business purposes underlying the formation of the partnership in issue in the instant case, a proper application of the economic substance doctrine, if it were to apply, would ignore the partnership and disallow the discounts for minority interest and lack of marketability.

I believe that, rather than holding that the economic substance doctrine is satisfied in the instant case, the Court should conclude that the economic substance doctrine does not apply to disregard a validly formed entity where the issue is the value for Federal gift and estate tax purposes of the interest transferred in that entity. In that regard, I agree with Judge Foley's concurring opinion in Knight v. Commissioner, 115 T.C. No. 36 (2000).

FOLEY, J., agrees with this concurring opinion.

* * * * *

PARR, J., dissenting: The majority, citing Frank Lyon Co. v. United States, 435 U.S. 561, 583-584, 55 L. Ed. 2d 550, 98 S. Ct. 1291 (1978), states: "the tax effects of a particular transaction are determined by the substance of the transaction rather than by its form." Majority op. p. 11. The majority also cites a long line of cases, see Helvering v. Clifford, 309 U.S. 331, 336, 84 L. Ed. 788, 60 S. Ct. 554 (1940); Kuney v. Frank, 308 F.2d 719, 720 (9th Cir. 1962); Frazee v. Commissioner, 98 T.C. 554, 561 (1992); Harwood v. Commissioner, 82 T.C. 239, 258 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986); Estate of Kelley v. Commissioner, 63 T.C. 321, 325 (1974); Estate of Tiffany v. Commissioner, 47 T.C. 491, 499 (1967), that require the Court to closely scrutinize family partnerships "because the family relationship 'so readily lends itself to paper arrangements having little or no relationship to reality.'" Majority op. p. 12 (quoting Kuney v. Frank, 308 F.2d 719, 720 (9th Cir. 1962)).

The majority is "skeptical of the estate's claims of business purposes related to executor and attorney's fees or potential tort claims", majority op. p. 13, is not persuaded that SFLP was formed to protect assets from will contests, does not believe that a joint investment vehicle was the purpose of the partnership, found that the formation and control of SFLP were orchestrated by Mr. Gulig without regard to joint enterprise, and found that the management of the assets contributed to SFLP was not the purpose of SFLP.

In this case, the facts clearly demonstrate that the paper arrangement, the written partnership agreement, had no relationship to the reality of decedent's ownership and control of the assets contributed to the partnership. Although under the partnership agreement a limited partner could not demand a distribution of partnership capital or income, the partnership (1) paid for Stone's surgery when she injured her back while caring for decedent, (2) distributed $ 3,187,800 to decedent's estate for State and Federal estate and inheritance taxes, (3) distributed $ 563,000 in 1995 and 1996 and $ 102,500 in 1998 to each of the Strangi children, (4) divided its primary Merrill Lynch account into four separate accounts in each of the Strangi children's names, (5) extended lines of credit to John Strangi, Albert T. Strangi, and Mrs. Gulig, and (6) advanced to decedent's estate $ 3.32 million to

post bonds with the Internal Revenue Service. It is clear that, contrary to the written partnership agreement, decedent and his successor in interest to his partnership interest (decedent's estate) had the ability to withdraw funds at will. If a hypothetical third party had offered to purchase the assets held by the partnership for the full fair market value of those assets, there is little doubt that decedent could have had the assets distributed to himself to complete the sale.

The majority, however, holds that, because the formalities were followed and SFLP was validly formed under State law, the partnership had sufficient substance to be recognized for tax purposes. The majority then values decedent's partnership interest as if the restrictions in the written partnership agreement were actually binding on the partners. The majority states, "The actual control exercised by Mr. Gulig, combined with the 99-percent limited partnership interest in SFLP and the 47-percent interest in Stranco, suggest the possibility of including the property transferred to the partnership in decedent's estate under section 2036." Majority op. p. 15. It seems incongruous that for purposes of section 2036 this Court could look to the actual control decedent exercised over the assets of the partnership, but for purposes of determining the appropriate discounts for valuing decedent's interest in the partnership this Court is limited to the written partnership agreement.

Assuming, arguendo, that the partnership must be recognized for Federal estate tax purposes, I would value the interest under the agreement that existed in fact, rather than under the written partnership agreement that had no relationship to the reality of decedent's ownership and control of the assets contributed to the partnership.

A person who maintains control over the ultimate disposition of property is, in practical effect, in a position similar to the actual owner of the property. See, e.g., Estate of Kurz v. Commissioner, 101 T.C. 44, 50-51, 59-60 (1993), supplemented by T.C. Memo 1994-221, affd. 68 F.3d 1027 (7th Cir. 1995). The Court should not allow a taxpayer who is not in fact limited by an agreement to claim a discount that is premised on that very limitation. A minority discount is allowed because a limited partner cannot cause the partnership to make distributions. Decedent and decedent's estate in fact caused the partnership to make distributions at will. The minority discount is not appropriate in this case.

Additionally, a discount for lack of marketability is allowed because a hypothetical third party would pay less for the partnership interest than for the assets. But in this case, under the actual partnership arrangement, decedent could have had all the assets distributed to himself and then sold them directly to the buyer. The lack of marketability discount, therefore, also is inappropriate in this case. Because the actual partnership arrangement provided for distributions at will, I would value the partnership interest at the value of the partnership's assets without any discount.

For the above reasons, I respectfully dissent.

BEGHE and MARVEL, JJ., agree with this dissenting opinion.

* * * * *

RUWE, J., dissenting: Decedent transferred property to a newly formed partnership in return for a 99-percent limited partnership interest. This was done 2 months before he died, as part of a plan to reduce tax on his estate. The estate presented testimony to support its argument that these actions were taken for business purposes. The trial judge clearly rejects these arguments and describes the testimony offered by the estate as "mere window dressing to conceal tax motives." Majority op. p. 13. Tax savings was the only motivating factor for transferring property to the partnership. Nevertheless, the majority validates this scheme by valuing decedent's 99-percent partnership interest at 31 percent below the value of the property that decedent transferred to the partnership.

Respondent argues that if the partnership interest that decedent received is to be valued at 31 percent less than the value of the property that decedent transferred to the partnership, then the difference should be considered to be a gift. The majority rejects respondent's gift argument. n1

n1 One of the reasons given by the majority for rejecting respondent's gift argument is "we do not believe that decedent gave up control over the assets". Majority op. p. 21. This finding is inconsistent with the majority's allowance of a 31 percent discount. If decedent owned assets worth $ 9,876,929, transferred legal title to those assets to a partnership in which he had a beneficial interest that exceeded 99 percent, and thereafter retained control over the transferred assets, how could the value of his property rights be 31 percent less after the transfer? Certainly, a hypothetical willing buyer and seller with reasonable knowledge of the relevant facts would be aware that decedent's property interests included control over the assets. The majority's analysis fails to adequately explain this apparent anomaly.

Respondent's gift tax argument is supported by the applicable statutes, regulations, and controlling opinions. If the value of the property that decedent transferred to the partnership was more than the value of the consideration that he received, and the transfer was not made for bona fide nontax business reasons, then the amount by which the value of the property transferred exceeds the value of the consideration is deemed to be a gift pursuant to section 2512(b).

Section 2512(b) provides:

SEC. 2512. VALUATION OF GIFTS.

(b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

Section 25.2512-8, Gift Tax Regs., provides:

Sec. 25.2512-8. Transfers for insufficient consideration.

-- Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor.

* * *

Transactions made in the ordinary course of business are exempt from

the above gift tax provisions. Thus, section 25.2512-8, Gift Tax

Regs., provides:

However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth. * * *

The Supreme Court has described previous versions of the gift tax statutes (section 501 imposing the tax on gifts and section 503 which is virtually identical to present section 2512(b)) in the following terms:

Sections 501 and 503 are not disparate provisions. Congress directed them to the same purpose, and they should not be separated in application. Had Congress taxed "gifts" SIMPLICITER, it would be appropriate to assume that the term was used in its colloquial sense, and a search for "donative intent" would be indicated. But Congress intended to use the term "gifts" in its broadest and most comprehensive sense. H. Rep. No. 708, 72d Cong., 1st Sess., p.27; S. Rep. No. 665, 72d Cong., 1st Sess., p.39; cf. Smith v. Shaughnessy, 318 U.S. 176, 87 L. Ed. 690, 63 S. Ct. 545; Robinette v. Helvering, 318 U.S. 184, 87 L. Ed. 700, 63 S. Ct. 540. Congress chose not to require an ascertainment of what too often is an elusive state of mind. For purposes of the gift tax it not only dispensed with the test of "donative intent." It formulated a much more workable external test, that where "property is transferred for less than an adequate and full consideration in money or money's worth," the excess in such money value "shall, for the purpose of the tax imposed by this title, be deemed a gift..." And Treasury Regulations have emphasized that common law considerations were not embodied in the gift tax.

To reinforce the evident desire of Congress to hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech, the Treasury Regulations make clear that no genuine business transaction comes within the purport of the gift tax by excluding "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)." Treas. Reg. 79 (1936 ed.) Art. 8. THUS ON FINDING THAT A TRANSFER IN THE CIRCUMSTANCES OF A PARTICULAR CASE IS NOT MADE IN THE ORDINARY COURSE OF BUSINESS, THE TRANSFER BECOMES SUBJECT TO THE GIFT TAX TO THE EXTENT THAT IT IS NOT MADE "FOR AN ADEQUATE AND FULL CONSIDERATION IN MONEY OR MONEY'S WORTH." See 2 Paul, Federal Estate and Gift Taxation (1942) p. 1113. [Commissioner v. Wemyss, 324 U.S. 303, 306, 89 L. Ed. 958, 65 S. Ct. 652 (1945); fn. ref. omitted; emphasis added.]

In light of what the Supreme Court said, the estate attempted to portray the transfer of property to the partnership as a business transaction. The majority soundly rejects this as a masquerade. Indeed, it is clear that the transfer was made to reduce the value of decedent's assets for estate tax purposes, while at the same time allowing the full value of decedent's property to pass to his children.

The Supreme Court has described the objective of the gift tax as follows:

The section taxing as gifts transfers that are not made for "adequate and full [money] consideration" aims to reach those transfers which are withdrawn from the donor's estate. * * * [Commissioner v. Wemyss, supra at 307.]

Under the applicable gift tax provisions and Supreme Court precedent,

it is unnecessary to consider what decedent's children received on

the date of the transfer in order to determine the value of the

deemed gift under section 2512(b). Indeed, it is not even necessary

to identify the donees. Section 25.2511-2(a), Gift Tax Regs.,

provides:

Sec. 25.2511-2. Cessation of donor's dominion and control.

-- (a) The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or

ascertainable.

In Robinette v. Helvering, 318 U.S. 184, 87 L. Ed. 700, 63 S. Ct. 540 (1943), the taxpayer argued that there could be no gift of a remainder interest where the putative remaindermen (prospective unborn children of the grantor) did not even exist at the time of the transfer. The Supreme Court rejected this argument stating that the gift tax is a primary and personal liability of the donor measured by the value of the property passing from the donor.

This case involves an attempt by a dying man (or his attorney) to transfer property to a partnership in consideration for a 99-percent partnership interest that would be valued at substantially less than the value of the assets transferred to the partnership, while at the same time assuring that 100 percent of the value of the transferred assets would be passed to decedent's beneficiaries. Assuming, as the majority has found, that decedent's partnership interest was worth less than the property he transferred, n2 section 2512(b) should be applied. Pursuant to that section the excess of the value of the property decedent transferred to the partnership over the value of the consideration he received is "deemed a gift" subject to the gift tax. By failing to apply section 2512(b) in this case, the majority thwarts the purpose of section 2512(b) which the Supreme Court described as "the evident desire of Congress to hit all the protean arrangements which the wit of man can devise that are not business transactions". Commissioner v. Wemyss, supra at 306.

n2 The majority's allowance of a 31-percent discount is in stark contrast to its rejection of respondent's gift argument on the ground that decedent did not give up control of the assets when he transferred them to the partnership. See majority op. p. 21. While the basis for finding that decedent did not give up control of the assets is not fully explained, it appears not to be based on the literal terms of the partnership agreement which gave control to Stranco, the corporate general partner. Decedent owned only 47 percent of the Stranco stock. Since the majority also rejects respondent's economic substance argument, the only other conceivable basis for concluding that decedent retained control over the assets that he contributed to the partnership is that the partnership arrangement was a factual sham. If that were the case, the partnership arrangement itself would be "mere window dressing" masking the true facts and the terms of the partnership arrangement should be disregarded. In an analogous situation the Court of Appeals for the Tenth Circuit disregarded the written terms of a transfer document as fraudulent. See Heyen v. United States, 945 F.2d 359 (10th Cir. 1991).

PARR, BEGHE, GALE, and MARVEL, JJ., agree with this dissenting opinion.

* * * * *

BEGHE, J., dissenting: Having joined the dissents of Judges Parr and Ruwe, I write separately to describe another path to the conclusion that SFLP had no effect on the value of Mr. Strangi's gross estate under sections 2031 and 2033. In my view, the property to be valued is the property originally held by Mr. Strangi, the so- called contributed property. Notwithstanding that the property in question may have been contributed to a partnership formed on Mr. Strangi's behalf in exchange for a 99-percent limited partnership interest, we're not bound to accept the estate's contention that the property to be valued is its interest in SFLP, subject to all the disabilities and resulting valuation discounts entailed by ownership of an interest in a limited partnership. Instead, the facts of this case invite us to use the end-result version of the step-transaction doctrine to treat the underlying partnership assets -- the property originally held by the decedent -- as the property to be valued for estate tax purposes.

The value of property for transfer tax purposes 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 to sell and both having reasonable knowledge of relevant facts. See United States v. Cartwright, 411 U.S. 546, 550-551, 36 L. Ed. 2d 528, 93 S. Ct. 1713 (1973); sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512-1, Gift Tax Regs. The majority state that SFLP's existence "would not be disregarded by potential purchasers of decedent's assets"; the majority also suggest that this is why the partnership should not be disregarded as a substantive sham. See majority op. p. 16.

I support the use of substance over form analysis to decide whether a transaction qualifies for the tax-law defined status its form suggests. A formally correct transaction without a business purpose may not be a "reorganization", and a title holder of property without an economic interest may not be the tax "owner". However, I share the majority's concerns about using substance over form analysis to alter the conclusion about a real-world fact, such as the fair market value of property, which the law tells us is the price at which the property actually could be sold. n1

n1 Against the grain of the majority's conclusions that the SFLP arrangements were neither a factual sham nor a substantive sham, I would observe that another "conceivable basis for concluding that decedent retained control over the assets that he contributed to the partnership" (Ruwe, J., dissenting opinion page 38 note 2) are the multiple roles played by Mr. Gulig, who had decedent's power of attorney and caused himself to be employed by Stranco to manage the affairs of SFLP, and the tacit understanding of the other family members that he would look out for their interests. Although I would agree with the majority that use of substantive sham analysis may not be appropriate in transfer tax cases, I believe that factual sham analysis can be used in appropriate cases in the transfer tax area and that the case at hand is one of those cases; the terms of the SFLP partnership agreement should be disregarded because the parties to the agreement didn't pay any attention to them. Cf. Heyen v. United States, 945 F.2d 359 (10th Cir. 1991). To adapt to the case at hand the hypothetical posed by the Court of Appeals in Citizens Bank & Trust Co. v. Commissioner, 839 F.2d 1249, 1254-1255 (7th Cir. 1988), the magic marker the Guligs used to paint the mustache on the Mona Lisa was filled with disappearing ink. However, the discussion in the text is presented as an alternative to a factual sham analysis.

Although my approach to the case at hand employs a step- transaction analysis, which is a variant of substance over form, I do not use that analysis to conclude anything about fair market value. Instead, I use it to identify the property whose transfer is subject to tax. Step-transaction analysis has often been used in transfer tax cases to identify the transferor or the property transferred.

The step-transaction doctrine is a judicially created concept that treats a series of formally separate "steps" as a single transaction if those steps are "in substance integrated, interdependent and focused toward a particular end result." Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987). The most far-reaching version of the step-transaction doctrine, the end-result test, applies if it appears that a series of formally separate steps are really prearranged parts of a single transaction that are intended from the outset to reach the ultimate result. See Penrod v. Commissioner, 88 T.C. at 1429, 1430 (citing Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 86 L. Ed. 775, 62 S. Ct. 540 (1942); South Bay Corp. v. Commissioner, 345 F.2d 698 (2d Cir. 1965); Morgan Manufacturing Co. v. Commissioner, 124 F.2d 602 (4th Cir. 1941); Heintz v. Commissioner, 25 T.C. 132 (1955); Ericsson Screw Machine Prods. Co., v. Commissioner, 14 T.C. 757 (1950); King Enters., Inc. v. United States, 189 Ct. Cl. 466, 475, 418 F.2d 511, 516 (1969)). The end- result test is flexible and grounds tax consequences on what actually happened, not on formalisms chosen by the participants. See Penrod v. Commissioner, supra.

The sole purpose of the transactions orchestrated by Mr. and Mrs. Gulig was to reduce Federal transfer taxes by depressing the value of Mr. Strangi's assets as they passed through his gross estate, to his children, via the partnership. The arrangement merely operated to convey the assets to the same individuals who would have received the assets in any event under Mr. Strangi's will. Nothing of substance was intended to change as a result of the transactions and, indeed, the transactions did

nothing to affect Mr. Strangi's or his children's interests in the underlying assets except to evidence an effort to reduce Federal transfer taxes. The control exercised by Mr. Strangi and his children over the assets did not change at all as a result of the transactions. For instance, shortly after Mr. Strangi's death SFLP made substantial distributions to the children, the Merrill Lynch account was divided into 4 separate accounts to allow each child to control his or her proportionate share of SFLP assets, and distributions were made to the estate to enable it to pay death taxes and post a bond. Mr. Strangi's testamentary objectives are further evidenced by his practical incompetency and failing health at formation and funding of SFLP and Stranco and the short time between the partnership transactions and Mr. Strangi's death.

The estate asserts that property with a stated value of $ 9,876,929, in the form of cash and securities, when funneled through the partnership, took on a reduced value of $ 6,560,730. It is inconceivable that Mr. Strangi would have accepted, if dealing at arm's length, a partnership interest purportedly worth only two- thirds of the value of the assets he transferred. This is especially the case given Mr. Strangi's age and health, because it would have been impossible for him ever to recoup this immediate loss.

It is also inconceivable that Mr. Strangi (or his representatives) would transfer the bulk of his liquid assets to a partnership, in exchange for a limited interest (plus a minority interest in the corporate general partner) that would terminate his control over the assets and their income streams, if the other partners had not been family members. See Estate of Trenchard v. Commissioner, T.C. Memo 1995-121; there the Court found "incredible" the assertion of the executrix that the decedent's transfer of property to a family corporation in exchange for stock was in the ordinary course of business. It is clear that the sole purpose of SFLP was to depress the value of Mr. Strangi's assets artificially for a brief time as the assets passed through his estate to his children. See Estate of Murphy v. Commissioner, T.C. Memo 1990-472, in which this Court denied decedent's estate a minority discount on a 49.65-percent stock interest because the prior inter vivos transfer of a 1.76-percent interest did "not appreciably affect decedent's beneficial interest except to reduce Federal transfer taxes." Estate of Murphy v. Commissioner, supra, 60 T.C.M. (CCH) 645, 661, 1990 T.C.M. (RIA) par. 90,472, at 90-2261.

Thus, under the end-result test, the formally separate steps of the transaction (the creation and funding of the partnership within 2 months of Mr. Strangi's death, the substantial outright distributions to the estate and to the children, and the carving up of the Merrill Lynch account) that were employed to achieve Mr. Strangi's testamentary objectives should be collapsed and viewed as a single integrated transaction: the transfer at Mr. Strangi's death of the underlying assets.

In many cases courts have collapsed multistep transactions or recast them to identify the parties (usually the donor or donee) or the property to be valued for transfer tax purposes. See, e.g., Estate of Bies v. Commissioner, T.C. Memo 2000-338 (identifying transferors for purposes of gift tax annual exclusions); Estate of Cidulka v. Commissioner, T.C. Memo 1996-149 (donor's gift of minority stock interests to shareholders followed by a redemption of donor's remaining shares treated as single transfer of a controlling interest); Estate of Murphy v. Commissioner, supra (decedent's inter vivos transfer of a minority interest followed by a testamentary transfer of her remaining shares treated as an integrated plan to transfer control to decedent's children); Griffin v. United States, 42 F. Supp. 2d 700 (W.D. Tex. 1998) (transfer of 45 percent of donor's stock to donor's spouse followed by a transfer by spouse and donor of all their stock to a trust for the benefit of their child treated as one gift by donor of the entire block). n2

n2 In Griffin v. United States, 42 F. Supp. 2d 700, 706 n.4 (W.D. Tex. 1998), the court distinguished Estate of Frank v. Commissioner, T.C. Memo 1995-132, where this Court declined to integrate the steps of the transaction.

The reciprocal trust doctrine, another application of substance over form, has been used in the estate and gift tax area to determine who is the transferor of property for the purposes of inclusion in the gross estate. See United States v. Grace, 395 U.S. 316, 321, 23 L. Ed. 2d 332, 89 S. Ct. 1730 (1969) (applying the reciprocal trust doctrine in the estate tax context to identify the grantor, and quoting with approval Lehman v. Commissioner, 109 F.2d 99, 100 (2d Cir. 1940): "The law searches out the reality and is not concerned with the form."). More recently, Sather v. Commissioner, T.C. Memo 1999-309, applied the reciprocal trust doctrine to cut down the number of present interest annual exclusions for gift tax purposes:

We must peel away the veil of cross-transfers to seek out the economic substance of the foregoing series of transfers.

* * *

* * * * * * *

We are led to the inescapable conclusion that the form in which the transfers were cast, i.e., gifts to the nieces and nephews, had no purpose aside from the tax benefits petitioners sought by way of inflating their exclusion amounts. The substance and purpose of the series of transfers was for each married couple to give to their own children their Sathers stock. After the transfers, each child was left in the same economic position as he or she would have been in had the parents given the stock directly to him or her. Each niece and nephew received an identical amount of stock from his or her aunts and uncles and was left in the same economic position in relation to the others. This was not a coincidence but rather was the result of a plan among the donors to give gifts to their own children in a form that would avoid taxes. * * * [Sather v.

Commissioner, T.C. Memo 1999-309, 78 T.C.M. (CCH) 456, 459-460, 1999 T.C.M. (RIA) par. 99,309, at 99-1964-99-1965.]

All this is set out most clearly in our reviewed opinion in Bischoff v. Commissioner, 69 T.C. 32 (1977), as explained by the Court of Appeals for the Federal Circuit in Exchange Bank & Trust Co. v. United States, 694 F.2d 1261, 1269 (Fed. Cir. 1982): "We agree with the majority in Bischoff and the appellee in this action [the United States] that the reciprocal trust doctrine merely identifies the true transferor, but the actual basis for taxation is founded upon specific statutory authority."

In Estate of Montgomery v. Commissioner, 56 T.C. 489 (1971), affd. 458 F.2d 616 (5th Cir. 1972), an elderly decedent, who was otherwise uninsurable, purchased a single premium annuity and was thereby able to obtain life insurance hat he assigned to trusts. The Court held that the arrangement was not life insurance within the meaning of the parenthetical exception contained in section 2039, and therefore, the proceeds of the policies were includable in decedent's gross estate. In so holding, the Court used the language of step transactions to find that the annuity and insurance were part of a single investment agreement.

Daniels v. Commissioner, T.C. Memo 1994-591, applied the step-transaction doctrine in a gift tax case in favor of the taxpayers to conclude that an outright gift of common stock to children and a simultaneous exchange of some common for preferred were parts of the same gift. As a result, the Commissioner's belated attempt to tax the imbalance in values on the common-preferred exchange was barred by the statute of limitations. My conclusion that the property to be valued for estate tax purposes should be the property transferred to SFLP is further supported by the decision of Citizens Bank & Trust Co. v. Commissioner, 839 F.2d 1249 (7th Cir. 1988), affg. Northern Trust Co. v. Commissioner, 87 T.C. 349 (1986). There, the Court of Appeals for the Seventh Circuit held that the taxable value of a gift is not altered by the terms of the conveyance; therefore, "restrictions imposed in the instrument of transfer are to be ignored for purposes of making estate or gift tax valuations". 839 F.2d at 1252-1253. I conclude that the formation of SFLP and subsequent distributions of partnership assets should be treated as parts of a single, integrated transaction, and that the SFLP agreement is properly viewed as a restriction included in the testamentary conveyance to the Strangi children. Accordingly, under Citizens Bank & Trust Co. v. Commissioner, supra, and the other authorities previously discussed, any reduction in values allegedly caused by the SFLP agreement should be disregarded; under sections 2031 and 2033, the contributed property is the property to be included and valued in the gross estate.

PARR, J., agrees with this dissenting opinion.

Full Text of Court Cases

Gulig (Estate of Strangi) v. Commissioner (II)

Case name: Gulig (Estate of Strangi) v. Commissioner (II)
Citation: 293 F.3d 279, 2002 U.S. App. LEXIS 11920
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Type of action: Estate and Gift Taxation
Judge: Clement
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1377

Keywords: Estate tax, Internal Revenue Service (IRS)

IN THE UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 01-60538

ROSALIE GULIG, Independent Executrix, on behalf of

the Estate of Albert Strangi, Deceased,

Petitioner-Appellee,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

Appeal from a Decision of

the United States Tax Court

June 17, 2002

Before DUHÉ, DeMOSS, and CLEMENT, Circuit Judges.

CLEMENT, Circuit Judge:I. FACTS AND PROCEEDINGS

In August 1994, Michael Gulig, as decedent Albert Strangi's attorney in fact,(1) (http://www.ca5.uscourts.gov/opinions/pub/01/01-60538-cv0.htm#N_1_) formed Strangi Family Limited Partnership ("SFLP") and its corporate general partner, Stranco, Inc. ("Stranco"), under Texas law. Strangi purchased 47 percent of Stranco for $49,350 and his four children purchased the remaining 53 percent for $55,650.(2) (http://www.ca5.uscourts.gov/opinions/pub/01/01-60538-cv0.htm#N_2_) Stranco transferred $100,333 to SFLP in return for a 1 percent general partnership interest. Strangi transferred property with a fair market value of $9,876,929, approximately 75 percent of which was cash and securities, to SFLP for a 99 percent limited partnership interest.

Decedent and his four children sat on Stranco's initial board of directors, with Rosalie Gulig serving as president. The partnership agreement provided that Stranco had sole authority over SFLP's business affairs; limited partners needed Stranco's consent to act on SFLP's behalf. Stranco employed Michael Gulig to manage the day-to-day affairs of SFLP and Stranco. SFLP's partnership agreement allowed it to lend money to partners, affiliates, or other persons or entities. Decedent's estate and the Strangi children have received various distributions from SFLP. On August 18, 1994, a charitable gift of 100 Stranco shares was given to McLennan Community College Foundation in decedent's memory.

Domiciled in Waco, Texas, Strangi died of cancer at the age of 81 on October 14, 1994. When decedent's will was admitted to probate on April 12, 1995, Rosalie Gulig was appointed sole executor of the estate. No claim against the estate or will contest was filed.

Strangi's estate reported Strangi's interest in SFLP as having a date-of-death value of $6,560,730, approximately $3 million lower than the value the assets had at the time of transfer from Strangi to the partnership. At the date of death, the property held by SFLP had increased in value to $11,100,922 due to the appreciation of securities. The valuation report applied a combined 33 percent minority interest discount for lack of marketability and lack of control.

On December 1, 1998, the Internal Revenue Service ("IRS") issued a notice of deficiency for $2,545,826 in federal estate taxes or, alternatively, $1,629,947 in federal gift taxes. Rosalie Gulig petitioned the tax court for a redetermination of the deficiencies. The tax court, sitting in review, considered whether SFLP should be disregarded for tax purposes under the business purpose and economic substance doctrine or alternatively as a restriction on the sale or use of property under I.R.C. § 2703(a)(2). Determining (with a 9-5 decision) that the partnership had economic substance and that § 2703 did not apply, the court proceeded to consider whether a taxable gift occurred to the extent that the value of assets Strangi transferred exceeded the value of his partnership interest and also determined the fair market value of decedent's interest at the date of death. Finding that Strangi retained enough control over the assets transferred to compensate for the disparity between value given and value received, the court did not find a taxable gift. The court accepted the 31 percent combined discount reached by the IRS's expert. Though ruling for the estate on all claims except valuation, the tax court suggested that if the Commissioner had timely filed his notice to amend to add an I.R.C. § 2036 claim, it probably would have used that section to include in the estate the assets Strangi transferred to SFLP.

II. ANALYSIS

A. Leave to amend to add a § 2036 claim

Fifty-two days before trial, the Commissioner filed a motion to amend to add a claim that under § 2036 the estate should include the value of SFLP's assets transferred from the decedent. The tax court denied the motion to amend, apparently because it considered the motion untimely. We review the tax court's decision to deny leave to amend for abuse of discretion. Halbert v. City of Sherman, Tex., 33 F.3d 526, 529 (5th Cir. 1994). "A decision to grant leave is within the discretion of the court, although if the court lacks a substantial reason to deny leave, its discretion is not broad enough to permit denial." State of Louisiana v. Litton Mortgage Co., 50 F.3d 1298, 1302-03 (5th Cir. 1995) (internal citations and quotes omitted). "In the absence of any apparent or declared reason--such as undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of allowance of the amendment, futility of amendment, etc.--the leave sought should, as the rules require, be 'freely give.'" Foman v. Davis, 371 U.S. 178, 182 (1962).

The only insight we have into the tax court's reasoning for the denial is its statement that, even though § 2036 might apply on the facts, it was "not an issue in this case, however, because respondent asserted it only in a proposed amendment to answer tendered shortly before trial. Respondent's motion to amend the answer was denied because it was untimely." However, the motion was made nearly two months, not "shortly," before trial and was unlikely to cause delay or prejudice. If the tax court's true reasoning was that the Commissioner could have sought to assert the applicability of § 2036 earlier in the proceedings, it did not assert such and did not discuss any evidence of bad faith or dilatory motive. We cannot assume bad faith on the record here. The record does not present an obvious reason for denial

of leave to amend. See Ashe v. Corley, 992 F.2d 540, 542-43 (5th Cir. 1993) ("Where reasons for denying leave to amend are 'ample and obvious,' the district court's failure to articulate specific reasons does not indicate an abuse of discretion."). We find that the denial was an abuse of discretion.

B. Business purpose and economic substance doctrine

We review the question of whether SFLP has a business purpose and economic substance, such that it should not be disregarded for tax purposes, for clear error. See Merryman v. Commissioner, 873 F.2d 879, 881 (5th Cir. 1989); ACM Partnership v. Commissioner, 157 F.3d, 231, 245 (3rd Cir. 1998). Under this standard of review, we agree with the tax court that the partnership has enough economic substance for SFLP to be recognized for federal estate tax purposes.

As the tax court noted, "[m]ere suspicion and speculation about a decedent's estate planning and testamentary objectives are not sufficient to disregard an agreement in the absence of persuasive evidence that the agreement is not susceptible of enforcement or would not be enforced by parties to the agreement." See Hall v. Commissioner of Internal Revenue, 92 T.C. 312, 335 (1989). SFLP's partnership agreement changed the legal relationships between decedent and his heirs and creditors. Potential purchasers of decedent's assets would not disregard the partnership. As the tax court stated, " [r]egardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes."

C. The remaining claims

Having carefully reviewed the record and read the briefs, we affirm the tax court's conclusions regarding § 2703 for essentially the reasons stated in that court's opinion. Section 2703 does not alter the determination that the estate included the decendent's interests in SFLP and Stranco and the tax court did not have to consider the applicability of the safe harbor provisions of section 2703(b) to the partnership agreement. We also affirm the tax court's conclusion that decedent's transfer of property to the partnership was not a taxable gift for essentially the reasons stated in that court's opinion. Finally, we adopt the tax court's ruling concerning the discounts and the fair market value of decedent's interest in SFLP at the date of death. However, the tax court may revisit this topic after considering the § 2036 claim.

III. CONCLUSION

We REVERSE the tax court's denial of leave to amend and REMAND for consideration of the § 2036 claim. We AFFIRM all other conclusions made by the tax court.

1. On July 19, 1988, decedent executed a power of attorney, naming Michael Gulig his attorney in fact. Michael Gulig is petitioner's husband and decedent's son-in-law.

2. Rosalie Gulig loaned her siblings the money needed to purchase the Stranco shares. Jeanne, John, and Albert T. Strangi each executed unsecured notes to Rosalie Gulig, with face amounts of $13,912.50 and an interest rate of 8 percent.

T.C. Memo. 2003-145

UNITED STATES TAX COURT

ESTATE OF ALBERT STRANGI, DECEASED, ROSALIE GULIG, INDEPENDENT EXECUTRIX, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent*

Docket No. 4102-99. Filed May 20, 2003.

Norman A. Lofgren, G. Tomas Rhodus, and Michael C. Kelsheimer, for petitioner.

Gerald L. Brantley, Lillian D. Brigman, Janice B. Geier, and John D. MacEachen, for respondent.

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* This opinion supplements our previously filed opinion in Estate of Strangi v. Commissioner, 115 T.C. 478 (2000), affd. in part and revd. and remanded in part 293 F.3d 279 (5th Cir. 2002).

SUPPLEMENTAL MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: This matter is before the Court on remand from the Court of Appeals for the Fifth Circuit for further consideration consistent with its opinion in Estate of Strangi v. Commissioner, 293 F.3d 279 (5th Cir. 2002) (Strangi II), affg. in part and revg. and remanding in part 115 T.C. 478 (2000) (Strangi I). The issue for decision on remand is whether the value of property transferred by Albert Strangi (decedent) to the Strangi Family Limited Partnership (SFLP) and Stranco, Inc. (Stranco), is includable in his gross estate pursuant to section 2036(a). Unless otherwise indicated, all section references are to the Internal Revenue Code in effect as of the date of death, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Facts with respect to this case were found in our original opinion in Strangi I and are incorporated by this reference. We summarize for convenience relevant facts from Strangi I and set forth additional findings for purposes of deciding the issue on remand.

General Background

Decedent and his first wife had four children: Jeanne, Rosalie, Albert T., and John Strangi (collectively the Strangi children). After divorcing his first wife in 1965, decedent

married Irene Delores Seymour (Mrs. Strangi), who had two daughters, Angela and Lynda Seymour (collectively the Seymour daughters), from a previous marriage. In 1985, Rosalie (hereinafter Mrs. Gulig) married Michael J. Gulig (Mr. Gulig), an attorney with the law firm of Sheehy, Lovelace and Mayfield, P.C., in Waco, Texas. On February 19, 1987, decedent and Mrs. Strangi executed wills that named the Strangi children and the Seymour daughters as residual beneficiaries in the event that either spouse predeceased the other.

During 1987 and 1988, Mrs. Strangi suffered a series of serious medical problems. In 1988, decedent and Mrs. Strangi decided to move from their then home in Fort Walton Beach, Florida, to Waco, Texas. To facilitate this move, decedent on July 19, 1988, executed a power of attorney naming Mr. Gulig as his attorney in fact and thereby authorizing Mr. Gulig, in decedent's "name, place and stead":

> To exercise, do, or perform any act, right, power, duty, or obligation whatsoever that I now have or may acquire * * * relating to any person, item, thing, transaction, business property, real or personal, tangible or intangible, or matter whatsoever;
>
> * * * * * * *
>
> To lease, purchase, exchange and acquire, and to bargain, contract, and agree for the lease, purchase, exchange, and acquisition of, and to take, receive and possess any real or personal property whatsoever, tangible or intangible, or interest therein, on such terms and conditions, and under such covenants as the attorney in fact shall deem proper;

> To improve, repair, maintain, manage, insure, rent, lease, sell, release, convey, subject to lien, mortgage, hypothecate, and in any way or manner deal with all or any part of any real or personal property whatsoever, intangible, or any interest therein, which I now own or may hereafter acquire, for me and in my name, and under such terms and conditions, and under such covenants as said attorney shall deem proper;
>
> To engage in and transact any and all lawful business of whatever nature or kind for me and in my name;
>
> To sign, endorse, execute, acknowledge, deliver, receive and possess such * * * [contracts, agreements, etc.] and such other instruments in writing of whatever kind and nature as may be necessary or proper in the exercise of the rights and powers herein granted.

Thus, among other things, Mr. Gulig was authorized to close the purchase of a residence in Waco. After the move to Waco, Sylvia Stone (Ms. Stone) was hired as decedent's housekeeper and also provided assistance with the care of Mrs. Strangi.

On July 31, 1990, decedent executed a new will, naming the Strangi children as the sole residual beneficiaries if Mrs. Strangi predeceased him. This will also designated Mrs. Gulig and Ameritrust Texas, N.A. (Ameritrust), as coexecutors of decedent's estate. Mrs. Strangi died on December 27, 1990.

During 1993, decedent had surgery to remove a cancerous mass from his back; was diagnosed with supranuclear palsy (a brain disorder that would gradually reduce his ability to speak, walk, and swallow); and had prostate surgery. Mr. Gulig thereafter took over decedent's affairs pursuant to the 1988 power of

attorney. Mr. Gulig also developed a close personal relationship with decedent after the death of Mrs. Strangi. Every morning, Mr. Gulig would visit decedent to have coffee and read the newspaper.

SFLP and Stranco

On August 11, 1994, Mr. Gulig attended a seminar provided by Fortress Financial Group, Inc. (Fortress), on the use of family limited partnerships as a tool for (1) asset preservation, (2) estate planning, (3) income tax planning, and (4) charitable giving. The following day, on August 12, 1994, Mr. Gulig, as decedent's attorney in fact, formed SFLP, a Texas limited partnership, and its corporate general partner, Stranco, a Texas corporation, and filed with the State of Texas the respective certificate of limited partnership and articles of incorporation. In August 1994 Mr. Gulig believed decedent had about 12 to 18 months to live. Mrs. Gulig expected decedent to survive about 2 years.

An Agreement of Limited Partnership of Strangi Family Limited Partnership (SFLP agreement) was prepared by Mr. Gulig using documents licensed from Fortress and sets forth the governing provisions for the entity. Stranco is designated therein as the managing general partner, the authority of which is broadly described as follows:

> Except as otherwise provided in this Agreement, the Managing General Partner of the Partnership, shall have

> the sole, exclusive and absolute right and authority to act for and on behalf of the Partnership and all of the Partners in connection with all aspects of the business of the Partnership.

More specifically, the SFLP agreement enumerates various rights, powers, and authorities of the managing general partner, including without limitation "to acquire, hold, lease, encumber, pledge, option, sell, exchange, transfer, dispose or otherwise deal with real or personal property (or rights or interests therein) of any nature whatsoever as may be necessary or advisable for the operation of the Partnership"; "to borrow or lend money for Partnership purposes"; and "to determine the use of the revenues of the Partnership for Partnership purposes". The SFLP agreement obligates the managing general partner to use its good faith efforts to manage partnership affairs in a prudent and businesslike manner and to act at all times in the best interests of the partnership. According to the SFLP agreement, limited partners are without "any authority or right to take part in the management of the business or transact any business" for the entity.

As regards distributions, the SFLP agreement provides that income from operations and capital transactions, after deduction for certain listed expenses:

> shall be distributed at such times and in such amounts as the Managing General Partner, in its sole discretion, shall determine, taking into account the reasonable business needs of the Partnership (including plan for expansion of the Partnership's business). The

> Managing General Partner's determination regarding whether or not to make distributions and the amount of distributions to be made shall be final and binding on all Partners. Such distributions shall be made to each Partner in accordance with such Partner's Interest in the Partnership.

Likewise, "Assets of the Partnership may be distributed in kind in the sole and absolute discretion of the Managing General Partner."

Pursuant to the SFLP agreement, the partnership would be dissolved and terminated upon: (1) A unanimous vote of the limited partners and unanimous consent of the general partners; (2) a decision of the managing general partner after the disposition of substantially all partnership assets; (3) an entry of judicial dissolution; (4) the death, insolvency, bankruptcy, removal, or withdrawal of any general partner, unless the limited partners within 90 days unanimously elect a new general partner to continue the business; (5) the involuntary transfer of a general partnership interest in the event there is only one general partner, unless the limited partners within 90 days vote unanimously to continue the partnership; or (6) December 31, 2014.

Upon dissolution and termination, SFLP was to be liquidated. The managing general partner was designated as liquidator and instructed to dispose of partnership assets first in payment of third-party debts, then in repayment of loans from partners, and

finally in repayment to partners of positive capital account balances.

By a series of transfer documents, Mr. Gulig assigned to SFLP property of decedent with a fair market value of $9,876,929, constituting approximately 98 percent of decedent's wealth, in exchange for a 99-percent limited partnership interest. The contributed property included decedent's interest in specified real estate (including the residence occupied by decedent), securities, accrued interest and dividends, insurance policies, an annuity, receivables, and partnership interests. About 75 percent of the contributed value was attributable to cash and securities. The majority of the asset transfer documents were dated August 12, 1994, while change of ownership forms for the life insurance policies were executed on August 14 and 15, 1994. Letters dated August 15, 1994, were also sent to the brokers holding decedent's securities accounts, to those administering the contributed partnership interests, and to the borrowers on notes payable to decedent advising them regarding transfer of the underlying assets to SFLP. All of the contributed property was reflected in decedent's capital account. Brokerage and bank accounts were opened in the name of the partnership during the period from August through October.

Mr. Gulig invited the Strangi children to participate in SFLP through an interest in Stranco. Decedent purchased

47 percent of Stranco for $49,350, and Mrs. Gulig purchased the remaining 53 percent for $55,650 on behalf of herself and her three siblings (with each thereby acquiring a 13.25-percent interest). The moneys were deposited into a bank account opened in August 1994 in Stranco's name. Stranco contributed a portion of these funds to SFLP in exchange for a 1-percent general partnership interest.

Stranco's articles of incorporation named decedent and the Strangi children as the initial five directors. On August 17, 1994, the Strangi children and Mr. Gulig met to execute the Stranco bylaws, a shareholders agreement, and a "Consent of Directors Authorizing Corporate Action in Lieu of Organizational Meeting" effective as of August 12, 1994. They also signed a "Unanimous Consent of Directors in Lieu of Special Meeting" that authorized the corporate president to execute a management agreement employing Mr. Gulig.

The Stranco bylaws set forth provisions governing corporate formalities. As pertains to shareholders, the bylaws state that a majority of the outstanding shares shall constitute a quorum at a meeting. Shareholders may also take informal action by means of a consent in writing signed by all shareholders.

Concerning directors, the bylaws specify that there shall be five directors, one of whom shall be elected president. At a meeting of the board, a majority of the directors then serving

shall constitute a quorum, and the act of a majority of the directors present at a meeting with a quorum shall be the act of the board. Directors may also take informal action by a written consent signed by all directors. The president shall be the principal executive officer of the corporation and, subject to the control of the board, shall generally supervise and control all of the business and affairs of the corporation. Among the particular powers or duties placed under the board is the payment of dividends, as follows: "The Board of Directors may declare, and the corporation may pay, dividends on its outstanding shares in any manner and upon any terms and conditions not restricted by the Articles of Incorporation or prohibited by law."

The management agreement executed by Stranco and Mr. Gulig described his duties as follows:

> Scope of Employment. Employee is hired to manage the day-to-day business of Employer. Additionally, the Employee shall manage the day-to-day business of the Strangi Family Limited Partnership, a Texas limited partnership (the "Partnership") in which Employer serves as the sole general partner and the managing partner of the Partnership. During the term of this Agreement, the Employee shall devote such portion of his time, attention, and energies to the businesses of the Employer and the Partnership and will diligently and to the best of his ability perform all duties incident to his employment hereunder. The duties of Employee shall include, but not be limited to, management of the Partnership's rental properties, cash and investment management, and the preparation and filing of all required governmental reports including tax returns.

In the shareholders agreement, decedent and the Strangi children agreed that at each annual meeting they would vote to reelect themselves (or a nominee) as the five directors. They further agreed that, if a vacancy occurred on the board by reason of the death, disability, resignation, retirement, or removal of a director so elected, they would cause the bylaws to be amended so as to reduce by one the number of directors.

Thereafter, each of the four Strangi children gave a .25-percent interest in Stranco to McLennan Community College Foundation (MCC Foundation), and the charity became a 1-percent shareholder in the corporation. MCC Foundation accepted the gift by execution on August 18, 1994, of an agreement to be bound by the terms of the preexisting shareholders agreement.

Decedent died of cancer on October 14, 1994, at the age of 81. Following decedent's death, Texas Commerce Bank, N.A. (TCB), successor in interest to Ameritrust, was asked to decline to serve as coexecutor of his estate. TCB subsequently did so, and decedent's will was admitted to probate on April 12, 1995, with Mrs. Gulig appointed as the sole executor.

After its formation, various monetary outlays were made from SFLP. From September 1993 until his death, decedent required 24-hour home health care that was provided by Olsten Healthcare (Olsten) and supplemented by Ms. Stone. During this time and while assisting decedent, Ms. Stone injured her back. The

resultant back surgery was paid for by SFLP. SFLP also paid nearly $40,000 in 1994 for funeral expenses, estate administration expenses, and related debts of decedent, including a $19,810.28 check to Olsten for nursing services. SFLP then paid more than $65,000 in 1995 and 1996 for estate expenses and a specific bequest to decedent's sister. In July 1995, SFLP distributed $3,187,800 to decedent's estate for Federal estate and State inheritance taxes. When such disbursements were made to or for the benefit of decedent or his estate, Stranco received corresponding and proportionate sums either in cash or in the form of adjusting journal entries. For accounting purposes, certain amounts expended by SFLP were initially recorded on its books as advances to, and accounts receivable from, partners. SFLP also accrued rent on the residence occupied by decedent and reported the rental income on its 1994 income tax return. The accrued amount was paid in January 1997. Mr. Gulig made all entries into the books and records of SFLP and Stranco and prepared all income tax returns for the entities.

Estate Tax Proceedings

On January 17, 1996, a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, filed on behalf of decedent's estate was received by the Internal Revenue Service. The value reported on the Form 706 for the gross estate was $6,823,582, which included $6,560,730 for decedent's interest in

SFLP and $24,551 for his stock in Stranco. The total value of the property held by SFLP as of the date of death was $11,100,922, to which discounts were applied in calculating the reported fair market value. The Form 706 also reflected other assets of $238,301 (including household and personal items, vehicles, securities, certain receivables, and bank account balances totaling $762) and claimed deductions of $43,280 for debts of decedent (including $5,161 for rents to SFLP) and $107,108 for expenses.

In a statutory notice dated December 1, 1998, respondent determined a deficiency in Federal estate tax of $2,545,826 and an alternative deficiency in Federal gift tax of $1,629,947. The estate tax deficiency resulted in large part from respondent's conclusion that decedent's interest in SFLP should be increased by $4,386,613 (to $10,947,343) and his interest in Stranco should be increased by $29,009 (to $53,560).

The proceedings in Strangi I were initiated in response to the foregoing notice of deficiency. Prior to trial, respondent attempted by motion to raise section 2036 as an issue. Strangi I at 486. That motion was denied as untimely. Id. With respect to the remaining issues, we held in Strangi I at 486-493: (1) The partnership was valid under State law and would be recognized for estate tax purposes; (2) section 2703 did not apply to the partnership agreement; (3) the transfer of assets to

SFLP was not a taxable gift; and (4) decedent's interests in SFLP and Stranco should be valued using the discounts applied by respondent's expert.

After entry of decision, respondent appealed to the Court of Appeals for the Fifth Circuit. The appellate court ruled as follows:

> We REVERSE the Tax Court's denial of leave to amend and REMAND with instructions that the court either (1) set forth its reasons for adhering to its denial of the Commissioner's motion for leave to amend, bearing in mind the mandate of the Federal Rule of Civil Procedure 15(a), or (2) reverse its denial of the Commissioner's motion, permit the amendment, and consider the Commissioner's claim under sec. 2036. We AFFIRM all other conclusions made by the tax court. [Strangi II at 282.]

Over petitioner's objection, leave was granted for respondent's amendment to answer and a second amendment to answer raising section 2036.

OPINION

I. Inclusion in the Gross Estate--Section 2036

A. General Rules

As a general rule, the Internal Revenue Code imposes a Federal tax "on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." Sec. 2001(a). The taxable estate, in turn, is defined as "the value of the gross estate", less applicable deductions. Sec. 2051. Section 2031(a) specifies that the gross estate comprises

"all property, real or personal, tangible or intangible, wherever situated", to the extent provided in sections 2033 through 2045.

Section 2033 broadly states that "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death." Sections 2034 through 2045 then explicitly mandate inclusion of several more narrowly defined classes of assets. Among these specific sections is section 2036, which reads in pertinent part as follows:

> SEC. 2036. TRANSFERS WITH RETAINED LIFE ESTATE.
>
> (a) General Rule.--The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death--
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Regulations further explain that "An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express, or implied, that the interest or right would later be conferred." Sec. 20.2036-1(a), Estate Tax Regs.

Given the language used in the above-quoted provisions, it has long been recognized that "The general purpose of this section is 'to include in a decedent's gross estate transfers that are essentially testamentary' in nature." Ray v. United States, 762 F.2d 1361, 1362 (9th Cir. 1985) (quoting United States v. Estate of Grace, 395 U.S. 316, 320 (1969)). Accordingly, courts have emphasized that the statute "describes a broad scheme of inclusion in the gross estate, not limited by the form of the transaction, but concerned with all inter vivos transfers where outright disposition of the property is delayed until the transferor's death." Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971).

As used in section 2036(a)(1), the term "enjoyment" has been described as "synonymous with substantial present economic benefit." Estate of McNichol v. Commissioner, 265 F.2d 667, 671 (3d Cir. 1959), affg. 29 T.C. 1179 (1958); see also Estate of Reichardt v. Commissioner, 114 T.C. 144, 151 (2000). Regulations additionally provide that use, possession, right to income, or other enjoyment of transferred property is considered as having been retained or reserved "to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit." Sec. 20.2036-1(b)(2), Estate Tax Regs. Moreover, possession or enjoyment of

transferred property is retained for purposes of section 2036(a)(1) where there is an express or implied understanding to that effect among the parties at the time of the transfer, even if the retained interest is not legally enforceable. Estate of Maxwell v. Commissioner, 3 F.3d 591, 593 (2d Cir. 1993), affg. 98 T.C. 594 (1992); Guynn v. United States, supra at 1150; Estate of Reichardt v. Commissioner, supra at 151; Estate of Rapelje v. Commissioner, 73 T.C. 82, 86 (1979). The existence or nonexistence of such an understanding is determined from all of the facts and circumstances surrounding both the transfer itself and the subsequent use of the property. Estate of Reichardt v. Commissioner, supra at 151; Estate of Rapelje v. Commissioner, supra at 86.

As used in section 2036(a)(2), the term "right" has been construed to connote "an ascertainable and legally enforceable power". United States v. Byrum, 408 U.S. 125, 136 (1972). Nonetheless, regulations clarify:

> With respect to such a power, it is immaterial (i) whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest; (ii) in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent; and (iii) whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's lifetime). The phrase, however, does not include a power over the transferred property itself which does not affect the enjoyment of the income received or earned during the decedent's life. * * * Nor does the phrase apply to a power held

> solely by a person other than the decedent. But, for example, if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee. [Sec. 20.2036-1(b)(3), Estate Tax Regs.]

Additionally, retention of a right to exercise managerial power over transferred assets or investments does not of itself result in inclusion under section 2036(a)(2). United States v. Byrum, supra at 132-134.

An exception to the treatment mandated by section 2036(a) exists where the facts establish "a bona fide sale for an adequate and full consideration in money or money's worth".

B. Burden of Proof

Typically, the burden of disproving the existence of an agreement regarding a retained interest has rested on the estate, and this burden has often been characterized as particularly onerous in intrafamily situations. Estate of Maxwell v. Commissioner, supra at 594; Estate of Reichardt v. Commissioner, supra at 151-152; Estate of Rapelje v. Commissioner, supra at 86. In this case, however, the section 2036 issues are new matters within the meaning of Rule 142(a). Thus, the burden of proof is on respondent.

C. Existence of a Retained Interest

Respondent contends that the value of the property transferred to SFLP and Stranco is includable in decedent's gross estate under either section 2036(a)(1) or section 2036(a)(2).

Underlying both of these arguments is the particular structure of the SFLP/Stranco arrangement, as set forth in the relevant governing documents.

The SFLP agreement provides that distributions of proceeds and assets from the entity shall be made in the sole discretion of the managing general partner. The SFLP agreement also designates Stranco as the managing general partner. Stranco, in turn, executed the management agreement employing Mr. Gulig to manage the day-to-day business of SFLP, as well as of Stranco itself. Yet Mr. Gulig was already decedent's attorney in fact pursuant to the 1988 general power of attorney. Under this instrument, Mr. Gulig was granted full and durable authority to act for decedent in his "name, place and stead". Mr. Gulig set up the SFLP/Stranco arrangement to facilitate decedent's estate planning goals and capitalized the partnership primarily with decedent's property.

When distilled to their most essential terms, the governing documents gave Mr. Gulig authority to specify distributions from SFLP, which is entirely consistent with his authority under the 1988 power of attorney. Although the estate protests that Mr. Gulig's authority under the management agreement was limited to managing "the day-to-day business" of the partnership and did not extend to making distributions or loans, the pertinent instruments provide no basis for concluding that making

distributions would be outside the day-to-day business of a partnership capitalized nearly exclusively with investment assets. As a practical matter, actual disbursement of funds occurred when checks were issued by Mr. and Mrs. Gulig in their various related capacities, pursuant to rights granted to them by decedent, acting through Mr. Gulig.

Hence, to summarize, the SFLP agreement named Stranco managing general partner with the sole discretion to determine distributions. The Stranco shareholders, including decedent (through Mr. Gulig), then acted together to delegate such authority to Mr. Gulig under the management agreement. Decedent's attorney in fact thereby stood in a position to make distribution decisions. Mrs. Gulig effectuated these decisions by signing checks to the recipients so designated.

1. Section 2036(a)(1)

Section 2036(a)(1) provides for inclusion of transferred property with respect to which the decedent retained, by express or implied agreement, possession, enjoyment, or the right to income. Enjoyment in this context is equated with present economic benefit.

a. Right to income

As a threshold matter, we observe that our analysis above of the express documents suggests inclusion of the contributed property under section 2036(a)(1) based on the "right to the

income" criterion, without need further to probe for an implied agreement regarding other benefits such as possession or enjoyment. The governing documents contain no restrictions that would preclude decedent himself, acting through Mr. Gulig, from being designated as a recipient of income from SFLP and Stranco. Such scenario is consistent with the reach of the right to income phrase as we described it in Estate of Pardee v. Commissioner, 49 T.C. 140, 148 (1967):

> section 2036(a)(1) refers not only to the possession or enjoyment of property but also to "right to the income" from property. The section does not require that the transferor pull the "string" or even intend to pull the string on the transferred property; it only requires that the string exist. See McNichol's Estate v. Commissioner, 265 F.2d 667, 671 (C.A. 3, 1959), affirming 29 T.C. 1179 (1958) * * *

b. Possession or enjoyment

The facts of this case support the finding of an implied agreement for retained possession or enjoyment. We have previously considered implicit retention of these benefits under section 2036(a)(1) in situations involving family limited partnerships in Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000); Estate of Thompson v. Commissioner, T.C. Memo. 2002-246; Estate of Harper v. Commissioner, T.C. Memo. 2002-121; and Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242. Although the instant case is based on limited post-transfer history, due in part to decedent's death only 2 months after creation of the partnership, we conclude that the reasoning underlying those

opinions directs a like result here. Fundamentally, the preponderance of the evidence shows that decedent as a practical matter retained the same relationship to his assets that he had before formation of SFLP and Stranco.

Circumstances that have been found probative of an implicitly retained interest under section 2036(a)(1) include transfer of the majority of the decedent's assets, continued occupation of transferred property, commingling of personal and entity assets, disproportionate distributions, use of entity funds for personal expenses, and testamentary characteristics of the arrangement. Guynn v. United States, 437 F.2d at 1150; Estate of Reichardt v. Commissioner, supra at 152-154; Estate of Thompson v. Commissioner, supra; Estate of Harper v. Commissioner, supra; Estate of Trotter v. Commissioner, T.C. Memo. 2001-250; Estate of Schauerhamer v. Commissioner, supra.

At the outset, we acknowledge that, in contrast to certain of the prior cases, the participants involved in the SFLP/Stranco arrangement generally proceeded such that "the proverbial 'i's were dotted' and 't's were crossed'." Strangi I at 486. Steps were taken to abide by the formal terms of the structure created. Such measures may give SFLP and Stranco sufficient substance to be recognized as legal entities in the context of valuation, which requires assumption of a hypothetical buyer and seller. They do not preclude implicit retention by decedent of economic

benefit from the transferred property for purposes of section 2036(a)(1).

First, we cannot lose sight of the fact that decedent contributed approximately 98 percent of his wealth, including his residence, to the SFLP/Stranco arrangement. Respondent alleges that the transfer left decedent with inadequate assets and cash flow to meet his living expenses, to which the estate takes objection. The estate goes to great lengths to counter respondent's assertion, claiming that decedent at his death possessed liquefiable assets of at least $172,000 and received on a monthly basis a pension of $1,438.18 and Social Security of $1,559. The estate also stresses that respondent has not established the amount of decedent's living expenses and maintains that, even if the $33,323.22 in checks paid from decedent's account in August and September were used as an estimate, the purported liquefiable assets would have covered decedent's needs for his concededly short life expectancy of 12 to 24 months. However, the relative dearth of liquefied (decedent's Form 706 showed two bank accounts with funds totaling $762), as opposed to "liquefiable", assets persuades us that decedent and his children and Mr. Gulig all expected that SFLP and Stranco would be a primary source of decedent's liquidity. It is unreasonable to expect that decedent would be forced to rely on sale of assets to meet his basic costs of living.

A second feature highly probative under section 2036(a)(1) is decedent's continued physical possession of his residence after its transfer to SFLP. The estate maintains that any otherwise negative implications of this circumstance are neutralized by the fact that SFLP "charged Mr. Strangi rent" on occupancy of the home and reported rental income on its 1994 tax return. Decedent likewise reported a rent obligation on his estate tax return. For accounting purposes, the accrued rent was recorded by SFLP on its books. Yet the accrued amount was not paid until January 1997. A residential lessor dealing at arm's length would hardly be content merely to accrue a rental obligation for eventual payment more than 2 years later. As we have remarked, accounting entries alone are of small moment in belying the existence of an agreement for retained possession and enjoyment. Estate of Reichardt v. Commissioner, 114 T.C. at 154-155; Estate of Harper v. Commissioner, T.C. Memo. 2002-121.

Concerning factors that relate to use of entity funds, the estate emphasizes that each disbursement for decedent or his estate was accompanied by a pro rata allotment to Stranco. Where, as here, the only interest in the partnership other than that held by the decedent is de minimis, a pro rata payment is hardly more than a token in nature. In these circumstances, pro rata disbursements are insufficient to negate the probability that the decedent retained economic enjoyment of his or her

assets. After all, distributing 1 percent to Stranco would not in any substantial way operate to curb decedent's ability to benefit from SFLP property. Accordingly, we direct our attention to the purpose, as opposed to the mechanics, of partnership distributions and expenditures.

The record reveals several instances where SFLP expended funds in response to a need of decedent or his estate. SFLP paid for Ms. Stone's back surgery to alleviate an injury she sustained in caring for decedent prior to the formation of SFLP. In 1994, SFLP expended nearly $40,000 for funeral expenses, estate administration, and related debts, including a $19,810.28 check to Olsten to pay for nursing services rendered to decedent before his death. These sums were followed in 1995 and 1996 by further payment of over $65,000 for estate expenses and a specific bequest. SFLP also disbursed approximately $3 million directed toward decedent's estate and inheritance taxes.

The estate seeks to justify these payments primarily by emphasizing that they were accounted for on SFLP's books as advances to partners and later closed as distributions, with pro rata amounts either advanced or distributed to Stranco. The evidence also indicates that the $65,000-plus amount was repaid in January 1997. The estate further explains that certain of these payments from SFLP were necessitated by the delay in

probate of decedent's estate engendered by the process of getting TCB to decline executorship.

To the extent that the estate's arguments focus on accounting manipulations, they are unavailing. As demonstrated in Estate of Reichardt v. Commissioner, supra at 154-155, and Estate of Harper v. Commissioner, supra, accounting adjustments do not preclude a conclusion that those involved understood that the decedent's assets would be made available as needs materialized. Belated repayment of certain amounts likewise does not refute the inference of an implicit agreement for retained enjoyment that arises from the demonstrated and contemporaneous availability of large sums. Furthermore, to the extent that the estate's explanations focus on a delay in probate, they lack specificity. The more salient feature would appear to be the insufficiency of the assets not contributed to SFLP and Stranco to cover the significant expenses reasonably to be expected to ensue in connection with decedent's poor health and death. That, in turn, speaks to retained enjoyment.

Regarding testamentary characteristics, the SFLP/Stranco arrangement also bears greater resemblance to one man's estate plan than to any sort of arm's-length, joint enterprise. As in Estate of Harper v. Commissioner, supra, "the largely unilateral nature of the formation, the extent and type of the assets contributed thereto, and decedent's personal situation are

indicative." Mr. Gulig established the entities using Fortress documents with little, if any, input from other family members. The contributed property included the majority of decedent's assets in general and his investments, a prime concern of estate planning, in particular. Decedent was advanced in age and suffering from serious health conditions. Furthermore, as discussed in Strangi I at 485-486, the purpose of the partnership arrangement was not to provide a joint investment vehicle for the management of decedent's assets, but was consistent with testamentary intent.

Moreover, the crucial characteristic is that virtually nothing beyond formal title changed in decedent's relationship to his assets. Mr. Gulig managed decedent's affairs both before and after the transfer. Decedent's children did not obtain a meaningful economic stake in the property during decedent's life. They raised no objections or concerns when large sums were advanced for expenditures of decedent or his estate, thus implying an understanding that decedent's access thereto would not be restricted.

In face of the foregoing realities, the estate argues that whatever possession or enjoyment of the contributed property decedent may have experienced was neither "retained" by means of a contemporaneous agreement nor "with respect to the transferred property". As regards the first point, the estate contends that

respondent has offered no evidence to prove a contemporaneous agreement requiring the distributions made, as opposed to an independent subsequent decision by Stranco to make the same outlay. According to the estate:

> Even if decisions to make distributions were made based on "sympathy for poor old dad," i.e., "Oops, Mr. Strangi imprudently put too much money into SFLP and we need to give some back" that would not meet the criteria set by judicial precedent for determining the existence of a retained expectation of possession of [sic] enjoyment: which is that there must have been an implied agreement that was contemporaneous with the transfer of the property at issue, not a subsequent agreement or act. * * * [Fn. ref. omitted.]

We are persuaded that the evidence and circumstances detailed above render such a contemporaneous agreement more likely than not.

