The Estate of Gallagher: The Tax Court's Valuation Is a Smorgasbord

Katherine A. Gilbert and C. Ryan Stewart

When a valuation analyst presents inconsistent, confusing, or inadequately supported assumptions and conclusions, the Tax Court can adopt certain pieces of the expert's analysis and reject or disregard other pieces of the expert's analysis. While the valuation analyst opinions are presented to the Tax Court for consideration, the Tax Court is not restricted to the opinions presented. Very rarely does the Tax Court accept all of the supporting analysis of a valuation expert's opinion. The Estate of Gallagher v. Commissioner *demonstrates how the Tax Court selects and rejects certain portions of valuation expert reports. And, this judicial decision reveals the Tax Court's views on topics of interest to taxpayers, attorneys, and valuation analysts.*

Introduction

The *Estate of Gallagher v. Commissioner* decision[1] provides insight into the Tax Court's stance on certain valuation issues, including the following:

1. The appropriate date for financial data used in the valuation
2. The propriety of relying on the guideline publicly traded company method and its proper application
3. The application of the discounted cash flow method and the appropriate methodology for estimating the cost of capital
4. Adjustments to account for the S corporation tax status of closely held companies
5. Adjustments to enterprise value
6. The selection and application of lack of control and lack of marketability discounts

Important Facts

Louise Paxton Gallagher ("decedent") died on July 5, 2004 ("valuation date") owning 3,970 units ("subject units") of Paxton Media Group, LLC (PMG).

On September 30, 2005, the Estate of Louise Paxton Gallagher (the "estate" or the "taxpayer"), filed the estate tax return reporting that the value of the subject units was $34,936,000 or $8,800 per unit, based on a valuation performed by the PMG president and chief executive officer, David Michael Paxton.

On June 13, 2007, the taxpayer received a notice of proposed adjustment from the Commissioner of Internal Revenue (the "Service") proposing an adjusted value of the decedents units of $49,500,000 as of the date of death.

After unsuccessful attempts at negotiation and requests for appeal, the taxpayer engaged Sheldrick, McGhee & Kohler, LLC (SMK) to perform a valuation of the subject units. That valuation concluded an estimated value of $26,606,940 as of the valuation date.

On June 6, 2008, the Service issued a notice confirming the notice of proposed adjustment estimating the value of the subject units at $49,500,000. On July 8, 2008, the taxpayer filed a petition for redetermination of deficiency, relying on the SMK fair market value estimate.

On November 19, 2009, the taxpayer filed an amendment to the petition to reflect the fair market value estimation of $28,200,000 which was the result of a valuation performed by Richard C. May (the "taxpayer's expert").

Before the trial, the Service engaged John A. Thomson (the "Service's expert") of Klaris, Thompson, & Schroeder, Inc. (KTS) to perform a valuation of the subject units. The Service's valuation expert estimated a fair market value of $40,863,000 for the subject units.

The Tax Court found that the value of the shares as of the valuation date was $32,601,640, an amount lower than the taxpayer's initial estate tax return filing position.

The Facts of the Case

As of the valuation date, PMG was a privately held, family-owned newspaper publishing company. The company increased in size by acquiring underperforming companies and changing their operations in order to improve financial performance.

As of the valuation date, PMG reported revenues of approximately $160 million. PMG published 28 daily newspapers, 13 paid weekly publications, and several specialty publications. The company also operated a television station as of the valuation date.

PMG elected to become an S corporation in 1996. And, the shareholders had no plans to terminate the S corporation tax election as of the valuation date.

The Service's expert relied on the discounted cash flow method and the guideline publicly traded company method in valuing the units of PMG. The Service's expert applied a 17 percent discount for lack of control to the fair market value indication derived using the discounted cash flow method. And, the Service's expert applied a discount for lack of marketability of 31 percent to the value indications of each valuation approach.

Each valuation method was weighted equally, and the estimated fair market value of the subject units was concluded to be $40,863,000 or $10,293.

