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Thought Leadership in Taxation-Related Valuation and Transfer Price Issues

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Thought Leadership in Taxation-Related Valuation and Transfer Pricing Issues
Editors for This Issue: Ben R. Duffy and Sam S. Nicholls

Forethoughts

This *Insights* issue focuses on taxation-related thought leadership discussions. These taxation-related discussions encompass federal income tax, gift tax, and estate tax issues.

Within the income tax area, the discussion topics include (1) intercompany transfer pricing of tangible property, intangible property, and services; (2) economic analysis related to the reasonableness of private company shareholder/employee compensation; and (3) solvency analysis related to the recognition (or nonrecognition) of cancellation of debt income. Within the gift and estate tax area, the discussion topics focus primarily on valuation analyses. These discussions encompass (1) the valuation of private companies, (2) the valuation of private company debt and equity securities, and (3) the identification and quantification of business valuation adjustments—that is, valuation discounts.

In particular, this *Insights* issue includes several thought leadership discussions related to tax pass-through entity ("TPE") issues. These discussion topics include (1) tax planning considerations related to the intergenerational transfer of TPE ownership interests and (2) the valuation of TPE companies and TPE company shares.

Finally, this *Insights* issue includes several thought leadership reviews of recent taxation-related judicial decisions. These judicial decisions—all from the U.S. Tax Court—provide important judicial guidance to taxpayers, to tax counsel, and to analysts related to (1) intercompany transfer pricing issues, (2) estate taxation valuation issues, and (3) gift taxation valuation issues.

Collectively, these thought leadership discussions present best practices related to both intercompany transfer pricing analyses and business and security valuation analyses. These best practices should inform taxpayers, tax counsel, and analysts with regard to tax planning, tax compliance, and tax controversy considerations.

Willamette Management Associates analysts regularly provide (1) business and security valuation analyses, (2) damages measurement analyses, and (3) intercompany transfer pricing analyses. Many of the valuation and transfer pricing analyses are performed for taxation planning, compliance, and controversy purposes. And, these taxation purposes include (1) state and local taxation "SALT") issues, (2) federal taxation issues, and (3) international taxation issues.

About the Editors

Ben R. Duffy

Ben Duffy is a manager in the firm's Atlanta office. He works in the firm's wealth management valuation services and transaction advisory services practices. His practice includes business valuation, damages analysis, and financial opinion services.

Ben develops business valuation analyses for purposes of taxation planning, compliance, and controversy (federal income, gift, and estate tax; transfer tax), forensic analysis and dispute resolution, strategic information and corporate planning, and ESOP-related transactions, financings, and litigation.

Ben is active in the ESOP professional community, and he is an executive committee member of the New South Chapter of the ESOP Association.

He was recently a co-presenter at the National Association of Certified Valuators and Analysts Georgia state chapter meeting, where he discussed issues related to subsequent events in a business valuation.

Sam S. Nicholls

Sam Nicholls is a vice president in the firm's Atlanta office. Sam's practice includes (1) the valuation of businesses, business ownership interests, and debt instruments for taxation purposes and (2) the measurement of economic damages for forensic analysis purposes.

Sam has significant experience in many areas of the business valuation profession. He previously served as an investment research analyst with both investment banks and investment managers, as a venture capital associate, and as a professor of investment banking. He earned a B.A. from Hamilton College and an M.B.A. from Yale School of Management.

Sam is an accredited senior appraiser in the business valuation discipline from the American Society of Appraisers, and he is a member of the National Center for Employee Ownership.

S Corporations, Limited Liability Companies, and Limited Partnerships—How to Avoid Costly Estate Planning Pitfalls When Making Stock Transfers and Recapitalizations Involving Nonvoting Stock

Steven B. Gorin, Esq.

S corporation shareholder agreements should be carefully crafted by legal counsel in order to avoid certain events that can imperil the company's S election. One important consideration is the language in the shareholder agreement related to nonvoting stock transfer restrictions. This issue is important because S corporations are not permitted to have a second class of stock. Such language, if properly drafted, can enable the private company owner to transfer more shares to the next generation at the appraised value of the gifted ownership interest. This discussion addresses how issues can arise in the course of estate planning or in the course of a private company sale, how to address such issues, and how a capital structure—including nonvoting shares—can reduce the private company's future tax liability. This discussion provides an example of an S corporation recapitalization involving both voting stock and nonvoting stock.[1]

Important Protections in S Corporation Shareholder Agreements

Legal counsel ("counsel") and valuation analysts ("analysts") often advise business owners that the terms set forth in an S corporation shareholder agreement should include a provision that the private company stock cannot be transferred to any person if such a transfer would make the corporation fail to be a "small business corporation" under Internal Revenue Code Section 1361(b)(1).[2] Because the federal income tax laws change over time, the stock transfer restriction should be as simple—and as broad—as the preceding sentence.

The S corporation shareholder agreement may define the term "transfer" as any event that causes the prevailing federal income tax law to treat ownership as having changed. Such a transfer may include transfers to a trust that is no longer a wholly owned grantor trust[3] even though the S corporation shares have not changed hands.

Notwithstanding these protections in the shareholder agreement, problems may occur for the S corporation or for its shareholders. For example, problems may occur if the S corporation does not have a qualified tax adviser approve every stock transfer other than to an individual who is a U.S. citizen.

These issues are important because the income tax consequences of losing an S election are harsh[4] and include the following:

1. The loss of the AAA[5] account
2. The possible imposition of a built-in gains tax[6]

The legislative history to Section 1362(f) explains the following:[7]

> If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.
>
> The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated. Likewise, it may be appropriate to waive the terminating event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

Accordingly, the Internal Revenue Service (the "Service") provides retroactive relief, so long as the taxpayer cannot get some benefit that it would not have received had it not followed the rules. Therefore, the Service may require adjustments to avoid unfair benefits.[8]

By allowing retroactive reinstatement, the Service allows an S corporation to avoid corporate level income tax. It would not be difficult to imagine an S corporation shareholder disagreeing with the relief and refusing to pay tax on his or her Form K-1 income, whipsawing the Service for having allowed the S corporation to avoid income tax. To avoid such a whipsaw, everyone who may be affected by the relief must consent.

If caught and corrected soon enough (generally 3 years and 75 days after the stock transfer), the taxpayer can obtain automatic relief.[9]

Otherwise, the correction may require an expensive and potentially time-consuming private letter ruling.[10]

As described above, either relief has the stated requirement that all of the S corporation shareholders consent to the relief for an inadvertent termination. Obtaining such consent may be difficult, for example, if the owner is no longer a shareholder or is incapacitated, deceased, or simply uncooperative.

An S corporation shareholder agreement should grant the company an irrevocable[11] durable power of attorney to sign such consents.

The S corporation shareholder agreement should also prohibit any shareholder from intentionally revoking the S election unless a particular threshold vote is attained. Counsel may consider having the shareholder agreement not only address express revocations. That is, counsel may also consider having the shareholder agreement allow the corporation's S election to be terminated by excess passive income.

An S corporation shareholder agreement may also address allocations of income upon a change in ownership or a termination of the S election. Generally, S corporation allocations of income are pro rata, per-share, per-day. Such allocations can cause unexpected results if income (including from a sale of the business) is not earned evenly throughout the year.

The Single Class of Stock Rule

S corporations cannot have more than one class of stock.[12]

Counsel should exercise extreme caution not to strip any partnership tax and accounting provisions from any operating agreement or partnership agreement forms if an unincorporated entity makes the election.[13]

Any preferred stock that was issued when an S election was made renders the election ineffective. However, the Service may grant relief retroactively if all defects are cured.[14] Similarly, preferred stock being issued after an S election is made can be cured.[15]

Issuing a "profits interest"[16] would violate the single class of stock rule, but it can qualify for inadvertent termination relief.[17] If a profits interest is desirable, then the S corporation should form a limited liability company ("LLC") subsidiary[18] and have the LLC issue profits interests.

Voting Stock and Nonvoting Stock

The issues considered in this discussion apply to C corporations as well as to S corporations, unless the discussion specifies otherwise.

Nonvoting Stock Permitted for S Corporations

Differences in stock voting rights do not by themselves create a second class of stock.[19] Generally, if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, a corporation is treated as having only one class of stock.[20]

Therefore, the corporation may issue voting and nonvoting stock, each of which confers identical rights to distribution and liquidation proceeds. Such a capital structure also avoids gift and estate tax problems under the Chapter 14 anti-freeze valuation rules.[21]

A shareholder being wrongfully shut out from participating in management did not cause the shareholder to lose status as a shareholder when the shareholder continued to enjoy the financial benefits of being a shareholder.[22]

Why Nonvoting Shares Are Needed for Estate Planning

The retention of the right to vote (directly or indirectly) the shares of stock of a "controlled corporation" causes the inclusion of the transferred stock into a decedent's estate.[23]

A corporation is a "controlled corporation" if, at any time after the transfer of the property and during the three-year period ending on the date of the decedent's death, the decedent owned (or was deemed to own under certain income tax family attribution rules)—or had the right (either alone or in conjunction with any person) to vote—stock possessing at least 20 percent of the total combined voting power of all classes of stock.

If the trustee consults with the grantor regarding how to vote the stock that the trust owns, the Service may take the position:

1. that the grantor has indirectly retained the right to vote in conjunction with the trustee and
2. that, therefore, the stock is includible in the grantor's estate for estate tax purposes.[24]

If the grantor is the trustee over transferred nonvoting stock, the fact that nonvoting stock can vote in extraordinary matters, such as mergers or liquidations, will not cause Section 2036 inclusion.[25]

However, if the grantor transfers nonvoting stock and retains the voting stock, then the transferred nonvoting stock will not be includible in the grantor's estate for estate tax purposes.[26]

Typically, the S corporation starts with one type of voting stock, and then it issues a stock dividend of nonvoting stock. The stock dividend does not constitute a taxable distribution.[27]

The tendency of this author is to distribute 19 shares of nonvoting stock for each share of voting stock. This procedure allows the voting stock to retain a significant portion, yet it allows the original owner to shift 95 percent of the distribution and liquidation rights when transferring the nonvoting stock to the next generation.

Cautions When Issuing Nonvoting Stock

The taxpayer should consider filing Form 8937 to report the issuance of nonvoting shares.[28] Form 8937 is due 45 days after issuing the shares or, if earlier, on January 15 following the calendar year of the issuance.[29]

> **"If the stock issuance would increase the franchise tax, the S corporation should consider effecting a reverse stock split."**

However, as it is stated in the instructions for Form 8937, "an S corporation can satisfy the reporting requirement for any organizational action that affects the basis if it reports the effect of the organizational action on a timely filed Schedule K-1 (Form 1120S) for each shareholder and timely gives a copy to all proper parties."[30]

These deadlines and exceptions are from the December 2011 instructions to Form 8937. The taxpayer should be careful to check the instructions, as well as the Service's website, for future developments regarding Form 8937.[31]

Issuing more shares may increase the S corporation's franchise tax. The S corporation should check both the state in which it was formed and each state in which the corporation registers to do business.

If the stock issuance would increase the franchise tax, the S corporation should consider effecting a reverse stock split. The purpose of such a reverse stock split is to decrease the number of shares before issuing the nonvoting stock.

The issuance of nonvoting shares will not annul grandfathering from Section 2703.[32]

If the corporation is a C corporation, then the stock issuance will not violate Section 1202 exclusion of gain on the sale of qualified small business stock.[33]

Reallocations between Voting Stock and Nonvoting Stock

Future reallocations between voting stock and nonvoting stock would not create income tax consequences.[34] However, to avoid a taxable gift, a swap of voting for nonvoting stock (or vice versa) should consider the disparity in their respective values.[35]

It is not unusual for even noncontrolling *voting* shares to be valued 3 to 5 percent higher than *nonvoting* shares, Therefore, the taxpayer may consider consulting a qualified appraiser when making a swap of voting for nonvoting stock (or vice versa).

A redemption plan will not cause second-class-of-stock issues when its purposes were:

1. to ensure that voting power and economic ownership between person A and person A's family and person B and person B's family remain approximately equal and
2. to prevent an individual shareholder from owning a disproportionate amount of voting versus nonvoting common stock.[36]

Example of Recapitalizing With Voting Stock and Nonvoting Stock

For example, let's assume that there are 100 shares outstanding (all voting shares), and the grantor gives 20 shares to a trust.

The procedures are summarized as follows:

1. Amend articles of incorporation to allow nonvoting stock
2. Give 19 shares of nonvoting stock for every share of voting stock, such that:
    a. the grantor has 80 voting shares and 1,520 nonvoting shares and
    b. the trust has 20 voting shares and 380 voting shares
3. The grantor transfers to the trust nonvoting shares pursuant to a formula[37] (which will likely be 21 shares) in exchange for all of the trust's 20 voting shares

Section 1036[38] allows the third procedure to be income-tax-free, even if the trust is not a grantor trust.

Adjustments to the Value of Shares for Transactions

Valuation Discounts when Redeeming Noncontrolling Shareholders

Citing Treasury Regulation 1.1361-1(l)(2)(iii)(A),[39] Letter Ruling 9433024 concluded that a certain stock redemption agreement, described below, would be "disregarded in determining whether X's shares of stock confer identical rights":

> X is a corporation organized under the laws of A. X filed a subchapter S election effective January 31, 1983. X's capital structure consists of a single class of common stock, 65% owned by the Majority Shareholder, Y, and 35% owned by 10 other shareholders (collectively, Minority Shareholders).
>
> Presently, X is negotiating a sale of substantially all of its assets to an unrelated third party. In the event a sale takes place, it is represented that each minority shareholder, pursuant to a Redemption Agreement,

has agreed to allow X to purchase their stock at a price equal to the proportionate share of the net fair market value of X's assets attributable to their block of X stock, subject to a minority discount. However, the Redemption Agreement establishes a minimum purchase price equal to the book value of the minority shareholders' stock as of the date the agreement is entered into.

Adjustments to Post-Redemption or Post-Sale Share Price

Relying on Treasury Regulation 1.1361-1(l)(2)(iii)(A), Letter Ruling 201218004 allowed the stock redemption proceeds to be adjusted such that the redeemed shareholders would receive additional payments if the corporation engages in certain sales transactions specified in the redemption agreement.

Similarly, Letter Ruling 201309003 approved a clause that allows:

1. the value of a certain claim against a third party to benefit members who sold their interest if any recovery is made and allows a person to purchase the S corporation's stock without requiring the selling original shareholder and
2. the purchaser to reach an agreement on the value of the claim.

Adjustments for Section 338(h)(10) Sales

Treasury Regulation 1.1361-1(l)(2)(v), "Special rule for section 338(h)(10) elections," provides the following guidance:

> If the shareholders of an S corporation sell their stock in a transaction for which an election is made under section 338(h)(10) and § 1.338(h)(10)-1, the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's length negotiations with the purchaser.

See part II.Q.8.e.iii.(f) Internal Revenue Code Sections 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

Straight Debt

Definition of Straight Debt

"Straight debt" does not constitute a second class of stock[40] (and it does not qualify as stock for purposes of subchapter S).[41] This rule applies notwithstanding the existence of debt classified under Treasury Regulation 1.1361-1(l)(5)(i).[42]

"Straight debt" means a written unconditional obligation, regardless of whether it is embodied in a formal note, to pay a sum certain on demand, or on a specified due date, if it:[43]

1. does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors;
2. is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and
3. is held by an individual (other than a nonresident alien), an estate, or a trust described in Section 1361(c)(2).

Clause (3) above, omits another type of creditor who qualifies under Section 1361(c)(5)(B)(iii): "a person which is actively and regularly engaged in the business of lending money."

The regulation cited above was promulgated before the statute referred to commercial lenders. The legislative history suggests that commercial lender qualification not include individuals who are commercial lenders.[44]

Being subordinated to other debt does not prevent the obligation from qualifying as "straight debt."[45]

How Debt Can Lose Its Qualification as Straight Debt

An obligation can lose its "straight debt" qualification by being materially modified or transferred to a third party who is not an eligible S corporation shareholder.[46]

Being "considered equity under general principles of federal tax law"[47] does not disqualify the obligation from being straight debt under this rule.[48] Therefore, the interest on a straight debt obligation is generally treated as interest by the corporation and the recipient. It does not constitute a distribution.[49]

“The income tax consequences of losing an S election are costly, including the possible imposition of a built-in gain tax.”

However, if the interest rate is unreasonably high, then an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest (without resulting in a second class of stock).[50]

A conversion from C corporation status to S corporation status is not treated as an exchange of debt for stock with respect to “straight debt” that is considered equity under general principles of federal income tax law.[51]

Debt Other than Straight Debt

Treasury Regulation 1.1361-1(l)(2)(i) provides a safe harbor for a:

> commercial contractual agreement, such as a . . . loan agreement, . . . unless a principal purpose of the agreement is to circumvent the one class of stock requirement.

However, debt is treated as a second class of stock of the corporation:

1. if it constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of federal income tax law and
2. if a principal purpose of creating the debt is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders.[52]

This rule does not apply to unwritten advances from a shareholder that do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time.[53]

This rule also does not apply to obligations of the same class that are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, and it is not treated as a second class of stock.[54]

Obligations that are considered equity that do not meet this safe harbor will not result in a second class of stock unless a principal purpose of the obligations is to circumvent:

1. the rights of the outstanding shares of stock or
2. the limitation on eligible shareholders.[55]

A provision for the conversion of debt to equity, using the stock’s value at the time the debt instrument is issued, does not render it a second class of stock.[56]

However, a convertible debt instrument is indeed considered a second class of stock if:

1. it would be treated as a second class of stock under provisions relating to instruments, obligations, or arrangements treated as equity under general principles or
2. it embodies rights equivalent to those of a call option that would be treated as a second class of stock under provisions relating to certain call options, warrants, and similar instruments.[57]

Summary and Conclusion

The bylaws for S corporations, operating agreements for LLCs, and partnership agreements for limited partnerships should include transfer restrictions that are simple and broad, like casting a wide net, to avoid jeopardizing their status as tax pass-through entities.

The income tax consequences of losing an S election are costly, including the possible imposition of a built-in gain tax.

S corporations may only have one class of stock and, to classify as such, may not have shares with a profits interest. They may have voting and nonvoting shares, but each class must have the same rights to distributions and liquidation proceeds.

A capital structure consisting of nonvoting stock can be beneficial for estate planning. Pursuant to Section 2036(b)(1), the retention of the right to vote (directly or indirectly) shares of stock of a “controlled corporation” causes the estate inclusion of the transferred stock.

Nonvoting shares may be created through the issuance of a stock dividend, which does not constitute a taxable distribution. The taxpayer should consider filing Form 8937 to report the issuance of nonvoting shares.

Although nonvoting shares of a corporation are not subject to Section 2036(b)(1), note that *Pierre v. Commissioner*[58] held that estate planning laws look to state law rights, so beware that this protection from Section 2036(b)(1) might not apply to nonvoting interests in LLCs or partnerships that are taxed as S corporations.

When gifting shares to the next family generation, the valuation of nonvoting shares usually includes a higher discount for lack of control, which enables the grantor to gift more shares at a given total value of the gift.

To avoid a gift being taxable, a swap of voting for nonvoting stock (or vice versa) should consider the disparity in the values of the stock. The taxpayer should consider consulting a qualified appraiser (or have tax counsel do so) when making a swap of voting for nonvoting stock (or vice versa). Often, attorneys will appoint qualified appraisers with whom they have worked before and found to be competent.

Issuing more shares may increase the S corporation's franchise tax. The S corporation should check both the state in which it was formed and each state in which the corporation registers to do business.

If the stock issuance would increase the franchise tax, the S corporation should consider effecting a reverse stock split in order to decrease the number of shares before issuing the nonvoting stock.

Notes:

1. This document is adapted from an excerpt of, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," a 2,800+ page PDF that discusses how federal income, employment and transfer taxes, and estate planning and trust administration considerations affect how one might structure a business and then transition the business through ownership changes, focusing on structural issues so that readers can plan the choice of entity or engage in estate planning with an eye towards eventual transfer of ownership in the business. The author sends a link to the most recent version in his free electronic newsletter (roughly quarterly), called *Gorin's Business Succession Solutions*. If you would like to receive the PDF and quarterly newsletter, please complete https://www.thompsoncoburn.com/forms/gorin-newsletter. All references in this discussion to a "part" are to the March 15, 2021, version of this PDF.
2. See part II.A.2.f Shareholders Eligible to Hold S Corporation Stock.
3. See part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures.
4. See parts II.E.2.b Converting from S Corporation to C Corporation and II.P.3.d Conversion from S Corporation to C Corporation.
5. See parts II.Q.7.b Redemptions or Distributions Involving S Corporations and II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation.
6. See part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Section 1374.
7. Senate Explanation of the Subchapter S Revision Act, P.L. 97-354 (10/19/82), "(e) Inadvertent terminations (secs. 1362(f))."
8. Regulation 1.1362-4(d), "Adjustments," provides the following:

   The Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation or QSub during the period specified by the Commissioner. In the case of stock held by an ineligible shareholder that causes an inadvertent termination or invalid election for an S corporation under section 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of the S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent the loss of any revenue due to the holding of stock by an ineligible shareholder (for example, a nonresident alien).
9. Rev. Proc. 2013-30, which is described in other parts of this document. The relevant Internal Revenue Service web page is https://www.irs.gov/businesses/small-businesses-self-employed/late-election-relief.
10. See parts II.A.2.e.ii Procedure for Making the S Election; Verifying the S Election; Relief for Certain Defects in Making the Election (and its companion parts II.A.2.e.iii Relief for Late S corporation Elections Within 3+ Years, II.A.2.e.iv Relief for Late QSub Elections, and II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity) and III.A.3.c.iii.(a) General Description of Deadlines for QSST and ESBT Elections (and its companion, part III.A.3.c.iii.(b) Flowchart Showing Relief for Late QSST & ESBT Elections).
11. Generally, a principal may revoke a durable power of attorney. However, a power coupled

"If the stock issuance would increase the franchise tax, the S corporation should consider effecting a reverse stock split in order to decrease the number of shares before issuing the nonvoting stock."

with an interest, such as in a shareholder agreement, may be irrevocable.

12. Section 1361(b)(1)(D).

13. Letter Ruling 200548021 refers to the operating agreement as a governing provision for purposes of Regulation 1.1361-1(l)(2)(i). Letter Rulings 201136004 and 201351017 allowed relief for inadvertent ineligibility to make an S election where perhaps the capital account partnership provisions had not been stripped out and were later caught; same with Letter Ruling 201528025, which definitely involved capital account partnership provisions that had not been stripped out and were later caught. Letter Ruling 201949009 involved not only partnership provisions but also issued profits interests that needed to be cured to cure the S election being ineffective due to those provisions. The Internal Revenue Service will not rule on whether a state law limited partnership violates the single class of stock rules. Rev. Proc. 2009-3, Section 3.01(100), which rule originated in Rev. Proc. 99-51.

14. Letter Rulings 201716009 and 201751007.

15. Letter Ruling 201949003, with the following fixes having occurred in addition to the usual representations of inadvertence and promise to make any adjustments the Service requires:

    X represents that on or about Date 5 it became aware that the issuance of the preferred stock may have inadvertently terminated its S corporation election. X represents that on Date 6 it took corrective action and (1) converted the preferred stock to common stock, (2) voted to cancel and retire all preferred stock, and (3) amended and restated its Articles of Incorporation to authorize only a single class of stock. X represents that as of Date 6 all issued and outstanding shares of preferred stock have been cancelled and retired. X also represents that its shareholders have taken into account their pro rata shares of X's separately and non-separately computed items pursuant to Section 1366 and have made any adjustments to stock basis as required under Section 1367. Furthermore, X represents that its shareholders have accounted for any distributions made under Section 1368.

16. For profits interests, see part II.M.4.f Issuing a Profits Interest to a Service Provider.

17. In Letter Ruling 201949009, an LLC made an S election. Later:

    On Date 3, X's Operating Agreement included provisions regarding partnerships. Section 4(j) of the Operating Agreement provides, in part, that it is intended that X will be treated as a partnership for federal income tax purposes and that each Member will be treated as a partner of a partnership for tax purposes. Section 4(a) provides, in part, that X shall have two (2) classes of Units: Class A Units and Profits Units. Sections, 4, 8, and 19 of the Operating Agreement state that a Profits Interest only shares in liquidation proceeds due to profits earned after the issuance of the Profit Unit. On Date 4 and Date 5, X issued Profits Interests.

    When X's shareholders discovered the effect of the partnership provisions and the issuance of the Profits Interests, X canceled the Profits Interests between Date 6 and Date 7. X amended its operating agreement on Date 8 to remove the partnership provisions and the Profits Interest provisions and to provide identical distribution and liquidation rights to X's shareholders.

    The ruling held:

    Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on Date 3 because X had more than one class of stock due to the provisions in the Operating Agreement. We also conclude that the termination of X's S corporation was inadvertent within the meaning of § 1362(f). Accordingly, under the provisions of § 1362(f), X will be treated as an S corporation from Date 3 until Date 9, provided that X's S corporation election was otherwise valid and not otherwise terminated under § 1362(d).

18. See part II.E.7.c.i Corporation Forms New LLC.

19. Section 1361(c)(4).

20. Regulation 1.1361-1(l)(1), which provides:

    General rule. A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (*l*)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

21. Section 2701(a)(2)(C) provides that Section 2701 does not apply to such a capital structure.

22. Enis v. Commissioner, T.C. Memo. 2017-222, reasoning:

> In determining stock ownership for Federal income tax purposes, the Court must look to the beneficial ownership of shares, not mere legal title. See *Ragghianti v. Commissioner*, 71 T.C. 346, 349 (1978), aff'd, 652 F.2d 65 (9th Cir. 1981). Cases concluding that a shareholder did not have beneficial ownership have considered both agreements between shareholders that removed ownership and provisions in the corporation's governing articles affecting ownership rights. See *Dunne v. Commissioner*, 2008 WL 656496, at *9. Mere interference with a "shareholder's participation in the corporation as a result of a poor relationship between the shareholders . . . does not amount to a deprivation of the economic benefit of the shares." *Id*. (citing *Hightower v. Commissioner*, T.C. Memo. 2005-274, aff'd without published opinion, 266 F.App'x 646 (9th Cir. 2008)); *Kumar v. Commissioner*, T.C. Memo. 2013-184.
>
> Petitioners contend that while Mrs. Enis was issued NLS shares, the removal of her power to exercise shareholder rights, as well as the actions of Dr. Ginsburg, removed the beneficial ownership of her shares. Petitioners, therefore, assert that they are not required to include pro rata shares of NLS' income. Petitioners identified no agreement or provisions in the corporation's governing articles removing beneficial ownership. Kumar does not support their position that a violation of the shareholders agreement could deprive them of the beneficial ownership of their shares. In *Kumar* we found that in the absence of an agreement passing the taxpayer's rights to his stock to another shareholder, a poor relationship between shareholders does not deprive one shareholder of the economic benefit of his shares. *Kumar v. Commissioner*, at *3. We, therefore, held that the taxpayer retained beneficial ownership. *Id*.
>
> Further, petitioners cited no authority, nor are we aware of any, that allows shareholders to exclude their shares of an S corporation's income because of poor relationships with other shareholders. While the relationships among the shareholders of NLS deteriorated, those poor relationships did not deprive Mrs. Enis of the economic benefit of her NLS shares. Indeed, ultimately, she sold her shares in 2014 for $436,165.