The second point mentioned stems from the estate's view that pro rata distributions were made not with respect to the transferred property, in which decedent possessed no legal interest under the Texas Revised Limited Partnership Act (TRLPA), Tex. Rev. Civ. Stat. Ann. art. 6132a-1, sec. 7.01 (Vernon Supp. 2003), but with respect to his partnership interest. Yet this argument relies on paper title to the exclusion of the practicalities that are the focus of section 2036(a)(1). The property contributed by decedent was the source of the payments made. Furthermore, the record suggests that the impetus underlying a number of significant SFLP disbursements was needs

of decedent or his estate, rather than exigencies pertaining to Stranco or the partnership itself.

Hence, the preponderance of the evidence establishes that decedent retained possession of, enjoyment of, or the right to income from the property transferred within the meaning of section 2036(a)(1).

2. Section 2036(a)(2)

Although we have held supra that section 2036(a)(1) requires the estate to include the value of the transferred assets in the gross estate for Federal estate tax purposes, the parties have argued extensively over the issue of whether section 2036(a)(2) applies. Consequently, we address the applicability of section 2036(a)(2) to the instant case. As stated above, section 2036(a)(2) mandates inclusion in the gross estate of transferred property with respect to which the decedent retained the right to designate the persons who shall possess or enjoy the property or its income. This provision was interpreted by the Supreme Court in United States v. Byrum, 408 U.S. 125 (1972), and both parties devote a significant portion of their respective arguments to the implications of that decision. We address these arguments as an alternative to our conclusions concerning section 2036(a)(1) and with particular consideration of the facts of this case.

In United States v. Byrum, supra at 126, the decedent, Mr. Byrum, created an irrevocable trust for the benefit of his

children. He funded the trust with shares of three closely held corporations but retained the right to vote the shares and to veto any sale or transfer of the stock. Id. at 126-127. As a result, Mr. Byrum at his death continued to have the right to vote not less than 71 percent of the common stock in each of the three corporations. Id. at 128-129. The three corporations were involved in lithography-related businesses and had a substantial number of minority shareholders unrelated to Mr. Byrum. Id. at 130 & n.2, 142 & n.20. (The Supreme Court noted that 11 of 12, 5 of 8, and 11 of 14 stockholders, respectively, in the three corporations appeared to be unrelated to Mr. Byrum. Id. at 142 n.20.) The trust instrument specified that there be, and Mr. Byrum named, an independent corporate trustee. Id. at 126. The trustee was authorized in its "absolute and sole discretion" to pay income and principal to or for the benefit of the beneficiaries. Id. at 127.

The Commissioner argued that, by retaining voting control over the corporations, Mr. Byrum was in a position to select the corporate directors and thereby to control corporate dividend policy. Id. at 131-132. According to the Commissioner, the scenario in dispute gave Mr. Byrum the ability to regulate the flow of income to the trust, which ability was characterized as tantamount to a grantor-trustee's power to accumulate trust income for remaindermen or to distribute to present

beneficiaries. Id. at 132. The Court had previously ruled that the latter power to accumulate rather than disburse constituted a right to designate under section 2036(a)(2). Id. at 135-136; United States v. O'Malley, 383 U.S. 627, 631 (1966).

Given the above facts, the Supreme Court held "that Byrum did not have an unconstrained de facto power to regulate the flow of dividends to the trust, much less the 'right' to designate who was to enjoy the income from trust property." United States v. Byrum, 408 U.S. at 143. The Court rejected the Commissioner's "control rationale" as it "would create a standard--not specified in the statute--so vague and amorphous as to be impossible of ascertainment in many instances." Id. at 137 n.10. In reaching its conclusion, the Court relied on a series of "economic and legal constraints" to which any power that Mr. Byrum might have had was subject and which prevented such power from being equivalent to a right to designate persons to enjoy trust income. Id. at 144.

The Court emphasized that the independent corporate trustee alone had the right under the trust instrument to pay out or withhold income. Id. at 137. Even if Mr. Byrum had managed to flood the trust with dividends, he had no way of compelling the trustee to pay out or accumulate that income. Id. at 143. The Court also noted that the power to elect directors conferred no legal right to command them to pay or not pay dividends. Id. at

137. Moreover, the flow of dividends from the corporations would be subject to economic vicissitudes, retained earnings policies, and business needs. Id. at 139-140. In this regard, the Court explained:

> There is no reason to suppose that the three corporations controlled by Byrum were other than typical small businesses. The customary vicissitudes of such enterprises--bad years; product obsolescence; new competition; disastrous litigation; new, inhibiting Government regulations; even bankruptcy--prevent any certainty or predictability as to earnings or dividends. There is no assurance that a small corporation will have a flow of net earnings or that income earned will in fact be available for dividends. Thus, Byrum's alleged de facto "power to control the flow of dividends" to the trust was subject to business and economic variables over which he had little or no control. [Id. at 249.]

Furthermore, the Supreme Court stressed that "A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests" and the directors of a corporation "have a fiduciary duty to promote the interests of the corporation." Id. at 137-138. Such duties were legally enforceable by means of, for example, a derivative suit. Id. at 141-142.

With respect to the case at bar, the estate asserts that decedent retained no legally enforceable rights of the genre required by United States v. Byrum, supra. The estate emphasizes that management powers are insufficient to warrant inclusion and points out that, under the SFLP agreement, the limited partner was without even the right to exercise any managerial authority.

The estate likewise reiterates that "right" as used in section 2036(a)(2) is not to be construed as control and notes that, under the TRLPA, Tex. Rev. Civ. Stat. Ann. art. 6132a-1, sec. 3.03 (Vernon Supp. 2003), a limited partner expressly does not participate in control of the business of a partnership by virtue of acting as an officer, director, or stockholder of a corporate general partner. In this connection, the estate also remarks that, as a minority shareholder of Stranco, decedent was without the ability to elect a majority of directors, thus retaining even less control than was present in United States v. Byrum, supra.

Moreover, the estate repeatedly invokes the concept that "any power which Mr. Strangi or Stranco might have would be subject to state law fiduciary duties. Such fiduciary duties effectively render Section 2036(a)(2) inapplicable under the teaching of Byrum."

Conversely, it is respondent's position that United States v. Byrum, supra, fails to shield the assets placed in SFLP and Stranco from the reach of section 2036. Respondent avers that decedent had legally enforceable rights based on the relevant written agreements, not mere de facto control or influence. Respondent argues that decedent's rights go beyond the management powers and influence at issue in United States v. Byrum, supra, and extend to designation of persons who shall enjoy entity property and income. Respondent sets forth several ways in which

decedent's authority can be derived from the provisions of the governing documents and the roles played by the family members involved. Furthermore, respondent maintains that no impediments comparable to those in United States v. Byrum, supra, existed to constrain decedent's powers and that the Supreme Court's reasoning is therefore inapplicable here. In the particular circumstances of this case, we agree with respondent.

a. Legally enforceable rights

On these facts, decedent can properly be described as retaining a right to designate who shall enjoy property and income from SFLP and Stranco within the meaning of section 2036(a)(2). In this regard, it is immaterial whether we characterize the pertinent documents and relationships as creating rights exercisable by decedent alone, in conjunction with other Stranco shareholders, or in conjunction with Stranco's president. See sec. 20.2036-1(b)(3), Estate Tax Regs.

With respect to SFLP income and as previously recounted in greater detail, the SFLP agreement named Stranco managing general partner and conferred on the managing general partner sole discretion to determine distributions. The Stranco shareholders, including decedent (through Mr. Gulig), then acted together to delegate this authority to Mr. Gulig through the management agreement. The effect of these actions placed decedent's attorney in fact in a position to make distribution decisions.

Mrs. Gulig effectuated such decisions by executing checks to the recipients so designated.

In addition to the rights described above related to income, decedent also retained the right, acting in conjunction with other Stranco shareholders, to designate who shall enjoy the transferred SFLP property itself. The Supreme Court indicated in United States v. Byrum, 408 U.S. at 143 n.23 (citing Commissioner v. Estate of Holmes, 326 U.S. 480 (1946)), that a "power to terminate the trust and thereby designate the beneficiaries at a time selected by the settlor" would implicate section 2036(a)(2). Pursuant to the SFLP agreement, the partnership would be dissolved and terminated upon a unanimous vote of the limited partners and the unanimous consent of the general partner. The shareholders agreement likewise specifies that dissolution of SFLP requires the affirmative vote of all Stranco shareholders. Once dissolution and termination occur, liquidation is accomplished as set forth in the SFLP agreement. The managing general partner is named as the liquidator, which in turn disburses partnership assets first in payment of debts and then in repayment of partners' capital account balances. Authority is expressly granted for distributions in kind. Accordingly, decedent can act together with other Stranco shareholders essentially to revoke the SFLP arrangement and thereby to bring about or accelerate present enjoyment of partnership assets.

Furthermore, it is noteworthy that such action would likely revest in decedent himself, as the 99-percent limited partner, the majority of the contributed property.

As regards property transferred to Stranco and income therefrom, decedent held the right, in conjunction with one or more other Stranco directors, to declare dividends. The corporation's bylaws authorize the board of directors to declare dividends from the entity. For the board to take such action, a majority vote of the directors at a meeting with a quorum present is sufficient. Under the bylaws, a majority of the directors then serving constitutes a quorum. Because Stranco had five directors, a quorum would consist of three, so two directors (e.g., decedent through Mr. Gulig and one other) could potentially act together to declare a dividend. The Stranco shareholders agreement further provided that each of the initial five directors would be reelected annually, thus effectively ensuring decedent's position on the board.

In response to various of the above concepts pertaining to joint action, particularly by stockowners, the estate suggests: "If the mere fact that a shareholder could band together with all of the other shareholders of a corporation and such banding together would be sufficient to cause inclusion under Section 2036, then it would have been impossible for the United States Supreme Court to reach the decision that it did in Byrum." The

estate's observation ignores the existence in United States v. Byrum, supra, of the independent trustee who alone had the ability to determine distributions from the disputed trust, notwithstanding any prior action by corporate owners or directors. It also ignores the identity of the shareholders in this case and the dual roles played by Mr. Gulig.

To summarize, review of the documentary evidence discussed above reveals that decedent here retained rights of a far different genre from those at issue in United States v. Byrum, supra. Rather than mere "control", management, or influence, there are traceable to decedent through the explicit provisions of the governing instruments ascertainable and legally enforceable rights to designate persons who shall enjoy the transferred property and its income. The estate's reliance on a limited partner's lack under the TRLPA of participation in control and under the SFLP agreement of management authority is thus misplaced. The alleged absence of such powers cannot negate the dispositive rights granted in the instant case. The SFLP/Stranco arrangement placed decedent in a position to act, alone or in conjunction with others, through his attorney in fact, to cause distributions of property previously transferred to the entities or of income therefrom. Decedent's powers, absent sufficient limitation as discussed infra, therefore fall within the purview of section 2036(a)(2).

b. Constraints upon rights to designate

The Supreme Court in United States v. Byrum, supra, relied upon several impediments to the exercise of powers held by Mr. Byrum in concluding that such powers did not warrant inclusion under section 2036(a)(2). Here, the rights held by decedent are of a different nature and were not accompanied by comparable constraints. In our view, the constraints alleged by the estate are illusory.

One circumstance highlighted by the Supreme Court was the existence of an independent trustee with the sole authority ultimately to pay or withhold income from the trust. Here, in contrast, no similar layer of independence was interposed. Rather, decisions with respect to distributions were placed in Stranco, of which decedent owned 47 percent and was the largest shareholder. All decisions ultimately were made by Mr. Gulig, who continued to act as decedent's attorney in fact.

Another element stressed by the Supreme Court was the manner in which the flow of funds allegedly under Mr. Byrum's control would be subject to economic and business realities consequent upon the status of the relevant corporations as typical small operating enterprises. Earnings and dividends of a small operating company could be affected by, inter alia, changes in products, in competition, or in industry regulation and outlook; use of funds for replacement of plant and equipment or for growth

and expansion; and the need to retain sufficient earnings for working capital. These complexities do not apply to SFLP or Stranco, which held only monetary or investment assets.

Yet another constraining factor cited by the Supreme Court was the presence of fiduciary duties held by directors and shareholders, and it is upon this aspect of the Supreme Court's opinion that the estate focuses. The Supreme Court emphasized that corporate directors and shareholders have a fiduciary duty to promote the best interests of the entity, as opposed to their personal interests. The Supreme Court further pointed to a substantial number of unrelated minority shareholders who could enforce these duties by suit.

The fiduciary duties present in United States v. Byrum, 408 U.S. 125 (1972), ran to a significant number of unrelated parties and had their genesis in operating businesses that would lend meaning to the standard of acting in the best interests of the entity. As a result, there existed both a realistic possibility for enforcement and an objective business environment against which to judge potential dereliction. Given the emphasis that the Supreme Court laid on these factual realities, Byrum simply does not require blind application of its holding to scenarios where the purported fiduciary duties have no comparable substance. We therefore analyze the situation before us to

determine whether the fiduciary duties relied upon by the estate would genuinely circumscribe use of powers to designate.

The estate summarizes its contentions regarding fiduciary duties as follows:

> Just like Mr. Byrum, Mr. Strangi's "rights" (whatever those rights appear to be) were severely limited by the fiduciary duties of other people who (according to Byrum) presumably could be counted on the [sic] observe those restraints against whatever desires they might otherwise have had to run pell-mell to do the bidding of the Decedent: (1) Mr. Gulig, who (separate and apart from his role as attorney-in-fact for Mr. Strangi) had fiduciary duties to Stranco, whom he served as manager; (2) the directors of Stranco, who had fiduciary duties to both Stranco and to SFLP as a whole; and (3) McLennan County Community College ("MCCC"), which had rights as a minority shareholder of Stranco and a fiduciary obligation to enforce such rights for the benefit of its own beneficiaries as well as the people of the State of Texas (with the Attorney General of Texas having the ability to step in to enforce such rights if MCCC failed in its duties).
> * * *

None of the foregoing obligations cited by the estate is sufficiently on par with those detailed in United States v. Byrum, supra, to bring the present case within the Supreme Court's rationale.

Concerning Mr. Gulig, any fiduciary duties that Mr. Gulig might have had in his role as manager of Stranco (and thereby of SFLP) are entitled to comparatively little weight on these facts. Prior to his instigation of the SFLP/Stranco arrangement, Mr. Gulig stood in a confidential relationship, and owed fiduciary duties, to decedent personally as his attorney in fact. Thus, to

the extent that Stranco or SFLP's interests might diverge from those of decedent, we do not believe that Mr. Gulig would disregard his preexisting obligation to decedent.

As regards fiduciary obligations of Stranco and its directors, these duties, too, have little significance in the present context. Although Stranco would owe a fiduciary duty to SFLP and to the limited partners, decedent owned the sole, 99-percent limited partnership interest. The rights to designate traceable to decedent through Stranco cannot be characterized as limited in any meaningful way by duties owed essentially to himself. Nor do the obligations of Stranco directors to the corporation itself warrant any different conclusion. Decedent held 47 percent of Stranco, and his own children held 52 of the remaining 53 percent. Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the United States v. Byrum, supra, scenario.

With respect to the role of MCC Foundation, United States v. Byrum, supra, affords no basis for permitting outcomes under section 2036(a)(2) to turn on factors amounting to no more than window dressing. A charity given a gratuitous 1-percent interest would not realistically exercise any meaningful oversight.

Lastly, we are unpersuaded that any different result should obtain on account of the Commissioner's having taken a contrary

position in certain previous administrative rulings. As the estate repeatedly brings to our attention, the Commissioner has cited United States v. Byrum, supra, in such rulings for the principle that fiduciary constraints counsel against inclusion of family limited partnership assets under section 2036(a)(2). See, e.g., Priv. Ltr. Rul. 94-15-007 (Apr. 15, 1994); Priv. Ltr. Rul. 93-10-039 (Mar. 12, 1993); Tech. Adv. Mem. 91-31-006 (Aug. 2, 1991). These written determinations are expressly declared by statute to be without precedential force. Sec. 6110(k)(3). Thus, any claimed reliance on them is unavailing. In any event, cursory exposition in limited factual circumstances does not preclude our analysis of statutory provisions and regulations in the context of this case.

In sum, the estate's averment that decedent's "'rights' * * * were severely limited by the fiduciary duties of other people who (according to Byrum) presumably could be counted on * * * [to] observe those restraints" rests on a faulty legal premise and ignores factual realities. First, the Supreme Court's opinion in United States v. Byrum, supra, provides no basis for "presuming" that fiduciary obligations will be enforced in circumstances divorced from the safeguards of business operations and meaningful independent interests or oversight. Second, the facts of this case belie the existence of any genuine fiduciary impediments to decedent's rights. We conclude that the

value of assets transferred to SFLP and Stranco is includable in decedent's gross estate under section 2036(a)(2).

D. Existence of Consideration

Having decided that decedent retained an interest in the assets transferred to SFLP and Stranco for purposes of section 2036(a), we evaluate whether the statute's application may nonetheless be avoided on the basis of the parenthetical exception for "a bona fide sale for an adequate and full consideration in money or money's worth". Availability of the exception rests on two requirements: (1) A bona fide sale, meaning an arm's-length transaction, and (2) adequate and full consideration. See Estate of Harper v. Commissioner, T.C. Memo. 2002-121. The situation before us meets neither of these criteria.

First, no bona fide sale, in the sense of an arm's-length transaction, occurred in connection with decedent's transfer of property to SFLP and Stranco. Mr. Gulig, as decedent's attorney in fact, prepared the arrangement using Fortress materials in absence of any meaningful negotiation or bargaining with other anticipated interest-holders. He determined how the entities would be structured and operated, what property would be contributed, and what interests various parties would obtain therein. Hence, decedent essentially stood on both sides of the transaction, a fact unchanged by the manner in which the Strangi

children opted to join after the substantive decisions had been made.

Second, full and adequate consideration does not exist where, as here, there has been merely a "recycling" of value through partnership or corporate solution. See Estate of Thompson v. Commissioner, T.C. Memo. 2002-246; Estate of Harper v. Commissioner, supra; Kimbell v. United States, 244 F. Supp. 2d 700 (N.D. Tex. 2003). As we recently explained in Estate of Harper v. Commissioner, supra:

> to call what occurred here a transfer for consideration within the meaning of section 2036(a), much less a transfer for an adequate and full consideration, would stretch the exception far beyond its intended scope. In actuality, all decedent did was to change the form in which he held his beneficial interest in the contributed property. * * * Without any change whatsoever in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise, there exists nothing but a circuitous "recycling" of value. We are satisfied that such instances of pure recycling do not rise to the level of a payment of consideration. To hold otherwise would open section 2036 to a myriad of abuses engendered by unilateral paper transformations.

We see no distinction of consequence between the scenario analyzed in Estate of Harper v. Commissioner, supra, and that of the present case. Decedent contributed more than 99 percent of the total property placed in the SFLP/Stranco arrangement and received back an interest the value of which derived almost exclusively from the assets he had just assigned. Furthermore, the SFLP/Stranco arrangement patently fails to qualify as the

sort of functioning business enterprise that could potentially inject intangibles that would lift the situation beyond mere recycling. Cf. Estate of Harrison v. Commissioner, T.C. Memo. 1987-8; Church v. United States, 85 AFTR 2d 2000-804, 2000-1 USTC par. 60,369 (W.D. Tex. 2000), affd. without published opinion 268 F.3d 1063 (5th Cir. 2001) (both involving contributions by other participants not de minimis in nature, for a genuine pooling of interests). We therefore hold that decedent did not engage in any transfer for consideration upon the creation and funding of SFLP and Stranco. Accordingly, the estate is entitled to no exception to the treatment mandated by section 2036(a).

II. Amount Includable

With respect to the amount includable in decedent's gross estate on account of a retained interest, the estate makes the following assertion:

> I.R.C. sec. 2036(a) only requires inclusion of property in a decedent's estate to the extent that the decedent retained an interest in the transferred property. Assuming arguendo that Decedent did retain an interest in some of the property transferred to SFLP, I.R.C. sec. 2036 does not automatically require inclusion of all of the property transferred by Decedent to SFLP and Respondent has not sustained his burden of proof of establishing the extent, if any, of any retained interest.

The foregoing premise, however, rests on a faulty understanding of the statute's operation. As we recently explained in Estate of Thompson v. Commissioner, supra:

> Section 2036(a) effectively includes in the gross estate the full fair market value, at the date of death, of all property transferred in which the decedent had retained an interest, rather than the value of only the retained interest. Fidelity-Philadelphia Trust Co. v. Rothensies, 324 U.S. 108 (1945). This furthers the legislative policy to "include in a decedent's gross estate transfers that are essentially testamentary--i.e., transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime." United States v. Estate of Grace, 395 U.S. 316, 320 (1969). Thus, an asset transferred by a decedent while he was alive cannot be excluded from his gross estate unless he "absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property." Commissioner v. Estate of Church, 335 U.S. 632, 645 (1949). * * * [Emphasis added.]

Regulations further detail that "If the decedent retained or reserved an interest or right with respect to a part only of the property transferred by him, the amount to be included in his gross estate under section 2036 is only a corresponding proportion". Sec. 20.2036-1(a), Estate Tax Regs. Accordingly, caselaw and regulatory authority converge to indicate that the full value of transferred property is includable unless there existed some specific portion of the contributed assets that the retained interest or rights could not reach.

Here, the record reveals that no part of the transferred property was exempt from the rights or enjoyment retained by decedent. The relevant documents make no distinction among the various assets contributed, nor does the evidence reflect that Mr. Gulig looked to particular assets in determining whether

amounts should be distributed. The preponderance of the evidence therefore establishes that the full value of the transferred assets is includable under section 2036(a).

Pursuant to section 2036(a), 99 percent of the net asset value of SFLP and 47 percent of the value of assets held by Stranco should be included in decedent's gross estate. Nonetheless, because respondent never asserted an increased deficiency in connection with the section 2036 issue, valuation of the property in dispute, i.e., interests in SFLP and Stranco, will be limited by the amounts determined in the notice of deficiency. The decision to be entered, however, will take into account any additional deductions to which the estate is entitled for costs and expenses incurred subsequent to the initial trial of this case.

To reflect the foregoing,

Decision will be entered under Rule 155.

Stringer v. Car Data Systems, Inc.

841 P.2d 1183 (1992)

314 Or. 576

Paul H. STRINGER and Timothy D. Schubert, Petitioners on Review, v. CAR DATA SYSTEMS, INC., an Oregon corporation; Consumer Data Systems, Inc., an Oregon corporation; James L. Adkisson; David W. Agnor; Sharon Agnor; James L. Agnor; Arlene L. Belanger; Peter G. Bock; Susan D. Ebner; Mark S. Boyd; Jeffrey Scott Carlson; Lawrence R. Custer; Stephen J. Ebner; William A. Henry; John H. Hodges, Sr.; Bernal Hug, Jr.; Virginia Hug; Celas A. Hug; Kent Hug; Cheryl Hug; Paul E. Johnson; Corleen Johnson; Mark Anthony Royal Kallenberger; David E. Lamb; Jacqueline C. Lamb; Steven D. Lee; Claudia J. Lee; Leslie R. Lock; Terry R. Lock; Steve P. Nagel; Henry B. Shafer; Bob Sievers, Jr.; Judy A. Sievers; Donald Smith; Richard M. Botteri and Weiss, Descamp & Botteri, a professional corporation, an Oregon professional corporation, Respondents on Review, and Elizabeth A. Perry; and James B. Kargman, Nominal Defendants.

CC A8907-04022; CA A65113; SC S38792.

Supreme Court of Oregon, In Banc.

Argued and Submitted May 5, 1992.

Decided November 19, 1992.

Robert J. McGaughey, of McGaughey & Georgeff, Portland, argued the cause and filed the petition for petitioners on review.

Mark A. Turner, of Ater Wynn Hewitt Dodson & Skerritt, Portland; Carolyn E. Wells, of Miller Nash Wiener Hager & Carlsen, Portland; and Thomas W. Brown, of Cosgrave, Vergeer & Kester, Portland, argued the cause and filed a response to the petition for review on behalf of the following respondents on review: Mr. Turner, for Car Data Systems, Inc., James L. Adkisson, Celas A. Hug, Peter G. Bock, Mark S. Boyd, Kent Hug, and David E. Lamb; Ms. Wells, for Arlene Belanger, Jeffrey Scott Carlson, Lawrence R. Custer, William A. Henry, John H. Hodges, Sr., Mark Anthony Royal Kallenberger, Leslie R. Lock, Terry R. Lock, Steve P. Nagel, Bob Sievers, Jr., and Judy A. Sievers; and Mr. Brown, for Richard M. Botteri and Weiss, Descamp & Botteri.

Glen H. Downs, Portland, filed a brief on behalf of amicus curiae Oregon Trial Lawyers Ass'n.

PETERSON, Justice.

This case involves what courts and commentators have described as a "cash-out merger," a "squeeze-out merger," or a "freeze-out merger." In this opinion, we will use the term "cash-out merger." Under ORS 60.551 to 60.594, majority shareholders may eliminate minority shareholders of a corporation by merger procedures that allow dissenting minority shareholders to receive "fair value" for their shares.

Plaintiffs were minority shareholders in Consumer Data Systems, Inc. (CDS), an Oregon corporation. They filed this action, claiming a violation of various rights incident to a cash-out merger involving CDS and another corporation, Car Data Systems, Inc. (Car Data). Plaintiffs allege that other CDS shareholders and directors breached a fiduciary duty owed to plaintiffs as minority shareholders. They seek compensatory and punitive damages.[1] The trial court dismissed their complaint for failure to state a claim, ORCP 21 A(8), and the Court of Appeals affirmed. *Stringer v. Car Data Systems, Inc.,* 108 Or.App. 523, 816 P.2d 677, modified on reconsideration, 110 Or.App. 14, 821 P.2d 418 (1991). We affirm the decision of the Court of Appeals, but on different grounds.

Before turning to the facts, a brief summary of cash-out mergers is appropriate.

At common law, each shareholder of a corporation was considered to have a "vested right" in the corporation. As a result, the rule in many jurisdictions was that a single shareholder could veto a proposed business combination. See Annot, Valuation of Stock of Dissenting Shareholders in Case of Consolidation or Merger of Corporation, Sale of its Assets, or the Like, 48 ALR3d 430, 435 (1973); *Chicago Corp. v. Munds,* 20 Del.Ch. 142, 172 A. 452, 455 (1934).

Legislatures, courts, and commentators found that the right of a single shareholder to veto business transactions trammeled the concept of corporate democracy. The veto was therefore eliminated. The general rule today is that decision-making by the majority must take precedence over the objection of a lone dissenter. See Revised Model Business Corporation Act § 13.02 (1984) (the "Model Act"); ORS 60.554(1).

The rejection of a minority veto and the recognition of majority rule has not occurred without regard for the potential abuses of a majority's power directed against minority interests. The linchpin of a dissenter's protection in merger cases is found in the statutory appraisal remedy. This remedy is designed to provide statutory protection to those minority shareholders who do not concur with the decision of the majority shareholders.

One device commonly used to eliminate minority shareholders who disagree with the majority shareholders about corporate decision-making is the cash-out merger. A typical

[1] In their complaint, plaintiffs also asked for rescission of the merger, for the appointment of a receiver, for the dissolution of CDS, and for an accounting. Those claims are not in issue here. Only plaintiffs' claims for compensatory and punitive damages remain. The lawyers for CDS and Car Data were also named as defendants. Because we conclude that plaintiffs have no claim apart from an appraisal, the claims against the lawyers also may not be maintained.

cash-out merger, and the appraisal remedy, are described in 1 F.H. O'Neal & R. Thompson, O'Neal's Oppression of Minority Shareholders 21-22, § 5:04 (2d ed):

> "Controlling shareholders often utilize a statutory merger as an instrument for squeezing out minority shareholders or altering their rights and preferences. In every state the corporation statute provides a statutory procedure by which two or more corporations can be combined into a single corporation even though less than all shareholders approve. * * *
>
> "* * * * *
>
> "Under the typical procedure for merger, the directors of the combining companies adopt a plan of merger, which sets forth the terms and conditions of the merger, including the manner in which shares of each of the constituent corporations are to be converted into shares, obligations, or other securities of the surviving corporation, or into cash or other property. The board then submits the plan to the shareholders of each constituent corporation. Depending on the corporation statute in the particular jurisdiction, the plan must be approved by holders of a majority or another specified proportion of each company's shares or by holders of a majority or specified proportion of shares with voting rights. * * * If the plan receives the required approval, it is then filed in a specified public office. A shareholder who dissents from a merger can force the corporation in which he has held stock or the surviving corporation, depending upon the statute, to purchase his shares at their appraised value." (Footnotes omitted.)

Undeniably, such mergers have a coercive element.

"Freezeouts, by definition, are coercive: minority stockholders are bound by majority rule to accept cash or debt in exchange for their common shares, even though the price they receive may be less than the value they assign to those shares. But this alone does not render freezeouts objectionable. Majority rule always entails coercion. It is, nonetheless, an acceptable rule of governance if all members of the voting constituency share a common goal and if all will be identically affected by the outcome of the vote. In the ordinary arm's-length merger negotiated by the managements of two unrelated corporations, stockholders of the merged entity are properly viewed as having a common interest in maximizing the returns on their stock, whether through periodic dividends or through sale or liquidation of the firm. Once approved by a statutory majority, the terms of such a merger will apply equally to each of the merging company's stockholders, and the common decision will satisfy the principle that all members of the class be treated alike. Majority rule is thus an appropriate means of deciding whether an arm's-length merger should be allowed, and it is of course a universal feature of the corporate law. Despite the element of coercion, dissenters to such a merger are bound, or remitted to an appraisal proceeding, by vote of a majority of their class, because it is assumed that any disagreement among the stockholders involves nothing more than a practical judgment about the best way to achieve a

common aim." Brudney & Chirelstein, A Restatement of Corporate Freezeouts, 87 Yale LJ 1354, 1357-58 (1978).

The Oregon statutes that permit cash-out mergers, ORS 60.481 to 60.501, contain procedural protections for minority shareholders. ORS 60.554 provides in part:

> "(1) Subject to subsection (2) of this section, a shareholder is entitled to dissent from, and obtain payment of the fair value of the shareholder's shares in the event of, any of the following corporate acts: "(a) Consummation of a plan of merger to which the corporation is a party if shareholder approval is required for the merger by ORS 60.487 or the articles of incorporation and the shareholder is entitled to vote on the merger or if the corporation is a subsidiary that is merged with its parent under ORS 60.491;
>
> "(b) Consummation of a plan of share exchange to which the corporation is a party as the corporation whose shares will be acquired, if the shareholder is entitled to vote on the plan[.]"

Dissenters from a proposed merger have a right to demand payment for their shares. ORS 60.571. If they do so, the corporation is then required to pay each dissenter "the fair value of the shareholder's shares, plus accrued interest." ORS 60.577(1). If the parties do not agree as to fair value for the shares, the corporation "shall commence a proceeding * * * to determine the fair value of the shares and accrued interest." ORS 60.591(1). A court then determines the fair value of the shares. The appraisal procedure is the sole remedy for dissenting shareholders in the absence of "unlawful or fraudulent" conduct. ORS 60.554(2) provides:

> "A shareholder entitled to dissent and obtain payment for the shareholder's shares under ORS 60.551 to 60.594 may not challenge the corporate action creating the shareholder's entitlement unless the action is unlawful or fraudulent with respect to the shareholder or the corporation."

Plaintiffs brought this action, claiming that defendants acted unlawfully incident to the transfer of CDS shares to Car Data, squeezing out plaintiffs. The trial court granted defendants' motions to dismiss for failure to state a claim. ORCP 21 A(8).

Plaintiffs' complaint alleges that plaintiffs Stringer and Schubert and two other shareholders owned 43 percent of the shares of CDS. Thirty-two individuals, including the six directors of CDS, owned the remaining 57 percent of CDS. According to the complaint, "[i]n late 1988 or early 1989, the CDS Directors and the larger CDS shareholders, Donald Smith, Mark Kallenberger and Lawrence Custer * * *, decided to squeeze the Minority Shareholders out of their ownership in CDS and to offer them a nominal sum for their stock, which sum was significantly below the fair market value of the stock." The directors and larger shareholders formed a new company that subsequently became Car Data, transferred their shares in CDS to Car Data in exchange for its stock, and solicited all the remaining shareholders, except for the four

minority shareholders, to participate in their plan. A total of 32 CDS shareholders transferred their stock, amounting to 57 percent of the CDS shares, to Car Data. Car Data shareholders then voted for a merger between Car Data and CDS. Pursuant to the merger proposal, each CDS shareholder would receive $0.002 per share. As owner of 57 percent of CDS, Car Data voted for the merger. The merger was approved over the objections of plaintiffs and two other minority shareholders.

Plaintiffs claimed that their shares were worth at least $0.10 per share and refused to accept the $0.002 offered them. Car Data rejected plaintiffs demand for $0.10 per share and instituted an appraisal proceeding in the circuit court pursuant to ORS 60.591.[2] Plaintiffs instituted this action in the circuit court against Car Data, CDS, the 32 individual former shareholders of CDS and the present shareholders of Car Data (the shareholder defendants), and the lawyers who represented both CDS and Car Data during the merger process. Plaintiffs' complaint contained three claims for relief: (1) a claim for breach of fiduciary duty against all defendants,[3] in which they prayed for rescission of the merger and appointment of a receiver, or, alternatively, for compensatory damages[4] and an award of punitive damages against Car Data and the shareholder defendants; (2) a claim for civil conspiracy against all defendants, in which they sought compensatory damages and punitive damages against Car Data and the shareholder defendants; and (3) a derivative claim against the former directors of CDS for failing to obtain the best price for all shareholders.

The circuit court stayed the proceedings in the present case pending trial of the appraisal case. The appraisal case was concluded, and this case then proceeded.[5]

Defendants moved to dismiss plaintiffs' claim on the grounds that (1) plaintiffs' sole remedy is under the appraisal procedure, and (2) even if appraisal is not the sole remedy, plaintiffs' complaint "fail[s] to state facts to support a claim for relief * * * for breach of fiduciary duty." The circuit court dismissed plaintiffs' complaint.

Plaintiffs appealed, pursuing their damages claims on theories of breach of fiduciary duty and civil conspiracy, but abandoned their derivative claim and rescission claim. The Court of Appeals affirmed. Stringer v. Car Data Systems, Inc., supra, 108 Or.App. at 527-28, 816 P.2d 677; id., 110 Or.App. at 17, 821 P.2d 418 (on reconsideration).

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[2] ORS 60.591(1) provides in part:
"If a demand for payment under ORS 60.587 remains unsettled, the corporation shall commence a proceeding within 60 days after receiving the payment demand under ORS 60.587 and petition the court under subsection (2) of this section to determine the fair value of the shares and accrued interest."

[3] All references to "defendants" or "all defendants" exclude nominal defendants Perry and Kargman, the two other minority shareholders of CDS.

[4] Plaintiffs sought damages based on what their 28.6 percent ownership interest would have been worth at the time of trial, i.e., what the value of their stock would have been if they had not been cashed out in the merger.

[5] The Court of Appeals affirmed the judgment of the circuit court in the appraisal action. *Chrome Data Systems, Inc. v. Stringer,* 109 Or. App. 513, 820 P.2d 831 (1991). Car Data had changed its name to Chrome Data Systems, Inc. after this action was brought, but before it instituted the appraisal proceeding.

Because this case comes to us on appeal of an order of dismissal, we must determine whether the complaint states a claim. In considering the sufficiency of plaintiffs' complaint, we accept all well-pleaded allegations of the complaint as true and give plaintiffs the benefit of all favorable inferences that may be drawn from the facts alleged. *Madani v. Kendall Ford, Inc.,* 312 Or. 198, 201, 818 P.2d 930 (1991). We quote pertinent portions of plaintiffs' complaint:

> "12. "Throughout 1988 and into 1989, CDS experienced continued success in selling its product. Its revenues during this period were increasing at a much faster rate than its expenses. All shareholders had a reasonable belief that the value of CDS would rise significantly over the next few years. "13. "In late 1988 or early 1989, the CDS Directors and the larger CDS shareholders, Donald Smith, Mark Kallenberger and Lawrence Custer (collectively referred to herein as the `Controlling Shareholders'), decided to squeeze the Minority Shareholders out of their ownership in CDS and to offer them a nominal sum for their stock, which sum was significantly below the fair market value of the stock (the `Plan'). The principal purpose of the Plan was to deprive the Minority Shareholders of most of the present value of their stock in CDS and to deprive the Minority Shareholders of their share of the anticipated significant rise in the value of CDS stock over the next few years.
>
> "* * * * *
>
> "24. "Throughout April 1989, while all defendants were carrying forth the Plan to squeeze out the Minority Shareholders, all defendants knew the $0.002 per share to be offered the Minority Shareholders was grossly less than the present fair market value of the shares. "25. "Throughout April 1989, while all defendants (except Kargman and Perry) were carrying forth the Plan to squeeze out the Minority Shareholders, all such defendants believed that the value of the CDS stock would greatly increase over the next few years, based on the increased business sales and profitability of CDS. "
>
> 26."In early 1989, CDS received an offer from a third party to purchase substantially all of the corporation's assets. This offer was at a price substantially greater than $0.002 per share.
>
> "27. "At a shareholders' meeting on February 6, 1989, the shareholders voted to reject this offer. All of the Majority Shareholders voted to reject this offer."

The thrust of plaintiffs' claims here is this (quoting from their brief):

> "The majority shareholders owe a duty of loyalty, good faith, fair dealing, and full disclosure to the minority shareholders. This duty is breached when the majority transfers corporate assets to themselves and offers the minority a mere fraction of the true value of their shares."

As stated above, ORS 60.554(2) provides that a dissenting shareholder "may not challenge the corporate action creating the shareholder's entitlement unless the action is unlawful or fraudulent with respect to the shareholder or the corporation." The dispositive question here is whether plaintiffs have alleged facts that would establish that defendants' conduct was "unlawful or fraudulent" within the meaning of ORS 60.554(2).

We start with the observation that this court may not question the wisdom of the Legislative Assembly in enacting the Oregon Business Corporation Act. That law drew upon the Model Business Corporation Act and contains procedures for majority shareholders to "squeeze out" minority shareholders. The legislative decision involved considerations affecting both majority shareholders and dissenting shareholders.

"The accompanying proposals as a whole are designed to benefit both minority shareholders and controlling shareholders. Minority shareholders benefit because the assertion of their rights is made easier, and penalties are introduced for vexatious obstruction by corporate management. Controlling shareholders benefit directly and indirectly. They benefit directly by the added incentives for dissenters to settle without a judicial appraisal. They benefit indirectly because the provision of an adequate appraisal right diminishes the justification for courts to enjoin or set aside corporate changes because of the absence of an `adequate remedy at law,' or because the corporate action `would operate as a fraud.'" Conard, Amendments of Model Business Corporation Act Affecting Dissenters' Rights (Sections 73, 74, 80, and 81), 33 BusLaw 2587, 2593 (1978).

In order to decide whether plaintiffs have a claim in addition to their rights under the appraisal procedure statutes, we must look more closely at those statutes. After both corporations have "consummated" a plan of merger, ORS 60.487, the appraisal procedures of ORS 60.551 to 60.594 may be invoked by dissenting shareholders. The procedures are:

First, a dissenting shareholder must give notice of intent to demand payment for his or her shares, ORS 60.564(1), and then demand payment and deposit the share certificates, ORS 60.571. The surviving corporation is required to "pay each dissenter * * * the amount the corporation estimates to be the fair value of the shareholder's shares, plus accrued interest." ORS 60.577(1). The payment must be accompanied by the "corporation's balance sheet," a "statement of the corporation's estimate of the fair value of the shares," and "explanation of how the interest was calculated," a "statement of the dissenter's right to demand payment under ORS 60.587," and a "copy of ORS 60.551 to 60.594." ORS 60.577(2).

A dissenter who is dissatisfied with the price paid may notify the corporation and demand payment of the dissenter's estimate of the shares' "fair value."[6] ORS 60.587.

[6] ORS 60.551(4) defines "fair value" as follows:

The corporation must then do one of three things: (1) not go forward with the merger, (2) pay the estimate to the shareholder, or (3) commence a proceeding in the circuit court to determine the fair value of the shares and accrued interest. ORS 60.587, 60.591.

In circuit court appraisal proceedings, dissenting shareholders who have been paid less than fair value of their shares by the corporation are entitled to a court award of the difference between the amount paid by the corporation and the fair value of the shares, plus interest. With exceptions not relevant here, the corporation also is required to pay "all costs of the proceeding, including the reasonable compensation and expenses of appraisers appointed by the court." ORS 60.594(1), 60.591(5)(a).

In addition, dissenters are entitled to "fees and expenses of [their] counsel and experts" if (1) "the corporation did not substantially comply with * * * ORS 60.561 to 60.587," or (2) the corporation "acted arbitrarily, vexatiously or not in good faith with respect to the rights provided by this chapter." ORS 60.594(2).

Under ORS 60.591(5), a dissenting shareholder is entitled to payment for that which has been taken, the fair value of the stock. In determining the fair value of a stock immediately before the merger, many factors are relevant, including, but not limited to, the following:[7] the price at which the shares had been selling; the amount, if any, of present share value increase or decrease because of anticipated future earnings of the corporation; corporate assets; corporate earnings or losses; corporate reputation; anticipated competition. ORS 60.551(4) excludes consideration of appreciation or depreciation in anticipation of the corporate action, unless it would be inequitable to exclude such appreciation or depreciation.

The fair value of corporate stock may be more or less than the sum of the parts of the corporation, depending on a host of factors. In determining the fair value of stock in a closely held corporation, ORS 60.551(4), the court's responsibility and authority is similar to that of a judge in a tax case or a domestic relations case involving the fair market value of stock of a corporation. In short, the court should take into account all relevant factors.[8]

"`Fair value,' with respect to a dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable."

[7] ORS 60.554(3) excludes cases involving shares "registered on a national securities exchange or prices * * * quoted on the National Association of Securities Dealers, Inc. Automated Quotation System as a National Market System."

[8] The Delaware court has held that "fair value * * * includes any damages, resulting from the taking, which the stockholders sustain as a class. If that was not the case, then the obligation to consider the [statutory obligation to take into account] `all relevant factors' in the valuation process would be eroded." Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del.1983). Although the Delaware statute, 8 Del C § 262(h), is not identical to ORS 60.551(4), and expressly includes "all relevant factors," it is reasonable to include those factors by implication. We need not and do not decide, in this case, what damages claims other than those asserted by plaintiffs herein would be permissible under ORS 60.551(4).

Plaintiffs' complaint in this case alleged neither fraud nor misleading representations that were relied upon by plaintiffs. From plaintiffs' complaint, one can infer only that the amount paid by CDS was unfair and unreasonably low, in an attempt to avoid paying fair value to plaintiffs for their shares.

Cases such as this are the very kind addressed by the statutory scheme. With the exception of punitive damages, every element of damages that plaintiffs seek herein is recoverable under ORS 60.551 to 60.594. The complaint contains no allegations of fact that, if proved, would support a punitive damages award.[9] The legislative plan expressly provides for recovery of attorney fees and expenses and of expert fees and expenses for arbitrary or vexatious action, or actions "not in good faith" in connection with the cash-out merger. See 60.594(1) and (2). This provision suggests to us that the legislature intended that, even if the corporation offers too little money to the dissenters for their shares "arbitrarily, vexatiously or not in good faith," ORS 60.594(2), and if the disagreement is solely as to the value of the shares, statutory appraisal is the exclusive remedy.[10]

The last clause of ORS 60.551(4) also is significant. To the extent, if any, that plaintiffs seek damages for "any appreciation or depreciation in anticipation of the corporate action," those damages can be considered if "exclusion would be inequitable." We agree with the Delaware Supreme Court that "there is a legislative intent to fully compensate shareholders for whatever their loss may be, subject only to the narrow limitation that one can not take speculative effects of the merger into account." *Weinberger v. UOP, Inc.,* 457 A.2d 701, 714 (Del.1983).

"`Thus, market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts which were known or which could be ascertained as of the date of merger and which throw any light on future prospects of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholders' interest, but must be considered by the agency fixing the value.' "This is not only in accord with the realities of present day affairs, but it is thoroughly consonant with the purpose and intent of our statutory law." Id. at 713 (quoting *Tri-Continental Corp. v. Battye,* [31 Del.Ch. 523,] 74 A.2d 71, 72 (Del.1950)).

In Weinberger, the Delaware court also stated:

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[9] In support of their punitive damages claim, plaintiffs allege that the acts of defendants, set forth in the text above at 8-9, "were wanton misconduct amounting to a deliberate disregard of the rights of the plaintiffs, entitling plaintiffs to an award of punitive damages."
"[I]f punitive damages are sought, facts must be alleged which, if proved, will establish the right to recover punitive damages." *Davis v. Tyee Industries, Inc.,* 295 Or. 467, 477, 668 P.2d 1186 (1983). A mere recitation that a defendant's conduct was wanton or malicious is a mere conclusion of the pleader. "Where punitive damages are sought, the complaint should set forth the ultimate facts which are claimed to support the recovery of punitive damages." Id. at 479, 668 P.2d 1186; accord: *Holden v. Pioneer Broadcasting Co.,* 228 Or. 405, 418, 365 P.2d 845 (1961).

[10] Where the dissenting shareholders vote for the merger or surrender their shares as a result of misrepresentation or fraud, they may bring a separate action for damages. See *Weinberger v. UOP, Inc.,* supra note 8, and *Rabkin v. Philip A. Hunt Chemical Corp.,* 498 A.2d 1099 (Del.1985). No such claims are made in this case.

> "But elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered." Id. at 713.

Plaintiffs' complaint clearly alleges a disagreement as to valuation, and we also can infer payment by Car Data of an unreasonably low price. Where the allegations show only a disagreement as to price, however, with no allegations that permit any inference of self-dealing, fraud, deliberate waste of corporate assets, misrepresentation, or other unlawful conduct, the remedy afforded by ORS 60.551 to 60.594 is exclusive. That is true even if the majority shareholders acted arbitrarily or vexatiously or not in good faith. *Stepak v. Schey,* 51 Ohio St.3d 8, 553 N.E.2d 1072, 1075 (1990) (remedy for breach of fiduciary duty involving only the price that a shareholder receives is limited to appraisal statute); *Schloss Associates v. C & O Ry.,* 73 Md.App. 727, 536 A.2d 147, 158 (1988) ("What we have then is essentially a complaint over price the amount and how it was establishedfor which the statutory appraisal right is a wholly adequate remedy."); *Green v. Santa Fe Industries, Inc.,* 70 N.Y.2d 244, 519 N.Y.S.2d 793, 800, 514 N.E.2d 105, 112 (1987) ("Here, * * * all of the actions with which defendant corporations are charged relate to price; there are no claims asserted against individual defendants based on dual representation; and it cannot be said that the `defendants are charged with bad faith which goes beyond issues of "mere inadequacy of price". *Cole v. National Cash Credit Association* 18 Del.Ch. 47, 156 A. 183, 187-88 [1931]'").[11] It may be that the $0.002 offer was insulting to plaintiffs, and it may even have been motivated by bad faith. But, because the facts alleged in the complaint, if established, support no claim for damages apart from the fair value of the shares, we believe that the legislature intended that dissenting shareholders in the position of plaintiffs be limited to their remedies under the appraisal statutes.

The decision of the Court of Appeals and the judgment of the circuit court are affirmed.

UNIS, Justice, concurring in part, dissenting in part.

The issue in this case is whether plaintiffs' complaint states a claim for breach of fiduciary duty and civil conspiracy. I cannot agree with the majority's holding that plaintiffs' complaint fails to state a claim under either theory. I would hold that plaintiffs' complaint states a claim for breach of fiduciary duty and civil conspiracy against all

[11] *Green v. Santa Fe Industries, Inc.,* upholds cash-out mergers motivated solely to freeze out minority shareholders. In Weinberger v. UOP, Inc., supra note 8, the Delaware court abandoned the "business purpose" rule requiring that a cash-out merger have some business purpose and was not merely for the purpose of squeezing out the minority shareholders that it had adopted in 1977. Other courts still require that a parent-subsidiary merger serve a business purpose. E.g., *Coggins v. New England Patriots Football Club,* 397 Mass. 525, 492 N.E.2d 1112, 1118 (1986). No such issue is presented here, and we express no opinion on that issue.

defendants [12] except defendant attorneys.[13] I agree with the majority that the complaint does not state a claim against defendant attorneys. I, therefore, concur in part and dissent in part.

Because plaintiffs' complaint was dismissed for failure to state a claim pursuant to ORCP 21 A(8),[14] this court must accept the allegations in the complaint as "true," *Madani v. Kendall Ford, Inc.,* 312 Or. 198, 201, 818 P.2d 930 (1991), and as "facts," *Nicholson v. Blachly,* 305 Or. 578, 580, 753 P.2d 955 (1988). Moreover, as the majority recognizes, we must give plaintiffs the benefit of all favorable inferences that may be drawn from the allegations. 314 Or. at 584, 841 P.2d at 1187. Applying these principles, the following seems to be a fair summary of those pleaded "facts" and favorable inferences to be drawn therefrom.

Plaintiffs Stringer and Schubert and three others founded CDS in 1986. Stock was sold in the corporation until, in 1989, there were 36 shareholders. Stringer and Schubert, along with the two nominal defendants in this case, retained about 43 percent of the stock. The stock was sold at about 10 cents a share during this period.

According to the complaint, CDS was successful during this period, and revenues were increasing faster than expenses. In early 1989, again according to the complaint, a third party made a written offer to purchase CDS at a price substantially above what was subsequently offered during the "squeeze-out" merger at issue here. CDS, by vote of the majority of shareholders, rejected the third party's offer.

The complaint alleges the following:

> "In late 1988 or early 1989, the CDS Directors and the larger CDS shareholders, Donald Smith, Mark Kallenberger and Lawrence Custer (collectively referred to herein as the `Controlling Shareholders'), decided to squeeze the Minority Shareholders out of their ownership in CDS and to offer then a nominal sum for their stock, which sum was significantly below fair market value of the stock (the `Plan'). The principal purpose of the Plan was to deprive the Minority Shareholders of most of the present value of their stock in CDS and to deprive the Minority Shareholders of their share of the anticipated significant rise in the value of CDS stock over the next few years." (Emphasis added).

[12] Elizabeth A. Perry and James B. Kargman are named as nominal defendants. Both were CDS shareholders who were not solicited to transfer stock to Car Data and did not vote for the merger.
[13] Defendant attorneys are Richard M. Botteri and Weiss, Descamp & Botteri, an Oregon professional corporation. In the complaint, plaintiffs allege only that the controlling shareholders of CDS retained legal services to "assist them in squeezing out the Minority Shareholders." The complaint does not state, and it cannot be inferred from the complaint, that the attorneys were made aware that the purpose of the merger was to temporarily devalue CDS's stock in order to capture for the majority shareholders some of the true value of the minority shareholders' stock. It is not unlawful simply to assist in an otherwise legitimate squeeze-out merger.
[14] The trial court also denied plaintiffs' leave to replead.

The complaint goes on to allege that the directors and the three larger majority shareholders, whom plaintiffs describe in their complaint as the "Controlling Shareholders," retained defendant attorneys to incorporate a new corporation, Car Data, as the vehicle for the completion of this plan.

The complaint also alleges that, in furtherance of the plan, the CDS directors and the "Controlling Shareholders" transferred all their CDS stock to Car Data and then solicited the participation of all CDS shareholders, except plaintiffs and the two nominal defendants. Once Car Data had obtained by these means a majority of the stock of CDS, a merger was proposed between CDS and Car Data.

As majority shareholder of CDS, Car Data approved the merger with a stock value of $0.002 per share, a price far below that previously offered by the third party. The stockholders of Car Data, i.e., the board of directors of CDS and all the former shareholders of CDS except plaintiffs and the two nominal defendants, also approved the merger. Plaintiffs allege that, as a result of this vote, the minority shareholders received $9,900 for stock with a fair market value of $290,000.

BREACH OF FIDUCIARY DUTY CLAIM

In plaintiffs' claim for breach of fiduciary duty, plaintiffs allege that the above acts by the directors, the collective majority of CDS shareholders and Car Data, constitute a breach of their fiduciary duty to the minority shareholders, including plaintiffs. Plaintiffs seek, inter alia, rescission of the merger or, in the alternative, damages equal to the fair market value of plaintiffs' proportionate share of defendant Car Data on the date of trial, plus punitive damages.

The majority holds that the allegations in plaintiffs' complaint "show only a disagreement as to price" and do not "permit any inference of self-dealing, fraud, deliberate waste of corporate assets, misrepresentation, or other unlawful conduct." 314 Or. at 590, 841 P.2d at 1190. The majority concludes that plaintiffs have no claim against defendants apart from their remedy under the appraisal statutes, ORS 60.551 to 60.594. This conclusion, in my judgment, ignores allegations that we must accept on an ORCP 21 A(8) motion as "true" pleaded "facts," and it ignores inferences favorable to plaintiffs that may be drawn from those allegations.

In 1987, the legislature adopted the Revised Model Business Corporation Act (RMBCA) sections 13.30 and 13.31, Or. Laws 1987, ch. 52, §§ 136 and 137, except for modifications necessary to conform to Oregon's judicial system. See Report of the Revised Model Business Corporation Act Task Force of the Business Law Section of the Oregon State Bar 63 (March 24, 1987). The sections became ORS 60.591 and ORS 60.594. These statutory provisions provide a dissenting shareholder with an appraisal remedy to secure "fair value" for shares in the event of a corporate act resulting in a merger.

The statutory provisions relating to the appraisal procedure are subject to ORS 60.554(2) and must be read in conjunction with that provision. ORS 60.554(2), which is taken from RMBCA section 13.02(b), provides that a dissenting shareholder "may not challenge the corporate action creating the shareholder's entitlement unless the action is unlawful or fraudulent with respect to the shareholder or the corporation." (Emphasis added.) The explanation for the exception provided for in ORS 60.554(2) is that "the prospect that shareholders may be `paid off' [through the appraisal procedure] does not justify the corporation in proceeding unlawfully or fraudulently." Official Comment to RMBCA section 13.02 at 1366 in 3 Model Business Corporation Act Annotated (3d ed, 1992 Supp).

Although the type of "unlawful" or "fraudulent" conduct required by ORS 60.554(2) to overcome the exclusive remedy of appraisal is not precisely defined, the Official Comment to RMBCA section 13.02 provides guidance. The Official Comment states that:

> "Because of the variety of situations in which unlawfulness and fraud may appear, this section makes no attempt to specify particular illustrations. Rather, it is designed to recognize and preserve the principles that have developed in the case law of Delaware, New York and other states with regard to the effect of dissenters' rights on other remedies of dissident shareholders." Id. at 1367 (emphasis added).

Thus, "[i]f the corporation attempts an action in violation of the corporation law on voting, in violation of clauses in articles of incorporation prohibiting it, by deception of shareholders, or in violation of a fiduciary duty," it cannot later hide behind the appraisal remedy provision of the RMBCA. Id. at 1366.

The Official Comment to RMBCA section 13.02(b) singles out *Weinberger v. UOP, Inc.,* 457 A.2d 701 (Del.Supr.1983), as an example of the case law that section 13.02(b) was designed to recognize and preserve. Id. at 1367. *Weinberger* recognizes that the statutory appraisal remedy may not be adequate, "particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets or gross and palpable overreaching are involved." *Weinberger v. UOP, Inc.,* supra, 457 A.2d at 714. Post-Weinberger Delaware decisions clearly recognize that appraisal rights are not the exclusive remedy in the face of allegations of misconduct.

In *Sealy Mattress Co. of N.J., Inc. v. Sealy, Inc.,* 532 A.2d 1324 (Del.Ch.1987), the Delaware Court of Chancery held that the minority shareholders were entitled to a preliminary injunction enjoining a squeeze-out merger. According to the court, "[a]s fiduciaries seeking to `cash out' the minority stockholders of a Delaware corporation in a non-arm's length merger, the defendants had a duty to be entirely and scrupulously fair to the plaintiffs in all respects." Id. at 1335. (citing *Weinberger v. UOP, Inc.,* supra, 457 A.2d at 710). The Delaware court was concerned that the majority stockholder not be allowed to "time or structure the transaction, or to manipulate the corporation's values,

so as to permit or facilitate the forced elimination of the minority stockholders at an unfair price." Id.

In *Sealy Mattress,* the court noted that the corporation's directors "were obliged to make an informed, deliberate judgment, in good faith, that the merger terms, including the price, were fair and that the merger would not become a vehicle for economic oppression." Id. Moreover, noted the Delaware court, "the directors (and the majority stockholder, to the extent that it involved itself in such matters) were obliged to disclose with entire candor all material facts concerning the merger, so that the minority stockholders would be able to make an informed decision as to whether to accept the merger price or to seek judicial remedies such as appraisal, an injunction, or a post-merger damage action." Id.

As in Sealy, none of the fiduciary obligations owed by corporate directors and majority shareholders were satisfied in this case.[15] Plaintiffs Stringer and Schubert alleged that the directors of CDS, acting with three certain larger CDS shareholders, developed a plan to squeeze out plaintiffs for a nominal sum, a sum significantly below the fair market value of plaintiffs' shares. The squeeze-out merger was implemented just after the majority shareholders had rejected a third-party offer to purchase substantially all of CDS assets at a price substantially greater than the $0.002 per share price set in the squeeze-out merger. The squeeze-out merger would have permitted the majority shareholders, which includes the six directors of CDS, to sell the CDS assets at this higher price without sharing any of the proceeds with the minority shareholders.

Such conduct by directors and the large shareholders does not meet duties of good faith and fair dealing imposed by Oregon law. See, e.g., *Zidell v. Zidell, Inc.,* 277 Or. 413, 418, 560 P.2d 1086 (1977) ("those in control of corporate affairs have fiduciary duties of good faith and fair dealing toward minority shareholders"); ORS 60.357 (requiring a director to discharge the duties of the office "in good faith"); ORS 60.361 ("[a] conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest"). With respect to the minority shareholders of CDS and, in particular, plaintiffs, the allegations of the complaint are, in my view, sufficient to permit an inference of self-dealing and gross, palpable, overreaching conducta violation of the fiduciary duty owed to plaintiffs by CDS directors and majority shareholders.[16] As such, the case should not have been dismissed at the pleading stage for failure to state a claim.

The majority admits that "[p]laintiffs' complaint clearly alleges a disagreement as to valuation, and we also can infer payment by Car Data of an unreasonably low price." 314 Or. at 590, 841 P.2d at 1190 (emphasis added). The majority, however, concludes that the only complaint plaintiffs make is the price of CDS's stock. Id. That interpretation

[15] It is unclear at this preliminary stage which, if any, of the defendants exercised majority shareholder control. Nevertheless, the allegation that the directors and the three larger CDS shareholders worked in concert to control CDS, together with the other allegations in plaintiffs' complaint, are sufficient to state a claim against those shareholders.

[16] Once the directors and the three larger shareholders of CDS transferred their stock to Car Data, it became the single majority shareholder in CDS.

ignores the means by which that price was alleged to have been determined, and who made that determination.

According to the allegations in plaintiffs' complaint and to inferences favorable to plaintiffs that may be drawn from those allegations, the directors of CDS hatched a plan to capture some of the corporation's stock at a bargain. This action, again taken from the complaint, was undertaken immediately following a purchase offer that these same directors, in their official capacity, had rejected. The inference drawn is that the directors of CDS, realizing the value of their stock, determined to capture as much of that value as possible for themselves. To do so, however, they needed to create a majority voting block.

To that end, the complaint alleges, the directors formed a paper corporation that had no assets whatsoever. The directors then transferred their CDS stock to the new corporation, Car Data. The complaint alleges that the purpose of the new corporation was to deprive a minority of the shareholders of CDS stock of the value of that stock. Surely the majority does not mean to hold that it is lawful for the directors of a corporation to plot unlawfully against some of the corporation's shareholders as long as those shareholders can subsequently defeat the unlawful plot through judicial action to determine the fair value of the company's stock. Yet that is the effect of the majority's holding.

I believe that the complaint alleges a breach of the fiduciary duty that the directors of CDS owed to plaintiffs as shareholders of CDS. The complaint does not allege that the directors wanted to "squeeze out" minority shareholders for the benefit of the corporation; it alleges that they conspired to steal some or most of the value of their stock by using a pseudo squeeze-out merger.[17] Car Data, the majority shareholder of CDS, was the vehicle used to accomplish that goal. The other shareholders who then joined the directors are implicated in the same misconduct.[18] Though they may not, as the majority states, have owed plaintiffs a fiduciary duty as shareholders, it nonetheless would be unlawful for them to conspire with the directors of the corporation to increase the value of their stock by creating a paper corporation with the intent to devalue temporarily the corporation's stock.

The inference fairly drawn from the complaint is that there was no "merger" in this case to which one could apply an appraisal remedy. Car Data, the complaint alleges, was no more than the alter ego of CDS's own directors and several of its largest shareholders. Its purpose, again according to the complaint, was to create a majority voting block to devalue the corporation's stock.

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[17] The majority recognizes that, in certain circumstances, such as a parent-subsidiary merger, courts may require that a cash-out merger have some business purpose, not just be undertaken to squeeze out minority shareholders. See 314 Or. at 590 n. 11, 841 P.2d at 1190. In this case, not only is there no business purpose for the merger of two corporations that share directors and majority shareholders, but the merger is alleged to be for the sole purpose of depriving the minority shareholders of one corporation of the value of their stock.

[18] See, infra, "Civil Conspiracy Claim."

Had the three larger majority shareholders ("Controlling Shareholders") conspired with the CDS directors to reject a legitimate purchase offer and then sold all CDS's assets to Car Data at far below market value so that they could resell Car Data at a windfall price, I do not believe that the majority would find it as difficult to find "overreaching." Yet, in this case, an allegation that certain shareholders and the directors of CDS created a paper corporation in order to accomplish the same result through a "merger" is considered insufficient. I do not believe that the drafters of the RMBCA or the Oregon legislature intended to create a vehicle for this kind of business practice simply because they wished to facilitate legitimate business mergers when there is a disagreement among shareholders over the wisdom of the merger.

In *Joseph v. Shell Oil Co.,* 498 A.2d 1117, 1122 (Del.Ch.1985), the Delaware Court of Chancery cautioned:

> "Because all inferences in the allegations in a complaint must be construed in favor of the plaintiffs, and because each suit is unique, complaints asserting a claim of unfair dealing as to a tender offer or freeze-out merger must be read carefully to determine if an appraisal will provide an adequate remedy if the claims prove to be true. Great care must be taken not to unjustifiably relegate objecting stockholders to an appraisal proceeding because to do so might have the result of precluding the imposition of an adequate remedy for serious breaches of fiduciary duty."

Appraisal actions are exclusive remedies only when the disagreement is over whether or not to accept an otherwise legitimate merger offer. When that is not the case, other courts allow actions to be pursued apart from an appraisal statute. See, e.g., *Rabkin v. Phillip A. Hunt Chemical Corp.,* 498 A.2d 1099 (Del.Supr.1985); *Coggins v. New England Patriots Football Club, Inc.,* 397 Mass. 525, 492 N.E.2d 1112 (1986); *Edelman v. Fruehauf Corp.,* 798 F.2d 882, 886-87 (6th Cir.1986); *Stepak v. Schey,* 51 Ohio St.3d 8, 553 N.E.2d 1072 (1990).