The taxpayer's valuation expert employed the guideline publicly traded company method and the discounted cash flow (DCF) method in his analysis. But, the taxpayer's valuation expert only relied on the DCF method in estimating the fair market value of the subject units as of the valuation date.

After the application of certain adjustments to enterprise value and a discount for lack of marketability of 30 percent, the estimated fair market value of the of PMG units, as estimated by the taxpayer's expert, was $28,200,000 or $7,100 per unit.

Therefore, the midpoint between the Service's expert value and the taxpayer's expert value (i.e., $34,531,500) was slightly below the taxpayer's initial filing position.

As the two valuation experts in this case disagreed on several issues, the Tax Court combined elements of each expert's analysis with its own judicial analysis. And, the Tax Court concluded that the fair market value of the subject block of units was $32,601,640.

The Points of Disagreement

The two opposing valuation experts not only disagreed on the estimated fair market value of the subject block of units, but also on assumptions and appropriate valuation procedures employed to reach their valuation conclusions.

Among other issues, the Tax Court considered the following areas of disagreement:

1. The date of financial information relevant to the valuation of the subject units as of the date of death
2. The propriety of relying on the guideline publicly traded company method and its proper application
3. The methods of developing financial forecasts, tax-affecting S corporation earnings, and the estimation of the cost of capital in relation to the application of the discounted cash flow method
4. The appropriate enterprise value adjustments
5. The appropriate size and type of applicable valuation discounts

Date of Financial Information

The latest data used by the expert for the Service was as of June 30, 2004. This was because the Service's expert believed it to more accurately reflect the financial condition of PMG as well as of the guideline companies as of the July 5, 2004, valuation date. The Service's expert reached this conclusion even though these data were not published until months after the valuation date.

The taxpayer's expert relied on financial information as of March 30, 2004, under the assumption that more recent financial data was unavailable as of the valuation date. Therefore, a hypothetical willing buyer and willing seller would not have had access to updated information.

The Tax Court determined that the June 2004 financial information should be used to value the subject PMG units. This is because hypothetical willing buyers and sellers could have obtained updated financial information by making inquiries to PMG and to the guideline companies.

Further, it was possible that financial analysts could have gathered non-publicly-available information from the public companies, as of the valuation date, prior to the availability of SEC filings.

Reliance on the Guideline Publicly Traded Company Method

While both valuation experts used the guideline publicly traded company method, only the Service's expert relied on that method for his final opinion of value for the subject units.

The Service's expert selected four guideline companies based on the belief that the selected companies' price multiples were reflective of "'an investor's assessment of both current and future earnings prospects as well as the business and financial risks, inherent in the Company's business as of the valuation date.'"[2]

The Tax Court found that the Service's expert was not justified in using the guideline publicly traded company method. The Tax Court reached this conclusion because the selected guideline companies were not adequately comparable to PMG.

The Tax Court determined that there were significant differences between PMG and the guideline companies. These differences included the following:

1. Size (PMG was one-third the median revenue and one-fourth the median total assets of the guideline companies)
2. Product mix (PMG had few specialty publications and no Internet component)
3. Historical growth
4. Liquidity
5. Leverage

The Discounted Cash Flow Method

Both valuation experts relied on the discounted cash flow method in their respective valuation analyses. However, there were several points of disagreement that were addressed by the Tax Court.

The major points of disagreement related to this valuation method included the following:

1. PMG's projections
2. Tax-affecting the PMG earnings
3. Cash flow normalization adjustments
4. Calculation of the appropriate discount rate

Each of these discounted cash flow valuation method issues are discussed below.

Revenue Projection

The Service's expert projected revenue based on the PMG historical revenue growth trend and statements made by PMG management indicating that PMG revenue would likely follow the historical trend. The Service's expert also included the impact of the completion of a planned acquisition in the forecast.