23. Section 2036(b)(1).

24. Rev. Rul. 80-346. TAM 9515003 argued that a taxpayer could not invoke Rev. Rul. 80-346 to argue for estate inclusion of voting stock:

> As the court noted in *In re Steen v. United States*, supra, allowing a taxpayer to disavow the form of the transaction (in this case, the explicit terms of the trust instrument) under these circumstances, would encourage inappropriate tax planning and unwarranted litigation and places the Service in an untenable administrative position. Accordingly, we doubt that a court would allow a taxpayer to disavow the trust instrument under the circumstances presented here.[2]
>
> [2] We note that the Tax Court has held that a taxpayer is precluded from even arguing against the form of the transaction in the absence of strong proof. Other courts have adopted an even more restrictive rule. Estate of *Robinson v. Commissioner*, 101 T.C. 499, 513-514 (1993).

The TAM concluded:

> However, we doubt that the decedent detrimentally "relied" on the revenue ruling and structured the transaction to ensure that the transferred stock would be includible in the gross estate on his death. On the contrary, the decedent was advised by counsel and, no doubt, created the trust in order to EXCLUDE the stock from his gross estate. If the intent was to ensure the stock was included in the gross estate, the trust instrument would have expressly provided for the decedent's retention of voting rights. Further, if the decedent had in some way relied on Rev. Rul. 80-346 in creating the trust, then consistency would require that the transfer be reported on the gift tax return as a transfer with a retained interest. This was not done.
>
> Finally, even though A, as executrix, followed the revenue ruling in including the stock in the gross estate, nonetheless, we do not believe that, as discussed above, the estate can gain a tax advantage by now disavowing the form of the transaction.

For more about the TAM and arguing estate tax inclusion, see fn 5397 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Section 754 Election or Required Adjustment for Built-in Loss).

25. Proposed Regulation 20.2036-2(a) (concluding two sentences).

26. See Section2036(b) (transfers of voting stock in a controlled corporation can be included in the transferor's estate for estate tax purposes if the transferor retains strings such as voting rights), Rev. Rul. 80-346 (even informal strings on voting stock held in trust can bring it into the settlor's estate), and both Rev. Rul. 81-15 and Proposed Regulation 20.2036-2 (the settlor's retention of voting stock outside of a trust will not cause the

Section 2036(b) inclusion of nonvoting stock transferred in trust); *Boykin v. Commissioner*, T.C. Memo. 1987-134 (same conclusion as Rev. Rul. 81-15 but without citing it). Rev. Rul. 81-15 does not appear to recognize that even nonvoting stock has some limited voting rights; fortunately, Proposed Regulation 20.2036-2(a) seems to recognize and approve of such a retention, as mentioned in fn. 233. Given that estate tax definitions regarding business entities tend to be sparse, one might also look to income tax rules regarding when the right to vote is significant. For purposes of determining whether a corporation was eligible to file a consolidated return, which turned on the presence of voting stock, voting for directors constituted a critical part of the right to vote. *Alumax Inc. v. Commissioner*, 109 T.C. 133 (1197), aff'd 165 F.3d 822 (11th Cir. 1999).

27. Section 301(a) taxes only a distribution of property, and refers to the Section 317(a) definition of "property." Section 317(a) provides that "property" does not include stock in the corporation making the distribution.
28. Section 6045(g).
29. Instructions for Form 8937 (revised December 2011). See www.irs.gov/pub/irs-pdf/i8937.pdf.
30. Instructions for Form 8937 (revised December 2011). See www.irs.gov/pub/irs-pdf/i8937.pdf.
31. See www.irs.gov/form8937.
32. See part II.Q.4.h Establishing Estate Tax Values, especially fn. 4332.
33. See fn 4920 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
34. Section 1036. Voting trust certificates are also eligible for an income-tax-free swap. Letter Ruling 200618004.
35. Bosca v. Commissioner, T.C. Memo. 1998-251.
36. Letter Ruling 201506003.
37. Use the principles of part III.B.3.d Disclaimers, found in part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.
38. See fn 6365 in part III.B.2.h.iii Swap Power (Section 1036 generally) and fn 650 in part II.D.4.a.i Classifying an Investment Trust (voting trust certificates).
39. Regulation 1.1361-1(l)(2)(iii)(A) is reproduced in part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules.
40. Regulation 1.1361-1(l)(5)(i).
41. Regulation 1.1361-1(b)(5) provides:

    Treatment of straight debt. For purposes of subchapter S, an instrument or obligation that satisfies the definition of straight debt in paragraph (l)(5) of this section is not treated as outstanding stock.

    This is important for Reg. § 1.1361-1(l)(3), which is reproduced in fn 3541 in part II.M.4.e.i Issuing Stock to an Employee - Generally.
42. Regulation 1.1361-1(l)(5)(i).
43. Regulation 1.1361-1(l)(5)(i).
44. House Report 104-586 (5/20/1996) for P.L. 104-188 (the Small Business Job Protection Act of 1996) expressed an intent that this cover "creditors, other than individuals, that are actively and regularly engaged in the business of lending money."
45. Regulation 1.1361-1(l)(5)(ii).
46. Regulation 1.1361-1(l)(5)(iii).
47. See part II.G.21 Debt vs. Equity.
48. Regulation 1.1361-1(l)(5)(iv).
49. Regulation 1.1361-1(l)(5)(iv).
50. Regulation 1.1361-1(l)(5)(iv).
51. Regulation 1.1361-1(l)(5)(v).
52. Regulation 1.1361-1(l)(4)(ii)(A).
53. Regulation 1.1361-1(l)(4)(ii)(B)(1).
54. Regulation 1.1361-1(l)(4)(ii)(B)(2), which further provides:

    Furthermore, an obligation or obligations owned by the sole shareholder of a corporation are always held proportionately to the corporation's outstanding stock.
55. Regulation 1.1361-1(l)(4)(ii)(B)(2).
56. Letter Ruling 201326012.
57. Regulation 1.1361-1(l)(4)(iv).
58. 133 T.C. 24 (reviewed opinion 2009).

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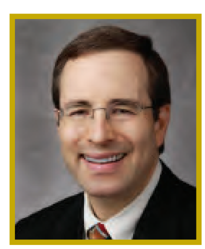


S Corporation Valuation Analysis Considerations

Andrew Duncan

This discussion addresses issues that the valuation analyst ("analyst") may consider when developing the business or stock valuation of an S corporation. These valuation issues include (1) the appropriate level of value for the valuation, (2) the sources of empirical data on which the analyst may rely, (3) the economic benefits associated with the S corporation's tax pass-through entity ("TPE") income tax status, (4) the quantitative models that analysts apply to account for the economic benefit associated with TPE tax status, and (5) the judicial precedent related to TPE valuation adjustments. Specifically, this discussion summarizes the so-called dividend income tax avoidance valuation adjustment model that was applied in the Estate of Jones *U.S. Tax Court judicial decision.*

Introduction

Historically businesses had two choices regarding federal income taxation status—before the Department of Treasury proposed the concept of creating an entity that had both:

1. a single layer of federal taxation and
2. limited liability protection.

That is, a business could elect C corporation federal income tax status that offered limited liability but was subject to taxation both on corporate income and shareholder distributions. Alternatively, a business could elect to be taxed as a partnership or sole proprietorship. While this structure shielded the business owners from double taxation, it offered no mitigation of liability.

Neither of these alternative income tax status elections were particularly advantageous to the typical small business.

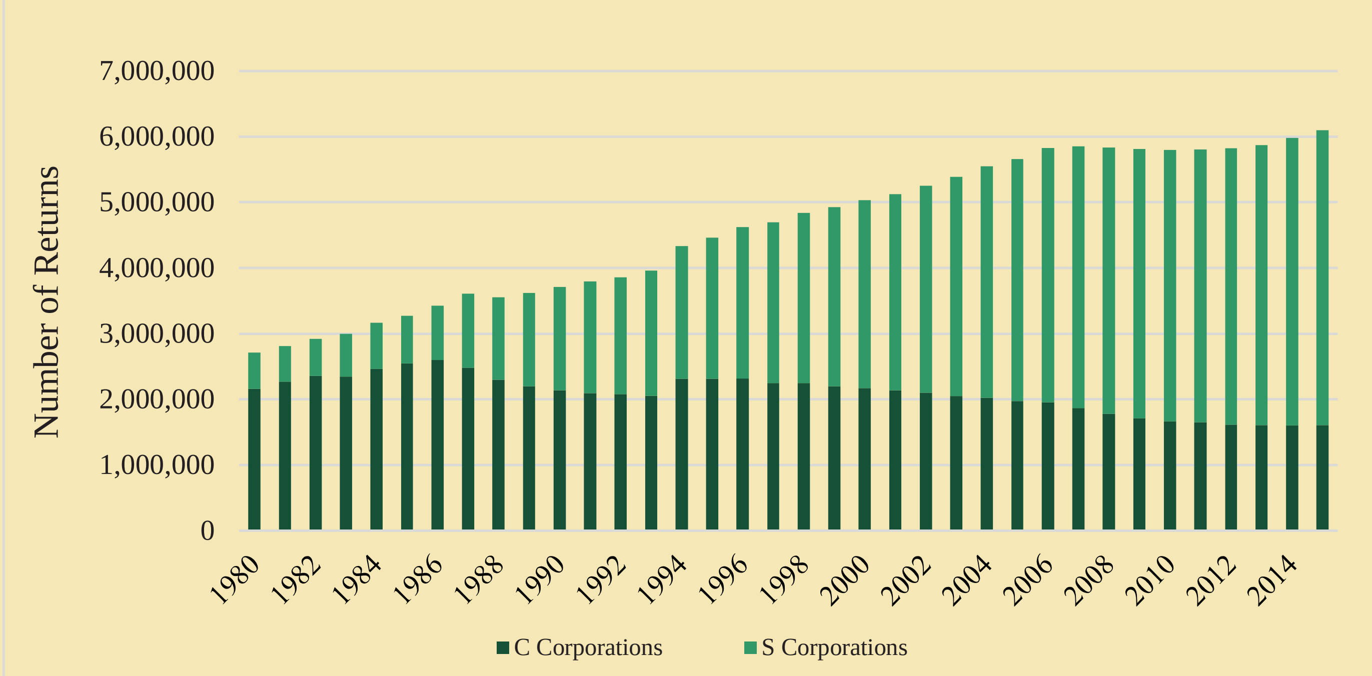
In 1958, Congress created the S corporation as part of a tax program to aid small businesses. The congressional intent was to mitigate the influence of income tax considerations in the selection of business form—by providing certain corporate entities and shareholders with the option to be taxed on a partnership basis. Therefore, S corporations achieved the advantageous corporate characteristics of limited liability—combined with the pass-through income attributes of a partnership.

Since the creation of subchapter S of the Internal Revenue Code, S corporations have become the most common business taxation structure in the United States.[1]

According to the most recently published statistics of the Internal Revenue Service (the "Service"), there were approximately 4.5 million S corporations operating in the United States as of 2015.[2]

Figure 1 illustrates the allocation of corporate income tax returns filed by S and C corporations between 1980 and 2015. Specifically, S corporations accounted for 20.1 percent of corporate income tax returns filed by corporations during 1980. That figure increased to 77.3 percent for the 2015 tax year.

Figure 1
S Corporation and C Corporation
Income Tax Returns Filed between 1980 and 2015



Therefore, it is important for a valuation analyst ("analyst") to be cognizant of (1) issues that may arise when developing a business valuation of an S corporation and (2) relevant judicial precedent guidance to both taxpayers and analysts concerning such issues.

Definition of an S Corporation

The Internal Revenue Code defines S corporations as "corporations that elect to pass corporate income, losses, deduction, and credits through to their shareholders for federal tax purposes."

S corporation shareholders (1) report their pro rata share of pass-through income and losses on their personal income tax returns and (2) pay federal income tax at their individual income tax rates. Additionally, dividends paid to shareholders (in excess of the amount of income tax due on the shareholder's pro rata share of S corporation taxable income) are received without the burden of federal income taxes.

Finally, the S corporation income that is not distributed will increase the equity tax basis of its shareholders.

In contrast, C corporations (1) are subject to income taxes at the corporate level, (2) are subject to dividend income taxes at the shareholder level, and (3) do not increase the equity tax basis by retaining earnings.

According to Internal Revenue Code Section 1361 and the corresponding Treasury Regulations, a company may elect S corporation status if the following criteria are met:

- The corporation must be a domestic corporation.
- The corporation must have only allowable shareholders which include the following:
  1. Individuals
  2. Certain trusts
  3. Estates
- Shareholders that do not meet the allowable shareholder criteria are as follows:
  1. Partnerships
  2. Other corporations
  3. Nonresident aliens
- The corporation must not have more than 100 shareholders.
- The corporation must only maintain one class of stock. As such, distributions and liquidations to shareholders must be made on a pro rata basis. However, the single class of stock can be differentiated with voting and nonvoting characteristics.

- The corporation must not be classified as an ineligible corporation; ineligible corporations include the following:
    1. Certain financial institutions
    2. Insurance companies
    3. Domestic international sales corporations

If the company meets the criteria listed above and elects S corporation status, the analyst should be aware of (1) the potential economic benefits associated with the advantageous business tax structure and (2) the various empirical data that may be applied in the course of developing the S corporation business valuation.

S Corporation Valuation Considerations

When developing an S corporation business valuation, the analyst typically considers the following questions:

1. Is there incremental value attributable to the income tax advantages of the company's tax pass-through entity ("TPE") status? If so, what is the most appropriate method to account for this incremental value in the business valuation?
2. Was the value of the S corporation derived from comparison with valuation characteristics of non-TPE entities? If so, what adjustments are appropriate to apply to the valuation of the subject S corporation?

There is not a one-size-fits-all answer to these questions. The analyst should first consider the assignment purpose and objective before selecting the appropriate (1) business valuation approaches and methods or (2) TPE-related valuation adjustments.

The following sections outline specific valuation considerations that an analyst should be aware of when developing a business valuation. A multitude of factors differentiate S corporations. Therefore, the following sections do not encompass all of the valuation issues an analyst may consider when developing an S corporation business valuation .

Level of Value

Controlling Equity Ownership Interest

It is important that the analyst understand the purpose and objective of the assignment before beginning any analysis of the S corporation. If the valuation purpose is to estimate the value of an S corporation controlling ownership interest for purposes of buying, selling, or merging the company, then the company's income tax status should be considered in the valuation.

One example of when a C corporation acquirer would pay a price premium for a TPE would be if the transaction included an election under Internal Revenue Code Section 338(h)(10) ("Section 338 election"). The Section 338 election may be made when the shareholders of the acquired company sell at least 80 percent of the equity.

The Section 338 election allows a stock equity purchase to be treated as if it were an asset purchase. This provides certain federal income tax advantages to the acquirer.[3]

It has been observed that "the positive income tax benefits to the buyer—of the step-up in the basis of the acquired assets available under the Section 338 election—is often much greater than the negative income tax attributes to the seller."[4]

Not only does the seller pay higher income taxes under a Section 338 election, but the buyer enjoys income tax advantages. A seller may use this as a bargaining chip when negotiating the transaction terms, effectively increasing the acquisition price in exchange for agreeing to the Section 338 election, which benefits the acquirer.[5]

This situation would be similar to the reason why acquirers pay control price premiums of which a portion of the premium includes synergies. Essentially, buyers and sellers share in the cost savings as part of the transaction consideration.

A specific example of this occurring is when Marvin J. Herb sold his Chicago bottling company to Coca-Cola Enterprises Inc. in 2001. The Chicago bottling company was an S corporation. The transaction was structured as an equity sale under a Section 338 election, under which Coca-Cola Enterprises identified $125 million in income tax savings it would achieve under Section 338. A spokesman for Coca-Cola Enterprises Inc. confirmed that it increased the price paid to Mr. Herb by $100 million due to these income tax benefits.[6]

Noncontrolling Equity Ownership Interest

If the analyst is developing a noncontrolling ownership interest valuation, then a direct comparison with values of other noncontrolling ownership interests may be an appropriate procedure in the business valuation. However, there may be a lack of reliable empirical data related to transactions involving noncontrolling equity ownership in S corporations.

Examples of situations in which the analyst may rely on empirical market data of publicly traded C corporations include the following:

- The analyst may apply an income approach method (i.e., the direct capitalization method or the discounted cash flow method). In the application of these income approach methods, the direct capitalization rate or the present value discount rate may be derived from empirical studies of investment rates of return on noncontrolling equity ownership interests in publicly traded C corporations.
- The analyst may apply a market approach method (i.e., the guideline publicly traded company method) to estimate the value of the S corporation equity interest. When applying the guideline publicly traded company method, pricing multiples applied to the subject S corporation are derived from empirical studies of (1) stock prices and (2) financial fundamentals of publicly traded C corporations.
- The analyst may apply (1) the market approach guideline merged and acquired company method or (2) an asset-based approach business valuation method to estimate the value of the S corporation equity interest. However, these valuation methods develop indications of value on a controlling interest level of value basis. In order to develop an opinion on a noncontrolling interest level of value basis, the analyst typically applies a discount for lack of control ("DLOC"). Such a DLOC may be derived from empirical studies of acquisitions price premiums paid for the equity securities of publicly traded C corporations.

If the analyst relies on empirical market data of publicly traded C corporations, all three generally accepted business valuation approaches can yield the equivalent value of a noncontrolling interest in a C corporation for a noncontrolling interest in an S corporation.

There are differences in the tax treatment of corporate income, dividends, and capital gains between S corporations, C corporations, and their respective shareholders. Those disparities in the income tax treatment of S corporations and C corporations may result in differing economic benefits attributable to the shareholders of each respective entity.

Exhibit 1 illustrates an example of those economic benefits. Exhibit 1 was developed using the following assumptions:

- Distribution (i.e., dividend) payout ratio of 50 percent of net income
- C corporation corporate income tax rate of 35 percent
- Individual ordinary income tax rate of 35 percent
- Dividend income tax rate of 15 percent
- Capital gains income tax rate of 15 percent
- Capital gains tax liability is economically recognized when incurred
- Capital appreciation of equity is derived from increases in retained earnings on a dollar-for-dollar basis
- No adjustment was made for qualified business income or the operations of the subject company

As presented in Exhibit 1, the net economic benefit differs between S corporation shareholders and C corporation shareholders. The primary economic benefit to the shareholders of an S corporation is the avoidance of double taxation on dividend income.

As such, analysts have developed and applied several models to measure the economic benefit to shareholders associated with the S corporation TPE taxation status.

Some of the economic generally accepted applied models that quantify this benefit include (1) the Van Vleet (S corporation economic adjustment multiple or "SEAM") model, (2) the Treharne model, (3) the Mercer model, (4) the Grabowski model, (5) the Fannon model, (6) the Sellers model, and (7) the adjustment for dividend income tax avoidance model.

This discussion focuses on one of these mathematical frameworks that quantify the adjustment that may be applied to the unadjusted equity value of an S corporation to account for differences in taxation status: the adjustment for dividend income tax avoidance model.

Adjustment for Dividend Income Tax Avoidance Model

As presented in Exhibit 1, a primary economic benefit to the S corporation shareholder is the avoidance of the C corporation dividend income tax on earnings that have already been taxed at the corporate level. The adjustment for dividend income tax avoidance model measures the economic benefit to S corporation shareholders through the application of an income approach valuation method (e.g., the direct capitalization method).

Exhibit 1
C Corporation versus S Corporation Income Tax Status
Comparison of the Net Economic Benefit to the Corporation Shareholders

Financial Fundamental		C Corporation	S Corporation
Pretax Income		$ 100,000	$ 100,000
Provision for Corporate Income Taxes	35%	$ (35,000)	NM
Net Income		$ 65,000	$ 100,000
Dividends:			
Distributions to S Corporation Shareholders	50%	NM	$ 50,000
Income Taxes Due by S Corporation Shareholders	35%	NM	$ (35,000)
Net Cash Flow Benefit to S Corporation Shareholders		NM	**$ 15,000**
Dividends to C Corporation Shareholders	50%	$ 32,500	NM
Dividend Tax Due by C Corporation Shareholders	15%	$ (4,875)	NM
Net Cash Flow Benefit to C Corporation Shareholders		**$ 27,625**	NM
Capital Gain:			
Net Income		$ 65,000	$ 100,000
Distributions/Dividends		$ (32,500)	$ (50,000)
Retained Earnings (net capital gain)		$ 32,500	$ 50,000
Effect of Increase in Income Tax Basis of Shares		NM	$ (50,000)
Taxable Capital Gain		$ 32,500	$ -
Capital Gain Tax Liability	15%	$ (4,875)	$ -
Net Capital Gain to Shareholders		**$ 27,625**	**$ 50,000**
Total Net Economic Benefit to Shareholders:			
Net Cash Flow Benefit to Shareholders		$ 27,625	$ 15,000
Net Capital Gain to Shareholders		$ 27,625	$ 50,000
Total Net Economic Benefit to Shareholders		**$ 55,250**	**$ 65,000**

Specifically, the analyst (1) estimates a normalized level of distributions (in excess of S corporation shareholder income tax liabilities), (2) estimates dividend income tax savings associated with those previously calculated excess distributions, and (3) capitalizes that level of savings into perpetuity in order to estimate the economic benefit attributable to the S corporation shareholders.

Normalized Level of Distributions

In applying the adjustment for the dividend income tax avoidance model, the analyst estimates a normalized level of income distributions in excess of shareholder income tax liabilities. Shareholders of an S corporation are taxed based on their apportionment of corporate income—whether or not that income is distributed.

Any S corporation income distributed to the shareholders in excess of their individual income tax liability is passed through tax free to the shareholder. Therefore, the analyst may estimate a normalized level of excess shareholder distributions to quantify the income tax savings.

The analyst may consider multiple factors when estimating a normalized level of distributions for the S corporation. Those factors may include, but are not limited to, the following:

1. The level of historical income distributions made to shareholders by the S corporation. If the S corporation has a specific policy

regarding the level of historical distributions, this policy may inform the future distribution expectations.

2. The level of income distributions projected to be paid by the S corporation. As a part of the due diligence process in the valuation engagement, the analyst should conduct a management interview. Information obtained from this management interview may help the analyst select a normalized level of distributions.

3. The stage in the business life cycle the subject S corporation occupies. For example, a start-up or growth-stage company may allocate substantially all of its cash flow to invest in business opportunities instead of shareholder distributions.

4. The current performance and outlook of the industry in which the S corporation operates. Strong industry performance may lead to excess cash flow generation by industry operators, which may then be distributed to shareholders.

5. The availability of investment opportunities with strong anticipated returns. The S corporation may be more likely to allocate funds to profitable investment opportunities than distributions if it can generate a strong return on that investment.

After estimating a normalized level of income distribution in excess of shareholder income tax liabilities, the analyst calculates the normalized benefit associated with dividend income tax avoidance, as compared to a C corporation.

Normalized Benefit for Dividend Income Tax Avoidance

The normalized benefit for dividend income tax avoidance is calculated by multiplying the normalized level of distributions (in excess of shareholder income tax liabilities) by the estimated income tax rate on dividend income.

The estimated income tax rate on dividend income has three components:

1. The federal dividend income tax rate
2. The state dividend income tax rate
3. The net investment income tax rate

For federal income tax purposes, dividends can be categorized as either ordinary or qualified. Ordinary dividends are taxed at the shareholder's standard income tax rate. However, qualified dividends are dividends that are subject to the 0 percent, 15 percent, or 20 percent maximum tax rate that applies to capital gains.[7]

The net investment income tax is imposed by Section 1411. The net investment income applies at a rate of 3.8 percent to certain net investment income earned by individuals, estates, and trusts that have income above statutory thresholds.[8]

After calculating the normalized benefit for income tax avoidance, the analyst should divide that figure by the applicable direct capitalization rate in order to estimate the present value of the benefit of dividend income tax avoidance.

Direct Capitalization Rate

The direct capitalization rate is equal to the present value discount rate (typically the "WACC") less the expected long-term growth rate. The WACC represents the weighted average cost of each of the components in the S corporation's capital structure. In this scenario, the analyst develops an opinion of value on a noncontrolling level of value basis. Therefore, the WACC is based on the actual capital structure of the S corporation.

The basic formula for calculating an after-tax WACC and the implied direct capitalization rate is as follows:

$$\text{Direct Capitalization Rate} = \text{WACC} - g$$

$$\text{WACC} = (Ke \times We) + (Kd\,[1-t] \times Wd)$$

where:

g	=	Expected long-term growth rate
Ke	=	Cost of equity capital
Kd	=	Pretax cost of debt capital
We	=	Percentage of equity capital in the capital structure
Wd	=	Percentage of debt capital in the capital structure
t	=	Effective C corporation income tax rate

The analyst divides the normalized benefit for income tax avoidance by the direct capitalization rate in order to estimate the present value of the benefit of dividend income tax avoidance associated with the S corporation status.

Implied TPE Benefit

The economic benefit associated with dividend income tax avoidance is often presented as a percentage premium that applies to the indicated value of equity of the S corporation. In order to calculate that percentage premium, the analyst divides the present value of dividend income tax avoidance by the indicated C corporation equivalent value of equity.

Exhibit 2 illustrates the calculation of the implied TPE benefit based on the adjustment for dividend income tax avoidance model.

Exhibit 2 was developed using the following assumptions:

- Normal level of shareholder distributions (in excess of tax liabilities) of $20,000
- C corporation dividend income tax rate of 30 percent
- Direct capitalization rate of 12 percent
- Indicated value of equity (C corporation equivalent value) of $1,000,000

The model, illustrated by the figure presented in Exhibit 2, concludes a 5 percent premium to indicated C corporation equivalent equity value attributable to the TPE status of the S corporation.

The following sections summarize a recent judicial opinion of the U.S. Tax Court related to tax affecting and subsequent adjustments when valuing an S corporation.