CIVIL CONSPIRACY CLAIM

Plaintiffs' complaint, in my opinion, also states a claim for civil conspiracy. In *Bonds v. Landers,* 279 Or. 169, 566 P.2d 513 (1977), this court upheld a judgment based on a theory of civil conspiracy,[19] stating:

> "`A civil conspiracy is a combination of two or more persons by concerted action to accomplish an unlawful purpose, or to accomplish some purpose not in itself unlawful by unlawful means.' 15A CJS 596, Conspiracy § 1(1), citing *Bliss v. Southern Pacific Co.,* 212 Or. 634, 321 P.2d 324 (1958); *Pitts v. King,* 141 Or.

[19] In *Bonds,* this court cited with favor the elements of civil conspiracy as set out in 15A CJS 599, Conspiracy § 1(2). Those elements are: "(1) Two or more persons, and for this purpose a corporation is a person; (2) an object to be accomplished; (3) a meeting of minds on the object or course of action; (4) one or more unlawful overt acts; and (5) damages as the proximate result thereof." *Bonds v. Landers,* 279 Or. 169, 174, 566 P.2d 513 (1977).

> 23, 15 P.2d 379, modified 141 Or. 23, 15 P.2d 472 (1932)." 279 Or. at 174, 566 P.2d 513.

Plaintiffs allege that defendants adopted a "plan" to deprive plaintiffs of the value of their stock. The underlying wrongful act was the breach of fiduciary duty by the directors and the collective majority of shareholders. Thus, the "concerted action" or "plan" of defendants to accomplish this unlawful act constitutes civil conspiracy.

CONCLUSION

In sum, I concur in that part of the majority's opinion that holds that plaintiffs' complaint fails to state a claim for breach of fiduciary duty and civil conspiracy against defendant attorneys. As against all other defendants, however, plaintiffs' complaint alleges facts that, if proved and considered along with favorable inferences to be drawn therefrom, would establish their right to recover for breach of fiduciary duty and civil conspiracy. I would hold, therefore, that defendants' ORCP 21 A(8) motions should have been denied, except as to defendant attorneys.

FADELEY, J., joins in this opinion.

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE SUNBELT BEVERAGE CORP. SHAREHOLDER LITIGATION) Consol. C.A. No. 16089-CC)

MEMORANDUM OPINION

Date Submitted: November 20, 2009
Date Decided: January 5, 2010

S. Mark Hurd and Samuel Taylor Hirzel II, of MORRIS, NICHOLS, ARSHT & TUNNELL LLP, Wilmington, Delaware; OF COUNSEL: Preston H. Longino, of LAW OFFICE OF PRESTON H. LONGINO, Phoenix, Arizona, Attorneys for Plaintiff.

Jesse A. Finkelstein, Srinivas M. Raju, and Blake Rohrbacher, of RICHARDS LAYTON & FINGER, P.A., Wilmington, Delaware; OF COUNSEL: Howard Graff and Judith R. Cohen, of DICKSTEIN SHAPIRO LLP, New York, New York, Attorneys for Defendants.

CHANDLER, Chancellor

This consolidated breach of fiduciary duty and appraisal proceeding arises out of the August 22, 1997 merger (the "Merger") of SBC Merger Corporation ("SBC") with and into Sunbelt Beverage Corporation ("Sunbelt"). One consequence—and a specific goal—of the Merger was the cash-out of Jane Goldring ("Goldring" or "Plaintiff") as a minority shareholder in Sunbelt.

Goldring contends that members of the Sunbelt board of directors ("Defendants") violated their fiduciary duties in cashing her out at an unfair price, for which Goldring seeks rescissory relief in the form of Arizona, Maryland, or another state in Sunbelt's wholesale alcohol distribution portfolio. In the alternative, Goldring seeks an appraisal of the fair value of her shares of Sunbelt stock as of the Merger date, an award of interest on the value of her shares, and an award of all costs and expenses, including attorneys' and experts' fees. Defendants, meanwhile, ask this Court to determine that the fair value of Sunbelt's stock at the time of the Merger was $45.83, that the Merger process was entirely fair, and that Goldring should not be awarded interest or attorneys' and experts' fees. Finally, defendants also ask the Court to strike exhibit A to Goldring's post-trial answering brief.

For the reasons set forth below, I determine that the fair value of Sunbelt at the time of the Merger was $114.04 per share. I award Goldring her pro rata share of Sunbelt's fair value on the date of the Merger, as well as pre- and post-judgment

interest, compounded monthly, at the legal interest rate. I also award Goldring all of her court costs and her experts' fees, but not her attorneys' fees. Lastly, I grant defendants' motion to strike exhibit A to Goldring's post-trial answering brief.

I. BACKGROUND

A. The Parties

Plaintiff Jane Goldring was an individual shareholder in Sunbelt. At the time of the Merger, Goldring held 120,000[1] shares of Sunbelt stock, or approximately 14.9% of the company. Although Goldring was the named stockholder, her husband, William Goldring, managed the investment pursuant to a permanent power of attorney to control all matters related to the Sunbelt stock.[2] The Goldring family has been engaged in the wholesale liquor business for four generations. Goldring viewed her investment in Sunbelt as a long-term investment, which would enable her to increase the presence and market share of the Goldring family in the wholesale alcohol distribution industry.

Defendant Sunbelt is a privately-held Delaware corporation engaged in the business of wholesale distribution of wine and spirits in multiple states. Sunbelt

[1] In their pre-trial stipulation, the parties agreed that Goldring held 120,000 shares of Sunbelt stock. The parties also stipulated that Goldring acquired her shares through two separate transactions, which, as discussed below, involved 54,000 shares and 60,000 shares, respectively. This appears to be a case in which the whole is greater than the sum of its parts. Given, however, that the parties agreed that Goldring held 120,000 shares, I will not probe more deeply the details relating to the number of shares Goldring held.

[2] For purposes of this Opinion, I will not differentiate between Goldring and her husband when I describe business activities and decisions.

formerly was a division of McKesson Corporation ("McKesson"), a public corporation that in 1988 began to divest its wine and spirits operations. McKesson approached Ray Herrmann ("Herrmann"), the former Vice-Chairman of McKesson Wine & Spirits, to inquire whether he would be interested in purchasing McKesson Wine & Spirits from McKesson. Herrmann responded by organizing a group of investors, including investment funds from the private investment firm of Weiss, Peck, and Greer ("WPG"),[3] to purchase McKesson Wine and Spirits. That purchase constituted the birth of Sunbelt. The consideration McKesson received for its 1988 sale of McKesson Wine & Spirits included a block of stock in Sunbelt and the right to designate a member of Sunbelt's board of directors so long as McKesson was a Sunbelt shareholder. Following this sale, McKesson and WPG were the primary shareholders of Sunbelt. Several other individuals held smaller amounts of Sunbelt stock and were involved in the management of Sunbelt.

The individual defendants were all members of Sunbelt's board of directors from at least mid-1994 through at least August 1997. These individuals include: Herrmann, Eugene Luciana, Herman Merinoff ("Merinoff"), Charles Merinoff, Spencer Merinoff, and Charles Andrews. Notably, the Merinoffs had been involved in the wholesale alcohol distribution industry for at least three generations.

[3] WPG's involvement in this divestiture was its first foray into the wholesale alcohol distribution industry.

B. Industry Background

In 1997, at the time of the Merger, a large number of states regulated the sale and importation of alcoholic beverages through a three-tier system, with suppliers at the top, wholesalers or distributors in the middle, and retailers at the bottom. Separate licenses were required to operate at each tier. Suppliers of alcoholic beverages generally could sell only to licensed in-state wholesalers, and wholesalers in turn generally could sell only to licensed in-state retailers. As of 1997, there were no publicly-traded distributors in the United States; regardless of size, these distributors universally were private closely-held companies, often family-owned, and did not make public disclosures of financial affairs.

C. Goldring Becomes a Sunbelt Shareholder

In 1991, Sunbelt acquired certain alcohol distribution rights in Florida held by Goldring, and in return issued to Goldring 54,000 shares of Sunbelt stock. At that time, the controlling shareholder in Sunbelt was WPG.

D. WPG and McKesson Seek to Sell Their Sunbelt Shares

In 1994, Philip Greer of WPG approached Goldring and asked if Goldring would be interested in acquiring the majority interest in Sunbelt held by WPG and McKesson. Goldring declined to make the acquisition but did express an interest in purchasing some number of additional shares of Sunbelt stock. Herrmann suggested WPG and McKesson approach Merinoff to inquire about his interest in

purchasing the controlling share of Sunbelt. By a stock purchase agreement dated March 31, 1994 ("1994 Agreement"), Colmar Investment Company LLC, an investment vehicle for the Merinoff family and certain other persons close to the Merinoffs, acquired Sunbelt common stock from WPG, McKesson, and other Sunbelt stockholders. Peter Pfister ("Pfister") was the WPG representative principally responsible for WPG's role in the negotiations of this agreement. The 1994 Agreement permitted the buyers to make purchases of Sunbelt stock over a period of three years, subject to a formula that would calculate the purchase price for each round of purchases ("WPG Formula" or "Formula").[4] At the same time as the 1994 Agreement, Goldring entered into a share purchase agreement ("1994 Shareholder Agreement") and acquired an additional 60,000 shares of Sunbelt stock. The 1994 Shareholder Agreement established, *inter alia*, that the WPG Formula would be the basis for a put of or call on Goldring's shares should certain triggering events occur.

E. Business Sweetens, Relations Sour

Goldring and Merinoff provide different accounts of events between March 31, 1994 and August 20, 1997. What is indisputable is that Sunbelt faced various business challenges in the early stages of that three-year period, including the loss of a key product line in Florida and South Carolina, but by 1997 Sunbelt seemed to

[4] There is a significant dispute over the implications of the various components of the Formula, which I discuss later in this Opinion.

have overcome those challenges and had posted record profits for the company. Goldring alleges that after becoming a Sunbelt shareholder she had received a steady stream of financial information about Sunbelt's operations, but that the flow dramatically decreased after the Merinoff interests assumed control of Sunbelt in 1994. Merinoff denies any decrease in financial information. By the spring and summer of 1997, an exchange of letters and conversations occurred, in which Merinoff expressed an intent to acquire Goldring's shares in Sunbelt, and in which Goldring expressed no interest in parting with those shares at the price Merinoff was offering. The initial exchange appears to have occurred during a trip to France. In a letter dated May 22, 1997, Goldring indicated he believed Merinoff's offer price extremely undervalued Sunbelt, especially given how profitable a year 1997 was proving to be for Sunbelt. In that letter, Goldring also suggested that an exchange could be made in which Goldring would acquire full rights to certain segments of Sunbelt's portfolio in return for Merinoff acquiring Goldring's shares.

Goldring believed Merinoff's offer price to be so low that she offered in a June 27, 1997 letter to purchase the entirety of the Sunbelt stock she did not already own. The purchase price of Goldring's offer was identical to the per-share price Merinoff had proposed for Goldring's own stock. If any other Sunbelt shareholder took Goldring's offer seriously, no one accepted. The letter and Goldring's offer had no impact. Merinoff reemphasized his intent to acquire

Goldring's shares, and Goldring reemphasized her view that Merinoff's valuation of Sunbelt stock was off the mark.

F. A Brewing Relationship with Young's Market

The summer of 1997 also saw an acceleration of planning for a stock swap between Sunbelt and Young's Market, the largest wholesale alcohol distributor in California as of 1997, with each company receiving 15% of the other. Goldring appears to have heard of the proposed relationship with Young's Market through the grapevine, and she believed a business relationship between Sunbelt and Young's Market would greatly enhance the value of Sunbelt, particularly given the consolidation in the industry that was occurring at that time. She mentioned this relationship and the business benefits in her June 27, 1997 letter. Yet in a July 14, 1997 letter, Merinoff informed Goldring that the stock swap with Young's Market was dependent upon Goldring's 15% share in Sunbelt being the Sunbelt stock that would be used in the stock swap.[5] In that same letter, Merinoff expressed his recollection that Goldring had previously made a verbal agreement with Merinoff to relinquish her shares upon Merinoff's request, at a price to be determined by the WPG Formula. On July 21, 1997, Herrmann sent Goldring a letter expressing that

[5] Vern Underwood, the President, Chairman, and CEO of Young's Market, testified in a 2001 deposition that he had never given a thought to which 15% of Sunbelt's stock Young's Market would need to acquire in 1997. That is, it appears Young's Market was indifferent to whether the Sunbelt stock was stock owned by Goldring or stock owned by any other Sunbelt shareholder, or newly issued shares of Sunbelt.

he too recollected that Goldring had previously promised Merinoff that Goldring would relinquish her Sunbelt stock upon request.

G. Final Purchase of Stock from McKesson and WPG

On July 31, 1997, McKesson and WPG sold their last remaining shares of Sunbelt stock to the Merinoffs ("July 31, 1997 Transaction" or "1997 Transaction"). The WPG Formula price for that transaction was $45.83. In completing the sale and parting with the last of its Sunbelt stock, McKesson was no longer entitled to a seat on Sunbelt's board of directors.

H. The August 6, 1997 Board Meeting

Sunbelt's board convened a week later, on August 6, 1997, to discuss a variety of matters, including the proposed business alliance with Young's Market. The board discussed the promises Goldring was said to have made relating to relinquishment of her stock at Merinoff's request, as well as her denial of having made any such promises. Before the conclusion of the meeting, the board authorized Sunbelt's officers to obtain a fairness opinion for a $45.83 per-share offer for Goldring's stock.

I. The Hempstead Fairness Opinion

Between Friday, August 8, 1997, and Friday, August 15, 1997, Mark Penny of Hempstead & Co. conducted a valuation of Sunbelt and prepared a fairness opinion for a proposed Sunbelt stock transaction at $45.83 per share. Penny

prepared this opinion in one week's time while simultaneously working on and traveling for another project. Penny's opinion used the following valuation approaches (and reached the following valuations): a discounted cash flow analysis ($36.68 per share); an analysis of prior transactions involving Sunbelt stock ($45.83 per share);[6] and an asset-based approach ($33.57 to $37.06 per share). On the basis of these valuations, Penny issued a fairness opinion that $45.83 was a fair price for a share of Sunbelt stock.

J. The August 18, 1997 Board Meeting

On August 18, 1997, Penny presented his fairness opinion to the Sunbelt board. The Sunbelt board then issued two authorizations: first, a call (the "Call") on Goldring's shares per the 1994 Shareholder's Agreement—which specified the Call would be at the WPG Formula—and, second, a freeze-out merger at the same WPG Formula price, or $45.83 as of July 31, 1997. The Merger became effective on August 22, 1997.

K. Litigation Commences

By letter to Sunbelt dated September 9, 1997, Goldring demanded appraisal of her shares under Delaware law. On December 12, 1997, Goldring filed her appraisal action in this Court, seeking a determination of the statutory fair value of her stock on August 22, 1997 plus interest, fees, expenses, and costs arising out of

[6] The earlier transactions were those involved in the July 31, 1997 sale of McKesson's and WPG's shares in Sunbelt, at the WPG Formula price.

the Merger. Nearly two years later, on August 12, 1999, Goldring filed a common law action for breach of fiduciary duty against Sunbelt and defendants, seeking rescission and rescissory damages. The latter filing occurred within weeks of a final decision by the United States District Court for the Southern District of New York that compelled Goldring to participate in arbitration that Sunbelt sought pursuant to the 1994 Shareholder Agreement. I stayed the Delaware proceedings, pending the outcome of arbitration in New York.

The New York arbitration hearing was conducted from October 1, 2001 through October 4, 2001. On December 18, 2001, the arbitration panel held that the Call and the Merger were attempts to eliminate Goldring as a minority shareholder without notice and without legal justification and to obtain her stock at a formula price, and that the Call was neither valid nor supported in law or in fact. The panel also held that it found no persuasive evidence that Goldring had ever promised she would relinquish her shares to Merinoff upon request, at the WPG Formula price or at any other price.

Following the conclusion of the New York arbitration, I lifted the stay on the Delaware proceedings and consolidated Goldring's appraisal action and her common law breach of fiduciary duty action. A three-day trial in the consolidated action was held on April 14, 16, and 17, 2009.

L. Expert Valuations

At trial, I heard testimony from valuation experts for both Goldring and defendants. Goldring's expert was Dr. Richard S. Ruback, the Willard Prescott Smith Professor of Corporate Finance at the Harvard Business School. Defendants' expert was Robert Reilly, a managing director of Willamette Management Associates, which is a valuation consulting, economic analysis, and financial advisory services firm.

Ruback used the following valuation approaches (and reached the following valuations): a discounted cash flow analysis ($114.04 per share)[7] and a comparable transactions analysis ($104.16 per share).[8]

Reilly used the following valuation approaches (and reached the following valuations)[9]: a discounted cash flow analysis ($36.30 per share), an analysis of

[7] This analysis and per-share value are Ruback's corrections to Reilly's own discounted cash flow analysis, to account for what Ruback believes are overstatements in Sunbelt's weighted average cost of capital. The Ruback and Reilly valuation models thus do not differ in terms of the underlying financial inputs. I note that Ruback had prepared an earlier discounted cash flow analysis, which involved corrections to Penny's own discounted cash flow analysis and which valued Sunbelt at $116.77 per share. One source of divergence between this value and $114.04 is the differing amounts for Sunbelt's fully diluted shares outstanding, as applied in the Reilly and Penny analyses.

[8] I will discuss below details relating to two versions of Ruback's comparable transactions analysis. The final operative per-share value, however, is $104.16.

[9] These valuations are described in defendants' post-trial briefs as those based upon Reilly's initial calculations but also "adjusted based upon the trial evidence." Defs.' Post-Trial Br., 62.

earlier transactions involving Sunbelt stock ($45.83 per share),[10] and an asset-based approach ($42.12 per share).

II. ANALYSIS

This case consists of both an entire fairness action[11] and a statutory appraisal action. The dual prongs of entire fairness—fair dealing and fair price—must both be satisfied.[12] Here, defendants bear the burden of demonstrating that the Merger was entirely fair, as they did not "use any of the procedural devices that could temper … the application of the entire fairness standard, such as a special negotiating committee of disinterested and independent directors or a majority-of-the-minority stockholder vote provision."[13] The element of fair price, furthermore, relates closely to the determination of fair value under the Delaware appraisal statute, 8 Del. C. § 262.[14] I therefore begin my analysis by examining briefly the issue of fair dealing and then turn to the related issues of fair price and statutory appraisal. I conclude with an examination of additional considerations, including

[10] The prior transactions were those involved in the July 31, 1997 sale of McKesson's and WPG's shares in Sunbelt, at the WPG Formula price.
[11] The relevant standard of review in this case is entire fairness, as there is no dispute that all defendants stood on both sides of the transaction. *See Kahn v. Lynch Commc'ns Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).
[12] *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).
[13] *Delaware Open MRI Radiology Assoc. v. Kessler*, 898 A.2d 290, 311 (Del. Ch. 2006).
[14] For additional discussion of this, see *id.* at 312 (noting that the "key issues relevant to each type of claim are common, and the differing rubrics have relatively little influence on the bottom line outcome of the case, which turns on whether the merger was financially fair.").

the shifting of fees and costs, and defendants' motion to strike an exhibit to Goldring's post-trial answering brief.

A. Fair Dealing

The goal of the Merger was to eliminate Goldring as a Sunbelt shareholder for the sole purpose of enabling the Merinoff family to join forces with Young's Market. The various attempts to acquire Goldring's shares in the months and weeks leading up to the Merger, itself ultimately a method of last resort, provide clear evidence of the intent behind the Merger. In their totality, defendants' tactics and approaches were nothing short of strong-armed. Sunbelt board members first communicated directly with Goldring in an attempt to acquire her Sunbelt shares at the WPG Formula price, alleging in a coordinated attack that Goldring had promised to sell her shares back to the Merinoffs upon the simple request from the Merinoffs that she do so. When these efforts bore no fruit, defendants issued the Call on Goldring's shares, which under the terms of the Shareholder Agreement was priced per the WPG Formula. Not surprisingly, the New York arbitration panel ultimately held the Call to be without justification in law or fact. Having foreseen the possibility that a court or arbitration panel may hold the Call to have been unjustified, defendants also approved a squeeze-out merger, devoid of procedural protections, as a final means of forcing Goldring out of the company and obtaining her 15% stake.

The process here was anything but fair. Instead, defendants employed a process that was jerryrigged every step of the way and that was transparent in its goal to eliminate Goldring before a stock swap with Young's Market, and to obtain her stock at the WPG Formula price. The ultimate step in the process, the Merger, included no procedural protections designed to ensure arm's-length bargaining or to approximate a fair valuation procedure. There was no special committee, no opportunity for genuine negotiations regarding the merger consideration, and no dissemination of material information that would level the playing field and prevent Goldring from becoming a drastically disadvantaged minority shareholder. Before the Merger was authorized, defendants obtained a fairness opinion for the proposed merger consideration of $45.83. Yet that fairness opinion itself is highly suspect. It was produced in approximately one week—during which the lead appraiser was busy working on at least one other matter that included a cross-country site visit and, thus, unable to work extensively and meaningfully with Sunbelt representatives—and just before the Sunbelt board meeting at which the board voted to issue the Call and to authorize the Merger. The "fairness opinion" was a mere afterthought, pure window dressing intended by defendants to justify the preordained result of a merger at the Formula price of $45.83 per share. In short, defendants abjured any semblance of a fair process.

B. Fair Value and Statutory Appraisal

The fairness of the Merger price is an analytical question "common to both the entire fairness and appraisal claims."[15] For the purposes of fair value, I will address the claims as one, through an analysis of the various methodologies employed in the parties' determination of Sunbelt's value at the time of the Merger. On the basis of that analysis I will determine which methodologies are most appropriate under Delaware law and in light of the particular circumstances of this case. On that basis, I will then determine the fair value of Sunbelt at the time of the August 22, 1997 Merger.

1. WPG Formula

At the heart of defendants' argument lies the WPG Formula. As discussed above, the WPG Formula determined the per-share price of Sunbelt stock for purposes of stock transactions that occurred between 1994 and 1997 and involved Herman Merinoff and others acquiring the remaining holdings of McKesson and WPG in Sunbelt. Defendants describe the WPG Formula as the outcome of an arm's-length negotiation between sophisticated parties and, thus, relevant under Delaware law as evidence of the fairness of the price Goldring received for her shares in the 1997 Merger, even if the negotiations underlying the Formula occurred in 1994 (three years before the cash-out Merger was even contemplated).

[15] *Id.* at 311.

Goldring asserts that there is no basis to assume the WPG Formula reflects fair value and that defendants' reliance on transactions pursuant to the Formula is circular. Ultimately, I conclude that the WPG Formula price is neither relevant to nor evidence of fair value and, thus, I decline to accord it any weight whatsoever in my determination of Sunbelt's fair value at the time of the Merger.

Defendants are correct in their assessment of the evidentiary import Delaware courts have accorded prior transactions in a company's stock. That import is grounded in the reasoning that the "fact that major shareholders … who had the greatest insight into the value of the company, sold their stock … at the same price paid to the remaining shareholders … powerfully implies that the price received was fair."[16] Additionally, even when provided with the results of expert valuations, a court may find arm's-length negotiations to be the most persuasive evidence of fair value.[17] But the cases to which defendants direct the Court involved transactions very different from the July 31, 1997 Transaction, and those differences are fatal to defendants' argument.

The 1997 Transaction did constitute an exchange of Sunbelt shares for cash, did occur in the weeks leading up to the Merger, and did involve sophisticated

[16] *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 117 (Del. 1995) (quoting *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1143 (Del. Ch. 1994)).
[17] *See, e.g., Prescott Group Small Cap, L.P. v. Coleman Co.*, 2004 WL 2059515, at *32 (Del. Ch. Sept. 8, 2004) (finding that "the most reliable and persuasive evidence of [the company's] fair value at the time of the [merger] is the value of the consideration that was negotiated at arm's length, and that [the acquirer] actually paid, to acquire the controlling interest [in the company] and to cash out the options held by minority shareholders.").

parties, both of which were members of (or had representatives on) Sunbelt's board of directors immediately before the 1997 Transaction. At first blush, these characteristics of the 1997 Transaction make the transaction seem similar in form to other earlier transactions that Delaware courts have examined and weighed when conducting valuation analyses. Yet this description of the 1997 Transaction does not reveal the key fact that the terms of the transaction were controlled by an agreement negotiated and signed *three years earlier*, in 1994, rather than the results of negotiations that occurred immediately before (or contemporaneously with) the Merger. The latter is the type of transaction that this Court has considered as relevant evidence to the question of fair value. The former is not.

There is no bright-line rule relating to the maximum length of time that may occur between an earlier transaction and a cash-out merger before the Court discounts the weight of the earlier transaction as evidence of fair value. Given the unusual circumstances here and the nature of this particular business, however, I conclude that three years is far too wide a gap between the two events. Defendants present what they describe as an "extensive record which establishes that the 1994 Transaction (whereby the Merinoff interest became shareholders in Sunbelt) and the WPG Formula (used to price subsequent stock purchases) were the result of hard, arm's-length negotiations between knowledgeable, financially sophisticated

parties each seeking to maximize their economic self-interests."[18] Those negotiations may have been hard and at arm's length, and the parties to them may have been knowledgeable and sophisticated, but what contractual terms the parties were willing to agree to in 1994 may be—and likely are—very different from the contractual terms that the parties would agree to in 1997, let alone different from the fair value of Sunbelt in 1997 as determined by the valuation techniques Delaware courts most frequently apply.

Defendants ask the Court to bridge the gap between 1994 and 1997 by considering the following question: if Sunbelt's 1997 fair value actually was anywhere close to the value Goldring ascribes to it, why would sophisticated investors such as McKesson, Pfister, and WPG agree to accept $45.83 per share in the sale of their remaining Sunbelt shares? According to defendants, "Pfister, WPG, and McKesson would not have been content to walk away from the many millions of dollars"[19] that adherence to the WPG Formula in effect would have denied them, even if it is the case, as defendants predict Goldring would assert, "that the sellers were contractually obligated to accept [the WPG Formula] price."[20] Furthermore, McKesson had a seat on Sunbelt's board until the sale of its last remaining shares in Sunbelt, which meant McKesson was in a position to have

[18] Defs.' Post-Trial Br., 8.
[19] *Id.* at 19.
[20] *Id.*

great insight into the value of Sunbelt and to gauge if over the course of three years there had grown to be a significant difference between: 1) the value of the company and 2) the share price as determined by the WPG Formula. But it is not up to me to gauge how effectively McKesson used whatever insight its board position provided it between 1994 and 1997. Nor am I entitled to speculate about the possible motivations of McKesson, Pfister, or WPG when they negotiated the terms of their exit strategy in 1994.[21] Ultimately, however, I am not persuaded by (nor do I find credible) any of the evidence offered by defendants that I should accept the valuation of Sunbelt that interested parties had struck *over three years before* defendants decided to cash out Goldring. It was defendants' burden to persuade me to accept the Formula as a proxy for Sunbelt's value, and they failed to meet their burden.

Despite my strong hesitation to accept the 1997 Transaction as evidence relevant to a determination of fair value, there are additional reasons to examine

[21] Nor can I determine the motivations of these individuals and groups at the time they negotiated and signed the 1994 Agreement. As noted above, Sunbelt describes those motivations as involving the maximization of economic interests. Goldring counters with a description of other motivations that may have guided the final decisions of the private-equity investors, even if those decisions resulted in a failure to maximize the value of their shares in Sunbelt as part of the transactions pursuant to the 1994 Agreement. These other potential motivations include ensuring a sufficient return on investment (rather than pure maximization of returns, or gauging returns in the same way Delaware courts determine fair value) or employing exit strategies based more on a strict time schedule rather than on returns on investment (for example, holding assets in a company or industry for no more than five to seven years). In deciding to what extent, if any, to weigh the WPG Formula in my determination of Sunbelt's fair value at the time of the Merger, I need not determine what motivations (or balance of motivations) guided those who were parties to the 1994 Agreement.

the WPG Formula more closely.[22] In short, although I believe the Formula is unreliable for the reason stated earlier, I nonetheless will examine the specific nature of the Formula.

Even a brief examination of that specific nature leads me to believe that the WPG Formula should not be used to determine fair value in this proceeding. First, the WPG Formula relies too heavily on the book value of Sunbelt,[23] provides a premium reliant solely on the company's net income in the two years preceding any Formula-based transaction,[24] and does not adequately incorporate the influence of intangibles and good will on the company's value.[25]

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[22] Goldring alleges that the WPG Formula in fact is the driving force behind Sunbelt's other valuation approaches, and has tainted the methodological integrity of those other approaches. I need not examine the connection between the WPG Formula and the results of Sunbelt's other valuation analyses, as there are independent reasons for rejecting those analyses.

[23] I do not believe Sunbelt to be a company in an industry—wholesale alcohol distribution—whose characteristics merit much, if any, use of book value in a determination of a company's fair value. Companies in this industry rely chiefly on agreements and good relationships with suppliers to conduct their primary business: moving and selling alcohol. Contrast this industry with one based primarily on natural resources or the intense reliance on physical, long-term assets, such as the coal or steel industry. Companies in the latter industries derive far more value from the use and maintenance of their physical assets, thus arguably justifying valuation driven by book value. Sunbelt, however, does not. It is for this reason that I also do not accord weight to Reilly's asset-based valuation approach, and decline to provide here a detailed discussion of that approach's specific findings. For an example of a context in which an asset-based approach is more appropriate, see *Neal v. Alabama By-Products Corp.*, 1990 WL 109243 (Del. Ch. Aug. 1, 1990), *aff'd*, 588 A.2d 255 (Del. 1991).

[24] Although I recognize that this premium did enable Pfister, WPG, and McKesson to realize some of any increases in Sunbelt's profitability that occurred while they remained Sunbelt shareholders, I do not believe a premium based on tax-adjusted net income adequately captures all elements of fair value to which a Sunbelt shareholder, or a former shareholder now contesting the Merger price, is entitled under Delaware law.

[25] As already noted, *see supra* note 23, Sunbelt is a company that relies heavily on agreements and good relationships with suppliers. Sunbelt's reputation in the industry, dependent in part on the names and reputations of the individuals who were shareholders in Sunbelt, is an intangible

Ruback's own quantitative examination of the WPG Formula also gives me pause, even beyond the complaint that the Formula does not calculate what the Court should accept as an indication of fair value. For example, Ruback compared the market capitalization of twelve public companies in SIC Code 514[26] to the value of those companies as calculated by the WPG Formula. On average, the WPG Formula valued these twelve public companies *three times less* than their market capitalizations.[27] Although I recognize that market capitalization is not necessarily—and most likely is not—strictly equivalent to fair value and that the efficient markets hypothesis has received due criticism, I also believe a consistent and drastic undervaluing of companies relative to their market capitalization in liquid equity markets strongly implies that the WPG Formula is valuing something very different from fair value. Furthermore, it is reasonable to expect that the WPG Formula would reach similar, even if not identical, results for a collection of companies outside SIC Code 514. If this Court and its valuation methodologies had, in the past, reliably and consistently determined the fair value of public

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asset. So too are the various agreements Sunbelt has with suppliers, even if those agreements can be canceled at a moment's notice, and particularly if the agreements are less likely to be canceled given Sunbelt's reputation in the industry and any enhancements to that reputation over time, however derived. The WPG Formula excludes these and other intangibles and, thus, fails to capture what I believe to be a significant source of value to Sunbelt, its operations, and its shareholders.

[26] As described in Ruback's expert rebuttal report, SIC Code 514 "includes wholesalers of groceries and related products, the industry with publicly traded firms most comparable to wholesalers of beverage alcohol, which are not publicly traded."

[27] Pl.'s Post-Trial Br., 56.

companies to be one-third of their market capitalization, I might have less concern about valuations using the WPG Formula. Defendants have not, however, provided any credible evidence that this Court's decisions and valuations suggest public securities markets systematically value companies at *three times their fair value*.

Perhaps with complete indifference to the evidence that the WPG Formula calculates the values of companies to be far lower than the value as determined by liquid securities markets, defendants ask the Court to consider the fact that Goldring "agreed that the WPG Formula would be utilized as a pricing mechanism for Sunbelt's option to purchase all of [her] shares (or [her] option to sell [her] shares) upon certain triggering events."[28] Defendants assert that "[w]hile these options are triggered by certain specific circumstances, if there were a chance any of those might occur, it is reasonable and appropriate to conclude that [Goldring] took pains to ensure [she] would receive a fair price for [her] Sunbelt shares."[29] This argument, however, has no legal relevance in the context of an appraisal proceeding. For one thing, there simply are too many variables that can change over the course of three years' time and over the shift in factual and legal contexts from the pricing of a put/call option—which is subject to a variety of triggering

[28] Defs.' Post-Trial Br., 16. This agreement occurred as part of the 1994 Shareholders Agreement.
[29] *Id.* at 18.

events—to the determination of fair value. In 1994, Goldring agreed to a valuation methodology in the event of a valid put or call. But no valid put or call ever occurred. Thus, the agreement has absolutely no relation to Goldring's statutory appraisal rights or to the accompanying valuation methodologies to which Goldring is now entitled under Delaware law.

The WPG Formula may have guided an unrelated transaction that occurred in the weeks before the Merger, but it was the result of an agreement negotiated and signed *three years before the Merger*. Given the potential for change in circumstances affecting Sunbelt's valuation over those three years, as well as the specific nature of the Formula and evidence that suggests the Formula tends to undervalue companies quite significantly, I attach no weight to the WPG Formula in my determination of Sunbelt's fair value at the time of the Merger.

2. Comparable Transactions Analysis

Defendants attack Ruback's comparable transactions analysis in its entirety, on the grounds that the analysis is flawed both methodologically and factually. Goldring proposes that I weigh Ruback's comparable transactions analysis as 50% of my final determination, though it is unclear if Goldring's proposal relates to Ruback's original analysis or his adjusted analysis.[30] For reasons I briefly describe

[30] Reilly indicated that Ruback's original comparables analysis did not account for the potential upwards impact of synergies on the pricing of the comparable transactions and, thus, the analysis's calculation of $149.69 per share may have been an overvaluation. Ruback responded

below, I believe it is most appropriate to accord no weight to either of Ruback's comparable transactions analyses.

The clash on comparables plays out on the field of fact rather than on the landscape of law. Goldring correctly notes that Delaware courts have used the comparable transactions approach when determining the fair value of companies,[31] and defendants are correct that Delaware courts have expressed reservations when using the approach[32] and that "the burden of proof on the question whether the comparables are truly comparable lie with the party making that assertion."[33] The parties do not appear to disagree on the relevant law. Here, the question turns on whether the companies involved in the transactions that underlie Ruback's analysis are sufficiently comparable to Sunbelt to merit inclusion of the transactions and thus to inspire confidence in the results of Ruback's comparables analysis. The inquiry also depends on whether certain aspects of Ruback's methodology

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by explaining his views that synergies likely did not influence the valuation upwards, yet he still completed an adjusted comparable transactions analysis that did account for the possibility that the comparable transactions were valued higher in anticipation of realizing synergies. Ruback's adjusted analysis resulted in an average per-share value of Sunbelt of $104.16.

[31] *See, e.g.*, *Dobler v. Montgomery Cellular Holding Co.*, 2004 WL 2271592 (Del. Ch. Sept. 30, 2004), *aff'd*, 880 A.2d 206 (Del. 2005) (affirming the Chancery Court's decision to give 65% weight to a comparable transactions analysis).

[32] *See, e.g.*, *Kleinwort Benson Ltd. v. Silgan Corp.*, 1995 WL 376911, at *4 (Del. Ch. June 15, 1995) (determining that a merger and acquisition analysis was unhelpful for appraising the going concern value of a company, given that the "merger and acquisition data undoubtedly contain[ed] post-merger value, such as synergies with the acquirer, that must be excluded from appraisal value.").

[33] *ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 916 (Del. Ch. May 26, 1999).

sufficiently compensate for concerns the Court may have regarding the suitability of specific elements of transactions Ruback used in his analysis.

I do have doubts about the comparability of the companies included in Ruback's analysis. These doubts are driven by the differences in size between the comparables and Sunbelt,[34] as well as the differences across product lines and geography, both of which stand to introduce differences across regulatory regimes. Furthermore, the companies were all privately held in a tightly controlled market. I am hesitant to examine what apparently are personality-driven transactions in a private market and to use the terms of those transactions to project what the value of another transaction should be.[35] When faced with these concerns, it is important to be particularly diligent about selecting companies and transactions that are as comparable as possible to the company in question. Ultimately, I am skeptical that Ruback's analysis achieved sufficient comparability, which alone is a basis for me to reject it as a reliable indicator of fair value.

Beyond the question of company comparability lie issues relating to methodology. Even if the companies themselves were more comparable to Sunbelt

[34] Ruback testified that due to economies of scale, Sunbelt's large size relative to the companies in the comparable transactions may mean a multiple should be *larger* for Sunbelt than for the comparables and, thus, the small size of the comparables relative to Sunbelt should not be a concern.

[35] Ruback also testified that the specific facts of the transactions in his comparables analysis suggest the terms of those transactions heavily favored the acquirers and, thus, that the sale prices may have been lower than the true values of the companies. This would result in artificially low calculations of the transaction multiples.

than I am willing to find, Ruback failed to account for important elements of specific transactions that stood to influence the accuracy of his calculations. Two examples of these elements are the transactions' inclusions of real-estate payments and post-closing price adjustments. Defendants assert that Ruback's analysis includes these failures and many other discrepancies. In response, Ruback noted that he could not estimate the impact of any such discrepancies without further studying the specific terms of the transactions, and that ultimately he relied on his use of the median multiple approach to compensate for any shortcomings related to specific companies or transactions. Although I do not agree with defendants that Ruback's comments were "academic doubletalk,"[36] I am not willing to rely on the employment of a median multiple approach as a justification for ignoring several known deficiencies in facts and methodology. The median multiple approach is at its best when it smooths out unknown or immeasurable sources of difference and error in an analysis. When, as appears to be the case here, there are known and measurable variations or errors in an already small sample size, the median multiple approach cannot be the sole justification for a failure to account for such variations or errors. That approach may help here to some extent with smoothing,

[36] Defs.' Post-Trial Answering Br., 41. Methodological issues aside, I believe Ruback's testimony was, in general, quite nuanced, and that nuances are what many academics bear in mind when providing expert testimony. And strict etymology aside, I was not impressed with defense counsel's efforts to characterize an appreciation for nuance as an adherence to Orwellian practices.

but I do not find it sufficient to inspire confidence in according weight to the comparable transactions analysis in my determination of Sunbelt's fair value.

There are a number of disputes about the factual and methodological bases of Ruback's comparable transactions analysis. Some of these bases may have increased the calculated values of Sunbelt, and others may have decreased it. It is unclear what resolution of those disputes would do, on balance, to the comparables calculation, but it is clear that neither party has provided me with the information required to independently address the issues with quantitative and methodological confidence. I could accept Ruback's comparables calculation as a Goldilocks valuation, nestled comfortably between valuations potentially above and below $104.16. Or I could attach partial weight to the comparable analysis in my final determination of Sunbelt's value, reflecting a marginal confidence that Ruback's comparables calculation hits somewhere in the vicinity of Sunbelt's fair value, even if it misses high or low. Given the clear shortcomings in Ruback's comparables analysis, however, I decline to do either. Instead, I attach no weight to Ruback's comparables analysis.

3. Discounted Cash Flow Analyses

The parties disagree on two components that significantly guide the results of their experts' respective discounted cash flow analyses: the appropriate level of the small-firm risk premium, and the propriety of including any kind of company-

specific risk premium. I will analyze these two components as they relate to the facts of this case and then briefly assess the legal basis for adjusting the value of Sunbelt to account for its post-Merger conversion to S-corporation status.

a. Small-Firm Risk Premium

The parties agree on the propriety of including a small-firm risk premium in the discounted cash flow analysis. The appropriate value of the premium, however, is a point of stout contention.

Both parties claim their respective experts followed the instructions of Ibbotson Associates ("Ibbotson")[37] when selecting the appropriate value of the small-firm risk premium. Ibbotson provides a table of the premium values that correspond to the deciles of company size as measured by market capitalization. The relationship between company size and premium value is inverse; that is, the larger a company's market capitalization, the smaller the corresponding risk premium. Ruback selected a premium of 3.47%, which is the value Ibbotson indicates should be used for micro-cap companies whose equity capitalization is at or below $201,169,500, or in the ninth and tenth deciles of equity capitalization on the New York Stock Exchange. Reilly, however, selected a premium of 5.78%,

[37] According to their website, Ibbotson Associates is "a leading authority on asset allocation with expertise in capital market expectations and portfolio implementation." Ibbotson Associates, Overview, http://corporate.morningstar.com/ib/asp/subject.aspx?xmlfile=1383.xml (last visited Dec. 18, 2009). In Delaware appraisal actions, valuation experts and this Court often rely on the data and guidance provided by Ibbotson.

which is the value Ibbotson measures as the size premium for companies in the tenth decile of equity capitalization on the New York Stock Exchange.

The divergence in Ruback and Reilly's selection of risk premiums presents the Court with two questions: what is the market capitalization of Sunbelt and the corresponding decile for that market capitalization, and what is the appropriate Ibbotson premium to use in a discounted cash flow analysis of Sunbelt, given that Ibbotson lists premiums for individual deciles as well as premiums for groups of deciles?

The first question poses an issue of circularity. The Ibbotson table assumes one already knows or has an estimate of a company's market capitalization. Based on that knowledge or estimate, one can determine which decile the company falls into and then select the corresponding premium from the Ibbotson table. But when the very issue in dispute is the value of the company itself and when a discounted cash flow analysis is a proposed means for resolving the dispute, the appropriate risk premium cannot be taken as exogenous. That is, a discounted cash flow analysis both *values* the size of a company (and thus points to the appropriate Ibbotson premium to use) and *relies* on the appropriate Ibbotson premium to determine the value of the company. This process is circular; which should come first, the valuation of the company or the selection of the Ibbotson risk premium?

Ruback's selection of a 3.47% premium ensures a larger calculated equity capitalization (and thus a company perhaps deserving of the 3.47% premium) than Reilly's selection of a 5.78% premium (which in turn ensures a smaller calculated equity capitalization and, thus, one perhaps deserving of the 5.78% premium). Reilly goes as far as to say that because his selection of a 5.78% premium results in a valuation that places Sunbelt in the tenth decile—the decile with a corresponding premium of 5.78%—I should take this as evidence that the 5.78% premium is appropriate. I cannot accept this asserted mathematical proof and proposed flow of causality. It is methodologically problematic to rely on a discounted cash flow analysis to determine the Ibbotson risk premium appropriate to use in the discounted cash flow analysis. There must be some independent basis or value[38] used for determining the propriety of applying a risk premium from the Ibbotson table, particularly when, as appears to be the situation here, the company's valuation may actually place the company close to the line between deciles.

[38] *See, e.g.*, *In re Emerging Commc'ns, Inc. S'holders Litig.*, 2004 WL 1305745, at *18-19 (Del. Ch. May 3, 2004) (acknowledging the possibility of employing an iterative process involving an independent valuation to overcome a circularity problem (in calculating the weighted average cost of capital), but ultimately: 1) rejecting both experts' assumed enterprise valuations; 2) finding that "the only sensible way (in the Court's view) to avoid the circularity … is to use an enterprise valuation of [the company] that is not litigation-drive"; and 3) declining to employ the iterative process and instead selecting independent estimates of both the company's enterprise value and the company's debt-to-value ratio); *Cede & Co. v. JRC Acquisition Corp.*, 2004 WL 286963 (Del. Ch. Feb. 10, 2004) (finding that the record did not support the methodology of using implied fair value (that is, a non-independent basis) to determine the appropriate equity size premium to select from the Ibbotson tables).

Each party's argument provides me with an option for circumventing this methodological problem. Defendants point to the result of Ruback's own comparable transactions analysis[39]—which calculates a value for Sunbelt that would place the company in the tenth decile—as a basis for selecting the tenth-decile premium of 5.78%. Although this calculation is one independent of a discounted cash flow analysis and thus could provide a basis for selecting a small-firm risk premium from the Ibbotson table, I prefer the option presented by Goldring and employed by Ruback: follow the strict language Ibbotson used to describe how it adjusted for small-firm premiums in its own publication, and apply a premium of 3.47% for companies in the ninth or tenth deciles.[40] This approach also helps to answer the second question posed above, that relating to whether to apply a risk premium from an individual decile or one assigned to a composite of deciles. According to Ibbotson, the 3.47% premium is a weighted balance between the ninth-decile premium of 2.65% and the tenth-decile premium of 5.78%. Given the uncertainty in Sunbelt's own value and whether Sunbelt falls on the smaller or larger side of the line between the ninth and tenth deciles, I believe it is more

[39] The analysis to which Sunbelt points is Ruback's adjusted comparable transaction analysis, which calculated an average per-share value of Sunbelt of $104.16.

[40] I elect not to use the comparable transactions analysis as a basis for determining the appropriate Ibbotson risk premium. As discussed earlier, I have several concerns about the methodology and factual information underlying the comparables analysis and, consequently, I will not factor the comparables analysis into my valuation of Sunbelt. It, therefore, is most appropriate not to rely on the comparables analysis's valuation of Sunbelt as a basis for determining the appropriate Ibbotson risk premium to use in a discounted cash flow analysis.

appropriate to select 3.47%, a small-firm risk premium that accounts for the possibility that the company is on either side of the line and that Ibbotson itself seems to have applied to all firms within (or between) the ninth and tenth deciles.

b. Company-Specific Risk Premium

In an appraisal action, "the proponent of a company specific premium bears the burden of convincing the Court of the premium's appropriateness."[41] Defendants accept this burden and point the Court to cases in which the Court has deemed a company-specific risk premium to be appropriate.[42] Yet as Vice Chancellor Strine explained in one of the cases defendants cited, even though courts may approve the use of these premiums, "[t]o judges, the company specific risk premium often seems like the device experts employ to bring their final results in line with their clients' objectives, when other valuation inputs fail to do the trick."[43] Proponents of a company-specific risk premium thus not only bear a burden of proof but also must overcome some level of baseline skepticism founded upon judges' observations over time of how parties have employed the quantitative

[41] *Hintmann v. Fred Weber, Inc.*, 1998 WL 83052, at *5 (Del. Ch. Feb. 17, 1998).
[42] *See, e.g.*, *Delaware Open MRI Radiology Assoc. P.A. v. Kessler*, 898 A.2d 290, 340-41 (Del. Ch. 2006) (declining to "quibble" with including a company-specific risk premium, and ultimately selecting the more conservative of the two premiums the parties presented); *Henke v. Trilithic Inc.*, 2005 WL 2899677, at *10 (Del. Ch. Oct. 28, 2005) (agreeing that an upwards adjustment to account for company-specific risk was appropriate); *Lane v. Cancer Treatment Ctrs. Of Am., Inc.*, 2004 WL 1752847, at *30-31 (Del. Ch. July 30, 2004) (accepting adjustments for company-specific risk); *ONTI, Inc. v. Integra Bank*, 751 A.2d. 904, 919-20 (Del. Ch. 1999) (applying a company-specific risk premium yet reducing the suggested value thereof after finding that not all risks outlined by valuation experts were risks specific only to the company).
[43] *Delaware Open MRI*, 898 A.2d at 339.

tool of a company-specific risk premium. Here, defendants have completely failed to clear this hurdle. I believe the use of a company-specific risk premium in this case is unwarranted.

Defendants offer three primary justifications for including a company-specific risk premium: (1) the at-will termination of supplier agreements that prevails throughout the wholesale alcohol distribution industry; (2) the competition Sunbelt faces from specific players such as Southern Wine & Spirits; and (3) the level of optimism contained in Sunbelt's management projections.[44]

I conclude that none of these justifications merits inclusion of a company-specific risk premium for Sunbelt. The first and second justifications clearly relate to the industry as a whole, rather than specifically to Sunbelt.[45] In the absence of defendants showing why Sunbelt *specifically* faces these first two risks in a manner greater than other industry players, I must rely on defendants' own description of

[44] *See* Defs.' Post-Trial Br., 31-41.

[45] Indeed, it is entirely possible that these first two factors pose *less* of a risk to Sunbelt than they do to other companies. Sunbelt's market size and presence could decrease the risk that a supplier would choose to terminate an agreement and in doing so lose the potential benefits of a relatively large distribution channel. Likewise, Sunbelt's size and presence could decrease the threat of a competitor cherry-picking a supplier from Sunbelt's portfolio, if the competitor believes Sunbelt would be more likely to respond or more likely to respond effectively than would a smaller competitor. Of course, Sunbelt's size could also open it up to greater risks and threats, if suppliers in this industry have an aversion to working with larger or more experienced companies, or if competitors believe a larger portfolio means cherry-picking would feel to Sunbelt more like a prick than a stab and, thus, would be less likely to elicit retaliation. The actual risks Sunbelt faces relative to its competitors are a matter of empirics. Sunbelt both fails to provide evidence demonstrating why the risks it faces are different from those its competitors face, and fails to persuade me that any differences in risk actually find Sunbelt in a more precarious position than are other companies in the industry.

these "unique risks in the alcoholic beverage wholesale industry"[46] as simply that—risks to everyone in the industry, not only to Sunbelt. As a result, these are not risks that merit inclusion of a company-specific risk premium.

I also believe Sunbelt's management projections to be an inappropriate basis for inclusion of a company-specific risk premium. First and foremost, I see no evidence, persuasive or otherwise, that at the time they were developed management projections were excessively or generously optimistic. Defendants thus have failed to meet their evidentiary burden to demonstrate to me that it was riskier for Sunbelt to rely on its specific management projections than it is for all companies to rely on management projections. Furthermore, even had defendants met that burden, I am skeptical that a company-specific risk premium is an appropriate response to optimistic management projections. It is not clear to me how one would or should value the appropriate company-specific risk premium to use as an adjustment for such projections. Also, this risk adjustment certainly would not be without its own irony. I do not believe a company should be able to manufacture justification for a company-specific risk premium (and all the quantitative uncertainty accompanied therewith) simply by adjusting its management projections such that there is a heightened risk in relying on those projections, no matter how unique that risk-thirsty practice may be to the company.

[46] Defs.' Post-Trial Br., 31.

The present case demonstrates another critical consideration in evaluating the propriety of a company-specific risk premium. Even if I were to have found persuasive the arguments defendants have made for inclusion of a company-specific risk premium, I would be especially skeptical of the 3% risk premium which defendants advocate. Reilly has provided no specific, quantitative explanation for why 3% is the appropriate level for a company-specific risk premium. It is important for any proposed company-specific risk premium to be based on a specific financial analysis, so that the Court can verify both the propriety of including the risk premium and the appropriate level of the premium.[47]

Defendants have failed to meet their burden to demonstrate why Sunbelt faces company-specific risks rather than risks faced by all companies in its industry and thus why valuations of the company merit inclusion of a company-specific risk premium. They also have failed to provide a rigorous, quantitative explanation for why their proposed company-specific risk premium of 3% is an appropriate discount. Accordingly, I make no adjustments to a calculation of Sunbelt's fair value on the basis of company-specific risks.

[47] *See, e.g., Gesoff v. IIC Industries, Inc.*, 902 A.2d 1130, 1158-59 (Del. Ch. 2006) (noting that the valuation expert's "application of the [company-specific risk premium] was based almost entirely on his subjective beliefs as to the correct discount rate," that the expert was "unable, crucially, to point to specific financial analyses on which the court could rely to derive such a discount," and that although the calculation of a company-specific risk premium inherently involves some level of subjectivity, the expert's analysis was "unmoored to any objective financial analysis the court can reasonably evaluate, and thus cannot be the basis of what are, in aggregate, substantial discounts to [the company's] fair value.").

c. Subchapter S Conversion

Both parties adjusted their respective valuations to take into account the effect of a conversion in Sunbelt to Subchapter S status, a 26% increase in the company's value, as calculated by Reilly and later accepted by Goldring. Though it may seem unusual for a court to interfere with rare harmony in opposing parties' valuation methodologies,[48] I now must do just that, for the parties have, in my view, failed to apply a fundamental principle of Delaware appraisal law.

As noted above, it is well settled that "[t]he basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him"[49] or her, and that "speculative elements of value that may arise from the 'accomplishment or expectation' of the merger are excluded."[50] Goldring owned shares in a C corporation, and those shares were taken from her. Further, it may be inaccurate even to describe Sunbelt's conversion to S-corporation status as an "accomplishment" or "expectation" of the Merger itself, for the Merger was only one part of a broader corporate reorganization plan that included a post-merger conversion to S-corporation status. Yet however one

[48] Sunbelt argues in its post-trial briefs that there should be no adjustment in the value of Sunbelt for its conversion to S-corporation status. This argument arises now, despite the fact that Sunbelt had already instructed Reilly to adjust the results of his discounted cash flow valuation to account for potential enhancements in the value of Sunbelt stock after Sunbelt's post-Merger conversion to S-corporation status. Following Sunbelt's instructions yet despite his own objection to the propriety of the adjustment, Reilly increased his valuation by 26%, and Goldring saw no reason to refrain from following suit.
[49] *Tri-Continental Corp. v. Battye*, 74 A.2d 71, 72 (Del. 1950).
[50] *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983).

describes Sunbelt's conversion to S-corporation status in the context of the corporate reorganization, Goldring never held nor ever would have held Sunbelt shares at the time it was an S corporation. She was cashed out as a shareholder in a C corporation.

Accordingly, I conclude that there is no basis for an upwards adjustment of the per-share value of Sunbelt on the basis of Sunbelt's post-merger conversion to an S corporation.[51] Consequently, I will not accord weight to valuation calculations that have incorporated an adjustment on the basis of Sunbelt's S-corporation conversion.

[51] Sunbelt explains its issuance of the instruction as a response to inquiries from Goldring's counsel, during depositions, about the potential impact of S-corporation conversion, though a 26% increase in Reilly's calculations is a most generous response to mere inquiries during depositions. I also wonder to what extent generosity and methodological flexibility—whether benefiting Sunbelt or not—may underlie other aspects of Sunbelt's valuations and arguments. Strictly in terms of the issue of S-corporation status, however, I need not explore the issues of generosity and flexibility or the question of why Sunbelt's position appears inconsistent. Nor do I need to examine Sunbelt's new argument against adjustment on the basis of S-corporation status, which is not an argument based on law but rather one of complete conjecture: the specific level of distributions Sunbelt may or may not make to its shareholders and thus the value those shareholders may or may not enjoy as a result of Sunbelt's status as an S corporation. Goldring correctly notes that the Court in *Delaware Open MRI* did not accept such conjecture, though Goldring fails to distinguish that Delaware Open MRI, unlike Sunbelt, was an S corporation *at the time of its merger*. Delaware Open MRI's pre-merger status as an S corporation is what entitled the minority shareholders in that case to a valuation incorporating the future benefits of being a shareholder in an S corporation. No matter what level of distributions Sunbelt ultimately elected to provide its shareholders after the Merger, Delaware law clearly excludes from the valuation of Goldring's shares any enhanced value stemming from Sunbelt's post-Merger conversion to S-corporation status.

4. Court's Valuation of Sunbelt and Determination of Appropriate Remedy

Because I have rejected Ruback's comparable transactions analysis, the WPG Formula, and adjustments based on Sunbelt's post-merger conversion to S-corporation status, I will value Sunbelt using the experts' discounted cash flow methodology. In doing so, I draw on the financial inputs as provided by Sunbelt and agreed upon by the valuation experts, and I use the discount rates employed by Ruback. Applying this methodology, I determine that the fair value of Sunbelt at the time of the 1997 Merger was $114.04 per share.

This determination represents fair value, will fully and fairly compensate Goldring, and suffers from none of the practical problems that afflict Goldring's proposed rescission remedy. The rescissory damages Goldring requests would require the Court to carve out approximately 15% of Sunbelt's distribution portfolio to reflect the 15% stake Goldring held in Sunbelt at the time of the Merger. Goldring suggests the distribution market of Arizona or Maryland as an example of an appropriate state market for the Court to carve out and award to her as "rescissory damages." I do not believe, however, that rescissory damages are appropriate in this case. Any such award would present significant issues related to complexity and implementation, not the least of which would find the Court engaged in another valuation analysis. I would first have to determine what valuation metric is most appropriate to use in seeking to identify 15% of Sunbelt's

portfolio, and I would then have to determine the period of time over which to value the company. Both of these elements, as well as others, pose an issue of arbitrariness, and certainly would not guarantee an award that accurately reflects 15% of Sunbelt's portfolio as of the Merger date, particularly given the ever-changing system of overlapping and tiered regulations in which an alcohol distributor such as Sunbelt operates. Simply put, Sunbelt and its business portfolio are too complex to unscramble and, ultimately, rescission is an equitable remedy that a court of equity will only grant, as an exercise of discretion, when that remedy is clearly warranted.[52] Here, given practical difficulties in crafting rescissory relief and the fact that $114.04 per share in money damages is a clearly adequate substitute remedy, I decline to award rescissory damages

C. Additional Considerations

1. Fees and Costs

Goldring seeks a shifting of attorney fees and costs in her favor.[53] Defendants oppose any such shift and propose that any shifting of fees should be in Sunbelt's favor.[54] I award to Goldring all court costs and expert witness fees that

[52] *See, e.g., Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983) (outlining examples of circumstances under which "the Chancellor's powers are complete to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages.").
[53] Pl.'s Post-Trial Br., 48.
[54] Defs.' Post-Trial Answering Br., 45 ("Given the evidence in this case of Mr. Goldring's ever-changing testimony at trial and Professor Ruback's cavalier approach to his expert obligations, if there is to be any fee-shifting in this case, it should be in favor of Sunbelt.").

she incurred in the process of litigating this consolidated action, but I decline to shift attorneys' fees.

It is within my discretion to determine costs of the proceedings and to tax the costs "upon the parties as the Court deems equitable in the circumstances."[55] In the present circumstances and on the basis of my analysis of defendants' conduct, I believe it is most equitable for defendants to pay the court costs Goldring incurred during the course of litigation. Likewise, I award Goldring all costs incurred in association with the testimony and preparation of her expert witness valuations.[56] The expert fees total $841,763, an amount that defendants have objected to as unreasonable both in the timing and activities upon which the fees were based.[57] Nevertheless, I have rejected defendants' objection, principally on the ground that a litigant who has paid fees at a time when it was uncertain the fees would be recovered is evidence of the fees' reasonableness.[58] In addition, after reviewing the fees, I have independently determined that they are reasonable

[55] 8 *Del. C.* § 262(j).
[56] *See* 10 *Del. C.* § 8906 ("[F]ees for witnesses testifying as experts … in cases in … the Court of Chancery … shall be fixed by the court in its discretion [and] taxed as part of the costs in each case and shall be collected and paid as other witness fees are now collected and paid."). *See also Dobler v. Montgomery Cellular Holding Co., Inc.*, 2002 WL 31112195 (Del. Ch. Aug. 29, 2002) (awarding expert costs on the basis of the discretion that 10 *Del. C.* § 8906 provides the Court).
[57] Defendants did not use the word "concern" or "objection" in their November 20, 2009 letter, but I believe it appropriate to accept defendants' letter as one expressing concern and objection over the total and source of the fees.
[58] *See, e.g.*, *Arbitrium (Cayman Islands) Handels AG v. Johnston*, 1998 WL 155550, at *2 (Del. Ch. Mar. 30, 1998) (determining fees to be reasonable, in part on the consideration that litigant had paid fees even though it was unclear if fee recovery would be possible later in the proceedings), *aff'd*, 720 A.2d 542 (Del. 1998).

for complex and hard fought litigation involving difficult valuation issues. Accordingly, I award Goldring $841,763 in expert fees.

I agree with defendants' analysis on the issue of shifting attorney fees: "to constitute bad faith [and thus warrant shifting of attorney fees contrary to the American Rule], the defendants' action must rise to a high level of egregiousness."[59] Here, I cannot find defendants' actions to be of the egregious, vexatious, or bad-faith sort that have merited the shifting of attorney fees in earlier cases.[60] Most notably, although I acknowledge many of the similarities Goldring identifies between the present matter and *Montgomery Cellular Holding Co. v. Dobler*,[61] I believe defendants' reliance on the transactions priced at the WPG Formula was sufficiently reasoned to preclude a finding that there was no legal issue in this case upon which reasonable parties could differ. That is, parties could and did reasonably differ on the legal import of the WPG Formula. The WPG Formula ultimately may have had no weight in my valuation analysis and may

[59] *Judge v. City of Rehoboth Beach*, 1994 WL 198700, at *2 (Del. Ch. Apr. 29, 1994).
[60] *See, e.g.*, *Arbitrium (Cayman Islands) Handels AG v. Johnston*, 705 A.2d 225 (Del. Ch. 1997) (finding that defendants acted in bad faith by, *inter alia*, opposing the action despite their knowledge that plaintiff's claim to majority shareholder status was valid and altering testimony, changing positions repeatedly, and falsifying evidence at trial), *aff'd*, 720 A.2d 542 (Del. 1998); *Abex Inc. v. Koll Real Estate Group, Inc.*, 1994 WL 728827, at *20 (Del. Ch. Dec. 22, 1994) (describing the case as one contrary to "a defendant resist[ing] a contractual liability on grounds as to which reasonable men could differ" and the defendant as having operated in bad faith via having "contest[ed] liability, threaten[ed] litigation, and force[d] plaintiffs to prosecute this action and litigate defenses that had no factual or legal merit.").
[61] 880 A.2d 206, 228 (Del. 2005) (upholding a Court of Chancery decision to award attorney fees on the basis of, *inter alia*, the merger price having been set unilaterally as well as unfairly low and not on the basis of any legitimate valuation of the company).

have played an unduly large role in guiding defendants' other valuations of Sunbelt stock at the time of the 1997 Merger, but it did present me with a legitimate legal question and a potentially legitimate valuation metric for Sunbelt. I therefore do not find defendants to have conducted themselves with the necessary egregiousness or vexatiousness to warrant shifting attorneys' fees.

2. Interest

Plaintiff seeks interest no lower than 7.14%, the highest rate of Sunbelt's borrowing costs as calculated by Reilly, defendants' valuation expert.[62] Defendants, meanwhile, propose two alternatives from which the Court can choose, the first being the prudent investor rate as calculated by Reilly (3.56% on a simple basis) and the second being a weighted combination of i) the 3.56% prudent investor rate, and ii) two different calculated rates for Sunbelt's actual cost of borrowing (in total, this weighted combination is 4.90%).[63]

Although in earlier cases this Court has awarded interest rates similar in value and justification to those for which both parties in the present case advocate,[64] in this case I will exercise my statutory discretion to award interest at

[62] Pl.'s Post-Trial Br., 60.
[63] Defs.' Post-Trial Br., 65.
[64] *See, e.g.*, *Delaware Open MRI Radiology Assoc., P.A., v. Kessler*, 898 A.2d 290, 343-44 (Del. Ch. 2006) (awarding a pre-judgment interest at a rate of 6.9%, compounded monthly, that is an average of a prudent investor rate and the company's actual cost of borrowing, and is the "more generous, but still responsible, rate of interest proposed by [plaintiffs]."); *Henke v. Trilithic Inc.*, 2005 WL 2899677, at *12-13 (Del. Ch. Oct. 28, 2005) (awarding the prudent investor rate of 6.14%, compounded monthly, rather than a weighted combination of a prudent investor rate and

the legal rate (5% greater than the Federal Reserve discount rate as measured during that period of time), compounded quarterly.[65] I do not find either party to have demonstrated good cause for me to depart from this statutory interest rate. When calculating the interest due, parties should be certain to adjust appropriately for each and every change in the Federal Reserve discount rate that has occurred over the course of this lengthy litigation.