The taxpayer's expert used the guideline companies' average long-term growth rate to forecast revenues and did not include the acquisition in the forecast. This is because he did not expect it to be accretive or dilutive to shareholder value. The Tax Court relied on the Service's expert revenue forecast. This is because the expected revenue based on historical performance seemed to be more reliable.

In addition, the Tax Court determined that, while the anticipated acquisition would not affect the PMG balance sheet, it would affect—and should be reflected in—the expected cash flow of PMG.

Operating Income Projection

Using the PMG 2004 budget and the PMG 2003 income statement, the Service's expert estimated operating income (excluding depreciation and amortization) by subtracting operating expenses (calculated as a constant percentage of revenue) from projected revenue.

The taxpayer's expert based his projected operating income margins on (1) average annual corporate overhead expenses, adjusted for self-insured life and health insurance from 2000 to 2003 and (2) an increase in cost of goods sold margins, reflective of expected increases in newsprint costs.

The Tax Court determined that the expert for the Service estimated a reasonable operating income margin. And, the Tax Court included the depreciation projection estimated by the taxpayer's expert in order to arrive at an operating income margin of 36.4 percent.

The Tax Court found that the taxpayer's expert provided insufficient support for the propriety of certain earnings and cost adjustments that he had made to the PMG historical financial statements that formed the basis for his projection.

Therefore, the Tax Court considered the adjustments to be improper and found the taxpayer expert's estimate of expected operating income margins to be unreliable.

Other Income Projection

The valuation experts disagreed on whether or not to include other net income and pension income/expense in the projected cash flow.

The taxpayer's expert adjusted the impact of these items out of the historical financial statements as well as the projected cash flow and added the entire amount of pension overfunding to the PMG enterprise value.

The Tax Court concluded that the taxpayer's expert failed to adequately explain how he arrived at the magnitude of the pension adjustment to enterprise value as well as why the overfunded plan provided no annual cash flow benefit.

The Service's expert did not make adjustments for these items. Therefore, the other income projected by the Service's expert was adopted by the Tax Court.

Tax-Affecting the Company Earnings

In its opinion regarding this case, the Tax Court stated that "Since most data on which stock valuation is based is derived from publicly traded C corporations, appraisers may tax affect an S corporation's earnings to reflect its S status in its stock value."[3]

The taxpayer's expert tax-affected PMG earnings, and the Service's expert did not.

Using a 39 percent income tax rate, the taxpayer's expert tax-affected the PMG estimated future earnings when calculating the PMG projected cash flows. He then used an income tax rate of 40 percent to calculate the cost of capital.

The Tax Court stated that the taxpayer's expert failed to explain:

1. why he tax-affected the PMG earnings and cost of capital and
2. why he used two different income tax rates.

The Tax Court concluded:

1. that the taxpayer's expert provided no support for ignoring the benefit of a reduced tax burden for the PMG equity holders and
2. that the imposition of an "unjustified fictitious" corporate tax burden on the PMG future earnings was inappropriate.

Cash Flow Normalization Adjustments

The valuation experts disagreed on the appropriate levels of capital expenditures and working capital additions in the forecasted cash flows.

The Service's expert estimated future capital expenditures at 2.77 percent of revenue, based on the PMG historical capital expenditure trend and on discussions with the PMG management.

The taxpayer's expert estimated that the PMG capital expenditures would increase from 2.3 percent to 3.1 percent of revenue during the projection period. He provided no justification for the increases in expected capital expenditures.

The Tax Court found the Service expert's capital expenditure analysis to be reasonable, and the Court adopted that projection.

The situation was much the same regarding the experts' working capital analyses. The taxpayer's expert projected that working capital would fluctuate but provided no justification for his assumptions. The Service's expert estimated working capital based on the PMG historical trend. The Tax Court ignored the working capital projection developed by the taxpayer's expert.