The Estate of Aaron U. Jones[9]

The ongoing debate regarding the appropriate application of income tax in a valuation of a TPE has frequently made its way to the U.S. Tax Court. The Service has consistently opposed applying income taxes on TPEs (i.e., partnerships and S corporations) when conducting a business valuation.

However, the judicial decision in the *Estate of Aaron U. Jones v. Commissioner of Internal Revenue* ("*Jones*") represents a landmark decision which confirms that the federal court system may consider the application of income taxes when valuing a TPE.

In the *Jones* case, Willamette Management Associates ("Willamette") was retained by the estate's counsel to provide valuation analysis and testifying expert services. The Tax Court agreed with the Willamette valuation inputs and assumptions in all material respects.[10]

There were a variety of issues considered in the *Jones* decision. But this discussion focuses on the issue of applying income tax to the valuation of a TPE. The Willamette analyst stated that it was appropriate (1) to treat the subject TPEs as C corporations from an income tax perspective and (2) to apply a premium to account for the economic benefit associated with dividend income tax avoidance.

The Willamette analyst provided the following reasons to substantiate his income tax valuation variables:

1. The present value discount rate applied was based on empirical data derived from publicly traded C corporations.
2. The pool of hypothetical willing buyers of a subject TPE often consists of C corporations that may not pay a premium for TPE income tax status.
3. The subject TPEs incurred income taxes at the shareholder level. Therefore, the subject TPEs incurred income tax expenses in the form of shareholder distributions for their respective income tax liabilities.

In the *Jones* case, the Willamette Management Associates analyst applied the adjustment for dividend income tax avoidance model to quantify the premium associated with subject entities' TPE status.

The analyst provided the following support for this position on a premium for the TPE tax status:

Exhibit 2
Illustrative Example of the TPE Valuation Adjustment Dividend Income Tax Avoidance Model

	Value
Normal Level of Shareholder Distributions (excess of income tax liabilities)	$ 20,000
Multiplied by: C Corporation Dividend Income Tax Rate (%)	30.0
Equals: Normalized Benefit for Dividend Income Tax Avoidance	$ 6,000
Divided by: Direct Capitalization Rate (%)	12.0
Equals: Present Value of the Benefit of Dividend Income Tax Avoidance	$ 50,000
Divided by: Indicated Value of Equity (C corporation equivalent value)	$ 1,000,000
Equals: Implied TPE Benefit (%)	5.0
Selected TPE Benefit Based on the Adjustment for Dividend Income Tax Avoidance Model (rounded)	5.0%

1. Excess shareholder distributions above income tax liabilities are not subject to taxes at the capital gains rate.
2. An acquiring company would pay an acquisition price premium for the subject entities' TPE tax status.

In contrast, the Service argued that a 0 percent income tax rate was appropriate for the valuation of the subject TPE given the lack of income tax burden incurred by the subject entities at the company level.

In the published judicial decision, the Tax Court concurred with the Willamette analyst's application of income taxes and the premium associated with dividend income tax avoidance.

Specifically, the Tax Court stated:

> We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of SJTC's flow-through status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include a reduction in the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy.

Summary and Conclusion

The S corporation federal income tax election provides its shareholders with the unique benefit of:

1. limited liability protection and
2. TPE income tax status.

Since its inception in 1958, the S corporation has become one of the most common business structures utilized in the United States. Analysts are frequently asked to value S corporation equity interests. Therefore, analyst should be aware of the issues that may arise in these valuations—as well as the judicial precedent guidance regarding S corporation valuation.

Specifically, analysts may consider whether (1) there is incremental value attributable to the income tax advantages associated with TPE tax status and (2) the value of the S corporation was derived from comparisons with valuation characteristics of non-TPEs.

In the S corporation valuation, many inputs are selected based on empirical data from non-TPEs. Therefore, it may be appropriate for the analyst to tax affect the subject S corporation. Since the subject S corporation maintains TPE tax status and avoids double taxation, it may be necessary to apply a price premium to offset the value decrease associated with the tax affecting procedure.

One method to quantify this price premium is the application of the adjustment for dividend income tax avoidance model. The procedures of (1) tax affecting and (2) applying a price premium (specifically the adjustment for dividend income tax avoidance model) were accepted in the judicial decision of the *Estate of Jones* case.

Given the history of federal court decisions regarding these issues, the analyst should prepare a thorough analysis when developing an S corporation business valuation.

Notes:

1. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008).
2. https://www.irs.gov/statistics/soi-tax-stats-integrated-business-data
3. Robert P Schweihs, "S Corporation Buyers and Sellers Should Consider Making a Section 338 Election," Willamette Management Associates *Insights* (Winter 2016): 73.
4. Ibid.
5. Ibid.: 76.
6. Mark Hendricks, "The S-Corp Windfall," *Crains Chicago Business* (May 7, 2005).
7. https://www.irs.gov/pub/irs-pdf/p550.pdf
8. https://www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax
9. Estate of Aaron U. Jones, v. Commissions, T.C. Memo 2019-101 (Aug. 19, 2019).
10. Scott R. Miller and Curtis R. Kimball, "Estate of Aaron U. Jones v. Commissioner of Internal Revenue: Increasing Acceptance of Tax-Affecting," Willamette Management Associates *Insights* (Winter 2020).

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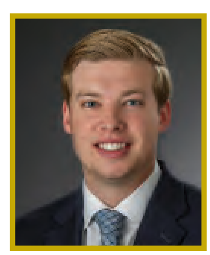

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The Coca-Cola Company & Subsidiaries v. Commissioner: Tax Court Rejects Coca-Cola Experts' Alternative Transfer Pricing Methods

Connor J. Thurman and John C. Ramirez

This discussion considers the recent judicial decision issued by the U.S. Tax Court (the "Tax Court") in The Coca-Cola Company & Subsidiaries v. Commissioner of Internal Revenue *matter (the "*Coca-Cola *case").*[1] *Specifically, this discussion describes (1) the background of the* Coca-Cola *case and (2) the intercompany transfer pricing issues involved in the judicial decision. Further, this discussion considers the Tax Court's conclusions related to the various transfer pricing methods applied by the parties' experts. In summary, the Tax Court concluded that the Coca-Cola Company ("Coca-Cola") experts' transfer pricing analyses did not result in an arm's-length price ("ALP") to be paid between Coca-Cola and its foreign affiliates. Further, the Tax Court concluded that the Internal Revenue Service's reallocation of taxable income to Coca-Cola from its affiliates, through the application of a comparable profits method transfer pricing analysis, did provide the best method for determining an ALP to be paid between Coca-Cola and its foreign affiliates.*

Introduction

Transfer pricing analysts ("analysts") are often engaged to determine the arm's-length price ("ALP") for the intercompany transfers of property or services for federal income tax planning compliance and controversy purposes.

For U.S. income tax purposes, related-party transactions are regulated by the Internal Revenue Service (the "Service") according to Internal Revenue Code Section 482 and the associated Treasury Regulations.

The purpose of Section 482 is to ensure that a domestic taxpayer clearly reflects the income attributable to controlled party transactions. According to Regulation 1.482-1, the standard to be applied in every intercompany transfer is that of a third-party taxpayer dealing at arm's length with an uncontrolled (and unrelated) taxpayer.

According to Regulation 1.482-1, a controlled transaction meets the arm's-length standard if the results of the controlled transaction are consistent with the results that would have been realized if two uncontrolled (i.e., unrelated, and independent) taxpayers had engaged in the same transaction under the same circumstances.

In the *Coca-Cola Company & Subsidiaries v. Commissioner of Internal Revenue* case, the Service's expert applied a comparable profits method ("CPM") analysis to reallocate taxable income from Coca-Cola to its foreign affiliates.

In rendering its decision, the Tax Court concluded that the Service did not abuse its discretion by reallocating income to Coca-Cola by employing a CPM analysis. That CPM transfer price analysis used the Coca-Cola foreign manufacturing affiliates as the tested parties and foreign independent bottlers as the comparable uncontrolled entities.

This judicial decision was a victory for the Service and an affirmation by the Tax Court that Coca-Cola was paid a transfer price by its affiliates that was not supported under the arm's-length standard.

This discussion describes the transfer pricing issues involved the Tax Court's recent decision in the Coca-Cola case. This discussion also considers the Tax Court's conclusions related to the various intercompany transfer pricing methods applied by the parties' experts.

Background of the Case

Coca-Cola is an industry leader in the soft drink and related beverage industry. Coca-Cola-branded beverages (including the Coca-Cola soft drink) are some of the most recognized (and most valuable) brands in the world.

Coca-Cola is the owner of certain intellectual property (the "Coca-Cola IP") related to Coca-Cola-branded beverages. The Coca-Cola IP is required to manufacture, distribute, and sell Coca-Cola-branded beverages.

The Coca-Cola IP includes trademarks, product names, logos, patents, secret formulas, and proprietary manufacturing processes.

Coca-Cola licenses the Coca-Cola IP to certain beverage concentrate manufacturing suppliers (the "suppliers"). Beverage concentrate is the syrup or powder that is mixed with water, sugar (in some cases), and carbon dioxide (in some cases) to produce finished consumer beverage products.

The suppliers use the Coca-Cola IP to produce beverage concentrate that is then sold to certain independent third-party bottlers (the "independent bottlers"). The independent bottlers produce the finished consumer beverage products so that the products may be sold to beverage distributors and retailers worldwide.

Coca-Cola enters into licensing agreements that grant the suppliers the limited right to use the Coca-Cola IP. Namely, these licensing agreements allow the suppliers to use the Coca-Cola IP to manufacture and distribute Coca-Cola-branded beverages.

However, these licensing agreements do not provide the suppliers with any ownership interest in the Coca-Cola IP.

During the 2007–2009 time period, the suppliers paid Coca-Cola for the right to exploit the Coca-Cola IP under a formulaic apportionment method. Coca-Cola and the Service had agreed in 1996 (when settling the Coca-Cola tax liabilities for the 1987–1995 time period) that this formulaic apportionment method represented an arm's-length standard.

Under the formulaic apportionment method, the suppliers satisfied the royalty obligations by:

1. paying actual royalties or
2. remitting dividends to Coca-Cola.

During the 2007–2009 time period, the suppliers remitted dividends of $1.8 billion to Coca-Cola to satisfy royalty obligations. The 1996 agreement between Coca-Cola and the Service did not address the transfer pricing method to be used subsequent to 1995.

After examining the Coca-Cola 2007–2009 income tax returns, the Service determined that the transfer pricing method Coca-Cola was utilizing did not result in an ALP. The Service determined that Coca-Cola overcompensated the suppliers and undercompensated itself for the right to exploit its IP.

The Service's expert performed a CPM analysis and reallocated income between Coca-Cola and the suppliers over the 2007–2009 time period. The Service CPM transfer price analysis relied on the profits earned between Coca-Cola and the independent bottlers as comparable uncontrolled entities.

The Service CPM transfer price analysis resulted in an increase in Coca-Cola's total taxable income for the 2007–2009 time period of over $9 billion.

Based on the CPM analysis results, the Service determined income tax deficiencies for Coca-Cola as presented in Exhibit 1.

Exhibit 1
Coca-Cola Tax Deficiencies
Based on the Service CPM Analysis

Year	Deficiency
2007	$1,114,116,873
2008	$1,069,425,951
2009	$1,121,220,625

The Service further determined that additional tax deficiencies existed due to the Coca-Cola use of "split-invoicing" by some of its foreign affiliates. The additional tax deficiencies due to split invoicing were $28,124,719 (2007), $43,314,595 (2008), and $63,465,860 (2009).

The Service-determined tax deficiencies resulted in Section 482 transfer pricing adjustments through which the Service reallocated a significant amount of income directly to Coca-Cola, primarily from foreign manufacturing affiliates (i.e., the suppliers) with plants located in South America, the Middle East, Africa, and Europe.

The Coca-Cola Intercompany Transfer Pricing Arrangement

Coca-Cola utilized the suppliers to manufacture Coca-Cola-branded beverage concentrates. The suppliers then sold and distributed the beverage concentrates to hundreds of independent bottlers worldwide.

The independent bottlers (mostly independent of Coca-Cola) used the beverage concentrate to produce the finished consumer beverage products (i.e., the Coca-Cola-branded beverages). These beverage products are marketed (directly or through distribution channels) to retail customers outside of the United States and Canada.

Coca-Cola utilized numerous local service companies (the "servicers") to manage certain activities related to advertising and marketing of the Coca-Cola-branded beverages. The servicers also maintained relationships with the independent bottlers, as well as performed certain research and development activities.

Coca-Cola granted the suppliers with licenses to exploit the Coca-Cola IP to facilitate production of the Coca-Cola-branded beverages.

The Coca-Cola IP included valuable trademarks, brand names, logos, patents, secret formulas, and proprietary manufacturing processes.

The Service argued to the Tax Court that the suppliers undercompensated Coca-Cola significantly for the right to exploit the Coca-Cola IP.

During the 2007–2009 time period, Coca-Cola reported income from the suppliers based on the so-called "10-50-50 method," consistent with the previous 11-year period. The "10-50-50 method" is a formulaic apportionment method that allowed the suppliers to secure 10 percent of gross sales as profit and split the remaining profit "50-50" with Coca-Cola.

Over the 2007–2009 time period, the suppliers paid dividends in excess of $1.8 billion to Coca-Cola under the "10-50-50 method."

Upon examination of the Coca-Cola income tax returns for 2007–2009, the Service determined that the "10-50-50 method" did not reflect an ALP because it undercompensated Coca-Cola for the use of the Coca-Cola IP.

The Service CPM Analysis

In order to determine what an ALP should have been between Coca-Cola and the suppliers, the Service reallocated income from the suppliers to Coca-Cola by relying on a CPM transfer price analysis. The Service CPM analysis relied on the independent bottlers as comparable uncontrolled entities.

The CPM analysis is described in the Section 482 Regulations as follows:

> The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.[2]

Specifically, the Section 482 Regulations state the following with regard to the application of the CPM:

> the determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable (comparable operating profit). Comparable operating profit is calculated by determining a profit level indicator for an uncontrolled comparable, and applying the profit level indicator to the financial data related to the tested party's

> most narrowly identifiable business activity for which data incorporating the controlled transaction is available (relevant business activity). To the extent possible, profit level indicators should be applied solely to the tested party's financial data that is related to controlled transactions. The tested party's reported operating profit is compared to the comparable operating profits derived from the profit level indicators of uncontrolled comparables to determine whether the reported operating profit represents an arm's length result.[3]

As noted, the CPM analysis is performed by determining a comparable operating profit level by an analysis of uncontrolled (i.e., unrelated) entity operating profit levels. The analyst then applies that operating profit level to the subject (or tested) entity.

To the extent that the actual profit level of the subject entity is not supported by the comparable operating profit level, that may indicate that the arm's-length standard is not satisfied.

For the purposes of its CPM analysis, the Service determined that the independent bottlers (i.e., the uncontrolled entities) were comparable to the suppliers (i.e., the tested entities).

The Service reached this determination because the independent bottlers and the suppliers:

1. operated in the same industry,
2. incurred similar risks,
3. held similar contractual relationships with Coca-Cola,
4. exploited much of the same Coca-Cola IP, and
5. shared the same income stream from sales of Coca-Cola-branded beverages.

The Service CPM analysis relied on an average return on assets ("ROA") for a comparable group of the independent bottlers. The Service then applied this average ROA to the suppliers' operating assets to determine an arm's-length operating profit.

The Service then reallocated any of the suppliers' profit above that "arm's-length" profit level (i.e., any excess profit) to Coca-Cola.

The Tax Court concluded that, by relying on the ROA of the independent bottlers as comparable entities to the suppliers, the Service CPM analysis was reliable and the analysis adequately represented the universe of independent bottlers engaged in the business of bottling and distributing Coca-Cola-branded beverages.

The Tax Court further concluded that the Service CPM analysis reasonably calculated operating assets by relying on the net book value figures reported by the independent bottlers and the suppliers. Further, the Service CPM analysis primarily calculated operating profit by adopting the parties' classifications as reported on the companies income statements.

Finally, the Service CPM transfer price analysis calculated geographically segmented independent bottler ROAs to improve the reliability of the CPM analysis conclusions.

Coca-Cola Proposed Alternatives

Coca-Cola challenged the Service CPM analysis (and the reallocations of income) as being not reasonable. Coca-Cola argued that the Service acted arbitrarily when it determined that the "10-50-50 method" no longer represented an arm's-length standard, despite the Service agreeing to the use of that method for the preceding five audit periods (more than a decade).

Further, Coca-Cola argued that the Service CPM analysis inappropriately reallocated income from the suppliers to Coca-Cola.

Coca-Cola claimed that the independent bottlers were not comparable entities to the suppliers because the suppliers owned valuable IP that were not reported on the suppliers' balance sheets or in a written contract.

Coca-Cola referred to these valuable assets as "marketing intangibles" or "IP associated with trademarks" and alleged that these IP were created when the suppliers financed advertising in foreign markets.

Coca-Cola contended that the independent bottlers were businesses that operate:

1. with little marketing and
2. at a different level of the global beverage market.

According to Coca-Cola, the suppliers owned local rights to the Coca-Cola IP and, therefore, should earn higher than typical returns as "master franchisees" or long-term licensees.

Coca-Cola provided three alternative methods to the Service CPM analysis. The Coca-Cola proposed alternative methods were as follows:

1. A comparable uncontrolled transaction ("CUT") method

2. A residual profit split method (“RPSM”)
3. An “unspecified method”

According to Coca-Cola, the CUT method and the RPSM were the “best methods” for determining the suppliers’ arm’s-length profit.

Alternatively, Coca-Cola claimed that if a CPM analysis based on ROA profit level is applied to the suppliers, each suppliers’ asset base should be increased to reflect the value of its “marketing intangibles.”

The “best method” rule is defined in the Section 482 Regulations as follows:

> The arm’s length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm’s length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm’s length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm’s length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm’s length result.[4]

As presented above, the “best method” in a transfer pricing context refers to the method that provides the most reliable measure of an ALP.

To demonstrate its position, Coca-Cola produced transfer pricing analysis reports from three different experts who relied on:

1. a CUT method analysis,
2. an RPSM analysis, and
3. an unspecific method analysis.

Comparable Uncontrolled Transaction Method

The first Coca-Cola expert opined that the CUT method represented the best method for determining the arm’s-length income that should be allocated to Coca-Cola. The expert derived the supposed CUTs from “master franchising transactions” that companies such as McDonald’s and Domino’s Pizza execute with regional franchisees globally.

The Coca-Cola expert claimed that regional franchisees may (1) own and operate their respective fast-food restaurant locations and/or (2) sub-franchise with owners of other individual restaurant locations.

The Coca-Cola expert relied on one “master franchising agreement” for the 2007–2009 time period in their analysis.

Based on a number of complex calculations and assumptions, Coca-Cola’s expert purported to extract a royalty rate from the “master franchising agreements” that was payable to the franchisor for the right to exploit its IP.

The Coca-Cola expert grouped together both the suppliers and the servicers of Coca-Cola into one operational unit referred to as “the Field.” In the Coca-Cola CUT method analysis, “the Field” represented a “master franchisee” that would license the Coca-Cola IP and assume the responsibility of maintenance and development of the Coca-Cola IP.

The Coca-Cola expert concluded that master franchisees paid McDonald’s and Domino’s Pizza an average royalty equal to 2.2 percent of gross retail sales. The 2.2 percent royalty was then applied to Coca-Cola’s branded beverage gross retail sales in the relevant foreign markets to conclude that an average 12.3 percent royalty rate was payable to Coca-Cola.

That is, the Coca-Cola expert concluded that the suppliers (acting at arm’s length) were entitled to receive 87.7 percent of Coca-Cola’s branded beverage gross retail sales in the relevant foreign markets.

Residual Profit Split Method

The second Coca-Cola expert opined that the RPSM represented the best method for determining the arm's-length income that should be allocated to Coca-Cola.

This Coca-Cola expert also grouped together both the suppliers and the servicers of Coca-Cola into "the Field."

According to this expert, from an economic perspective, the suppliers and the servicers together encompass the counterparty to Coca-Cola in the analyzed intercompany licensing transactions.

To establish a residual profit to be split between Coca-Cola and "the Field," the expert first estimated the "routine profit" of the Field. The expert concluded the Field routine profit was 8.5 percent based on consideration that the suppliers act as "contract manufacturers."

The transfer price expert subtracted this 8.5 percent routine profit from the total operating profit of the suppliers and the servicers in order to estimate the "residual profit."

The transfer price expert claimed that the residual profit should be split (or allocated) between "the Field" and Coca-Cola based on historical consumer advertising spending.

Based on that analysis, the expert allocated the residual profit to "the Field" 94.6 percent, 95.1 percent, and 95.4 percent in 2007, 2008, and 2009, respectively.

The expert concluded the Coca-Cola residual profit allocation (or royalty rate) to be 5.4 percent in 2007, 4.9 percent in 2008, and 4.6 percent in 2009. The expert then compared the concluded Coca-Cola royalty rates to the actual royalty rates paid by the suppliers to Coca-Cola over the 2007–2009 time period.

This comparison resulted in an indication that billions of dollars of profit should actually be reallocated back to the suppliers from Coca-Cola.

Unspecified Method

The third Coca-Cola expert opined that a so-called "asset management model" represented the best method for determining the arm's-length income that should be allocated to Coca-Cola. The "asset management model" would be considered an unspecified method as that term is defined in the Section 482 Regulations.

Under the third Coca-Cola expert's analysis, Coca-Cola operates as the "headquarters" and "the Field" operates as the actual business enterprise. In this scenario, Coca-Cola operates as a "skilled asset manager" that focuses on issues of governance, best practices sharing, and high-level strategy.

The expert argued that hedge fund managers (i.e., skilled asset managers) are typically compensated in a two-tiered structure, receiving:

1. a base fee computed based on "assets under management" and
2. a profit fee based on annual "net asset appreciation."

Under this asset management model, the transfer price expert determined that (1) a 2 percent base fee and (2) a 20 percent profit fee to be paid from the suppliers to Coca-Cola was reasonable.

The Coca-Cola expert produced a series of calculations and assumptions to estimate Coca-Cola "assets under management" and annual "net asset appreciation" during the 2007–2009 time period.

The transfer price expert then converted the 2 percent base fee and 20 percent profit fee percentages into royalties payable from the suppliers to Coca-Cola.

The result of the asset management model analysis equaled a weighted average annual royalty rate for Coca-Cola of 9.3 percent.

Tax Court Opinions Related to the Coca-Cola Proposed Alternatives

After consideration of the (1) Service CPM analysis, (2) Coca-Cola CUT method analysis, (3) Coca-Cola RPSM analysis, and (4) Coca-Cola so-called "asset management model" analysis, the Tax Court determined that the Service CPM analysis provided the best indication of an ALP to be paid between Coca-Cola and the suppliers.

The following section of this discussion summarizes some of the Tax Court's reasons for not relying on the Coca-Cola proposed alternative transfer pricing methods.

Tax Court's Comments on the Coca-Cola CUT Method Analysis

The Tax Court noted several issues with the Coca-Cola CUT method analysis that rendered it as not representing an ALP.

First, the Tax Court disagreed with the Coca-Cola CUT method analysis premise that suppliers are responsible for managing Coca-Cola's foreign businesses and overseeing the relationships with the independent bottlers. The Tax Court also disagreed that the suppliers are responsible for marketing activities or for expenditures related to exploiting and developing the Coca-Cola IP.

The Tax Court noted that the Coca-Cola CUT method analysis relied on a premise that inappropriately conflated the suppliers with the servicers as one operating unit called "the Field." All three Coca-Cola proposed transfer pricing method analyses relied on this premise of "the Field."

The Tax Court disagreed with "the Field" premise in all three of the Coca-Cola proposed alternative transfer pricing method analyses.

According to the Tax Court, one flaw with "the Field" is that the Section 482 Regulations require that income be properly allocated among "controlled taxpayers." The "controlled taxpayers" in the Coca-Cola case are Coca-Cola, the suppliers, and the servicers.

Coca-Cola and the Service agreed that the servicers transacted at arm's length with Coca-Cola. The Tax Court stated that by conflating the suppliers and the servicers into "the Field," the Coca-Cola CUT method analysis creates a controlled taxpayer that does not actually exist.

Second, the Tax Court disagreed that the suppliers could be considered "master franchisees" as described in Coca-Cola's CUT method analysis. The suppliers operated with short-term contracts that Coca-Cola could (and routinely did) terminate at its discretion.

However, in the Coca-Cola CUT method analysis, the "master franchisees" operated with long-term contracts (10 to 50 years) that provided numerous exclusive rights in specific regions.

Third, according to the Tax Court, the CUT method is especially reliable only if there are uncontrolled transactions involving the transfer of the same IP under substantially similar circumstances as the controlled transaction.

The Tax Court determined that neither Coca-Cola nor Coca-Cola's expert provided any pricing data for uncontrolled transactions with the same IP (e.g., the Coca-Cola trademarks, brand names, etc.). Instead, the Coca-Cola CUT method analysis relied on pricing data from the fast-food restaurant industry.

Fourth, the Coca-Cola expert did not provide convincing evidence that the analyzed CUTs had comparable contractual terms. According to the Tax Court, the Coca-Cola CUT method analysis failed to even compare the contractual terms that the suppliers operated under and the "master franchisees" operated under. In fact, four of the five transactions analyzed in the Coca-Cola CUT method analysis did not include actual master franchise agreements.

Finally, the Tax Court stated that Coca-Cola's CUT method analysis itself was deficiently implemented. Notably, the CUT method analysis included dozens of assumptions, estimates, adjustments, and reallocations related to operating expenses and income streams.

According to the Tax Court, the CUT method analysis assumptions were "aggressive" and almost always favored Coca-Cola. And, the Tax Court agreed with the Service's interpretation that many of the Coca-Cola CUT method analysis assumptions were mathematically or economically unsound.

For the various reasons described above, the Tax Court concluded that the Coca-Cola CUT method analysis did not satisfy the arm's-length standard required under Section 482.

Tax Court's Comments on the Coca-Cola RPSM Analysis

The Tax Court noted several issues with the Coca-Cola RPSM analysis that rendered it as not representing an ALP.

First, the Tax Court stated that (much like with the CUT method analysis) the Coca-Cola RPSM analysis reliance on "the Field" premise inappropriately conflates the suppliers with the servicers as one operating unit.

According to the Tax Court, "the Field" premise inappropriately resolved certain weaknesses within the RPSM analysis, chief among them that the suppliers did not actually perform any of the valuable functions identified in the RPSM analysis.