D. Defendants' Motion to Strike

Defendants ask the Court to strike exhibit A of plaintiff's post-trial answering brief. Exhibit A is a 2007 *BeverageWorld* article that examines Sunbelt's success and its future prospects. The article quotes extensively from an interview with Charles Merinoff. Defendants argue that "Mr. [Charles] Merinoff's 2007 statements about Sunbelt's circumstances a decade [after the Merger] prove nothing about Sunbelt's fair value as of 1997—or about the fairness of the Merger consideration when it was set in 1997."[66] Goldring contests the assertion that there is no relevant link between the 2007 *BeverageWorld* article and the Court's

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the company's actual cost of borrowing, given "the Petitioner's failure to diligently prosecute [the] action."); *Chang's Holdings, S.A. v. Universal Chemicals and Coatings*, 1994 WL 681091, at *2, *5 (Del. Ch. Nov. 22, 1994) (employing "a sliding scale that alters the relevance of the prudent investor rate and the cost of borrowing rate according to the relative fault of the parties in causing the delay [in the appraisal action]" to award a simple interest rate of 7.79%).

[65] *See* 8 *Del. C.* § 262(h) (stating that "[u]nless the Court in its discretion determines otherwise for good cause shown, interest from the effective date of the merger through the date of payment of the judgment shall be compounded quarterly and shall accrue at 5% over the Federal Reserve discount rate … as established from time to time during the period between the effective date of the merger and the date of payment of the judgment.").

[66] Defs.' Reply in Further Support of Mot. to Strike, 4.

process of determining Sunbelt's fair value at the time of the Merger. According to Goldring, the 2007 article and the success of Sunbelt it covers are "relevant both for purposes of impeachment [of Sunbelt's claims of industry and company risk] and to show Defendants' bad-faith in connection with this litigation."[67] Specifically, Goldring asks the Court to weigh the contents of the 2007 *BeverageWorld* article and its description of Sunbelt's stellar success in the alcohol distribution industry against defendants' arguments that Sunbelt operated in a high-risk industry, that its management projections in and before 1997 were optimistic and aggressive, and that Reilly's discounted cash flow analysis incorporated appropriate adjustments for industry-specific and company-specific risk.[68]

Exhibit A, an article written and published ten years after the Merger, is irrelevant to my analysis of issues prevailing at the time of the Merger. I have already ruled on the propriety of the risk adjustments found in both defendants' and plaintiff's discounted cash flow analyses. My findings and conclusions on those adjustments are based entirely on evidence known to the parties in 1997. Evidence discussing Sunbelt's success as of and in the years immediately before 2007 and Sunbelt's prospects for future growth is beyond the time relevant to my determination of Sunbelt's fair value in July-August 1997 (the time of the Merger) and my determination of the propriety of the methodology underlying both parties'

[67] Pl.'s Resp. to Defs.' Mot. to Strike, 2.
[68] *Id.* 3-4.

expert valuations. It matters not that Sunbelt has performed extremely well since defendants squeezed Goldring out, and despite the high levels of risk that, according to defendants and their experts, Sunbelt faces. Accordingly, I grant defendants' motion to strike exhibit A.

III. CONCLUSION

For the reasons discussed above, I determine that the fair value of Sunbelt Beverage Corporation at the time of the Merger was $114.04 per share. Goldring is entitled to her pro rata share of Sunbelt's fair value on the date of the Merger, as well as pre- and post-judgment interest, compounded quarterly, at a rate of five percent above the Federal Reserve discount rate on each day of the relevant time period. I also award Goldring all court and filing costs and experts' fees, and I grant defendants' motion to strike exhibit A to Goldring's post-trial answering brief.

Counsel shall agree upon a form of implementing Order, which shall be submitted within twenty days of this date.

IT IS SO ORDERED.

847 S.W.2d 116 (1992)

Jerry E. THEILEN

v.

Virginia D. THEILEN.

No. WD 45658.

Missouri Court of Appeals, Western District.

November 24, 1992.

John R. Shank, Jr., Gunn, Shank & Harman, P.C., Kansas City, for appellant.

Michael P. Keleher, Keleher & Eastman, Gladstone, for respondent.

Before KENNEDY, P.J., and SPINDEN and SMART, JJ.

SMART, Judge.

This dissolution of marriage proceeding raises questions concerning the valuation of certain marital property interests and concerning the adequacy of maintenance and child support awards. Judgment is affirmed in part and modified in part.

Dr. Theilen ("Husband") is a 43 year old dentist practicing in Claycomo, Missouri. He had been married to his wife, Virginia, almost 19 years at the time of the decree. He has been practicing dentistry 15 years. He and his twin brother, James Theilen, each own fifty percent of the stock in their professional corporation. He and his brother are partners in a real estate partnership (Twin Center) which owns the building occupied by their practice. In addition, they are partners in a venture (Dental Data) which owns and leases equipment to their professional corporation.

The trial court calculated Husband's stock in the professional corporation to have a value of $105,000.00. The value of Husband's general partnership interest in Twin Center Partnership was determined to be $80,000.00. The court valued Husband's interest in Dental Data Services at $60,000.00. Thus, Husband's interest in the three entities together was $245,000.00. The marital residence was found to have a net value of $127,000.00. Other marital property was valued at $146,391.00.

Husband was ordered to pay $1,040.00 in child support for his two teenage daughters, $520.00 for each child. Husband was also ordered to pay Mrs. Theilen ("Wife") $800.00 per month in maintenance. $92,970 in marital property was awarded to Wife, and Husband received $53,421 in other marital property. Husband, who was awarded the residence and the businesses, was ordered to pay $166,226.00 to Wife as additional distribution of marital property.

Appellate review of this action is governed by the standards set forth in *Murphy v. Carron,* 536 S.W.2d 30, 32 (Mo. banc 1976), which require the trial court's judgment to be affirmed unless it is against the weight of the evidence, erroneously declares the law, or erroneously applies the law.

Twin Center Partnership

Husband's first point on appeal is that the trial court erred in finding the net value of the Twin Center Partnership to be $160,000.00. Husband contends that the sole asset of the partnership, a commercial building, is encumbered by a debt which exceeds its fair market value.

Thomas Smeed, Husband's expert, testified at trial that in his opinion the commercial building in which Husband's dental practice is housed had a fair market value of $825,000.00 and an outstanding debt of $867,438.00, resulting in a negative value of $42,438.00. The building, which was completed in 1985, contains about 9,200 square feet. It is a two story building. The primary tenant of the building is the dental practice of Jerry and James Theilen, which occupies the first floor. The building had recently lost the other tenants in the building. The evidence did not reveal any particular reason to expect the building to continue to lack occupancy. Robert Boland, Wife's expert, testified that the net value of Husband's interest in the partnership was $118,949.00. Using the capitalization of income approach, Mr. Boland calculated the value based upon a weighted average of the previous four years and nine months of the partnership's operation. Mr. Boland testified that a valuation method focusing on the vacancies in the building would not be appropriate because this type method ignores the cyclical nature of real estate. Wife's expert used a capitalization of income method which took into account the financial data of past years in determining a current value. The court's valuation of the partnership interest at $80,000.00 was within the range of the two valuations. *See Howerton v. Howerton,* 796 S.W.2d 665, 667 (Mo.App.1990). It is the trial court's job to analyze all of the evidence and assess the credibility of the witnesses. When the trial court calculates an amount that is "within the range of evidence, an appellate court generally will not find the determination erroneous or weigh the evidence." *In re Marriage of Lewis,* 808 S.W.2d 919, 925 (Mo.App.1991); *see also Vohsen v. Vohsen,* 801 S.W.2d 789, 792 (Mo.App.1991). The trial court's determination was within the range of the values testified to and therefore, cannot be faulted. Point I is denied.

Dental Data Services

Husband's second argument on appeal is that the trial court erred in valuing his interest in Dental Data Services at $60,-000.00, because such a value is based upon an historical approach of capitalization and fails to take into account current economic conditions. In his brief, Husband refers this court to a profit and loss statement dated October 8, 1991, for Dental Data Services. In the comments on this statement, Husband states that Theilen & Theilen is two months behind on its rent payments to Dental Data due to cash flow problems and that Dental Data has had to purchase $26,314.32 of additional equipment. Husband did not offer testimony at trial as to the value of his interest. Mr. Boland, Wife's expert, testified that the partnership interest was worth $124,515.00 in 1990, and that he

had insufficient data from which to base the value in 1991 because he had never received from appellant the financial documents he had requested to make this determination. Mr. Boland utilized a cash flow method with a weighting factor in valuing the partnership interest. The trial court valued the interest at $60,000.00. Again, based upon the evidence presented, the trial court's valuation fell within the range of the evidence. *Lewis,* 808 S.W.2d at 925. Husband has not shown any error on the trial court's valuation. Point II is denied.

Theilen & Theilen, D.D.S., P.C.

Husband challenges the trial court's valuation of his interest in the professional corporation at $105,000.00. He argues that this determination is erroneous in that it relies on the capitalization of income approach. In valuing the professional corporation, Husband's expert, Mr. Smeed, utilized an approach he called the "Comparable Characteristics" method which calculates a fair market value based on valuation of three components: 1) the in-place value of physical assets; 2) the face value of consumable supplies; and 3) the value of any intangible assets. Mr. Smeed's valuation included valuation of the dental equipment ($37,995.00), office furnishings and equipment ($2,600.00), dental supplies ($5,000.00), office supplies ($200.-00), accounts receivable (he valued Husband's share at $16,707.20)[1] and intangibles ($0.00). Mr. Smeed testified that he valued intangibles at zero because of the difficulty of predicting where Husband's patients would go after a sale of his interest to a third party. Mr. Smeed also did not include the value of any corporation bank accounts. Wife's expert, Mr. Boland, took another approach to value, employing a capitalization method in valuing Husband's interest. Mr. Boland valued Husband's interest at $149,670.00, which was based upon valuation of the corporation's tangible assets ($37,672.74), accounts receivable ($91,992.48), and intangibles[2] ($169,676.00). Mr. Boland multiplied the total corporation value of $299,341.22 by 50%, thus determining Husband's one-half interest to be $149,-670.00.

Husband contends on appeal that Mr. Boland's calculation of his interest was erroneous, and that the trial court erred in valuing Husband's interest at $105,000.00. Husband relies on *Hanson v. Hanson,* 738 S.W.2d 429 (Mo. banc 1987) in charging this error. In *Hanson,* which involved a spouse's interest in an oral surgery partnership, the Supreme Court of Missouri examined goodwill as a marital asset in dissolution proceedings involving a professional practice. *Id.* Goodwill in a professional practice has been defined as "the value of the practice which exceeds its tangible assets and which is the result of the tendency of clients/patients to return to and recommend the practice irrespective of the reputation of the

[1] Mr. Smeed calculated this amount by first subtracting the dollar amount of accounts receivable over 120 days old from the total accounts receivable for the corporation ($91,992.48 -$25,694.00 = $66,298.48). He then determined that Dr. Theilen's production rate equalled 28%. Multiplying this production rate by the accounts receivable base he arrived at $18,-563.55. Finally, Mr. Smeed determined that the accounts receivable had a collectibility factor of 90%, arriving at a final value of $16,707.20. The problem with this approach is that, regardless of his individual production, Husband had a fifty percent interest in all the receivables by virtue of his ownership of fifty percent of the stock. Therefore, Smeed's calculation of the value of the accounts receivable was incorrect.

[2] Mr. Boland valued the intangible assets based on a percentage of gross collections for 1991. Gross collections through September 30, 1991 were $424,191.00. Mr. Boland annualized this figure to account for all of 1991 determining the value to be $565,588.00. Based on a study of dental surveys and statistics and drawing from his own experience, Mr. Boland used a 30% factor multiplied by the gross collections for 1991, $565,588.00, to determine an intangible asset value of $169,676.

individual practitioner." *Id.* at 434 (Mo. banc 1987). Reliance by patients/clients on the reputation and skill of the individual practitioner is generally related inversely to the number of practitioners in the practice. *Id.* at 435. In determining the evidentiary standard for proving the existence of goodwill, the court in *Hanson* indicated that the acceptable method of valuation was the "fair market value" approach. The court stated:

Because of the difficulties inherent in separating the reputation of the professional from that of his enterprise, evidence that other professionals are willing to pay for goodwill when acquiring a practice is, in our view, the only acceptable evidence of the existence of goodwill. Thus, as a matter of proof, the existence of goodwill is shown only when there is evidence of a recent actual sale of a similarly situated professional practice, an offer to purchase such a practice, or expert testimony and testimony of members of the subject profession as to the existence of goodwill in a similar practice in the relevant geographic and professional market.

Id.

Under *Hanson,* the trial court may not include a value for goodwill or intangible factors without there being specific evidence, such as evidence of a recent actual sale of a similar practice, to support it. *Id.* The court in *Hanson* rejected capitalization as an approach to determining goodwill because of the speculative nature of placing a present value on the future earning capacity of the individual professional, and because of the inequity of compelling a professional practitioner to pay a share of a value that is not realizable by sale or other method of liquidation. *Id.* Similarly, in *Taylor v. Taylor,* 736 S.W.2d 388 (Mo. banc 1987), which involved a chiropractic practice, the court specifically rejected testimony by Mr. Boland taking a capitalization approach similar to that taken in this case.

Under the *Hanson* approach, the trial court should consider the value of the tangible assets, accounts receivable, and monetary assets of a professional practice. Goodwill will rarely be found to exist in the case of a sole practitioner or small office because of the individualized nature of the client/patient attention. *Hanson,* 738 S.W.2d at 435. A professional share in a large partnership or professional corporation may, in contrast, have a significant goodwill value. When determining the existence of goodwill by reference to sales of similar professional practices, the value of a covenant not to compete should be excluded. *Johnston v. Johnston,* 778 S.W.2d 674, 676 (Mo.App.1989). Perhaps a reason for this rule is that no professional practitioner is required to give up his profession in order to be divorced. Therefore, any value attributable to a theoretical non-competition covenant should be excluded from the calculation.

Here, there was no evidence that Husband could sell, on the open market, his interest in the corporation for a value in excess of a proportionate share of the tangible and monetary assets and accounts receivable unless he were to also provide a covenant not to compete. The shareholder agreement of Husband does not include any covenant not to compete upon the sale of his stock. Apart from a negotiated non-competition agreement, therefore, Husband would be free to compete by opening an office down the street. Indeed, especially with the second floor of the office building now vacant, and available for Husband to rent, it is doubtful any purchaser would pay for any intangible factors in order to purchase

Husband's interest. If that is so, the best estimate of what someone would pay is the net value of the tangible assets, the receivables, and the monetary assets.

Respondent suggests that, even if the determination of value is restricted to a "fair market value" approach, nevertheless the evidence of the 1985 transaction involving two other dentists, Yingling and Feldhaus, establishes a basis for finding a goodwill value in the Theilen practice. This court disagrees. The 1985 transactions were not at all comparable to the circumstances at hand. Those were transactions in which each of the dentists constituting the "buyer" in the transactions were paying for the privilege of severing an independent contractor relationship between the respective dentist and the Theilens' corporation. Previously, these dentists had entered into a contract to work in space provided by the corporation and using equipment provided by the corporation in return for the payment of a percentage of revenues to the corporation. In 1985, the relationship was being terminated, and the dentist in each case was being released from a covenant not to compete. The dentist was not buying any physical assets other than patient charts, records, x-rays, and patient lists. In addition, the dentist in each case was buying the percentage interest of the corporation in the accounts receivable. In addition, the corporation was providing a no-compete covenant by agreeing it would not contact, directly or indirectly, the patients whose charts were being purchased by buyer. For these reasons, together with the fact that one of the dentists agreed, as part of the transaction, to lease space from the Twin Center partnership, these transactions are completely distinguishable. *See* ***Gerard v. Gerard,*** 825 S.W.2d 21 (Mo.App.1992).

This case is somewhat unusual in that the professional relationship of the Theilen brothers may be exceptionally close. There is an indication in the evidence that the Theilen brothers would often care for each other's patients somewhat interchangeably. In such a case, it is problematical to determine whether, if Husband were to sell his interest in the corporation and set up a practice down the street or upstairs in the same building, his former patients would stay with the corporation or would be inclined instead to seek out Husband in his new office. Without having specific evidence of this theoretical event, the court has nothing but speculation to entertain in this regard. The trial court may have believed that there was, in fact, a basis for concluding the existence of goodwill in such a circumstance, but at this point it is not supported in the record. *Hanson* leaves open the possibility that expert testimony as to the existence of goodwill in a similar practice in the relevant market could be presented, but it is doubtful such evidence would be available in this case.

Here, the evidence shows that the corporation owns dental equipment of $37,-672.24, office furniture of $2,600, dental supplies of $5,000, and office supplies of $200. The corporation had total accounts receivable of $91,992.48, and bank accounts amounting to $15,126.82. This court is unaware of any other factors which should be included in the valuation under the *Hanson* formula. The finding of the trial court as to the value of Husband's interest in the professional corporation, and the order as to the division of marital property based thereon, is reversed because the valuation of the corporation was not based strictly on the competent evidence. The case is remanded for findings and orders consistent with this opinion.

Award of Child Support

Husband also challenges the award of child support in the amount of $520.00 per child, totalling $1,040.00, claiming the award was erroneous in the following ways: 1) it failed to consider Husband's income at the time of the dissolution; 2) it failed to consider the award of maintenance granted to Wife; 3) it failed to consider Husband's debts; 4) it failed to consider the actual needs of the children; and 5) there was no evidence to support presumed continuing partnership distributions which were included by the trial court in its calculation of child support.

Husband's first contention is that the trial court erred in its award of child support because the award failed to consider Husband's income at the time of the dissolution. He also contends that the trial court's award of child support surpassed both his own Form 14 calculation, as well as Wife's Form 14 calculations. Husband is mistaken in this contention in that Wife's Form 14 calculated the child support amount at $1,074.03. It is true, however, that the trial judge did not rely on the forms submitted by the parties to determine his calculation of child support. In the decree of dissolution, the trial judge states that "child support under Rule 88.01 and Form 14, consistent with the Findings of Fact made herein by the Court, is hereby determined to be just and appropriate." The trial judge found Husband's gross income to be $6,333.00 per month in the decree of dissolution. He found that Wife's gross income was $760.00 per month, but also found that she could earn $960.00 per month if she were working 40 hours per week. Based upon the trial court's findings, which are supported in the evidence, we conclude that the trial judge performed his own Form 14 calculations based upon his findings, which, according to our calculations, yielded the figure of $1,036.17. The trial court obviously rounded this figure to $1,040.00, in order to obtain the round figure of $520.00 per month per child.

There is a rebuttable presumption that the child support amount calculated in Form 14 is the amount that should be awarded as set forth in Rule 88.01. A departure from the amount calculated in Form 14 requires a specific finding made by the trial judge that the Form 14 amount would be unjust or inappropriate. *Beeman v. Beeman,* 816 S.W.2d 15, 17 (Mo.App. 1991). The trial judge here prepared his own Form 14 based upon his findings of fact and then rounded his result to obtain $1,040.00 total child support award, or $520.00 per child. Although the court did not round to the nearest dollar, this rounding is close enough that the award should not be disturbed on appeal.

None of Husband's other contentions regarding error of the child support award change the initial determination reached by this court. First, there is no evidence that the trial court did not consider Husband's income at the time of trial. The trial court had numerous exhibits before it for examination, numbering over 100. These exhibits were satisfactory in detailing Husband's sources of income. The trial judge made a finding that Husband's gross income equaled $6,333.00 per month. Nothing in the record mandates a conclusion that this finding was erroneous.

Husband also argues that the child support award should have taken into account the award of maintenance that he is required to pay to Wife. Husband argues "Rule 88.01 sets forth a worksheet which provides for a reduction to the non-custodial parent and a corresponding increase to the custodial parent if there is another court-ordered obligation which results in either payments by non-custodial parent or income by the custodial parent." The Directions for Use of Form No. 14 explain each entry on the worksheet. Line 2b

provides a blank for "Other spousal support payments being made." This entry is explained in the Directions for Use as follows: "Enter the monthly amount of any other court or administrative order for spousal support from monthly gross income to the extent that such payments are actually being made to a person not a party to the action." Wife is a party to this action. An entry in line 2b would result from a maintenance order payable to a previous spouse. Therefore, the maintenance award that Husband is required to pay to Wife should not be considered in this entry. This does not mean that the trial court did not consider child support and maintenance in relation to one another. Indeed, the trial court would have considered the child support in making the award of maintenance.

Husband also suggests that the child support is erroneous because it fails to take into consideration his outstanding debts. Rule 88.01 provides that the child support amount should consider "the financial resources and needs of the parents." Again, the trial court had over 100 exhibits in front of it when making its findings and determinations, plus testimony from both parties to this action. The evidence suggests that all of the financial resources and obligations of both parties were considered. Husband's suggestion is without merit.

Next, Husband contends that the award did not consider the actual needs of the children. Evidence was presented that the expenses of the children were $910.37 per month, which did not take into consideration the expense of housing or utilities. There is no evidence to suggest that the trial court did not consider the actual needs of the children.

Finally, Husband asserts that there is no evidence to support the inclusion of partnership distributions in Husband's income in the Form 14 calculations. Form 14 Directions for Use provides that gross income includes "income from salaries, wages, overtime compensation, commissions, bonuses, dividends, severance pay, pensions, interest, trust income, annuities, capital gains, social security benefits, retirement benefits, workers' compensation benefits, unemployment compensation benefits, disability insurance benefits, and spousal support actually received from a person not a party to the order." It is clear that partnership distributions would be included in this definition. Nothing in this definition or in Rule 88.01 requires the distributions be stable and fixed as long as there is a reasonable expectation of continuity. Here, it is reasonable to assume that the real estate partnership and Dental Data would continue to generate income for Husband. Therefore, the trial court did not err in including these distributions in the child support calculation. Point IV is denied.

Maintenance

Husband's fifth point on appeal is that trial court abused its discretion in awarding Wife $800.00 per month maintenance because the award was unwarranted and wholly beyond the means of Husband to pay, and because Wife has the ability to properly care for herself. Section 452.335, RSMo Supp.1991 sets forth the guidelines that the trial court must follow in awarding maintenance. This section gives the trial court "great latitude" in calculating maintenance. *In re Marriage of Ross,* 772 S.W.2d 890, 893 (Mo.App.1989). A balancing test is utilized in determining the appropriate amount of maintenance which balances the reasonable needs of the party seeking the support against the ability of the other spouse to pay. *Schelsky v. Schelsky,* 796 S.W.2d 888, 892 (Mo.App. 1990). Appellate intervention is not warranted unless the maintenance award is "wholly beyond the means of the spouse

who pays maintenance." *Id.* The party challenging the award, in this case Husband, bears the "`stark burden' to show an abuse of such discretion so as to `shock' the appellate court's sense of justice." *Id.* This is so because an award of maintenance is presumed correct. *Ross,* 772 S.W.2d at 893.

Based upon the evidence presented, the trial judge made the following findings: 1) Wife was 41 years old and in reasonably good health; 2) she has a high school diploma and degree in cosmetology with some experience in the early part of the marriage in hair dressing; 3) following a one year period of working in Husband's office, Wife had not been employed outside the home prior to the separation of the parties, since 1980; 4) aside from her current experience as a receptionist in an optometrist office, she has had no other skills or work experience; 5) Wife lacks sufficient property, including marital property apportioned to her, to provide for her reasonable needs and is unable, at this time, to support herself through appropriate employment; 6) there is no substantial evidence that she will be able to obtain better employment in the immediate future and, therefore, maintenance should be continuing and modifiable.

Husband points out that Wife has an earning capacity of $11,520.00 a year, an award of personal property of $92,970.00, and a substantial award of marital property. He also states that his net monthly income is $4,463.00 and that after he has deducted the house payment and the child support, he is left with $1,571.00 in funds. Husband testified that in 1990 he had approximately $5,660 in disposable income each month, which contradicts his contention that his net monthly income is $4,463.00.[3] Husband also ignores the fact that the $2,000.00 payments to Wife are required only if he does not sell the house within 180 days after the judgment. If Husband succeeds in selling the residence, he will be relieved of his mortgage payment. From the above it is clear that $800.00 per month in maintenance is not wholly beyond the means of Husband to pay.

Husband further contends that Wife is able to take care of herself based upon her award of marital assets and her earning capacity. The trial court found that Husband made $6,333.00 in gross income per month and that Wife could make $960.00 working on a full time basis. Husband's gross income, therefore, is six times greater than Wife's expected income. Wife testified that aside from her children's expenses, which she calculated as $910.37 not including housing or utilities, she requires an additional $2,752.68 a month to meet her own living expenses. The evidence does not show that Wife has an outstanding earning capacity or that she will develop a substantially greater earning capacity in the near future. The evidence does show that Wife earns substantially less than what is needed to pay her monthly expenses. It has been consistently held that a party is not required to deplete his or her share of marital property before being awarded maintenance. *Barth v. Barth,* 800 S.W.2d 127, 129 (Mo.App.1990).

It also should not be overlooked, and was not overlooked by the trial court, that Wife's efforts in the early years of the marriage contributed to Husband's ability to gain a dental degree and a license to practice dentistry. There was also no evidence that she contributed to the demise of the marriage through any misconduct, while there was evidence of

[3] It is possible that a reason for this contradiction is the fact that Dr. Theilen's partnership interest in Twin Center has allowed him a significant tax shelter. Thus, viewed from the end of the year, his "disposable income" is higher than his net paycheck.

Husband's misconduct. There is no reason to believe that justice requires that Husband be able to abandon his marital responsibilities without having to provide financially for his ex-spouse, even if such provision means that Husband has few resources for his desired lifestyle.

For the foregoing reasons, there was substantial evidence to support the amount of the trial court's award of maintenance. Since, however, the division of marital property will be adjusted as a result of re-evaluation of Husband's interest in the professional corporation, this court hereby sets aside the award of maintenance so that the trial court may re-consider the maintenance award in the light of any adjustment in the property division.

Tax Consequences

Husband's last point on appeal is that the trial court failed to consider the tax consequences of the division of property or orders concerning debt. However, the record does not show that the trial court was advised of tax consequences which should be considered, and a party who fails to advise the court of tax consequences of a property division will not be heard to complain on appeal concerning such consequences. *In re Marriage of Ross,* 772 S.W.2d 890, 892 (Mo.App. 1989). Point VI is denied.

Conclusion

This court finds that the trial court's evaluation of Husband's interest in the Twin Center partnership and the Dental Data Services partnership were not erroneous. The court finds that the evaluation of Husband's interest in the professional corporation was erroneous in that the court should have found the value of his interest to be limited to the value of the physical assets, investments and operating cash, and accounts receivable.

The award of child support is not erroneous and is affirmed. The award of maintenance is not erroneous; however, we reverse the award and the trial court will be allowed to further adjust the maintenance on remand, if the trial court deems it appropriate and just, because of the possible interrelatedness of the maintenance award and the division of marital property.

The case is remanded to the trial court with instructions to make a new finding of the value of Husband's interest in the professional corporation, allowing nothing for goodwill, and to adjust the division of marital property accordingly. The award of maintenance is reversed and the trial court is also permitted to adjust the award of maintenance, if the trial court deems it just and appropriate, in view of the adjustments made in the other components of the decree. In all other respects, the judgment of the trial court is affirmed.

All concur.

546 So.2d 99 (1989)

William De Forest THOMPSON, Appellant,

v.

Tobitha THOMPSON, Appellee.

No. 87-1356.

District Court of Appeal of Florida, Fourth District.

July 7, 1989.

Edna L. Caruso of Edna L. Caruso, P.A., and Searcy & Denney, P.A., West Palm Beach, for appellant.

Jane Kreusler-Walsh of Klein, Beranek & Walsh, P.A., and Ronald Sales of Ronald Sales, P.A., West Palm Beach, for appellee.

PER CURIAM.

The former husband appeals from property distribution, permanent alimony and award of attorney's fees provisions of the trial court's final judgment of dissolution. We affirm.

The guiding principles for this opinion, as for many marriage dissolution cases, are found in *Canakaris v. Canakaris,* 382 **So.2d** 1197 (Fla. 1980), *Tronconi v. Tronconi,* 466 **So.2d** 203 (Fla. 1985), and their progeny. These principles may be expressed as follows:

(1) Distribution of existing marital assets, and award of permanent periodic alimony, lump sum alimony, child support, special equity and exclusive use of jointly owned property as remedies in dissolution orders are parts of an overall scheme that should be reviewed not piecemeal but as a whole, applying the abuse of discretion standard. If a reasonable person could have concluded as did the trial court, there has been no abuse of discretion.

(2) Generally, marital assets should be distributed equally, unless a disparity is shown in the respective parties' contributions, or another relevant factor justifies a variation.

100 *100 (3) In awarding lump sum alimony, the court should consider all relevant circumstances in order to assure equity and justice between the parties. It should be awarded only in special circumstances, such as where, for example, the receiving spouse assisted the paying spouse in accumulating property; and where the paying spouse's financial condition makes it possible without jeopardy to that party's business, profession or employment. This principle, expressed in *Canakaris,* is lifted directly from and attributed to the opinion in *Yandell v. Yandell,* 39 **So.2d** 554 (Fla. 1949).

In the instant case, the former wife acted during four early years of this twenty-three year marriage simultaneously as mother, housekeeper, and substantial economic provider, while the husband completed his collegiate and legal education. Thereafter she bent her energies primarily to a career as wife and mother, managing the household and rearing the parties' children. Upon becoming a member of the bar, the husband, after a more or less average start insofar as level of professional earnings is concerned, has, in the last several years, developed an impressively lucrative plaintiff's practice in personal injury and medical malpractice cases.

Applying the guiding principles cited above, we conclude that a reasonable person could have created the economic scheme employed by the trial court in this case. It is not lopsidedly in favor of the former wife, as the former husband urges. The record fails to support the former husband's supposition that the trial court wished to punish him for adultery. The level of periodic alimony awarded is in line with the husband's voluntary payments during the parties' separation preceding the dissolution, the former wife's needs and the former husband's financial ability. The lump sum alimony, payable over a period of years, may be perceived as recognition, in some measure, of the former wife's extraordinary part in making the husband's successful professional career possible. The award of attorney's fees and costs to the former wife appears justified.

There is no compelling reason to conclude that the trial court factored in the value of the husband's professional association's good will in making the property distribution. Nevertheless, inasmuch as this is an issue herein, we certify the following question as being one of great public importance:

> IN MARRIAGE DISSOLUTION PROCEEDINGS TO WHICH AN OWNER OF A PROFESSIONAL ASSOCIATION IS A PARTY, MAY THE VALUE OF THE PROFESSIONAL ASSOCIATION'S GOOD WILL BE FACTORED IN IN DETERMINING THE PROFESSIONAL ASSOCIATION'S VALUE?

Attention of bench and bar is called to Miller, *Professional Goodwill, The Phantom Asset?,* 14 The Family Law Commentator (1989). The article discusses the above issue in light of the Florida Supreme Court's declination of jurisdiction to review *Moebus v. Moebus,* 529 **So.2d** 1163 (Fla.3d DCA 1988), *rev. denied,* 539 **So.2d** 475 (Fla. 1989), which opinion answers this question in the negative.

DOWNEY and GLICKSTEIN, JJ., and SNYDER, ARTHUR I., Associate Judge, concur.

Full Text of Court Cases

Tri-Continental Corp. v. Battye

Case name: Tri-Continental Corp. v. Battye
Citation: 1950 Del. LEXIS 23
Date of decision: June 8, 1950
Country: US
State or Federal: State
State/Jurisdiction: Delaware
Court: Supreme Court
Type of action: Dissenting Shareholder
Judge: Wolcott
SIC: 6211 Security Brokers, Dealers, and Flotation Companies (security dealers and underwriters)
NAICS: 523120 Securities Brokerage

Keywords: Discount rate, Fair market value (FMV)

COUNSEL:

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Charles F. Richards, of the firm of Richards, Layton & Finger, and George Rosier and Zelig R. Nathanson, of the firm of Austrian & Lance, of New York City, for appellees.

JUDGES:

TERRY, CAREY, Layton and WOLCOTT, JJ., sitting.

OPINIONBY:

WOLCOTT

OPINION:

WOLCOTT, Judge, delivering the opinion of the court:

Section 61 of the General Corporation Law, Revised Code 1935, § 2093, provides that upon the merger of a corporation, stockholders who object to the merger and who fulfill the statutory requirements to register their objection shall be paid the value of their stock on the date of the merger, exclusive of any element of value arising from the expectation or accomplishment of the merger. The meaning of the word "value" under this section of the corporation law has never been considered by this court. However, the Court of Chancery has on several occasions applied a definition of value under the section. This definition was first formulated in Chicago Corporation v. Munds, 20 Del.Ch. 142, 172 A. 452, and was followed in Root v. York Corporation, 29 Del.Ch. 351, 50 A.2d 52, and In re General Realty

& Utilities Corporation, 29 Del.Ch. 480, 52 A.2d 6. We think the basic doctrine of valuation applied in Chicago Corporation v. Munds, supra, was formulated in accordance with proper principles and the better reasoned authorities.

The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern. By value of the stockholder's proportionate interest in the corporate enterprise is meant the true or intrinsic value of his stock which has been taken by the merger. In determining what figure represents this true or intrinsic value, the appraiser and the courts must take into consideration all factors and elements which reasonably might enter into the fixing of value. Thus, market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts which were known or which could be ascertained as of the date of merger and which throw any light on future prospects of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholders' interest, but must be considered by the agency fixing the value.

The rule as stated requires that certain obvious conclusions be drawn. Thus, since intrinsic or true value is to be ascertained, the problem will not be settled by the acceptance as the sole measure of only one element entering into value without considering other elements. For example, as was specifically held in Chicago Corporation v. Munds, supra, market value may not be taken as the sole measure of the value of the stock. So, also, since value is to be fixed on a going-concern basis, the liquidating value of the stock may not be accepted as the sole measure of value.

General was a regulated closed-end investment company with leverage, and was engaged in the business of investing in the stock market generally seeking to acquire and hold a cross-section of the stock market. Investments were made by General primarily with the possibility of capital appreciation in view. General's portfolio held diversified investments, practically all of which fell within the class of marketable securities readily liquidated.

A regulated close-end investment company is of a peculiar nature. The common stockholder of a closed-end company has no right at any time to demand of the company his proportionate share of the company's assets. n1 A regulated investment company is required to distribute all of its income from dividends and interest to its stockholders but, in so doing, pays no tax on the amounts so distributed. It also has the option of distributing net long-term capital gains to its stockholders or retaining them and paying a flat 25% tax. As in the case of individuals, a regulated investment company has the right to deduct capital losses from its capital gains.

n1 In contradistinction, the stockholders of the so-called open-end company have the right at the close of business on designated days to demand from the company their proportionate share of the company's assets.

On September 30, 1948, the day preceding the merger, General had outstanding debentures and preferred stock equaling in value 60.8% of the total assets of the company, leaving 39.2% of the company's assets applicable to the common stock. This condition of General made applicable the principle of leverage. Simply stated, this meant that since the debentures and preferred stock of General were a fixed liability, the same amount of assets at all times was required to be set off against them. The result of this unalterable fact was that if the stock market declined, thus decreasing the value of the

assets of General, all of the decrease fell upon the common stock. On the other hand, when the stock market rose, thus increasing the value of General's assets, all of the increase accrued to the benefit of the common stock.

Experience demonstrates that when the stock market declines, the market price of the common stock of closed-end investment companies with leverage declines at a more rapid rate because of the resulting shrinkage of asset value behind the common stock. Conversely, a rise in the stock market results in a rise in the market price of the common stock of such companies at a more rapid rate than the market is increasing generally.

The closed-end feature and leverage have a direct effect on the market value of the common stock of closed-end investment companies. When the market price of the common stock moves into a certain price range in relation to its net asset value, upward leverage disappears and the stock sells on the market at a lower price than its net asset figure. This fact, together with the inability of the common stockholder to withdraw his proportionate interest in the assets of the company, has consistently resulted in a lower market value of the common stock in comparison with its net asset value. This difference between the net asset value and the market value of the common stock of a closed-end investment company is known as discount.

The record discloses that the common stock of General, prior to the merger, was selling within the price range which brought discount into play. The appraiser found the discount rate applicable to General to be 25%. This rate of discount is accepted for the purposes of this case since the parties do not argue that this finding was error.

Discount, therefore, may be applied to net asset value to determine on any day a theoretical or constructed market value of the common stock of a closed-end investment company with leverage. On September 30, 1948, the net asset value of the common stock of General was $ 4.90 per share and, if the discount of 25% is applied to that figure, a market value of General's common stock on that day of $ 3.67 per share is constructed.

The appraiser considered various factors which all agree should be considered in valuing the common stock of General. Those factors were: The nature of the enterprise, i. e., a regulated closed-end investment company; leverage; discount; net asset value; market value; management; earnings and dividends; expenses of operation; particular stockholdings in General's portfolio; and a favorable tax situation which General had.

The appraiser found that the factors of management, earnings and dividends, expenses of operation, and the particular stockholdings of General, under the circumstances, were not entitled to be debited or credited in arriving at a value for the common stock. It is not necessary to review his reasons, for the parties are agreed that his findings in this respect were correct. Since, however, earnings and dividends of a corporation are ordinarily of prime importance in valuing common stock, we feel, in order to avoid future confusion, that we should state briefly why they are not of much importance in this case. The reason is that General was an investment company with large leverage which meant that normal income of the company necessarily went in large part to the servicing of the senior debentures and preferred stock, leaving a relatively small amount left to be paid out in dividends to the common. Actually, dividends on the common stock of General in the past were negligible, nor were the prospects for the future materially brighter.

The favorable tax situation of General was found by the appraiser to be worth 29c to each share of common stock. This finding is not urged as error. The favorable tax situation resulted from realized losses in 1948 and loss carryovers which would have enabled General to take profits gained before the end of 1948 equal to the realized losses incurred in 1948 and the loss carryover expiring at the end of that year, to the extent of over $ 1,500,000, without paying a 25% capital gains tax or distributing the proceeds to its stockholders who would then be taxed on them.

The appraiser found that, at the time of merger and prior thereto, there was no actual market of General's common stock uninfluenced by the merger and, accordingly, excluded actual market value of the stock as a factor to enter into the final determination of value. This was not error, nor would it have been error had the appraiser constructed a hypothetical uninfluenced market value by discounting the net asset value of the common stock on the day of merger and giving some effect to it in his final valuation. Had there been an actual market value uninfluenced by the merger in existence, it would have been error to disregard it, but the absence of such an element does not require the construction of a hypothetical market value to be given effect in the final determination of value.

A great deal of argument in this cause has turned around the phrase "net asset value" which is simply a mathematical figure representing the total value of the assets of General less the prior claims. The net asset value of the common stock of General could be determined as of any date by computing the total market value of the securities in the portfolio, adding to that sum the cash in the company's possession, deducting the total of the outstanding liabilities, debentures and preferred stock, and dividing the final result by the number of common shares outstanding.

However, since the value of dissenting stock is to be fixed on a going-concern basis, the taking of the net asset value as the appraisal value of the stock obviously is precluded by the rule. This is so because, primarily, net asset value is a theoretical liquidating value to which the share would be entitled upon the company going out of business. Its very nature indicates that it is not the value of stock in a going concern.

Furthermore, since we are called upon to fix the value of common stock in a closed-end investment company with leverage, an additional reason exists for the refusal to fix the value of that stock at its net asset value. This reason is that the common stockholder of a closed-end company can never withdraw his proportionate interest from the company as long as it is a going concern. He can obtain his full proportionate share of the company's assets, or the net asset value of his stock, only upon liquidation of the company. n2 He cannot obtain the net asset value of his common stock by sale of the stock because of discount which is always applicable when the stock of the closed-end investment company is selling within the necessary price range, and which prevents the sale of the common stock except at a price less than the net asset value.

n2 Actually, net asset value of common stock of a closed-end company could never, as a practical matter, be obtained since liquidation would be accompanied by expense and would probably result in driving the market down through the sudden sale of large blocks of stock, thus automatically decreasing the net asset value.

Since, therefore, net asset value is, in reality, a liquidating value, it cannot be made the sole criterion of the measure of the value of the dissenting stock. The appraiser, therefore, properly concluded that net asset value as of September 30, 1948 should not be taken as the basis for arriving at the appraisal

value. He preferred, and we think correctly,to construct an asset value on the basis of month-end averages of the portfolio securities over a reasonable period of time. This method resulted in an asset figure of $ 5.15 per share of common stock of General. The appraiser also found that, during the period over which his average was taken, the stock market was normal. This finding is not attacked as error.

The fact that the stock market was normal during the period used for the establishment of the asset value of General's common stock bears directly on the application of the principle of leverage in this case. The element of leverage, it will be recalled, operates to increase the value of the common stock of a closed-end company as the stock market rises and, conversely, operates to decrease the value of the common stock of closed-end companies as the stock market sinks. The finding that the general level of the stock market is normal means that no adjustment in the value of the common stock was required because of the element of leverage. This is important because leverage, in the valuation of the common stock of closed-end companies, must be considered and given effect if it is an operating element at the time value is to be determined. The market being normal, leverage was not operating. Therefore, the value of the common stock of General did not have to be debited or credited because of the principle of leverage.

To the per share asset value of $ 5.15 so determined, the appraiser added 29c, the value of the favorable tax situation of General, to each share of its common stock. The result of $ 5.44 is called by the appraiser the "fair asset value" of a share of the common stock of General. The appraiser then arrived at the true or intrinsic value of a common share of General by applying the discount to the fair asset value of $ 5.44, and arrived at a value of $ 4.08 per share for the common stock of General.

The Vice Chancellor adopted the findings of the appraiser in every particular, but disagreed with him as to the method of arriving at the value of the common share from those findings. He differed with the method of arriving at value used by the appraiser primarily because he was of the opinion that discount "has exclusive application to the question of but one element of value, namely, market value." With this as his premise, he reached the conclusion that the appraiser,in discounting the fair asset value of $ 5.44, had in fact constructed a market value of the common share, and had committed error when he gave 100% weight to that constructed market value.

The Vice Chancellor was of the opinion that net asset value unaltered by the discount factor must be considered as an independent element of value because it was a value based on mere possession, an important factor when capital appreciation is the principal attraction to the investor. He, accordingly, felt that constructed market value and net asset value should be fairly weighed in order to determine the value of the shares involved. Recognizing that the weighting of different elements of value necessarily is arbitrary, he gave a weight of 40% to net asset value and a weight of 60% to constructed market value, reaching the conclusion that the value of a common share of General was $ 4.62.

We do not agree with the Vice Chancellor in this respect for the reason that he has treated "fair asset value" as though it were the same as "net asset value". That they are not the same is apparent when it is considered that fair asset value was arrived at from averages in a normal stock market.Furthermore, the inclusion of the value of the favorable tax position of General necessarily means that "fair asset value" includes elements value of the common share which could not possibly be included in "net asset value" which necessarily is determined from a mathematical computation of the market values of the portfolio securities.

The 29c item would have accrued to the benefit of the common stockholders of General only after General's management had taken advantage of its favorable tax situation. While the possibility existed, advantage had not been taken of it at the time of the merger. The 29c, therefore, was an entirely hidden and prospective asset. Its inclusion in the fair asset value of the common share was to give effect to the prospect of future advances in the value of the common share, and was to include an element of value which, under no circumstances, could have been reflected in a net asset value, a value fixed by the market price of General's portfolio securities.

These circumstances make it clear to us that the appraiser's fair asset value includes several elements which, in turn, affect the true value of the common shares. It includes "net asset value" and, furthermore, it includes an element of value over and above net asset value which can only represent the investment possibility of the common stock which the Vice Chancellor refers to as an important element based "on mere possession". It is, therefore, obvious that discounting of the "fair asset value" of General's common stock will not, as the Vice Chancellor held, result in a constructed market value. A constructed market value results only from the discount of net asset value. This must be the fact since discount is fixed by experience in the market, and is nothing more than the average rate of difference between the actual market prices of General's common stock and the net asset value of that stock computed from the basic fact of the market prices of General's portfolio securities.

The dissenting stockholder is entitled to receive the intrinsic value of his share in a going concern. This can mean only that he is entitled to receive that sum which represents the amount he would have received as a stockholder in one way or another as long as the company continued in business. Since we are dealing with a regulated closed-end investment company with leverage from which the stockholder cannot withdraw his proportionate interest, and since dividends on the stock of such companies are of small importance, it follows that the only way in which a common stockholder of a going closed-end company with leverage can obtain the value of his stock is by the sale of it on the market. Furthermore, whenever he seeks to do so, he, by force of circumstances, must sell at a discount, whenever this is an operating element.

The conclusion is, therefore, inescapable that the full value of the corporate assets to the corporation is not the same as the value of those assets to the common stockholder because of the factor of discount. To fail to recognize this conclusion in the valuing of common stock of a regulated closed-end company with leverage is to fail to face the economic facts and to commit error. Discount is an element of value which must be given independent effect in the valuing of common stock of regulated closed-end investment companies with leverage, and is not confined solely to the construction of a hypothetical market value.

The ultimate value of General's common stock, therefore, is the percentage of the fair asset value which could reasonably be expected, at some time, to have been realized by the common stockholder. The most critical factor to be determined in the fixing of such value is the fair asset value, itself. If it is an amount which contains within it the proportionate interest the common stock has in the assets of the company, the possibility of capital appreciation inherent in the company and the effect of leverage, then fair asset value has been properly determined. Application of the independent element of discount to that amount will give the true or intrinsic value of the common stock of the regulated closed-end investment company with leverage under consideration. The important thing to bear in mind is that value

of stock in a going concern is to be measured in terms of ability to realize that value through various media. In the case of General, the only way to realize the common stock value was by the sale of the stock.

We believe that the appraiser was correct in his method of determining value and in the result reached by him. The Vice Chancellor, in weighting as he did fair asset value instead of net asset value, has in effect overbalanced the weight to be given to the element of possible capital appreciation to the extent that he has committed error.

We are asked to apportion costs of this proceeding between the parties rather than against Tri-Continental alone, as was done by the order of the Vice Chancellor. In Meade v. Pacific Gamble Robinson Co., 30 Del.Ch. 509, 58 A.2d 415, we refused to modify an order for costs unless there was present an abuse of judicial discretion. In the absence of a showing of bad faith on the part of the dissenting stockholders, or a showing that the statutory procedure was made use of for the purpose of being "bought off", we think it reasonable to tax all costs against the surviving corporation. There is no showing, or hint, of such bad faith on the part of the dissenting stockholders. The order taxing costs will not be disturbed.

A mandate will be entered reversing the order of the Vice Chancellor and directing him to give effect to the valuation of the appraiser.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

US Salt, Inc.,

Plaintiff,

Civ. No. 07-1988 (RHK/JSM)
MEMORANDUM OPINION AND ORDER

v.

Broken Arrow, Inc.,

Defendant.

Evon M. Spangler, Perry M. de Stefano, Spangler and de Stefano, PLLP, St. Paul, Minnesota, for Plaintiff.

Wallace G. Hilke, Amy R. Mason, Daniel N. Sacco, Lindquist & Vennum PLLP, Minneapolis, Minnesota, for Defendant.

INTRODUCTION

The issue before the Court is whether US Salt has any evidence of damages that should be submitted to a jury. For the reasons set forth below, the Court finds that it does not and consequently its breach-of-contract claim fails as a matter of law.

BACKGROUND

This case arises out of a contract dispute between US Salt and Broken Arrow. US Salt alleged that Broken Arrow violated the agreement when it stopped shipping salt. The Court agreed with US Salt and granted its motion for summary judgment as to

liability on this claim.[1] The parties then submitted their voluminous trial materials on the issue of damages and filed numerous evidentiary objections. US Salt relied heavily on its damages expert, Arthur H. Cobb, to prove its lost-profits claim.[2] Broken Arrow, however, moved to exclude Cobb's proposed testimony and expert reports under Federal Rule of Evidence 702. Under Rule 702, an expert may testify if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case. The party offering expert testimony has the burden to prove its admissibility. Lauzon v. Senco Prods., Inc., 270 F.3d 681, 686 (8th Cir. 2001).

The Court carefully reviewed Cobb's expert reports, his deposition testimony, and the parties' briefs, including their arguments at the April 24, 2008 pretrial hearing. It concluded that Cobb's proposed testimony was not sufficiently reliable under Rule 702. Cobb issued two reports, both of which had very little analysis and were riddled with unsupported assumptions. Cobb initially opined that US Salt's lost profits were $1,800,000, but later revised that number in his supplemental report to a range of

[1] Although the Court denied Broken Arrow's motion for summary judgment on US Salt's breach of express and implied warranty claims, it later dismissed those claims with prejudice because the record conclusively established that the nonconforming salt had been cured. (See Doc. No. 127.) At the pretrial hearing on April 24, 2008, counsel for US Salt was unable to specifically identify any damages related to these claims. (See 4/24/08 Unofficial Tr. at 15.) Furthermore, US Salt never disclosed these damages as part of its initial disclosures or in its response to Broken Arrow's interrogatory on damages. See Fed. R. Civ. 26(a)(1)(A)(iii), Fed R. Civ. P. 26(e)(1)(A), Fed. R. Civ. P. 37(c)(1).

[2] The Court points out that US Salt's exhibit list (Doc. No. 89) contained a number of documents related to lost profits that were never previously disclosed to Broken Arrow. (See Exs. 94-97.) Furthermore, these documents were completely inconsistent with US Salt's initial-damages disclosure and with Cobb's two expert reports. (See Doc. No. 113 at 4.)

$600,000 to $1,060,000. (See Doc. No. 65 Exs. A-B.) Damages that are remote, speculative, or conjectural are not recoverable as a matter of law. Leoni v. Bemis Co., Inc., 255 N.W.2d 824, 826 (Minn. 1977). Although the law does not require mathematical certainty in the proof and calculation of lost profits, it requires evidence of definite profits *grounded upon a reasonable factual basis.* See Cardinal Consulting Co. v. Circo Resorts, Inc., 297 N.W.2d 260, 266-67 (Minn. 1980). Notably, Cobb relied almost exclusively on the assumptions and estimates provided by US Salt's president and owner, Tom Johnson. (See, e.g., Doc. No. 65 Ex. F at 23-24, 26-27, 33-35, 48-49, 52, 87-88, 90-92.) But Cobb did nothing to investigate the market conditions in Minnesota or verify the estimates in his reports despite the fact that US Salt's sales projections and goals were based on vague and speculative information. (Id. at 17, 27-32, 34-35, 41, 48-49, 76-78, 80; Ex. G at 53, 56, 58-59, 68, 72.) The difficulties with Cobb's expert reports are illustrated by his deposition testimony:

> Q: Did Mr. Johnson tell you who had prepared Exhibit 30?[3]
>
> A: I think there was a reference that a person who had acted in a financial role for the company had initially prepared Exhibit 30. I don't remember the person's name . . . .

(Cobb's Jan. 25, 2008 Dep. at 52.)

> Q: Did you speak with the person who actually prepared this document?
>
> A: No.

(Id.)

[3] Exhibit 30 is an incomplete spreadsheet that was prepared by US Salt's former office manager, which purportedly shows US Salt's lost profits. (See Doc. No. 112 at Ex. B; Ex. C at 170-71.)

> Q: Have you done anything to verify . . . that it's accurate?
>
> A: Not that comes to mind.

(Id.)

> Q: Did you ask Mr. Johnson to provide you with any backup documentation for any of these items [in Exhibit 30?]
>
> A: No.

(Id. at 34.) In essence, Cobb has not formed an opinion as to US Salt's lost profits; he has simply adopted Johnson's opinion as to US Salt's expected sales and the nature of the market. But as illustrated by Johnson's testimony, US Salt's expected sales were speculative at best:

> Q: Did Mr. Capone ever tell you the volume of salt he expected to buy from you?
>
> A: He gave me different estimates, and then like I say, from what he gave I had no way of verifying it until I started bagging or trying to do that.

(Johnson Dep. at 217.)

> Q: Throughout your marketing efforts were you able to get a written commitment from any customer regarding how much they would pay for solar salt?
>
> A: No.

(Id. at 226.) In the Court's view, Johnson's assumptions and estimates as to US Salt's expected sales were nothing more than optimistic projections. And Cobb's wholesale acceptance of Johnson's projections without any verification of these estimates or any independent market analysis is simply too speculative to submit to a jury. See Hammann v. 1-800 Ideas.com, Inc., 455 F. Supp. 2d 942, 948 (D.

Minn. 2006) (Schiltz, J.) ("Damages for lost profits, especially for a relatively new business venture, must be supported by specific, concrete evidence, not by mere 'speculation and conjecture.'") (citing Mostly Media, Inc. v. U.S. W. Commc'ns, 186 F.3d 864, 866 (8th Cir. 1999) (noting that "[t]he burden of proof required of a plaintiff in a lost-profits case is admittedly heavy" and affirming district court's determination that the proof of damages was too speculative)). In neither his expert reports nor his depositions could Cobb identify a reliable factual basis for his opinions regarding US Salt's expected sales, demand for solar salt, or the market conditions in Minnesota. Accordingly, the Court excluded Cobb's unreliable testimony regarding lost profits.[4]

The Court recognized that these evidentiary rulings left US Salt with little or no evidence of damages. It then asked if there were any remaining damages for trial, to which US Salt's counsel responded: "[w]ell, there are damages that we have not – we were not planning on including in the case because we were looking primarily at the lost profits . . . ." (4/24/08 Unofficial Tr. at 6.) Nonetheless, the Court requested that US Salt promptly provide Broken Arrow and the Court with a summary of what damages, if any, it believed remained for trial. (Id. at 46-47, 49.)

[4] The Court also excluded Johnson's proposed testimony with respect to lost profits (Doc. No. 127) because, as acknowledged by counsel for US Salt, Johnson does not have the financial expertise or specialized knowledge that is necessary for calculating and presenting its complex lost-profits claim to a jury. (4/24/08 Unofficial Tr. at 26-28.) Furthermore, the record shows that Johnson's assumptions for expected sales were based on speculative information and were devoid of any evidence showing that a proven market existed for this product or that comparable businesses that were similarly structured had been successful. See Cardinal, 297 N.W.2d at 267-68 (explaining how a new business can prove its lost profits).

US Salt, however, appeared to misunderstand the Court's request. Instead of providing a summary of previously claimed damages that remained for trial, it submitted an itemized list of damages totaling approximately $225,491 that had never been previously disclosed to Broken Arrow. Its new damages claim was made up of the following items: (a) equipment costs: $172,797; (b) rail-car demurrage: $28,280; (c) bag costs: $22,798; (d) fliers: $1,246; and (e) travel costs: $370. Broken Arrow moved to exclude US Salt's new damages claim, arguing that such damages were never disclosed and would unfairly prejudice Broken Arrow on the eve of trial.

The Court held a hearing on April 30, 2008 to address the issue of damages. Attached to US Salt's one-page list of damages were hundreds of exhibits that were not cross-referenced to its itemized list of damages. Notably, US Salt did not provide any explanation as to how it calculated its damages or why they were appropriate to submit to a jury. Because the Court did not fully understand US Salt's proffer of damages, it continued the trial to May 12, 2008, and directed US Salt to submit a memorandum explaining its damages theory and a document that cross-referenced its itemized damages with the attached exhibits. The Court also ordered the parties to meet with Magistrate Judge Mayeron on May 8, 2008 for a settlement conference in light of its recent evidentiary rulings. The parties' submissions on the issue of damages followed.[5]

[5] The trial was rescheduled to June 10, 2008. (See Doc. Nos. 130-31.) The parties informed the Court on May 21, 2008 that they were unable to reach a settlement.

ANALYSIS

US Salt contends that its new damages claim should be allowed as reliance damages under the Minnesota Uniform Commercial Code ("UCC") and as incidental and consequential damages. Broken Arrow, however, argues that US Salt's new damages claim should be excluded because US Salt never previously disclosed such evidence.[6] Broken Arrow asserts that the exclusion of US Salt's new damages claim would leave US Salt with no evidence of damages, which would require dismissal of US Salt's breach-of-contract claim.

The record shows that during the discovery process, Broken Arrow served an interrogatory on US Salt that required US Salt to identify its damages theories and the factual basis and methodology for its calculations. But US Salt never disclosed the damages it now seeks to present at trial in its response to that interrogatory. Broken Arrow's interrogatory on the issue of damages and US Salt's answer were as follows:

> **Interrogatory No. 14:** Describe in detail all damages that you allege in this action together with your method for calculating damages and a complete description of all evidence that you understand to support your claim of damages.
>
> **Answer:** See Exhibit 30 which is hereby attached and incorporated by reference herein showing the detail of damages and the method for calculating. Discovery is ongoing. Plaintiff reserves the right to supplement its answer.

[6] Broken Arrow also argues that reliance damages are not permitted under the Minnesota UCC and that US Salt's new damages do not qualify as incidental or consequential damages. For the reasons explained below, the Court need not address these arguments because US Salt's new damages claim was never previously disclosed to Broken Arrow as required by the discovery rules.

(Doc. No. 112 Ex. A at 17.) Exhibit 30 relates to US Salt's lost-profits claim; nowhere does it disclose the damages US Salt now seeks. (Id. at Ex. B.) In fact, US Salt acknowledges that this is a new damages claim. (See Pl.'s Reply Mem. on New Damages Theory at 1-5.)

The purpose of discovery is to "make a trial less a game of blind man's bluff and more a fair contest with the basic issues and facts disclosed to the fullest practicable extent." United States v. Procter & Gamble Co., 356 U.S. 677, 682 (1958) (citing Hickman v. Taylor, 329 U.S. 495, 501 (1947)). Notably, US Salt was required to disclose the calculation of its damages in its initial disclosures. See Fed. R. Civ. P. 26(a)(1)(A)(iii) (requiring as part of the initial disclosures "a computation of each category of damages claimed by the disclosing party.") Furthermore, US Salt was required to supplement its disclosures "in a timely manner if [it] learns that in some material respect the disclosure or response is incomplete or incorrect, and if the additional or corrective information has not otherwise been made known to [Broken Arrow] during the discovery process." Fed. R. Civ. P. 26(e)(1)(A).

Here, it is undisputed that US Salt never disclosed the damages it now seeks to offer at trial and never supplemented its disclosures on damages as required by the Federal Rules of Civil Procedure. So what is the consequence here? Rule 37(c)(1) provides that the Court must exclude the undisclosed evidence at trial unless a party shows that failure to comply with Rule 26(a) or 26(e) was substantially justified or harmless. The Eighth Circuit has set forth four factors that the Court should consider in

determining whether a failure to disclose was justified or harmless: (1) the importance of the excluded material; (2) the explanation for failing to comply with the disclosure rules; (3) the potential prejudice from allowing the material to be used at trial; and (4) the availability of a continuance to cure such prejudice. Citizens Bank v. Ford Motor Co., 16 F.3d 965, 966 (8th Cir. 1994).

Applying these factors, the Court determines that the nondisclosure of US Salt's new damages claim was neither substantially justified nor harmless. There is no question that the undisclosed damages are important to US Salt's claim. Despite the importance of this evidence, however, US Salt has failed to present a reasonable explanation for its failure to disclose this evidence of damages. It attempts to explain its failure to disclose on the basis that this Court's exclusion of its lost-profits claim forced it to now disclose a new damages claim. "The problem with [US Salt's] response is that the time for calculating damages and disclosing its theory on damages was long ago." Multimatic, Inc. v. Faurecia Interior Sys. USA, Inc., No. 05-60120, 2007 WL 627874, at *7 (E.D. Mich. Feb. 26, 2007) (finding that party had offered no justification for its failure to disclose information regarding its damages calculation and that such failure had "blindsided" other side and therefore was prejudicial given that discovery was closed). The purpose of discovery "is to narrow the issues, *to eliminate surprise*, and to achieve substantial justice." Greyhound Lines, Inc. v. Miller, 402 F.2d 134, 143 (8th Cir. 1968) (emphasis added). As part of its initial disclosures, US Salt was required to disclose a computation of each category of damages. See Fed. R. Civ. P. 26(a)(1)(A)(iii). If the

evidence for its damages claim became known or available only after its initial disclosure, then its initial response should have been supplemented pursuant to Rule 26(e)(1)(A). "For litigation to function efficiently, parties must provide clear and accurate responses to discovery requests. Parties are entitled to accept answers to previous interrogatories as true, and to refrain from seeking additional discovery directed to the same issue." ELCA Enters., Inc. v. Sisco Equip. Rental & Sales, Inc., 53 F.3d 186, 190 (8th Cir. 1995) (affirming district court's exclusion of evidence of damages because of plaintiff's incomplete interrogatory responses and "an eleventh-hour attempt to switch the basis for its alleged damages") (internal quotations and citations omitted).

The record shows that US Salt's new damages claim came unexpectedly on the eve of trial and only after the Court excluded its evidence on lost profits. The Court concludes that it would be highly prejudicial to Broken Arrow if the undisclosed evidence for US Salt's new damages claim was allowed at trial given that Broken Arrow has not had a full opportunity to test the reliability of this evidence through discovery and expert analysis. For example, US Salt's failure to disclose has prevented Broken Arrow from retaining an expert witness to offer testimony on the value of the used equipment and from deposing other witnesses, including Johnson, on these specific damages. It would be fundamentally unfair to allow US Salt to proceed with a completely new damages claim that was never revealed during the discovery process. Moreover, the record shows that all of the evidence US Salt seeks to introduce was in its possession

from the very early stages of the litigation and it offers no excuse for its failure to disclose other than its strategic decision to seek only lost profits as damages.[7]

Finally, the Court concludes that a continuance is unwarranted under the circumstances here. Although the Court could further delay the trial and open up discovery on US Salt's new damages claim, it would be unduly prejudicial to Broken Arrow given that US Salt is completely responsible for creating this situation. At this very late stage of the proceedings, the Court finds that it is neither appropriate nor economical to reopen discovery on US Salt's new damages claim.

Based on the foregoing, the Court concludes that US Salt's failure to disclose its new damages claim was neither substantially justified nor harmless. Accordingly, this evidence must be excluded. See Fed. R. Civ. P. 37(c)(1).

