Estate of Miriam M. Warne v. Commissioner: Valuation Discounts Allowed on Controlling Ownership Interests

Curtis R. Kimball

This discussion summarizes the judicial decision in the Estate of Miriam M. Warne v. Commissioner of Internal Revenue*. Specifically, this discussion focuses on the valuation issues of the case, including the calculation and the application of a discount for lack of control and a discount for lack of marketability with regard to the valuation of private company controlling ownership interests.*

Introduction

Historically the Internal Revenue Service (the "Service") has been skeptical of taxpayer claims that controlling ownership interests in corporations, partnerships, or limited liability companies ("LLCs") should be valued based on the application of a discount for lack of control ("DLOC") or a discount for lack of marketability ("DLOM").

Judge Buch weighed in on this and related issues in the U.S. Tax Court case of *Estate of Warne v. Commissioner of Internal Revenue*, filed February 18, 2021 ("the *Warne* case").[1]

During the final years of her life, Miriam Warne transferred noncontrolling ownership interests in various LLCs that owned long-term family real estate investments in California. The LLCs were held in a family trust.

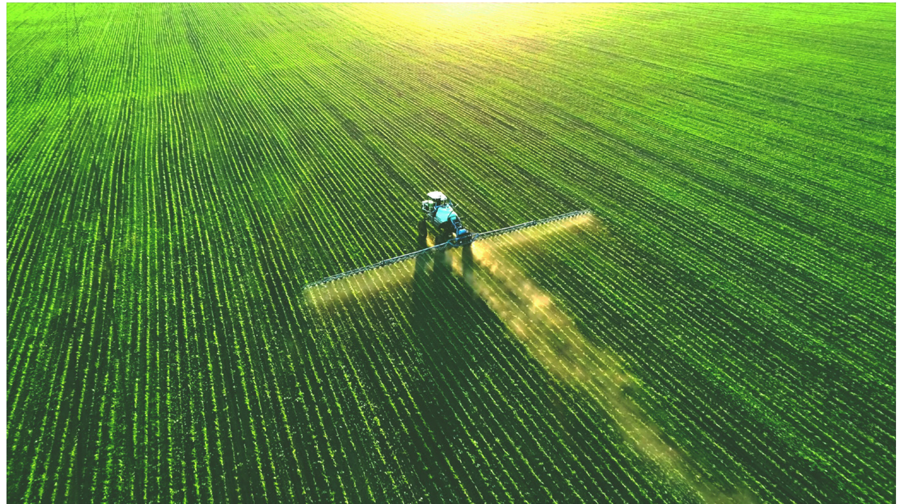
When Mrs. Warne died, the family trust held the remaining controlling ownership interests in the LLCs. Her estate also donated the entire membership interest in one LLC to two charitable organizations, with 25 percent going to one charity and 75 percent going to another.

Upon audit, the Service determined that the fair market value of certain ground leases within the LLCs had been understated. The Service also determined that more modest DLOC and DLOM adjustments were applicable to the remaining controlling ownership interests held in the family trust. These interests were taxable in the estate.

Both sides engaged testifying experts to explain and defend their positions with regard to (1) valuing real estate ground leases and (2) selecting applicable valuation discounts. The Tax Court was skeptical of each expert's analysis, and performed its own valuations, relying on the experts' underlying data.

The Estate obtained small discounts from the Tax Court, but lost on the issue of valuation discounts applicable to the real estate LLC interests donated to charities as part of the estate plan.

The basic lesson from the *Warne* case is that a noncontrolling ownership interest cannot be combined with a controlling ownership interest in order to avoid applying valuation discounts to the noncontrolling interest charitable gift.



Background of the Case

Ms. Warne gifted noncontrolling ownership interests in five LLCs to her descendants during her lifetime. The transfer date for these gifts was December 27, 2012. No gift tax returns were timely filed.

The family had invested in California real estate for many years, holding each property (or related properties) in a separate LLC. Over time, the real estate appreciated in value significantly, and the LLC interests were valued on her estate tax return at approximately $73.7 million.

The judicial decision in this matter did not detail the total value of the LLCs' underlying real estate.

Ms. Warne died on February 4, 2014, with her remaining LLC interests held in a revocable family trust (the "Trust"), the assets of which were subject to estate tax.

As trustee, Ms. Warne was also the managing member of each LLC. The operating agreements for each LLC granted significant control powers to the majority interest holder, such as the ability (1) to unilaterally dissolve the LLC and (2) to appoint and remove managers.