Notably, these valuable supplier functions included implementing consumer advertising and managing relationships with the independent bottlers. However, none of these functions was actually performed by the suppliers. Rather, these functions were performed by the servicers. Thus, by inappropriately relying on "the Field" premise, the RPSM analysis assigned these valuable functions to the suppliers.

Second, the Coca-Cola RPSM analysis concluded that the residual profit should be split among Coca-Cola and the suppliers based on the respective spending on marketing, over a 70-plus year period in the foreign markets where the Coca-Cola-branded beverages were sold.

However, the Tax Court noted that the RPSM analysis:

1. did not have reliable historical data related to all foreign markets and
2. did not account for the fact that no supplier had a consistent market to itself because the beverage concentrate supply was regularly shifted between various suppliers over this period.

The RPSM analysis indicated that Coca-Cola had spent billions of dollars related to foreign market advertising and that "the stock of consumer awareness in each country created by TCCC [Coca-Cola] depreciated and was replaced by new investments by the Foreign Licensees [suppliers] in existing and new products."[5]

The RPSM analysis considered these "investments" as "marketing-related IP," "IP associated with trademarks," and/or "intangible development costs."

The Tax Court noted that such costs were incurred by the servicers, and not by the suppliers.

The RPSM analysis then "amortized" these costs over the relevant period, indicating that the historical advertising expenses (i.e., Coca-Cola's portion) decreased every year while "the Field's" portion increased.

The Tax Court disagreed that such advertising costs could be classified as IP and certainly would not be owned by the suppliers.

Third, the Tax Court stated that even if the suppliers did own the IP that the RPSM analysis indicated, that analysis did not determine how much of the relative value that this IP contributed could be assigned to Coca-Cola or the suppliers.

Fourth, the Tax Court determined that the reliability of the advertising expense data relied on in the RPSM analysis and the assumptions contained therein was limited.

Notably, the Tax Court claimed that there exists no economic consensus on:

1. whether ordinary advertising expense data can be properly capitalized into IP or
2. what the useful life of such IP would be.

Further, the Tax Court stated that these so-called "marketing-related IP," "IP associated with trademarks," or "intangible development costs" could not reasonably be used by an unrelated party without ownership of the numerous other IP owned by Coca-Cola.

Lastly, the Tax Court noted that under the RPSM analysis assumptions and methodology, over time, Coca-Cola's older advertising expenses would be amortized out of existence and eventually, "the Field's" share of the "marketing-related IP" would approach 100 percent. That is, the suppliers could require Coca-Cola to pay the suppliers for the right to use Coca-Cola's own IP.

For the various reasons described above, the Court found that the Coca-Cola RPSM analysis did not satisfy the arm's-length standard required under Section 482.

Tax Court's Comments on the Coca-Cola Unspecified Method Analysis

The Tax Court noted several issues with the Coca-Cola "asset management model" analysis that rendered it as not representing an ALP.

The Tax Court stated that, by the expert's own admission, the asset management model analysis would not typically be applied to determine the ALP of an IP license. The Tax Court noted that was an understatement.

According to the Tax Court, the asset management model did not resemble any of the "specified methods" for estimating the value of IP under the Section 482 Regulations.

In fact, the Tax Court noted that the expert described the assignment as developing a transfer pricing methodology "without the constraint of specific transfer pricing regulations."

The asset management model was found to be not meaningful by the Tax Court for purposes of the Coca-Cola case.

Significantly, the asset management model inappropriately assumed that Coca-Cola would need to be compensated only for asset management services that include functions related to:

1. governance,
2. sharing of best practices, and
3. high-level strategy.

The Tax Court noted that the asset management model ignored the contributions made by Coca-Cola that were relevant to the case. That is, it ignored the numerous and valuable IP required to manufacture, distribute, and sell Coca-Cola-branded beverages in foreign markets.

Specifically, the Tax Court stated that hedge fund managers typically do not supply such IP to the companies managed in their portfolios. In the Tax Court's view, by compensating Coca-Cola only for the services described above, the asset management model ignored the IP that are central to the Coca-Cola case.

For the various reasons described above, the Tax Court concluded that the Coca-Cola asset management model analysis did not satisfy the arm's-length standard required under Section 482.

Summary and Conclusion

This discussion (1) described the background of the *Coca-Cola* case and (2) summarized the transfer pricing issues involved in the judicial decision.

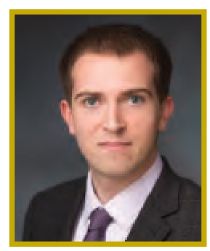
The *Coca-Cola* case demonstrates certain issues that analysts should be aware of in the context of an intercompany transfer price analysis.

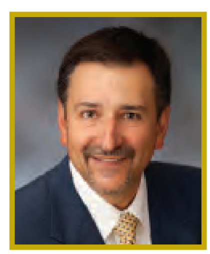
Some of the takeaways to be considered by taxpayers and analysts from the *Coca-Cola* judicial decision are listed below.

- By applying the ROA of independent bottlers, as comparable entities to the suppliers, the Service's CPM transfer price analysis was reliable and adequately represented the universe of independent bottlers engaged in the business of bottling and distributing Coca-Cola-branded beverages.
- The Coca-Cola experts inappropriately conflated the suppliers and the servicers in order to support fundamentally flawed positions in their analyses. By failing to analyze the actual relevant entities only (i.e., Coca-Cola and the suppliers), the Coca-Cola experts produced analyses that the Tax Court was inclined to reject.
- In a transfer pricing context, analysts should avoid assuming hypothetical scenarios (e.g., that the suppliers performed valuable functions that included implementing consumer advertising and managing relationships with the independent bottlers) that do not actually exist.
- Analysts should rely on an application of the "specified methods" for estimating the value of IP under the Section 482 Regulations and not rely on de novo methods such as the "asset management model."
- A transfer pricing method should produce credible results in order to be considered reliable under the arm's-length standard. For example, a transfer pricing method should not indicate unreasonable results, such as Coca-Cola being required to pay the suppliers for the right to exploit its own IP (as assumed in the Coca-Cola RPSM analysis).

Notes:

1. The Coca-Cola Company & Subsidiaries v. Commissioner, 155 T.C. No. 10 (2020).
2. Regulation 1.482-5(a).
3. Regulation 1.482-5(b)(1).
4. Regulation 1.482-1(c)(1).
5. The Coca-Cola Company & Subsidiaries v. Commissioner, at *71 (2020).





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Now More Complex than Ever: Intercompany Loan and Financial Guarantee Pricing Considerations

Michael L. Binz

The impact on financial markets from the COVID-19 pandemic and related interest rate volatility has attracted increased scrutiny of intercompany loan pricing by taxing authorities. The use of financial guarantees has also become more pervasive as external lenders are more inclined to request parent company guarantees. The Organisation for Economic Cooperation and Development ("OECD") recently issued guidance regarding the transfer pricing for intercompany financial transactions. This OECD guidance has made validating intercompany financial transactions a more complex process. Transfer pricing analysts are often asked to develop transfer pricing studies necessary to support the pricing for intercompany loans and financial guarantees. These studies provide economic support for a multinational corporation's transfer pricing decisions in the event of challenge or dispute by the Internal Revenue Service or other national tax authorities. This discussion focuses on Internal Revenue Service and OECD guidance with regard to the transfer pricing considerations for multinational corporation intercompany loans and financial guarantees.

Introduction

Intercompany financial transactions between related members of multinational entities may be documented by a variety of financial agreements. Such multinational corporation transactions include related-party loans, financial or performance-based guarantees, cash pooling, and factoring arrangements.

When multinational companies engage in intercompany financial transactions, the Internal Revenue Service (the "Service") and other national taxing authorities typically require that a transfer price be established for the subject transaction. Whatever form the intercompany financial transaction takes for local country income tax purposes, these arrangements are considered "controlled" transactions.[1]

Intercompany transfer pricing rules, for federal income tax purposes, require that these arrangements be structured at an arm's-length comporting with how comparable, unrelated parties would structure similar agreements.

This discussion focuses on the issues, factors, and constraints that transfer pricing analysts ("analysts") and other tax practitioners should consider when pricing intercompany loans and financial guarantees for federal income tax purposes.

Navigating the technical guidance from the Service and the Organisation for Economic Cooperation and Development ("OECD") for pricing intercompany loans and financial guarantees is not easy. Some of the guidance is vague and open to interpretation, and it may also be challenging in certain cases to identify arm's-length transactions that are reasonably comparable.

This discussion also examines how the passive benefit bestowed on a subsidiary[2] based on its relationship with the parent company is a factor when pricing an intercompany transaction.

This discussion also references guidance from the Service and recent OECD guidelines regarding transfer pricing for multinational corporation intercompany loans and financial guarantees.

Arm's-Length Price and "Best Method" Regulations

The purpose of Internal Revenue Code Section 482 ("Section 482") is to ensure that taxpayers clearly report the income attributable to controlled transactions and prevent tax avoidance.

Section 482 essentially requires that a controlled taxpayer mirror the vantage point of an uncontrolled taxpayer by the "true taxable income."

Section 482 provides rules and guidance for the determination of true taxable income of controlled taxpayers in specific situations—including loans, advances, or the use of tangible property or intangible property.

Regulations 1.482-2 through 1.482.7 discuss the methods used to evaluate whether transactions between or among members of a controlled group meet and satisfy the arm's-length standard to determine the true taxable income of a controlled taxpayer.

While Section 482 does not provide direct guidance regarding the appropriate method to estimate an arm's-length price for related-party loans, the Section 482 Regulations do provide general information for selecting the most appropriate arm's-length price under the best method rule based on the specific facts and circumstances surrounding a related-party loan transaction.

The best method rule (under the Section 482 Regulations) is discussed in the following paragraph:

> 1.482-1(c) Best method rule (1) In general. The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

"Section 482 essentially requires that a controlled taxpayer mirror the vantage point of an uncontrolled taxpayer by the 'true taxable income.'"

As described in the Regulations, the best method rule requires use of whatever method provides the most reliable measure of an arm's-length result.

Although Regulation 1.482-3(a) defines applicable methodologies for tangible property, and Regulation 1.482-9(a) defines applicable methodologies for controlled services transactions, a definition of applicable methodologies for intercompany loans and financial guarantees is not provided within the regulations.

The services cost method is specifically excluded for use when pricing financial transactions, including guarantees.

Interest Rate Regulations

When pricing a related-party loan or financial guarantee, benchmarking an appropriate arm's-length interest rate against an uncontrolled, comparable transaction is considered the appropriate starting point.

The Regulations provide the following guidance for the selection of an arm's-length interest rate:

> 1.482.2(a)(1)(i) Loans or advances—Interest on bona fide indebtedness—In general. Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.

> 1.482-2(a)(2)(i) Arm's length interest rate—In general. For purposes of section 482 and paragraph (a) of this section, an arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors shall be considered, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.
>
> 1.482-2(a)(2)(ii) Funds obtained at situs of borrower. Notwithstanding the other provisions of paragraph (a)(2) of this section, if the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's length rate for any taxable year shall be equal to the rate actually paid by the lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate under the standards set forth in paragraph (a)(2)(i) of this section.

The Section 482 Regulations provide guidance for pricing U.S.-dollar-denominated loans, which includes a "safe haven" interest rate based on the applicable federal rate ("AFR").

Multinational taxpayers sometimes rely on the safe haven provision and use the AFR (1) due to its simplicity and (2) to avoid the time and effort required to determine and document a true arm's-length rate of interest.

Multinational corporation taxpayers should beware the pitfalls of using the AFR safe haven, which is limited to three maturity ranges: 0–3 years (short-term rate), 3–9 years (mid-term rate), and 9+ years (long-term rate). Additionally, the AFR rates make no distinction or differentiation for entity-specific characteristics such as size, industry, type of business, and so forth.

The use of the AFR is particularly troublesome for intercompany loans to foreign entities where additional political, economic, and currency risks typically exist. Because the AFR does not capture the true credit risk associated with foreign subsidiary operations, foreign currency loans are excluded from the safe haven provision.

Furthermore, because AFRs tend to be relatively low due to their composition of blended U.S. Treasury rates, these rates are highly unlikely to be accepted by foreign tax authorities with respect to potential intercompany transfer pricing disputes.

Passive Association Benefit Guidance

The benefit derived from a subsidiary's relationship with its parent company is called a "passive association benefit." For example, a subsidiary may enjoy greater access to credit markets, even in the absence of explicit backing from its parent.

The relationship between a subsidiary and its parent entity, and any benefits derived from the relationship, are considered to be passive. This relationship is widely recognized in intercompany transfer pricing cases.

This passive benefit is an important factor. The subsidiary's association with, and implicit backing from, a multinational parent may exact credit terms for a multinational subsidiary that are more favorable than if the subsidiary were a stand-alone entity.

Regulation 1.482-9(l)(3)(v) addresses the benefit of passive association among related party members of a controlled group, as follows:

> A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer's status as a member of a controlled group. A controlled taxpayer's status as a member of a controlled group may, however, be considered for purposes of evaluating comparability between controlled and uncontrolled transactions.

Examples 15 through 17 in Regulation 1.482- 9 discuss whether or not a benefit is received by a foreign subsidiary as a result of specific actions of a domestic parent company or through a passive association with the parent company.

Example 15 presents a scenario involving a recently acquired subsidiary which won a contract shortly after acquisition. The contract was much larger and more complex than any project the foreign subsidiary had previously executed. In this example, it was determined that the foreign subsidiary did *not* receive a benefit.

Chapter 7.13 of the OECD guidelines contains language specific to the impact that passive association may have on a related entity's ability to obtain credit on more favorable terms due to the association.[3]

For example, if no service would have been received in which an associated enterprise, by reason of its affiliation alone, had a credit rating higher than it would have if unaffiliated, but whereby an intra-group service would usually exist where the higher credit rating was attributed to a guarantee by another group member.

From a transfer pricing perspective, the passive association benefit can have significant implications for a subsidiary. For instance, a stand-alone firm's ability to access the credit markets would be entirely dependent upon its own ability to generate sufficient cash flow to make the required loan payments.

In the case of a controlled subsidiary, the credit markets would likely make some assumption regarding the parent company's likelihood to intervene if the subsidiary encountered financial difficulty. Even if this is deemed implicit support—no formal guarantee is made—the credit markets will likely evaluate the controlled subsidiary differently than if it were a stand-alone entity.

The upshot of all this is that the related-party subsidiary may carry a *de facto* higher credit rating and will likely have access to more funds at lower comparable rates of interest.

OECD Guidance

On October 15, 2015, the OECD issued a report under its Base Erosion and Profit-Sharing ("BEPS") initiative. The BEPS report and related guidance changed the transfer pricing outcomes in a number of situations and now requires additional analysis and documentation.

The OECD transfer pricing guidance revised the interpretation of the arm's-length principle based on an expanded view of the economic substance of a controlled transaction. The new guidance requires additional functional and risk analysis referred to as "accurately delineating the actual transaction."

Under the updated OECD guidance, the contractual allocation of risk will be respected only if each party contractually allocates risk, is considered to control the allocated risk, and has the financial capacity to bear the allocated risk.

The accurate delineation of the intercompany transaction requires assessing the actual behavior or the "real deal" between the parties to a transaction compared to the written contractual terms and provisions.

An important element is the specific requirement that funding risk be distinguished from operational risk.

The OECD guidance prohibits the provider of financial capital to be the claimant to residual income unless it also manages and controls the operational risks. When the provider of the financial capital and the entity managing and controlling the operational and financial risks are one and the same, no adjustment is necessary.

When the management and control of operational and financial risks are not governed by the same entity, the guidance specifies who in fact (1) has access to or provided financial capital, (2) performs operations, and (3) manages and controls the risks of those activities.

When more than one entity controls the risks that drive the returns, each entity may be entitled to a share of the income, depending on its respective contributions to value creation.

The process is outlined as follows:

1. Review the contractual terms of the transaction.
2. Review the functions, assets, risks of each participant, including the assessment of how each of these relate to the generation of value with the multinational enterprise.

3. Review the characteristics of the property transferred or the services provided.
4. Review the economic circumstances of the parties and the market in which the parties operate.
5. Review the business strategies pursued by the parties.

In February 2020, the OECD issued additional guidance on transfer pricing for financial transactions. This guidance discusses the need to assess factors including the ability of the recipient to obtain a loan from an unrelated party as part of evaluating the nature of intercompany financing classified as debt or equity.

Although the ability to repay the loan in full is not required under the OECD guidance, the ability to reduce the loan balance and refinance the remaining balance should be considered.

The OECD guidance further identifies the following characteristics that should be considered in pricing intercompany loans:

- The contractual terms
- Functional analysis
- Characteristics of financial instruments
- Economic circumstances
- Business strategies

The OECD guidance on the pricing of intercompany loans is generally consistent with Section 482 Regulations and generally accepted transfer pricing practices—and highlights the following considerations:

- Delineating accurately the actual transaction between the related parties
- Determining the credit rating of the borrower and other economic circumstances of the transaction
- Benchmarking the interest rate by reference to transactions between unrelated parties

Loan Pricing

The Section 482 Regulations do not provide direct guidance related to transfer pricing intercompany loans and financial guarantees. There are, however, a number of different methods that analysts typically consider when pricing intercompany loans and related guarantees.

These methods include the following:

1. Comparable uncontrolled prices
2. Price quotations
3. Insurance pricing models
4. Standby letters of credit
5. Credit default swaps
6. Put options

The first two methods are based on direct comparable market indications, while the other four methods are equivalent to the pricing of a hedge on the underlying loan that would effectively eliminate default risk.

Whichever method is applied when pricing an intercompany loan, the first procedure is estimating the borrower's credit rating.

This procedure requires two ratings. The first is a true stand-alone rating with no implicit benefit for passive association (either with a parent corporation or a related subsidiary). The second is a stepped-up rating reflecting the implicit benefit provided by any passive association. These two ratings can then serve as a floor and ceiling for pricing the subject intercompany loan.

If a credit rating has already been assigned by a commercial credit rating agency, such as Standard & Poor's or Moody's, it is important to understand if the assigned rating reflects the benefit of passive association.

If a rating has not been assigned by a commercial credit rating agency, it is then necessary to determine a hypothetical rating.

A hypothetical rating can be developed by using a credit model based on the borrower's industry, size, and financial ratios. An adjustment for the passive benefit step-up can then be applied, if necessary.

Once a hypothetical credit rating is determined, market guideline debt instruments are identified and selected for benchmarking. Market data regarding corporate loans and bond yields are common sources which can be used to assess the financial conditional and relative standing of a particular entity.

The following attributes are also considered when assessing comparability for a specific transaction:

1. Currency
2. Timing of the transaction
3. Principal amount

4. Duration of the loan
5. Embedded loan rights

Although an entity's credit rating can provide a good indication of its relative borrowing cost, loan-specific factors and attributes also need to be considered and reflected by the concluded interest rate.

Loan Guarantee Considerations

A partial guarantee may elevate creditworthiness to a level between (1) the borrower's stand-alone credit rating and (2) the credit rating of the guarantor. A full guarantee should, in theory, raise the borrower's credit rating to the level held by the guarantor.

The following factors need to be considered when pricing a loan guarantee:

1. Whether the guarantee confers a benefit
2. Whether the guarantee is implicit or explicit
3. Whether the guarantee should be considered a service or a capital contribution

For a loan guarantee to be considered a compensable service, the guarantee must be explicit and confer a tangible benefit. Even if the guarantee is explicit and confers a benefit, an intercompany fee should only be charged if the benefit of the guarantee exceeds the benefit that would have been accrued through any implicit guarantees from the parent company.

An example of a guarantee that does not meet the criteria of a compensable service for transfer pricing purposes is provided in example 18 of Regulation 1.482-9. In this example, Company X (the parent company) sends a letter to the financial institution in Country B, which represented that Company X had a certain percentage ownership in Company Y (the foreign subsidiary) and that Company X planned to maintain that ownership.

This allowed Company Y to obtain more favorable terms on its contract but, for taxation purposes, it is not considered a chargeable service because it was neither an explicit guarantee nor a tangible benefit. This type of implicit guarantee is often referred to as a "comfort letter" and no transfer price is necessary in this instance.

Another caveat with regard to loan guarantees is the manner in which the transaction is structured. In some cases, the tax administrator may believe that the underlying economic substance of a transaction aligns more with a different classification of the transaction. This belief may be especially true for controlled transactions where a subsidiary is significantly undercapitalized or newly created with the sole purpose of undertaking a specific contract.

The recent guidance from the OECD describes financial guarantees in general terms, as follows:

> 10.155. A financial guarantee provides for the guarantor to meet specified financial obligations in the event of a failure to do so by the guaranteed party. There are various terms in use for different types of support from one member of a multinational entity group to another. At one end of the spectrum is the formal written guarantee at the other is the implied support attributable solely to membership in the multinational entity group.
>
> 10.156. The accurate delineation of financial guarantees requires initial consideration of the economic benefit arising to the borrower beyond one that derives from passive association.
>
> 10.157. From the borrower perspective, a financial guarantee may allow the guaranteed party to obtain a more favorable interest rate since the lender has access to a wider pool of assets or enabling the borrower to access a larger amount of funds.

10.158. From the perspective of a lender, the consequence of one or more explicit guarantees is that the guarantor(s) are legally committed; the lender's risk would be expected to be reduced by having access to the assets of the guarantor(s) in the event of the borrowers default. Effectively, this may mean that the guarantee allows the borrower to borrow on the terms that would be applicable if it had the credit rating of the guarantor rather than the terms it could obtain based on its own non-guaranteed rating.

Loan Guarantee Pricing

The process for pricing related-party loan guarantees is similar to the process for pricing intercompany loans.

As with intercompany loans, the first procedure is to determine the subsidiary's stand-alone credit rating. Then, through the identification of third-party pricing data and the selection of comparable transactions, a benchmark for a comparable, uncontrolled interest rate can be established.

This interest rate should then be compared to the rate received by the subsidiary that has the attached parent company guarantee. It does not matter whether the loan originated from the parent or from an independent third party.

The point is, the higher rate determined under an uncontrolled pricing methodology should serve as a benchmark for the combined pricing of the controlled loan interest rate and the pricing of the guarantee. Like an interest rate, the guarantee fee is typically in the form of an annual percentage rate on the unpaid principal balance of the loan.

The difference between the uncontrolled interest rate and the related-party loan rate obtained by the borrower sets an upper boundary for the pricing of the guarantee. This upper boundary represents the highest interest rate the subsidiary would pay for the guarantee in an uncontrolled transaction.

It would, in effect, leave the subsidiary ambivalent as to whether it would choose to:

1. obtain a lower rate loan secured by a guarantee from the parent,
2. obtain a lower rate loan secured by a guarantee from an independent third party, or
3. obtain a higher rate loan without a guarantee.

The combined uncontrolled pricing conclusions would be equal for each scenario.

This procedure for measuring the benefit conferred with and without the guarantee is commonly referred to as the "yield approach" or the "benefit approach."

Once the ceiling price for the guarantee has been estimated, establishing the transactional transfer price is less straightforward. At issue is the level of implicit benefit that should be factored into the equation.

It is reasonable to expect that the parent company would not charge the subsidiary the full uncontrolled price of the guarantee. The parent company's influence, via ownership control, of the subsidiary makes the security provided by the guarantee less risky and potentially less costly than the security provided by an independent third-party guarantee.

A somewhat simplistic procedure would be to share the economic profit generated by the guarantee. In this procedure, the transfer pricing floor is an estimated cost to the parent of providing the guarantee, and the ceiling is a stand-alone price that the subsidiary would have paid to an independent third party for the guarantee.

A rate between these two benchmarks would likely be considered arm's length. This subject is addressed further below in a judicial decision involving General Electric.

Another procedure used to calculate a lower bound for the related-party loan guarantee is to establish the amount of additional equity capital that a parent would need to contribute to the subsidiary. This amount would be at a level enabling the borrower to achieve a credit rating that would fetch the same interest rate for a controlled transaction as for an arm's-length transaction.

Generally, a guarantor would charge a price that is at least large enough to cover the expected loss of equity in the event of default, plus a profit.[4]

General Electric Capital Canada Example

A 2009 high profile judicial decision that includes many of the topics addressed in this discussion is the *General Electric Capital Canada* ("GECC") decision.[5]

In that matter, GECC issued commercial paper that was backed by an explicit guarantee from GE Capital US ("GECUS"), for which GECC paid GECUS 100 basis points.

Canadian tax authorities determined that the transfer price was not at arm's length, arguing that in the absence of the guarantee, the GECC credit rating would have been equal to that of GECUS solely based on the subsidiary's status as an associated entity.

This view takes an extreme interpretation of the passive association benefit, whereby only the parent's credit rating is applicable in determining loan rates and guarantee fees. The decision was appealed by GECC.

In its ruling on the appeal, the Tax Court of Canada used both a stand-alone approach and the concept of implicit support conveyed by the parent to determine an appropriate credit rating for GECC. The Tax Court of Canada recognized that implicit support has real, but limited value.

The explicit support provided by the guarantee that brought the rate down to a level in line with the parent's credit rating conferred a tangible benefit.

The Tax Court of Canada ruled that the interest cost savings to GECC were determined to be 183 basis points based on a purely stand-alone credit rating relative to the parent rating.

The Tax Court of Canada ruled that the guarantee fee of 100 basis points originally established by GECC and GECUS was arm's length in light of the implicit support the subsidiary gained via its status as a related-party entity.

This judicial decision clarified that the implicit support provided by a parent to a subsidiary is economically relevant, but the extent of that value is limited and remains open to interpretation. A rate below arm's length was allowed in this matter, but the process of quantifying and applying an implicit support adjustment was not clarified.

Summary and Conclusion

There are a number of complex issues to consider in the determination of intercompany transfer pricing rates for multinational corporation loans and financial guarantees. At a base level, these issues relate to whether the subject loan or financial guarantee confers a benefit and whether the transaction merits transfer pricing consideration.

To the extent the borrowing subsidiary could feasibly obtain a loan from an independent third-party lender without a guarantee and an explicit benefit has been provided by the parent, then an intercompany transfer pricing rate should be established.

Guidance and regulations on transfer pricing for financial transactions continue to receive increased attention. Recent judicial decisions involving multinational entities often seem to provide their own interpretation of existing guidance.

Many countries have added regulations that go beyond the more general guidance offered by the OECD.

For these reasons, when establishing transfer pricing rates for loans and financial guarantees, analysts may want to consider each of the following:

1. Regulations in the parent company's country
2. Regulations in the subsidiary's country
3. OECD guidance
4. Relevant court cases that may influence the respective tax administrators

The benefit that a borrower may achieve from related-party status in a multinational corporation may be considered in establishing transfer pricing rates for loans and financial guarantees.