The Cost of Capital

Both valuation experts estimated the appropriate cost of capital for PMG by calculating the weighted average cost of capital (WACC). However, the Tax Court stated that "We have previously held that WACC is an improper analytical tool to value a 'small, closely held corporation with little possibility of going public.'"[4]

In this case, the use of the WACC was allowed because both experts used it. As the Tax Court had determined that tax-affecting the cost of capital was inappropriate in this case, the only other points of disagreement between the experts were (1) the cost of equity capital and (2) the appropriate capital structure to use in computing the WACC.

The taxpayer's expert used the capital asset pricing model (CAPM) to estimate a cost of equity of 13.5 percent. The Service's expert used the build-up model to calculate a 20 percent cost of equity.

The Tax Court held that the build-up model was the appropriate method to calculate the cost of equity. This is because "the special characteristics associated generally with closely held corporate stock make CAPM an inappropriate formula to use in this case."[5]

However, the Tax Court found, along with other faults, that the company-specific risk premium was applied incorrectly by the Service's expert. After making modifications, the Tax Court concluded a cost of equity of 18 percent.

The cost of debt capital was estimated to be 6.6 percent by the Service's expert based on:

1. the PMG weighted 2003 and 2004 pretax cost of debt and
2. the average of Baa corporate bonds as of the valuation date

In addition, the Service's expert considered industry factors, the interest rate environment, and the PMG leverage. The taxpayer's expert calculated the cost of debt at 5 percent based on the PMG cost of debt and financial condition as well as on the interest rate environment.

The Tax Court concluded that the 6.6 percent cost of debt was reasonable.

The Service's expert estimated a capital structure of 75 percent debt and 25 percent equity based on the book values of debt and equity in the PMG capital structure as of the valuation date because a noncontrolling shareholder would not be able to change it.

The taxpayer's expert estimated the PMG capital structure to be 15 percent debt and 85 percent equity, based on the capital structures of the guideline companies that he had determined to be insufficiently comparable for use in the guideline publicly traded company method.

The Tax Court concluded that market values should be used in determining the appropriate capital structure to be used in the WACC formula.

The PMG market value was not readily known because of its status as a closely held company. Therefore, the use of PMG's actual book value capital structure was appropriate to use in this case.

The capital structure estimate developed by the taxpayer's expert was given no weight because of his contradictory stance on the use of guideline public company data.

The Tax Court concluded that the appropriate weighted average cost of capital was 10 percent.

Enterprise Value Adjustments

The taxpayer's expert applied a deficient working capital adjustment to the PMG noncontrolling enterprise value, based on the levels of working capital observed in the guideline public companies.

The Tax Court concluded that the adjustment was not adequately explained and that the use of guideline public company data was contradictory to the taxpayer expert's determination that the guideline public companies he had selected were not sufficiently comparable as to provide a reliable basis for comparison. The Service's expert did not make a similar adjustment.

The taxpayer's expert adjusted the indication of value from the DCF method by:

1. $12.8 million to account for S corporation shareholder tax savings
2. $44.3 million to reflect the discounted future value of goodwill, and
3. $6.7 million to account for PMG's extra marginal tax shield.

The Tax Court concluded that the impact of these S corporation benefits is properly reflected through the application of a 0 percent tax rate under the discounted cash flow method. The Tax Court disregarded all of the S corporation adjustments to enterprise value made by the taxpayer's expert. The Service's expert did not make any adjustments to enterprise value to reflect S corporation benefits.

Both valuation experts made adjustments to account for the effect of PMG's outstanding stock options as of the valuation date. The Service's expert calculated the PMG fair market value per unit by dividing by the number of fully diluted units as of the valuation date.

The taxpayer's expert subtracted the expected proceeds from the option exercise, $12.1 million, from the estimated enterprise value.

The Service's expert did not convince the court that his analysis was reflective of how the PMG stock option program worked. And, the Tax Court adopted the taxpayer's expert's methodology for accounting for the stock options.

Valuation Discounts

Discount for Lack of Control

The Service's expert applied a 17 percent discount for lack of control, calculated using a selected control premium of 20 percent based on *Mergerstat Review* data, to his controlling interest DCF value.