Having no evidence of damages, US Salt cannot prevail on its breach-of-contract claim as a matter of law. Under Minnesota law, a breach-of-contract claim consists of four elements: (1) a valid contract; (2) performance by the plaintiff of any conditions precedent; (3) a material breach of the contract by the defendant; and (4) damages. Parkhill v. Minn. Mut. Life Ins. Co., 174 F. Supp. 2d 951, 961 (D. Minn. 2000) (applying

[7] US Salt alleged in its Complaint that it was seeking incidental and consequential damages. As such, US Salt argues that Broken Arrow was on notice for the damages it now seeks. The Court disagrees. US Salt produced more than 15,000 pages of documents in response to Broken Arrow's discovery requests. (Third Hilke Aff. ¶ 8.) These documents were not segregated or organized according to the document requests to which they were responsive. (Id.); see also Fed. R. Civ. P. 34(b)(2)(E)(i). Furthermore, Broken Arrow is not required to examine this material in order to discern every possible claim for damages that might conceivably be made when it had already asked US Salt to specify its calculation of damages. See ELCA, 53 F.3d at 190 (party posing the interrogatory is entitled to rely on the answer given by the opponent). It is US Salt's responsibility under the federal rules to disclose its damages calculation. US Salt, however, failed to do that with respect to the damages it now seeks to offer at trial.

Minnesota law). "A breach of contract claim fails as a matter of law if the plaintiff cannot establish that [it] has been damaged by the alleged breach." Jensen v. Duluth Area YMCA, 688 N.W.2d 574, 578-79 (Minn. Ct. App. 2004).

Because US Salt cannot prove damages – an essential element of its breach-of-contract claim – that claim necessarily fails. See id.; see also Multimatic, 2007 WL 627874, at *7-8 (excluding evidence of damages because party did not include its calculation of damages in its initial disclosures or in its interrogatory responses. Because the party had no evidence of damages, it could not prevail on its claim as a matter of law).

CONCLUSION

Based on the foregoing, and all the files, records, and proceedings herein, **IT IS ORDERED** that US Salt's new damages claim is **EXCLUDED** and its Complaint (Doc. No. 1) is **DISMISSED WITH PREJUDICE**.

LET JUDGMENT BE ENTERED ACCORDINGLY.

Date: May 30, 2008

s/Richard H. Kyle
RICHARD H. KYLE
United States District Judge

116 T.C. No. 11

UNITED STATES TAX COURT

ESTATE OF W.W. JONES II, DECEASED, A.C. JONES IV, INDEPENDENT EXECUTOR, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13926-98. Filed March 6, 2001.

D formed a family limited partnership (JBLP) with his son and transferred assets including real property, to JBLP in exchange for a 95.5389-percent limited partnership interest. D also formed a family limited partnership (AVLP) with his four daughters and transferred real property to AVLP in exchange for an 88.178-percent limited partnership interest. D's son contributed real property in exchange for general and limited partnership interests in JBLP, and the daughters contributed real property in exchange for general and limited partnership interests in AVLP. All of the contributions were properly reflected in the capital accounts of the contributing partners. Immediately after formation of the partnerships, D transferred by gift an 83.08-percent limited partnership interest in JBLP to his son and a 16.915-percent limited partnership interest in AVLP to each of his daughters.

Held: The transfers of property to the partnerships were not taxable gifts. See Estate of Strangi v. Commissioner, 115 T.C. 478 (2000).

Held, further, sec. 2704(b), I.R.C., does not apply to this transaction. See Kerr v. Commissioner, 113 T.C. 449 (1999).

Held, further, the value of D's gift to his son was 83.08-percent of the value of the underlying assets of JBLP, reduced by a lack-of-marketability (8%) discount. The value of D's gift to each of his daughters was 16.915 percent of the value of the underlying assets of AVLP, reduced by secondary market (40%) and lack-of-marketability (8%) discounts.

Held, further, the gifts of limited partnership interests are not subject to additional lack-of-marketability discounts for built-in capital gains. Estate of Davis v. Commissioner, 110 T.C. 530 (1998), distinguished.

William R. Cousins III, Robert Don Collier, Robert M. Bolton, and Todd A. Kraft, for petitioner.

Deborah H. Delgado and Gerald L. Brantley, for respondent.

COHEN, Judge: Respondent determined a deficiency of $4,412,527 in the 1995 Federal gift tax of W.W. Jones II. The issues for decision are (alternatively): (1) Whether the transfers of assets on formation of Jones Borregos Limited Partnership (JBLP) and Alta Vista Limited Partnership (AVLP) (collectively, "the partnerships") were taxable gifts pursuant to section 2512(b); (2) whether the period of limitations for assessment of gift tax deficiency arising from gifts on formation

is closed; (3) whether restrictions on liquidation of the partnerships should be disregarded for gift tax valuation purposes pursuant to section 2704(b); and (4) the fair market value of interests in the partnerships transferred by gift after formation. Unless otherwise indicated, all section references are to the Internal Revenue Code in effect on the date of the transfers, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulated facts are incorporated in our findings by this reference. W.W. Jones II (decedent), resided in Corpus Christi, Texas, at the time the petition in this case was filed. Decedent subsequently died on December 17, 1998, and a motion to substitute the estate of W.W. Jones II, deceased, A.C. Jones IV, independent executor, as petitioner was granted. The place of probate of decedent's estate is Nueces County, Texas. At the time of his appointment as executor, A.C. Jones IV (A.C. Jones), also resided in Nueces County, Texas.

For most of his life, decedent worked as a cattle rancher in southwest Texas. Decedent had one son, A.C. Jones, and four daughters, Elizabeth Jones, Susan Jones Miller, Kathleen Jones Avery, and Lorine Jones Booth.

During his lifetime, decedent acquired, by gift or bequest, the surface rights to several large ranches, including the Jones Borregos Ranch, consisting of 25,669.49 acres, and the Jones Alta Vista Ranch, consisting of 44,586.35 acres. These ranches were originally acquired by decedent's grandfather and have been held by decedent's family for several generations. The land on these ranches is arid natural brushland, and commercial uses include raising cattle and hunting.

Motivated by his desire to keep the ranches in the family, decedent became involved in estate planning matters beginning in 1987. In 1994, decedent's certified public accountant suggested that decedent use partnerships as estate and business planning tools. Following up on this suggestion, A.C. Jones prepared various projections for decedent concerning a hypothetical transfer of the ranches to partnerships and the discounted values that would attach to the partnership interests for gift tax purposes.

A.C. Jones, Elizabeth Jones, Susan Jones Miller, Kathleen Jones Avery, and Lorine Jones Booth each owned a one-fifth interest in the surface rights of the Jones El Norte Ranch. They acquired this ranch by bequest from decedent's aunt in 1979. The Jones El Norte Ranch was also originally owned by decedent's grandfather and has also been owned by decedent's extended family for several generations.

Effective January 1, 1995, decedent and A.C Jones formed JBLP under Texas law. Decedent contributed the surface estate of the Jones Borregos Ranch, livestock, and certain personal property in exchange for a 95.5389-percent limited partnership interest. The entire contribution was reflected in the capital account of decedent. A.C. Jones contributed his one-fifth interest in the Jones El Norte Ranch in exchange for a 1-percent general partnership interest and a 3.4611-percent limited partnership interest.

On January 1, 1995, the same day that the partnership was effectively formed, decedent gave to A.C. Jones an 83.08-percent interest in JBLP, leaving decedent with a 12.4589-percent limited partnership interest. Decedent used a document entitled "Gift Assignment of Limited Partnership Interest" to carry out the transfer. The document stated that decedent intends that A.C. Jones receive the gift as a limited partnership interest.

Federal income tax returns for 1995, 1996, 1997, and 1998 were filed for JBLP and signed by A.C. Jones as tax matters partner. Attached to each return were separate Schedules K-1 for each general partnership interest and each limited partnership interest. The Schedules K-1 for the limited partnership interest of A.C. Jones included the interest in partnership received by gift from decedent.

Also effective January 1, 1995, decedent and his four daughters formed AVLP under Texas law. Decedent contributed the surface estate of the Jones Alta Vista Ranch in exchange for an 88.178-percent limited partnership interest. The contribution was reflected in decedent's capital account. Susan Jones Miller and Elizabeth Jones each contributed their one-fifth interests in the Jones El Norte Ranch in exchange for 1-percent general partnership interests and 1.9555-percent limited partnership interests, and Kathleen Jones Avery and Lorine Jones Booth each contributed their one-fifth interest in the Jones El Norte Ranch in exchange for 2.9555-percent limited partnership interests. The following chart summarizes the ownership structure of AVLP immediately after formation:

Partner	Percentage	Interest
Elizabeth Jones	1.0	General
	1.9555	Limited
Susan Jones Miller	1.0	General
	1.9555	Limited
Kathleen Jones Avery	2.9555	Limited
Lorine Jones Booth	2.9555	Limited
Decedent	88.178	Limited

On January 1, 1995, the same day that the partnership was effectively formed, decedent gave to each of his four daughters a 16.915-percent interest in AVLP, leaving decedent with a 20.518-percent limited partnership interest. Decedent used four separate documents, one for each daughter, entitled "Gift Assignment of Limited Partnership Interest" to carry out the

transfers. Each document stated that decedent intended for his daughters to receive the gifts as limited partnership interests.

Federal income tax returns for 1995, 1996, 1997, and 1998 were filed for AVLP and signed by Elizabeth Jones as tax matters partner. Attached to each return were separate Schedules K-1 for each general partnership interest and each limited partnership interest. The Schedules K-1 for each daughter's limited partnership interest included the partnership interest received by gift from decedent.

Decedent's attorney drafted the partnership agreements of both JBLP and AVLP with the intention of creating substantial discounts for the partnership interests that were transferred by gift. Both partnership agreements set forth conditions for when an interest that is transferred by gift or by other methods may convert to a limited partnership interest. Section 8.3 of the JBLP agreement provides that the general partner and 100 percent of the limited partners must approve the conversion to a limited partnership interest in writing, and section 8.3 of the AVLP agreement provides that the general partners and 75 percent of the remaining limited partners must approve the conversion in writing. Both agreements also require that an assignee execute a writing that gives assurances to the other partners that the assignee has acquired such interest without the intention to distribute such interest, and the assignee must execute a

counterpart to the partnership agreement adopting the conditions therein.

Sections 8.4 and 8.5 of the partnership agreements provide that, before a partner may transfer an interest in the partnerships to anyone other than decedent or any lineal descendant of decedent, the partnership or remaining partners shall have the option to purchase the partnership interest for the lesser of the agreed upon sales price or appraisal value. The partnership may elect to pay the purchase price in 10 annual installments with interest set at the minimum rate allowed by the rules and regulations of the Internal Revenue Service.

Section 9.2 of the agreements provides that the partnerships will continue for a period of 35 years. Section 9.3 provides that a limited partner will not be permitted to withdraw from the partnership, receive a return of contribution to capital, receive distributions in liquidation, or redemption of interest except upon dissolution, winding up, and termination of the partnership.

Section 9.4 of the partnership agreements provides for the removal of a general partner and the dissolution of the partnership. The AVLP agreement provides that a general partner may be removed at any time by the act of partners owning an aggregated 75-percent interest in the partnership. The JBLP agreement provides that a general partner may be removed at any time by the act of the partners owning an aggregated 51-percent

interest in the partnership. After removal, if there is no remaining general partner, the remaining limited partners shall designate a successor general partner. If the limited partners fail to designate a successor general partner within 90 days, the partnership will dissolve, affairs will be wound up, and the partnership will terminate. Except upon dissolution, windup, and termination, both partnership agreements prohibit a limited partner from withdrawing and receiving a return of capital contribution, distribution in liquidation, or a redemption of interest.

Section 5.4 of the AVLP agreement originally provided that the general partners could not sell any real property interest that was owned by the partnership without first obtaining the consent of partners owning a majority interest in the partnership. This section was later amended so that partners owning 85 percent of the partnership must consent to a sale of real property.

On January 1, 1995, the Jones Alta Vista Ranch had a fair market value of $10,254,860, and the Jones Borregos Ranch, livestock, and personal property that were contributed by decedent to JBLP had a fair market value of $7,360,997. Neither partnership ever made a section 754 election. At the time that decedent transferred interests in the partnerships by gift to his children, the net asset values (NAV) of the underlying

partnership assets that were held by AVLP and JBLP were $11,629,728 and $7,704,714, respectively. JBLP and AVLP had bases in their assets of $562,840 and $1,818,708, respectively.

Attached to his 1995 Federal gift tax return, decedent included a valuation report prepared by Charles L. Elliott, Jr. (Elliott), who also testified as the estate's expert at trial. The partnerships were valued on the return and by Elliott at trial using the NAV method on a "minority interest, nonmarketable" basis. Nowhere in his report did Elliott purport to be valuing assignee interests in the partnership. The valuation report arrived at an NAV for the partnerships and then applied secondary market, lack-of-marketability, and built-in capital gains discounts. The expert report concluded that a 66-percent discount from NAV is applicable to the interest in JBLP and that a 58-percent discount is applicable to the interest in AVLP. On the return, decedent reported gifts of "an 83.08 percent limited partnership interest" in JBLP valued at $2,176,864 and a "16.915 percent limited partnership interest" in AVLP to each of his four daughters, valued at $821,413 per interest.

In an affidavit executed on January 12, 1999, A.C. Jones stated that the gifts that he and his sisters received from decedent were "limited partnership interests". The sole activity

of AVLP is the rental of its real property. AVLP produces an average annual yield of 3.3 percent of NAV.

OPINION

Gift at the Inception of the Partnerships

In an amendment to the answer, respondent contends that decedent made taxable gifts upon contributing his property to the partnerships. Using the value reported by decedent on his gift tax return, respondent argues that, if decedent gave up property worth $17,615,857 and received back limited partnership interests worth only $6,675,156, decedent made taxable gifts upon the formation of the partnerships equal to the difference in value.

In Estate of Strangi v. Commissioner, 115 T.C. 478, 489-490 (2000), a decedent formed a family limited partnership with his children and transferred assets to the partnership in return for a 99-percent limited partnership interest. After his death, his estate claimed that, due to lack-of-control and lack-of-marketability discounts, the value of the limited partnership interest was substantially lower than the value of the property that was contributed by the decedent. The Commissioner argued that the decedent had made a gift when he transferred property to the partnership and received in return a limited partnership interest of lesser value. The Court held that, because the taxpayer received a continuing interest in the family limited partnership and his contribution was allocated to his own capital

account, the taxpayer had not made a gift at the time of contribution.

In Shepherd v. Commissioner, 115 T.C. 376, 379-381 (2000), the taxpayer transferred real property and stock to a newly formed family partnership in which he was a 50-percent owner and his two sons were each 25-percent owners. Rather than allocating contributions to the capital account of the contributing partner, the partnership agreement provided that any contributions would be allocated pro rata to the capital accounts of each partner according to ownership. Because the contributions were reflected partially in the capital accounts of the noncontributing partners, the value of the noncontributing partners' interests was enhanced by the contributions of the taxpayer. Therefore, the Court held that the transfers to the partnership were indirect gifts by the taxpayer to his sons of undivided 25-percent interests in the real property and stock. See id. at 389.

The contributions of property in the case at hand are similar to the contributions in Estate of Strangi and are distinguishable from the gifts in Shepherd. Decedent contributed property to the partnerships and received continuing limited partnership interests in return. All of the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interests was not

enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts.

Because the contributions do not reflect taxable gifts, we need not decide whether the period of limitations for assessment of a deficiency due to a gift on formation has expired.

Section 2704(b)

Respondent determined in the statutory notice, and argues in the alternative, that provisions in the partnership agreements constitute applicable restrictions under section 2704(b) and must be disregarded when determining the value of the partnership interests that were transferred by gift.

Section 2704(b) generally states that, where a transferor and his family control a partnership, a restriction on the right to liquidate the partnership shall be disregarded when determining the value of the partnership interest that has been transferred by gift or bequest if, after the transfer, the restriction on liquidation either lapses or can be removed by the family. Section 25.2704-2(b), Gift Tax Regs., provides that an applicable restriction is a restriction on "the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."

Respondent argues that both partnership agreements contain provisions limiting the ability of a partner to liquidate that are more restrictive than the default Texas partnership provisions. Specifically, respondent points to section 9.2 of the partnership agreements, which provides that each partnership shall continue for a period of 35 years. Respondent also points to section 9.3 of the partnership agreements, which prohibits a limited partner from withdrawing from the partnership or from demanding the return of any part of a partner's capital account except upon termination of the partnership.

Respondent compares sections 9.2 and 9.3 of the partnership agreements with section 6.03 of the Texas Revised Limited Partnership Act (TRLPA). TRLPA section 6.03 provides:

> A limited partner may withdraw from a limited partnership at the time or on the occurrence of events specified in a written partnership agreement and in accordance with that written partnership agreement. If the partnership agreement does not specify such a time or event or a definite time for the dissolution and winding up of the limited partnership, a limited partner may withdraw on giving written notice not less than six months before the date of withdrawal to each general partner * * *.

Tex. Rev. Civ. Stat. Ann. art. 6132a-1, sec. 6.03 (West Supp. 1993).

Respondent's argument is essentially the same as the argument we rejected in Kerr v. Commissioner, 113 T.C. 449, 469-474 (1999). In Kerr, the taxpayers and their children formed two

family limited partnerships with identical liquidation restrictions. Shortly after formation, the taxpayers transferred limited partnership interests to their children by gift. On their Federal gift tax return, the taxpayers claimed substantial discounts in the value of the interests compared to the value of the underlying assets due to lack of control and lack of marketability. The partnership agreements provided that the partnerships would continue for 50 years.

The Court held:

> Respondent's reliance on TRLPA section 6.03 is misplaced. TRLPA section 6.03 governs the withdrawal of a limited partner from the partnership--not the liquidation of the partnership. TRLPA section 6.03 sets forth limitations on a limited partner's withdrawal from a partnership. However, a limited partner may withdraw from a partnership without requiring the dissolution and liquidation of the partnership. In this regard, we conclude that TRLPA section 6.03 is not a "limitation on the ability to liquidate the entity" within the meaning of section 25.2704-2(b), Gift Tax Regs.

Id. at 473. In sum, the Court concluded that the partnership agreements in Kerr were not more restrictive than the limitations that generally would apply to the partnerships under Texas law. See id. at 472-474. Respondent acknowledges that Kerr is applicable to this issue but argues that Kerr was incorrectly decided. However, we find no reason to reach a result that is different than the result in Kerr. Thus, section 2704(b) does

not apply here. See also Knight v. Commissioner, 115 T.C. 506, 519-520 (2000); Harper v. Commissioner, T.C. Memo. 2000-202.

Valuation of Decedent's Gifts of Limited Partnership Interests

A gift of property is valued as of the date of the transfer. See sec. 2512(a). The gift is measured by the value of the property passing from the donor, rather than by the property received by the donee or upon the measure of enrichment to the donee. See sec. 25.2511-2(a), Gift Tax Regs. The fair market value of the transferred property is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. See United States v. Cartwright, 411 U.S. 546, 551 (1973); sec. 25.2512-1, Gift Tax Regs. The hypothetical willing buyer and the hypothetical willing seller are presumed to be dedicated to achieving the maximum economic advantage. See Estate of Davis v. Commissioner, 110 T.C. 530, 535 (1998). Transactions that are unlikely and plainly contrary to the economic interests of a hypothetical willing buyer or a hypothetical willing seller are not reflective of fair market value. See Estate of Strangi v. Commissioner, 115 T.C. 478, 491 (2000); Estate of Newhouse v. Commissioner, 94 T.C. 193, 232 (1990); Estate of Hall v. Commissioner, 92 T.C. 312, 337 (1989).

As is customary for valuation issues, the parties rely extensively on the opinions of their respective experts to support their differing views about the fair market value of the gifts of partnership interests. The estate relies on Elliott, a senior member of the American Society of Appraisers and a principal in the business valuation firm of Howard Frazier Barker Elliott, Inc. Respondent relies on Francis X. Burns (Burns), a candidate member of the American Society of Appraisers and a principal in the business valuation firm of IPC Group, Inc. Each expert prepared a report.

We evaluate the opinions of the experts in light of the demonstrated qualifications of each expert and all other evidence in the record. See Estate of Davis v. Commissioner, supra at 536. We are not bound by the formulae and opinions proffered by expert witnesses, especially when they are contrary to our judgment. Instead, we may reach a determination of value based on our own examination of the evidence in the record. Where experts offer contradicting estimates of fair market value, we decide what weight to give those estimates by examining the factors used by the experts in arriving at their conclusions. See id. Moreover, because valuation is necessarily an approximation, it is not required that the value that we determine be one as to which there is specific testimony, provided that it is within the range of figures that properly may

be deduced from the evidence. See Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo. 1974-285. The experts in this case agree that, in ascertaining the fair market value of each gift of interest in the partnerships, one starts with the fair market value of the underlying assets of each partnership and then applies discounts for factors that limit the value of the partnership interests.

A. Nature of Interests Transferred

The first argument of the estate is that the partnership interests that were transferred by decedent were assignee interests rather than limited partnership interests. The estate claims that decedent and the recipients of the gifts did not fulfill the necessary requirements set forth in the partnership agreements for transferring limited partnership interests. The JBLP agreement provides that, upon an exchange of an interest in the partnership, the general partner and 100 percent of the remaining limited partners must approve, in writing, of a transferred interest becoming a limited partnership interest. The AVLP agreement provides that the general partners and 75 percent of the limited partners must approve, in writing, of a transferred interest's becoming a limited partnership interest. Because these written approvals were not carried out, the estate contends that the recipients of the gifts are entitled only to the rights of assignees.

In Kerr v. Commissioner, 113 T.C. 449, 464 (1999), the taxpayers held greater than 99 percent of the partnership interests of two family limited partnerships as general and limited partners. The taxpayers' children held the remaining partnership interests, totaling less than 1 percent of overall ownership, as general partners. The partnership agreements provided that no person would be admitted as a limited partner without the consent of all general partners. In 1994, the taxpayers transferred a large portion of their limited partnership interests to trusts for which they served as trustees. At trial, the taxpayers argued that, although they made these transfers to themselves as trustees, pursuant to the family limited partnership agreement, their children as general partners had to consent to the admission of the trustees as limited partners. The taxpayers argued that the interests held by the trusts should be valued as assignee interests. The Court looked at all of the surrounding facts and circumstances in holding that the interests that were transferred by the taxpayers were limited partnership interests. See id. at 464.

On review of the facts and circumstances of the case at hand, decedent, like the taxpayers in Kerr, transferred limited partnership interests to his children rather than assignee interests. The evidence shows that decedent intended for the transfers to include limited partnership interests and that the

children consented to the transfer of limited partnership interests, having waived the requirement of a writing.

Pursuant to the AVLP agreement, Susan Jones Miller and Elizabeth Jones as general partners would have had to consent in writing to the transfer of the interests as limited partnership interests. Also, 75 percent of the remaining limited partners, i.e., Elizabeth Jones, Susan Jones Miller, Kathleen Jones Avery, Lorine Jones Booth, and decedent, would have had to consent in writing. Pursuant to the JBLP agreement, A.C. Jones as general partner would have had to consent in writing to the transfer as a limited partnership interest. Also, all of the remaining limited partners, i.e., A.C. Jones and decedent, would have had to consent in writing.

Although the estate argues that the absence of written consents leads to the conclusion that the interests transferred were assignee interests, it is difficult to reconcile that position with the language that decedent, his children, and Elliott used to document and characterize the transfers. First, the documents entitled “Gift Assignment of Limited Partnership Interest”, created by decedent to carry out the transfers, state that, after the transfers are complete, each child will hold his or her newly acquired interest as a “limited partnership interest”. Second, in his 1995 Federal gift tax return, decedent describes the gifts as “limited partnership interests” rather

than assignee interests. Third, in an affidavit executed on January 12, 1999, A.C. Jones states that the gifts that he and his sisters received from decedent were "limited partnership interests". Fourth, the 1995, 1996, 1997, and 1998 Federal income tax returns for JBLP and AVLP, signed by A.C. Jones and Elizabeth Jones, respectively, designate the interests as limited partnership interests on the Schedules K-1. Fifth, although he claimed at trial that he was valuing assignee interests, Elliott's written report referred only to limited partnership interests. These factors lead to the conclusion that the estate's argument, that decedent transferred assignee interests, was an afterthought in the later stages of litigation.

Also, after giving the gifts to his daughters, decedent was left with a 20.518-percent limited partnership interest. Section 5.4 of the AVLP agreement was modified so that consent of 85 percent of the partners was required in order for a general partner to sell a real estate interest belonging to the partnership. With this modification, decedent could retain the power to block unilaterally a sale of a real estate interest even after giving the gifts. This amendment would not have been necessary if the daughters had received only assignee interests.

This case is distinguishable from Estate of Nowell v. Commissioner, T.C. Memo. 1999-15, relied on by petitioner. In Estate of Nowell, the partnership agreements specified that the

recipient of limited partnership interests would become an assignee and not a substitute limited partner unless the general partners consented to the assignee's admission as a limited partner. The Court there decided that interests in the partnerships should be valued for estate tax purposes as assignee interests rather than as limited partnership interests.

The transactions in Estate of Nowell differ from the gifts in the case at hand in that the beneficiaries, the estate, and the decedent in Estate of Nowell never treated the passing interests in the partnerships as limited partnership interests. The record was void of evidence that showed that a limited partnership interest was in fact transferred. Here, the conduct of decedent, A.C. Jones, and the daughters reflects that limited partnership interests were actually transferred by decedent.

B. Value of the Transferred Interest in JBLP

Having concluded that decedent transferred an 83.08-percent limited partnership interest in JBLP to A.C. Jones, the next issue for decision is the value of the limited partnership interest. The estate relies on the conclusions of Elliott, who opined that the value of the interest in JBLP is subject to a secondary market discount of 55 percent, a lack-of-marketability discount of 20 percent, and an additional discount for built-in capital gains. Respondent relies on the valuation of Burns, who opined that no discounts apply.

Section 9.4 of the JBLP agreement provides that a general partner may be removed at any time by the act of the partners owning an aggregate 51-percent interest in the partnership. After removal, if no general partners remain, the limited partners shall designate a successor general partner. If the limited partners fail to designate a successor general partner within 90 days, the partnership will dissolve, affairs will be wound up, and the partnership will terminate.

Section 9.4 effectively gives ultimate decision-making authority to the owner of the 83.08-percent limited partnership interest. Under the threat of removal of the general partner, the 83.08-percent limited partner would have the power to control management, to compel a sale of partnership property, and to compel partnership distributions. If the general partner refused, the 83.08-percent limited partner could force liquidation within 90 days. Having the ability to force liquidation also gives the 83.08-percent limited partner the right to force a sale of the partnership assets and to receive a pro rata share of the NAV. Because the 83.08-percent limited partner has the power to control the general partner or to force a liquidation, the discounts proffered by Elliott are unreasonable and unpersuasive. The size of the interest to be valued and the nature of the underlying assets make the secondary market an improbable analogy for determining fair market value.

We do not believe that a seller of the 83.08-percent limited partnership interest would part with that interest for substantially less than the proportionate share of the NAV.

Burns opined that no discount for lack of control should apply for the reasons stated above. We agree. He also concluded that "the size and the associated rights of the interest would preclude the need for a marketability discount." He recognized that section 8.4 of the partnership agreement purported to give family members the power to prevent a third-party buyer from obtaining an interest in the JBLP, but he maintained that "to adhere to the fair market value standard, an appraiser must assume that a market exists and that a willing buyer would be admitted into the partnership." We believe that there is merit to this position. Self-imposed limitations on the interest, created with the purpose of minimizing value for transfer tax purposes, are likely to be waived or disregarded when the owner of the interest becomes a hypothetical willing seller, seeking the highest price that the interest will bring from a willing buyer. The owner of the 83.08-percent interest has the ability to persuade or coerce other partners into cooperating with the proposed sale. Nonetheless, liquidation of a partnership and sale of its assets, the most likely threat by which the owner of such a controlling interest would persuade or coerce, would involve costs and delays. The possibility of litigation over a

forced liquidation would reduce the amount that a hypothetical buyer would be willing to pay for the interest. See Adams v. United States, 218 F.3d 383 (5th Cir. 2000); Estate of Newhouse v. Commissioner, 94 T.C. 193, 235 (1990). A marketability discount would apply, but we believe that, under the circumstances of this case, an 8-percent discount more accurately reflects reality. This amount approximates the discount for lack of marketability proposed by Burns with respect to AVLP, as discussed below.

The experts also disagree about whether a discount attributable to built-in capital gains to be realized on liquidation of the partnership should apply. The parties and the experts agree that tax on the built-in gains could be avoided by a section 754 election in effect at the time of sale of partnership assets. If such an election is in effect, and the property is sold, the basis of the partnership's assets (the inside basis) is raised to match the cost basis of the transferee in the transferred partnership interest (the outside basis) for the benefit of the transferee. See sec. 743(b). Otherwise, a hypothetical buyer who forces a liquidation could be subject to capital gains tax on the buyer's pro rata share of the amount realized on the sale of the underlying assets of the partnership over the buyer's pro rata share of the partnership's adjusted basis in the underlying assets. See sec. 1001. Because the JBLP

agreement does not give the limited partners the ability to effect a section 754 election, in this case the election would have to be made by the general partner.

Elliott opined that a hypothetical buyer would demand a discount for built-in gains. He acknowledged in his report a 75- to 80-percent chance that an election would be made and that the election would not create any adverse consequences or burdens on the partnership. His opinion that the election was not certain to be made was based solely on the position of A.C. Jones, asserted in his trial testimony, that, as general partner, he might refuse to cooperate with an unrelated buyer of the 83.08-percent limited partnership interest (i.e., the interest he received as a gift from his father). We view A.C. Jones' testimony as an attempt to bootstrap the facts to justify a discount that is not reasonable under the circumstances.

Burns, on the other hand, opined, and respondent contends, that a hypothetical willing seller of the 83.08-percent interest would not accept a price based on a reduction for built-in capital gains. The owner of that interest has effective control, as discussed above, and would influence the general partner to make a section 754 election, eliminating any gains for the purchaser and getting the highest price for the seller. Such an election would have no material or adverse impact on the preexisting partners. We agree with Burns.

Petitioner relies on Eisenberg v. Commissioner, 155 F.3d 50 (2d Cir. 1998), revg. T.C. Memo. 1997-483, and Estate of Davis v. Commissioner, 110 T.C. 530, 546-547 (1998). Those cases, however, are distinguishable. In the contexts of those cases, the hypothetical buyer and seller would have considered a factor for built-in capital gains in determining a price for closely held stock in a corporation. In Eisenberg, the Court of Appeals emphasized that earlier Tax Court cases declining to recognize a discount for unrealized capital gains were based on the ability of the corporation, under the doctrine of General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), to liquidate and distribute property to its shareholders without recognizing built-in gain or loss and thus circumvent double taxation. The Court of Appeals went on to explain that the tax-favorable options ended with the Tax Reform Act of 1986, Pub. L. 99-514, sec. 631, 100 Stat. 2085, 2269. In reversing our grant of summary judgment on this issue and remanding the case for determination of gift tax liability, the Court of Appeals cited and quoted from Estate of Davis v. Commissioner, supra, in support of its reasoning.

In Estate of Davis, the Court rejected the Government's argument that no discount for built-in capital gains should apply because of the possibility that the corporation could convert to an S corporation and avoid recognition of gains on assets

retained for 10 years. Applying the hypothetical buyer and seller test, the Court, based on the record presented, including the testimony of experts for both parties, concluded that a discount for tax on built-in gains would be applied.

In the cases in which the discount was allowed, there was no readily available means by which the tax on built-in gains would be avoided. By contrast, disregarding the bootstrapping testimony of A.C. Jones in this case, the only situation identified in the record where a section 754 election would not be made by a partnership is an example by Elliott of a publicly syndicated partnership with "lots of partners * * * and a lot of assets" where the administrative burden would be great if an election were made. We do not believe that this scenario has application to the facts regarding the partnerships in issue in this case. We are persuaded that, in this case, the buyer and seller of the partnership interest would negotiate with the understanding that an election would be made and the price agreed upon would not reflect a discount for built-in gains.

C. Value of Interests in AVLP

The estate relies on the conclusions of Elliott, who opined that the value of each transferred interest in AVLP is subject to a secondary market discount of 45 percent, a discount for lack of marketability equal to 20 percent, and an additional discount for built-in capital gains. Burns opined that the transferred

interests are entitled to a secondary market discount of 38 percent, a discount for lack of marketability equal to 7.5 percent, and no discount for built-in capital gains.

An owner of a 16.915-percent limited partnership interest in AVLP does not have the ability to remove a general partner. As such, a hypothetical buyer would have minimal control over the management and business operations. Also, a 16.915-percent limited partnership interest in AVLP is not readily marketable, and any hypothetical purchaser would demand a significant discount. In calculating the overall discount for the AVLP interests, both experts use data from different issues of the same publication regarding sales of limited partnership interests on the secondary market. The publication was the primary tool used by both experts.

Burns, using the May/June 1995 issue, opined that interests in real estate-oriented partnerships with characteristics similar to AVLP traded at discounts due to lack of control equal to 38 percent on January 1, 1995. The May/June 1995 issue contained data regarding the sale of limited partnership interests during the 60-day period ended May 31, 1995. Burns classified AVLP as a low-debt partnership making current distributions.

Elliott, using the May/June 1994 issue, opined that similar partnerships traded at a secondary market discount of 45 percent. The secondary market discount is an overall discount encompassing

discounts for both lack of control and lack of marketability for minority interests in syndicated limited partnerships. The May/June 1994 issue contained data regarding the sale of limited partnership interests during the 60-day period ended May 31, 1994.

The estate argues that Burns' conclusion, which is based on data found in the May/June 1995 issue, is flawed because such information was not available on January 1, 1995, the date the gift was made. The estate contends that, since a gift of property is valued, pursuant to section 2512(a), as of the date of the transfer, posttransfer data cannot affect our decision. However, Burns does not use the posttransfer data to prove directly the value of the transferred interests. Instead, he uses the May/June 1995 issue to show what value would have been calculated if, on January 1, 1995, decedent had looked at transactions involving the sale of interests in similarly situated partnerships occurring at that point in time. Data regarding such transactions involving similarly situated partnerships were available on the valuation date. Therefore, the data available in the May/June 1995 issue are relevant as they provide insight into what information would have been found if, on January 1, 1995, decedent had looked at transactions occurring on or near the valuation date.

The data on which Burns relied show that interests in similarly situated partnerships were trading at a 38-percent discount from April 2 to May 31, 1995. The data on which Elliott relied show that interests in similarly situated partnerships were trading at a 45-percent discount from April 2 to May 31, 1994. Therefore, transfers of interests on or around January 1, 1995, would have been trading at a discount somewhere between 38 and 45 percent. Because the data on which Burns relied are closer in time to the transfer date of the 16.915-percent AVLP interests, we give greater weight to his determination. Recognizing that the valuation process is always imprecise, a 40-percent discount is reasonable. This discount is a reduction in value for an interest trading on the secondary market and encompasses discounts for lack of control and lack of marketability.

Elliott opines that an additional 20-percent discount for lack of marketability is applicable because the partnerships that are the subject of the data in the publication are syndicated limited partnerships. He believes that, although there is a viable market for syndicated limited partnership interests, a market for nonsyndicated, family limited partnership interests does not exist. The additional 20-percent discount opined by Elliot is also attributable to sections 8.4 and 8.5 of the AVLP agreement, which attempt to limit the transferability of

interests in AVLP. In calculating the additional discount, Elliott relied on data found in various restricted stock and initial public offering studies.

Elliott acknowledges that the secondary market for syndicated partnerships is not a strong market and that a large discount for lack of marketability is already built into the secondary market discount. Although Elliott adjusts his analysis of the data found in the restricted stock and initial public offering studies to take into consideration the lack-of-marketability discount already allowed, his adjustment is inadequate. His cumulation of discounts does not survive a sanity check.

Sections 8.4 and 8.5 of the AVLP agreement do not justify an additional 20-percent discount. An option of the partnership or the other partners to purchase an interest for fair market value before it is transferred to a third party, standing alone, would not significantly reduce the value of the partnership interest. Nevertheless, the right of the partnership to elect to pay the purchase price in 10 annual installments with interest set at the minimum rate allowed by the rules and regulations of the Internal Revenue Service would increase the discount for lack of marketability. Texas courts have been willing to disregard option clauses that unreasonably restrain alienation. See Procter v. Foxmeyer Drug Co., 884 S.W.2d 853, 859 (Tex. App.

1994). We express no opinion whether this election is enforceable under Texas law. Because this clause would cause uncertainty as to the rights of an owner to receive fair market value for an interest in AVLP, a hypothetical buyer would pay less for the partnership interest. See Estate of Newhouse v. Commissioner, 94 T.C. 193, 232-233 (1990); Estate of Moore v. Commissioner, T.C. Memo. 1991-546. We believe that an additional discount equal to 8 percent for lack of marketability, to the NAV previously discounted by 40 percent, is justified.

For the reasons set forth in the built-in capital gains analysis for JBLP, an additional discount for lack of marketability due to built-in gains in AVLP is not justified. Although the owner of the percentage interests to be valued with respect to AVLP would not exercise effective control, there is no reason why a section 754 election would not be made. Elliott admits that, because AVLP has relatively few assets, a section 754 election would not cause any detriment or hardship to the partnership or the other partners. Thus, we agree with Burns that the hypothetical seller and buyer would negotiate with the understanding that an election would be made. Elliott's assumption that Elizabeth Jones and Susan Jones Miller, as general partners, might refuse to cooperate with a third-party purchaser is disregarded as an attempt to bootstrap the facts to justify a discount that is not reasonable under the

circumstances. Therefore, a further discount for built-in capital gains is not appropriate in this case.

D. Conclusion

The schedules below summarize our conclusions as to fair market value for the transferred JBLP and AVLP limited partnership interests:

83.08-Percent Interest in JBLP

NAV of limited partnership	$ 7,704,714
	83.08%
Pro rata NAV	6,401,076
Lack of marketability (8%)	(512,086)
Fair market value	$ 5,888,990

16.915-Percent Interest in AVLP

NAV of limited partnership	$11,629,728
	16.915%
Pro rata NAV	1,967,168
Secondary market (40%)	(786,867)
	1,180,301
Lack of marketability (8%)	(94,424)
Fair market value	$ 1,085,877

We have considered all remaining arguments made by both parties for a result contrary to those expressed herein, and, to the extent not discussed above, they are irrelevant or without merit.

To reflect the foregoing,

Decision will be entered under Rule 155.

Full Text of Court Cases

Wall v. Commissioner

Case name: Wall v. Commissioner
Citation: T.C. Memo 2001-75; 2001 Tax Ct. Memo LEXIS 97
Date of decision: March 27, 2001
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Beghe, Renato
Experts: Donna J. Walker, CFA, ASA
Gary L. Schroeder, ASA
SIC: 2522 Office Furniture, Except Wood
NAICS: 337214 Office Furniture (except Wood) Manufacturing
450

JUDGES: Beghe, Renato

OPINIONBY: BEGHE, RENATO

OPINION: These are gift tax valuation cases in which the transferred property is nonvoting common stock of a family corporation given by petitioners to 20 trusts for their 10 children. The value per share determined by the statutory notices exceeded the value claimed in the gift tax returns by only 17 percent. The reports prepared by the experts for trial came up with values that widened the gap between the parties' initial positions. In Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 451-452 (1980), the Court suggested that valuation cases should be settled, and warned the parties that in some cases the Court might be persuaded to adopt the position of one party, rather than to split the difference between their positions; these are such cases. Held: the determination of value in the statutory notices is sustained.

Rex A. Guest and Melvin L. Katten, for petitioners.

Michael F. O'Donnell and George W. Bezold, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

BEGHE, Judge: Respondent determined a $73,789 deficiency in petitioner John E. Wall's gift tax for calendar 1992. Respondent also determined a $73,789 deficiency in the 1992 gift tax of Mr. Wall's spouse, petitioner Joanne Wall. Mrs. Wall is a party to these consolidated cases solely because petitioners elected to treat Mrs. Wall as the donor of one-half of the gifts Mr. Wall made during 1992. See sec. 2513. n1

n1 All section references are to the Internal Revenue Code in effect for 1992, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise specified.

The only issue for decision is the fair market value, as of January 1, 1992, of 9,380 shares of Demco, Inc., nonvoting common stock, which Mr. Wall gave on that date to 20 trusts for the benefit of his children. Petitioners claimed on their gift tax returns that the fair market value of the stock was $221.75 per share. Respondent asserted in the statutory notices that the correct value was $260.13 per share, approximately 17 percent more than the value claimed by petitioners.

FINDINGS OF FACT

Petitioners resided in Madison, Wisconsin, when they filed the petitions in the cases at hand.

Demco, Inc. (Demco), is a Wisconsin corporation that has elected to be an S corporation for Federal income tax purposes.

Mr. Wall was Demco's sole stockholder immediately before the gifts in issue. He owned all 1,200 issued and outstanding shares of Demco's voting common stock and all 12,000 issued and outstanding shares of Demco's nonvoting common stock.

On January 1, 1992, Mr. Wall (as grantor) and Michael O. Hartz (as trustee) created two irrevocable trusts for the benefit of each of Mr. Wall's 10 children. Of these 20 trusts, 10 were known as "annual exclusion" trusts, and 10 were known as "nonvoting stock" trusts.

Also on January 1, 1992, Mr. Wall gave 443 shares of his Demco nonvoting common stock to each of the annual exclusion trusts and 495 shares of his Demco nonvoting common stock to each of the nonvoting stock trusts. As a result of these transactions, Mr. Wall gave 938 shares of the Demco nonvoting common stock to trusts for the benefit of each of his 10 children, for total gifts of 9,380 shares (collectively, the gifts).

After the gifts, Mr. Wall continued to own all 1,200 shares of Demco's voting common stock and the remaining 2,620 shares of Demco's nonvoting common stock.

Demco's stock was not listed on an exchange on or around the date of the gifts, and there was no other public market for Demco stock.

DEMCO'S HISTORY AND BUSINESS

Demco is a direct mail distributor and manufacturer of office supplies, furniture, and accessories. Demco's principal customers are libraries, schools, and professional and business offices. Demco distributes its products nationwide and has over 100,000 customers.

Demco started doing business in 1906 as part of the Democrat Printing Company of Madison, Wisconsin. In 1931, Demco was chartered as Demco Library Supplies, Inc., a company owned and operated by Norman Bassett. In January 1972, Demco became a wholly owned subsidiary of George Banta Co. of Menasha, Wisconsin, a publicly owned educational printer. In 1978, following a failed takeover attempt by another corporation, Demco's management (including Mr. Wall, who was then Demco's president and chief executive officer) acquired Demco's stock in a leveraged buyout.

Demco's headquarters are in Madison, Wisconsin. At the time of the gifts, Demco also operated a 15,700 square foot distribution facility in Fresno, California, and a 131,000 square foot distribution, manufacturing, and converting facility in DeForest, Wisconsin.

Demco had built a strong reputation for quality, service, and moderate pricing by the time of the gifts, all of which gave Demco good name recognition and a strong market position. Demco also had a strong continuing customer base which generated repeat business.

Demco had an experienced management team at the time of the gifts that had worked together for many years. Demco's relationship with its workforce (which was nonunion) was good, turnover was low, and Demco had not experienced any difficulty recruiting qualified employees at all levels. During 1991, the year immediately prior to the gifts, Demco had approximately 235 employees.

Demco's net revenues and net income for 1987-91 (the 5 years prior to the gifts), and Demco's projected net revenues and net income for 1992 (the year of the gifts, as projected by management around the time of the gifts) were as shown in the following table: n2

n2 The financial information in the table was compiled from Demco's audited and unaudited financial statements and management's projections for 1992, as adjusted by petitioners' expert Donna J. Walker (Ms. Walker) to eliminate the results of Demco's media division, which was sold in 1991. Respondent's expert Gary L. Schroeder (Mr. Schroeder) considered this information to be reliable and used it to prepare his report.

YEAR NET REVENUES NET INCOME

1987 $ 21,922,286 $ 1,615,877

1988 25,060,137 1,314,997

1989 27,256,611 1,361,810

1990 29,770,281 1,002,367

1991 30,536,365 511,072

1992 (Projected) 31,260,786 1,434,198

As the foregoing table shows, Demco's net revenues increased steadily from 1987 to 1991 and were projected to continue to increase in 1992. Demco's net income, however, decreased from 1987-90, then fell more sharply in 1991, but was projected to recover in 1992.

The decrease in Demco's net income was not caused by any increase in Demco's cost of goods sold; Demco's gross margin increased from 43.9 percent of net revenues in 1987 to 45.5 percent of net revenues in 1991. Rather, Demco's declining profitability was attributable to increases in its marketing and administrative expenses. From 1987 to 1991, Demco's marketing expenses increased from 16.5 percent of net revenues to 19.3 percent; administrative expenses increased even more sharply over the same period, from 9.7 percent of net revenues to 16.3 percent.

Demco's management predicted that these trends would be reversed and that Demco's net income would return to historic levels in 1992. n3 Nevertheless, at the beginning of 1992 general economic conditions were unfavorable and Demco's principal customers (libraries and schools) were suffering from budget cuts. However, many economists predicted that a weak recovery would begin in mid to late 1992.

n3 In particular, Mr. Wall testified that the expenses of a poorly performing division had caused 1991 earnings to decline by approximately $535,000; that division was later terminated.

MEDIA DIVISION SALE

From about 1970 or 1971 to June 1, 1991, Demco operated two other businesses, which the parties refer to as Demco's "media division". One of these businesses converted paperback books for use in school libraries, by rebinding the books in hard covers using Demco's "Turtle Back" process. The other business provided periodical subscriptions management services for libraries.

In June 1991, Demco discontinued the operations of the media division and sold the division's assets to a limited partnership. An S corporation owned entirely by Mr. Wall was the purchasing partnership's 1-percent general partner; an irrevocable trust for the benefit of Mr. Wall's family was the purchaser's 99-percent limited partner.

The sales price for the media division's assets was $1,200,000. Of this amount, Demco received $120,000 in cash; it also received the purchasing partnership's note (media note) for the remaining $1,080,000 due. The media note was collateralized by substantially all of the acquired assets and bore interest at 7.64 percent. Mr. Wall expected Demco to receive full payment of the media note, and the note's outstanding principal amount had been reduced to approximately $430,000 by the time of trial.

PRIOR TRANSACTIONS IN DEMCO STOCK

The parties have identified six transactions in Demco stock that occurred between 1978 and the gifts in 1992. All six transactions involved the sale or repurchase of stock to or from Demco employees. Three of the transactions occurred more than 5 years before the gifts. The three others occurred approximately 2 years before the gifts, on February 9, 1990, when Demco redeemed a total of 600 shares of its voting common stock from three of its officers.

The redeemed shares were subject to a buy-sell agreement at the time of the redemptions. The redemptions were not made pursuant to that agreement, because neither of the events that would have triggered the agreement (the death or termination of employment of any of the officers/shareholders) had occurred. The redemption price paid to each officer was instead determined through individual negotiations. However, under the terms of the buy-sell agreement, each officer ultimately would have been entitled to receive the book value of his stock upon his death or earlier termination of employment. n4

n4 As matters turned out, two of the officers did not retire until 6 years after the redemptions, in 1998; the third officer was still employed by Demco at the time of trial (March 1999).

The parties agree that the book value of the redeemed stock shortly before the redemptions was $4,391 per share. The average redemption price of $4,750 per share therefore exceeded that book value by approximately 8 percent.

Demco's equity capital immediately before the redemptions consisted of 1,800 shares of voting common stock, 1,200 of which were owned by Mr. Wall. The 600 shares redeemed therefore represented a one-third, voting but noncontrolling, interest in Demco. If (1) the average redemption price was equal to the fair market value of the redeemed stock and (2) each share of Demco's stock had the same value, then after adjusting for the greater number of shares (13,200) outstanding at the time of the gifts, the $4,750 average redemption price would have been equivalent to approximately $432 per share. n5

n5 The calculation is ($4,750 average redemption price per share) times (1,200 shares outstanding after redemption) equals ($5,700,000 post-redemption value) divided by (13,200 shares outstanding at time of gifts) equals ($432 per share).

Demco's net income fell sharply during the 2 years between the redemptions and the gifts. n6

n6 Petitioners asserted before trial that the redemptions and the sale of the media division had "never been properly raised as issues by respondent". Petitioners objected on that ground to our consideration of any facts or issues relating to those transactions.

Notwithstanding their objections, petitioners introduced evidence at trial concerning the redemptions and the media division sale. Petitioners' briefs do not mention any objection to our consideration of this evidence. Moreover, petitioners' briefs contain extensive proposed findings of fact concerning both the redemptions and the media division sale; they also set forth petitioners' arguments on the effect those transactions should have on our determination of the fair market value of Demco stock. As a result, petitioners have waived their objections. See Stringer v. Commissioner, 84 T.C. 693, 706 (1985), affd. without published opinion 789 F.2d 917 (4th Cir. 1986); Estate of Miller v. Commissioner, T.C. Memo 1998-416 (objection to admission of testimony held waived because objecting party's brief proposed finding of fact and set forth argument based on that testimony). We also note that the original report of petitioners' expert Ms. Walker discussed both the redemptions and the media division sale. Petitioners submitted a copy of that report with their gift tax returns and rely on it in the cases at hand.

OPINION

PRELIMINARY OBSERVATIONS

Before discussing our findings and analysis of value, we make some observations about the cases at hand and about valuation cases generally.

First, the parties' original positions, as set forth in the gift tax returns and the statutory notices, were not very far apart. The $260.13 value determined in the notices was only 17 percent greater than the $221.75 value claimed in the returns.

Second, this litigation has not helped the parties settle and compromise their differences; to the contrary, it has driven the parties further apart. The overall value of $192.20 per share set forth in the revised report of petitioners' expert Donna J. Walker (Ms. Walker) is lower than the value claimed in the gift tax returns; the overall value of $273.99 per share set forth in the report of respondent's expert Gary L. Schroeder (Mr. Schroeder) is higher than the value determined in the statutory notices, although respondent has not asserted an increased deficiency. n7

n7 Notwithstanding their differing conclusions about value, the parties' experts agree on many important matters concerning the proper measure of Demco's historical financial performance, the methods to be used to appraise value based on that performance, and the availability and magnitude of lack of marketability and nonvoting stock discounts. See infra p. 38.

In light of these observations, what the Court had to say in Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441 (1980), concerning the "pure factual issue" of valuation, is particularly germane to the cases at hand:

As the Court repeatedly admonished counsel at trial, the issue is more properly suited for the give and take of the settlement process than adjudication. The existing record reeks of stubbornness rather than flexibility on the part of both parties, based upon "an overzealous effort * * * to infuse a talismanic precision" into their respective views as to valuation. We are convinced that the valuation issue is capable of resolution by the parties themselves through an agreement which will reflect a compromise Solomon-like adjustment, thereby saving the expenditure of time, effort, and money by the parties and the Court -- a process not likely to produce a better result. Indeed, each of the parties should keep in mind that, in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the Court to reach. * * * [Id. at 451-452; citations omitted.]

Of course, because the parties have insisted that we value the Demco stock, we shall do our job.

For the reasons set forth below, we conclude petitioners have not shown that the value of the gifts was less than the $260.13 per share respondent determined in the statutory notices. To the contrary, the record persuades us that the value was at least equal to that amount.

In reaching this conclusion, we are not imposing a sanction on petitioners, cf. the taxpayer's argument in Estate of Kaplin v. Commissioner, 748 F.2d 1109, 1111-1112 (6th Cir. 1984), revg. on another ground T.C. Memo 1982-440, nor should Buffalo Tool & Die be interpreted as expressing an intention to do so in any comparable circumstances. See Parker v. Commissioner, 86 T.C. 547, 562 (1986). We have merely found respondent's original determination in the statutory notices to be closer to the actual value than either petitioners' return position or the position taken in petitioners' expert's revised report.

RELEVANT LAW

Section 2512(a) provides that, if a gift is made in property, "the value thereof at the date of the gift shall be considered the amount of the gift." Value for this purpose is fair market value; i.e., 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 to sell, and both having reasonable knowledge of relevant facts. See sec. 25.2512-1, Gift Tax Regs.; see also United States v. Cartwright, 411 U.S. 546, 551, 36 L. Ed. 2d 528, 93 S. Ct. 1713 (1973).

Mr. Wall gave 9,380 shares of Demco nonvoting common stock to 20 trusts for the benefit of his children on January 1, 1992. The cases at hand therefore require us to determine the fair market value of that Demco stock as of the date of the gifts, January 1, 1992.

If stock is listed on an exchange or there is otherwise a market for the stock, fair market value generally is determined by reference to the stock's quoted selling prices or bid and asked prices, at or around the time of the gift. See sec. 25.2512-2, Gift Tax Regs. If there is no market for the stock, arm's-length transactions made in the normal course of business, within a reasonable time before or after the date of the gift, may be the best evidence of fair market value. See Ward v. Commissioner, 87 T.C. 78, 101 (1986); Estate of Andrews v. Commissioner, 79 T.C. 938, 940 (1982); Duncan Indus., Inc. v. Commissioner, 73 T.C. 266, 276 (1979).

Demco stock was not listed on an exchange at the time of the gifts, and there was no other public market for Demco stock. The parties have identified six transactions in Demco stock occurring prior to the gifts. However, three of these transactions occurred more than 5 years before the gifts. The three others (the redemptions from Demco's officers) were consummated almost 2 years before the gifts; Demco's net income declined sharply during those years. Moreover, the officers whose stock was redeemed would have been entitled, under the terms of the buy-sell agreement, to receive the book value of the stock upon their deaths or earlier terminations of employment. The redemption price actually paid was only slightly higher than book value. For all these reasons, the redemptions and other prior transactions in Demco stock are not the best evidence of, and should not by themselves determine, the fair market value of Demco stock on the date of the gifts.

In cases such as those at hand, where there is no market for the stock to be valued and there are no dispositive arm's-length transactions, fair market value is to be determined by taking all "relevant factors" into account. n8 See sec. 25.2512-2(f), Gift Tax Regs. The factors we must consider are those that an informed buyer and an informed seller would take into account. See Hamm v. Commissioner, 325 F.2d 934, 938 (8th Cir. 1963), affg. T.C. Memo 1961-347. Rev. Rul. 59-60, 1959-1 C.B. 237, "has been widely accepted as setting forth the appropriate criteria to consider in determining fair market value", Estate of Newhouse v. Commissioner, 94 T.C. 193, 217 (1990); it lists the following factors to be considered, which are quite similar to the "relevant factors" listed in section 25.2512-2(f), Gift Tax Regs.:

n8 Petitioners' expert Ms. Walker stated that the three transactions in Demco stock that occurred more than 5 years before the gifts were "not deemed relevant to the valuation" due to the passage of time. By contrast, Ms. Walker asserted that the redemptions were "not conclusively indicative of fair market value" due to the buy-sell agreement. However, she never stated that they were irrelevant.

We agree with Ms. Walker's conclusion that none of the prior transactions is determinative. However, we believe that the redemptions, which took place at a price equivalent to approximately $432 per share, are nevertheless relevant evidence of the value of the gifts, to be taken into account with all other relevant factors. Although the three officers/shareholders could have received book value for their stock upon their deaths or terminations of employment, two of the officers did not choose to retire until 6 years after the redemptions; the third was still in Demco's employ at the time of trial.

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

In short, the fair market value of the Demco stock is a question of fact that depends on all the circumstances. See Anderson v. Commissioner, 250 F.2d 242, 249 (5th Cir. 1957), affg. in part and remanding in part on another ground T.C. Memo 1956-178; Estate of Newhouse v. Commissioner, supra at 217; Skripak v. Commissioner, 84 T.C. 285, 320 (1985). The weight to be accorded any particular evidentiary factor is also to be determined by the circumstances. See sec. 25.2512-2(f), Gift Tax Regs.

As is customary in valuation cases, the parties primarily rely on expert opinion evidence to support their positions. We evaluate expert opinions in light of the demonstrated qualifications of each expert and all other evidence in the record. See Anderson v. Commissioner, supra at 249; Parker v. Commissioner, supra at 561. We have broad discretion to evaluate '"the overall cogency of each expert's analysis.'" Sammons v. Commissioner, 838 F.2d 330, 334 (9th Cir. 1988) (quoting Ebben v. Commissioner, 783 F.2d 906, 909 (9th Cir. 1986), affg. in part and revg. in part T.C. Memo 1983-200), affg. in part and revg. in part on another ground T.C. Memo 1986- 318. Expert testimony sometimes aids the Court in determining value; sometimes it does not, particularly when the expert is merely an advocate for the position argued by one of the parties. See, e.g., Estate of Halas v. Commissioner, 94 T.C. 570, 577 (1990); Laureys v. Commissioner, 92 T.C. 101, 129 (1989).

We are not bound by the formulas and opinions proffered by an expert witness and will accept or reject expert testimony in the exercise of sound judgment. See Anderson v. Commissioner, supra at 249; Estate of Newhouse v. Commissioner, supra at 217; Estate of Hall v. Commissioner, 92 T.C. 312, 338 (1989). Where necessary, we may reach a determination of value based on our own examination of the evidence in the record. See Lukens v. Commissioner, 945 F.2d 92, 96 (5th Cir. 1991) (citing Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo 1974-285)). Moreover, while we may accept the opinion of an expert in its entirety, see Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. at 452, we may be selective in the use of any part of such opinion or reject the opinion in its entirety, see Seagate Tech., Inc. v. Commissioner, 102 T.C. 149, 186 (1994), and authorities cited therein. Finally, because valuation necessarily results in an approximation, the figure at which we arrive need not be directly attributable to specific testimony if it is within the range of values that may properly be arrived at from consideration of all the evidence. See Silverman v. Commissioner, supra at 933; Alvary v. United States, 302 F.2d 790, 795 (2d Cir. 1962).

PETITIONERS' EXPERT'S REPORTS

Petitioners rely on two reports prepared by Ms. Walker as the primary evidence in support of their position. Ms. Walker received a bachelor of arts degree from the University of Wisconsin at Madison. She is a Chartered Financial Analyst and a member of the American Society of Appraisers, holding the Accredited Senior Appraiser (business valuation) designation.

Ms. Walker prepared her first report several years before trial; a copy of that report was submitted with petitioners' gift tax returns for the year in issue. n9 Ms. Walker prepared a revised report shortly before trial, to respond to respondent's criticism of Ms. Walker's failure to include an "income-based"

n9 Although Ms. Walker's original report concluded that the overall value of the gifts was $211.20 per share, petitioners reported a 5 percent higher value, $221.75 per share, on their gift tax returns. Mr. Wall testified that the reason for this was his accountants' advice, based on their experience with respondent's local personnel, that the lack of marketability and nonvoting stock discounts determined by Ms. Walker "might better be a little more conservative" determination of value in her original report.

Ms. Walker was a principal of Willamette Management Associates, Inc., when she prepared her original report. She was a principal of Columbia Financial Advisors, Inc., when she prepared her revised report; she was still a principal of Columbia at the time of trial. Respondent stipulated Ms. Walker's qualifications and expert status.

MS. WALKER'S ORIGINAL REPORT

In her original report, Ms. Walker relied almost entirely on the "guideline public company", or "market-based", approach to appraise the fair market value of the Demco stock. n10 In one variation of this approach, Ms. Walker calculated several measures of Demco's historical financial performance; she then used her guideline company data to determine how the public stock markets would have valued a company with those performance measures. In the other variation, Ms. Walker applied the guideline public company data to three measures of Demco's projected financial performance for 1992, the year of the gifts.

n10 Ms. Walker's original report did include one "income- based" approach, in which Ms. Walker appraised Demco's value by capitalizing Demco's distributions to stockholders for 1991 (as adjusted by Ms. Walker). However, Ms. Walker concluded that this approach deserved very little weight.

HISTORICAL PERFORMANCE MEASURES APPROACH

To avoid having to take into account differing amounts of leverage, Ms. Walker decided to perform her analysis on a "debt free" basis. She examined Demco's audited and unaudited financial statements for the 5 years prior to the year of the gifts, i.e., for 1987-91; she then used those statements to develop measures of what Demco's financial performance would have been, if it had had no debt. n11

n11 Because she wanted to perform her analysis on a continuing operations basis, Ms. Walker further adjusted her performance measures to eliminate financial results attributable to Demco's media division, which was sold in June 1991.

The debt-free performance measures Ms. Walker developed were the following:

1. Earnings before interest and taxes (EBIT) for 1991 and for 1987-91.

2. Earnings before depreciation (including amortization), interest, and taxes (EBDIT) for 1991 and 1987-91.

3. Debt free net income (DFNI) for 1991 and 1987-91.

4. Debt free cash-flow (DFCF) for 1991 and 1987-91.

5. Debt free book value of total invested capital (BVIC) for 1991.

Ms. Walker determined that seven publicly traded companies were sufficiently similar to Demco to serve as guideline companies. n12 She examined the performance measures and trading prices of the guideline companies, in order to determine the multiples of the performance measures at which the public stock markets valued the total invested capital of the guideline companies. Applying these multiples to Demco's performance measures, and giving greater weight to the indicated values developed from the earnings based measures, Ms. Walker determined that the publicly traded

equivalent value of Demco's total invested capital, as of December 31, 1991, was $10,550,000. n13 Ms. Walker then subtracted the book value of Demco's debt ($5,636,000) from this amount, to conclude that the indicated fair market value of Demco's equity (before applying any discounts) was $4,914,000.

n12 The companies were Action Products International, Inc.; Banta Corp.; Educational Development Corp.; Kleer-Vu Industries, Inc.; Library Bureau, Inc.; Stuart Hall Co., Inc.; and United Stationers, Inc.

n13 Although Ms. Walker's reports appraised the value of Demco stock as of Dec. 31, 1991, the day before the date of the gifts, the parties have not suggested and nothing in the record suggests that Ms. Walker's opinion would be any different with respect to the stock's value as of the date of the gifts. For convenience, we hereinafter discuss Ms. Walker's reports and opinions as though they referred to fair market value as of the date of the gifts rather than the day before.

Because the guideline public company method determines value by reference to the trading prices of minority interests, Ms. Walker did not apply a minority discount to her indicated value of Demco's equity. However, on the basis of several studies comparing the trading prices of restricted stock with freely traded stock, and other studies comparing the trading prices of stock before and after initial public offerings, Ms. Walker concluded that a 40-percent lack of marketability discount should be applied to her guideline public company value. In addition, on the basis of other studies comparing prices of voting and nonvoting stock, Ms. Walker concluded that a further 5-percent discount should be applied to reflect the nonvoting status of the stock given by Mr. Wall.

After having applied these discounts, under Ms. Walker's historical performance measures/guideline public company approach the fair market value of the Demco nonvoting common stock as of the date of the gifts was $212.20 per share. n14

n14 The calculation is (total equity value) times (1 minus lack of marketability discount) times (1 minus nonvoting discount) divided by (number of shares outstanding), or ($4,914,000) times (.6) times (.95) divided by (13,200) equals ($212.20 per share). measures, Ms. Walker concluded that the publicly traded equivalent value of Demco's equity was $4,900,000. This is not materially different from the $4,914,000 value Ms. Walker determined using historical performance measures.