This association benefit is recognized by both the Service and the OECD. However, there remains no standard method or guidance for quantifying that level of benefit.

Any credit rating step-up or other adjustment mechanism to reflect an association benefit will certainly require adequate documentation and compelling rationale.

Notes:

1. A controlled transaction is a transaction in which a financial agreement is made between two or more enterprises that are associated enterprises with respect to each other. http://www.oecd.org/ctp/glossaryoftaxterms.htm
2. *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4,8-10* (Paris: OECD, 2020). www.oecd.org/tax/beps/transfer-pricing-guidance-on-financial-transactions-inclusive-framework-on-beps-actions-4-8-10.htm 14 November 2013 no. IFZ 2013/184 M
3. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, (Paris: OECD Publishing, 2017).
4. BNA, Inc., *Daily Tax Report* 8, No. 15 (January 24, 2008).
5. General Electric Capital Canada Inc. v. The Queen, 2009 TCC 563 (Dec. 4, 2009).

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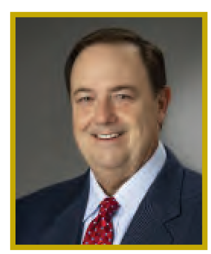


Thought Leadership Discussion

Reasonableness of Shareholder/Employee Compensation Analysis for C Corporations and S Corporations

John C. Ramirez and Connor J. Thurman

The reasonableness of private company shareholder/employee compensation is often a controversial issue in the context of federal income taxation. This is because what is considered reasonable compensation by the employer corporation taxpayer is often considered unreasonable by the Internal Revenue Service ("Service"). According to Internal Revenue Code Section 162, in order to be deductible for federal income tax purposes, executive compensation must be (1) "reasonable in amount" and (2) "based on services actually rendered." The income-tax-related consequences associated with unreasonable shareholder/employee compensation can be significant (and include payroll taxes, late payments, and tax return filing penalties). For this reason, it is important that financial analysts understand the factors that the Service and the federal courts consider when analyzing the reasonableness of shareholder/employee compensation. This discussion focuses on the generally accepted factors and methods applied to analyze the reasonableness of private company shareholder/employee compensation.

Introduction

The reasonableness of private company shareholder/employee compensation is an important, and often controversial, income tax consideration. This statement is true for the private corporation structured as either a C corporation or an S corporation. This is because the shareholder/employees of such private corporations may be motivated to deviate from arm's-length levels of compensation in order to minimize their income tax burden.

For this reason, the reasonableness of compensation paid to the shareholder/employees of such private corporations is often one of the first issues that is scrutinized by the Service during the examination of either the shareholder/employee or the private employer corporation.

In addition, the income-tax-related consequences associated with a finding of unreasonable shareholder/employee compensation can be significant. These consequences can include payroll taxes, late payments, and return filing penalties.

For the S corporation shareholder/employee, the Service is typically concerned with an unreasonably low level of employee compensation. This is because S corporation earnings are not subject to the self-employment tax, so officers/shareholders may receive minimal, small, or no wages/salary income to avoid employment taxes.

That is, earnings distributed to an S corporation shareholder/employee in excess of payments for services rendered to, or on behalf of, the companies are not subject to various employment taxes. Such employment taxes include Federal Insurance Contributions Act ("FICA"), Federal Unemployment Tax Act ("FUTA"), State Unemployment Tax Act ("SUTA"), Medicare insurance, and others ("employment taxes").

For a C corporation, the Service is typically concerned with an unreasonably high (or excessive) level of employee compensation. In such cases, the Service often claims that the excess shareholder/employee compensation:

1. absorbs taxable income and
2. represents a disguised dividend to the shareholder/employee.

Due to the potential scrutiny regarding compensation levels, a shareholder/employee or employer corporation may engage a financial analyst ("analyst") to perform a reasonable compensation analysis.

The Role of the Analyst

Analysts and other financial advisers often assess the reasonableness of private corporation shareholder/employee compensation for various reasons. These reasons may include income taxation, financial accounting, ownership transition, litigation, and corporate governance.

To ensure that reasonable compensation analyses can withstand the scrutiny of the Service or the federal courts, it is important that analysts fully understand what factors and methods should be considered when determining the reasonableness of shareholder/employee compensation.

This discussion focuses on the generally accepted factors and methods that should be considered in a reasonableness of shareholder/employee compensation analysis for a C corporation or an S corporation.

The Reasonable Compensation Objective

This discussion does not focus on the reasonableness of compensation paid to the owners of partnerships, sole proprietors, or limited liability companies ("LLCs"). This is because the compensation paid to owners of these types of entities may be characterized as distributions—which are not subject to employment taxes.

For purposes of this discussion, the objective of a reasonableness of compensation analysis is to estimate the amount of shareholder/employee compensation that is reasonable and, therefore, deductible as a business expense under Internal Revenue Code Section 162 ("Section 162").

To achieve this objective, analysts and other financial advisers often look for guidance from both:

1. Securities and Exchange Commission ("SEC") administrative rulings and
2. judicial precedent.

The following discussion considers some of the SEC administrative rulings and the judicial precedent that analysts may look to for procedural guidance when analyzing the reasonableness of shareholder/employee compensation.

Reasonableness of Shareholder/Employee Compensation

For income tax purposes, the reasonableness of shareholder/employee compensation may be controversial. This is because, like other business expenses, salaries, wages, and other compensation should be directly connected with a trade or business in order to qualify for as an income tax deduction.

According to Regulation 1.162-1, "Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. . . . Among the items included in business expenses are management expenses."

According to Section 162(a)(1), "there shall be allowed as a deduction 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."

The difficulty in estimating reasonable compensation is that the amount that is considered reasonable to one party may be considered unreasonable to another party.

Mad Auto Wrecking, Inc.

The issue of determining what is a reasonable amount of shareholder/employee compensation

was articulated in *Mad Auto Wrecking, Inc. v. Commissioner*, as follows:

> 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. The term "reasonable", however, must reflect the intrinsic value of employees in the broadest and most comprehensive sense.[1]

The form of shareholder/employee compensation does not affect its tax deductibility to the taxpayer corporation.[2]

What is important, however, is that the shareholder/employee compensation should reflect what would "ordinarily be paid for like services by like enterprise under like circumstances."[3]

Therefore, in order to qualify as an income tax deduction, shareholder/employee compensation should meet four requirements. These four requirements are discussed below.

Income Tax Deduction Requirements

Four requirements for a shareholder/employee compensation income tax deduction, as described in Regulation 1.162-7, are as follows:

1. An ordinary and necessary expense
2. Reasonable in amount
3. Based on services actually rendered
4. Actually paid or incurred by the taxpayer corporation

In short, the provisions in the Treasury Regulations are intended to prevent the employer corporation from characterizing amounts that are actually dividends as salary (i.e., employee compensation). In addition, the determination of what is a reasonable amount of shareholder/employee compensation is made based on the specific facts and circumstances of each individual case.

And, according to Regulation 1.162-7, this determination is made based on consideration of the subject taxpayer facts that exist at the "date when the contract for services was made, not those existing at the date when the contract is questioned" by the Service.

Income Tax Considerations

For the S corporation, the Service is typically concerned with whether the shareholder/employee is paid an unreasonably low level of compensation.

This is because the S corporation "noncompensation" income distributions are not subject to compensation-related employment taxes, such as FICA, FUTA, SUTA, Medicare, and others.

Accordingly, the lower the amount of the shareholder/employee compensation, the lower the amount of employment taxes paid by both (1) the shareholder/employee and (2) the employer corporation.

For this reason, an S corporation shareholder/employee may often "pay" himself or herself by taking periodic S corporation income distributions instead of taking a reasonable salary.

In such cases, both the S corporation employer and the shareholder/employee avoid paying employment taxes when the shareholder takes noncompensation income distributions. This is because noncompensation S corporation income distributions do not qualify as wages, so they are not subject to employment taxes.

When an S corporation allocates an unreasonably small percent of its corporate earnings as compensation, the Service may challenge the reasonableness of the shareholder/employee compensation.

For the private C corporation, the Service is typically concerned with whether the shareholder/employee is paid an excessive amount of compensation. This is because compensation payments are a tax-deductible expense for the C corporation.

Accordingly, the greater the amount of shareholder/employee compensation, the lower the amount of the C corporation taxable income.

Unreasonable, or excessive, amounts of shareholder/employee compensation, however, may be recharacterized by the Service as nondeductible dividend payments. That is, no income tax deduction is allowed to a C corporation for compensation paid to the shareholder/employee that exceeds a reasonable amount.

Factors Specific to an S Corporation

There are several factors specific to an S corporation that should be considered in the analysis of the reasonableness of shareholder/employee compensation. These S corporation factors include the following:

1. According to Regulation 31.3121(d)-1(b), the S corporation officers are generally considered to be employees of the taxpayer corporation when they provide more than minor (i.e., substantial) services to that corporation.
2. According to Regulation 1.162-7(a), as with a C corporation, the S corporation shareholder/employee compensation should be (a) reasonable in amount and (b) purely for services rendered.
3. According to Revenue Ruling 59-221, the S corporation shareholder income distributions are exempt from self-employment tax.
4. According to Revenue Ruling 74-44, the dividends paid to S corporation shareholders may be recharacterized as wages when such dividends are paid to shareholders in lieu of reasonable compensation for services performed for the S corporation.

Based on the above-listed regulatory guidance, the U.S. Tax Court and other federal courts typically consider several factors when determining if a payment made by an S corporation to a shareholder/employee is either a dividend or employee compensation.

Dividend or Employee Compensation?

The federal courts have found that S corporation dividends made to shareholders are actually disguised employee compensation subject to employment taxes when the following factors are present:[4]

1. The S corporation employee/shareholder performs substantial services to the taxpayer corporation but receives little or no employee compensation.
2. The S corporation employee/shareholder receives profit distributions in proportion to the amount of stock owned in the taxpayer corporation.
3. No other individuals work at the S corporation business.
4. The S corporation employee/shareholder owns most or all of the company stock.
5. Corporate distributions are characterized as shareholder loans, but there are no supporting shareholder loan documents.
6. The S corporation employee/shareholder worked elsewhere at a similar position but earned a much higher wage in that position.
7. The S corporation does not have a specific fixed formula for determining the amount of the employee/shareholder salary.
8. The S corporation employee/shareholder compensation rate is less than the compensation rate for a comparable position at a comparable company.
9. The S corporation employee/shareholder is compensated at a rate lower than other nonshareholders/employees who work in similar positions at the subject company.

If challenged by the Service, the taxpayer corporation bears the burden of proof to demonstrate that the amount of the shareholder/employee compensation is reasonable.[5]

Moreover, if some amount of the shareholder/employee compensation is determined to be excessive, then only that portion of the compensation that is determined to be reasonable will be deductible.[6]

Given the controversial aspects associated with the reasonableness of shareholder/employee compensation, it is important that the analyst understand and consider the factors and methods that the Service and the federal courts typically consider when testing the reasonableness of shareholder/employee compensation.

Other Relevant Factors

For many years, the Service and the federal courts have applied a multifactor analysis to test the reasonableness of private company shareholder/employee compensation. A multifactor analysis is an analytical method applied to solve a complex problem based on an analysis of the relevant factors that contribute to the complexity of the problem.

The generally accepted reasonableness of shareholder/employee compensation factors considered by many courts today were first articulated over 60 year ago in the *Mayson Manufacturing Company v. Commissioner* decision.[7]

More recently, in *Pulsar Components International, Inc. v. Commissioner*,[8] the Tax Court expanded the *Mayson* factors to include the following factors that are generally considered to estimate the reasonableness of shareholder/employee compensation:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work
3. The size and complexities of the employer's business
4. A comparison of salaries paid with the employer's gross and net income
5. The prevailing general economic conditions
6. A comparison of salaries with distributions to officers and retained earnings
7. The prevailing rates of compensation for comparable positions in comparable concerns
8. The salary policy of the employer as to all employees
9. The amount of compensation paid to the particular employee in previous years
10. The employer's financial condition
11. Whether the employer and employee dealt at arm's length
12. Whether the employee guaranteed the employer's debt
13. Whether the employer offered a pension plan or profit-sharing plan to its employees
14. Whether the employee was reimbursed by the employer for business expenses that the employee paid personally

Historically, the reasonableness of shareholder/employee compensation factors presented in the *Pulsar* case include the factors typically considered by the federal court and the Service.[9]

The analyst typically considers the Pulsar factors as part of an analysis of the reasonableness of private company shareholder/employee compensation.

The Independent Investor Test to Estimate Reasonable Compensation

Several methods are available for performing a reasonableness of private company shareholder/employee compensation analysis. The analyst may consider (and may apply) the three generally accepted private company business valuation approaches in the application of the so-called independent investor test.

That is, the analyst may apply the market approach, the income approach, and/or the asset-based approach in the business valuation component of the independent investor test.[10]

Analysts, the Service, and the federal courts will typically rely on one or a combination/reconciliation of generally accepted business valuation approaches and methods in the application of the independent investor test. An application of one or more business valuation approaches and methods should be based on the context of a hypothetical independent investor.

Comparable Positions at Comparable Companies

The analyst may consider comparable positions at comparable companies. When applying this analysis, the analyst may perform a comparison of the taxpayer company's compensation for the subject employee to the appropriate level of compensation paid in the subject company's industry.

An industry compensation comparison is the first procedure in a market-based reasonable compensation analysis. The analyst performs such a comparison to answer the question, "How much compensation would be paid for this same position, held by a non-owner in an arms-length employment relationship, at a similar company?"[11]

The procedures applied to analyze this reasonableness of compensation factor typically include the following:

1. Financial ratio analysis
2. Industry salary survey analysis

These procedures are used to estimate a range of reasonable compensation for a subject shareholder/employee. The range is based on an analysis of the compensation paid at “guideline” companies (or industries) to executive with similar duties, responsibilities, skills, and functions.

Financial Ratio Analysis

In a financial ratio analysis, the compensation of the shareholder/employee is compared to the taxpayer company sales, profit before interest and taxes, assets, and other financial measures. These subject company financial ratios are then compared to comparable company and/or industry financial ratios.

Many sources of executive compensation empirical data are available to develop comparable company financial ratios.

For example, in an SEC proxy statement analysis, the reasonableness of executive compensation is estimated based on a comparison of the subject shareholder/employee compensation to the levels of compensation paid to comparable executives of comparable publicly traded companies.

SEC proxy statement rules require the disclosure of public company executive and director compensation.

These SEC rules require publicly traded companies to disclose in their proxy statements, the total compensation of the company’s most highly paid executive officers.

These SEC proxy statement disclosures of executive compensation can be used to develop a market-based range of compensation (e.g., expressed as a ratio of revenue and/or earnings) for:

1. comparable publicly traded companies or
2. a particular industry.

As with any market-based ratio analysis, the analyst should have a thorough understanding of the subject company and the subject industry before using this procedure.

This is because macroeconomic trends and industry fluctuations can result in significant variability in market-based financial ratios.

In addition, the reliability of a financial ratio analysis can be affected by the following:

1. The comparability of the subject company to the selected publicly traded companies or industry
2. The quantity and quality of information disclosed in the selected data source

Properly applied, however, a financial ratio analysis can provide the analyst with relevant market-based information with which to assess the reasonableness of shareholder/employee compensation.

Industry Salary Survey Analysis

In an industry salary survey analysis, the analyst analyzes the levels of actual compensation paid to comparable executives within the subject industry.

An important factor to consider in determining the reasonableness of shareholder/executive compensation is the prevailing rates of compensation paid for comparable executive positions in comparable companies.

Typically, to be considered “comparable,” companies generally operate in the same industry (or line of business) with similar clients, products, and suppliers. In addition, the companies are of a similar size, usually measured in terms of assets or sales.

The subject shareholder/employee position may be considered comparable to an industry survey executive position if the nature and scope of the duties performed in both positions are similar.

In many private corporations, however, the duties and responsibilities of the subject shareholder/employee may not easily be characterized into one position. For example, the subject shareholder/employee duties and responsibilities may encompass the positions of CEO, top salesman, and head of human resources.

To ensure the subject shareholder/employee position is comparable to the industry survey executive position, the analyst should develop an understanding of the actual duties and responsibilities of the individual shareholder/employee.

In order to properly apply the industry salary survey data, it is important to understand the following:

1. How the data are compiled
2. The timeliness of the data
3. The data comparability to the subject company and/or position

Sources of Compensation Data

Numerous sources of compensation data are widely available. These sources vary in price, with some being free to access and others being quite expensive.

Some compensation data sources:

1. only relate to specific industries,
2. only include executive-level information,
3. only provide salary information, or
4. only provide salary and benefits information.

For these reasons, it is typically beneficial to rely on more than one compensation data source in a reasonableness of shareholder/employee compensation analysis.

The selection of a compensation data source depends on many factors. Some of these factors may include the following:

- **Industry**: There are industry-specific compensation data sources available for certain industries, particularly in the healthcare sector. There may not be an industry-specific compensation report available for some industries.
- **Position**: There are more compensation data reports available for executive-level staff positions (e.g., chief executive officer or chief financial officer) than there are for lower-level staff positions.
- **Budget**: Some executive-level compensation data sources and industry-specific compensation data sources are very expensive.

In the industry compensation comparison analysis, the analyst may consider industry data sources including the following:

- General industry surveys by Standard Industrial Classification code and the North America Industry Classification System
- Salary surveys produced by trade organizations, trade journals, or industry analyst studies
- Proxy statements and/or annual reports for publicly traded companies (these are SEC-required filings that can be accessed through the SEC website or various other data aggregation tools)
- Private company compensation information sourced through databases such as the Risk Management Association

The discussion below presents specific examples of (1) fee-based general compensation databases, (2) free salary surveys, and (3) industry-specific sources.

Fee-Based General Compensation Databases

The following list summarizes several fee-based, multi-industry compensation surveys. This list is not intended to be exhaustive.

- **Economic Research Institute** ("ERI"): ERI offers salary and other data for thousands of positions across thousands of locations. ERI allows the analyst to search for data based a particular city or states and provides base salary, annual incentives, and total compensation.
- **Willis Towers Data Services**: Willis Towers Watson, a compensation and benefits consulting company, publishes several compensation surveys. Some of these surveys include the (1) *General Industry Compensation Policies and Practices Survey* and (2) *General Industry Long-Term Incentives Policies and Practices Survey*. Surveys are available on a regional basis and include salaries, short-term incentives, and more.
- **Compdata Surveys**: Compdata Surveys publishes several compensation surveys including (1) *BenchmarkPro*, (2) *Benefits USA*, and (3) *Executive Compensation*. These surveys include salary data, pay practices, health insurance data, and more. These data are provided on a regional basis.
- **Mercer**: Mercer publishes executive compensation surveys for the United States, Canada, and worldwide. Surveys can be provided on an industry-specific basis and include base salary, long-term and shot-term incentives, and total compensation.
- **Culpepper**: Culpepper compensation surveys are available for the technology, life sciences, and health care sectors. Culpepper also provides a general industry compensation survey. The data include base salary, long-term and short-term incentives, total compensation, and equity compensation.
- **Aon Total Compensation Center**: Aon publishes compensation data for specific industries including energy, health care, and information technology. Aon also publishes executive compensation surveys and other benefits surveys.

Free Salary Survey Sources

The following list summarizes several free salary surveys. This list is not intended to be exhaustive.

- **Bureau of Labor Statistics** ("BLS"): The BLS, a division of the U.S. Department of Labor, provides a significant amount of information on pay and benefits. Salary information is available by occupation, region, state, and metropolitan statistical area. The BLS also produces reports on benefits and employer compensation costs.
- **CareerOneStop.org**: This website is sponsored by the U.S. Department of Labor and the data are sourced from the BLS.

Information is available for hundreds of occupations in the United States.

- **Salary.com**: This website contains several databases that provide salary information for thousands of occupations. The data are gathered from surveys of human resources personnel in the United States and are updated monthly. Some data is provided only on a subscription basis.

Industry-Specific Sources

The following list summarizes several industry-specific surveys. This list is not intended to be exhaustive.

- **Medical Group Management Association** ("MGMA"): MGMA publishes several health-care-related compensations surveys on an annual basis. MGMA surveys include data related to provider compensation, management compensation, physician placement starting salary, and academic practice compensation.
- **Institute of Management Accountants** ("IMA"): The IMA publishes an annual *Global Salary Survey*. The data contained therein are organized by various groupings including (1) academic degree, (2) location, (3) firm size, and (4) job title.
- **Zweig White**: This company produces many benchmarking reports for the engineering and architecture sector. This company publishes an annual *Salary Surveys of Architecture* report, among others.

The Independent Investor Test

The independent investor test is based on an analysis of the actual rate of return on owners' equity of the private company compared with a market-derived required rate of return on owners' equity.

According to the Service, "the rationale behind the Independent Investor Test is that investors pay employees to work to increase the value of the assets entrusted to their management."[12]

According to the Service, in a typical application of the independent investor test (within an income approach reasonable compensation analysis), "a high rate of return indicates that the subject assets' value increased and that the subject employee provided valuable services."[13]

Therefore, if an investor earns a rate of return above what may be reasonably expected, then the subject employee's compensation is presumed to be reasonable.

We note that the reasonable compensation presumption may not be true if the rate of return is attributable to an extraneous event rather than to the subject employee's efforts.

This independent investor test analysis may be performed at various assumed levels of shareholder/employee compensation and usually considers all forms of compensation including dividends, stock appreciation, and corporate earnings.

"[I]f an investor earns a rate of return above what may be reasonably expected, then the subject employee's compensation is presumed to be reasonable."

The independent investor test is often considered by the U.S. Tax Court (and by other federal courts) to be a meaningful method of indirectly testing the reasonableness of shareholder/employee compensation.

In *Elliotts, Inc. v. Commissioner*,[14] the Tax Court noted that the independent investor test considers whether an outside investor in the taxpayer corporation would have approved the subject executive compensation.

An example of the application of the independent investor test is presented in *Exacto Spring Corporation v. Commissioner*. The judicial decision in the *Exacto Spring Corporation* case is summarized as follows:

> A corporation can be conceptualized as a contract in which the owner of assets hires a person to manage them. The owner pays the manager a salary and in exchange the manager works to increase the value of the assets that have been entrusted to his management; that increase can be expressed as a rate of return to the owner's investment. The higher the rate of return (adjusted for risk) that a manager can generate, the greater the salary he can command. If the rate of return is extremely high, it will be difficult to prove that the manager is being overpaid, for it will be implausible that if he quit if his salary was cut, and he was replaced by a lower-paid manager, the owner would be better off; it would be killing the goose that lays the golden egg.[15]

Independent Investor Test Summary

In other words, the maximum salary that an independent investor would be willing to pay to an executive is a function of:

1. the expected return an investor would demand for his investment in the private corporation and
2. the actual return on investment after all expenses, including officer compensation, have been paid.

Independent Investor Test Example

The independent investor test can be demonstrated in the following simplified illustrative example.

Let's assume that a private company has a value of $10 million. If an independent equity investor in the company requires a 10 percent return on equity, then the private company would need to generate net income of $1 million to satisfy the investor.

If paying the executive a particular salary causes the company net income to fall below the investor's expected rate of return, then it is unlikely that the independent investor would agree to pay the executive that amount of salary.

Summary and Conclusion

Private company shareholder/employee reasonable compensation is an important income tax consideration. This is because what is considered a reasonable level of compensation by the individual or corporate taxpayer may often be considered unreasonable by the Service.

This is particularly true for the shareholder/employee of a C corporation or an S corporation. This is because the shareholder/employee of such a private corporation is often motivated to deviate from an arm's-length level of compensation in order to minimize their income taxes.

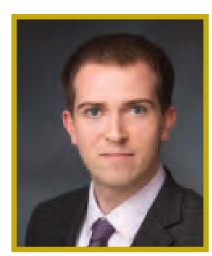
Over the years, the Service and the federal courts have developed generally accepted factors and methods used to analyze private company shareholder/employee reasonableness of compensation. These generally accepted factors and methods were developed based on statutory authority, administrative rulings, and judicial precedent.

To ensure that reasonable compensation analyses can withstand the scrutiny of the Service and the federal courts, the analyst (and the taxpayer) should fully understand the generally accepted factors and methods that are considered when determining the shareholder/employee reasonableness of compensation.

The analyst's understanding of these issues is especially important when performing a reasonableness of shareholder/employee compensation analysis for a C corporation or an S corporation.

Notes:

1. Mad Auto Wrecking, Inc. v. Commissioner, T.C. Memo 1995-153.
2. Treasury Regulation 1.162-7(b)(2).
3. Treasury Regulation 1.162-7(b)(3).
4. Robert F. Reilly, "Reasonableness of Shareholder/Employee Compensation in Closely Held Business Valuation," *American Journal of Family Law* (Fall 2005).
5. Long Island Drug Co., Inc. v. Commissioner, 111 F.2d 593 (2d Cir. 1940).
6. Treasury Regulation 1.162-8.
7. See for example: Pulsar Components International, Inc. v. Commissioner, T. C. Memo 1996-129; Elliotts, Inc. v. Commissioner, 48 TCM 1245, T.C. Memo 1984-516; Mad Auto Wrecking, Inc. v. Commissioner, T.C. Memo 1995-153; Exacto Spring Corporation v. Commissioner, 196 F.3d 833, 838 (7th Cir. 1999).
8. Pulsar Components International, Inc. v. Commissioner, T. C. Memo 1996-129.
9. Internal Revenue Service, "Reasonable Compensation Job Aid for IRS Valuation Professionals" (October 29, 2014): 9–10.
10. Internal Revenue Service, "Reasonable Compensation Job Aid for IRS Valuation Professionals."
11. Ibid.
12. Ibid.
13. Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949).
14. Elliotts, Inc. v. Commissioner, 48 TCM 1245 (1984).
15. Exacto Spring Corporation v. Commissioner, 196 F.3d 833, 838 (7th Cir. 1999).



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Guide to Intangible Asset Valuation

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Best Practices Discussion

Service Alleges Taxable Gift for Exchange of Promissory Notes Based on Differences in Note Values

Samuel S. Nicholls

This discussion provides an illustrative example of an unintentional gift that arose when one family generation exchanged assets with the next family generation. The assets were debt securities. The Internal Revenue Service (the "Service") alleged that the size of the gift was equal to the difference in the debt security face values—which was a substantial difference—on each side of the exchange. As it turned out, the difference in the debt security fair market values, which was the appropriate measurement of the amount of the gift, was significantly less than the amount of the gift alleged by the Service.