The five LLCs, the interests taxable in the estate, and the estate tax return fair market values for these interests, are summarized as follows:

1. WRW Properties, LLC – 78 percent valued at $18,006,000
2. Warne Ranch, LLC – 72.5 percent valued at $8,720,000
3. VJK Properties, LLC – 86.3 percent valued at $11,325,000
4. Warne Investments, LLC – 87.432 percent valued at $10,053,000
5. Royal Gardens, LLC ("RG") – 100 percent valued at $25,600,000

The terms of the Trust stipulated that 75 percent of RG would be donated to a Warne family charitable foundation and the other 25 percent would be donated to a church upon Ms. Warne's death. The estate tax return reported the charitable donations at the undiscounted prorated percentage ownership interest received by each charitable donee.

Upon audit, the Service determined higher values for the five LLC interests:

1. by increasing the value of each of the LLC's underlying real estate assets (a topic not considered in this discussion) or
2. by reducing the valuation discounts claimed by the estate in valuing four of the LLC interests.

The Service also decreased the value of the estate's charitable donations by applying valuation discounts to the controlling 75 percent and noncontrolling 25 percent ownership interest in RG. The Service also claimed penalties for the taxpayer's failure to timely file the gift tax returns.

The Taxpayer Expert's Opinion on the Valuation Issues

At trial, the taxpayer retained a testifying valuation expert to defend the discounts applicable to the LLC ownership interests. This testifying expert developed his discounts with reference to 100 percent of the adjusted net asset value of each LLC, as these entities were real estate investment holding companies.

The adjusted net asset value was based on the underlying real estate values less liabilities.

The Estate's expert in this case applied a DLOC and a DLOM. One risk factor noted was the prospect that the other Warne family members would oppose and litigate any attempt by the controlling ownership interest holder to sell the real estate and to dissolve and liquidate the LLC.

Taxpayer's Discount for Lack of Control

The Estate's expert based his analysis of the applicable DLOC concluded from the Mergerstat Control Premium Study data.

The expert compared the price premiums paid in transactions for complete control (defined as acquisitions of 90 percent or greater ownership) relative to transactions for majority control (defined as acquisitions of 50.1 percent or greater ownership). The difference in price premiums between these types of transactions was 9.47 percent.

The valuation expert next adjusted this result for the specific factors to the subject LLCs in this case. These specific factors included the following:

- The subject LLCs were real estate holding companies, and real estate is generally considered to be a less volatile, less risky asset than a business. Therefore, real estate companies exhibit smaller DLOCs.
- The controlling ownership interests enjoyed considerable control rights under the operating agreements.
- The risk of litigation arising from the other members, as discussed above.

The Estate's expert concluded that the DLOC for each LLC interest was between 5 and 8 percent.

Taxpayer's Discount for Lack of Marketability

Next, the Estate's expert considered the application of the DLOM in this case. He relied upon a database of restricted public stock transactions. There are a number of such studies and data sources.

The expert-selected sample consisted of 714 restricted stock transfer transactions with an average implied discount of 21.1 percent and a median implied discount of 16.2 percent. He also arranged the data by quintiles, based on the financial characteristics of the sample companies.

The Estate's expert next placed the subject LLCs (and he ended up applying the same factors to all five LLCs) within the matrix of the quintiles for six financial factors as follows:

- Total revenue
- Market value
- Total assets
- Balance sheet risk
- Market-to-book value
- Market risk volatility

The expert weighted each factor according to his perception of their significance. The first three factors received a "medium weight." The last two factors received "significant weight."

He concluded that the publicly traded equivalent restricted stock DLOM was between 10 and 12 percent.

The Estate's expert then considered data from the holding periods for the restricted stock. Over the years, public company restricted stock has been subject to different holding periods before trading is unrestricted. He assumed that a six-month period was appropriate in the *Warne* case. This assumption resulted in a sample of 41 transactions, with a six-month holding period.

The median and average indicated DLOM of the six-month restriction transactions was 7.4 and 9.7 percent, respectively. In order to account for the shorter holding period of the LLCs, the Estate's expert reduced the discounts by 25 percent to arrive at a conclusion that the DLOM in the Warne LLC case was between 5 and 10 percent.

Total Valuation Discount

After considering all of the above-mentioned factors, the Estate's expert concluded a combined total discount of 10 percent (inclusive of the DLOC and the DLOM).

The Service Expert's Opinion on the Valuation Issues

The Service's expert, Espin Roback, prepared a similarly structured analysis of the DLOC and the DLOM. The Service's expert also arrived at a combined total discount.

The Service's Expert's Discount for Lack of Control

The Service's expert used closed-end funds ("CEFs") to determine the DLOC. This expert drew his sample from publicly traded CEFs that were classified as real estate funds. There were nine of these CEFs.