FORECASTED-EARNINGS APPROACH

Ms. Walker also applied the guideline public company approach to Demco's projected earnings for 1992, the year of the gifts. Using projections made by Demco's management, Ms. Walker calculated three forecasted earnings measures for Demco: 1992 EBIT, EBDIT, and after tax earnings. Applying multiples derived from two of her guideline companies to these forecasted earnings

CONCLUSION OF MS. WALKER'S ORIGINAL REPORT

Giving great weight to the two guideline company approaches (historical performance and 1992 forecasted earnings), and giving very little weight to a capitalized distributions approach, n15 Ms. Walker concluded that the publicly traded equivalent value of Demco's equity was $4,890,000. After applying the 40-percent lack of marketability and 5-percent nonvoting discounts, Ms. Walker concluded that the fair market value of the Demco nonvoting common stock on the date of the gifts was $211.20 per share. n16

n15 See supra note 10.

n16 The calculation is ($4,890,000) times (.6) times (.95) divided by (13,200) equals ($211.16) per share, which Ms. Walker rounded to $211.20. criticism, Ms. Walker's revised report combined an income-based approach with the market-based approach of her original report.

MS. WALKER'S REVISED REPORT

In February 1999, Ms. Walker prepared a revised report appraising the value of the Demco stock. This report was prepared in response to respondent's criticism that Ms. Walker's original report had failed to include an income-based determination of Demco's value. In response to respondent's

MS. WALKER'S INCOME-BASED APPROACH

In general, a market-based appraisal concentrates on a company's historical performance measures and, by reference to guideline public company multiples, attempts to determine the price at which the stock of a company with those performance measures would trade. An income-based appraisal, by contrast, is more forward looking; it attempts to predict, and then determine the present value of, all future returns an investor could expect to receive from an investment in the subject company. See Pratt et al., Valuing Small Businesses and Professional Practices 236-240 (3d ed. 1998). n17

n17 As Ms. Walker's reports and testimony made clear, no bright line separates market-based appraisal methods from income-based methods. For example, Ms. Walker's market-based appraisal used some performance measures derived from Demco's forecasted income for 1992. Also, both Ms. Walker and respondent's expert Mr. Schroeder determined the discount (or capitalization) rates used in their income-based appraisals by reference to the actual rates of return available on publicly traded investments. See infra pp. 28-29 and pp. 35-36.

Because an income-based approach attempts to value directly the future cash-flows that will be generated by an investment in the subject company, it will produce accurate results only if an accurate forecast of the company's future earnings is available. See id. at 257. It appears from the record that at the time of the gifts, Demco's management had only predicted 1 year (1992) of future results. Ms. Walker stated in her revised report that she normally would have a 3- to 5-year forecast available when performing an income-based appraisal.

It is important to note that because Ms. Walker did not have a long-term forecast, she did not attempt to predict Demco's future cash-flows for use in her income-based analysis. Moreover, because Demco's historical cash-flow varied greatly from year to year, Ms. Walker did not use Demco's historical cash-flows in her analysis either. Instead, Ms. Walker used Demco's historical results to develop what she called Demco's "normalized" free cash-flow; she then simply assumed that this cash-flow would grow 5 percent per year indefinitely after 1992.

More particularly, in her income-based appraisal Ms. Walker: (1) Examined Demco's operating results for 1987-91 and its forecasted results for 1992; (2) used those results to derive what she called Demco's "normalized free cash-flow", or "dividend paying capacity"; (3) assumed this normalized cash-flow would continue indefinitely after 1992 and grow 5 percent per year; and (4) determined the present value of that indefinite cash-flow using a 22.75-percent capitalization rate. n18 As the preceding sentence makes clear, the two key variables in this approach are Demco's normalized free cash-flow and the appropriate discount or capitalization rate to be used to determine the present value of that cash-flow.

n18 Ms. Walker described this method as a form of the "constant growth dividend discount model". Ms. Walker stated that she typically used this method when she did not have a long-term forecast for the subject company.

In order to determine Demco's normalized free cash-flow, Ms. Walker began by adding Demco's 1987 to 1991 pretax income to its forecasted 1992 pretax income; she then divided that sum by the number of years in the period (6) to arrive at an average annual pretax income of $1,097,381. Ms. Walker then made the following adjustments to this average to arrive at normalized free cash-flow:

1. She subtracted hypothetical income taxes at a 34-percent rate. n19

n19 Because Demco is an S corporation, it is not subject to Federal income tax and pays only a small amount of State income tax. Nevertheless, Ms. Walker computed Demco's normalized free cash-flow by subtracting a hypothetical income tax, at a 34-percent rate, from Demco's average income for 1987-92. This is referred to as "tax- effecting" Demco's income.

As Ms. Walker acknowledged in her testimony, appraisers disagree on whether it is appropriate to tax-effect the income of an S corporation. The argument in favor of tax-effecting stresses that many potential buyers of S corporations are C corporations. Because a C corporation would be unable to maintain a target company's S corporation status following an acquisition, the C corporation would tax-effect the S corporation's income (at C corporation rates) in deciding how much it would pay for the S corporation. See Trugman, Understanding Business Valuation: A Practical Guide to ValuingSmall to Medium-Sized Businesses, at 198-199 (1998). By contrast, the argument against tax-effecting stresses that although an S corporation's stockholders are subject to tax on the corporation's income, they are generally not subject to a second level of tax when that income is distributed to them. This could make an S corporation at least somewhat more valuable than an equivalent C corporation. However, tax-effecting an S corporation's income, and then determining the value of that income by reference to the rates of return on taxable investments, means that an appraisal will give no value to S corporation status.

In her revised report, Ms. Walker computed the present value of Demco's tax-effected cash-flow using a capitalization rate determined by reference to the market rates of return on Treasury securities and common stocks. See infra pp. 28-29. The interest and dividends on such investments are fully taxable to their holders. Because this methodology attributes no value to Demco's S corporation status, we believe it is likely to result in an undervaluation of Demco's stock. See Gross v. Commissioner, T.C. Memo 1999-254.

2. She subtracted an amount equal to 5 percent of Demco's working capital in 1991, because she assumed working capital would grow from that level at a 5-percent rate.

3. She added an amount equal to 5 percent of Demco's indebtedness in 1991, because she assumed debt would increase from that amount at a 5-percent rate.

4. She subtracted an amount equal to the excess of Demco's average capital expenditures for 1987-91 over its average depreciation and amortization for that period.

5. She increased the overall result by 5 percent, because she assumed Demco would grow 5 percent from 1991 to 1992.

On the basis of all these calculations and assumptions, Ms. Walker determined that Demco's normalized free cash-flow for 1992 would be $720,317.

Ms. Walker developed her capitalization rate in part by reference to two sources: (1) The 1991 yield on long-term Treasury securities, as set forth in the report of respondent's expert; and (2) the rates of return on publicly traded stocks (the Ibbotson data) as set forth in Ibbotson Associates, Stocks, Bonds, Bills, & Inflation, 1992 Yearbook.

As Ms. Walker correctly noted, respondent's expert stated in his report that in December 1991, the rate of return on a risk- free investment (long-term Treasury securities) was 7.7 percent. n20 According to Ms. Walker, the Ibbotson data revealed that historically, the annual return on the Standard & Poors 500 Composite Common Stock Index (S & P 500) was 7.4 percentage points higher than a risk-free return; it also revealed that the annual return on stocks of smaller companies was 5.1 percentage points higher than the overall S & P 500 return.

n20 We note that in her original report Ms. Walker stated that at the end of 1991, the yield on 30-year Treasury bonds was only 7.39 percent; she also stated that this yield was expected to be 7.30 percent in June 1992 and 7.49 percent at the end of 1992.

Ms. Walker was of the opinion that because Demco was significantly smaller than the average small public company, investors would demand an additional risk premium of 2.55 percentage points (one-half the 5.1 percentage point additional return on small company stocks) on any investment in Demco stock. Therefore, on the basis of the Ibbotson data and her opinion, Ms. Walker concluded that an appropriate capitalization rate for Demco was 22.75 percent, calculated as follows: (1) A 7.7-percent risk-free rate; plus (2) a 7.4-percent equity-risk premium; plus (3) a 5.1-percent small company risk premium; and plus (4) an additional 2.55-percent premium to reflect Demco's exceptionally small size.

Taking her normalized free cash-flow of $720,317, and capitalizing this at a net rate of 17.75 percent (i.e., 22.75 percent capitalization rate, less 5-percent assumed growth rate), Ms. Walker concluded that under her income-based method the value of Demco's equity would be $4,058,124.

Ms. Walker also concluded in her revised report, as she had in her original report, that a 40-percent lack-of-marketability discount and a 5-percent nonvoting discount should be applied. After applying these discounts, the value of the nonvoting Demco common stock on the date of the gifts, under Ms. Walker's income-based analysis, was $175.24 per share.

CONCLUSION OF MS. WALKER'S REVISED REPORT

Ms. Walker's original report concluded that the fair market value of the Demco nonvoting common stock, as of the date of the gifts, was $211.20 per share. As noted, under Ms. Walker's income-based analysis the stock's value was $175.24 per share.

In her revised report, Ms. Walker relied on both her market-based and her income-based results to arrive at her final opinion on the value of the Demco stock. Giving these methods equal weight (and after rounding), Ms. Walker stated in her revised report that in her opinion, the value of the Demco nonvoting common stock was $192.20 per share on the date of the gifts.

MS. WALKER'S TESTIMONY

Although Ms. Walker's revised report was more recent than, and incorporated the conclusions of, her original report, Ms. Walker did not disavow her original report at trial. To the contrary, Ms. Walker testified that it remained her opinion that her original report's $211.20 conclusion was a reasonable indication of fair market value. She further observed that valuation is not an exact science; as she saw it, her revised report simply indicated that one could justify a lower value than her original report's $211.20 value, if one chose to do so.

RESPONDENT'S EXPERT'S REPORT

Respondent primarily relies on the February 1999 report of Gary L. Schroeder to support respondent's position. n21 Mr. Schroeder is associated with the St. Louis area office of Mentor Valuations, Inc. Like Ms. Walker, Mr. Schroeder is a member of the American Society of Appraisers and holds the Accredited Senior Appraiser (business valuation) designation. Mr. Schroeder's report employed both a guideline public company approach and an income-based approach to appraise the value of the Demco stock.

n21 Mr. Schroeder had prepared an earlier version of his report in January 1996; respondent relied on that report to prepare the statutory notices. Mr. Schroeder's 1996 report had concluded that the overall value of the gifts was $260.13 per share, the same amount asserted in the statutory notices. Mr. Schroeder's February 1999 report concluded that the overall value was $273.99 per share. There are only two material differences in methodology between the two versions of Mr. Schroeder's report. First, in his 1999 report, Mr. Schroeder treated the media note as a nonoperating asset (see infra p. 32); he had not been able to do this in his 1996 report due to a lack of financial data. Second, in his 1999 report Mr. Schroeder gave his income-based value for Demco's stock approximately twice the weight of his market-based value; he had given his income and market- based values approximately equal weight in his 1996 report.

MR. SCHROEDER'S GUIDELINE COMPANY APPROACH

Except for its treatment of the media note (discussed immediately below) and its conclusion as to value, Mr. Schroeder's guideline company approach was quite similar to Ms. Walker's. In fact, Mr. Schroeder used Ms. Walker's calculations of Demco's net revenues and net income as the starting point for the derivation of his performance measures. He also used two of the guideline companies chosen by Ms. Walker, Educational Development Corporation and Library Bureau, Inc. However, Mr. Schroeder used only four performance measures and three guideline companies to derive Demco's value; this is far fewer than the 12 measures and seven companies used by Ms. Walker. n22 In addition, the multiples chosen by Mr. Schroeder appeared to vary more from one guideline company to another than the multiples chosen by Ms. Walker.

n22 The four measures used by Mr. Schroeder were: "adjusted net income" for 1991 and for 1987 to 1991, and "revenues" for 1991 and for 1987 to 1991. Mr. Schroeder's revenues were equal to Demco's net revenues as calculated by Ms. Walker. Mr. Schroeder's "adjusted net income" was equal to Demco's net income as calculated by Ms. Walker, less: (1) The 6 months of interest on the media note included in Ms. Walker's net income for 1991; (2) a few nonrecurring items; and (3) a provision for income tax at 34 percent.

The third guideline company used by Mr. Schroeder was Viking Office Products, Inc.

Notwithstanding these distinctions, the major methodological difference between the guideline company approaches of Mr. Schroeder and Ms. Walker is that Mr. Schroeder treated the media note as a separate, "nonoperating" asset. As a result, Mr. Schroeder used a three-step procedure to derive his market-based value for Demco. First, he developed four historical performance measures for Demco that completely excluded the media division's operating results and the interest payable on the media note. Second, he applied the guideline company multiples he developed to those measures. Third, he added the media note's $1,080,000 face amount to his guideline company value.

Having performed these steps, Mr. Schroeder concluded that the value of Demco's equity, before any discounts, was $6,800,000. On the basis of his review of studies similar to those cited by Ms. Walker, Mr. Schroeder concluded that both lack of marketability and nonvoting stock discounts should be applied. Like Ms. Walker, Mr. Schroeder concluded that the lack of marketability discount should be 40 percent. However, he concluded that the nonvoting stock discount should be only 2 percent as opposed to the 5-percent discount proposed by Ms. Walker.

Applying these discounts to his total equity value, Mr. Schroeder concluded that under his market-based method the value of the Demco nonvoting common stock on the date of the gifts was approximately $2,840,000, or $303.03 per share. This is approximately $92 per share more than Ms. Walker's $211.20 market-based value. It is also approximately $33 per share more than the $269.70 market- based value (and approximately $43 more than the $260.13 overall value) determined in the earlier version of Mr. Schroeder's report, on which respondent relied in preparing the statutory notices. See supra note 21.

MR. SCHROEDER'S INCOME-BASED APPROACH

Mr. Schroeder's income-based approach differs from Ms. Walker's income-based approach in several important respects. First, in his income-based approach Mr. Schroeder again treated the media note as a nonoperating asset whose value should be added to the present value of Demco's predicted future income from sources other than the note. Second, Mr. Schroeder expressly stated that his approach was designed to produce a "control" value for Demco, rather than a minority value; he therefore applied a 17-percent minority discount to the present value of Demco's future income. Third, Mr. Schroeder's determinations of both Demco's future income and the appropriate discount rate to apply to that income were quite different from Ms. Walker's.

With respect to his estimation of Demco's future income, Mr. Schroeder, unlike Ms. Walker, did attempt to predict Demco's operating results for 1992-96. Of course, because Demco's management had not made any long-term forecasts, Mr. Schroeder's predictions, like Ms. Walker's extrapolations, necessarily were based to a considerable extent on Demco's historical operating results. Nevertheless, Mr. Schroeder did specifically predict that Demco's distribution, marketing, and administrative expenses would decline from their 1991 levels. He also predicted that management's forecasted 1992 net income was too high. n23

n23 We note that Mr. Schroeder, like Ms. Walker, tax effected Demco's future cash-flows by subtracting hypothetical income tax from Demco's projected net income (Mr. Schroeder used a 40-percent rate, while Ms. Walker used a 34-percent rate). We believe this is likely to result in an undervaluation of Demco because Demco is an S corporation. See supra note 19. forecast; he then increased that rate by 0.5 percentage points for each of the next 4 years, to arrive at a terminal rate of 17 percent. By contrast, Ms. Walker chose a 22.75- percent rate, as discussed above.

With respect to the appropriate discount rate, Mr. Schroeder chose a rate of 15 percent for 1992, the first year of his

Mr. Schroeder's explanation for his choice of rates was not very clear. Mr. Schroeder claimed that at the time of the gifts long-term BAA rated corporate bonds were yielding approximately 9 percent. Mr. Schroeder then asserted that because an investment in Demco was riskier than an investment in BAA bonds, a 6-percentage point risk premium would be appropriate. However, he did not explain why this was an appropriate premium.

Mr. Schroeder also attempted to justify his rates by reference to the Ibbotson data. According to Mr. Schroeder, the Ibbotson data showed that the average historical return on small company stocks was 17.5 percent. Mr. Schroeder then asserted that a lower rate than this would be appropriate for his analysis, because controlling investors would accept a lower rate of return than minority investors would; once again, Mr. Schroeder did not offer any support for this assertion. Moreover, Mr. Schroeder did not contest Ms. Walker's observations that 7.7 percent was an applicable risk- free rate at the time of the gifts and that small company stocks have historically yielded 12.5 percentage points more than risk-free investments.

Setting these objections aside for the moment, Mr. Schroeder calculated his income-based value of Demco as follows. First, he calculated the present value of Demco's 1992-96 projected net income, by discounting it at his 15- to 17-percent rates. Second, he computed a 1997 residual value for Demco, by assuming that Demco's 1996 projected net income would grow at 3 percent per year in perpetuity and capitalizing that income at his 17-percent rate; he then discounted that terminal value back to a present value as of the date of the gifts. Third, he added the foregoing values together and applied his 17-percent minority discount, to arrive at an income- based minority equity value of $4,770,010. Fourth, he added the face amount of the media note to arrive at a total equity value of $5,850,010. Fifth and finally, he applied his 40-percent lack-of- marketability and 2-percent nonvoting discounts, to arrive at rounded values of $2,440,000 or $260.61 per share. This is approximately $85 per share higher than Ms. Walker's $175.24 per share income-based value.

MR. SCHROEDER'S CONCLUSION

Mr. Schroeder made his overall appraisal of Demco's value by combining his income-based and market-based values and giving the income-based value approximately twice as much weight. In Mr. Schroeder's overall opinion, the fair market value of the Demco nonvoting common stock Mr. Wall gave to his children, as of the date of the gifts, was $2,570,000 or $273.99 per share.

VARIOUS POSITIONS AS TO VALUE

The following table sets forth the various positions as to value taken by the parties or their experts:

EVENT OR REPORT VALUE PER SHARE

Gift Tax Returns $ 221.75

Statutory Notices $ 260.13

Ms. Walker's Original Report $ 211.20

Ms. Walker's Revised Report $ 211.20 (original report's market-

based value)

$ 175.24 (new income-based value)

$ 192.20 (overall value conclusion)

Mr. Schroeder's Report $ 303.03 (market-based value)

$ 260.61 (income-based value)

$ 273.99 (overall value conclusion)

DISCUSSION

As we observed at the outset, the parties' original positions on the value of the gifts were quite close; this litigation has driven the parties further apart. The overall value asserted in Ms. Walker's revised report is less than the value asserted in her original report and the value claimed by petitioners on their gift tax returns. Similarly, the value asserted in Mr. Schroeder's report is greater than the value determined in his prior report that was used to prepare the statutory notices.

Notwithstanding their differing conclusions as to value, Ms. Walker and Mr. Schroeder agree on the following important points.

1. Both accept the same data as an accurate representation of Demco's financial performance.

2. Both agree that the guideline companies used in the market-based approaches are in fact comparable to Demco; two of the three companies used by Mr. Schroeder were included in the seven companies used by Ms. Walker.

3. Ms. Walker used a capitalization rate of 22.75 percent in her income-based analysis, while Mr. Schroeder used rates varying from 15 to 17 percent. However, Ms. Walker assumed that Demco would grow 5 percent per year, while Mr. Schroeder assumed 3-percent growth. The difference between the experts' positions (17.75-percent effective or net capitalization rate for Ms. Walker, 12-to-14-percent net rate for Mr. Schroeder) is therefore less than first appears.

4. Both Ms. Walker and Mr. Schroeder agreed that a 40- percent lack of marketability discount was appropriate.

5. Both Ms. Walker and Mr. Schroeder agreed that a nonvoting stock discount should also be applied; Ms. Walker asserted that the discount should be 5 percent while Mr. Schroeder contended that a 2-percent discount was more appropriate.

Despite the closeness of the parties' original positions and the large areas of agreement between the experts that existed even at time of trial, the parties have been unable to settle their differences, and we are now required to value the Demco stock.

Respondent determined in the statutory notices that the value of the gifts was $260.13 per share. This determination is presumed to be correct; petitioners have the burden of proving it to be incorrect. See Rule 142(a); Welch v. Helvering, 290 U.S. 111, 78 L. Ed. 212, 54 S. Ct. 8 (1933); Estate of Jung v. Commissioner, 101 T.C. 412, 423 (1993).

Ms. Walker's and Mr. Schroeder's reports were generally thoughtful and professional, and their testimony was responsive and helpful. Nevertheless, for the reasons set forth below, we conclude that Ms. Walker's guideline company approach significantly understated Demco's value, while Mr. Schroeder's guideline approach somewhat overstated value and has other flaws that limit its reliability. We also conclude that the experts' income-based approaches are entitled to little weight, in part because it was very difficult to predict Demco's future income as of the time of the gifts.

As a result, we conclude petitioners have not shown that the value of the gifts was less than the $260.13 per share determined in the statutory notices. To the contrary, the record establishes to our satisfaction that the value lay between the experts' guideline company values and was at least $260.13 per share.

PROBLEMS WITH THE GUIDELINE COMPANY APPROACHES

Although Ms. Walker's guideline company approach was thorough and clear, deserves careful consideration, and is entitled to some weight, we believe it systematically understated Demco's value. First, it did not adequately take account of the value of the $1,080,000 media note. Second, it used erroneous measures of Demco's projected income for 1992. Third, it did not use all the guideline company multiples but instead picked and chose among the lowest.

TREATMENT OF MEDIA NOTE

As noted above, Ms. Walker adjusted Demco's historical performance and forecasted earnings measures to eliminate income attributable to the media division; that division was sold on June 1, 1991, in exchange for cash and the media note. However, Ms. Walker did not then readjust Demco's measures to include pro forma interest amounts on the media note, or any other amounts reflecting the media division's income from 1987 until the date of sale. As a result, the only income attributable to the media note reflected in the measures calculated by Ms. Walker was the 6 months' worth of interest that accrued on the note from the sale date to the end of 1991 and the interest projected to be received in 1992.

Demco's performance measures, as calculated by Ms. Walker, therefore understated Demco's earning power and value. In fact, Ms. Walker testified that under her analysis, Demco's ownership of the media note -- a $1,080,000 face amount, fully collateralized, interest bearing asset -- did not materially increase the value of the Demco stock. By contrast, the nonoperating asset method used by Mr. Schroeder took the value of the media note into account, by adding it to the guideline value based on his performance measures, and we believe it is preferable to Ms. Walker's approach in that respect.

In her testimony, Ms. Walker admitted that Mr. Schroeder's treatment of the media note was a reasonable approach. However, Ms. Walker also stated that in her opinion, a minority discount should be applied to the value of the media note under that approach, because a minority stockholder could not require liquidation of Demco and thus could not realize the note's full value.

We agree with Ms. Walker on this point. We conclude that although Mr. Schroeder's treatment of the media note is preferable because it recognizes the note's value, it somewhat overstates that value to a minority stockholder. However, even if the 25-percent minority discount Ms. Walker proposed at trial were applied to the value of the media note, in addition to her 40-percent lack of marketability and 5-percent nonvoting stock discounts, then treating the media note as a nonoperating asset would add approximately $35 per share to Ms. Walker's values.

ERRONEOUS INCOME AMOUNT

The forecasted earnings measures Ms. Walker used in her guideline company approach were significantly less than the measures actually projected by Demco's management. For example, Ms. Walker's original report stated that Demco was projecting 1992 EBIT of $1,372,000 and 1992 earnings of $1,034,615. However, Demco was actually projecting that its earnings would be approximately $400,000 higher; i.e., 1992 EBIT of $1,774,306 and earnings of $1,434,198. We conclude that Ms. Walker simply made a few transcription errors; nevertheless, these errors mean that Ms. Walker's appraisals significantly understated Demco's value.

If the 1992 EBIT and earnings actually projected by Demco were substituted for the erroneous amounts used by Ms. Walker, then Ms. Walker's appraisal of the Demco stock under her forecasted earnings approach would have been approximately $289 per share, approximately $77 per share higher than the forecasted earnings value set forth in her original report. The record does not disclose Demco's projected EBDIT for 1992. However, based on Demco's historical depreciation, we conclude that the measure of 1992 EBDIT used by Ms. Walker was, like her 1992 EBIT and earnings measures, also approximately $400,000 too low. If Ms. Walker's measure of Demco's 1992 EBDIT were also increased by $400,000, then Ms. Walker's forecasted earnings value would have been approximately $315 per share, approximately $103 per share higher than the value in her original report. We note that these values are quite close to the $303 guideline company value set forth in Mr. Schroeder's report.

CHOICE OF MULTIPLES

When Ms. Walker applied the guideline public company method to Demco's historical performance measures, she did not use the multiples of all seven companies she had identified as comparable. Instead, she consistently chose a multiple determined by reference to the two or three companies with the lowest multiples, as shown in the following table.

Mean Multiple of

the Comparable Multiple Used by

Measure Companies Ms. Walker

1991 EBIT 10.1 8.2

1987-91 EBIT 7.3 6.5

1991 EBDIT 7.7 5.0

1987-91 EBDIT 7.5 4.7

1991 DFNI 13.6 13.0

1987-91 DFNI 11.7 9.5

1991 DFCF 8.8 6.5

1987-91 DFCF 7.0 6.4

BVIC 1.19 1.25

Measure	Mean Multiple of the Comparable Companies	Multiple Used by Ms. Walker
1991 EBIT	10.1	8.2
1987-91 EBIT	7.3	6.5
1991 EBDIT	7.7	5.0
1987-91 EBDIT	7.5	4.7
1991 DFNI	13.6	13.0
1987-91 DFNI	11.7	9.5
1991 DFCF	8.8	6.5
1987-91 DFCF	7.0	6.4
BVIC	1.19	1.25

Ms. Walker justified her disregard of most of the comparable companies' multiples by referring to the decline in Demco's earnings from 1990-92. According to Ms. Walker, three of the seven comparable companies had also suffered recent earnings declines; it therefore made more sense to determine the applicable multiples by reference to those companies, rather than by reference to the comparable companies as a whole.

Ms. Walker'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 into 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. For these reasons we believe that the multiples used by Ms. Walker resulted in an understatement of the value of the Demco stock. See Pratt et al., Valuing Small Businesses and Professional Practices 276 (3d ed. 1998) (warning the analyst that she should be cautious and careful, when using the guideline public company method, to ensure that the use of certain companies for some measures but not for others does not introduce bias or distortion into the value indications).

If the mean multiples of the comparable companies had been applied to Demco's historical performance measures instead of the multiples used by Ms. Walker, then the value of the Demco stock under Ms. Walker's historical performance measures approach would have been approximately $300 per share, approximately $88 per share higher than the historical performance measures value in Ms. Walker's original report. n24

n24 The statement in the text assumes that each performance measure is equally weighted. Ms. Walker stated that she gave the earnings-based measures greater weight, but we are unable to determine the weighting she used. only four performance measures; the multiples he used seemed to vary greatly

from company to company, and his choice of multiples was not very well explained.

We have similar concerns with Ms. Walker's choice of multiples in her forecasted earnings approach. Ms. Walker's original report discussed the forecasted earnings multiples of only two of the seven comparable companies. Moreover, the multiples Ms. Walker used were lower than even those two companies' multiples; the stated reason for this was that Demco was predicting higher earnings growth.

MR. SCHROEDER'S GUIDELINE COMPANY APPROACH

Notwithstanding the foregoing criticisms of Ms. Walker's guideline company approach, we do not believe Mr. Schroeder's guideline public company approach deserves controlling weight. As noted above, Ms. Walker's guideline analysis was thorough and well explained; it is still entitled to some weight. In addition, Mr. Schroeder's approach somewhat overstates the media note's effect on value, because it does not apply a minority discount. We also accept Ms. Walker's criticism that it would have been preferable if Mr. Schroeder had used more than three guideline companies. Moreover, we note that Mr. Schroeder used

PROBLEMS WITH THE INCOME-BASED APPROACHES

Ms. Walker testified that in theory, income-based approaches should produce more accurate determinations of value, because they attempt to value directly the future income streams flowing from an investment. She also testified, however, that many assumptions must be made to employ such approaches and the results are highly sensitive to the assumptions used. Most importantly, if the subject company's future income is unpredictable, then income-based methods will produce inaccurate appraisals of the company's value. See Pratt et al., supra at 257.

We conclude that as of the date of the gifts, it was very difficult to predict Demco's future income. It appears that as of that date Demco's management had predicted only 1 year of future results. Due to the lack of a long-range forecast, Ms. Walker did not even attempt to predict Demco's future revenues. Instead, she used an average of Demco's historical and forecasted results to create a measure she described as Demco's "normalized" free cash-flow, and assumed this would grow at a constant rate. In this connection, we note that one of the leading treatises on business valuations cautions that historical averages or pure extrapolations from those averages are usually inadequate bases for an income-based analysis; an analyst should use such averages only if she can explain why they are a reasonable proxy for future expectations. See Pratt et al., supra at 240, 254. Given the fluctuations in Demco's net income, the difficulties being experienced by Demco's major customer groups, and the unsettled economic conditions around the time of the gifts, it appears less likely than usual that Demco's past results could have served to predict its future results. We also note that Ms. Walker's original report relied entirely on a market-based approach; her revised report added an income-based approach only in response to respondent's criticism of her original report. For all these reasons, we conclude that Ms. Walker's income-based approach is entitled to little weight.

Although Mr. Schroeder at least attempted to predict Demco's future income, his income-based analysis suffers from the same flaws as Ms. Walker's. Mr. Schroeder's predictions, like Ms. Walker's extrapolations, were based to a great extent on Demco's average past performance. In addition, Mr. Schroeder did not explain or justify very well either his assumptions about future changes in Demco's performance or his choice of discount rates. We also note that although Ms. Walker had little criticism of Mr. Schroeder's guideline company approach--or couched that criticism in terms of reasonable

professional differences--she identified several more serious problems with Mr. Schroeder's income-based approach. For all these reasons, we conclude that Mr. Schroeder's income-based analysis, like Ms. Walker's, is entitled to little weight.

CONCLUSION

Ms. Walker's market-based appraisal of the Demco nonvoting common stock was $211.20 per share; Mr. Schroeder's market-based appraisal was $303.03 per share. For the reasons set forth above, Ms. Walker's market-based appraisal significantly understated Demco's value. As we have explained, treating the media note as a nonoperating asset would have increased Ms. Walker's market-based values by approximately $35 per share, even after applying the 25- percent minority discount Ms. Walker suggested. Similarly, using the correct projections for Demco's 1992 earnings would have added approximately $103 per share to Ms. Walker's forecasted earnings based valuation, while using the mean multiples of the comparable companies, instead of the lower multiples chosen by Ms. Walker, would have added approximately $88 per share to Ms. Walker's historical performance measures based valuation. Nevertheless, we still conclude that Mr. Schroeder's market-based appraisal somewhat overstated Demco's value, in part because it did not apply a minority discount to the media note; we also conclude that it does not deserve controlling weight because it used very few performance measures and comparable companies.

Ms. Walker's and Mr. Schroeder's income-based appraisals were lower than their market-based appraisals, at $175.24 per share and $260.61 per share, respectively. However, we conclude that those income-based appraisals are entitled to little weight for the reasons set forth above. n25

n25 We also note that both experts' income-based analyses probably understated Demco's value, because they determined Demco's future cash-flows on a hypothetical after tax basis, and then used market rates of return on taxable investments to determine the present value of those cash-flows. See supra notes 19, 23.

On the basis of the foregoing and all the other facts and circumstances, we conclude petitioners have not shown that the value of the Demco nonvoting common stock, as of the date of the gifts, was less than $260.13 per share. To the contrary, the record establishes that it was at least equal to that amount.

To reflect all the foregoing,

DECISIONS WILL BE ENTERED

FOR RESPONDENT.

T.C. Memo. 2000-51

UNITED STATES TAX COURT

ESTATE OF ETTA H. WEINBERG, DECEASED, MELLON BANK, DONALD H. HERMAN AND LOUISE W. ALBERT, EXECUTORS, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 5076-97. Filed February 15, 2000.

Steven T. Stern and David J. Ackerman, for petitioners.

Alan S. Kline, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WHALEN, Judge: Respondent determined a deficiency of $760,515 in the Federal estate tax of the estate of Mrs. Etta H. Weinberg, herein referred to as the decedent. After concessions by the parties, the sole issue for decision is the fair market value of a limited partnership

interest over which the decedent had a general power of appointment on the date of her death.

Throughout this opinion, all section references are to the Internal Revenue Code as in effect on the date of decedent's death, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation and the accompanying exhibits are incorporated herein.

The decedent died on December 15, 1992. She was a resident of Philadelphia, Pennsylvania, at that time. She was also a widow. Her husband, Mr. Bernard Weinberg, had died in 1964. She was survived by two children from her marriage to Mr. Weinberg, Mr. Paul S. Weinberg and Ms. Louise W. Brown.

On the date of her death, the decedent possessed a general power of appointment over the principal of a so-called marital deduction trust that had been created under the last will and testament of her late husband (referred to herein as Trust A). Trust A held a 25.235-percent interest in a limited partnership, the Hill House Limited Partnership (Hill House).

Hill House owned and operated an apartment complex that consisted of an 11-story building containing 188 apartment units, an office suite, a two-level underground parking garage, and a swimming pool. The apartment complex had been constructed in 1964. At the time of the decedent's death, only three of the apartment units in the complex were vacant. As of December 31, 1992, there was one mortgage on the property in the principal amount of $448,544. The mortgage was payable in monthly installments of $18,406, including principal and interest at the annual rate of 6.25 percent. The final mortgage payment was due on April 1, 1993. The parties agree that on the date of the decedent’s death the fair market value of the apartment complex was $10,050,000.

Hill House is governed by the Hill House Limited Partnership Agreement of May 1, 1980. Article IV of the agreement governs distributions to the partners. Paragraph 4.1 of the agreement gives the general partner sole discretion to determine when distributions are made. It further provides: “Such distributions shall be made pro rata to the Partners in accordance with their respective Percentage Interests.” Article VII of the agreement governs the transferability of partnership interests, and paragraph 7.3 thereof gives all partners a right of first

refusal under which a partner who wishes to transfer his, her, or its interest in Hill House to a third party must first offer to sell the interest to the other partners on the same terms and conditions offered by the third party. Paragraph 7.4 of the agreement gives the general partner absolute discretion to consent to or deny the substitution of a limited partner, unless the purchaser is already a partner.

The Limited Partnership Agreement sets forth the following list of partners and the percentage interest of each:

General Partner	Percentage Interest
Paul S. Weinberg	1.000
Limited Partners	
Trust A	25.235
Paul Trust	14.982
Etta H. Weinberg, copartner in M.E.L. Realty Co.	14.395
Anne K. Gross, copartner of M.E.L. Realty Co.	8.648
Barbara G. Reines, copartner in M.E.L. Realty Co.	8.648
Paul Trust, copartner in M.E.L. Realty Co.	14.395
Anne K. Gross	9.390
Max and Esther S. Oppenheim	3.307

As shown above, the decedent’s son, Mr. Paul S. Weinberg, was the sole general partner of Hill House and

held a 1-percent interest in the partnership in that capacity. He was also the sole beneficiary of the Paul S. Weinberg Testamentary Trust that had been created under his father's last will and testament (referred to above and herein as the Paul Trust). The Paul Trust had a limited partnership interest of 14.982 percent in Hill House and an additional interest of 14.395 percent in Hill House as a copartner of M.E.L. Realty Co.

On November 2, 1984, the decedent created an inter vivos trust, and on February 17, 1989, she substantially amended it. The amended trust directed that upon the decedent's death the trustees were to distribute all the decedent's interests in Hill House to a trust that she had created earlier for the benefit of her son, Mr. Paul S. Weinberg, and his issue (the Paul Family Trust). This distribution was to include the 25.235-percent interest in Hill House held in Trust A, over which the decedent possessed a general power of appointment. The decedent's will states that the decedent exercised her power of appointment over the subject limited partnership interest as provided in the amended trust. Her will states as follows:

> I exercise in full the power of appointment given to me under Article III of the Last Will

> and Testament of my late husband, BERNARD WEINBERG, and direct that all assets governed thereby be distributed to my Trustees under my Trust executed November 2, 1984, as amended, whereunder I am now Trustee. In the event that such Trust, for any reason, is not in existence at the time of my death, I exercise my power of appointment in favor of my Executors.

The financial statements of Hill House for the years 1990 through 1992 report the following:

	1990	1991	1992
Rental income	$1,928,127	$2,003,912	$2,057,151
Total income	1,996,306	2,082,707	2,137,058
Net income	754,465	893,678	843,275
Cash	722,128	836,450	801,078
Mortgage payable	810,211	635,012	48,544
Distributions	650,000	600,000	800,000

On the estate tax return filed on behalf of the decedent's estate, the executors of the estate reported $1,075,000 as the value of the 25.235-percent interest in Hill House over which the decedent held a general power of appointment. The estate now claims that the fair market value is $971,838. In the notice of deficiency, respondent determined that the fair market value of the subject interest in Hill House was $2,422,500. Respondent now claims that the fair market value is $1,770,103.

OPINION

Section 2031(a) provides that the value of the gross estate of a decedent is determined by including the value at the time of the decedent's death of all property, real or personal, tangible or intangible, wherever situated. Section 2041 provides generally that a decedent's gross estate shall include the value of all property over which the decedent has a general power of appointment at the time of his or her death. See sec. 2041(a)(2).

As mentioned above, at the time of her death, the decedent possessed a general power of appointment over a 25.235-percent limited partnership interest in Hill House. In this opinion, we sometimes refer to this interest as the subject limited partnership interest. Thus, the decedent's gross estate includes the value of this interest. The sole issue for decision in this case is the fair market value of the subject limited partnership interest.

Fair market value is defined for Federal estate and gift tax purposes as 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 to sell and both having reasonable knowledge of all the relevant facts. See sec. 20.2031-1(b), Estate Tax Regs.; United States v.

Cartwright, 411 U.S. 546, 551 (1973); Estate of Andrews v. Commissioner, 79 T.C. 938, 940 (1982). This is an objective test based upon hypothetical buyers and sellers in the marketplace and is not based upon a particular buyer or seller. See Estate of Bright v. United States, 658 F.2d 999, 1005-1006 (5th Cir. 1981); Estate of Andrews v. Commissioner, supra at 956.

The value of an item of property as of the date of a person's death is a question of fact. See Hamm v. Commissioner, 325 F.2d 934, 938 (8th Cir. 1963), affg. T.C. Memo. 1961-347; Estate of Newhouse v. Commissioner, 94 T.C. 193, 217 (1990). The taxpayer bears the burden of proving that respondent's determination of fair market value of property is incorrect. See Rule 142(a). The Court as the trier of fact must weight all relevant evidence and draw appropriate inferences. See, e.g., Estate of Hall v. Commissioner, 92 T.C. 312, 335 (1989).

The determination of fair market value is an inherently imprecise process. See Estate of Gilford v. Commissioner, 88 T.C. 38, 50 (1987); Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 452 (1980). On numerous occasions, this Court has stressed the appropriateness of settling valuation issues. See Estate

of Andrews, supra at 956; Buffalo Tool & Die Manufacturing Co. v. Commissioner, supra at 452; Messing v. Commissioner, 48 T.C. 502, 512 (1967); Furman v. Commissioner, T.C. Memo. 1998-157.

In this case, the parties agree that in valuing the subject limited partnership interest a minority discount and a lack of marketability discount must be applied. The minority discount accounts for a decedent's lack of control over the property. See Ward v. Commissioner, 87 T.C. 78, 106 (1986); Harwood v. Commissioner, 82 T.C. 239, 267 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986); Estate of Andrews v. Commissioner, supra at 953. The lack of marketability discount accounts for the fact that there is no ready market for a decedent's interest in the property. See Estate of Andrews v. Commissioner, supra at 953. While the parties agree that both discounts are appropriate, they disagree about the amount of each discount, and, thus, they disagree about the value of the subject limited partnership's interest.

To establish the value of the subject limited partnership interest, the parties rely upon the testimony and report of their respective expert witnesses. The Court evaluates an expert opinion in light of the demonstrated

qualifications of the expert and all other evidence of value. See Estate of Newhouse v. Commissioner, supra at 217; Parker v. Commissioner, 86 T.C. 547, 561 (1986). The Court is not bound by the opinion of any expert witness. See Estate of Newhouse v. Commissioner, supra at 217; Estate of Hall v. Commissioner, supra at 338; Parker v. Commissioner, 86 T.C. at 561. The Court may adopt an expert's entire opinion or selectively choose to adopt some portion of the expert's opinion. See Parker v. Commissioner, supra at 562. Because valuation necessarily results in an approximation, the value at which the Court arrives need not be one as to which there is specific testimony if it is within the range of values that may properly be arrived at from consideration of all the evidence. See Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. T.C. Memo. 1974-285.

Petitioners' Expert

Petitioners rely on the expert report of Mr. Robert M. Siwicki of Howard, Lawson & Co. Mr. Siwicki is an accredited senior appraiser with the American Society of Appraisers and holds a master's degree in finance from the Wharton School.

Mr. Siwicki valued the subject limited partnership interest using both the capitalization of income approach and the net asset value approach. Under the capitalization of income approach, it is necessary to identify the income stream to be capitalized. The income stream is then capitalized using a rate of return realized by hypothetical investors on comparable investments. Under the net asset value approach, it is necessary to determine the net asset value of the asset. If necessary, that value is then discounted to reflect the minority ownership of the interest.

Mr. Siwicki started his valuation in this case by reviewing the data on 85 publicly registered real estate partnerships compiled in the May/June 1992 edition of "The Perspective", a bimonthly publication of Partnership Profiles, Inc., which provides market data for publicly registered limited partnership interests. Mr. Siwicki focused on limited partnerships that invested in residential property, had little or no debt, and made cash distributions to the limited partners. He identified seven publicly registered real estate partnerships that he believed were comparable to Hill House. They are listed

below with their yield and discount to net asset value (NAV):

Partnership	Type of Investment	Yield	Discount to NAV
American Insured Mortgage 86	M	10.6%	35%
American Insured Mortgage 88	M	9.1%	30%
Hutton/ConAm Realty Investors 4	E	8.9%	NA[3]
IDS/Balcor Income Properties	E	11.1%	51%
Krupp Insured Plus	M	10.9%	29%
Krupp Insured Plus II	M	10.1%	13%
Shearson Lehman Sr. Income Fund	E	11.5%	NA[3]

[3] Not available.

Four of the above partnerships, those with an “M” in the column entitled Type of Investment, did not own real properties but invested in portfolios of federally insured mortgages. Mr. Siwicki believed that they were “less risky than their equity-based counterparts” and “would be expected to have lower discounts to NAV compared to equity-based real estate partnerships.” He selected the IDS Balcor Income Properties, a partnership that owned only two apartment buildings, as the limited partnership that was most comparable to Hill House that owned a single property. The data for IDS Balcor reported a yield of approximately 11 percent and a net asset value discount of 51 percent.

In identifying an appropriate income stream, Mr. Siwicki noted that there was a "disconnect between the performance of the [Hill House] partnership and the amount of distributions being made". For that reason, he chose as

the income stream a 3-year average of the cash distributions made during the years 1990 through 1992, $683,333 (i.e., total distributions during 3-year period, $2,050,000, divided by 3). In calculating the average distributions, Mr. Siwicki did not adjust the average to take into account the final mortgage payment due on April 1, 1993.

A 25.235-percent share of the 3-year average of cash distributions (i.e., the share attributable to the subject limited partnership interest) is $172,439 (i.e., $683,333 x 25.235 percent). Mr. Siwicki capitalized that amount, $172,439, by 11 percent, the approximate yield of an interest in IDS Balcor, to arrive at $1,567,627 as the value of the subject limited partnership interest.

As mentioned above, the parties agree, for purposes of this case, that the fair market value of the Hill House apartment complex on the date of death was $10,050,000. On the basis of the financial statements of Hill House for 1992 and the fair market value of the property as stipulated by the parties, Mr. Siwicki determined that the net asset value of Hill House on the date of the decedent's death was $10,332,769. Thus, the subject 25.235-percent interest in the net asset value of Hill House was

$2,607,474. By applying the discount of 51 percent identified in the case of IDS Balcor, Mr. Siwicki computed $1,277,662 as the value of the subject limited partnership interest using the net asset value approach (i.e., $2,607,474 x .49).

Mr. Siwicki combined the values he computed under the two approaches by weighting the capitalization approach by 75 percent and the net asset value approach by 25 percent. Mr. Siwicki felt a 3-to-1 ratio adequately emphasized the fact that the capitalization approach was the more important approach for this partnership interest. This resulted in a value of the subject limited partnership interest of $1,495,136.

Mr. Siwicki then applied a 35-percent discount to the above value to account for the lack of marketability of the subject limited partnership interest. He reviewed various market studies on illiquid securities to arrive at the amount of this discount. In particular, he relied on a study by the Securities and Exchange Commission (SEC) that compared sales between 1966 and 1969 of the restricted stock of companies that also had freely tradable, publicly traded counterparts.

After analyzing the various market studies on illiquid securities, Mr. Siwicki concluded that the lack of marketability discount for the subject limited partnership interest was most comparable to the portion of the SEC study that reported a 30-percent discount for restricted securities of nonreporting over-the-counter issuers. However, Mr. Siwicki believed the subject limited partnership interest warranted a greater discount due to two differences. First, he found that there was no prospect of a public market ever developing for this interest. Second, he found that the restrictions on the sale of this interest were perpetual, as opposed to the restrictions in the studies which lasted for only 1 to 3 years. Thus, Mr. Siwicki concluded a 35-percent discount represented the lack of marketability of the interest. After applying this discount, Mr. Siwicki concluded that the fair market value of the subject limited partnership interest on the date of death was $971,838.

Mr. Siwicki's analysis is summarized as follows:

Petitioner's Expert	Capitalization Approach		Net Asset Value Approach	
Distributions during 1990	$650,000.00	Value of apartment complex	$10,050,000.00	
Distributions during 1991	600,000.00	Other assets	840,075.00	
Distributions during 1992	800,000.00	Total liabilities	557,306.00	
Total distributions	2,050,000.00	Net Asset Value of Hill House	10,332,769.00	
Average annual distributions	683,333.33			
Percentage interest	0.25235	Percentage interest	0.25235	
Share of average annual distributions	172,439.17	Share of Net Asset Value	2,607,474.26	
Percentage yield of IDS Balcor Income Properties	0.11	Less: Discount of 51%	1,329,811.87	
Value of Hill House before marketability discount	1,567,628.82	Value of Hill House before marketability discount	1,277,662.39	
Weight of capitalization approach	0.75	Weight of Net asset value approach	0.25	
	1,175,721.61		319,415.60	$1,495,137.21
Less: Marketability discount of 35%				523,298.02
Fair Market Value of the subject limited partnership interest				971,839.19

The values computed by Mr. Siwicki are slightly different from the above values because of rounding.

Respondent's Expert

Respondent relies on the testimony and expert report of Dr. Samuel J. Kursh who is certified as a business appraiser by the Institute of Business Appraisers, Inc., and holds a doctorate in business administration from George Washington University.

Dr. Kursh valued the subject limited partnership interest using only the capitalization of income approach. According to Dr. Kursh, the net asset value approach is inappropriate for valuing the subject interest in Hill House because the partnership's underlying asset was income-producing real estate. Respondent argues that the net asset value is irrelevant because a hypothetical buyer could not control the sale of the underlying property or the liquidation of the partnership.

Dr. Kursh began his valuation by computing a discount rate. To do this, he selected comparables from the limited partnerships referenced in the May/June 1993 edition of "The Perspective". This is the same publication used by petitioner’s expert but a later edition. Dr. Kursh

selected partnerships that owned real estate (residential and/or commercial), had low debt or leverage, had cash flows greater than their distributions and capital expenditures, and had assets that were valued by independent appraisers. Dr. Kursh's criteria produced 16 comparables. According to his report, investors in these 16 comparables "anticipated annual returns from cash distributions ranging from 9.31 percent to 11.58 percent." Dr. Kursh selected the midpoint of those yields, 10.45 percent, as the rate of return an investor would require for a minority interest investment in a limited partnership with the characteristics of the comparables.

Dr. Kursh then made three adjustments to the average yield of the comparables to take into account the particular characteristics of Hill House. First, Dr. Kursh added 50 basis points to account for the fact that Hill House owned only one piece of property and thus lacked diversity, while the comparables owned multiple pieces of property. Second, Dr. Kursh subtracted 100 basis points to account for the fact that the general partner of Hill House was also a limited partner. According to Dr. Kursh, this commonality of interest would tend to ensure cash

distributions to the limited partners. Again, this characteristic was not present in the comparables. Lastly, Dr. Kursh subtracted 25 basis points to account for the fact that the data for the comparables might include distressed sales. Dr. Kursh based this adjustment on the following editor's note in "The Perspective":

> Limited partnership investments are generally illiquid, long term investments. Sellers of such investments are often considered distressed for various reasons and find it necessary to accept discounted sales prices. As a result, the above price information may not reflect the intrinsic value of a limited partnership interest.

After making the above adjustments to the average yield, Dr. Kursh concluded that a potential purchaser would require an investment in Hill House to yield a rate of return of 9.7 percent (i.e., 10.45 + .50 - 1.00 - .25).

For an income stream, Dr. Kursh used the cash distributions made by Hill House in 1992, $800,000. A 25.235-percent share of the 1992 cash distributions is approximately $202,000. Because the only liability on the property was the mortgage that was due to be fully paid on April 1, 1993, Dr. Kursh believed that the partnership would realize a substantial increase in income after that

date. Dr. Kursh reasoned that the aggregate distributions made during 1992 were at the minimum level of distributions that a potential buyer would anticipate. Applying the discount rate of 9.7 percent to the decedent's 1992 distributions of $202,000, Dr. Kursh computed the value of the decedent's interest in Hill House of $2,082,474 (i.e., $202,000 ÷ 9.7 percent).

Dr. Kursh then applied a marketability discount. In order to determine the amount of this discount, he used the Quantitative Marketability Discount Model (QMDM) that is described in a book written by Mr. Z. Christopher Mercer entitled Quantifying Marketability Discounts (1997). The QMDM is an economic model that attempts to relate the present value of the future returns of an investment in the form of distributions and capital appreciation to the amount an investor is willing to pay for the investment. The QMDM incorporates various factors, including: The expected distribution yield (i.e., the expected annual return through distributions), the expected growth rate of value (i.e., the expected growth in the underlying asset value), the required holding period return (i.e., the rate of return on similar investments), and the assumed holding

period. The QMDM consists of various summary tables in which implied marketability discounts are enumerated for each set of the above four factors.

As to this case, Dr. Kursh assumed the expected growth rate of value to be between 3 and 4 percent. Dr. Kursh based this determination on the historical inflation rate. He assumed the expected distribution yield to be 10 percent, based on the yields for comparable real estate investments. He assumed a required holding period return of 16.4 percent. This percentage was calculated using the rates of return on publicly traded securities as modified by specific characteristics of the particular investment. And lastly, Dr. Kursh assumed a holding period of 10 to 15 years. From the QMDM tables, Dr. Kursh's assumptions produced a marketability discount of 15 percent.

After applying the 15-percent marketability discount, Dr. Kursh concluded that the fair market value of the subject limited partnership interest on the date of death is $1,770,103. Dr. Kursh's analysis is summarized as follows:

Respondent's Expert		Capitalization Approach
Distributions during 1992		$800,000.00
Percentage interest		0.25235
Share of distributions during 1992		201,880.00
Rounded		202,000.00
Average yield of 16 comparables	10.45%	
Plus: Adjustment for lack of diversity	0.50%	
Less: Adjustment for commonality	-1.00%	
Less: Adjustment for distressed sales	-0.25%	
Percentage yield		9.70
Value of Hill House before marketability discount		2,082,474.23
Less: Marketability discount of 15%		312,371.13
Fair market value of the subject limited partnership interest		1,770,103.10

Analysis and Conclusions

As described above, both experts determined the fair market value of the subject limited partnership interest and then calculated and applied an appropriate discount to account for the diminished marketability of the interest. Strictly speaking, neither expert computed a minority discount. They both computed the fair market value of the subject limited partnership interest as a minority interest. Nevertheless, it is useful to compare the minority discounts that are implied in the experts' computations. It is also helpful to compare the combined discounts implied in their computations. The following schedule shows the values of the subject limited

partnership interest and the marketability discounts determined by the experts and the minority discounts and the combined discounts implied by the experts' computations:

	Petitioner's Expert	Respondent's Expert
Net asset value of Hill House	$10,332,769.00	$10,332,769.00
25.235-percent share	2,607,474.26	2,607,474.26
Minority discount percentage	42.6596	20.1344
FMV of the subject interest before marketability discount	1,495,136.00	2,082,474.00
Marketability discount percentage	35.00	15.00
FMV of the subject interest	971,838.00	1,770,103.00
Combined discount percentage	62.7287	32.1143

As shown above, the computations of petitioner's expert imply a combined discount of 62.7287 percent and the computations of respondent's expert imply a combined discount of 32.1143 percent. We do not fully agree with either expert. Set out below is our view of some of the points about which the parties' experts disagree and our conclusion regarding the fair market value of the subject limited partnership interest.

First, we agree with petitioner's expert that it is appropriate to consider the fair market value of the

subject limited partnership interest as computed under both the net asset value and the capitalization approaches. We also agree with petitioner that a weighted average of 75 percent for the capitalization approach and 25 percent for the net asset value approach adequately reflects the attributes of this partnership.

In Estate of Andrews v. Commissioner, 79 T.C. 938 (1982), we considered the value of the decedent's stock in four closely held corporations, each of which was engaged principally in the ownership, operation, and management of commercial real estate properties. In valuing the decedent's 20-percent stock interest in each of the corporations, the parties differed over the weight to be given to earnings and to the net asset value of the corporations. The taxpayer argued that the corporations should be characterized as operating companies and greater weight should be placed on earnings and dividend-paying capacity than on net asset values. See id. at 944. The Commissioner argued, contrary to the Government's position in this case, that the corporations were in the nature of investment companies and would be valued by a hypothetical investor based upon a buyer's right to share in the value

of the corporation's underlying net assets. See id. at 943. For that reason, the Commissioner argued that the corporations should not be valued using earnings and dividend-paying capacity. See id. In resolving that dispute, we stated as follows:

> [R]egardless of whether the corporation is seen as primarily an operating company, as opposed to an investment company, courts should not restrict consideration to only one approach to valuation, such as capitalization of earnings or net asset values. * * * Certainly the degree to which the corporation is actively engaged in producing income rather than merely holding property for investment should influence the weight to be given to the values arrived at under the different approaches but it should not dictate the use of one approach to the exclusion of all others. [Id. at 945; citations omitted.]

In this case we do not agree with respondent that the net asset value approach is irrelevant on the ground that a hypothetical buyer of the subject limited partnership interest would have no control over when the underlying property was sold or when the partnership was liquidated. The net asset value should still be considered because the value of the underlying real estate will retain most of its inherent value even if the corporation is not efficient in securing a stream of rental income. See id. at 944. Thus,

weight must be given to the net asset value of the partnership's underlying assets even though a hypothetical buyer of the subject limited partnership interest would have no ability to directly realize the value by forcing liquidation. See id. at 945.

Second, we agree with petitioner's expert that for purposes of computing the fair market value of the subject limited partnership interest under the capitalization of income approach, it is appropriate to use the average of the distributions made during the years 1990 through 1992, rather than the amount of the 1992 distribution. As mentioned above, paragraph 4.1 of the partnership agreement grants the general partner sole discretion to determine when distributions are made. While there is no guaranty that past distributions will reflect the distributions to be made in the future, we believe that an average of the distributions over 3 years better reflects the cash distributions that an investor could reasonably anticipate in the future, than the distributions made during 1992 of $800,000, an amount that exceeds the 3-year average by $116,667. We do not agree with respondent's position that an investor would consider the 1992 distributions of

$800,000 to be the minimum future distributions because the final mortgage payment was to be made in April 1993.

Third, we agree with respondent's expert's use of 16 comparables. Respondent's expert selected 16 comparables and found the midpoint of the returns of those comparables, 10.45 percent. He made three adjustments and arrived at 9.7 percent as the return that an investor would require from Hill House. On the other hand, petitioner's expert in effect based the yield used in his computation on a single comparable. We believe that the use of a single comparable can be problematic, and we prefer the approach of respondent's expert in using a number of comparables. Cf. Estate of Hall v. Commissioner, 92 T.C. 312, 339-340 (1989).

As noted above, respondent's expert did not use the net asset value approach. Nevertheless, using the 16 comparables that respondent's expert selected, it appears that an investor would discount the net asset value of Hill House by 53.4 percent to arrive at the fair market value of the subject limited partnership interest under the net asset value approach. We computed this discount using a

method similar to the method used by Dr. Kursh in computing the rate of return of 10.45 percent used in his analysis.

Finally, we do not agree with the marketability discount computed by either expert. We disagree with the discount computed by Dr. Kursh on the basis of the QMDM model because slight variations in the assumptions used in the model produce dramatic differences in the results. For example, if the holding period for the investment were extended from 10 to 15 years, the period assumed by Dr. Kursh, to 15 to 20 years, and the required holding period return were increased to 20 percent from the return assumed by Dr. Kursh of between 16 to 18 percent, the QMDM table produces a 30-percent discount, twice the amount of the discount produced using Dr. Kursh's assumptions. Because the assumptions are not based on hard data and a range of data may be reasonable, we did not find the QMDM helpful in this case.

Similarly, we disagree with Mr. Siwicki's computation of a marketability discount. Mr. Siwicki arrived at an initial marketability discount, 30 percent, based upon his review of an SEC study of unregistered shares of nonreporting over-the-counter companies. He increased the

discount by 5 percent to reflect the perpetual restrictions on this interest and the slim prospect of the interest ever being publicly traded. We believe that Mr. Siwicki failed adequately to take into account certain characteristics of the subject limited partnership interest that suggest a decrease in the marketability discount. These factors include consistent dividends, the nature of the underlying assets, and a low degree of financial leverage.

Based on all the evidence of record, we find that a marketability discount of 20 percent should be applied to the subject limited partnership interest.

Valuation

Based upon the entire record of this case, we find the date-of-death fair market value of the subject limited partnership interest is $1,309,650.64. Our analysis is summarized in the following schedule:

Court's Analysis		Capitalization		Net Asset Value	
Distributions during 1990		$650,000.00	Value of apartment complex	$10,050,000.00	
Distributions during 1991		600,000.00	Other assets	840,075.00	
Distributions during 1992		800,000.00	Total liabilities	557,306.00	
Total distributions		2,050,000.00	Net Asset Value of Hill House	10,332,769.00	
Average annual distributions		683,333.33			
Percentage interest		0.25235	Percentage interest	0.25235	
Share of average annual distributions		172,439.17	Share of Net Asset Value	2,607,474.26	
Average yield of 16 comparables	10.45%				
Plus: Adjustment for lack of diversity	0.50%				
Less: Adjustment for commonality	-1.00%				
Less: Adjustment for distressed sales	-.025%				
Percentage yield		9.70%	Less: Discount of 53.4% approach	1,392,391.25	
Value of Hill House before marketability discount		1,777,723.40	Value of Hill House before marketability discount	1,215,083.01	
Weight of capitalization approach		0.75%	Weight of net asset value approach	0.25	
Fair market value of the subject limited partnership interest		1,333,292.55		303,770.75	$1,637,063.30
Less: Marketability discount of 20%					327,412.66
Fair market value of the subject limited partnership interest					1,309,650.64

Based upon the foregoing, and concessions,

Decision will be entered under Rule 155.

Weinberger v. UOP, Inc.

457 A.2d 701 (1983)

William B. WEINBERGER, Plaintiff Below, Appellant, v. UOP, INC., et al., Defendants Below, Appellees.

Supreme Court of Delaware.

Submitted: July 16, 1982.
Decided: February 1, 1983.

William Prickett (argued), John H. Small, and George H. Seitz, III, of Prickett, Jones, Elliott, Kristol & Schnee, Wilmington, for plaintiff.

A. Gilchrist Sparks, III, of Morris, Nichols, Arsht & Tunnell, Wilmington, for defendant UOP, Inc.

Robert K. Payson and Peter M. Sieglaff, of Potter, Anderson & Corroon, Wilmington, and Alan N. Halkett (argued) of Latham & Watkins, Los Angeles, Cal., for defendant The Signal Companies, Inc.

Before HERRMANN, C.J., McNEILLY, QUILLEN, HORSEY and MOORE, JJ., constituting the Court en Banc.

MOORE, Justice:

This post-trial appeal was reheard en banc from a decision of the Court of Chancery.[1] It was brought by the class action plaintiff below, a former shareholder of UOP, Inc., who challenged the elimination of UOP's minority shareholders by a cash-out merger between UOP and its majority owner, The Signal Companies, Inc.[2] Originally, the defendants in this action were Signal, UOP, certain officers and directors of those companies, and UOP's investment banker, Lehman Brothers Kuhn Loeb, Inc.[3] The present Chancellor held that the terms of the merger were fair to the plaintiff and the other minority shareholders of UOP. Accordingly, he entered judgment in favor of the defendants.

Numerous points were raised by the parties, but we address only the following questions presented by the trial court's opinion:

1) The plaintiff's duty to plead sufficient facts demonstrating the unfairness of the challenged merger;
2) The burden of proof upon the parties where the merger has been approved by the purportedly informed vote of a majority of the minority shareholders;

[1] Accordingly, this Court's February 9, 1982 opinion is withdrawn.
[2] For the opinion of the trial court see *Weinberger v. UOP, Inc.,* Del. Ch., 426 A.2d 1333 (1981).
[3] Shortly before the last oral argument, the plaintiff dismissed Lehman Brothers from the action. Thus, we do not deal with the issues raised by the plaintiff's claims against this defendant.

3) The fairness of the merger in terms of adequacy of the defendants' disclosures to the minority shareholders;
4) The fairness of the merger in terms of adequacy of the price paid for the minority shares and the remedy appropriate to that issue; and
5) The continued force and effect of *Singer v. Magnavox Co.,* Del.Supr., 380 A.2d 969, 980 (1977), and its progeny.

In ruling for the defendants, the Chancellor re-stated his earlier conclusion that the plaintiff in a suit challenging a cash-out merger must allege specific acts of fraud, misrepresentation, or other items of misconduct to demonstrate the unfairness of the merger terms to the minority.[4] We approve this rule and affirm it.

The Chancellor also held that even though the ultimate burden of proof is on the majority shareholder to show by a preponderance of the evidence that the transaction is fair, it is first the burden of the plaintiff attacking the merger to demonstrate some basis for invoking the fairness obligation. We agree with that principle. However, where corporate action has been approved by an informed vote of a majority of the minority shareholders, we conclude that the burden entirely shifts to the plaintiff to show that the transaction was unfair to the minority. *See, e.g., Michelson v. Duncan,* Del.Supr., 407 A.2d 211, 224 (1979). But in all this, the burden clearly remains on those relying on the vote to show that they completely disclosed all material facts relevant to the transaction.

Here, the record does not support a conclusion that the minority stockholder vote was an informed one. Material information, necessary to acquaint those shareholders with the bargaining positions of Signal and UOP, was withheld under circumstances amounting to a breach of fiduciary duty. We therefore conclude that this merger does not meet the test of fairness, at least as we address that concept, and no burden thus shifted to the plaintiff by reason of the minority shareholder vote. Accordingly, we reverse and remand for further proceedings consistent herewith.