Introduction

One cause of an audit and notice of deficiency by the Internal Revenue Service (the "Service") is when the fair market value of a business interest or exchanged asset is disputed. Sometimes the Service is mistaken. And, sometimes the Service correctly identifies mistakes, flawed reasoning, or unsupported judgment related to the taxpayer's valuation. Sometimes the taxpayer neglects to have legal counsel retain a valuation analyst ("analyst") to appraise the asset that is gifted or exchanged.

This discussion presents an illustrative example of what was intended to be a reasonable swap of promissory notes between parents and their two children. Unfortunately, it proved costly to not have the taxpayer's counsel hire an analyst to value the transferred interest.

Lacking a qualified valuation report, the taxpayer incurred significant legal costs that could have been avoided—in addition to the costs of the analyst who could have been retained at the outset to avoid all of this. A stitch in time saves nine.

Fortunately, in this case, the taxpayer's counsel engaged Willamette Management Associates to provide valuation analyses and testifying expert services, resulting in a taxpayer-favorable settlement. All names, dates, types of companies, and amounts have been modified for illustrative purposes.

Background to the Alleged Gift

Breaking from Tradition, Parents Borrow from Children

A husband and wife (the "parents") owned and operated majority-owned, privately owned companies that operated in three sectors—hospitality, real estate, and restaurants. An opportunity arose to acquire a business that operated in one of these sectors, and the parents expected meaningful synergies with some of their current holdings.

The parents decided to swap several notes that they owned for the Parent Note, effectively extinguishing their indebtedness to the children. They exchanged these assets on February 18, 2010 (the "Exchange"). On one side of the Exchange, the parents received the note that they had owed.

On the other side of the Exchange, the Children's Holding Company received several notes, two of which were notes owed by each child to the parents.

An important factor affecting the fair market value of the notes was: not only were the notes received by the Children's Holding Company collateralized, but they were guaranteed per the allonge and guarantee of the assignor. The assignor was a trust of the parents.

The roadblock was the source of cash. The parents were nearly tapped out after pledging their personal assets against loans taken out by their business holdings. Their empire was overlevered. The parents could attempt to sell some of their existing holdings, but that would take time.

The parents' two children each had ownership interests in an investment holding company (the "Children's Holding Company") funded by the parents and structured as a limited partnership. Despite the children having nonvoting units, the parents spoke with the children about having the Children's Holding Company serve as the source of cash for the parents' acquisition. All parties agreed that the potential acquisition at the proposed terms was too good to pass up.

The parents obtained a loan from the Children's Holding Company in the form of a $50 million promissory note (the "Parent Note"). The loan proceeds were sufficient to acquire the business. The Parent Note was an interest-only note that paid interest at the prime rate. If the Parent Note went in default, it would pay the prime rate plus 3 percent.

I Will Forgive You . . . If You Will Forgive Me

After a little over six years, the parents decided they wanted to begin delevering their holdings, both at the personal and entity levels. In addition to the ownership of operating companies, real estate, and marketable securities, their assets included notes receivable from various entities and individuals.

If any of these notes went in default, the lender had the right to take title to the collateral. Because of the allonges and guarantees, if the collateral in liquidation did not cover all principal, any shortfall would be covered by the guarantee of the assignor. The assignor's net assets significantly exceeded the aggregate principal and accrued interest of the notes received by the Children's Holding Company.

Taxable Gift Alleged by the Service

The Service alleged that the size of the gift was equal to the difference between:

1. the outstanding principal and interest of the Parent Note and
2. the outstanding principal and interest of the five notes owned by the parents that were transferred to the Children's Holding Company.

This simple math does not add up, as such a face value comparison is inconsistent with the concept of fair market value.

Exhibit 1 displays the outstanding principal and accrued interest of each note. The Children's Holding Company, in exchange for transferring the Parent Note to the parents, received five notes owed to the parents by (1) Recreation Holdings, LLC; (2) Insurance Policy Holdings, LLC; (3) a business associate of the parents; and (4) the two children (the "Children Notes").

Exhibit 1
Assets Exchanged between Parents and Children's Holding Company
Alleged Size of Gift Subject to Taxation
As of February 18, 2010

Promissory Notes Given to Parents by Children's Holding Company:	Outstanding Principal $	Outstanding Accrued Interest $	Outstanding Principal and Interest $
Childrens' Holding Company Was the Lender			
Debtors:			
Parents	50,000,000	10,000,000	60,000,000

Promissory Notes Given to Children's Holding Company by Parents:	Outstanding Principal $	Outstanding Accrued Interest $	Outstanding Principal and Interest $
Parents Were the Lenders			
Debtors:			
Recreation Holdings, LLC	30,000,000	2,800,000	32,800,000
Insurance Policy Holdings, LLC	5,000,000	200,000	5,200,000
Business Associate of Parents	5,000,000	1,000,000	6,000,000
Son	1,500,000	-	1,500,000
Daughter	1,500,000	-	1,500,000
			47,000,000
Taxable Gift by the Children to the Parents as Alleged by the Service			**13,000,000**

Recreation Holdings, LLC, owned and operated a large marina and resort. A significant portion of its assets was its 99-year leasehold with the Department of the Interior. Insurance Policy Holdings, LLC, was a holding company that owned life insurance policies on the lives of the parents.

The purpose of the loan was to pay for the issuance policy premiums, and the holding company also held cash. The note owed by the business associate was collateralized by real estate properties, and the purpose of the loan was to acquire residential apartment communities.

Including accrued interest, the Parent Note had a nominal value of $60 million. This amount exceeded, by $17 million, the aggregate nominal value of the Children Notes. This amount was the amount the Service alleged was a taxable gift to the parents by the Children's Holding Company.

Exhibit 1 presents the obligor of each note and its outstanding principal and interest.

The Matter Is Litigated—Tax Counsel Retains a Valuation Analyst

The Value Gap Is the Gift—Fair Market Value Is the Standard

The Service claimed that the gift was the amount of the "value gap" based on outstanding principal and accrued interest. However, the exchanged note value gap may be higher or lower than the face value value gap at *fair market value*.

In this illustrative example, counsel was hired to litigate the notice of deficiency, and tax counsel then retained an analyst to provide an opinion of the fair market value of each note exchanged.

Fair market value, as this term is used in the Internal Revenue Code and set forth in the Treasury Regulations, is defined as the price at which the subject interest would change hands between a hypothetical willing buyer and hypothetical willing seller, with both having reasonable knowledge of all relevant facts, and neither party being under any compulsion to buy or sell. Fair market value also assumes that the price is paid all in cash or its economic equivalent at closing.

First Steps in the Valuation Analysis

When counsel retains an analyst, one part of the process is identifying and requesting all pertinent documentation. If the taxpayers orally represented that some percentage of their assets were pledged on loans, it is preferred to obtain written documentation rather than an oral representation.

If the assets involved in the dispute include notes, the analyst may need certain data, such as the indenture, history of the timeliness of payments and accrued interest, and an analysis of the value of any collateral (if there are security interests attached).

If the note is collateralized, it may be important to identify the assets that serve as collateral and identify which data are required to estimate the value of the collateral.

Valuation Analysis

The remainder of this discussion analyzes each of the notes exchanged, the fair market value of each, the total fair market values on each side of the Exchange, and the taxable gift.

The Exchange occurred on February 18, 2010, not long after the crashes of the capital markets and real estate sector. One of the fulcrums for the fair market value of a private company note is the selected market-based yield.

Initial Observations

Parent Note—Considerations

The Parent Note was unsecured and in serious default, both on the principal and the accrued interest. A hypothetical buyer of the note would consider this a risk despite the size of the parents' business holdings.

From the risk perspective of a lender, it is not just a matter of whether you have the money to pay me back, it is a matter of whether you will, in fact, pay me back the money.

An analysis of the corporate holdings of the parents, the scope of their guarantees of loans to their corporate holdings, and the parents' annual cash flow indicated that a reasonable Moody's rating for the Parent Note was CCC for corporate bonds.

Years prior to 2009, the parents would have obtained a much higher credit rating. However, the parents credit rating suffered after the crash of the real estate sector.

Children Notes—Considerations

The Children Notes were all secured. Additionally, all the notes had an allonge and guarantee of a trust of the parents. A review of the indentures reveals that all but one of the five notes had durations of less than a year. For instance, one note was a demand note and another note was in default and was secured by real estate.

The following section discusses each of the notes, the analysis of risk factors and terms, and illustrative examples of the fair market values of each note. This example shows that the amount of the alleged gift is far less than the amount that was alleged by the Service.

Fair Market Value of the Parent Note

Although the obligors of the Parent Note are individuals, not corporations, the parents' primary assets are the companies that they control and operate. As individuals, the parents are exposed to similar risk/reward factors as the companies they own.

In this example, the market-based yield to apply to the Parent Note is selected based on indicated yields on corporate bonds with similar durations.

As presented in Exhibit 2, the parents' sector exposure was to hospitality, real estate, and restaurants at 50 percent, 25 percent, and 25 percent, respectively. To reasonably incorporate the lending risk of each sector, this example applies a weighted average market yield based on the indicated market yield of each sector.

The analysis considers individual debt securities as guideline securities to arrive at an indicated market yield to apply to the Parent Note.

Exhibit 3 presents the credit ratings, years to maturity, and yield to maturity of selected guideline bonds. Each guideline bond was unsecured (as was the Parent Note) and had varying durations. Exhibit 3 provides an illustrative example of how an analyst would arrive at an indicated market yield of 17.73 percent for the hospitality sector.

Debt securities with Moody's rating CCC were selected for the following reasons:

1. The Parent Note was in default.
2. No principal had been paid well past maturity.

Exhibit 2
Sector-Based High Yield Data
Weighted Average Yield
Based on Parents' Industry Sector Exposure

Industry Sector	Parents' Assets by Sector $	Weight %	Indicated Market Yield %	Weighted Yield %
Hospitality	200,000,000	50.00%	17.73%	8.87%
Real Estate	100,000,000	25.00%	17.24%	4.31%
Restaurants	100,000,000	25.00%	16.50%	4.13%
Total	400,000,000	100.00%		17.30%

Weighted Average Market Yield	**17.30%**

3. Many of the parents' assets had been pledged, leaving few assets to sell so in order to make principal payments on the Parent Note.

There was no new maturity date by contract. In this illustrative example, the selected maturity date is predicated on a loan workout or an extension of the maturity date by the lender. Many of the parents' assets had been pledged to guarantee other loans.

Estimating when the parents may be able to begin paying principal required an analysis of the parents' current assets, their expected future cash flow, and all obligations, guarantees, and seniority in the pecking order among lenders. These factors, in this example, resulted in selecting eight years as a maturity date.

An adjustment was applied to the indicated yields because none of the comparable bonds had exactly an eight-year duration. In fact, many were well below eight years. Matching durations is important in selecting a reasonable, market-based yield.

To adjust the indicated yields to what they would be if the bonds had an eight-year duration, this example applies an exponential yield from the publicly traded debt.

Regression analysis results in the following formula for the slope and intercept: Y = 0.0877×(EXP(0.88×8)), where the "times 8" refers to the duration of the subject note. This results in a duration-adjusted, market-based yield of 17.73 percent, whereas the median was 12.00 percent. The median, which would be improper to use with such wide differences in durations from the subject note, is much less because many of the publicly traded bonds have durations of only one to three years. In contrast, the Parent Note matures in eight years.

The longer the maturity, the higher the risk. Therefore, the higher the yield demanded by the market to compensate for taking on more risk.

Exhibit 4 applies the weighted average market yield of 17.30 percent, based on the parents'

Exhibit 3
Market Yields—Hospitality Industry
As of the Date of Transfer

Publicly Traded High Yield Debt Issued by Hospitality Industry Companies	Seniority	Credit Rating	Years to Maturity	Yield to Maturity
Company A	Unsecured	CCC	3.70	12.00%
Company B	Unsecured	CCC	3.70	12.00%
Company C	Unsecured	CCC	7.90	15.00%
Company D	Unsecured	CCC	7.49	16.00%
Company E	Unsecured	CCC	2.57	14.00%
Company F	Unsecured	CCC	0.61	12.00%
Company G	Unsecured	CCC	9.53	22.00%
Company H	Unsecured	CCC	7.74	18.00%
Company I	Unsecured	CCC	7.12	19.00%
Company J	Unsecured	CCC	3.45	12.00%
Company K	Unsecured	CCC	2.95	10.00%
Company L	Unsecured	CCC	2.95	12.00%
Company M	Unsecured	CCC	2.55	8.00%
Company N	Unsecured	CCC	0.84	8.00%
Company O	Unsecured	CCC	1.25	10.00%
Exponential Public Debt Yield (adjusted for 8 years to maturity for subjec				17.73%
Selected 8-Year Public Debt Yield				**17.73%**

Exhibit 4
Promissory Note Owed by the Parents to the Children's Holding Company
Fair Market Value
As of February 18, 2010

Based on Selected High Yield Indexes of Transportation, Banks, and Real Estate:

Outstanding Principal ($)	50,000,000	(equals original principal)
Outstanding Accrued Interest ($)	10,000,000	(debtor has paid no interest and is in default)
Maker/Debtor	Parents	
Note Holder	Childrens' Holding Company	
Valuation Date	2/18/2010	
Issuance Date	6/30/2003	
Interest Rate	6.25%	(prime plus 3% when in default)
Type	Interest Only	
Payment	Annually	
Maturity Date	12/31/2017	
Selected Risk-Adjusted Rate	**17.30%**	

Payment Date	Beginning Principal and Accrued Interest $	Annual Interest $	Partial Period	Adjusted Annual Interest $	Payments of Original Accrued Interest	Total Payments $	Ending Principal and Accrued Interest $	Total Payment ($)	Discounting Period	Present Value Factor 17.30%	Present Value of Total Payment $
12/31/2010	60,000,000	3,750,000	0.87	3,246,575	1,250,000	4,496,575	58,750,000	4,496,575	0.8658	0.8710	3,916,517
12/31/2011	58,750,000	3,671,875	1.00	3,671,875	1,250,000	4,921,875	57,500,000	4,921,875	1.8658	0.7425	3,654,492
12/30/2012	57,500,000	3,593,750	1.00	3,593,750	1,250,000	4,843,750	56,250,000	4,843,750	2.8658	0.6330	3,066,094
12/31/2013	56,250,000	3,515,625	1.00	3,515,625	1,250,000	4,765,625	55,000,000	4,765,625	3.8658	0.5396	2,571,531
12/31/2014	55,000,000	3,437,500	1.00	3,437,500	1,250,000	4,687,500	53,750,000	4,687,500	4.8658	0.4600	2,156,250
12/31/2015	53,750,000	3,359,375	1.00	3,359,375	1,250,000	4,609,375	52,500,000	4,609,375	5.8658	0.3922	1,807,797
12/30/2016	52,500,000	3,281,250	1.00	3,281,250	1,250,000	4,531,250	51,250,000	4,531,250	6.8658	0.3343	1,514,797
12/31/2017	51,250,000	3,203,125	1.00	3,203,125	1,250,000	54,453,125	-	54,453,125	7.8658	0.2850	15,519,141
				27,309,075	10,000,000	87,309,075		87,309,075			34,206,619

Indicated Fair Market Value ($) (rounded) **34,207,000**

exposure to three sectors, to arrive at the present value of future cash flow from the Parent Note.

As presented in Exhibit 4, the parents received this loan from the Children's Holding Company about six and a half years before the Exchange. They owed $50 million in principal. Having been in default on interest payments, they owed $10 million in accrued interest.

The note was unsecured and, being subordinate to all other lenders to the parents and the entities they controlled, relied on the future cash flow of the parents to meet its obligations.

Selecting a maturity date, such as a new one negotiated between a hypothetical willing buyer and hypothetical willing seller, may be based on an analysis of the parents' cash flow and the financial conditions of the parents controlled holdings.

Two factors that may be taken into account are (1) the stability of cash flow of companies controlled by the parents and (2) the predictability of future distributions from the companies to the parents.

The analyst applied an expected eight-year maturity date, which could either be called a loan workout period or a renegotiated maturity extension. One valuation question is: In what future year would the parents most likely have the ability to repay, or begin repaying portions of, the principal of $50 million, as well as the beginning balance of accrued interest and annual interest payments?

An analyst could use a weighted average of several scenarios with different maturity dates or, if the taxpayer and its advisers have a good understanding of the future income of the obligor, an analysis could be as detailed as having the taxpayer pay off principal in several installments, rather than only at the end of the term.

Per the terms of the indenture, the Parent Note when in default carried an interest rate at the prime rate of 3.25 percent plus 3.00 percent, equalling a 6.25 percent interest rate.

Exhibit 4 shows the payments of annual interest as well as an assumption that the debtor repays outstanding accrued interest of $10 million in eight installments at the end of each year until maturity eight years later. The total payments of principal, interest, and accrued interest over eight years would be $87.3 million.

This figure exceeded the outstanding principal and accrued interest because interest is charged on the accrued interest balance as well as on the principal balance.

Next, a present value factor is applied to each total payment. The present value factor converts the selected risk-adjusted rate of 17.3 percent to a multiplier that incorporates the discounting period (in years) in the formula.

Each year's payment of principal, interest, and accrued interest is multiplied by the present value factor for that year.

The summation of the present value for each year results in the fair market value of the Parent Note, which was $34.2 million.

Because the selected market-based yield of 17.30 percent vastly exceeded the stated interest rate of 6.25 percent, the fair market value was substantially less than the outstanding principal and interest of $60 million.

Fair Market Value of the Children Notes—Recreation Holdings, LLC

One of the five notes held by the parents and exchanged with the Children's Holding Company was a note with debtor Recreation Holdings, LLC. The debtor was under slight, but not severe, distress and would likely delay payments on the outstanding accrued interest.

An analysis of historical and projected financial results, trends in occupancy rates, and the underlying industry indicated that the debtor would likely have the ability to pay outstanding accrued interest in two years, but would be able to pay annual interest on schedule.

A liquidation analysis revealed that the indicated fair market value of the total assets was significantly less than the fair market value of the note. The total assets included a leasehold interest with the U.S. Department of Interior.

Recreation Holdings, LLC, had obtained the leasehold and built many of its properties at the peak of the real estate bubble.

Exhibit 5 shows the characteristics of this note.

In this example, there is an index of hospitality bonds with duration that match the maturity date of this note. This market-based yield of 15.2 percent was selected. The note paid annual interest at the greater of 10 percent or the prime rate plus 4 percent. The note matures in 20 years.

Exhibit 6 presents the annual cash flow to the lender, with an assumption that accrued interest outstanding was paid over three years, as the real estate sector recovered.

The fair market value of this note was $20.2 million, compared to its outstanding principal and accrued interest of $32.8 million. The difference between the coupon rate and the risk-adjusted rate resulted in a significant discount from face value.

Technically, a hypothetical holder of this note could have declared the note in default and seized all assets. Would that action yield its highest and best use? Is it better to hold the note, or to seize the collateral?

The liquidation analysis is presented in Exhibit 7. Exhibit 7 summarizes what would have been multiple exhibits of analysis. Our liquidation analysis applies the adjusted net asset value method to arrive at the indicated fair market of total equity. This would have represented the entity's value in orderly liquidation, if the note holder were to exercise its right to declare the note in default.

Because the indicated value of total equity is approximately 50 percent of the fair market value of the note, the highest and best use of the note is, based on an analysis of Recreation Holdings, LLC, to continue to hold the note. An important consideration in doing so was that the parents had attached

Exhibit 5
Fair Market Value of Promissory Note
Owed by Recreation Holdings, LLC, to the Parents
Market Yield Based on Hospitality Index Rated B
As of February 18, 2010

Scenario 1:
(1) 20-Year Duration
(2) Based on Selected Hospitality Bond Index with Same Duration and Rated B

Outstanding Principal on Valuation Date ($)	30,000,000
Outstanding Accrued Interest on Valuation Date ($)	2,800,000
Outstanding Principal and Accrued Interest ($)	32,800,000
Maker/Debtor (obligor)	Recreation Holdings, LLC
Note Holder (obligee)	Parents
Security Interest	Secured by All Limited Liability Company Assets including Leasehold Interest
Valuation Date	2/18/2010
Issue Date	3/30/2009
Interest Rate (stated coupon per indenture)	10% (greater of 10% or prime rate plus 4%)
Type	Interest Only
Payment	Annually (compounded interest)
Maturity Date	3/30/2029
Assumption	Accrued Interest Paid Off during 2012, 2013, and 2014
Selected Risk-Adjusted Rate	**15.20%**
Risk-Adjusted Rate Based on →	BFV U.S. Hospitality (B rating, 20-year duration)

Exhibit 6
Fair Market Value of Promissory Note
Owed by Recreation Holdings, LLC, to the Parents
Market Yield Based on Hospitality Index Rated BBB
As of February 18, 2010

Payment Date	Principal and Accrued Interest $	Annual Interest $	Partial Period	Adjusted Annual Interest $	Payments of Original Accrued Interest $	Payments of Principal	Principal, Accrued Interest, and Annual Interest Payments $	Ending Principal and Accrued Interest $	Discounting Period	Present Value Factor 15.20%	Present Value of Total Payment $
3/30/2010	32,800,000	3,280,000	0.11	359,452	-	-	359,452	32,800,000	1.0	0.8681	312,024
3/30/2011	32,800,000	3,280,000	1.00	3,280,000	-	-	3,280,000	32,800,000	2.0	0.7535	2,471,547
3/30/2012	32,800,000	3,280,000	1.00	3,280,000	933,333	-	4,213,333	31,866,667	3.0	0.6541	2,755,931
3/30/2013	31,866,667	3,186,667	1.00	3,186,667	933,333	-	4,120,000	30,933,333	4.0	0.5678	2,339,308
3/30/2014	30,933,333	3,093,333	1.00	3,093,333	933,333	-	4,026,666	30,000,000	5.0	0.4929	1,984,647
3/30/2015	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	6.0	0.4278	1,283,531
3/30/2016	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	7.0	0.3714	1,114,176
3/30/2017	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	8.0	0.3224	967,167
3/30/2018	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	9.0	0.2799	839,555
3/30/2019	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	10.0	0.2429	728,780
3/30/2020	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	11.0	0.2109	632,622
3/30/2021	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	12.0	0.1831	549,151
3/30/2022	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	13.0	0.1589	476,693
3/30/2023	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	14.0	0.1379	413,796
3/30/2024	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	15.0	0.1197	359,198
3/30/2025	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	16.0	0.1039	311,804
3/30/2026	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	17.0	0.0902	270,663
3/30/2027	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	18.0	0.0783	234,951
3/30/2028	30,000,000	3,000,000	1.00	3,000,000	-	-	3,000,000	30,000,000	19.0	0.0680	203,950
3/30/2029	30,000,000	3,000,000	1.00	3,000,000	-	30,000,000	33,000,000	-	20.0	0.0590	1,947,441
				58,199,452	2,800,000	30,000,000	90,999,452				20,196,935
								Indicated Fair Market Value ($) (rounded)			**20,197,000**

Exhibit 7
Fair Market Value of Promissory Note
Owed by Recreation Holdings, LLC, to the Parents
Scenario 2—Liquidation
As of February 18, 2010

Scenario 2:

(1) Orderly Liquidation
(2) Based on Adjusted Net Asset Value Method

Outstanding Principal and Accrued Interest ($)		32,800,000
Maker/Debtor (obligor)		Recreation Holdings, LLC
Notes Holder (obligee)		Parents
Valuation Date		2/18/2010
Maturity Date		3/30/2029
Collateralized		Secured by All Limited Liability Company Assets including Leasehold Interest with U.S. Dept. of Interior
Fair Market Value of Total Assets ($)		15,000,000
Less: Discount for Exposure Period and Liquidation Costs ($)	-5%	(750,000)
Equals: Adjusted Net Assets Available as Collateral ($)		14,250,000
Indicated Fair Market Value ($) (rounded)		**14,250,000**

an allonge and guarantee to the note as part of the Exchange.

Although the fair market value of the primary real estate asset was less than the principal amount of the note, the allonge and guarantee covered the difference.

The reason the fair market value of equity was negative (assets of $14.25 million, debt of $32.8 million) was that the entity acquired a leasehold and developed luxury property, using the note as capital, at the peak of the real estate sector's cycle.

Fair Market Value of the Children Notes—Insurance Holdings, LLC

The purpose of this entity was to hold life insurance policies on the parents for the benefit of the children. It was funded with loans both from banks and the parents.

The banks were owed $11 million and the parents were owed $5.2 million. The banks were senior lenders and the parents were subordinated lenders. The note held by the parents was part of the Exchange.

Exhibit 8 presents the assets of Insurance Holdings, LLC, at fair market value. Exhibit 8 presents the pecking order of claims, should the rights to this demand note be exercised.

The fair market value of the life insurance policies was equal to their interpolated terminal reserve values. If the entity were liquidated, it could meet the obligation to the note holder.

The fair market value of this note is presented in Exhibit 9. Because this is a demand note, with no maturity date, selecting an appropriate maturity date depends on the facts and circumstances of the case.

This example presented a fair market value under the assumption that the holder would exercise their right to demand payment of principal, and that this would take three months to complete orderly liquidation of the assets of Insurance Holdings, LLC.

In this example, the analyst received documentation showing untimeliness of the payment of insurance premiums. After further analysis of the financial status of the capital contributors (other than banks) to this entity, the analyst concluded that a rational investor would, more likely than not, seek to recoup his or her loan as soon as possible.

Exhibit 8
Insurance Holdings, LLC
Fair Market Value of Assets and
Hypothetical Payments of All Obligations Upon Demand
As of February 18, 2010

	Fair Market Value as of 3/31/09 $
ASSETS	
Current Assets:	
Cash and Cash Equivalents	6,000,000
Total Current Assets	6,000,000
Long-Term Assets:	
Life Insurance Policy #1	5,000,000
Life Insurance Policy #2	500,000
Life Insurance Policy #3	4,000,000
Life Insurance Policy #4	700,000
Life Insurance Policy #5	500,000
Total Long-Term Assets	10,700,000
TOTAL ASSETS	16,700,000
Order of Claims by Obligees Against Assets	
Assets Liquidated at Fair Market Value	16,700,000
Less: Obligations to Bank Lenders	(11,000,000)
Equals: Remaining Assets Available to Note Owed to the Parents	5,700,000
Less: Note Owed to the Parents	(5,200,000)
Equals: Remaining Assets	500,000

The note could be repaid based on the value of the total equity of the borrower in orderly liquidation.

Another factor considered was that the nonoperating entity generates zero cash flow from selling any goods or services. The entity's assets produce no cash flow until an unknown date of death (no visibility) that unlocks the full value of the policies.

