Pierson M. Grieve v. Commissioner: Tax Court Rejects Theoretical Valuation Methodology

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This discussion considers the recent decision issued by the U.S. Tax Court in Pierson M. Grieve v. Commissioner of Internal Revenue. *Specifically, this discussion describes (1) the main topics of this judicial decision, (2) the valuation issues of this judicial decision, and (3) the Tax Court's judicial conclusion. In summary, the Tax Court rejected the novel valuation theory applied by the Internal Revenue Service's valuation analyst in the case.*

Introduction

Valuation analysts ("analysts") are often engaged to value noncontrolling, nonmarketable interests in limited liability companies ("LLCs") for gift and estate tax compliance and/or planning purposes. The standard of value typically relied on for these gift and estate tax compliance and/or planning valuation engagements is the fair market value standard.

Internal Revenue Service Revenue Ruling 59-60 defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property."[1]

In a recent U.S. Tax Court (the "Court") case—*Pierson M. Grieve v. Commissioner of Internal Revenue*[2] (the "*Grieve* case")—the Internal Revenue Service (the "Service") valuation analyst applied a theoretical methodology to value noncontrolling, nonmarketable interests in an LLC. In rendering its decision, the Court rejected this theoretical valuation methodology and deferred to the taxpayer's original valuation reports included in the gift tax return filed by Mr. Grieve.

This judicial decision was a victory for the taxpayer in the *Grieve* case and an affirmation by the Tax Court that "imaginary scenarios" which fall outside the definition of fair market value should not be relied upon in valuation analyses performed for gift and estate tax compliance and/or planning purposes. That conclusion especially holds if the facts of the case show that such scenarios are not "reasonably probable."

Background of the Case

Pierson M. Grieve was married to Florence Grieve, and they had three children. Florence died on

October 1, 2012. Their eldest child, Margaret Grieve, practiced law in the financial services industry.

From 1983 to 1996, Mr. Grieve served as chairman and chief executive officer of Ecolab, Inc. ("Ecolab"), a publicly traded corporation headquartered in St. Paul, Minnesota. During his tenure at Ecolab, Mr. Grieve acquired Ecolab stock which he and his family continue to own.

In the late 1980s or early 1990s, Mr. Grieve established the Grieve Family Limited Partnership. Pierson M. Grieve Management Corp. ("PMG") was the general partner of the Grieve Family Limited Partnership. These entities were created to preserve and manage the Grieve family wealth. Mr. Grieve consolidated management of his assets in PMG.

In the early 2000s, Margaret Grieve actively assisted Mr. Grieve with management of the family's wealth. In 2008, Margaret purchased PMG from Mr. Grieve for $6,200 and became the president of PMG. Margaret had owned all outstanding shares of PMG since 2008. Although she managed the Grieve family wealth through PMG, she never received compensation.

In 2012, Mr. and Mrs. Grieve requested assistance from a law firm to update their estate plan. Unfortunately, Florence passed away before the updated estate plan was finalized. As part of the Grieves' updated estate plan, Margaret assumed full time responsibility for managing the Grieve family wealth—as she had been responsible for investing and managing the Grieve family wealth since 2012.

Margaret worked with the law firm on the Grieves' updated estate plan which formed two pass-through entities: (1) Rabbit 1, LLC ("Rabbit"), and (2) Angus MacDonald, LLC ("Angus").

Rabbit 1, LLC, Background

On July 31, 2013, Rabbit was created as an LLC under the laws of the State of Delaware. Subsequently, on August 28, 2013, PMG contributed $2 in exchange for 20 Class A voting membership units, representing a 0.2 percent controlling membership interest in Rabbit.

On that same date, the Pierson M. Grieve Revocable Trust ("Grieve Revocable Trust") contributed $998 for 9,980 Class B nonvoting membership units, representing a 99.8 percent noncontrolling membership interest in Rabbit.

On September 3, 2013, Mr. Grieve transferred 82,984 Ecolab shares with a fair market value of $7,682,659 to Rabbit's brokerage account. Additionally, Mr. Grieve deposited cash of $1 million in Rabbit's account on September 18, 2013. As of October 9, 2013, Rabbit had no debt and a net asset value of $9,102,757.

Angus MacDonald, LLC, Background

Angus was created as an LLC under the laws of the State of Delaware on August 13, 2012, with two initial members: PMG and Florence Grieve. On September 7, 2012, PMG contributed $200 in exchange for 20 Class A voting membership units, representing a 0.2 percent controlling membership interest in Angus.