In considering the nature of the remedy available under our law to minority shareholders in a cash-out merger, we believe that it is, and hereafter should be, an appraisal under 8 *Del.C.* § 262 as hereinafter construed. We therefore overrule *Lynch v. Vickers Energy Corp.,* Del.Supr., 429 A.2d 497 (1981) (*Lynch II*) to the extent that it purports to limit a stockholder's monetary relief to a specific damage formula. *See Lynch II,* 429 A.2d at 507-08 (McNeilly & Quillen, JJ., dissenting). But to give full effect to section 262 within the framework of the General Corporation Law we adopt a more liberal, less rigid and stylized, approach to the valuation process than has heretofore been permitted by our courts. While the present state of these proceedings does not admit the plaintiff to the appraisal remedy per se, the practical effect of the remedy we do grant him will be co-extensive with the liberalized valuation and appraisal methods we herein approve for cases coming after this decision.

Our treatment of these matters has necessarily led us to a reconsideration of the business purpose rule announced in the trilogy of *Singer v. Magnavox Co., supra; Tanzer v. International General Industries, Inc.,* Del.Supr., 379 A.2d 1121 (1977); and *Roland*

[4] In a pre-trial ruling the Chancellor ordered the complaint dismissed for failure to state a cause of action. *See Weinberger v. UOP, Inc.,* Del.Ch., 409 A.2d 1262 (1979).

International Corp. v. Najjar, Del.Supr., 407 A.2d 1032 (1979). For the reasons hereafter set forth we consider that the business purpose requirement of these cases is no longer the law of Delaware.

I.

The facts found by the trial court, pertinent to the issues before us, are supported by the record, and we draw from them as set out in the Chancellor's opinion.[5]

Signal is a diversified, technically based company operating through various subsidiaries. Its stock is publicly traded on the New York, Philadelphia and Pacific Stock Exchanges. UOP, formerly known as Universal Oil Products Company, was a diversified industrial company engaged in various lines of business, including petroleum and petro-chemical services and related products, construction, fabricated metal products, transportation equipment products, chemicals and plastics, and other products and services including land development, lumber products and waste disposal. Its stock was publicly held and listed on the New York Stock Exchange.

In 1974 Signal sold one of its wholly-owned subsidiaries for $420,000,000 in cash. *See Gimbel v. Signal Companies, Inc.,* Del. Ch., 316 A.2d 599, *aff'd,* Del.Supr., 316 A.2d 619 (1974). While looking to invest this cash surplus, Signal became interested in UOP as a possible acquisition. Friendly negotiations ensued, and Signal proposed to acquire a controlling interest in UOP at a price of $19 per share. UOP's representatives sought $25 per share. In the arm's length bargaining that followed, an understanding was reached whereby Signal agreed to purchase from UOP 1,500,000 shares of UOP's authorized but unissued stock at $21 per share.

This purchase was contingent upon Signal making a successful cash tender offer for 4,300,000 publicly held shares of UOP, also at a price of $21 per share. This combined method of acquisition permitted Signal to acquire 5,800,000 shares of stock, representing 50.5% of UOP's outstanding shares. The UOP board of directors advised the company's shareholders that it had no objection to Signal's tender offer at that price. Immediately before the announcement of the tender offer, UOP's common stock had been trading on the New York Stock Exchange at a fraction under $14 per share.

The negotiations between Signal and UOP occurred during April 1975, and the resulting tender offer was greatly oversubscribed. However, Signal limited its total purchase of the tendered shares so that, when coupled with the stock bought from UOP, it had achieved its goal of becoming a 50.5% shareholder of UOP.

Although UOP's board consisted of thirteen directors, Signal nominated and elected only six. Of these, five were either directors or employees of Signal. The sixth, a partner in the banking firm of Lazard Freres & Co., had been one of Signal's representatives in the negotiations and bargaining with UOP concerning the tender offer and purchase price of the UOP shares.

[5] *Weinberger v. UOP, Inc.,* Del.Ch., 426 A.2d 1333, 1335-40 (1981).

However, the president and chief executive officer of UOP retired during 1975, and Signal caused him to be replaced by James V. Crawford, a long-time employee and senior executive vice president of one of Signal's wholly-owned subsidiaries. Crawford succeeded his predecessor on UOP's board of directors and also was made a director of Signal.

By the end of 1977 Signal basically was unsuccessful in finding other suitable investment candidates for its excess cash, and by February 1978 considered that it had no other realistic acquisitions available to it on a friendly basis. Once again its attention turned to UOP.

The trial court found that at the instigation of certain Signal management personnel, including William W. Walkup, its board chairman, and Forrest N. Shumway, its president, a feasibility study was made concerning the possible acquisition of the balance of UOP's outstanding shares. This study was performed by two Signal officers, Charles S. Arledge, vice president (director of planning), and Andrew J. Chitiea, senior vice president (chief financial officer). Messrs. Walkup, Shumway, Arledge and Chitiea were all directors of UOP in addition to their membership on the Signal board.

Arledge and Chitiea concluded that it would be a good investment for Signal to acquire the remaining 49.5% of UOP shares at any price up to $24 each. Their report was discussed between Walkup and Shumway who, along with Arledge, Chitiea and Brewster L. Arms, internal counsel for Signal, constituted Signal's senior management. In particular, they talked about the proper price to be paid if the acquisition was pursued, purportedly keeping in mind that as UOP's majority shareholder, Signal owed a fiduciary responsibility to both its own stockholders as well as to UOP's minority. It was ultimately agreed that a meeting of Signal's executive committee would be called to propose that Signal acquire the remaining outstanding stock of UOP through a cash-out merger in the range of $20 to $21 per share.

The executive committee meeting was set for February 28, 1978. As a courtesy, UOP's president, Crawford, was invited to attend, although he was not a member of Signal's executive committee. On his arrival, and prior to the meeting, Crawford was asked to meet privately with Walkup and Shumway. He was then told of Signal's plan to acquire full ownership of UOP and was asked for his reaction to the proposed price range of $20 to $21 per share. Crawford said he thought such a price would be "generous", and that it was certainly one which should be submitted to UOP's minority shareholders for their ultimate consideration. He stated, however, that Signal's 100% ownership could cause internal problems at UOP. He believed that employees would have to be given some assurance of their future place in a fully-owned Signal subsidiary. Otherwise, he feared the departure of essential personnel. Also, many of UOP's key employees had stock option incentive programs which would be wiped out by a merger. Crawford therefore urged that some adjustment would have to be made, such as providing a comparable incentive in Signal's shares, if after the merger he was to maintain his quality of personnel and efficiency at UOP.

Thus, Crawford voiced no objection to the $20 to $21 price range, nor did he suggest that Signal should consider paying more than $21 per share for the minority interests. Later, at the executive committee meeting the same factors were discussed, with Crawford repeating the position he earlier took with Walkup and Shumway. Also considered was the 1975

tender offer and the fact that it had been greatly oversubscribed at $21 per share. For many reasons, Signal's management concluded that the acquisition of UOP's minority shares provided the solution to a number of its business problems.

Thus, it was the consensus that a price of $20 to $21 per share would be fair to both Signal and the minority shareholders of UOP. Signal's executive committee authorized its management "to negotiate" with UOP "for a cash acquisition of the minority ownership in UOP, Inc., with the intention of presenting a proposal to [Signal's] board of directors ... on March 6, 1978". Immediately after this February 28, 1978 meeting, Signal issued a press release stating:

> The Signal Companies, Inc. and UOP, Inc. are conducting negotiations for the acquisition for cash by Signal of the 49.5 per cent of UOP which it does not presently own, announced Forrest N. Shumway, president and chief executive officer of Signal, and James V. Crawford, UOP president.
>
> Price and other terms of the proposed transaction have not yet been finalized and would be subject to approval of the boards of directors of Signal and UOP, scheduled to meet early next week, the stockholders of UOP and certain federal agencies.

The announcement also referred to the fact that the closing price of UOP's common stock on that day was $14.50 per share.

Two days later, on March 2, 1978, Signal issued a second press release stating that its management would recommend a price in the range of $20 to $21 per share for UOP's 49.5% minority interest. This announcement referred to Signal's earlier statement that "negotiations" were being conducted for the acquisition of the minority shares.

Between Tuesday, February 28, 1978 and Monday, March 6, 1978, a total of four business days, Crawford spoke by telephone with all of UOP's non-Signal, i.e., outside, directors. Also during that period, Crawford retained Lehman Brothers to render a fairness opinion as to the price offered the minority for its stock. He gave two reasons for this choice. First, the time schedule between the announcement and the board meetings was short (by then only three business days) and since Lehman Brothers had been acting as UOP's investment banker for many years, Crawford felt that it would be in the best position to respond on such brief notice. Second, James W. Glanville, a long-time director of UOP and a partner in Lehman Brothers, had acted as a financial advisor to UOP for many years. Crawford believed that Glanville's familiarity with UOP, as a member of its board, would also be of assistance in enabling Lehman Brothers to render a fairness opinion within the existing time constraints.

Crawford telephoned Glanville, who gave his assurance that Lehman Brothers had no conflicts that would prevent it from accepting the task. Glanville's immediate personal reaction was that a price of $20 to $21 would certainly be fair, since it represented almost a 50% premium over UOP's market price. Glanville sought a $250,000 fee for Lehman Brothers' services, but Crawford thought this too much. After further discussions Glanville finally agreed that Lehman Brothers would render its fairness opinion for $150,000.

During this period Crawford also had several telephone contacts with Signal officials. In only one of them, however, was the price of the shares discussed. In a conversation with Walkup, Crawford advised that as a result of his communications with UOP's non-Signal directors, it was his feeling that the price would have to be the top of the proposed range, or $21 per share, if the approval of UOP's outside directors was to be obtained. But again, he did not seek any price higher than $21.

Glanville assembled a three-man Lehman Brothers team to do the work on the fairness opinion. These persons examined relevant documents and information concerning UOP, including its annual reports and its Securities and Exchange Commission filings from 1973 through 1976, as well as its audited financial statements for 1977, its interim reports to shareholders, and its recent and historical market prices and trading volumes. In addition, on Friday, March 3, 1978, two members of the Lehman Brothers team flew to UOP's headquarters in Des Plaines, Illinois, to perform a "due diligence" visit, during the course of which they interviewed Crawford as well as UOP's general counsel, its chief financial officer, and other key executives and personnel.

As a result, the Lehman Brothers team concluded that "the price of either $20 or $21 would be a fair price for the remaining shares of UOP". They telephoned this impression to Glanville, who was spending the weekend in Vermont.

On Monday morning, March 6, 1978, Glanville and the senior member of the Lehman Brothers team flew to Des Plaines to attend the scheduled UOP directors meeting. Glanville looked over the assembled information during the flight. The two had with them the draft of a "fairness opinion letter" in which the price had been left blank. Either during or immediately prior to the directors' meeting, the two-page "fairness opinion letter" was typed in final form and the price of $21 per share was inserted.

On March 6, 1978, both the Signal and UOP boards were convened to consider the proposed merger. Telephone communications were maintained between the two meetings. Walkup, Signal's board chairman, and also a UOP director, attended UOP's meeting with Crawford in order to present Signal's position and answer any questions that UOP's non-Signal directors might have. Arledge and Chitiea, along with Signal's other designees on UOP's board, participated by conference telephone. All of UOP's outside directors attended the meeting either in person or by conference telephone.

First, Signal's board unanimously adopted a resolution authorizing Signal to propose to UOP a cash merger of $21 per share as outlined in a certain merger agreement and other supporting documents. This proposal required that the merger be approved by a majority of UOP's outstanding minority shares voting at the stockholders meeting at which the merger would be considered, and that the minority shares voting in favor of the merger, when coupled with Signal's 50.5% interest would have to comprise at least two-thirds of all UOP shares. Otherwise the proposed merger would be deemed disapproved.

UOP's board then considered the proposal. Copies of the agreement were delivered to the directors in attendance, and other copies had been forwarded earlier to the directors participating by telephone. They also had before them UOP financial data for 1974-1977, UOP's most recent financial statements, market price information, and budget projections

for 1978. In addition they had Lehman Brothers' hurriedly prepared fairness opinion letter finding the price of $21 to be fair. Glanville, the Lehman Brothers partner, and UOP director, commented on the information that had gone into preparation of the letter.

Signal also suggests that the Arledge-Chitiea feasibility study, indicating that a price of up to $24 per share would be a "good investment" for Signal, was discussed at the UOP directors' meeting. The Chancellor made no such finding, and our independent review of the record, detailed *infra,* satisfies us by a preponderance of the evidence that there was no discussion of this document at UOP's board meeting. Furthermore, it is clear beyond peradventure that nothing in that report was ever disclosed to UOP's minority shareholders prior to their approval of the merger.

After consideration of Signal's proposal, Walkup and Crawford left the meeting to permit a free and uninhibited exchange between UOP's non-Signal directors. Upon their return a resolution to accept Signal's offer was then proposed and adopted. While Signal's men on UOP's board participated in various aspects of the meeting, they abstained from voting. However, the minutes show that each of them "if voting would have voted yes".

On March 7, 1978, UOP sent a letter to its shareholders advising them of the action taken by UOP's board with respect to Signal's offer. This document pointed out, among other things, that on February 28, 1978 "both companies had announced negotiations were being conducted".

Despite the swift board action of the two companies, the merger was not submitted to UOP's shareholders until their annual meeting on May 26, 1978. In the notice of that meeting and proxy statement sent to shareholders in May, UOP's management and board urged that the merger be approved. The proxy statement also advised:

> The price was determined after *discussions* between James V. Crawford, a director of Signal and Chief Executive Officer of UOP, and officers of Signal which took place during meetings on February 28, 1978, and in the course of several subsequent telephone conversations. (Emphasis added.)

In the original draft of the proxy statement the word "negotiations" had been used rather than "discussions". However, when the Securities and Exchange Commission sought details of the "negotiations" as part of its review of these materials, the term was deleted and the word "discussions" was substituted. The proxy statement indicated that the vote of UOP's board in approving the merger had been unanimous. It also advised the shareholders that Lehman Brothers had given its opinion that the merger price of $21 per share was fair to UOP's minority. However, it did not disclose the hurried method by which this conclusion was reached.

As of the record date of UOP's annual meeting, there were 11,488,302 shares of UOP common stock outstanding, 5,688,302 of which were owned by the minority. At the meeting only 56%, or 3,208,652, of the minority shares were voted. Of these, 2,953,812, or 51.9% of the total minority, voted for the merger, and 254,840 voted against it. When Signal's stock was added to the minority shares voting in favor, a total of 76.2% of UOP's outstanding shares approved the merger while only 2.2% opposed it.

By its terms the merger became effective on May 26, 1978, and each share of UOP's stock held by the minority was automatically converted into a right to receive $21 cash.

II.

A.

A primary issue mandating reversal is the preparation by two UOP directors, Arledge and Chitiea, of their feasibility study for the exclusive use and benefit of Signal. This document was of obvious significance to both Signal and UOP. Using UOP data, it described the advantages to Signal of ousting the minority at a price range of $21-$24 per share. Mr. Arledge, one of the authors, outlined the benefits to Signal:[6]

Purpose Of The Merger

1) Provides an outstanding investment opportunity for Signal — (Better than any recent acquisition we have seen.)
2) Increases Signal's earnings.
3) Facilitates the flow of resources between Signal and its subsidiaries — (Big factor — works both ways.)
4) Provides cost savings potential for Signal and UOP.
5) Improves the percentage of Signal's `operating earnings' as opposed to `holding company earnings'.
6) Simplifies the understanding of Signal.
7) Facilitates technological exchange among Signal's subsidiaries.
8) Eliminates potential conflicts of interest.

Having written those words, solely for the use of Signal, it is clear from the record that neither Arledge nor Chitiea shared this report with their fellow directors of UOP. We are satisfied that no one else did either. This conduct hardly meets the fiduciary standards applicable to such a transaction. While Mr. Walkup, Signal's chairman of the board and a UOP director, attended the March 6, 1978 UOP board meeting and testified at trial that he had discussed the Arledge-Chitiea report with the UOP directors at this meeting, the record does not support this assertion. Perhaps it is the result of some confusion on Mr. Walkup's part. In any event Mr. Shumway, Signal's president, testified that he made sure the Signal outside directors had this report prior to the March 6, 1978 Signal board meeting, but he did not testify that the Arledge-Chitiea report was also sent to UOP's outside directors.

Mr. Crawford, UOP's president, could not recall that any documents, other than a draft of the merger agreement, were sent to UOP's directors before the March 6, 1978 UOP meeting. Mr. Chitiea, an author of the report, testified that it was made available to Signal's directors, but to his knowledge it was not circulated to the outside directors of UOP. He specifically testified that he "didn't share" that information with the outside directors of UOP with whom he served.

[6] The parentheses indicate certain handwritten comments of Mr. Arledge.

None of UOP's outside directors who testified stated that they had seen this document. The minutes of the UOP board meeting do not identify the Arledge-Chitiea report as having been delivered to UOP's outside directors. This is particularly significant since the minutes describe in considerable detail the materials that actually were distributed. While these minutes recite Mr. Walkup's presentation of the Signal offer, they do not mention the Arledge-Chitiea report or any disclosure that Signal considered a price of up to $24 to be a good investment. If Mr. Walkup had in fact provided such important information to UOP's outside directors, it is logical to assume that these carefully drafted minutes would disclose it. The post-trial briefs of Signal and UOP contain a thorough description of the documents purportedly available to their boards at the March 6, 1978, meetings. Although the Arledge-Chitiea report is specifically identified as being available to the Signal directors, there is no mention of it being among the documents submitted to the UOP board. Even when queried at a prior oral argument before this Court, counsel for Signal did not claim that the Arledge-Chitiea report had been disclosed to UOP's outside directors. Instead, he chose to belittle its contents. This was the same approach taken before us at the last oral argument.

Actually, it appears that a three-page summary of figures was given to all UOP directors. Its first page is identical to one page of the Arledge-Chitiea report, but this dealt with nothing more than a justification of the $21 price. Significantly, the contents of this three-page summary are what the minutes reflect Mr. Walkup told the UOP board. However, nothing contained in either the minutes or this three-page summary reflects Signal's study regarding the $24 price.

The Arledge-Chitiea report speaks for itself in supporting the Chancellor's finding that a price of up to $24 was a "good investment" for Signal. It shows that a return on the investment at $21 would be 15.7% versus 15.5% at $24 per share. This was a difference of only two-tenths of one percent, while it meant over $17,000,000 to the minority. Under such circumstances, paying UOP's minority shareholders $24 would have had relatively little long-term effect on Signal, and the Chancellor's findings concerning the benefit to Signal, even at a price of $24, were obviously correct. *Levitt v. Bouvier,* Del.Supr., 287 A.2d 671, 673 (1972).

Certainly, this was a matter of material significance to UOP and its shareholders. Since the study was prepared by two UOP directors, using UOP information for the exclusive benefit of Signal, and nothing whatever was done to disclose it to the outside UOP directors or the minority shareholders, a question of breach of fiduciary duty arises. This problem occurs because there were common Signal-UOP directors participating, at least to some extent, in the UOP board's decision-making processes without full disclosure of the conflicts they faced.[7]

[7] Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length. *See, e.g., Harriman v. E.I. duPont de Nemours & Co.,* 411 F.Supp. 133 (D.Del.1975). Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued. *Johnston v. Greene,* Del.Supr., 121 A.2d 919, 925 (1956). Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the

B.

In assessing this situation, the Court of Chancery was required to:

> examine what information defendants had and to measure it against what they gave to the minority stockholders, in a context in which `complete candor' is required. In other words, the limited function of the Court was to determine whether defendants had disclosed all information in their possession germane to the transaction in issue. And by `germane' we mean, for present purposes, information such as a reasonable shareholder would consider important in deciding whether to sell or retain stock.
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> * * * * * *
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> ... Completeness, not adequacy, is both the norm and the mandate under present circumstances.

Lynch v. Vickers Energy Corp., Del.Supr., 383 A.2d 278, 281 (1977) (*Lynch I*). This is merely stating in another way the long-existing principle of Delaware law that these Signal designated directors on UOP's board still owed UOP and its shareholders an uncompromising duty of loyalty. The classic language of *Guth v. Loft, Inc.,* Del.Supr., 5 A.2d 503, 510 (1939), requires no embellishment:

> A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.

Given the absence of any attempt to structure this transaction on an arm's length basis, Signal cannot escape the effects of the conflicts it faced, particularly when its designees on UOP's board did not totally abstain from participation in the matter. There is no "safe harbor" for such divided loyalties in Delaware. When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain. *Gottlieb v. Heyden Chemical Corp.,* Del.Supr., 91 A.2d 57, 57-58 (1952). The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts. *Sterling v. Mayflower Hotel Corp.,* Del.Supr., 93 A.2d 107, 110 (1952); *Bastian v. Bourns, Inc.,* Del.Ch., 256 A.2d 680, 681 (1969), *aff'd,* Del.Supr., 278 A.2d 467 (1970); *David J. Greene & Co. v. Dunhill International Inc.,* Del.Ch., 249 A.2d 427, 431 (1968).

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test of fairness. *Getty Oil Co. v. Skelly Oil Co.,* Del.Supr., 267 A.2d 883, 886 (1970); *Puma v. Marriott,* Del.Ch., 283 A.2d 693, 696 (1971).

There is no dilution of this obligation where one holds dual or multiple directorships, as in a parent-subsidiary context. *Levien v. Sinclair Oil Corp.,* Del.Ch., 261 A.2d 911, 915 (1969). Thus, individuals who act in a dual capacity as directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations, and in the absence of an independent negotiating structure (see note 7, *supra*), or the directors' total abstention from any participation in the matter, this duty is to be exercised in light of what is best for both companies. *Warshaw v. Calhoun,* Del. Supr., 221 A.2d 487, 492 (1966). The record demonstrates that Signal has not met this obligation.

C.

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. Moore, *The "Interested" Director or Officer Transaction,* 4 Del.J. Corp.L. 674, 676 (1979); Nathan & Shapiro, *Legal Standard of Fairness of Merger Terms Under Delaware Law,* 2 Del.J. Corp.L. 44, 46-47 (1977). *See Tri-Continental Corp. v. Battye,* Del.Supr., 74 A.2d 71, 72 (1950); 8 *Del.C.* § 262(h). However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness. However, in a non-fraudulent transaction we recognize that price may be the preponderant consideration outweighing other features of the merger. Here, we address the two basic aspects of fairness separately because we find reversible error as to both.

D.

Part of fair dealing is the obvious duty of candor required by *Lynch I, supra.* Moreover, one possessing superior knowledge may not mislead any stockholder by use of corporate information to which the latter is not privy. *Lank v. Steiner,* Del. Supr., 224 A.2d 242, 244 (1966). Delaware has long imposed this duty even upon persons who are not corporate officers or directors, but who nonetheless are privy to matters of interest or significance to their company. *Brophy v. Cities Service Co.,*Del. Ch., 70 A.2d 5, 7 (1949). With the well-established Delaware law on the subject, and the Court of Chancery's findings of fact here, it is inevitable that the obvious conflicts posed by Arledge and Chitiea's preparation of their "feasibility study", derived from UOP information, for the sole use and benefit of Signal, cannot pass muster.

The Arledge-Chitiea report is but one aspect of the element of fair dealing. How did this merger evolve? It is clear that it was entirely initiated by Signal. The serious time constraints under which the principals acted were all set by Signal. It had not found a suitable outlet for its excess cash and considered UOP a desirable investment, particularly since it was now in a position to acquire the whole company for itself. For whatever reasons, and they were only Signal's, the entire transaction was presented to and approved by UOP's board within four business days. Standing alone, this is not necessarily indicative of any lack of fairness

by a majority shareholder. It was what occurred, or more properly, what did not occur, during this brief period that makes the time constraints imposed by Signal relevant to the issue of fairness.

The structure of the transaction, again, was Signal's doing. So far as negotiations were concerned, it is clear that they were modest at best. Crawford, Signal's man at UOP, never really talked price with Signal, except to accede to its management's statements on the subject, and to convey to Signal the UOP outside directors' view that as between the $20-$21 range under consideration, it would have to be $21. The latter is not a surprising outcome, but hardly arm's length negotiations. Only the protection of benefits for UOP's key employees and the issue of Lehman Brothers' fee approached any concept of bargaining.

As we have noted, the matter of disclosure to the UOP directors was wholly flawed by the conflicts of interest raised by the Arledge-Chitiea report. All of those conflicts were resolved by Signal in its own favor without divulging any aspect of them to UOP.

This cannot but undermine a conclusion that this merger meets any reasonable test of fairness. The outside UOP directors lacked one material piece of information generated by two of their colleagues, but shared only with Signal. True, the UOP board had the Lehman Brothers' fairness opinion, but that firm has been blamed by the plaintiff for the hurried task it performed, when more properly the responsibility for this lies with Signal. There was no disclosure of the circumstances surrounding the rather cursory preparation of the Lehman Brothers' fairness opinion. Instead, the impression was given UOP's minority that a careful study had been made, when in fact speed was the hallmark, and Mr. Glanville, Lehman's partner in charge of the matter, and also a UOP director, having spent the weekend in Vermont, brought a draft of the "fairness opinion letter" to the UOP directors' meeting on March 6, 1978 with the price left blank. We can only conclude from the record that the rush imposed on Lehman Brothers by Signal's timetable contributed to the difficulties under which this investment banking firm attempted to perform its responsibilities. Yet, none of this was disclosed to UOP's minority.

Finally, the minority stockholders were denied the critical information that Signal considered a price of $24 to be a good investment. Since this would have meant over $17,000,000 more to the minority, we cannot conclude that the shareholder vote was an informed one. Under the circumstances, an approval by a majority of the minority was meaningless. *Lynch I,* 383 A.2d at 279, 281; *Cahall v. Lofland,* Del.Ch., 114 A. 224 (1921).

Given these particulars and the Delaware law on the subject, the record does not establish that this transaction satisfies any reasonable concept of fair dealing, and the Chancellor's findings in that regard must be reversed.

E.

Turning to the matter of price, plaintiff also challenges its fairness. His evidence was that on the date the merger was approved the stock was worth at least $26 per share. In support, he offered the testimony of a chartered investment analyst who used two basic approaches to valuation: a comparative analysis of the premium paid over market in ten other tender offer-merger combinations, and a discounted cash flow analysis.

In this breach of fiduciary duty case, the Chancellor perceived that the approach to valuation was the same as that in an appraisal proceeding. Consistent with precedent, he rejected plaintiff's method of proof and accepted defendants' evidence of value as being in accord with practice under prior case law. This means that the so-called "Delaware block" or weighted average method was employed wherein the elements of value, i.e., assets, market price, earnings, etc., were assigned a particular weight and the resulting amounts added to determine the value per share. This procedure has been in use for decades. *See In re General Realty & Utilities Corp.,* Del.Ch., 52 A.2d 6, 14-15 (1947). However, to the extent it excludes other generally accepted techniques used in the financial community and the courts, it is now clearly outmoded. It is time we recognize this in appraisal and other stock valuation proceedings and bring our law current on the subject.

While the Chancellor rejected plaintiff's discounted cash flow method of valuing UOP's stock, as not corresponding with "either logic or the existing law" (426 A.2d at 1360), it is significant that this was essentially the focus, i.e., earnings potential of UOP, of Messrs. Arledge and Chitiea in their evaluation of the merger. Accordingly, the standard "Delaware block" or weighted average method of valuation, formerly employed in appraisal and other stock valuation cases, shall no longer exclusively control such proceedings. We believe that a more liberal approach must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court, subject only to our interpretation of 8 *Del.C.* § 262(h), *infra. See also* D.R.E. 702-05. This will obviate the very structured and mechanistic procedure that has heretofore governed such matters. *See Jacques Coe & Co. v. Minneapolis-Moline Co.,* Del.Ch., 75 A.2d 244, 247 (1950); *Tri-Continental Corp. v. Battye,* Del.Ch., 66 A.2d 910, 917-18 (1949); *In re General Realty and Utilities Corp., supra.*

Fair price obviously requires consideration of all relevant factors involving the value of a company. This has long been the law of Delaware as stated in *Tri-Continental Corp.,* 74 A.2d at 72:

> The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern. By value of the stockholder's proportionate interest in the corporate enterprise is meant the true or intrinsic value of his stock which has been taken by the merger. In determining what figure represents this true or intrinsic value, the appraiser and the courts must take into consideration all factors and elements which reasonably might enter into the fixing of value. Thus, market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts which were known or which could be ascertained as of the date of merger and which throw any light on *future prospects* of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholders' interest, but *must be considered* by the agency fixing the value. (Emphasis added.)

This is not only in accord with the realities of present day affairs, but it is thoroughly consonant with the purpose and intent of our statutory law. Under 8 *Del.C.* § 262(h), the Court of Chancery:

> shall appraise the shares, determining their *fair* value exclusive of any element of value arising from the accomplishment or expectation of the merger, together with a fair rate of interest, if any, to be paid upon the amount determined to be the *fair* value. In determining such *fair*value, the Court shall take into account *all relevant factors* ... (Emphasis added)

See also ***Bell v. Kirby Lumber Corp.,*** Del. Supr., 413 A.2d 137, 150-51 (1980) (Quillen, J., concurring).

It is significant that section 262 now mandates the determination of "fair" value based upon "all relevant factors". Only the speculative elements of value that may arise from the "accomplishment or expectation" of the merger are excluded. We take this to be a very narrow exception to the appraisal process, designed to eliminate use of *pro forma* data and projections of a speculative variety relating to the completion of a merger. But elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered. When the trial court deems it appropriate, fair value also includes any damages, resulting from the taking, which the stockholders sustain as a class. If that was not the case, then the obligation to consider "all relevant factors" in the valuation process would be eroded. We are supported in this view not only by *Tri-Continental Corp.,* 74 A.2d at 72, but also by the evolutionary amendments to section 262.

Prior to an amendment in 1976, the earlier relevant provision of section 262 stated:

> (f) The appraiser shall determine the value of the stock of the stockholders ... The Court shall by its decree determine the value of the stock of the stockholders entitled to payment therefor ...

The first references to "fair" value occurred in a 1976 amendment to section 262(f), which provided:

> (f) ... the Court shall appraise the shares, determining their fair value exclusively of any element of value arising from the accomplishment or expectation of the merger....

It was not until the 1981 amendment to section 262 that the reference to "fair value" was repeatedly emphasized and the statutory mandate that the Court "take into account all relevant factors" appeared [section 262(h)]. Clearly, there is a legislative intent to fully compensate shareholders for whatever their loss may be, subject only to the narrow limitation that one can not take speculative effects of the merger into account.

Although the Chancellor received the plaintiff's evidence, his opinion indicates that the use of it was precluded because of past Delaware practice. While we do not suggest a monetary result one way or the other, we do think the plaintiff's evidence should be part of the factual mix and weighed as such. Until the $21 price is measured on remand by the valuation standards mandated by Delaware law, there can be no finding at the present stage of these proceedings that the price is fair. Given the lack of any candid disclosure of the material

facts surrounding establishment of the $21 price, the majority of the minority vote, approving the merger, is meaningless.

The plaintiff has not sought an appraisal, but rescissory damages of the type contemplated by *Lynch v. Vickers Energy Corp.,* Del.Supr., 429 A.2d 497, 505-06 (1981) (*Lynch II*). In view of the approach to valuation that we announce today, we see no basis in our law for *Lynch II*'s exclusive monetary formula for relief. On remand the plaintiff will be permitted to test the fairness of the $21 price by the standards we herein establish, in conformity with the principle applicable to an appraisal — that fair value be determined by taking "into account all relevant factors" [*see* 8 *Del.C.* § 262(h), *supra*]. In our view this includes the elements of rescissory damages if the Chancellor considers them susceptible of proof and a remedy appropriate to all the issues of fairness before him. To the extent that *Lynch II,* 429 A.2d at 505-06, purports to limit the Chancellor's discretion to a single remedial formula for monetary damages in a cash-out merger, it is overruled.

While a plaintiff's monetary remedy ordinarily should be confined to the more liberalized appraisal proceeding herein established, we do not intend any limitation on the historic powers of the Chancellor to grant such other relief as the facts of a particular case may dictate. The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved. *Cole v. National Cash Credit Association,* Del.Ch., 156 A. 183, 187 (1931). Under such circumstances, the Chancellor's powers are complete to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages. Since it is apparent that this long completed transaction is too involved to undo, and in view of the Chancellor's discretion, the award, if any, should be in the form of monetary damages based upon entire fairness standards, i.e., fair dealing and fair price.

Obviously, there are other litigants, like the plaintiff, who abjured an appraisal and whose rights to challenge the element of fair value must be preserved.[8] Accordingly, the quasi-appraisal remedy we grant the plaintiff here will apply only to: (1) this case; (2) any case now pending on appeal to this Court; (3) any case now pending in the Court of Chancery which has not yet been appealed but which may be eligible for direct appeal to this Court; (4) any case challenging a cash-out merger, the effective date of which is on or before February 1, 1983; and (5) any proposed merger to be presented at a shareholders' meeting, the notification of which is mailed to the stockholders on or before February 23, 1983. Thereafter, the provisions of 8 *Del.C.* § 262, as herein construed, respecting the scope of an appraisal and the means for perfecting the same, shall govern the financial remedy available to minority shareholders in a cash-out merger. Thus, we return to the well established principles of *Stauffer v. Standard Brands, Inc.,* Del.Supr., 187 A.2d 78 (1962) and *David J. Greene & Co. v. Schenley Industries, Inc.,* Del.Ch., 281 A.2d 30 (1971), mandating a stockholder's recourse to the basic remedy of an appraisal.

III.

[8] Under 8 *Del.C.* § 262(a), (d) & (e), a stockholder is required to act within certain time periods to perfect the right to an appraisal.

Finally, we address the matter of business purpose. The defendants contend that the purpose of this merger was not a proper subject of inquiry by the trial court. The plaintiff says that no valid purpose existed — the entire transaction was a mere subterfuge designed to eliminate the minority. The Chancellor ruled otherwise, but in so doing he clearly circumscribed the thrust and effect of *Singer. Weinberger v. UOP,* 426 A.2d at 1342-43, 1348-50. This has led to the thoroughly sound observation that the business purpose test "may be ... virtually interpreted out of existence, as it was in *Weinberger.*"[9]

The requirement of a business purpose is new to our law of mergers and was a departure from prior case law. *See Stauffer v. Standard Brands, Inc., supra; David J. Greene & Co. v. Schenley Industries, Inc., supra.*

In view of the fairness test which has long been applicable to parent-subsidiary mergers, *Sterling v. Mayflower Hotel Corp.,* Del.Supr., 93 A.2d 107, 109-10 (1952), the expanded appraisal remedy now available to shareholders, and the broad discretion of the Chancellor to fashion such relief as the facts of a given case may dictate, we do not believe that any additional meaningful protection is afforded minority shareholders by the business purpose requirement of the trilogy of *Singer, Tanzer,*[10] *Najjar,*[11] and their progeny. Accordingly, such requirement shall no longer be of any force or effect.

The judgment of the Court of Chancery, finding both the circumstances of the merger and the price paid the minority shareholders to be fair, is reversed. The matter is remanded for further proceedings consistent herewith. Upon remand the plaintiff's post-trial motion to enlarge the class should be granted.

*** * * * * ***

REVERSED AND REMANDED.

[9] Weiss, *The Law of Take Out Mergers: A Historical Perspective,* 56 N.Y.U.L.Rev. 624, 671, n. 300 (1981).
[10] *Tanzer v. International General Industries, Inc.,* Del. Supr., 379 A.2d 1121, 1124-25 (1977).
[11] *Roland International Corp. v. Najjar,* Del. Supr., 407 A.2d 1032, 1036 (1979).

37 T.C.M. (CCH) 883 (1978)
T.C. Memo. 1978-208.

Richard O. Wheeler and Betty P. Wheeler
v.
Commissioner.

Docket No. 6482-73.

United States Tax Court.

Filed June 7, 1978.

Fenelon Boesche, 1300 NBT Building, 320 S. Boston Ave., Tulsa, Okla. and James Littleton Daniel, for the petitioners. G. Phil Harney, for the respondent.

884 *884 ## Memorandum Findings of Fact and Opinion

IRWIN, Judge:

The Commissioner determined the following deficiencies in petitioners' joint Federal income tax:

Year	Deficiency
1968	$68,999.26
1969	94,607.93

In an amendment to the answer the Commissioner asserted an alternative deficiency of $140,783.76 for the year 1968 should this Court find a certain stock transaction to be taxable in that year rather than in the taxable year 1969. This alternative deficiency for 1968 would result in a reduced deficiency for the year 1969.

Certain concessions having been made, the issues remaining for our decision are:

(1) whether certain stock, debentures and a note received by petitioner Richard O. **Wheeler** in the taxable year 1968 constituted compensation for services or a distributable portion of joint venture capital gain;

(2) whether restrictions on the stock received prevented income realization in the year of receipt;

(3) the fair market value of the stock, if any, on the date of receipt;

(4) the fair market value of the debentures and the note on the date of receipt; and

(5) whether petitioners, by amendment to their petition, made a timely election under section 1304(a)[1] of the Internal Revenue Code to have the benefits of the income averaging provisions apply.

Findings of Fact

Some of the facts have been stipulated. The stipulation of facts along with attached exhibits are incorporated herein by this reference.

Petitioners, husband and wife, resided in Tulsa, Okla., at the time of filing their petition herein. The filed joint Federal income tax returns for the calendar years 1968 and 1969 with the Internal Revenue Service Center in Austin, Tex. Since Betty P. **Wheeler**

is a party hereto solely by reason of having filed joint income tax returns with her husband for the years in issue, Richard O. **Wheeler** alone will hereafter be referred to as the petitioner.

In 1958 petitioner went into the real estate development and construction business building warehouses, churches, and small shopping centers. In some of these real estate projects petitioner had an ownership interest in the property being developed and in others he did not.

It was in early 1961 that petitioner first met Ainslie Perrault. Although Mr. Perrault had no experience as a real estate developer, he was a very successful businessman, having owned a variety of business interests. Petitioner sought out Mr. Perrault to obtain financing for a project petitioner was contemplating. At that time petitioner had an option to purchase a tract of land and a lease commitment from National Cash Register Company for a building to be constructed on the land. What petitioner needed from Mr. Perrault was the front money necessary to exercise the option. Mr. Perrault agreed to provide the funds in return for a 50 percent interest in the project. Petitioner thereafter took title to the land in his name and followed through with the construction and leasing of the building. The project ultimately proved successful.

The next project in which the parties joined involved remodeling the Skelly Oil Building. This time Perrault initiated the project and requested that petitioner join forces with him. Perrault again offered to finance the project if petitioner would agree to remodel and acquire tenants for the building. The parties agreed to divide the profits on a 90 percent — 10 percent basis. The building was remodeled, leased, and eventually sold to the Franklin Realty Company in Philadelphia at a profit.

After these two successful ventures, Perrault and petitioner decided to seek other projects that were larger in scope. In 1962 a general oral agreement was entered into under which Perrault was to provide the necessary front money for the projects and petitioner was to undertake to carry them through the financing, construction and occupancy phases. The essential term of the agreement was that profits would be divided 75 percent to Perrault and 25 percent to petitioner after Perrault recovered his investment plus a 6 percent interest factor. Petitioner was also to receive a salary of $700 per month (later raised to $1,000) as
885 part of the agreement. Perrault was to *885 absorb overall losses incurred on the projects undertaken; however if an individual project ran a loss while the venture was operating at a profit, the loss was to be shared in the profit ratio previously indicated. The association between petitioner and Perrault was a marriage of capital and know-how.

Subsequent to this general arrangement between the principals, they began to look for new ventures. It was agreed that Perrault would hold legal and record title as nominee in order to protect his investment in the projects. However, petitioner and Perrault held themselves out as co-owners for the years during which the oral agreement and a later written agreement were in effect.

In 1965 petitioner and Perrault confirmed their 1962 verbal agreement in writing. Petitioner requested the written agreement for several reasons. Prior to 1965 Mr. Perrault had been represented by petitioner's brother, presumably as his attorney. As a result, petitioner felt safe with a verbal agreement. However, petitioner's brother died and petitioner thereafter felt a written agreement was necessary to protect his interest in the projects. Also Perrault was in his middle or upper sixties at that time and petitioner felt he would be better protected with a written agreement. While petitioner was not totally satisfied with the agreement as written, he felt he had lost much of the earlier leverage which he had in his bargaining position due to the death of his brother. He, therefore, felt compelled to accept the agreement as written by Perrault because his alternatives were to proceed on the basis of the oral agreement or walk off, neither a satisfactory alternative.

Under the agreement, petitioner and Perrault undertook six real estate projects. In 1965 the first of these projects was sold at a profit. Petitioner reported his share of the joint venture capital gain as gain from the sale of a capital asset. He has consistently reported gain from the sale of the projects in this manner. It is this manner of reporting the gain from the sale of three of the projects in the years 1968 and 1969 to which respondent objects.

The projects sold in 1968 were the Camelot Inn, the Mansion House, and the University Club Tower. Perrault and **Wheeler** handled all of these projects similarly. In the case of the Camelot Inn, for example, it was petitioner who suggested the site to be acquired and that a motel be erected. Perrault agreed that it would be a good project so the site was acquired using Perrault's funds. Petitioner's duties with respect to the projects included supervising construction, hiring subcontractors to do the specialty work, approving payrolls, making payments for materials, approving change orders, and approving interim payments to

subcontractors. Additionally, in the cases of the Mansion House and the University Club Tower which were financed through an F.H.A. guarantee, it was petitioner who had sole responsibility for developing the final figures necessary to obtain the financing. Petitioner also performed a number of duties jointly with Perrault, such as selecting the architects for the projects and obtaining permanent financing for the Camelot Inn. Subcontracts were mutually agreed upon before signing, which either Perrault or **Wheeler** had the authority to do.

Petitioner did not report any current operating revenues nor did he deduct any expenses with respect to the projects on his Federal income tax returns for the years in issue. Rather, during the period of years that the projects were operated under the Perrault-**Wheeler** arrangement and before the properties were sold, Perrault reported all the current operating income and deducted all the expenses with respect to the projects. Upon sale of the properties, the profit reported by Perrault was the gain on the sale of the projects reduced by petitioner's 25 percent share, that is, petitioner's share was taken off the top.

After completion of the projects, and a brief period of operation, the Camelot Inn, University Club Tower, and Mansion House were sold to the Kin-Ark Oil Company on May 23, 1968, in exchange for Kin-Ark Oil Company stock and debentures.

Kin-Ark Oil Company was a small conglomerate whose stock was traded on the American Stock Exchange. Average trading volume for the stock was approximately 10,000 shares per month. The company had incurred losses in each of the three years preceding the year of sale.

Petitioner's share of the sale proceeds was 32,029 shares of unregistered Kin-Ark Oil Company stock which was subject to an investment letter restriction, unregistered Kin-Ark Oil Company convertible debentures,[2] and a note from the University Club
886 *886 of Tulsa in the face amount of $37,500.[3] As part of the agreement Kin-Ark Oil Company was to use its best efforts to effect registration of the stock within approximately eight months after consummation of the sale. The stock was eventually registered sometime in early 1969.

Petitioner reported the proceeds in 1968 as his share of joint venture capital gain, and not as compensation for services. Although the stock which he received traded on the American Stock Exchange at a mean price of $5.875 per share on the date of receipt, petitioner reported the stock as having a value of $2.15 per share on that date. Petitioner subsequently sold that same stock in April 1969 for approximately $7.39 per share. Similarly, while the face value of the debentures he received was $200,000, petitioner reported them as having a fair market value of $135,844 on the date of their receipt. Petitioner sold the debentures in September 1969 for $151,784.50. Finally, the $37,500 note, which was petitioner's share of a debt owed the joint venture by the University Club of Tulsa, was reported for Federal income tax purposes as having a value of $25,000. The club settled the note in full for $33,750 in 1969. Thus, in tabular form, petitioner reported the 1968 and 1969 transactions as follows:

	Sale Price	Cost (Value at 5-23-68)	Capital Gain
32,029 Kin-Ark common	$236,841.90	$ 68,741	$168,100.90
200M Kin-Ark debentures	151,784.50	135,844	15,940.50
Cash—**Wheeler**-Perrault Venture[4]	33,750.00	25,000	8,750.00
Cash—from Perrault[5]	25,163.00	—	25,163.00
Totals	$447,539.40	$229,585	$217,954.40
Reported long-term capital gain			$108,977.20

Respondent, in the notice of deficiency, objected to not only the characterization and timing of the income reported by petitioner, but also to the values which petitioner assigned to each of the three instruments discussed above. Respondent asserted that

the proceeds which petitioner received from the sale of the projects were not his share of joint venture capital gain, but rather were compensation for services. He further asserted that the investment letter restriction to which the stock received by petitioner was subject was such a severe restriction that no income was realized in the year of receipt, but rather in the year the restriction lapsed. As a result, he included the stock in petitioner's income in 1969 at its full unrestricted value on the date of its receipt (May 23, 1968) in accordance with section 1.421-6(d)(2)(i), Income Tax Regs. As for the debentures, respondent maintained that the value was not $135,844 as reported by petitioner, but rather $150,000. Finally, respondent determined that the University Club note had a fair market value of $33,750 on the date it was received by petitioner. Thus, respondent treated the transactions as follows:

887 *887

	Received In 1969	Ordinary Income In 1968	Ordinary Income In 1969	Capital Gain In 1969
32,029 Kin-Ark common	$236,841.90	$	$188,170.38	$48,671.52
200M Kin-Ark debentures	151,784.50	150,000	.....	1,784.50
University Club note	33,750.00	33,750	.....	.....
Cash from Ainslie Perrault	25,163.00	.....	25,163.00	.....
Totals	$447,539.40	$183,750	$213,333.38	$50,456.02
Recognized Capital Gain				$25,228.01

Opinion

Briefly restated, petitioner entered into an agreement with Perrault to acquire and develop specific tracts of real property. Petitioner was to provide the "know-how" and Perrault the necessary finances. It was agreed that Perrault should recoup his investment plus a six percent interest factor, and that remaining profits, if any, were to be divided 75 percent to Perrault and 25 percent to petitioner. The parties followed through with their agreement and, among others, constructed the Camelot Inn, the University Club Tower and the Mansion House, all located in Tulsa, Okla. These properties were sold in 1968 to Kin-Ark Oil Company in exchange for unregistered common stock and convertible debentures of Kin-Ark Oil Company plus unsecured notes of the University Club of Tulsa, a tenant in the University Club Tower. Petitioner had the stock, debentures and note which he received in 1968 appraised and reported this transportation for Federal income tax purposes as a long term capital gain based on the appraised values. In 1969, petitioner sold the stock and debentures and received payment on the University Club note. On the basis of these transactions he reported long term capital gain on his 1969 Federal income tax return.

The salient issue which emerges from this set of facts is one of income characterization. This issue must necessarily be resolved by a determination of whether the agreement between petitioner and Perrault was one of joint venture or one of employment. Thus, we must determine the elements necessary to form a valid joint venture and whether those elements existed in the case before us.

Setting forth the particular elements of a joint venture is not as easy as might appear. A threshold issue we need determine is whether Federal or local law is determinative of the existence of a joint venture for Federal income tax purposes. In the instant case both parties assumed Oklahoma law alone was applicable in determining whether a joint venture had been formed. However, we to not agree.[6]

This and other courts have previously had to deal with the problem of whether Federal or local law is determinative of the existence of a joint venture for Federal income tax purposes. These decisions have not been consistent nor have they

addressed other decisions apparently to the contrary. In each instance the court determined which body of law was to apply in deciding whether a joint venture arrangement existed without explanation as to why that particular body of law should apply.

A "joint venture" is not specifically defined by the Internal Revenue Code of 1954. The closest thing to a definition appears in both section 761(a) and section 7701(a)(2) where it is stated that "the term `partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization".[7] However, because a joint venture is an entity taxable as a partnership, cases dealing with the choice of law question with respect to partnerships are of probative value.[8]

The Supreme Court has thrice dealt with the Federal-state choice of law problem in relation to partnerships. *Commissioner v.*
888 *888 *Culbertson* [49-1 USTC ¶ 9323], 337 U.S. 733 (1949); *Commissioner v. Tower* [46-1 USTC ¶ 9189], 327 U.S. 280 (1946); *Lusthaus v. Commissioner* [46-1 USTC ¶ 9190], 327 U.S. 293 (1946). In each of the three cases the Court tested for the existence of a partnership using a Federal standard, ignoring the result at which an application of local law would have arrived. [9]

However, lower courts have differed as to whether the similarity of a joint venture to a partnership is sufficient to include a joint venture within the umbra cast by the trilogy of cases decided by the Supreme Court. There are a number of cases which hold Federal law determinative of the existence of a joint venture for Federal income tax purposes. *Estate of Kahn v. Commissioner* [74-2 USTC ¶ 9524], 499 F. 2d 1186 (2d Cir. 1974), affg. a Memorandum Opinion of this Court [Dec. 31,623(M)]; *Arthur Venneri Co.v. United States* [65-1 USTC ¶ 9190], 340 F. 2d 337 (Ct. Cl. 1965); *Haley v. Commissioner* [53-1 USTC ¶ 9350], 203 F. 2d 815 (5th Cir. 1953); *First Mechanics Bank v. Commissioner* [**37**-2 USTC ¶ 9393], 91 F. 2d 275 (3d Cir. 1937); *Herzberg v. United States* [59-2 USTC ¶ 9578], 176 F. Supp. 440 (S.D. Ind. 1959); *Luna v. Commissioner* [Dec. 26,967], 42 T.C. 1067 (1964); *Beck Chemical Equipment Corp. v. Commissioner* [Dec. 22,265], 27 T.C. 840 (1957).[10] There are, however, also cases which appear to apply a state law standard. *Joe Balestrieri & Co.v. Commissioner* [49-2 USTC ¶ 9479], 177 F. 2d 867 (9th Cir. 1949); *Fishback v. United States* [63-2 USTC ¶ 9555], 215 F. Supp. 621 (D.S.D. 1963); *Frazell v. United States* [63-1 USTC ¶ 9244], 213 F. Supp. 457 (W.D. La. 1963), revd. and remanded on other grounds [64-2 USTC ¶ 9684] 335 F. 2d 487 (5th Cir. 1964), petition for rehearing denied per curiam 339 F. 2d 885 (5th Cir. 1964), cert. denied 380 U.S. 961 (1965); *Flanders v. United States* [59-1 USTC ¶ 9424], 172 F. Supp. 935 (N.D. Cal. 1959); *Copeland v. Ratterree,* an unreported case (N.D.N.Y. 1957, 52 AFTR 1309, 57-2 USTC ¶ 9895); *Tate v. Knox* [55-1 USTC ¶ 9483], 131 F. Supp. 514 (D. Minn. 1955). Finally, there are those cases which do not state whether a Federal or local law standard is being applied. *S. & M. Plumbing Co.v. Commissioner* [Dec. 30,634], 55 T.C. 702 (1971); *Podell v. Commissioner* [Dec. 30,456], 55 T.C. 429 (1970); *Au v. Commissioner* [Dec. 26,110], 40 T. C 264 (1963), affd. [64-1 USTC ¶ 9447] 330 F. 2d 1008 (9th Cir. 1964), cert. denied 379 U.S. 960 (1965).[11] See also *Smith v. Commissioner* [Dec. 15,862], 8 T.C. 1319 (1947). Thus it can be seen that we have an issue, the resolution of which is anything but clear.

The fact that there is a Federal standard for partnerships, we believe, provides a strong inference that the standard governing the existence of joint venture is likewise Federal.[12] As previously stated, sections 761(a) and 7701(a)(2) provide that "the term `partnership' includes a * * * joint venture." It seems patently unreasonable that the term "partnership" as used in the Code should be defined utilizing a Federal standard and that the term "joint venture," an entity subsumed within the term "partnership" for Federal income tax purposes, should be defined utilizing standards of local law. To do so would open the door for potential conflict because a joint venture as defined under local law might not bear the necessary indicia of partnership as that term is defined for Federal income tax purposes. Conversely, an entity, not technically a joint venture under local law, may well be an entity taxable as a partnership for Federal income tax purposes.[13]

889 *889 Additionally, everything stated by the Supreme Court in the *Tower, Lusthaus,* and *Culbertson* cases is equally applicable to joint ventures. *Beck Chemical Equipment Corp. v. Commissioner, supra.* In those three cases the paramount concern of the Court was that if classifications were left to determinations of state law, problems of form over substance would abound. As a result the Supreme Court found it necessary that the word "partnership" for purposes of Federal income taxation mean something other than the word "partnership" for purposes of state law. Federal tax statutes are designed to accomplish different purposes and goals than are state statutes. State courts are mindful of the purposes and goals of the state statutes when they classify an entity.[14] When an entity must be classified for purposes of a Federal income tax statute, policy considerations of Federal income tax law should govern that classification, not policy consideration of state law.[15]

From the foregoing, the process of inductive reasoning should lead us to a rule of law stated generally as follows:

> Whether or not a joint venture exists for tax purposes is determined by applying the same tests used in determining the existence of a partnership. * * * Though it has been held that state law applies in determining whether there was a joint venture, the sounder view seems to be that state law is not determinative. * * * [6 Mertens, Law of Federal Income Taxation, sec. 35.05, p. 29.] [Fn. refs. omitted.]

Having decided that a Federal standard is appropriate, we must proceed to determine what that standard is. Again the trilogy of Supreme Court cases must first be examined to see if they offer any guidance. In the case of *Commissioner v. Culbertson, supra,* it is stated that the primary consideration in determining whether an entity taxable as a partnership exists is whether:

> the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. * * * [337 U.S. at 742]

See also *Luna v. Commissioner, supra.* Thus the single most important consideration is the parties' intent to enter into a joint venture. And there are particular elements, none of which are conclusive, which are indicative of the existence or nonexistence of such intent. They are:

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to
> 890 respondent or to persons *890 with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise. [*Luna v. Commissioner, supra* at pp. 1077-1078.]

The agreement between the parties seems fairly clear in this case. It specifically stated:

> The parties hereto are associated in a joint venture, under the name of "Perrault and **Wheeler**", for the purpose of holding, developing, and managing real property for investment purposes.[16]

It was further stated:

> The venture shall relate to and include the projects described on Exhibits "A", "B', and "C" attached hereto and such other projects as Perrault and **Wheeler** shall *mutually agree upon* and designate from time to time * * * [Emphasis supplied.]

The actual conduct of the parties supported the existence of a joint venture agreement between the parties. It was petitioner who exercised his authority on a day-to-day basis in selecting subcontractors, signing subcontracts, approving payrolls, approving interim payments to subcontractors, approving payments for materials, approving change orders in construction, and negotiating the F.H.A. commitments among other things. While any one of these duties may not raise one to the status of a joint venturer, the total authority granted to petitioner was certainly consistent with such status.

Petitioner was to use his best efforts and so much of his time as was reasonably necessary for the successful completion of the projects; his efforts were to be particularly related to the acquisition, ownership, development and operation of real estate and improvements thereon. Perrault was to contribute cash, credit, or other financing for the purchase and development of the projects covered by the agreement.

Little control was exercised over the petitioner's drawing account. He testified that his drawing account was very informal with no restriction as to amount. This seems supported in the record because at the point in time in 1969 when petitioner released his interest in the Villa Roma project he had a debit balance in his drawing account in the amount of $12,162.

Profits were to be allocated 75 percent to Perrault and 25 percent to petitioner. Cumulative losses were to be borne solely by

Perrault; however, once operation of the venture resulted in a profit on a cumulative basis, losses on individual projects were to be allocated in accordance with the ratios indicated above.

Business was transacted under the name of "Perrault and **Wheeler**." The parties maintained an office in which they based their business operations. The stationery bore a "Perrault and **Wheeler**" letterhead. Advertising for the real estate projects also indicated a partnership type relationship between the parties.

Additionally, we believe the manner in which Perrault reported the sales transaction for tax purposes is highly significant in seeking to determine intent. Perrault did not report 100 percent of the profit and then take a deduction for petitioner's share as compensation, even though it would have had significant tax advantages for him to have done so. This indicates to us that Perrault, who for tax purposes had an interest adverse to the existence of a joint venture, intended that a joint venture exist between himself and petitioner. Of course, petitioner likewise reported the transaction as if a joint venture existed between the parties.

Separate books of account were maintained for the venture's operations. Perrault was given the authority to keep those books by means of which the net profits of the venture were to be computed, subject however to **Wheeler's** right of examination at all reasonable times. Cf. *Estate of Kahn v. Commissioner, supra.* The books were required to be kept using a generally accepted
891 method of accounting and petitioner could submit any dispute to Arthur Anderson & Co., certified public accountants, *891 whose determination on the disputed matter would be conclusive on the parties.

Respondent argued at trial that the fact Perrault reported all current operating income and current operating expenses from the operation of the projects was fatal to the finding of a joint venture because it indicated that petitioner did not truly share in the results of the venture's operations. However, this is not so. The agreement stated that petitioner was not to receive any distribution of profits until Perrault received, out of his share of operating income or sales proceeds (from the projects), an amount equal to his capital and advances plus six percent interest thereon. The agreement also provided that Perrault was to bear all losses in connection with each project until operation of the projects, on a cumulative basis, resulted in a profit. In the relatively brief period that the joint venture actually operated each of the projects there was not a sufficient amount of operating income generated to entitle petitioner to begin receiving his share of the profits. As a result, Perrault's reporting of all income and expenses during this period comported perfectly with the agreement between the parties and was not adverse to the existence of a joint venture interest in petitioner.

To be sure, there are factors in the agreement which tend to indicate the relationship between the parties was not that of a joint venture. Title to the properties was held solely in Perrault's name.[17] Cumulative losses of the venture were to be borne solely by Perrault. Petitioner could not borrow or lend money on behalf of the venture, execute a security instrument, release any debt or claim except upon payment in full, compromise or submit to arbitration any controversy involving the venture or to sell, assign, pledge, or mortgage his net profits interest in the venture. However, these restrictions on petitioner's authority were merely protection for Perrault's capital advances, and characteristics such as Perrault's holding title to the properties or bearing all the losses have been specifically recognized by respondent as insufficient to negate the existence of a joint venture. Rev. Rul. 54-84, 1954-1 C.B. 284. Perrault was also restricted in his authority to deal with assets of the venture, and although he was not restricted as severely as petitioner, the restriction on Perrault was designed to accomplish the same purpose as those on the petitioner, that is to protect the other party's share of the joint venture income.[18]

A relationship having salient characteristics similar to the one here at issue has been recognized by respondent as a joint venture. In Rev. Rul. 54-84, *supra,* respondent held that the combination of service and capital partners, the absence of loss sharing, and title being held to venture property by one venturer (the one who made the capital contributions) was not fatal to the existence of a joint venture. Without specifically passing on the validity of the above ruling, we believe petitioner's contribution of his skill and know-how in developing commercial realty and Perrault's contribution of the capital necessary to get the projects under way were essential elements of the business enterprise. While not entirely free from doubt, we believe the totality of the relationship between the parties must be viewed as a joint venture.[19]

The remaining issues for our resolution concern problems of valuation. Both parties briefed these issues as if we would have to determine the timing and amount of compensation for services rendered (i.e., they assumed a ruling adverse to petitioner on

the classification issue). In order to increase the amount of compensation received by petitioner, respondent asserted in the notice of deficiency that the stock had no ascertainable fair market value upon receipt because of the investment letter restriction, but that fair market value could be determined only at such time as the restrictions lapsed. See section 1.421-6(d)(2)(i), Income Tax Regs. Petitioner contended that the property had an ascertainable fair market value on the date of receipt so as to have a lesser amount taxed as compensation at ordinary income rates, and a greater amount of subsequently realized
892 capital gain. In light of our resolution of the first issue, that petitioner's *892 share of the proceeds represented his distributable share of joint venture capital gain income, it is not clear that the positions of the parties would remain as they argued at trial and on brief because it now appears that we have an issue which is only one of timing. However, because the problem of valuation (including the question of whether the stock received had an ascertainable fair market value on the date of receipt, a question which goes to the issue of timing) is factual in nature, we will utilize the contentions of the parties to aid us in arriving at the proper resolution of the timing and valuation issues.

In the 1968 exchange, petitioner gave up his interest in three parcels of improved real property owned by the joint venture in exchange for 32,029 shares of unregistered stock of Kin-Ark Oil Company, unregistered convertible debentures of Kin-Ark Oil Company and a note of the University Club of Tulsa. The stock, as traded on the American Stock Exchange, had a mean price of $5.875 per share on May 23, 1968, the date the sale transaction took place. However, petitioner reported the stock on his return as having a value of $2.15 per share. Petitioner contends that this value is appropriate taking into account discount factors based on the investment letter restriction to which the stock received was subject, a blockage factor attributable to the large number of shares received, and the possibility that the stock would be delisted because Kin-Ark Oil Company had incurred losses in each of the three preceding years. The unregistered convertible debentures had a face value of $200,000 but were reported by petitioner on his return as having a fair market value of $135,844 on the date of their receipt. Petitioner supports this discount based on the fact that the company was incurring losses and because the equity portion of the balance sheet was fairly modest when compared with the total capital structure of Kin-Ark Oil Company. However, respondent contends the appropriate value to have been $150,000. Finally, the University Club note had a face value of $37,500 but was reported by petitioner as having a value of $25,000 on the date it was received due to the "shakey financial condition of the club." Respondent contends the value of the note to have been $33,750.

The standard of fair market value is easily articulated, to wit:

> the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both being reasonably informed as to all relevant facts. [*Jack Daniel Distillery v. United States* [67-2 USTC ¶ 9499], 379 F. 2d 569 (Ct. Cl. 1967.)]

Unfortunately, the application of that standard is not self-executing. Nonetheless, that standard must be applied and a value derived for each of the three items received by petitioner in exchange for his interest in the joint venture property.

The first item which must be valued is the restricted common stock of Kin-Ark Oil Company. In order to do so some of the cases which have valued restricted stock will be examined.

There may be times when stock is so severely restricted that it does not have an ascertainable fair market value. *Helvering v. Tex-Penn Oil Co.* [**37**-1 USTC ¶ 9194], 300 U.S. 481 (1937); *MacDonald v. Commissioner* [56-1 USTC ¶ 9284], 230 F. 2d 534 (7th Cir. 1956), reversing [Dec. 20,651] 23 T.C. 227 (1954); *Propper v. Commissioner* [**37**-1 USTC ¶ 9236], 89 F. 2d 617 (2d Cir. 1937); *Kuchman v. Commissioner* [Dec. 18,934], 18 T.C. 154 (1952). However, this is the exception rather than the rule. More often, although a restrictive sales agreement will have a depressing effect on value, it will not render the value of the stock indeterminable. *Heiner v. Gwinner,* [40-2 USTC ¶ 9663], 114 F. 2d 723 (3d Cir. 1940), cert. den. 311 U.S. 714 (1940); *LeVant v. Commissioner* [67-1 USTC ¶ 9387], 376 F. 2d 434 (7th Cir. 1967); *Victorson v. Commissioner* [64-1 USTC ¶ 9198], 326 F. 2d 264 (2d Cir. 1964); *Husted v. Commissioner* [Dec. 28,392], 47 T.C. 664 (1967); *Arc Realty Co.v. Commissioner* [Dec. 24,230], 34 T.C. 484 (1960); *Kalech v. Commissioner* [Dec. 20,818], 23 T.C. 672 (1955). We think that in light of the circumstances here present, such as the agreement by Kin-Ark Oil Company to utilize its best efforts to effect registration of the stock within approximately eight months after the transaction and the possibility of a private sale during the interim, that the Kin-Ark Oil Company stock was not "so severely restricted" that it did not have an ascertainable fair market value on May 23, 1968, the date of its receipt by petitioner.