There were uncertainties over this entity's ability to pay note principal on demand and, in its operating role, pay insurance premiums.

The principal of the note cannot be repaid unless all insurance policies are paid upon death, whenever that is, or sold in a secondary transaction. The value of the entity in orderly liquidation is based on selling the insurance policies in secondary transactions.

Fair Market Value of the Children Notes—Owed to Parents by Business Associate

The parents lent their business associate $5 million approximately three and one-half years before the Exchange. The loan was secured by various parcels of real estate, some were land for residential development; some were already developed.

The business associate owed accrued interest of $1 million, had not been making timely payments, and was severely delinquent past the maturity date. The selected maturity date for this note was based on the time for orderly liquidation of the collateral assets.

A real estate appraiser appraised the properties. The real estate appraisal report was provided to the analyst by taxpayer's counsel.

Exhibit 10 presents the fair market value of total assets that served as collateral. In an orderly liquidation, after estimated transaction costs of 5 percent, there is sufficient value attributable to exercising one's rights as the holder of a demand note and recoup the principal.

Exhibit 11 applies a market-based yield based on the one-year Treasury bill rate. For the sake of simplicity, this illustration applies a risk-free rate.

Exhibit 9
Fair Market Value of Promissory Note
Owed by Insurance Holdings, LLC, to Parents
Multiple Advance Promissory Note—Not to Exceed $10 Million
As of February 18, 2010

Outstanding Principal on Valuation Date ($)	5,000,000
Outstanding Accrued Interest on Valuation Date	200,000
Total Principal and Accrued Interest ($)	5,200,000
Maker/Debtor (obligor)	Insurance Holdings, LLC
Note Holder (obligee)	Parents
Valuation Date	2/28/2010
Issuance Date	6/22/07
Interest Rate	4.91% (long-term applidable federal rate per note indenture)
Type	Interest Only
Payment	Annually
Maturity Date	On Demand
Collateralized	Yes
Selected Risk-Adjusted Rate	**0.19%** → 90-Day U.S. Treasury Bill Rate

Payment Date	Beginning Principal and Accrued Interest	Annual Interest	Partial Period	Adjusted Annual Interest	Payments of Principal and Accrued Interest	Ending Principal and Accrued Interest	Total Payment	Discounting Period	Present Value Factor 0.19%	Present Value of Total Payment
	$	$		$	$	$	$			$
5/30/2010	5,200,000	255,320	0.25	63,655	5,200,000	-	5,263,655	0.2493	0.9995	5,261,023
							Indicated Fair Market Value ($) (rounded)			**5,261,000**

Since the assets to be liquidated were real estate properties, a more appropriate risk-adjusted rate may have been tied to the real estate sector.

The analysis assumes that all properties were under contract at fair market value as of the date of the Exchange. Furthermore, as with all the Children Notes, this note was accompanied by an allonge and guarantee from the parent's trusts.

The original maturity date was December 31, 2007, and the note was in default. Per the note indenture, the lender had the right to take title to the collateral.

This example assumes that it takes one year to receive proceeds from the sales of properties and that each property's proceeds are paid exactly one year after the date of the Exchange.

Fair Market Value of the Children Notes—Owed by Son to Parents

In 2003, the son obtained a loan from the parents in the amount of $1.5 million. The purpose of the loan was for the purchase

Exhibit 10
Fair Market Value of Promissory Note
Owed to the Parents by the Business Associate
Summary of Fair Market Value of the Collateral
As of February 18, 2010

Property	Fair Market Value $
Apartment Complex	1,500,000
Land for Residential Development	600,000
Apartment Complex	3,000,000
Land for Residential Development	100,000
Land for Residential Development	350,000
Land for Residential Development	400,000
Land for Residential Development	500,000
	6,450,000

Liquidation of the Collateral	Payment of Principal and Accured Interest
Assets Liquidated at Fair Market Value	6,450,000
Less: Transaction Costs at 5.0 Percent	(322,500)
Equals: Proceeds from Sales of Properties	6,127,500
Less: Principal and Accrued Interest Owed to the Parents	(6,000,000)
Equals: Surplus/(Deficiency) in Assets Available	127,500

Exhibit 11
Fair Market Value of Promissory Note
Owed to the Parents by the Business Associate
As of February 18, 2010

Outstanding Principal on Valuation Date ($)	5,000,000	
Outstanding Accrued Interest on Valuation Date ($)	1,000,000	
Total Principal and Accrued Interest ($)	6,000,000	
Maker/Debtor (obligor)	Business Associate of Parents	
Note Holder (obligee)	Parents	
Valuation Date	2/18/2010	
Issuance Date	10/2/06	
Interest Rate	5.25%	(prime rate of 3.25 percent plus 2.00 percent)
Type	Interest Only	
Payment	Annually	
Maturity Date	12/31/2007	
Collateralized	Yes	
Selected Risk-Adjusted Rate	**0.44%**	→ 1-Year U.S. Treasury Bill Rate

Payment Date	Beginning Principal and Accrued Interest $	Annual Interest $	Partial Period	Adjusted Annual Interest $	Payments of Principal and Accrued Interest $	Total Payment $	Discounting Period	Present Value Factor 0.44%	Present Value of Total Payment $
2/18/2011	6,000,000	315,000	1.00	-	6,000,000	6,000,000	1.00	0.9956	5,973,600

Indicated Fair Market Value ($) [rounded] 5,974,000

Exhibit 12
Fair Market Value of Promissory Note
Owed by the Son to the Parents
As of February 18, 2010

Original Principal Amount ($)	1,500,000	
Outstanding Principal on Valuation Date ($)	1,500,000	
Outstanding Accrued Interest on Valuation Date ($)	12,000	
Maker/Debtor (obligor)	Son	
Note Holder (obligee)	Parents	
Valuation Date	2/18/2010	
Issuance Date	12/1/2003	
Interest Rate	4.01% (short-term applicable federal rate per note indenture)	
Type	Interest Only	
Payment	Annually	
Maturity Date	12/31/20010	
Collateralized	Yes (real estate)	
Selected Risk-Adjusted Rate	**5.00%**	→ Average Mortgage Rate per Freddie Mac

Payment Date	Beginning Principal and Accrued Interest $	Annual Interest $	Partial Period	Adjusted Annual Interest $	Payments of Principal and Accrued Interest $	Ending Principal and Accrued Interest $	Total Payment $	Discounting Period	Present Value Factor 5.00%	Present Value of Total Payment $
12/31/2010	1,512,000	60,631	0.87	52,491	1,512,000	-	1,564,491	0.8658	0.9586	1,499,722

Indicated Fair Market Value ($) [rounded] 1,500,000

Exhibit 13
Fair Market Value of Promissory Note Owed by the Daughter to the Parents As of February 18, 2010

Original Principal Amount ($)	1,500,000
Outstanding Principal on Valuation Date ($)	1,500,000
Outstanding Accrued Interest on Valuation Date ($)	12,000
Maker/Debtor (obligor)	Daughter
Note Holder (obligee)	Parents
Valuation Date	2/18/2010
Issuance Date	8/1/2004
Interest Rate	3.78% (short-term applicable federal rate per note indenture)
Type	Interest Only
Payment	Annually
Maturity Date	12/31/2010
Collateralized	Yes (real estate)
Selected Risk-Adjusted Rate	**5.00%** → Average Mortgage Rate per Freddie Mac

Payment Date	Beginning Principal and Accrued Interest $	Annual Interest $	Partial Period	Adjusted Annual Interest $	Payments of Principal and Accrued Interest $	Ending Principal and Accrued Interest $	Total Payment $	Discounting Period	PV Factor 5.00%	PV of Total Payment $
12/31/2010	1,512,000	57,154	0.87	49,481	1,512,000	-	1,561,481	0.8658	0.9586	1,496,836

Indicated Fair Market Value ($) [rounded] **1,500,000**

of a lot, which the son developed into a successful rental property. This note was secured by the property and matures in less than a year after the Exchange date.

Exhibit 12 presents the inputs and calculations to arrive at its fair market value.

The market-based yield was the average mortgage rate per Freddie Mac of 5 percent—not much higher than the coupon rate in the indenture. The note matures less than a year after the Exchange.

To assess the risk of principal being paid, the analyst observed that the son was able to access his trust, as a beneficiary, to meet principal and interest payments if necessary. The son's trust agreement authorizes the trustee to make distributions for expenses including health, education, maintenance, and support. It also allows the son, as settlor, to revoke the trust and provides that all the trust property would revert back to the son. Therefore, the son had full access, at any time, to the assets of this trust.

As of the date of the Exchange, the son's trust had total assets with a stated value of $75 million, total liabilities of $25 million, and corpus of $50 million. The assets consisted of the following:

1. Publicly traded stock in XYZ Inc. with a stated value of $50 million
2. An equity interest in privately held ABC Inc. with a stated value of $20 million
3. A note receivable with a stated value of $5 million

The analyst also considered the timeliness of interest payments for the note.

The fair market value of the note was equal to its outstanding principal and accrued interest.

Fair Market Value of the Children Notes—Owed by Daughter to Parents

In 2004, the daughter obtained a loan from the parents in the amount of $1.5 million to purchase a home. This note was secured by the property and matures in less than a year after the Exchange date.

Exhibit 13 presents the inputs and calculations to arrive at its fair market value.

The only difference from the note owed by the son is the stated interest rate based on the short-

Exhibit 14
Assets Exchanged between the Parents and the Children's Holding Company
Summary of Concluded Fair Market Values
As of February 18, 2010

Assets Received by Children's Holding Company:		Assets Received by Parents:	
Promissory Notes Held by Parents		*Promissory Note Held by Children's Holding Company*	
Debtor	Fair Market Va;ie $	Debtor	Fair Market Value $
Recreation Holdings, LLC	20,197,000		
Insurance Policy Holdings, LLC	5,261,000		
Business Associate of Parents	5,974,000		
Son	1,500,000		
Daughter	1,500,000	Parents	34,207,000
Total FMV of Promissory Notes	34,432,000		34,207,000
Fair Market Value of Assets Exchanged	**34,432,000**	**Fair Market Value of Asset Exchanged**	**34,207,000**

Fair Market Value of Assets Received by Childrens' Holding Company	34,432,000
Less: Fair Market Value of Asset Received by Parents	(34,207,000)
Equals: Taxable Gift by Parents to Children's Holding Company ($) [rounded]	**225,000**

term applicable federal rate at the time the note was issued. The daughter had the same access to her trust and same level of net assets at her behest.

The note owed by the daughter had a fair market value of $1.5 million.

Actual Gift Size Based on Opinions of Fair Market Value

This example illustrates the valuation of the notes and opinions of fair market value. Now, the analysis sums up the fair market values on each side of the Exchange to see how much of a gift was made.

Exhibit 14 calculates the fair market values of the assets and concludes with the size of the taxable gift.

The Service's notice of deficiency alleged there was a taxable gift in the amount of $13 million owed by the Children's Holding Company because the nominal value of the note given to the parents exceeded the sum of the nominal values of the notes given by the parents to the Children's Holding Company by $13 million.

Based on a fair market value analysis, the Parent Note was worth $225,000 less than the aggregate fair market value of the Children Notes. This amount was determined to be the gift. Instead of the Children's Holding Company owing gift tax on $13 million, the parents owe gift tax on $225,000.

Summary and Conclusion

After thorough analysis of all the notes involved with the Exchange, the taxpayers and the Service agreed that the value gap (the gift), based on the relative fair market values, was only $225,000 (compared to the alleged $13 million fair market value calculated by the Service). Also, rather than the Children's Holding Company owing the gift tax, it is the parents who owed the gift tax.

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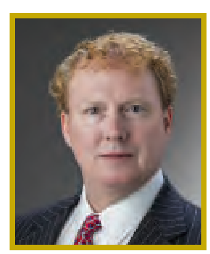

Annuity Payment Analysis for Grantor Retained Annuity Trusts

Ben R. Duffy

A grantor retained annuity trust ("GRAT") is an estate planning instrument that may be used to transfer wealth from the trust grantors to the trust beneficiaries. During the GRAT term, the grantor receives annuity payments. From time to time, valuation analysts are asked to estimate the fair market value of the GRAT annuity payment stream. Because a GRAT typically has predetermined payments during its remaining term, a GRAT annuity payment stream is generally comparable to a debt instrument. And, the valuation of GRAT annuity payments is generally comparable to the valuation of promissory note payments. This discussion provides an overview of GRATs. And, this discussion illustrates the valuation of transferred GRAT annuity payments.

Introduction

A grantor retained annuity trust ("GRAT") is an irrevocable trust that remits to the grantor (i.e., the creator) principal payments plus a stated interest rate, typically on an annual basis. The payments are typically expressed as either:

1. a fixed dollar amount or
2. a percentage of the value of the assets transferred to the trust.

Upon the last payment, any assets remaining in the trust—that is, assets that are not used to satisfy the annuity payments of principal and interest—are transferred to the beneficiaries of the irrevocable trust free of any gift or estate taxes. This statement is true unless a taxable gift resulted from the creation of the trust.

The trust grantor retains the right to predetermined principal and interest payments during the GRAT term. If the trust grantor dies during the term of the GRAT, then the assets of the GRAT will, in general, be included in the grantor's gross estate for federal estate tax purposes.

When the assets being contributed to a GRAT are not publicly traded, then a valuation analyst ("analyst") may be engaged to estimate the value of the privately held assets. This discussion focuses on the valuation of GRAT annuity payments—and not on the valuation of the underlying assets of the GRAT itself.

The analysis of GRAT annuity payments is generally comparable to the analysis of promissory note payments. The annuity payments are established under the terms and conditions of the subject GRAT agreement.

In the instance that the GRAT annuity payments are transferred, a taxpayer may engage an analyst to estimate the fair market value of the remaining GRAT annuity payments.

grantor dies during the GRAT term, regardless of whether the assets have a significantly greater value than the remaining annuity payments due to the grantor.[1]

Consequently, the death of the grantor may eliminate any estate tax benefits obtained by creating the GRAT.

Additionally, the grantor does not obtain any tax benefits associated with creating the GRAT if the GRAT assets do not appreciate during the GRAT term and outperform the Internal Revenue Code Section 7520 rate.

In some instances, analysts are retained to estimate the fair market value of a GRAT annuity payment stream. The following sections describe the generally accepted process for estimating the present value of future GRAT annuity payments.

How Does a GRAT Work?

In order to understand how a GRAT works, it is helpful to understand the role of each party to a GRAT. Typically, there are three parties to a GRAT:

1. The grantor
2. The beneficiary
3. The trustee

The grantor contributes assets to the GRAT and is also the recipient of the GRAT annuity payments.

The beneficiary is the recipient of the grantor-contributed assets at the end of the GRAT term.

The trustee typically manages the trust on the grantor's behalf, and also transfers the assets held in the GRAT to the beneficiary at the end of the GRAT term.

In some instances, the grantor may also be the GRAT trustee. During the term of the GRAT, the annuity payments may be expressed as a fixed dollar amount or as a percentage fixed to the value of the contributed assets.

At the end of the defined term of the GRAT, the trustee transfers the remaining GRAT assets to the beneficiary (or a trust for the beneficiary), free of any gift or estate taxes.

Typically, in order to calculate the taxable gift to the beneficiary, the total value of the annuity payments is subtracted from the total value of the remaining assets of the GRAT.

The grantor retains the right to payments during the life of the grantor. Therefore, the GRAT assets are typically included in the grantor's estate if the

Valuation Analysis of the Remaining GRAT Annuity Payments

An analyst may consider all generally accepted security valuation approaches and methods in the GRAT analysis. The income approach is typically applied in a GRAT annuity payment analysis. The value of a fixed-income instrument typically is a function the following two factors:

1. The income stream
2. The risk-adjusted required rate of return for holding such a security

A frequently applied method for the valuation of remaining GRAT annuity payments is the discounted cash flow method (an income approach valuation method).

When securities cannot be bought or sold in the public market where the price can be readily observed, the value of the payments may be estimated by discounting the contractually scheduled payment amounts to present value. This discounting procedure involves applying a risk-adjusted required yield rate (or discount rate).

Because a GRAT typically has predetermined payments during its remaining term, a GRAT is similar to a debt instrument—such as an annuity promissory note.

If the annuity payments are being transferred, the analyst may want to consider the gift tax regulations which define fair market value for promissory notes as follows:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value. Unless returned at face value, plus accrued interest, it must be shown by satisfactory evidence that the note is worth less than the unpaid amount (because of the interest rate, or date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property, if any, pledged or mortgaged as security is insufficient to satisfy the it.[2]

The next section provides an example of a GRAT annuity payment valuation analysis. This illustrative valuation analysis applies the discounted cash flow valuation method.

Remaining GRAT Annuity Payments—Valuation Example

In a GRAT annuity payment analysis, the analyst may evaluate the subject GRAT by projecting the cash flow of the subject GRAT as stipulated by the subject GRAT agreement and then applying the required market yield.

Terms and Conditions of the Subject GRAT

The first procedure in the analysis of remaining GRAT annuity payments is typically a review of the terms and conditions of the subject GRAT.

During the review of the subject GRAT agreement, the analyst may determine the following:

1. The date of formation (when the GRAT was funded)
2. The date of the first annuity payment
3. The termination date
4. The annuity payment calculation/formula
5. The assets contributed to the trust

In the instance that the assets contributed to the GRAT are not publicly traded, the analyst may need to estimate the fair market value of the assets as of the date of formation. Additionally, the analyst may need to estimate the value the GRAT assets as of the valuation date for the annuity payment stream analysis.

This example assumes that the assets contributed to the GRAT are 10,000 shares of ABC Company Inc. and that the shares have been appraised at $500 per share. Therefore, the fair market value of the contributed assets is $5 million as of the formation date.

The subject GRAT agreement includes terms that are summarized in Exhibit 1 below.

Exhibit 1
Illustrative Terms of the Subject GRAT

Initial Funded Amount	$5,000,000
Date of Formation	3/31/2017
Date of First Annuity Payment	3/31/2018
Initial Annuity Payout Percentage	8.45%
Annual Increase in Yield	20.00%
Termination Date	3/31/2024

According to the hypothetical subject GRAT agreement, the annuity amount consists of seven payments, the first payment equal to 8.45 percent of the initial fair market value of the property transferred to the GRAT.

The initial annuity amount will increase by 20 percent in each succeeding year of the subject GRAT term.

The annuity amount is to be paid annually on the day preceding each anniversary of the subject GRAT.

Based on this information, one can project the annual annuity payments. The projected annuity payment schedule is presented in Exhibit 2.

Exhibit 2
Subject GRAT Annuity Payment Schedule

Payment Date	Annual Annuity Payout	Total Annuity Payment ($)
3/31/2018	8.45%	422,500
3/31/2019	10.14%	507,000
3/31/2020	12.17%	608,400
3/31/2021	14.60%	730,080
3/31/2022	17.52%	876,096
3/31/2023	21.03%	1,051,315
3/31/2024	25.23%	1,261,578
		5,456,969

After the analyst has reviewed the subject GRAT agreement and projected the future GRAT annuity payments, the next procedure is to determine the appropriate present value discount rate to apply to the future GRAT annuity payments.

Selecting the Appropriate Present Value Discount Rate

In order to estimate the appropriate present value discount rate for future GRAT annuity payments, the analyst may analyze the risks associated with the subject GRAT. Generally, in a valuation of any payment stream or cash flow, the riskier the cash flow, the greater the present value discount rate.

The analyst may consider the following risk factors pertaining to future GRAT annuity payments:

1. Duration
2. Quality of the underlying assets
3. Coverage covenants (e.g., interest rate, debt service, asset coverage)

The analyst may also consider market indicators and market factors associated with the GRAT, including the following:

1. The risk-free rate
2. Individual debt yields
3. Industry outlook
4. Economic outlook

Additional factors may need to be considered depending on the complexity of the assignment.

In a GRAT annuity payment analysis, the risk analysis of the underlying GRAT assets is especially important. The subject GRAT is susceptible to risks associated with the volatility of the underlying assets.

If the underlying assets do not outperform the Section 7520 federal applicable rate, the grantor (1) will receive back the trust property and (2) will not receive the estate tax benefits associated with the GRAT.

Section 7520 Federal Midterm Rate Analysis

Since the Section 7520 federal midterm rate is the "hurdle rate" for the GRAT to be successful, the analyst may consider the Section 7520 federal midterm rate when estimating the fair market value of the remaining annuity payments of the GRAT.

Let's assume that as of March 31, 2021, an analyst is engaged to estimate the value of the remaining annuity payments of the GRAT described in Exhibits 1 and 2. The analyst may elect to estimate the present value of the annuity payments by discounting the future annuity payments by the March 2021 federal midterm rate.

The present value of the remaining annuity payments, after applying the March 2021 federal 7520 midterm rate of 0.74 percent,[3] is presented in Exhibit 3.

After discounting the remaining annuity payments by the Section 7520 federal midterm rate of 0.74 percent, the present value of the GRAT annuity payments is approximately $3.87 million, indicating a total discount of approximately 1.3 percent.

Although the Section 7520 federal midterm rate provides the minimum required return of the GRAT assets, it is a formula rate that does not consider the specific risks attributable to the subject GRAT annuity payments.

Let's assume you are offered the opportunity to purchase a stream of GRAT annuity payments. GRAT A is funded with $1 million of Coca-Cola Company publicly traded stock. GRAT B is funded with $1 million of stock for a privately owned dial-up Internet service business.

If the underlying GRAT assets do not outperform the federal Section 7520 midterm rate, the GRAT will fail and you will not receive all of the GRAT annuity payments.

Which GRAT annuity payment stream would you rather purchase? A better question may be, how much of a discount would be required for you to select GRAT B over GRAT A?

This scenario is intended to illustrate that not every annuity payment stream is equal. Therefore, the analyst may consider a market-based yield analysis in order to determine the appropriate discount rate for a stream of GRAT annuity payments.

Market-Based Yield Analysis

In addition to applying the Section 7520 federal midterm rate, the analyst may also consider market-based yields to maturity that reflect the risks associated with the remaining annuity payments of the subject GRAT. The analyst may consider various market sources for applicable market yield data.

The analyst may consider comparable corporate bonds, comparable corporate bond indexes, Treasury bonds, interest rates of comparable debt securities, and other comparable securities.

If the analyst elects to utilize a bond or bond index as a risk proxy, then the analyst should determine what comparable publicly traded bond or bond index best represents the risk associated with the remaining annuity payments.

In order to determine which bond grade is the most comparable to the risk associated with the remaining GRAT annuity payments, the analyst may consider reviewing a bond rating scale. Standard & Poor's ("S&P"") provides a bond rating scale,[4] which can assist the analyst for selecting a comparable bond rating.

Exhibit 3
Present Value of the Subject GRAT Annuity Payments
Section 7520 Federal Midterm Rate

Payment Date	Annual Annuity Payout	Total Annuity Payment ($)	Selected Market Yield	Present Value Factor	Present Value of Cash Flow ($)
3/31/2021	14.60%	730,080	0.74%	1.0000	730,080
3/31/2022	17.52%	876,096	0.74%	0.9927	869,661
3/31/2023	21.03%	1,051,315	0.74%	0.9854	1,035,927
3/31/2024	25.23%	1,261,578	0.74%	0.9781	1,233,956
		3,919,069			3,869,623

S&P broadly defines the investment-grade bond ratings as follows:[5]

- "AAA" – An obligator has extremely strong capacity to meet its financial commitments.
- "AA+ or AA-" – An obligator has very strong capacity to meet its financial commitments.
- "A+ or A-" – An obligator has strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions.
- "BBB+ or BBB-" – An obligator has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligator to meet its financial commitments.

S&P broadly defines the sub-investment-grade bond ratings benchmarked in our analysis as follows:[6]

- "BB+ or BB-" – An obligator is less vulnerable in the near term than other lower-rated obligors. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitments.
- "B+" – An obligator is more vulnerable than the obligors rated 'BB+ or -', but the obligor currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.
- "B" – An obligator is more vulnerable than the obligors rated 'B+', but the obligors currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.
- "B-" – An obligator is more vulnerable than the obligors rated 'B', but the obligors currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.
- "CCC" – An obligator is currently vulnerable, and is dependent upon favorable business, financial, and economic conditions to meet its financial commitments.
- "CC" – An obligator is currently highly vulnerable. The 'CC' rating is used when default has not yet occurred, but S&P Global Ratings expects default to be a virtual certainty, regardless of the anticipated time to default.
- "C" – An obligator is currently highly vulnerable and is expected to have lower chances of recovery than higher rated obligations.
- "D" – An obligator rated D is in default or in breach of an imputed promise.

After selecting the most appropriate bond rating to utilize as a risk proxy for the GRAT annuity payments, the analyst also considers the term to maturity. If the GRAT is anticipated to terminate (along with the annuity payments) in four years, then a 20-year bond yield may not be the most appropriate proxy.

Going back to the previous GRAT example from Exhibits 2 and 3, let's compare the difference in applying a market-based yield versus the Section 7520 midterm rate.

Assume that the GRAT and its underlying assets were carefully analyzed, and the analyst determines that the risk of the GRAT annuity payments is comparable to holding a high-quality corporate bond (AAA, AA, and A).

In this case, the analyst may decide to limit the screen to bonds and bond indexes that are rated AAA, AA, or A. Based on the four remaining years of GRAT payments, as presented in Exhibit 2, the analyst may decide to select a bond or bond index with a comparable term. In this case, the five-year Federal Reserve Bank of St. Louis ("FRED") High Quality Corporate Bond Spot Rate may be a reasonable proxy.

As of March 31, 2021, the five-year FRED High Quality Corporate Bond Spot Rate is 1.33 percent. Exhibit 3 presents the present value of the remaining subject GRAT annuity payments by applying the 1.33 percent present value discount rate.

After discounting the remaining annuity payments by the five-year FRED High Quality Corporate Bond Spot Rate of 1.33 percent, the total present value of cash flow is approximately $3.83 million, indicating a total discount of approximately 2.2 percent.

Because of today's historically low interest rates, the discount rates applied to the GRAT annuity payment examples in Exhibits 3 and 4 are much lower than the discount rates that may have been applied to these annuity streams two to three years ago. To illustrate this difference, Exhibit 5 compares the differences of applying various market yields.

Summary and Conclusion

Analysts may be engaged to estimate the present value of future annuity payments (or specifically GRAT annuity payments). The valuation should consider (1) the terms and conditions of the subject annuity payments and (2) the volatility and risk associated with the underlying assets of the trust.