On that same date, Mrs. Grieve contributed $99,800 in exchange for 9,980 Class B nonvoting membership units, representing a 99.8 percent noncontrolling membership interest in Angus. Then on September 26, 2012, Mrs. Grieve transferred her 99.8 percent noncontrolling interest in Angus to her husband.

Exhibit 1 presents a summary of the net assets held by Angus and their respective fair market values as of November 1, 2013.

Exhibit 1
Angus MacDonald, LLC
Fair Market Value of Assets
As of November 1, 2013

Assets	Fair Market Value ($)
Cash and Short-Term Investments	$20,665,824
Limited Partnership Interests	7,316,882
Investments in Venture Capital Funds	406,406
Promissory Notes	3,581,571
Total Assets	$31,970,683

Operations of Rabbit and Angus

Rabbit and Angus were similarly managed. Margaret Grieve was the sole owner of PMG and served as the chief manager of both Rabbit and Angus.

As previously stated, PMG owned 20 Class A voting units, or a 0.2 percent controlling membership interest, in both Rabbit and Angus. The LLC agreements for Rabbit and Angus provided for reasonable compensation to Margaret for her role as chief manager, but she chose not to receive compensation.

For both Rabbit and Angus, the holder of Class A nonvoting membership units—PMG—possessed

all voting powers (control) for all purposes. The holders of the Class B nonvoting membership units in Rabbit and Angus had no voting powers and could not participate in any management decisions or actions for each respective entity.

The LLC agreements for Rabbit and Angus contained provisions regarding the transfer of membership units to persons other than the initial members. Full consent of all members owning Class A voting membership units was required before a member could transfer all or part of his or her units—unless the transferee qualified as a "permitted transferee" as defined in the LLC agreements.

Permitted transferees included only lineal descendants of Mr. and Mrs. Grieve, a trust created for the exclusive benefit of any one or more of such lineal descendants and/or their spouses, and in the case of Rabbit, a charitable organization.

The Rabbit and Angus Class B nonvoting membership units have not been sold or transferred since their assignment to the Pierson M. Grieve 2013 Grantor Retained Annuity Trust (the "GRAT") and the Grieve 2012 Family Irrevocable Trust (the "Irrevocable Trust"), respectively, in 2013. Further, the Rabbit and Angus Class B nonvoting membership units have never been offered for sale.

The Gifts

Margaret Grieve, in her capacity as trustee of the Grieve Revocable Trust, assigned the 9,980 Class B nonvoting membership units of Rabbit to the GRAT on October 9, 2013. At which time, Mr. Grieve determined that the fair market value of the 9,980 Class B nonvoting units of Rabbit was $5,903,769.

South Dakota Trust Co., LLC, as trustee of the Irrevocable Trust, and Mr. Grieve executed a single-life private annuity agreement. As part of the single-life annuity agreement, Mr. Grieve assigned his 9,980 Class B nonvoting units of Angus to the Irrevocable Trust in exchange for a single-life annuity that paid an annual sum of $1,420,000.

On November 1, 2013, it was determined that the single-life private annuity had a fair market value of $8,043,675. As a result of this transaction, Mr. Grieve planned to make a net taxable gift to the Irrevocable Trust to the extent that the fair market value of his 9,980 Class B nonvoting membership units in Angus exceeded the fair market value of the single-life private annuity.

Valuation Issues and Valuation Analyst Opinions

Valuation Reports in the Gift Tax Return

In Mr. Grieve's original and timely filing of his 2013 Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, he included valuation appraisal reports prepared by Value Consulting Group ("VCG").

VCG applied an asset-based business valuation approach, specifically the adjusted net asset value method, in its analyses of the 9,980 Class B nonvoting membership units of Rabbit and the 9,980 Class B nonvoting membership units of Angus.

VCG concluded it was necessary to apply discounts for lack of control and lack of marketability to determine the fair market value of the noncontrolling, nonmarketable Class B nonvoting membership units of Rabbit and Angus.

In concluding the fair market value of the 9,980 Class B nonvoting membership units of Rabbit, VCG applied a discount for lack of control of 13.4 percent and a discount for lack of marketability of

25 percent. In concluding the fair market value of the 9,980 Class B nonvoting membership units of Angus, VCG applied a discount for lack of control of 12.7 percent and a discount for lack of marketability of 25 percent.

In selecting the discounts for lack of control applicable to the Class B nonvoting membership interests in both Rabbit and Angus, VCG relied on a study regarding control premium data and noncontrolling ownership interests held in publicly traded closed-end mutual funds.