Before proceeding, it should be noted that petitioner's subsequent sales of the instruments being valued may play a part in the
893 valuation process. In the present *893 case petitioner received Kin-Ark Oil Company stock, Kin-Ark Oil Company debentures, and the note from the University Club of Tulsa. Within the year following the year of receipt petitioner sold all three items. To the extent factors external to the character of the instruments themselves do not contribute to any dramatic increase, we believe the subsequent sales prices are probative evidence of fair market value on the date of receipt. Courts have utilized subsequent events in the bad debt area which requires a determination of worthlessness, *Minneapolis, St. Paul Railroad Co.v. United States* [64-1 USTC ¶ 9213], 164 Ct. Cl. 226 (1964); *Portland Manufacturing Co.v. Commissioner* [Dec. 30, 729], 56 T.C. 58 (1971), as well as in the cases of valuation generally. *Estate of Brown v. Commissioner* [70-1 USTC ¶ 12,683], 425 F. 2d 1406 (5th Cir. 1970); *Arc Realty Co. v. Commissioner, supra*[20] *Couzens v. Commissioner* [Dec. 3931], 11 B.T.A. 1040, 1165 (1928). However, care must be used in utilizing such sales as evidence of value and proper regard must be given to factors arising in the interim between the date of valuation and the date of sale. Clearly, the proximity of such sale to the valuation date will greatly influence the weight to be accorded such sale in the valuation process.

Because of the proximity of the subsequent sales to the date of receipt by petitioner, and the absence of any evidence showing outside factors which would explain marked fluctuations in value between the date of receipt by petitioner and the date of sale, we do find the later sales prices highly probative evidence of the correct value of the instruments received by petitioner on May 23, 1968. At a minimum, these later sales indicate what the buyer and seller might reasonably have expected the value of the instruments to be on the valuation date. Now we must proceed to value each specific instrument on that date.

It may be possible that a letter agreement restriction could in some instances cause a discount from market value by as much as 60 percent, the amount contended by petitioner. However, the situation here was not one where petitioner's stock was subject to an investment letter restriction and petitioner had no rights of his own apart from those restrictions; rather, he had an agreement with Kin-Ark Oil Company that it was to use its best efforts to effect registration within approximately eight months after the date of the sale. In light of this ancillary agreement with Kin-Ark Oil Company and considering the later sales prices received by petitioner for the Kin-Ark Oil Company stock, we hold that a 60 percent discount factor is excessive. However, we do feel that some discount due to the investment letter restriction is appropriate, and estimating as best we can from the evidence presented, we hold the appropriate discount to be 10 percent.

Petitioner also maintains that a discount was appropriate in recognition of the blockage factor. An excellent discussion of blockage is contained in the case of *Bankers Trust Co.v. United States* [75-2 USTC ¶ 9593], 518 F. 2d 1210, 1221-1222 (Ct. Cl. 1975), cert. den. 424 U.S. 966 (1976), where it is stated:

> While a large block of shares dumped on the market at one moment will ordinarily depress the market price for a time, *Seas Shipping Co.v. Comm'r, supra* 371 F. 2d at 530, the courts which have considered the blockage issue have concluded that the problem should be treated in terms of whether the market could have absorbed the shares within a reasonable period of time. *Richardson v. Comm'r* [45-2 USTC ¶ 10,225], 151 F. 2d 102 (C.A. 2, 1945), *cert. denied* 326 U.S. 796, 66 S. Ct. 490, 90 L. Ed. 485 (1946); *White Farm Equipment Co., supra,* 61 T.C. at 215. In those cases in which either a blockage discount has been allowed or the market price disregarded entirely because too large a block was involved, the number of shares being valued was very much greater than the total shares traded in a year. See, e.g., *Amerada Hess Corp., supra,* 517 F. 2d at 89, 91 (665,000 shares being valued; 444,000 traded during entire year); *Moore-McCormack Lines, Inc., supra,* 44 T.C. at 760 (300,000 shares being valued; 166,000 traded during entire year). * * *

In the case before us petitioner received 32,029 shares of Kin-Ark Oil Company stock. Testimony by petitioner's witness at trial indicated that the average trading volume for the Kin-Ark Oil Company shares during the first five months of 1968 was in excess
894 of 10,000 shares per month. Clearly, the 32,029 shares received by petitioner were far below the total *894 number of shares traded in a year. We think that the market would absorb petitioner's shares within a reasonable period of time. As a result, a blockage discount is inappropriate.

Nor should any discount be allowed merely because of the possibility the stock could be delisted as of December 31, 1969. We believe the investing public would be aware this possibility existed and the market price would accordingly reflect the depressing effect which this possibility had on the stock's value.

Therefore, based on all the evidence in the present case, we find the value of the Kin-Ark Oil Company stock to have been $169,353 at the time it was received by petitioner in 1968.

Turning now to the debentures, petitioner reported them as having a value of $135,844 on the date of their receipt. Testimony from petitioner's expert witness indicated that this discount from the $200,000 face value was in recognition of the high risk nature of the security. This risk was attributable to the following factors; the company was incurring losses, the equity portion of the balance sheet was fairly modest when compared with its total capital structure, and the securities were not readily marketable. A high rate of return (13 percent) was utilized by petitioner's appraiser to reflect the necessity that these debentures had to yield an attractive investment return in order to offset the risks associated with those securities.[21] However, while we are convinced that a substantial discount from face value is appropriate, the burden of proof to establish a value lower than that asserted by the Commissioner is on the taxpayer. *Welch v. Helvering* [3 USTC ¶ 1164], 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure. Although the petitioner herein has certainly established that a discount from face is appropriate, it was incumbent upon him to lay a foundation from which this Court could sufficiently quantify the fair market value of the debentures to show that they had a value lower than the $150,000 value asserted by the Commissioner. We feel he has not done this, and accordingly we find the Commissioner's value of $150,000 is correct.

The same must be said with respect to the note of the University Club of Tulsa which had a face value of $37,500, but was reported by petitioner as having a value of $25,000 on the date of its receipt. Petitioner testified that the $12,500 discount reflected the "very shakey" financial condition of the club due to undercapitalization, the fact that enthusiasm for the club had waned due to a delay in construction, and the fact that the club had overextended its financial resources in spending too much money for interior finishing. Once again, while these factors would all tend to indicate the note had a value less than face, petitioner has failed to demonstrate that a value lower than the $33,750 value asserted by the Commissioner is appropriate. *Welch v. Helvering, supra;* Rule 142(a), Tax Court Rules of Practice and Procedure. Accordingly, we hold the fair market value of the note on May 23, 1968, to have been $33,750.

Decision will be entered under Rule 155.

[1] All statutory references are to the Internal Revenue Code of 1954 as in effect for the years in issue.

[2] The conversion price of the debentures was $5.60 per share.

[3] While the parties here have stipulated that the note was part of the sales proceeds, there is evidence in the record that the note was owned by the Perrault-**Wheeler** business entity prior to the sale and that it was not actually part of the sales proceeds. However, because the parties have stipulated that the note was part of the sales proceeds, we find accordingly.

[4] This represents a note from the University Club of Tulsa. Although petitioner treats the proceeds from this portion of the transaction as the proceeds of a sale or exchange, it was actually proceeds from the satisfaction of indebtedness. However, because of our holding as to the value of the note on the date it was received by petitioner, it will not be necessary for us to raise an issue as to the characterization of the proceeds of the note.

[5] Although not clear from the record, this figure apparently represents a payment by Perrault to petitioner for petitioner's relinquishment of his interest in a fourth project of the venture (Villa Roma). This apparently occurred in 1969 and payment received by petitioner was in the form of a credit against his prior advances and cash. A discrepancy appears in the record as to the precise amount of this final settlement, but, if necessary, this can be resolved by the parties in the Rule 155 computation.

[6] We cannot reconcile respondent's position here with his position in Rev. Rul. 54-85, 1954-1 C.B. 284, finding a particular business entity a joint venture without knowing the status of the entity under local law.

[7] See J. Sullivan, "Conflicts Between State Partnership Laws and the Internal Revenue Code," 15 Tax L. Rev. 105, 113 (1959), where the generally broader classification of the term partnership in the Internal Revenue Code is specifically noted. See also section 301.7701-3(a), Proced. & Admin. Regs.

[8] Id. at 230-231, where is is stated:

Joint ventures, the last of the specifically enumerated classes considered as partnerships, are generally considered to be partnerships and subject to the same rules as partnerships. Some efforts are made to distinguish them from partnerships on the ground that they are intended to carry out a specific transaction or a single enterprise rtaher than carry on a continuing business.90 Neither such distinctions nor

limited applicability of partnership law to some aspects of joint venture operations or the actions of the members of joint ventures justify different treatment for tax purposes. [Fn. ref. omitted.]

See also 6 Mertens, Law of Federal Income Taxation, sec 35.05, p. 29, which states:

Whether or not a joint venture exists for tax purposes is determined by applying the same tests used in determining the existence of a partnership. * * *

[9] See *Earp v. Jones* [42-2 USTC ¶ 9765], 131 F. 2d 292 (10th Cir. 1942), where an entity recognized as a partnership under Oklahoma law was held not to be a partnership for Federal income tax purposes. See also *Kelly v. Commissioner* [Dec. 30,317(M)], T.C. Memo. 1970-250, where the Tax Court stated, "there may be a partnership for Federal income tax purposes even though there is no partnership as a matter of State law."

[10] *Baughn v. Commissioner* [Dec. 29,887(M)], T.C. Memo. 1969-282; *Badger Co.v. Commissioner* [Dec. 28,592(M)], T.C. Memo. 1967-178.

[11] *Melbourne Ranches, Inc. v. Commissioner* [Dec. 31,029(M)], T.C. Memo. 1971-264.

[12] Indeed, section 301.7701-1(c), Proced. & Admin. Regs., states: the classes into which organizations are to be placed for purposes of taxation are determined under the Internal Revenue Code. * * *

[13] See *Kelly v. Commissioner,* cited at footnote 9, *supra.*

[14] In *Estate of Kahn v. Commissioner, supra,* a state court in a previous case involving the taxpayer wanted to find a partnership so the taxpayer's associate could maintain an action for an accounting under state law. This Court and the Court of Appeals found no partnership so Kahn (the taxpayer) would be taxed on all the funds with which he absconded.

[15] While the parties here agree that the issue is whether a joint venture was formed between petitioner and Perrault, and apparently most courts would approach the problem in this manner, it may well be that the best approach to the issue before us lies not in determining whether a joint venture has been formed, but rather whether an entity taxable as a partnership has been formed. In the statute it seems as though the terms "syndicate," "group," "pool," and "joint venture" are merely illustrative of the concept of an entity taxable as a partnership under Federal tax law and the "catch-all" phrase "or other unincorporated organization" is intended to bring within the meaning of the term partnership entities of a kind like those specifically enumerated. Thus, the key determination using this approach would not be whether a joint venture or any other of the enumerated entities had been formed, but rather whether an entity is of the same generic class as those entities and is, therefore, taxable as a partnership. This approach was used in *Bartholomew v. Commissioner* [51-1 USTC ¶ 9150], 186 F. 2d 315 (8th Cir. 1951), and apparently in *Estate of Kahn v. Commissioner, supra.* For instance this Court in *Kahn* dealt specifically with the issue of whether a joint venture had been formed which would then be taxable as a partnership. See *Grober v. Commissioner* [Dec. 31,623(M)], T.C. Memo. 1972-240. We applied a Federal standard to find no joint venture had been formed. However, the Second Circuit, in affirming our decision, seemingly ignored the intermediate step of determining whether a joint venture had been formed and went directly to the question of whether an entity taxable as a partnership had been formed. Clearly this latter approach would entail the use of a Federal standard because the Supreme Court has stated that the ultimate determination of whether an entity is taxable as a partnership is to be governed by a Federal standard. *Commissioner v. Culbertson, supra; Commissioner v. Tower, supra; Lusthaus v. Commissioner, supra.* See also J. Sullivan cited at footnote 8, *supra.*

[16] Paragraph 10 of the agreement between Perrault and petitioner stated:

The parties stipulate and agree that no partnership has been or is hereby created or intended between them. The parties shall be joint venturers only and only with respect to the projects herein designated and upon the limited basis herein set forth. Pursuant to Section 761(a) of the Internal Revenue Code of 1954, Perrault and **Wheeler** hereby elect to exclude this venture from the application of all or any part of the Subchapter K, Subtitle A, Chapter I of the Internal Revenue Code of 1954, to the full extent permitted by regulations issued by the Secretary of the Treasury or his delegate. Perrault may cause to be filed with the Internal Revenue Service an appropriate election on behalf of himself and **Wheeler** to be so excluded.

[17] Although title to the property was held in Perrault's name, there are indications in the record that the parties intended petitioner's interest in the properties to be one of ownership. For instance, in documents filed with the Federal Housing Administration Perrault listed petitioner as a co-owner of the Mansion House and University Club Tower.

[18] Paragraph 5(d)(ii) of the agreement between Perrault and petitioner stated: "Perrault shall not, however, withdraw or utilize funds of the venture for any purpose unrelated to the venture unless the venture has retained, after such withdrawals, sufficient cash or liquid assets to equal **Wheeler's** share of the profits."

[19] Because of our resolution of this issue in favor of petitioners, we need not decide the income averaging issue which petitioners only sought to raise if the income received was determined to be compensation for services rendered.

[20] *Mills v. Commissioner,* a Memorandum Opinion of this Court dated Aug. 19, 1946.

[21] In valuing the debentures, petitioner assumed the stock had a fair market value of $2.15 per share and that the convertible feature was of no value. However, in light of the value which we have determined the stock to have had, the convertible feature does have significance in valuing the debentures.

Full Text of Court Cases

Williams v. Williams

Case name: Williams v. Williams
Citation: 667 So. 2d 915
Date of decision: February 7, 1996
Country: US
State or Federal: State
State/Jurisdiction: Florida
Court: Court of Appeals
Type of action: Marital Dissolution
Judge: Ryder
SIC: 8721 Accounting, Auditing, and Bookkeeping Services (auditing accountants)
NAICS: 541219 Other Accounting Services
61

Keywords: Professional practice

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Judges: Ryder, Danahy, and Fulmer

Opinion by: Ryder

Verne Williams, the former husband, seeks review of the lower court's valuation of property for purposes of equitable distribution. He also challenges the court's decision to award primary custody of his son to the former wife, Kim Williams. We affirm the custodial determination without discussion. We likewise affirm the court's valuation of the parties' marital residence, known as the Clark Road Property. We hold, however, that the trial court erred in assigning a value for goodwill to the husband's accounting practice, Verne Williams Accounting, Inc. Accordingly, we reverse on that issue.

Under Florida law, the goodwill of professional practice can be a marital asset subject to division in a dissolution proceeding, if it exists and if it was developed during the marriage. Thompson v. Thompson, 576 So. 2d 267, 269 (Fla. 1991). The Thompson court emphasized, however, that for goodwill to be a marital asset, it must exist separate and apart from the reputation or continued presence of the marital litigant. 576 So. 2d at 270. The first step in analyzing goodwill is to determine whether it exists. Young v. Young, 600 So. 2d 1140, 1142 (Fla. 5th DCA 1992), review denied, 613 So. 2d 13 (Fla. 1992).

The evidence in this case failed to establish the existence of goodwill in the husband's practice. Mr. Williams was the only accountant in his practice. He performs all of the work himself, and he alone deals with his clients. The Young court noted that, when attempting to determine whether goodwill exists in a practice such as this, the evidence should show recent actual sales of a similarly situated practice, or

expert testimony as to the existence of goodwill in a similar practice in the relevant market. 600 So. 2d at 1142 (citing Hanson v. Hanson, 738 S.W. 2d 429, 435 (Mo. 1987)). The wife's expert discussed sales of other accounting practices, but none were similar to Mr. Williams's. While the expert did mention he knew of a one-man accounting practice that had been for sale in 1993, he gave no details of the sale, nor did he state whether goodwill had been a factor in the sale. Moreover, the husband's expert, who testified the practice had no goodwill, stated that no one would buy the practice without a noncompete clause. This is telling evidence of a lack of goodwill. See Walton v. Walton, 657 So. 2d 1214 (Fla. 4th DCA 1995).

Under these facts, we hold that the evidence failed to show the existence of goodwill in Verne F. Williams, Inc., separate and apart from the reputation and continued presence of Mr. Williams. The trial court, therefore, erred when it valued the business's goodwill at $43,200.00 for purposes of equitable distribution. Accordingly, we remand for further proceedings consistent with this opinion.

Affirmed in part, reversed in part and remanded.

DANAHY and FULMER, JJ., Concur.

Full Text of Court Cases

Estate of Yeager v. Commissioner

Case name: Estate of Yeager v. Commissioner
Citation: T.C. Memo 1986-448, 1986 Tax Ct. Memo LEXIS 157
Date of decision: September 17, 1986
Country: US
State or Federal: Federal
Court: United States Tax Court
Type of action: Estate and Gift Taxation
Judge: Goffe
SIC: 6719 Offices of Holding Companies, NEC
NAICS: 551112 Offices of Other Holding Companies

Keywords: Estate tax, Preferred stock

COUNSEL:

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Robert F. Geraghty, for the respondent.

OPINIONBY:

GOFFE

OPINION:

MEMORANDUM FINDINGS OF FACT AND OPINION

GOFFE, Judge: The Commissioner determined a deficiency in petitioner's Federal estate tax in the amount of $115,601. After concessions, the issues for decision are the fair market value of common and Class B preferred stock in Cascade Olympic Corporation on the alternate valuation date of March 3, 1980, and whether certain corporate stock characterized by the Commissioner as community property was the separate property of the decedent's surviving spouse.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated herein by reference.

Richard O. Yeager (the decedent) died testate on September 3, 1979. At all times pertinent to this case, the decedent resided in Shelton, Washington. The decedent was survived by his wife, Jean (now Mrs. Manning), whom he married on September 8, 1960. Mrs. Manning had two sons by a former marriage,

Mack Davis Elliott and Scott Elliott, and a grandson, Jeffrey Elliott. Throughout their marriage, the decedent and Mrs. Manning were residents of the State of Washington. Mrs. Manning resides in Olympia, Washington.

The mailing address of the Estate of Richard O. Yeager, deceased, Jean M. Manning, Executrix (petitioner), was Shelton, Washington, at the time the petition in this case was filed. Mrs. Manning has been duly appointed and qualified as the personal representative of the decedent's estate. The estate is being administered in the Superior Court of Mason County, Washington. Petitioner filed a timely estate tax return with the Internal Revenue Service in Ogden, Utah, upon which it elected the alternate valuation date of March 3, 1980. The estate tax return reported an estate tax liability of $33,237, which petitioner elected to pay in installments pursuant to section 6166. n1

n1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect at the date of the decedent's death, and all Rule references are to the Rules of Practice and Procedure of this Court.

On the date of his death, decedent owned, among other things, 100 shares of common stock and 50 shares of Class B preferred stock of Cascade Olympic Corporation (hereinafter referred to as Cascade Olympic) as his separate property. The 100 shares of common stock of Cascade Olympic represented 50.25 percent of the voting power in the corporation. Cascade Olympic was the common parent of a group of affiliated corporations as defined by section 1504. The other corporations within this group were Capital Cascade, Inc. (Capital Cascade), Capitol Center, Inc. (Capitol Center), Center Offices, Inc. (Center Offices), and Capital Cascade Investment Corporation (Cascade Investment). Except for the parent corporation, Cascade Olympic, all of the affiliated corporations listed above had only common stock outstanding as of the alternate valuation date. The affiliated corporations were incorporated under the laws of the State of Washington on the following dates: Cascade Olympic, August 13, 1948; Capital Cascade, June 21, 1956; Capitol Center, June 25, 1962; Center Offices, March 21, 1966; Cascade Investment, December 18, 1978. n2

n2 Most of these corporations began existence under another name now held by another of the affiliated corporations. We will refer to each of these corporations solely by its legal name during the period relevant to this case.

Each of the affiliated corporations was owned in part by at least one other member of the affiliated group, although all of the corporations also had minority shareholders who were not members of the affiliated group. The ownership of the common stock of each member of the affiliated group was as follows:

Corporation	Shareholder	Percentage of Ownership	Par Value Per Share	Mumber of Shares of Common Stock
Cascade Olympic	Decedent	50.25	$100.00	100
	Others	49.75		99
				199
Capital Cascade	Cascade Olympic	81.69	$ .40	196,374
	Center Offices	12.48		30,000

	Others	5.83		14,016
				240,390
Capitol Center	Center Offices	86.01	$ .50	34,364
	Others	13.99		5,565
				39,929
Center Offices	Cascade Olympic	39.92	$ 10.00	1,996
	Capital Cascade	42.40		2,120
	Capitol Center	4.14		207
	Others	13.54		677
				5,000

Until his death, the decedent was president, chief executive officer, and a director of Cascade Olympic, Capital Cascade, and Capitol Center. He was the only officer and director of these corporations who was involved in their day-to-day affairs. The decedent was also president of Center Offices until 1979. The presence of the decedent was critical to the operation of both Cascade Olympic and the affiliated corporations.

On the alternate valuation date, March 3, 1980, the officers of Cascade Olympic and Capital Cascade, all of whom were also directors, were as follows: Jean Manning, President; William McCann, Vice-President; and Mack D. Elliott, Secretary-Treasurer. At that date, the officers of Capitol Center, all of whom were also directors, were as follows: Jean Manning, President; Glendon A. Ferguson, Vice-President; and Mack D. Elliott, Secretary-Treasurer. Harold Sargent and Roy McConkey were also directors. The officers of Center Offices, all of whom were also directors, were as follows: Mack D. Elliott, President; P. W. Harrington, Vice-President; and Patricia Kennedy, Secretary-Treasurer. Jean Manning was a director of Center Offices, but not an officer.

On the alternate valuation date Cascade Olympic had three classes of stock, each of which had a $100 par value: common, Class A preferred, and Class B preferred. The owners of the common stock were entitled to vote. The holders of Class A and Class B preferred stock had no voting rights, but were entitled to annual, noncumulative dividends up to a maximum of 5 percent of par value before the payment of any dividends to the holders of common stock. Upon dissolution, the holders of Class A preferred stock were entitled to a preference to the extent of par value and accumulated dividends, if any, while the holders of both Class B preferred and common stock were entitled to share equally in the remaining assets.

As of March 3, 1980, the alternate valuation date, 1,980 shares of Cascade Olympic Class A preferred were outstanding, 200 of which were owned by Capital Cascade and 1,780 of which were owned by individuals other than the decedent or Mrs. Manning. As of that date, the Class A and Class B preferred stock of Cascade Olympic was held as follows:

	Preferred A	Preferred B
Shareholder	Number of Shares	Number of Shares

Decedent		50
Center Offices		120
Capital Cascade	200	232
Others	1,780	119
	1,980	521

The principal assets of Capital Cascade included third-party receivables, real estate, and stock ownership in Center Offices. During the 1960's and until 1975 or 1976, a division of Capital Cascade operated as a construction company, at times employing up to 500 people.

On March 1, 1978, Capital Cascade sold the common stock of an unrelated corporation for $900,000 to CHG International, Inc. (CHG). The contract terms provided for a $50,000 down payment and payments of $6,000 each month thereafter with the balance payable in full on or before 10 years from the date of sale. With interest accruing on the unpaid principal balance at the rate of 8.5 percent per annum, required monthly payments of CHG were insufficient to cover accrued interest on the note.The note provided that the "Maker shall be entitled to a moratorium on monthly payments (not to exceed in the aggregate 36 monthly payments, which may be taken at any time and from time to time in any combination or combinations during the term of this note) * * *." On December 20, 1979, CHG invoked the moratorium provision as of January 1, 1980. Capital Cascade required CHG to pay 3 months of interest payments that were in arrears before permitting the moratorium. At the end of the 3-year moratorium period, CHG settled the obligation.

On December 26, 1978, Capital Cascade and CHG entered into a purported limited partnership agreement to form Talisman Associates. Capital Cascade lent CHG $360,000, secured by a promissory note, which CHG invested in a property known as Talisman Apartments. On that same date, Capital Cascade executed an option on another property on behalf of the partnership. Capital Cascade brought suit in Pierce County Superior Court against CHG to recover the amount due on the Talisman Apartment loan and the price paid for the option. The court concluded, inter alia, that the promissory note was enforceable according to its terms but that the purported partnership agreement and option were unenforceable.

In February 1978, Capital Cascade acquired a note from Bel Corporation (Bel) of Anchorage, Alaska, an unrelated entity, which required Bel to pay the sum of $15,000. Bel defaulted on the note and in February 1979, Capital Cascade brought suit to collect the balance of the note plus interest. Bel answered the lawsuit in March 1979, denying liability on the note and asserting counterclaims. As of December 31, 1979, the unpaid balance of the note was $16,598. In 1980, Capital Cascade concluded that the note was uncollectible and claimed it as a bad debt on its Federal tax return for the taxable year 1980.

On August 10, 1976, Capital Cascade entered into a joint venture agreement with Structurals Northwest, Limited, to participate in the construction of the Comprehensive Health Facility, a hospital in Bethel, Alaska (the Bethel project or the project). The primary involvement of Capital Cascade was to provide financing. Cascade Olympic Construction Company d/b/a Structurals Northwest, Ltd. (the joint venture),

contracted with the prime contractor to furnish and install siding, prefabricated panels, and decking. The joint venture subcontracted its materials and installation responsibilities to H.F. Industries and Adkins Steel Company, respectively.

St. Paul Fire & Marine Insurance Company (St. Paul), on behalf of the joint venture, executed a performance bond in favor of the prime contractor. Indemnity agreements were executed in favor of St. Paul as surety by others, including, Cascade Olympic, Capital Cascade, and the decedent and Mrs. Manning. The Bethel project was scheduled for completion by August 1, 1978, and the contract provided for liquidated damages for any delay in completion in addition to exposure to liability for deficiencies in the project.

The Bethel project was not timely completed. Two major problems developed with the project which affected Capital Cascade. The first was a structural problem with the siding and delamination of panels that could have resulted in potential liability of up to $2 million, but which was eventually resolved by hiding the defect with signs. The second, more substantial problem was that the other joint venturer, Structurals Northwest, and its owner had no money for completing the project nor money for the indemnity agreements. After Capital Cascade advanced $174,000 to the joint venture through the surety, arrangements were made for St. Paul to advance the remainder of the funds needed to complete the project. During 1979, Capital Cascade paid or accrued expenditures for the Bethel project approximating $467,000, representing amounts paid by both Capital Cascade and by St. Paul. As of December 31, 1979, Capital Cascade expected to pay a minimum of $184,000 to complete the Bethel project.

In the fall of 1979, the joint venture owed money to both of its subcontractors, H.F. Industries and Adkins Steel. By the end of 1979, Adkins Steel had stopped work on the project and had joined H.F. Industries in a proceeding under the Miller Act, 40 U.S.C. sec. 270a et seq., to recover damages from the joint venture. In response to the claims under the Miller Act, the joint venture employed engineers to analyze the project's problems and the potential liabilities. The prime contractor also filed a claim with the U.S. Department of Health, Education and Welfare (HEW) for its unwarranted certification requirements that delayed the completion of the project.

By March 3, 1980, Capital Cascade had incurred major losses on the Bethel project and the extent of further losses or potential recoveries was uncertain. The best estimate as of that date as to the losses anticipated on the project was: (1) $50,000 to $200,000 to repair the panels; (2) $500 per day liquidated damages for a period in excess of 19 months; (3) $300,000 maximum exposure in the suit brought by the prime contractor; (4) $66,000 maximum liability to the prime contractor for the cost of heating the building for the subcontractors through two extra winters; (5) uncertain exposure for the delamination problems in a range from zero to $2 million; (6) up to $85,000 liability to Adkins Steel, a subcontractor to the joint venture; and (7) legal and engineering fees of approximately $130,000. Counterbalancing these claims, however, were likely possibilities of recovery for the joint venture's claims against HEW through the prime contractor's suit, the payment of the retainage on the project, and the likelihood of a reduction in the eventual liability for many of the risks listed.

The Bethel project was finally completed on September 30, 1980, and accepted by HEW in February 1981. Capital Cascade recovered a total of $507,000 in the years 1982 and 1983 as a result of the recovery by the prime contractor for its claims against HEW which served to offset some of the losses incurred by Capital Cascade with respect to the hospital. Capital Cascade also recovered $97,000 in

retainage from the prime contractor and approximately $50,000 for extras ordered during the construction process. Capital Cascade's final net loss on the Bethel project was approximately $650,000.

The principal assets of Capitol Center included receivables, the Tacoma Mall Office Building (Tacoma Mall), and stock ownership in affiliated companies. Tacoma Mall was acquired by Capitol Center in 1975. The fair market value of Tacoma Mall on the alternate valuation date was $5,200,000. The outstanding mortgage on Tacoma Mall was placed on the property in early 1968 and it required monthly payments of $17,400. The note, due in full in March 1993, carried an interest rate of seven percent, and included a substantial prepayment penalty. As of the alternate valuation date, the unpaid balance on the note was $1,845,086. The mortgagee was approached after September 1980, about the possibility of a waiver of the prepayment penalties or a discount for prepayment. Although the prevailing interest rate on comparable obligations entered into at or near the alternate valuation date was approximately 12.5 percent, the mortgagee declined to agree to more favorable repayment terms.

All of the income of Capitol Center for the taxable year 1979 was derived from the rental of its principal asset, Tacoma Mall, to an affiliated corporation, Center Offices. n3 Center Offices leased Tacoma Mall from Capitol Center and managed and operated the property. Management problems became apparent, however, after the death of the decedent and Mrs. Manning assumed management of the property from Center Offices from 1980 until April 1981. Thereafter Tacoma Mall was managed by an independent property management firm.

n3 Since 1981, Center Offices has been inactive.

Tacoma Mall was not available for purchase as of the alternate valuation date nor was any sale of the property anticipated at that time. The only justification for a sale of Tacoma Mall in March 1980, would have been to provide cash to advance to Capital Cascade. However, such an infusion of cash would have complicated the efforts of Capital Cascade to obtain the assistance of the bonding company. It also would not have been in the interest of the minority shareholders of Capitol Center. At that time, there was no business purpose for selling Tacoma Mall from the viewpoint of Capitol Center.

After the preparation and the filing of the estate tax return, a potential buyer approached Capitol Center. Although no offer to purchase materalized, the possibility of a sale focused the attention of the board of directors on solutions to the problems that had developed with the management of Tacoma Mall since the death of the decedent. In the fall of 1980, the board of directors of Capitol Center, which included representatives of the minority shareholders, decided that a sale might be advisable in light of the management problems. Although the property has never been listed for sale, the availability of Tacoma Mall was made known after September 1980 to all major real estate brokers in the area, real estate investment companies, and Merrill Lynch. A number of proposals were received and two were accepted in late 1980, one as primary and another as backup. The board of directors of Capitol Center made the concurrent decision to change management of Tacoma Mall should neither proposal result in a completed sale.

Cascade Investment was organized by the decedent prior to his death. The only property transferred to Cascade Investment upon its incorporation was cash in the amount of $4,800. Cascade Investment was never activated. The intentions of the decedent with respect to the operations of this corporation were not known. At one time, a transfer of Cascade Olympic Class B preferred stock to Cascade Investment

was anticipated and a stock certificate was prepared but never delivered to Cascade Investment. The certificate was cancelled in January or February of 1980, immediately after a meeting was held to dissolve Cascade Investment. Cascade Investment was reported as an affiliated corporation on Cascade Olympic's consolidated income tax returns for the calendar years 1979 through 1982. During the period relevant to this case, Cascade Investment earned no income. Cascade Investment was administratively dissolved by the State of Washington on December 30, 1983, for failure to comply with notice and licensing requirements.

As of March 3, 1980, the book values of the assets of Cascade Olympic and its affiliated corporations, excluding the interests held by each corporation in an affiliated corporation, were as follows:

Assets:	Book Value
Cash	$ 53,500
Accounts Receivable	16,767
Current Portion Notes, Loans, Contracts Receivable	335,600
Marketable Securities	51,247
Federal Tax Receivable	4,632
TOTAL CURRENT ASSETS	$ 461,746
Land	$ 352,495
Buildings, Furniture and Fixtures Net Depreciation	1,976,031
Long-term Notes, Loans, Contracts Receivable	1,756,970
Other Investments	44,042
Other Receivables	31,986
Goodwill of Subsidiaries Purchased	584,770
Mortgage Reserve for Taxes and Insurance	11,789
Utilities Deposit	160
TOTAL ASSETS	$5,219,989
Liabilities:	
Notes Payable	$ 227,870
Accounts Payable	307,465

Advance Rental Income	32,665
Accrued Interest	10,763
Current Portion Long-Term Debt	82,500
TOTAL CURRENT LIABILITIES	$ 661,263
Unearned Discount	$ 2,127
Long-Term Debt	1,762,586
Deferred Income	747,410
Minority Interests in Unconsolidated Subsidiaries	766,339
Stockholder's Equity	
Class A	$180,000
Class B	16,900
Common	19,900
Retained earnings	1,063,464
	1,280,264
TOTAL LIABILITIES	$5,219,989

On the date of decedent's death, Cascade Olympic, Capital Cascade, and others owned the outstanding stock of BHC, Inc. (BHC), but BHC was not a member of the Cascade Olympic affiliated group. BHC was incorporated on April 9, 1979, under the laws of the State of Washington, to own, develop, and market real property. The principal assets of BHC included receivables from Thousand Trails, Inc. (also known as Pacific Rim) and land. The initial officers of BHC, all of whom were also directors, were as follows: the decedent, President; Mack D. Elliott, Vice-President; and Mrs. Manning, Secretary-Treasurer. As of the alternate valuation date, BHC had two classes of stock, each of which had a $1.00 par value: common and Class A preferred. The owners of the common stock were entitled to vote. The holders of Class A preferred stock had no voting rights, but were entitled to annual, non-cumulative dividends up to a maximum of 5 percent of par value before the payment of any dividends to the holders of common stock. Upon dissolution, the holders of Class A preferred stock were entitled to a liquidating preference to the extent of par value. In April 1979, the following persons acquired BHC stock by purchase or in exchange for real property:

Stockholder	Common Shares	Class A Preferred Shares
Cascade Olympic	2,000	17,500
Capital Cascade		2,500
Decedent		30
Jean Manning		10

Mack Elliott		10	
Others	2,000		20,000
	4,050		40,000

In May 1979, BHC entered into a Subcription Agreement with Thousand Trails, Inc. (Thousand Trails), a travel- trailer/campground business, which provided for the acquisition by Thousand Trails of 2,000 shares of the common and 20,000 shares of the preferred stock of BHC. The purchase price was $510,000, to be paid by the assignment of certain installment contracts yielding a monthly return of $11,300 for 5 years. The BHC stock to be purchased under the Thousand Trails subscription agreement was to be held in escrow as a guarantee for the value of the Thousand Trails installment contracts. The parties to the subscription agreement further agreed that, upon completion of the stock purchase, they would execute a buy/sell agreement whereby either party could make a purchase offer for the entire interest of the other. The party receiving the offer could then buy the other parties' interest or sell its own at the offered price. Alternatively, Thousand Trails could then tender all of its preferred and common shares for certain real estate described in the agreement. BHC was also required under the terms of the agreement to loan $250,000 to Thousand Trails for 12 months.

Mrs. Manning had no stock interest in Cascade Olympic or any of its subsidiaries prior to her marriage to the decedent. In 1965, she acquired 10 shares of Cascade Olympic common stock. The shares were given to her by her husband as a gift. Her ownership of these shares continued through March 1980. In 1969, Mrs. Manning purchased 660 shares of Capital Cascade stock for $1,200 with the proceeds from the sale of her residence which was separately owned by her. Her ownership of the 660 shares of Capital Cascade continued through March 1980.

Petitioner filed a timely estate tax return with the Internal Revenue Service in Ogden, Utah, using the alternate valuation date of March 3, 1980. The major assets of the estate were the 100 shares of common stock of Cascade Olympic valued by the estate at $357,500 and 50 shares of Preferred B stock of Cascade Olympic valued at $178,750. The estate tax return reported an estate tax liability of $33,237.

On August 31, 1983, the Commissioner mailed a statutory notice of deficiency to petitioner. As relevant to this opinion, the Commissioner determined that the value of all of the shares of Cascade Olympic was $7,166.60 per share resulting in a value of 100 shares of common stock of Cascade Olympic at $716,660 and 50 shares of Preferred Class B stock of Cascade Olympic at $358,330. The Commissioner also determined that 510 n4 shares of Capital Cascade and 10 shares of Cascade Olympic in the name of Mrs. Manning were community property and that half of the value of those shares or $44,248 should be included in the estate. The deficiency determined was $115,601.

n4 There is no explanation of the discrepancy between the 510 shares described in the statutory notice and the 660 shares which respondent concedes were owned by Mrs. Manning.

Petitioner disputes the deficiency and claims that its return overstated the value of the Cascade Olympic stock and that there is no estate tax due or payable by reason of the decedent's death. Petitioner, therefore, claims an overpayment of estate tax.

ULTIMATE FINDINGS OF FACT

The fair market value of each share of common and Class B preferred stock in Cascade Olympic Corporation held by decedent as of the alternate valuation date of March 3, 1980, is $3,395 with a total fair market value of $509,250.

The shares of Cascade Olympic and Capital Cascade held in the name of Mrs. Manning, the widow of decedent, were her separate property in which the decedent held no interest at the time of his death.

OPINION

The Commissioner's determination in his statutory notice of deficiency is presumptively correct, and petitioner has the burden of disproving each individual adjustment. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). The issues for decision in this case are the valuation of stock held by the decedent and the nature of the interest, if any, held by the decedent in shares of Capital Cascade and Cascade Olympic held in the name of Mrs. Manning. We shall discuss the valuation issue first.

The valuation controversy is over the value of shares of Cascade Olympic. As demonstrated in our findings of fact, however, the valuation of these particular shares requires an examination of the entire group of interrelated corporations including members of the consolidated group and BHC.To recapitulate, Cascade Olympic directly owned 81.69 percent of Capital Cascade, 39.92 percent of Center Offices, and 49.38 percent of the common stock of BHC. As Capital Cascade and Center Offices each owned interests in at least one of the other affiliated corporations or BHC (not a member of the affiliated group), however, the valuation of the Cascade Olympic stock held by decedent must consider the valuation of those interests as well.

Relevant portions of section 20.2031-1(b), Estate Tax Regs., provide:

The value of every item of property includible in a decedent's gross estate under sections 2031 through 2044 is its fair market value at the time of the decedent's death, except that if the executor elects the alternate valuation method under section 2032, it is the fair market value thereof at the date, and with the adjustments, prescribed in that section. The fair market value 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 to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. * * * The value is generally to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of the property. * * * All relevant facts and elements of value as of the applicable valuation date shall be considered in every case. * * *

Valuation issues are inherently imprecise and capable of resolution only by a Solomon-like pronouncement. Buffalo Tool & Die Mfg. Co. v. Commissioner, 74 T.C. 441, 452 (1980); Messing v. Commissioner, 48 T.C. 502, 512 (1967). We must, however, apply the facts and circumstances test of section 20.2031-1(b), Estate Tax Regs., and establish the fair market value of the stock held by decedent as the parties have failed to agree. The fair market value of closely held stock on any given date is a factual question and requires that we consider and weigh all relevant evidence in the record. Mauldin v. Commissioner, 60 T.C. 749, 759 (1973); Kaplan v. Commissioner, 43 T.C. 663, 665 (1965).

We have carefully considered all of the evidence contained in the entire record including the stipulations of fact, the testimony of all witnesses presented by the parties, and the numerous exhibits. We have analyzed all of the evidence and given due weight to each item with proper regard for the fact that the burden of proof is upon petitioner. Among the factors considered in valuing the stock were the following: the organization and history of the corporations; their capital structure, financial condition, the nature of their business, and the overall manner in which the business was operated; the number of outstanding shares of each class of Cascade Olympic's stock and identity of the shareholders; the fact that Cascade Olympic's shares were not listed on any exchange, were not dealt with through brokers or in over-the-counter trading, and had not been the subject of any sales; the character and amounts of Cascade Olympic's assets and liabilities and those of the corporations in which Cascade Olympic held an interest; the book value and fair market value of the underlying assets of Cascade Olympic, its affiliated corporations and BHC; and all other factors which in our view or that of the witnesses were relevant and material to the value of such stock on the alternate valuation date.

Petitioner's expert witness valued the decedent's shares in Cascade Olympic at $264,000 and respondent's expert witness valued the same shares at $1,278,132 assuming a power to liquidate and $1,175,516 assuming inability to liquidate. The value determined in the statutory notice of deficiency was $1,074,990.

Although opinion evidence is obviously admissible and relevant on the question of value, we must weigh such evidence in the light of the demonstrated qualifications of the experts and of all other relevant evidence of value. Anderson v. Commissioner, 250 F.2d 242, 249 (5th Cir. 1957), affg. a Memorandum Opinion of this Court. Furthermore, we are not bound by the opinion of any expert witness when that opinion is contrary to our own judgment. Barry v. United States, 501 F.2d 578 (6th Cir. 1974); Tripp v. Commissioner, 337 F.2d 432 (7th Cir. 1964), affg. a Memorandum Opinion of this Court; Kreis' Estate v. Commissioner, 227 F.2d 753, 755 (6th Cir. 1955). We may embrace or reject expert testimony, whichever, in our best judgment is appropriate. Helvering v. National Grocery Co., 304 U.S. 282 (1938); Silverman v. Commissioner, 538 F.2d 927, 933 (2d Cir. 1976), affg. a Memorandum Opinion of this Court. In weighing the opinions of the expert witnesses, we have considered the following: their qualifications and demeanor; their familiarity with Cascade Olympic and its affiliated corporations and their assets and liabilities; the soundness of the valuation method employed; and skill employed in assembling, analyzing, and weighing supporting data.

Where there is an on-going business such as we have in this case, it is inappropriate to treat the underlying asset value as the sole criterion in determining stock value. See Hamm v. Commissioner, 325 F.2d 934, 941 (8th Cir. 1963), affg. a Memorandum Opinion of this Court; Estate of Andrews v. Commissioner, 79 T.C. 938, 945 (1982); Portland Manufacturing Co. v. Commissioner, 56 T.C. 58, 80 (1971), affd. without published opinion (9th Cir. April 21, 1975). In the cases in which stock was valued solely on the basis of asset value, the corporations were, in essence, in the business of selling their assets, and thus, earnings were not a reliable indicator of value. Harwood v. Commissioner, 82 T.C. 239 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986) (timber business); Estate of Huntington v. Commissioner, 36 B.T.A. 698 (1937) (real estate subdivision and sales). However, the degree to which the corporation is actively engaged in producing income rather than merely holding property for investment should influence the weight to be given to earnings power and other factors as opposed to net asset value. Estate of Andrews v. Commissioner, 79 T.C. at 945.

In this case, the primary business of each of the corporations is the management, development and sale of real estate, and the investment in related obligations. Under these circumstances, earnings, in the form of rent, are conceded by both parties to not be a realistic gauge of the value of the stock at issue. Therefore, we believe that the appropriate method of valuing the stock held by the decedent in this case is by reference to the value of the corporate assets, adjusted however for the appropriate discounts and premiums. Estate of O'Connell v. Commissioner, 640 F.2d 249 (9th Cir. 1981), affg. in part and revg. in part a Memorandum Opinion of this Court; Hamm v. Commissioner, supra; Estate of Lee v. Commissioner, 69 T.C. 860, 870 (1978).

Both parties agree that the appropriate measure of the value of the stock of Cascade Olympic held by the decedent is the value of the underlying assets held by each of the corporations in which Cascade Olympic held an interest, adjusted for factors such as minority interests, control factors, liquidity or lack of marketability, and the structure of the corporations. Both experts reviewed the consolidated income tax returns and varying numbers of the documents supporting both the assets and liabilities of each corporation and the contested stock ownership. Neither expert contacted all relevant parties nor reviewed all relevant contracts and loan agreements.

There is substantial agreement on the fair market value of the assets although the discounts applied to liabilities, particularly the mortgage held on Tacoma Mall, vary widely. The primary area of disagreement between the expert witnesses of petitioner and respondent is the appropriate premiums and discounts to be applied to the value of the net assets of all of the affiliated corporations. They differ further on the value of the minority interests held in each of the relevant corporations and how to allow for the minority interests when valuing the Cascade Olympic stock at issue.

Shares of stock of a corporation which represent a minority interest are usually worth less than a proportionate share of the value of the assets of the corporation. Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981) (en banc); Harwood v. Commissioner, supra; Estate of Andrews v. Commissioner, supra; Estate of Zaiger v. Commissioner, 64 T.C. 927 (1975). The minority discount is recognized because the holder of a minority interest lacks control over corporate policy, cannot direct the payment of dividends, and cannot compel a liquidation of corporate assets. See Harwood v. Commissioner, 82 T.C. at 267; Estate of Andrews v. Commissioner, 79 T.C. at 953; Drybrough v. United States, 208 F.Supp. 279, 287-288 (W.D.Ky. 1962). A lack of liquidity discount, on the other hand, reflects the fact that there is no ready market for shares in a closely held corporation. Liquidity discounts and minority discounts must be determined on the basis of the shares being valued without combining those shares with the shares of affiliated parties. See Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982); Estate of Lee v. Commissioner, supra. "For purposes of valuation, one should construct a hypothetical sale from a hypothetical willing seller to a similarly hypothetical willing buyer," regardless of the fact that "the reality of the situation may be that the stock will most probably be sold to a particular party or type of person." Estate of Andrews v. Commissioner, 79 T.C. at 955-956. However, "the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect the value of the stock in the hands of decedent * * *." 79 T.C. at 956.

Applying these standards to the facts at issue, the decedent was the owner of a majority interest only in Cascade Olympic, and did not hold sufficient voting power even in Cascade Olympic to liquidate the corporation without the assistance of shares held by other parties. Wash. Rev. Code Ann. secs. 23A.20.030 and 23A.28.030 (1969). However, because the decedent's majority interest in the voting

shares of Cascade Olympic enabled him to control the board of directors of Cascade Olympic, he could direct Cascade Olympic to vote for the liquidation of Capital Cascade or its merger into Cascade Olympic. Wash. Rev. Code Ann. secs. 23A.08.370 and 23A.08.380 (1969). As there were minority interests in each of the corporations other than the interest of the decedent or Cascade Olympic, fiduciary constraints would limit such actions. We find, however, that there were no plans as of the alternate valuation date to liquidate or merge any of the corporations into any of the other corporations. Further, as of that date, there were valid business reasons to affirmatively avoid any such action because such action would expose those assets to the uncertainty of the liability exposure of Capital Cascade.

Respondent and his expert argue that no business purpose for the complex corporate structure headed by Cascade Olympic was presented and that the corporations must be viewed as essentially one economic entity. The corporate structure selected by a taxpayer is generally respected absent fraud, alter ego situations, or other circumstances not present here. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). Disregarding the corporations' individual status is not lightly done. Petitioner has presented ample justification for the decision to hold the various assets and particularly the contingent liabilities within separate corporate structures. Further, respondent has failed to note that all of the corporations at issue had minority shareholders whose interests would not necessarily be met by either a liquidation or a merger of their corporations resulting in a change in the form and nature of their investment. Respondent's philosophical objection to the complexity of the intercorporate relationships in this case cannot justify the decision of his expert to, in essence, disregard this structure merely because it makes the valuation more complex.

Respondent's expert valuation of the Cascade Olympic stock held by the decedent proceeds, however, from this preliminary decision to treat all of the corporations as one consolidated corporation rather than as a group of corporations. He used the financial statements of each corporation for the taxable year 1979, the most current financial information available, to estimate the fair market value of all assets and all liabilities. These values were netted to obtain an adjusted fair market value for the net assets of each corporation.

The value of the minority interests in the non-stock assets and liabilities of each of the corporations was then subtracted. The manner of accounting for the minority interests failed, however, to subtract the value held by the minority shareholders in each corporation consisting of the stock of one of the other members of the affiliated group and BHC.

Various discount factors, including a discount of 20 percent for the complicated ownership structure, were then applied to arrive at the final estimate of the adjusted fair market value as of the alternate valuation date of the Cascade Olympic stock held by the decedent. In essence, respondent's expert assumes that the corporate structure actually in existence has been collapsed in order to facilitate the computations necessary to determine the value of the stock at issue.

Respondent's expert relied, to a large extent, upon the materials in respondent's files which were incomplete. He met with company management only once and was virtually unaware of the importance of the decedent to Cascade Olympic and its subsidiaries. The adjustments made to the book value of the assets and liabilities appeared to depend more upon a general approach toward mortgages and promissory notes than a particularized inquiry as to the nature of the item before him. For example, the mortgage on Tacoma Mall was discounted from $1.8 million to $1.3 million on the assumption that its

low interest rate would result in a willingness by the lender to not only waive prepayment penalties but also accept a prepayment at less than book value. Respondent's expert failed, however, to learn that the mortgagee refused to accept any change in terms.

A further failing in respondent's expert's valuation is discounting the value of the Preferred A and Preferred B shares of Cascade Olympic not held by the decedent by approximately 99 percent, to an amount below par value, because of the lack of control held by minority shareholders of Cascade Olympic, resulting in a corresponding increase in value of the common shares held by the decedent. This discount ignores the par value of $100 which was the minimum amount to be received by each owner of Preferred A and Preferred B upon liquidation absent bankruptcy. This methodology places a far higher value upon the common stock than can be justified.

Respondent's expert did not review the subscription agreement between Thousand Trails and BHC, and yet he valued the Thousand Trails' subscription obligation as equivalent to an easily transferrable medium grade corporate bond. Respondent's expert then applied a lower than market discount rate despite a concession at trial that it would have been difficult to sell the obligation on the open market without further discount. In a similar fashion, many of the obligations held by the various corporations were not discounted on the basis of a knowledge of their terms nor on the basis of whether they were current, nor were appropriate interest rates always used for the discounting to the alternate valuation date.

On the other hand, we find that we are unable to rely totally on the opinion of petitioner's expert. He also relied heavily on company management and its advisors to supply him with the correct data without further personal verification. The financial statements and income tax returns of Cascade Olympic reflected 521 outstanding shares of Class B preferred stock. Yet petitioner's expert assumed for purpurses of his report that there were 591 shares outstanding, presumably from information he obtained from corporate management. Although he reviewed more of the underlying documentation than did respondent's expert, the values selected for the assets and liabilities were, in some instances, based upon assumptions rather than fact. Further, in the examination of the Bethel project liabilities, much of the information relied upon was unknown on the alternate valuation date.

His method of valuation in general, however, is a far better reflection of the fair market value of the shares of Cascade Olympic held by the decedent under the corporate structure that actually existed. His use of simultaneous, interdependent equations, although complex, accounts for the inter-relationships of the corporations and the value of the minority interests not only in the non-stock assets but also in the stock ownership of the affiliated corporations.

The final valuation figure selected for petitioner's interest in Cascade Olympic was, however, heavily dependent upon the expert's description of Cascade Olympic as a closed-end investment company with investments in a number of other corporations. He applied a discount of 45 percent to the value of the Cascade Olympic shares due to this view of the structure of the company. A portion of this discount was also due to the importance of the decedent to the operations of the corporations.

An additional discount was applied for the effect of capital gains tax payable by the shareholders of BHC, although transaction costs are not ordinarily considered when no liquidation or merger was, in fact, anticipated. Estate of Andrews v. Commissioner, 79 T.C. at 942; Estate of Piper v. Commissioner,

72 T.C. 1062, 1086-1087 (1979); Estate of Cruikshank v. Commissioner, 9 T.C. 162 (1947). Appropriate adjustments were made for lack of liquidity.

We have pointed out above the defects of the approaches used by the experts of both parties. Having taken diametrically opposed views as to the factors to be weighed in valuing the stock involved in this case, the parties "failed successfully to conclude settlement negotiations -- a process clearly more conducive to the proper disposition of disputes such as this." Messing v. Commissioner, 48 T.C. 502, 512 (1967). Because we have concluded that there are basic flaws in the valuations offered by both of the experts, we must necessarily make our best judgment of value. While we have considered both of the valuation reports, we have also weighed all other relevant factors shown in the record. We have accepted the valuations placed on the underlying assets and liabilities by petitioner's expert to a large degree, but have applied the appropriate discounts for the restricted marketability of the shares and the lack of control held by Cascade Olympic in a number of the affiliated companies holding a number of the underlying assets. The closed-end investment company discount has been removed although we have retained a 10 percent discount for the effect of the death of the decedent upon the management of the corporations. We have also adjusted the valuation to allow for our factual finding that only 521 shares of Preferred B were outstanding upon the alternate valuation date. Based upon all of these facts and upon the entire record, we conclude and find as a fact that the fair market value of the shares of Cascade Olympic held by the decedent as of the alternate valuation date was $3,395 per share for a total fair market value of $509,250.

The second issue for decision is whether decedent held an interest in the shares of Cascade Olympic and Capital Cascade in the name of his surviving spouse, Jean Manning. In determining the nature and extent of decedent's community interest in these shares, this Court must look to the laws of the State of Washington where the decedent and Mrs. Manning resided throughout their marriage. Katz v. United States, 382 F.2d 723 (9th Cir. 1967). Under the laws of the State of Washington, all property acquired after marriage by either husband or wife or both, is presumed to be community property. Wash. Rev. Code Ann. sec. 26.16.030 (1986). While the presumption is rebuttable, the burden rests upon the spouse asserting the separate character of the property acquired by purchase during the marriage to establish his or her claim by clear and satisfactory evidence. Berol v. Berol, 37 Wash. 2d 380, 223 P.2d 1055, 1056 (1950). Indefinite evidence that certificates of stock issued in one spouse's name were intended to be separate property is also insufficient to rebut the presumption. In re Wheeler Estate, 123 Wash. 531, 212 P. 1043 (1923). In this case, however, we find the testimony of Mrs. Manning regarding events occurring over 15 years before trial to be credible and sufficient to rebut the presumption. We find that the 10 shares of Cascade Olympic stock acquired by her in 1965 were a gift to her by the decedent and that the 660 shares of Capital Cascade stock acquired by her in 1969 were purchased with separate funds. All of the shares of Cascade Olympic and Capital Cascade stock held in the name of Mrs. Manning were, therefore, separate property and decedent had no interest in the shares at the time of his death.

Decision will be entered Under Rule 155.

Full Text of Court Cases

In re Marriage of Zells

Case name: In re Marriage of Zells
Citation: 572 N.E.2d 944,1991 Ill. LEXIS 30
Date of decision: April 18, 1991
Country: US
State or Federal: State
State/Jurisdiction: Illinois
Court: Supreme Court
Type of action: Marital Dissolution
Judge: Heiple
SIC: 8111 Legal Services
NAICS: 541110 Offices of Lawyers

Keywords: Marital dissolution, Personal goodwill

COUNSEL:

Melvyn H. Berks, of Des Plaines, for appellant.

Joel S. Ostrow, of Chicago, for appellee.

JUDGES:

Justice Heiple delivered the opinion of the court. Justice Calvo took no part in the consideration or decision of this case.

OPINIONBY:

HEIPLE

OPINION:

JUSTICE HEIPLE delivered the opinion of the court:

This case concerns the division and distribution of marital property between a lawyer and his spouse. There are two issues. The first is whether a lawyer's contingent fee contracts are subject to valuation, division and distribution as part of the marital estate. The second issue is whether professional goodwill is a marital asset and subject to division or distribution. Our conclusion is that neither contingent fee contracts nor professional goodwill is subject to valuation, division or distribution as marital assets.

The circuit court of Cook County determined that contingent fee contracts are marital assets which are subject to equal division between the parties. The court also determined that the goodwill of the husband's law practice is a marital asset. The appellate court affirmed the valuation and distribution of

goodwill, but held that contingent fees are not marital assets subject to division. (197 Ill. App. 3d 232.) We reverse and remand.

We agree with that part of the appellate court's opinion which found that contingent fees are not marital assets. In its determination, the appellate court relied on three factors:

"First, the nature of a contingent fee contract indicates that an attorney has neither the right to receive the fee until the case is disposed of, nor any assurance that he ever will receive the fee. Second, the amount of the contingent fee depends on the amount of the award or settlement in the case; therefore its ultimate value, if any, remains highly speculative during the pendency of the case. * * * Third, the worth of a contingent fee to an attorney, if any, remains intangible until the firm receives cash or other consideration for the services rendered." 197 Ill. App. 3d at 237.

The context for the consideration of fees, contingent or otherwise, is in the determination of income for support and maintenance. Fees earned by an attorney contribute to the annual income figures relied upon in awarding maintenance and support. Future earned fees would be considered should the subject of maintenance be revisited.

Additionally, we note the impermissible ethical conflict posed by a court-ordered division of contingent fees. Rule 5.4 of the Illinois Rules of Professional Conduct (134 Ill. 2d R. 5.4) provides in part:

"(a) A lawyer or law firm shall not share legal fees with a nonlawyer, except that:

(1) an agreement by a lawyer with the lawyer's firm, partner, or associate may provide for the payment of money, over a reasonable period of time after the lawyer's death, to the lawyer's estate or to one or more specified persons;

(2) a lawyer who undertakes to complete unfinished legal business of a deceased lawyer may pay to the estate of the deceased lawyer that proportion of the total compensation which fairly represents the services rendered by the deceased lawyer; and

(3) a lawyer or law firm may include nonlawyer employees in a compensation or retirement plan, even though the plan is based in whole or in part on a profit-sharing arrangement." 134 Ill. 2d R. 5.4.

This court outlined the potential harms associated with fee-sharing arrangements between attorneys and non-attorneys in O'Hara v. Ahlgren, Blumenfeld & Kempster (1989), 127 Ill. 2d 333 (revenue-sharing agreement between attorney's widow and new law firm to which she sold her husband's practice held to violate Rule 3 -- 102 of the Code of Professional Responsibility (107 Ill. 2d R. 3 -- 102)). While it is not necessary to here restate these harms in full, we reaffirm the reasoning of O'Hara and decline to enlarge the exceptions to include a contingent fee fee-sharing arrangement resulting from a judgment of dissolution.

We next address the issue of the goodwill value of the law practice. Goodwill represents merely the ability to acquire future income. Consideration of goodwill as a divisible marital asset results in gross inequity.

In the instant case, the trial court purported to divide the marital assets but offset an award of real assets to the wife against professional goodwill or blue sky which was assigned to the lawyer husband. This type of disproportionate division has been the basis for the decisions of other State courts that professional goodwill is not a marital asset. Holbrook v. Holbrook (Wis. App. 1981), 103 Wis. 2d 327,

309 N.W.2d 341 (marital estate did not include goodwill or intangible value of husband's partnership interest in reputable law firm); Powell v. Powell (1982), 231 Kan. 456, 648 P.2d 218 (goodwill in a professional medical practice was not an asset subject to division in a divorce action).

Panels of the Illinois appellate court have similarly held that the goodwill of a professional business is not marital property subject to division. The first district adopted this position with its decision In re Marriage of Wilder (1983), 122 Ill. App. 3d 338. The appellate court held that the trial court's failure to set a fixed monetary value for goodwill in valuing the husband's stock in his medical practice, a professional corporation, was not error. (122 Ill. App. 3d at 348.) The Wilder position was in contrast to the earlier fifth district decision In re Marriage of White (1981), 98 Ill. App. 3d 380, wherein the appellate court stated that goodwill is a factor to be considered in valuing a professional corporation "under the theory that despite the intangible quality of good will in a professional practice, it is of value to the practicing spouse both during and after the marriage and its value is manifested in the amount of business and, consequently, in the income which the spouse generates." (98 Ill. App. 3d at 384.) The Wilder court held that the White definition of goodwill is reflected in three of the factors which the trial court must consider in reaching a just property distribution under section 503(d) of the Illinois Marriage and Dissolution of Marriage Act (the Dissolution Act) (Ill. Rev. Stat. 1989, ch. 40, par. 101 et seq.):

"[T]he relevant economic circumstance of each spouse when the division of property is to become effective[,] * * * [the] occupation, amount and sources of income, vocational skills, [and] employability * * * of each of the parties * * * [and] the reasonable opportunity of each spouse for future acquisition of capital assets and income." Ill. Rev. Stat. 1989, ch. 40, pars. 503(d)(4), (d)(7), (d)(10).

The third district followed the reasoning of Wilder in In re Marriage of Courtright (1987), 155 Ill. App. 3d 55, holding that the goodwill value of the husband's medical practice was not a marital asset. The court stated:

"Although many businesses possess this intangible known as good will, the concept is unique in a professional business. The concept of professional good will is the sole asset of the professional. If good will is that aspect of a business which maintains the clientele, then the good will in a professional business is the skill, the expertise, and the reputation of the professional. It is these qualities which would keep patients returning to a doctor and which would make those patients refer others to him. The bottom line is that this is reflected in the doctor's income-generating ability.

* * *

Although good will was not considered in the court's valuation of the business itself, it was a factor in examining [the husband's] income potential. To figure good will in both facets of the practice would be to double count and reach an erroneous valuation." 155 Ill. App. 3d at 58-59.

The reasoning presented in Courtright is correct. Adequate attention to the relevant factors in the Dissolution Act results in an appropriate consideration of professional goodwill as an aspect of income potential. The goodwill value is then reflected in the maintenance and support awards. Any additional consideration of goodwill value is duplicative and improper.

For the foregoing reasons, we affirm in part and reverse in part the judgment of the appellate court, reverse the judgment of the circuit court, and remand the cause to the circuit court for further proceedings.

Appellate court affirmed in part and reversed in part; circuit court reversed; cause remanded.

JUSTICE CALVO took no part in the consideration or decision of this case.

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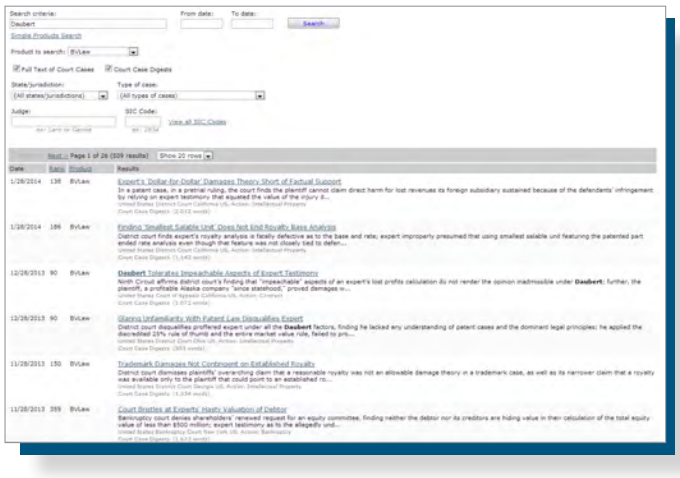

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