The expert arrived at a range of discounts from 3.5 to 15.7 percent, with a median discount of 11.9 percent.

The expert compared this sample to the Warne LLCs using financial factors as follows:

- Distribution yields
- Total assets
- Market price
- Net asset value per share
- Discount or premium to net asset value

He concluded that the control rights of the Warne LLCs warranted a discount "at the bottom of the range."

Based on this analysis, the Service expert concluded that the DLOC was 2 percent in this case.

The Service Expert's Discount for Lack of Marketability

The Service's expert utilized a similar method of examining and drawing a relevant sample from restricted stock transfer transactions. He utilized his own firm's database, the Pluris DLOM Database.

The expert's initial sample size of transactions totaled 2,398, with an average implied DLOM of 21.4 percent and a median implied DLOM of 18.6 percent.

The Service's expert also arranged the data by quintiles, based on the financial characteristics of the sample data companies.

He next placed the subject LLCs (and he ended up applying the same factors to all five LLCs) within the matrix of the quintiles for six financial factors as follows:

- Stock price per share
- Market value
- Book value
- Market-to-book ratio
- Trading volume
- Block size of the transaction

The Service expert weighted each financial factor equally and arrived at a 14.5 percent average DLOM. However, he also considered an adjustment for the Warne LLCs "strongest and weakest" qualities.

After considering these qualities, the Service expert concluded that the appropriate DLOM in this case was 2 percent.

Total Valuation Discount

The Service's expert concluded that the combined total discount for DLOC and DLOM was 4 percent.

Sources of Information on DLOCs and DLOMs for Controlling Ownership Interests

Discount for Lack of Control Sources

There are a number of data sources or methods for deriving a DLOC with regard to the valuation of private business interests.

First, discounts can be derived from public company merger and acquisition transactions, measuring the implied difference between the control price of the acquisition and the pre-announcement price of the shares presumably trading at their noncontrolling interest price.

Second, further analysis can be performed to compare the implied difference between the price of 100 percent acquisition transactions and of acquisition transactions in which less than 100 percent, but still controlling interests, were acquired by buyers in the public market.

Third, valuation discounts can be derived from public companies which liquidated by comparing the pre-announcement trading price to the amount per share ultimately received by the shareholders from the liquidation.

Fourth, for a private company, a factor analysis methodology can be applied to value each of the

intangible assets not held by a controlling—but less than 100 percent—ownership interest relative to the factors of control held by a 100 percent controlling ownership interest.

The quantitative measurement can be performed either as incremental cash flow added or on the basis of incremental costs avoided. The value of ownership control derives from the investor's ability to influence the entity by exercising the so-called prerogatives of control.

The following nonexhaustive list indicates some of the typical prerogatives of ownership control:

1. Select the management of the entity
2. Determine management compensation and perquisites
3. Set operational and strategic policy and change the course of entity business
4. Acquire and/or liquidate entity assets
5. Select suppliers, vendors, and subcontractors with whom to do business
6. Borrow funds on the behalf of the entity
7. Liquidate, dissolve, sell, or recapitalize the entity
8. Declare and pay distributions
9. Change the articles of incorporation or bylaws

All of these data sources or methods should be adjusted to conform to the facts of each situation under analysis. For example, the implied discount between a publicly traded company's per-share buyout price and the trading price of the same shares prior to the announcement of the acquisition is a comparison of a 100 percent control ownership interest to a small noncontrolling interest.

Discount for Lack of Marketability Sources

There are also a number of data sources and methods for deriving a DLOM with regard to the valuation of private business interests.

First, there are a number of studies of DLOM based on sales of stock of publicly traded companies that are temporarily restricted from trading. Although the size of the blocks of shares issued in these restricted stock studies can be substantial, they are almost always noncontrolling interests.

Second, there are studies of private sales of shares of companies that subsequently went public. These pre-initial-public-offering studies always involve noncontrolling interest transactions.

Third, there are factor analysis methodologies which utilize option pricing model valuation techniques to arrive at an indicated value based on inputs of various factors that are assumed to influence the DLOM. These factors can include duration, volatility, and interim returns to the subject interest.

As noted for the analysis of DLOC, these data sources or methods should be adjusted to conform to the facts of each situation under analysis.

The Tax Court's Opinion on the Valuation Issues

The Tax Court was initially skeptical that any discount should be applied to a large controlling interest as a general matter. Judge Buch noted that, "When a majority interest holder exerts control similar to that which the Family Trust can exercise in the LLCs, we have held that no discount for lack of control applies.[2] Because the parties agree to a discount for lack of control, we will find one."