In selecting the discounts for lack of marketability applicable to the Class B nonvoting membership interests in both Rabbit and Angus, VCG relied on restricted stock studies that addressed discounts for lack of marketability of closely held equity interests.

VCG concluded that the fair market value of the 9,980 Class B nonvoting membership units of Rabbit plus the required statutory interest was equal to the fair market value of the annuity payments received by Mr. Grieve under the GRAT agreement, as of October 9, 2013. Therefore, Mr. Grieve reported a total taxable gift of zero related to the transfer of the 9,980 Class B nonvoting membership units of Rabbit to the GRAT.

Based on the adjusted net asset value method used in its analysis, VCG concluded that the fair market value of the 9,980 Class B nonvoting membership units of Angus was $20,890,934 on a noncontrolling, nonmarketable basis as of November 1, 2013.

Mr. Grieve relied on VCG's estimate of fair market value for the 9,980 Class B nonvoting membership units of Angus and reported a net taxable gift of $9,966,659.

The Service Valuation Analyst's Opinions

Upon audit, the Service disputed the fair market values assigned to the gifts by the taxpayer. The values determined by the Service for the 9,980 Class B nonvoting membership units of Rabbit and Angus were $8,918,940 and $31,456,742, respectively. These values were estimated by an independent valuation analyst.

In his valuation analysis, the valuation analyst for the Service sought the actual price at which a 99.8 percent noncontrolling interest in both Rabbit and Angus would transact.

The Service valuation analyst concluded that any willing seller of the Class B nonvoting units in both Rabbit and Angus would first look to acquire control of the 0.2 percent interest in the entities held by the Class A voting membership unit holder in order to avoid large discounts that a willing buyer would seek.

According to his testimony, the valuation analyst for the Service opined that purchasing the Class A voting membership units would result in consolidated control and further maximize the value of the Class B nonvoting units by reducing any discount sought by a hypothetical willing buyer.

The valuation analyst for the Service began his valuation analysis for Rabbit with the net asset value stipulated by the taxpayer and the Service of $9,067,074 as of October 9, 2013. In his valuation analysis of Angus, he relied on the net asset value of Angus as determined by VCG and used in the gift tax return filed by Mr. Grieve.

To arrive at the appropriate premiums for the Class A voting units of Rabbit and Angus, the valuation analyst for the Service developed a theoretical application of the discounted net asset value method. He selected and applied a discount for lack of control and discount for lack of marketability of 10 percent and 20 percent, respectively, for both Rabbit and Angus.

This theoretical valuation approach produced a 28 percent total discount applicable to each entities' net asset value. The discounted values were then used to estimate a reasonable premium that a person would pay to acquire the Class A voting membership units.

The Service valuation analyst deducted the reasonable premium amounts from the undiscounted net asset values to determine the fair market value of the Class B nonvoting membership units of both Rabbit and Angus.

According to the valuation analyst for the Service, a hypothetical willing seller of the 9,980 Class B nonvoting membership units, or a 99.8 percent noncontrolling membership interest, would be expected to seek to limit the dollar amount of any discount sought by a hypothetical willing buyer by consolidating ownership through the acquisition of the 20 Class A voting membership units.

The valuation analyst for the Service estimated the fair market value of 9,980 Class B nonvoting membership units of Rabbit and Angus to be (1) 99.8 percent of the undiscounted net asset value of each respective entity less (2) the premium required to purchase the 0.2 percent Class A voting membership interests in each respective entity.

The valuation analyst for the Service concluded $130,000 and $450,000 to be the reasonable premiums a hypothetical seller could pay PMG for its 0.2 percent Class A voting membership interests in Rabbit and Angus, respectively.

Based on this theoretical, novel valuation methodology, the valuation analyst for the Service concluded the fair market value of the Rabbit Class B nonvoting membership units was $8,918,940, or approximately $894 per unit, and the fair market value of the Angus Class B nonvoting membership units was $31,456,742, or approximately $3,152 per unit as of the respective valuation dates.

The Taxpayer Valuation Analyst's Opinions

In response to the Service's notice of deficiency, the taxpayer relied on the valuation conclusions from another independent valuation analyst. After the taxpayer's new valuation analyst estimated the net asset value of Rabbit and Angus, he applied the market approach and the income approach to estimate the value of the 9,980 Class B nonvoting membership units of both Rabbit and Angus.

The market approach and income approach are generally accepted business valuation approaches often considered and applied in valuation analyses prepared for gift and estate tax compliance and planning purposes.