The taxpayer's expert did not apply a discount for lack of control to the DCF indication of value because he claimed it was already on a noncontrolling ownership interest basis.

The Tax Court agreed with the discount methodology of the Service expert. But, the Tax Court determined that reasons for selecting a control premium 10 percentage points below the median premium for all industries and 20 percentage points below the median premium for PMG's industry were not justified.

The Tax Court selected a premium of 30 percent which resulted in a 23 percent discount for lack of control.

> “. . . the valuation analyst should take great care to ensure that the methodologies and assumptions used in a valuation analysis are adequately justified and supported. . . .”

Discount for Lack of Marketability

The valuation experts in this case selected similar marketability discounts of 30 percent and 31 percent for the taxpayer’s expert and Service’s expert, respectively.

The Service’s expert relied on restricted stock studies and selected the 31 percent discount based on the PMG reputation and its distribution and redemption trend.

The taxpayer’s expert referenced restricted stock studies and pre-IPO studies and selected a discount based on the facts that the PMG stock (1) was more restricted and (2) had a longer anticipated holding period than the restricted stock used in the studies.

While the Tax Court has previously disregarded marketability discounts on stock with a holding period greater than two years when based on the restricted stock and pre-IPO studies, the Tax Court used them as the benchmark range for marketability discounts in this case. This was because both experts relied on them.

The Tax Court concluded that a 31 percent discount for lack of marketability was appropriate.

The Value Determined by the Tax Court

After considering the expert reports and determining the appropriate valuation variables and valuation methods for this case, the Tax Court concluded that the fair market value of the subject units of PMG was $32,601,640.

Summary and Conclusion

It is important for the valuation analyst to remember that the taxpayer generally bears the burden of proof in federal tax litigation. As a result, the valuation analyst should take great care to ensure that the methodologies and assumptions used in a valuation analysis are adequately justified and supported by:

1. sound valuation principles and theory,
2. appropriate data, and
3. the relevant facts of the case.

A recurring theme in this case was that the Tax Court disregarded or ignored several parts of the analysis performed by the taxpayer’s expert. This is because the Tax Court perceived that the valuation analyst failed to provide adequate explanations and support for his work.

The valuation analyst also needs to be consistent when determining the reliability of certain data used in the valuation analysis (e.g., the taxpayer expert’s use of guideline company data in the discount cash flow method after deeming the guideline companies unsuitable for the application of the guideline publicly traded company method).

However, it is important to note that the fair market value determined by the Tax Court was closer to the taxpayer expert’s estimate of value than the value estimated by the Service’s expert.

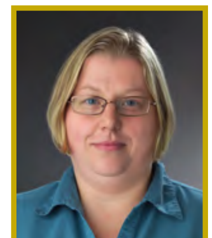
In this case, the Tax Court addressed several issues of interest to both valuation professionals and taxpayers. The Tax Court’s judicial views on these issues are insightful.

However, the Tax Court’s stance on how to reflect S corporation benefits in the valuation analysis is not conclusive in terms of appropriate or acceptable methodologies that should be employed by valuation analysts going forward.

Therefore, while valuation analysts should perform their valuation analyses based on generally accepted valuation practices and procedures and in accordance with applicable valuation standards, they should also be aware of how the courts could ultimately evaluate their valuation reports and valuation analyses.

Notes:

1. Estate of Louise Paxton Gallagher v. Commissioner, T.C. Memo 2011-148 (June 28, 2011).
2. Id. at 7.
2. Id. at 12.
3. Id. at 13, citing Estate of Hendrickson v. Commissioner, T.C. Memo 1999-278 (Aug. 23, 1999).
4. Id. at 14.



Katherine Gilbert is a senior associate in our Atlanta office. She can be reached at (404) 485-2312 or at kagilbert@willamette.com.

Ryan Stewart is a manager in our Atlanta office. He can be reached at (404) 475-2318 or at crstewart@willamette.com.