The Tax Court also rejected any adjustment based on the possibility of litigation among the LLC interest holders upon dissolution.

The Estate's expert "speculates that any attempt by the majority interest holder to dissolve the LLCs would be met with 'strong opposition and potential litigation' for other Warne family members. We cannot give any meaningful weight to his speculation."

An expert's rebuttal report submitted by the taxpayer on this issue apparently had little influence on the Tax Court.

The Tax Court's Decision on the Discount for Lack of Control

The Tax Court decided that the DLOC "should be low."

The Tax Court concluded that the taxpayer expert's analysis was insufficient and inadequate for the following reasons:

- The CEFs used were too dissimilar to the subject Warne LLCs.
- The selected CEF sample size was too small.
- The discounts observed in the CEF sample were minority interest discounts and inappropriate to apply to controlling interests.[3]

The Tax Court was likewise skeptical of the Service expert's analysis. "While [his] method appears sound, he did not provide the Court information regarding the size and makeup of his sample."

And, as noted, the Tax Court rejected any speculation about litigation among the LLC members that would increase the DLOC.

As a result of these deliberations, the Tax Court concluded that a DLOC of 4 percent was appropriate.

The Tax Court's Decision on the Discount for Lack of Marketability

Since both valuation experts utilized restricted stock study data, the Tax Court based its conclusion on its assessment of which expert's analysis was more thorough and credible.

The Tax Court decided that the taxpayer expert's analysis was more credible. The Tax Court based this conclusion on the following factors:

- The analysis considered additional metrics.
- The report and testimony provided a more thorough explanation of the process.
- The expert explained which were the most important factors in this case, and gave them more weight.

In contrast, the Tax Court criticized the Service's expert for "providing little information to support this conclusion." The analysis did not justify the substantial decrease in the DLOM percentage from the indicated discount average of his sample data.

The Tax Court characterized the Service expert's conclusion as a "visceral reduction . . . instead of a statistical one."

As a result, the Tax Court adopted a DLOM at the lowest end of the Estate expert's range of DLOMs—at 5 percent.

Total Valuation Discount

The Tax Court concluded that the combined total valuation discount applicable to the LLCs for DLOC and DLOM was 6.9 percent, based on taking serial discounts of 2.0 percent for the DLOC and 5.0 percent for the DLOM.

This resulting total valuation discount falls in between the Estate's total discount of 10 percent and the Service's total discount of 4 percent.

Other Issues Addressed in the Judicial Decision

The Tax Court also opined on two other issues.

First, the Tax Court opined that the charitable gifts of the RG LLC should each be discounted. The Tax Court reasoned that the gifts should be treated as separate interest gifts, and not a joint gift of 100 percent, as the taxpayer's legal counsel argued.

The value of the property received by each donee determined the amount of the charitable deduction available to the Estate.

Since the Estate and the Service had reached a stipulated agreement as to the discounts if the Tax Court found that these would apply, the total discount for the 75 percent interest to the family foundation was 4 percent and the discount to the church's 25 percent interest was 27.385 percent.

Second, the Tax Court opined that the gift tax returns were not timely filed. And, since no evidence was offered to support the taxpayer's claim that there was any reasonable cause for this delay, the penalties for late filing should be applied under Section 6651 (a)(1).

Summary and Conclusion

There are various data sources and methods for calculating a DLOC and a DLOM. However, the data sources or analysis methods should be adjusted to conform to the facts of each set of facts under analysis.

The Tax Court in the *Warne* case decided that, since the litigating parties—through their experts or by stipulation—concluded that a DLOC and a DLOM should be applied to the five subject LLC interests, valuation discounts may be applied.

However, the Tax Court opined that the valuation discounts applicable to the controlling interests "should be low."

The resulting decision that the applicable total discounts for DLOC and DLOM should be 6.9 percent fell in between the Estate's total discount of 10 percent and the Service's total discount of 4 percent.

Notes:

1. Estate of Warne v. Commissioner of Internal Revenue, T.C. Memo 2021-17 (Feb. 18, 2021).
2. Estate of Jones v. Commissioner., 116 T.C. 121, 135 (2001); Estate of Streighthoff v. Commissioner, T.C. Memo 2018-178, at *4, *5, and *23 *aff'd*, 954 F.3d 713 (5th Cir. 2020).
3. Grieve v. Commissioner, T.C. Memo 2020-28, at *12 and *36.

Curtis Kimball is a managing director in our Atlanta office. Curt can be reached at (404) 475-2307 or at crkimball@willamette.com.