In his market approach analysis, the valuation analyst for the taxpayer analyzed and relied upon publicly traded closed-end mutual funds to estimate the discount for lack of control and relied upon restricted stock studies to estimate the discount for lack of marketability.

Based on the market approach analysis, the taxpayer's valuation analyst selected a discount for lack of control and a discount for lack of marketability of 15.1 percent and 25.0 percent, respectively, and applied these selected discounts to the net asset value of Rabbit. He also selected discounts for lack of control and lack of marketability of 12.6 percent and 25.0 percent, respectively, and applied these selected discounts to the net asset value of Angus.

Although the selected discounts were different, the market approach he applied was like the approach applied in the VCG analysis.

The taxpayer's valuation analyst also used the income approach in his analysis of the Class B nonvoting membership units of Rabbit and Angus. In his income approach analysis, he estimated the price a hypothetical investor would pay for the 9,980 Class B nonvoting membership units by considering investment risks and expected rates of return based on empirical studies regarding required rates of return for investments that lack control and marketability.

The taxpayer's valuation analyst assigned equal weight to the value indications derived from the market and income approaches to reach his conclusion of $5,884,000 (or $590 per unit) for the 9,980 Class B nonvoting membership units in Rabbit and $19,854,000 (or $1,989 per unit) for the Class B nonvoting membership units in Angus.

The Court's Opinion on the Valuation Issues

In its opinion, the Court rejected the novel valuation theory relied upon by the valuation analyst for the Service. In doing so, the Court noted that the focus should be on the value of the Class B nonvoting membership units on the date of the gifts and hypothetical willing investors, not the value of the

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Class B nonvoting membership units on the basis of imaginary subsequent events.

The Court emphasized the reliance on the definition of fair market value from Revenue Ruling 59-60 when it stated the following:

> To determine the fair market values of the Class B (nonvoting) units we look at the willing buyer and willing seller of the Class B (nonvoting) units, and not the willing buyer and willing seller of the Class A units.

Further, the Court noted the holder of the Class A voting membership units in both Rabbit and Angus, Margaret Grieve, as sole owner of PMG, had testified that she had no intention of selling the controlling membership interests, and certainly not at the premium that was estimated by the valuation expert for the Service.

The Court highlighted that reports prepared by the valuation expert for the Service did not include or rely on empirical data which supported his estimated 5 percent premium that a hypothetical willing seller of the Class B nonvoting membership units would expect for the Class A voting membership units.

The Court emphasized that the Service valuation analyst (1) provided no evidence indicating that his theoretical valuation methodology had ever been subjected to peer review and (2) cited no case law to support this valuation methodology.

In the Court’s conclusion, it found no reason to object to the discounts for lack of control and lack of marketability applied in the VCG valuation reports originally filed with the taxpayer’s gift tax return. Further, the Court found the fair market value estimates presented in the VCG valuation reports to be the most reliable.

Summary and Conclusion

The takeaways to be considered from the *Grieve* decision are listed below.

- While the argument presented by the valuation analyst for the Service had intuitive economic appeal, the Court did not consider the hypothetical willing investor argument consistent with the definition of fair market value in Revenue Ruling 59-60 and consistent with valuation analyses prepared for gift and estate tax compliance and planning purposes.
- Valuations prepared for gift and estate tax compliance should provide an estimate of fair market value for the property as of the date of the gift without consideration of “imaginary subsequent” scenarios that are not “reasonably probable” based on the explicit facts of the case.
- The fact that the controlling member of Rabbit and Angus—Margaret Grieve as sole owner of PMG—testified she had no intention of selling the controlling membership interests in the entities—and that she would have required much higher premiums than those estimated by the valuation analyst for the Service, is reasonably expected to have influenced the Court in its decision to reject the Service valuation analyst’s theoretical valuation methodology.
- For cases involving discounts used to estimate the fair market value of property for gift and estate tax compliance purposes, it seems likely more of these types of challenges will be brought by the Service at the agent level, but the facts from the Grieve case seem to be on the side of the taxpayer.
- The Internal Revenue Service will not necessarily ignore GRAT transaction values which may work in favor of the taxpayer depending upon the facts and circumstances surrounding the case.
- Valuation analysts, in certain instances, may have to testify jointly or concurrently at the request of the Court.

Notes:

1. Rev. Rul. 59-60 (159-1 C.B. 237).
2. Pierson M. Grieve v. Commissioner, T.C. Memo 2020-28 (March 2, 2020).

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