Exhibit 4
Present Value of the Subject GRAT Annuity Payments
5-Year FRED High Quality Corporate Bond Spot Rate

Payment Date	Annuity Payout	Annuity Payment ($)	Market Yield	Value Factor	Present Value of Cash Flow ($)
3/31/2021	14.60%	730,080	1.33%	1.0000	730,080
3/31/2022	17.52%	876,096	1.33%	0.9869	864,597
3/31/2023	21.03%	1,051,315	1.33%	0.9739	1,023,898
3/31/2024	25.23%	1,261,578	1.33%	0.9611	1,212,507
		3,919,069			3,831,082

Exhibit 5
Discount Rate Sensitivity Analysis

Selected Market Yield	Present Value of Cash Flow ($)
1.33%	3,831,082
3.00%	3,726,053
5.00%	3,610,000
10.00%	3,340,000

An analyst may evaluate the future annuity payments of a GRAT by:

1. projecting the cash flow of the subject GRAT as stipulated by the subject GRAT agreement and then
2. applying the required market yield. As discussed, there are various sources and proxies for determining the appropriate market yield rate (i.e., discount rate) to apply to projected annuity payments.

Clients should confer with trust and estate counsel regarding the strategy of implementing a GRAT. If the grantor elects to contribute privately held assets to the GRAT, the grantor should engage an analyst to estimate the fair market value of the underlying GRAT assets.

Notes:

1. Internal Revenue Code Sections 2036 and 2039
2. Internal Revenue Code Section 25.2512-4.
3. https://www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates
4. https://www.spglobal.com/ratings/en/about/intro-to-credit-ratings
5. Ibid.
6. Ibid.

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GUIDE TO PROPERTY TAX VALUATION

Robert F. Reilly and Robert P. Schweihs

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Income Tax and Other Considerations Related to Debt Restructuring and Debt Cancellation

C. Ryan Stewart

In an environment caused by the COVID-19 pandemic, many debtor entities have become financially distressed—due to decreased revenue and inconsistent cash flow. As a result, these debtor entities may take advantage of government-sponsored aid programs as well as opportunities to work with creditors to gain relief through debt restructuring. When debt is forgiven in a debt restructuring, it causes the debtor taxpayer to recognize cancellation of debt ("COD") income for federal income tax purposes. However, under certain circumstances, the debtor taxpayer can avoid recognition of a portion—or all—of the COD income to the extent that the debtor taxpayer is insolvent or in bankruptcy. This discussion summarizes (1) the federal income tax rules for COD income recognition and (2) the provisions for the nonrecognition of COD income in certain circumstances. Further, this discussion summarizes both the income tax and valuation considerations that boards of directors, debtor company managers, and valuation analysts may consider when evaluating debt restructuring strategies.

Introduction

On March 11, 2020, the World Health Organization declared COVID-19 a pandemic.[1] The advanced spread of COVID-19 and the ultimate impact on the economy, consumer confidence, and market valuations were highly uncertain and susceptible to speculation.

Due to certain strategies employed in an attempt to slow the spread of the virus, including stay-at-home orders, social distancing, indoor capacity restrictions, supply chain disruption, public fear, uncertainty, and doubt, many businesses were forced to shut down operations.

Often, the businesses that were able to withstand the initial waves of the pandemic were left in a distressed financial state and challenged in terms of the ability to fund operating expenses and service debt.

As a result, the government and many lending institutions implemented programs designed to provide relief to debtor entities. This relief was provided in the form of loans, debt forbearance, renegotiation of debt terms, and debt cancellation among other forms of assistance. By early April 2021, Congress had passed several rounds of legislation to address the financial and economic impact of the pandemic on individuals and companies.

New legislation can often be complicated to evaluate and put into practice. Prior to the date of this publication, the Internal Revenue Service was in the process of reviewing the American Rescue Plan Act of 2021[2] (signed into law March 11, 2021[3]). Therefore, its precise impact on taxpayers was not understood at the time of preparing this discussion. Additionally, nothing in this discussion should be construed as tax, legal, or investment advice.

This discussion provides an overview of the income tax implications of several of the aforementioned debt relief alternatives when viewed in the context of restructuring the debt of debtor entities during times of financial distress.

This discussion also focuses on certain exceptions to the recognition of cancellation of debt ("COD") income as well as the resulting considerations that advisers, managers, and boards of directors should be aware of when analyzing debt restructuring opportunities for distressed companies.

Cancellation of Debt Income

COD income occurs when debt is forgiven, discharged, or canceled for less than the full amount owed on the debt. The amount of debt that is canceled is considered income, and it is typically included as taxable income on the debtor's income tax return corresponding to the year in which the cancelation occurred.

Internal Revenue Code Section 108 provides exclusion provisions for the recognition of COD income. These exclusions include the following:

1. The bankruptcy exception
2. The insolvency exception

These exceptions are designed to preserve the debtor taxpayer entity's "fresh start" and reduce or eliminate the burden of an immediate income tax liability when debt is forgiven.

Debt Restructuring Events that Trigger COD Income

Typically, a distressed debtor entity will engage in a debt restructuring to stabilize operations and the financial position of the entity as well as enhance cash flow.

Outside of a bankruptcy context, distressed debtor companies typically engage in debt restructuring in the following circumstances:

1. An ownership change is not expected.
2. The creditor and debtor taxpayer entities prefer to avoid a bankruptcy proceeding.

Examples of debt restructuring activities may include, but are not limited to, the following:

1. The distressed debtor entity repurchasing existing debt at a price discount through a debt recapitalization
2. A creditor swapping recourse or nonrecourse debt for newly issued equity securities or instruments (i.e., shares of stock or warrants)
3. The distressed debtor entity raising new equity capital in order to de-lever the balance sheet
4. The distressed debtor entity negotiating with creditors for more favorable debt terms such as loan maturity, debt mix, flexible payment schedules, interest rate reductions or interest only provisions, or payment-in-kind interest features
5. The subordination of shareholder debt to third-party debt

Debtor companies may analyze potential outcomes before engaging in these types of activities in order to assess the income tax implications and whether they would be deemed as significant modifications under current tax rules.

Creditors are often amenable to restructuring debt to be more favorable to a borrower when they believe that the restructuring will increase the chances of repayment. Under certain circumstances, when a business becomes financially distressed, the creditor may partially reduce or even totally discharge the debt.

For example, debt issued to a debtor entity by related parties or shareholders may be totally or partially discharged outside of a bankruptcy scenario. Related-party and shareholder loans are frequent among smaller family-owned or other private businesses.

When debt is forgiven or partially discharged, under Section 61, COD income in the amount of the debt discharged is included in the entity's gross income. This is because the taxpayer entity did not include the loan proceeds in income when the proceeds were received.

A reduction in liabilities without a corresponding reduction in assets is a discharge of indebtedness income. The COD income quantifies the improvement in the taxpayer entity's financial position resulting from the restructuring.

For example, if a creditor forgives a $300,000 debt, the debtor entity financial position would improve by $300,000 and it would recognize $300,000 of taxable income.

Creditors frequently require compensating securities such as preferred stock as an inducement to restructure the debt and as compensation for the lost returns on the debt that was restructured or discharged.

In some instances the creditor will receive warrants in exchange for discharging a portion of the debt and adjusting the terms of the remaining debt. The exchange of equity for debt will be discussed further in the next section.

The Exchange of Equity for Debt

The formula below presents the amount of COD income to be recognized under Section 108 in a debt restructuring that involves the exchange of equity for debt.

$$\text{COD Income} = \frac{\text{Excess of the amount of the debt that is forgiven}}{\text{Fair market value of the equity exchanged in order to cancel the debt}}$$

If the capital structures of the entity post-restructuring are more complex, the calculations that may be required to estimate the amount of the COD income also become more complex. In order to estimate the economic improvement in the debtor entity's debt position following the debt restructuring, the equity securities issued as compensation to the creditor may be valued.

While this provides needed debt relief and improvement in the financial position of the debtor entity during the time of distress, problems could arise when the debtor entity recovers. Equity holders that were not part of the down round equity financing could claim that the new equity holders invested at a price that was too low.

A fairness opinion of the transaction in addition to the valuation of the new equity would help to protect against such claims and bolster the integrity of the restructuring process.

Under Section 108(e)(2), the discharge of the debt will not result in COD income to the extent that payment of the liability would have resulted in an income tax deduction.

COD Income Recognition Exceptions

Section 108 provides several exceptions to the COD income recognition in the following circumstances:

1. The debtor entity is involved in a Chapter 11 bankruptcy proceeding.
2. The debtor entity is insolvent immediately prior to the forgiveness of debt.

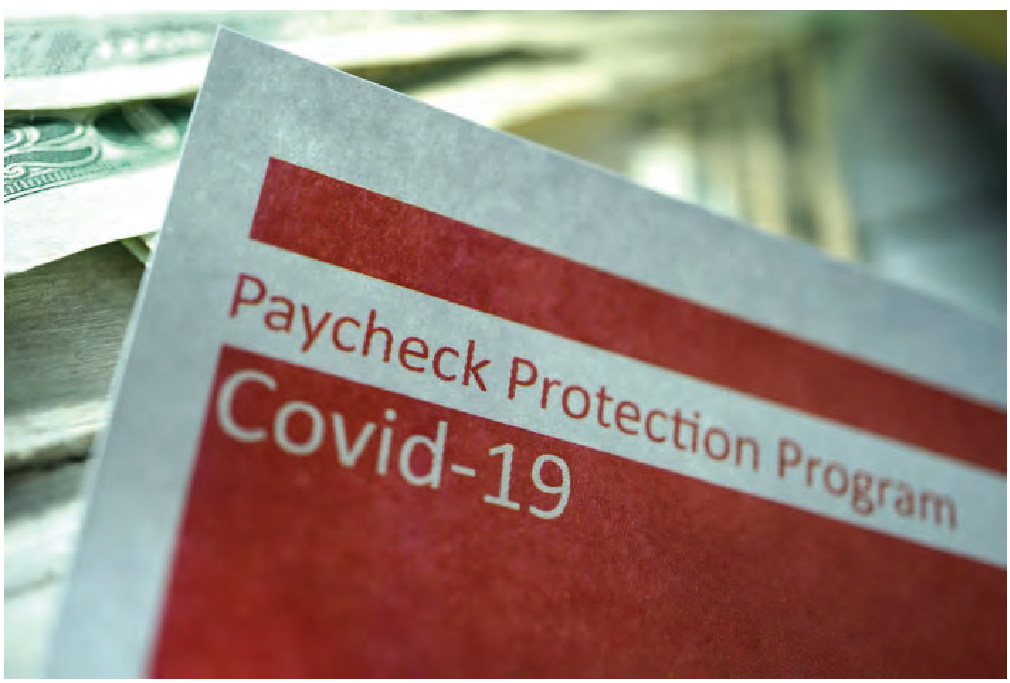
The reasoning behind these exclusions is to allow for an entity that is undergoing bankruptcy to have a "fresh start." Burdening the debtor entity with a large tax liability from relief granted by the bankruptcy process or from the discharge of debt would be counterproductive to the objectives of the Chapter 11 reorganization process.

Additional exclusion provisions under Section 108 that may be applied to COD income include the following:

1. The discharge of qualified farm indebtedness
2. In the case of a business taxpayer other than a C corporation, the discharge of qualified business-related real property indebtedness
3. The discharge of qualified principal residence indebtedness prior to 2012

Paycheck Protection Program

In addition to relief provided in the tax regulations, Congress passed laws to provide economic aid to qualifying businesses.



As part of the CARES Act of 2020 the Paycheck Protection Program ("PPP") was introduced in order to provide businesses that were disrupted by COVID-19 related economic impacts with loans so that they could remain in operation.

Under the PPP program, loans are available to fund payroll and group health benefit costs, rent and utilities, and additional items. Additionally, amounts forgiven under the PPP loan program are not considered taxable income for federal income tax purposes.

Subsequent legislation was passed to specify that certain expenses paid using PPP loan proceeds are deductible for federal income tax purposes.

However, depending on the state, any PPP loan COD income and the associated tax attributions may be treated differently for state income tax purposes. Due diligence may be conducted to ensure that any PPP loans can be accounted for as part of either a valuation or a debt restructuring analysis.

Debtor Entity Insolvency Reduces the Recognition of COD Income

Section 108 provides for the portion of the COD income that is excluded from gross income, based on the debtor entity's insolvency at the time of the discharge.

According to Section 108(a)(3), if the debt discharge occurs when the debtor entity was insolvent, then the amount of COD income excluded will not exceed the amount by which the debtor entity is insolvent. Therefore, in certain instances, the amount of the COD income will be reduced, but not totally eliminated.

The amount of COD income excluded under this section is applied to reduce the tax attributes of the debtor entity. The debtor entity's tax position is affected by the COD income whether or not any income is actually realized.

The debtor entity may exclude COD income under Section 108(b) at the cost of decreasing certain tax attributes.

Income Tax Attributes

To the extent that the debtor entity excludes any COD income from gross income, a corresponding reduction is applied to the income tax attributes of the debtor entity in the following order:

1. Net operating losses ("NOL")
2. General business tax credits
3. Minimum tax credits
4. Capital loss carryovers
5. Income tax basis reduction
6. Passive activity loss credit carryovers
7. Foreign tax carryovers

According to Section 108(b)(5), the debtor entity also has the option to elect to reduce the basis of its depreciable property prior to reducing any other entity income tax attributes.

Illustrative Example

For example, let's consider the following scenario:

1. The debtor entity has an NOL balance of $333,000.
2. The debtor entity has $333,000 in implied COD income from debt restructuring.
3. No exclusions of COD income are available.

The debtor entity may use the NOL balance to offset the COD income. Thereby, the debtor entity will decrease the realized COD income to $0. As a result, the debtor entity's tax attributes are reduced by $333,000.

If the debtor entity in the above scenario is insolvent by $333,000 under Section 108 (a)(1)(B), then the implied COD income and the realized COD income are both $0. However, due to Section 108(b), the debtor entity's tax attributes are still reduced by $333,000.

The Section 108 COD income recognition exceptions are applied differently for partnerships and corporations. Therefore, the type of business entity structure is an important consideration for the purpose of performing an insolvency analysis.

COD Income Recognition for Different Business Structures

Under Section 61, COD income is considered ordinary income and is subject to federal income taxation at the time the debt is discharged. However, these income tax repercussions are different based on the entity structure.

S Corporations

When an S corporation recognizes COD income, this causes a reduction in the entity's tax attributes at the corporation level. Since S corporations do not have NOLs, this affects each shareholder's

distributive share of losses and deductions that have been excluded for the taxable year of the debt discharge.

The result of this calculation is a readjustment of each shareholder's excess losses that carry forward into the years following the year of debt discharge.

Further, if the S corporation's liabilities are cancelled, then the COD income will not be included in the S corporation's taxable income.

The S corporation may consider and comply with the provisions of Section 1366(d) to make the most of a difficult situation and to allow the shareholder to benefit from losses generated at the S corporation level.

The S corporation may accomplish this by structuring the addition of funds as a back-to-back loan—as opposed to either:

1. a guarantee of S corporation debt or
2. a co-borrowing.

This result occurs because neither of these investment structures will generate a tax basis for future S corporation loss recognition purposes.

C Corporations

When a C corporation recognizes COD income, this also results in a reduction of the entity's tax attributes at the corporation level. The difference relative to S corporations is that C corporations have NOLs.

Therefore, the taxpayer's intent is to typically try to preserve the NOL tax attributes.

Partnerships

In the event that a partnership defaults on its debt obligations, and a portion or all of that debt is released by the creditor, the partnership will recognize COD income. The COD income realized is allocated among the partners based on their respective ownership percentages.

Even though the COD income is realized at the partnership level, the determination of whether or not that COD income is to be recognized is made at the partner level.

The reason for this is because if one partner is bankrupt or considered insolvent, then that partner would likely not recognize any COD income allocated by the partnership.

On the other hand, if the other partners are solvent, then the other partners may recognize their respective portion of the realized COD income.

COD Income Recognition Requirements Related to Recourse Debt and Nonrecourse Debt

When there is a reduction in debt that is recourse debt, often times, such a reduction will result in taxable COD income. Recourse debt is debt that is personally guaranteed by the debt holder.

That is, in the event that the debt holder defaults on its obligation to the lender, the lender may pursue legal action against the debt holder. When the debt is nonrecourse, the lender does not have the right to pursue anything other than the collateral for the debt.

For example, often private companies need outside capital for an expansion of operations or for working capital needs. The private company owner may personally guarantee the business loan.

That personal guarantee is typically required because private businesses:

1. often have difficulty in accessing capital and
2. are likely to be forced to pay higher interest rates.

In the event the debtor entity defaults in its debt obligations, the lender may bring legal action against not only the debtor entity, but also against the business owner.

On the other hand, if a homeowner defaults on his home loan (nonrecourse), the bank may collect the collateral (i.e., the home). However, the bank may not take further legal action against the homeowner.

When a lender forecloses on real estate as part of a settlement related to a recourse loan, the foreclosure is reflected as a property sale. The proceeds from the foreclosure sale are equal to the lesser of:

1. the amount of the debt or
2. the fair market value of the real estate.

If the debt related to the recourse loan is greater than the fair market value of the real estate, then the taxpayer entity will recognize COD income related to the sale of the real estate.

Since a foreclosure sale is treated as a property sale, the amount of any taxable gain or loss is determined in accordance with the Section 1221 and the Section 1231 requirements.

In the event that the debt related to the recourse loan is less than the fair market value of the real estate, the proceeds from the foreclosure sale are considered to be equal to the amount of the recourse debt. As a result, the debtor entity does not recognize any COD income.

When a lender forecloses on real estate as part of a settlement related to a nonrecourse loan, the foreclosure sale is still reflected as a property sale. However, the difference is that the proceeds from the foreclosure sale are equal to the amount of the debt related to the nonrecourse loan.

In this case, the fair market value of the real estate is not relevant. It is also noteworthy that the debtor entity will not recognize COD income.

In the event that the discharged debt is greater than the real estate cost basis, the taxpayer entity will recognize either capital gains income or ordinary income according to Section 1231. However, such income will not be treated as COD income.

Federal Income Tax Definition of Insolvency

According to the U.S. Bankruptcy Code Section 101(32)(A), the term "insolvency" is defined as a financial condition such that the sum of an entity's debts is greater than all of such entity's property, at a fair value valuation.

However, the term "insolvent" is defined in Section 108(d)(3) as the excess of the liabilities over the fair market value of the assets as determined immediately before the debt discharge.

Procedures to Quantify Debtor Taxpayer Entity Insolvency

Insolvency under Section 108 occurs when the debtor entity liabilities exceed the fair market value of the debtor entity assets. The amount by which the debtor entity is insolvent for Section 108(a)(1)(B) exclusion purposes is determined on the basis of the assets and liabilities immediately prior to the debt discharge.

The determination of insolvency (for income tax purposes) depends on the fair market value of the debtor entity assets. Therefore, valuation of the debtor entity is an important element in the insolvency determination.

The valuation methods and procedures for measuring debtor entity insolvency for COD income exclusion purposes should consider the concept of "highest and best use" (i.e., is the value of the assets greater under a going-concern basis or an orderly liquidation basis?).

Property Valuation Approaches

The three generally accepted property valuation approaches used to estimate the fair market value of the debtor entity assets are as follows:

1. The cost approach
2. The income approach
3. The market approach

Once the fair market value of the debtor entity's assets is estimated, the valuation analyst is able to measure the insolvency of the debtor entity. The amount of insolvency is then netted against the amount of the recognizable COD income.

Illustrative Example

For example, if a creditor forgives a $200,000 debt, the debtor entity will generally recognize $200,000 of taxable income. However, if the taxpayer entity is insolvent, the debtor entity would be able to exclude part or all of COD income realizable from the debt discharge.

In order to illustrate the process of measuring the debtor taxpayer insolvency and the effect of the insolvency exclusion on recognizable COD income, let's consider the following example.

A valuation is performed and the fair market value of the debtor entity's net assets is estimated to be negative $100,000 (i.e., total assets of $200,000 less total liabilities of $300,000). Let's assume that the creditor forgives $200,000 of long-term debt. That debt forgiveness will result in $200,000 of taxable income to the debtor.

This negative net asset value implies that the debtor entity is insolvent by $100,000. Therefore, the debtor entity may take advantage of the Section 108 insolvency exclusion.

The taxpayer's COD income of $200,000 will be partially offset by the taxpayer's insolvency amount of $100,000.

Due to its eligibility for the insolvency exclusion, the debtor entity may net the insolvency amount against the COD income. Therefore, the taxpayer will only recognize $100,000 of COD taxable income.

Summary and Conclusion

As a result of the global pandemic, many debtor entities have found the need to restructure their business debt. The debt restructuring may include a renegotiation of the outstanding debt terms. Or, in many cases, the debt restructuring may include the partial forgiveness of debt, resulting in the debtor entity COD income.

"Due to the COVID-affected economic environment, many debtor entities would not be able to continue operating without restructuring their business debt."

Due to the COVID-affected economic environment, many debtor entities would not be able to continue operating without restructuring their business debt. The trade-off of the debt restructuring is that the debtor entity may have to recognize income related to the COD.

Section 108 and the related regulations determine what portion of the COD income is to be excluded from taxable income, based on the determination of the debtor entity insolvency at the time the debt is discharged.

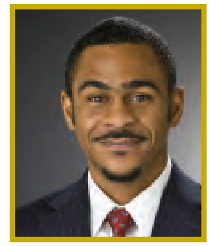
Analysts should consider generally accepted property valuation approaches and methods when analyzing debtor entity debt restructuring alternatives and their respective impacts on income taxes, cash flow, and equity valuation.

Debtor entities should be aware of the COD income recognition tax rules and plan for their impact in the context of debt restructuring. Further, debtor entity managers and boards of directors may make decisions based on a debtor entity net asset valuation analysis. As such an analysis provides insight for decision making.

Additional analyses—such as solvency and fairness opinions—may also help to protect the debtor entity against future claims by any parties to the restructuring transactions.

Notes:

1. https://www.who.int/emergencies/diseases/novel-coronavirus-2019/interactive-timeline#event-71
2. https://www.irs.gov/newsroom/irs-statement-american-rescue-plan-act-of-2021
3. https://www.congress.gov/bill/117th-congress/house-bill/1319



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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.

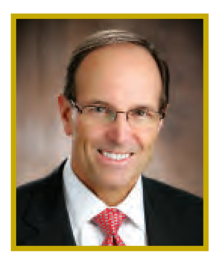
The Tax Court in the *Warne* case decided that, since the litigating parties—through their experts or by stipulation—concluded that a DLOC and a DLOM should be applied to the five subject LLC interests, valuation discounts may be applied.

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.



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Nelson v. Commissioner: Tax Court Opines on the Transfer of Fixed-Dollar Value Amounts and the Application of Multitier Discounts

George Haramaras, CPA

This discussion reviews the 2020 U.S. Tax Court decision, Nelson v. Commissioner*. In particular, this discussion (1) summarizes the factual background of the case, (2) considers both the valuation and the taxation issues addressed in the judicial decision, and (3) examines the implications of this Tax Court judicial decisions with regard to taxpayers, tax counsel, and valuation analysts.*

Introduction

Nelson v. Commissioner (the "*Nelson* case")[1] was a significant U.S. Tax Court decision during 2020. In this judicial decision, the U.S. Tax Court ("Tax Court") addressed two topics related to valuation.

The first topic concerned whether the two ownership interest transfers in the *Nelson* case represented (1) fixed percentages of partnership interests or (2) a dollar value that determined the amount of partnership interests transferred.

The second topic concerned the applied discounts for lack of control and lack of marketability at two organizational levels—for a limited partnership that had a multitier organizational structure.

This discussion reviews the *Nelson* decision. Specifically, this discussion describes the factual background of the *Nelson* case. This discussion examines the following:

1. The factual issues of the *Nelson* case
2. The conclusions reached by the Tax Court
3. The guidance that can be extracted from this judicial guidance for taxpayers, tax counsel, and valuation analysts ("analysts")

In the *Nelson* decision, there are implications for multiple parties including the taxpayer, the tax counsel representing taxpayers on gift transactions, and the analyst.

Lastly, it is noteworthy that the *Nelson* decision is currently on appeal by James C. Nelson and Mary P. Nelson (collectively, the "Petitioners").

Background and Case Summary

First, this discussion summarizes the subject companies involved in the *Nelson* case. Second, this discussion reviews the background of the transfers and of the dispute.

Subject Companies Involved in the *Nelson* Case

Background of Longspar, Ltd.

The *Nelson* case involves the transfers of limited partnership interests in Longspar, Ltd. ("Longspar"). Longspar was formed on October 1, 2008, as a Texas limited partnership and was headquartered in Midland, Texas. Longspar was formed (1) to consolidate and protect family assets and (2) to make gifts without fractionalizing the ownership interests in closely held family businesses.

Mr. and Mrs. Nelson were the sole owners of the Longspar general partnership interests. Together they held a 1.0 percent general partnership interest in Longspar.

The general partnership interest and the limited partnership interests in Longspar on December 31, 2008 (the "valuation date"), prior to the transfers, are summarized in Exhibit 1.

As of the valuation date, Longspar held various assets including cash, marketable securities, investments in private equity and venture capital funds, and receivables. The primary asset of Longspar, however, was an ownership interest in Warren Equipment Co. ("Warren Equipment").

Longspar also held 65,837 common stock shares of Warren Equipment. The Longspar sole liability as of the valuation date was an accounts payable balance of $5,000.

The net assets of Longspar are summarized in Exhibit 2.

As presented in Exhibit 2, the fair market value of its investment in Warren Equipment represented nearly all of the assets held by Longspar.

What triggered the dispute with the Internal Revenue Service (the "Service") was the transfer of limited partnership interests in Longspar. Because the Longspar investment in Warren Equipment represented approximately 99 percent of total assets, the valuation of Warren Equipment was contested in the *Nelson* decision. The following discussion describes Warren Equipment.

Background of Warren Equipment Co.

In 1971, Johnny Warren ("Mr. Warren," the father of Mrs. Nelson) founded Compressor Systems, Inc. ("CSI"), with another family. In 1975, Mr. Warren and his brother-in-law purchased the other family's ownership interest in CSI, making CSI wholly owned by the Warren family.

CSI manufactures, sells, and rents natural gas compressors and services, and it also provides servicing and financing for natural gas compressors.

Mr. Warren continued to expand CSI and acquired or founded new business ventures. To facilitate this

Exhibit 1
Longspar, Ltd.
Ownership Schedule

Partners	Partnership Interest (%)
General Partners:	
James C. Nelson	0.50
Mary P. Nelson	0.50
Limited Partners:	
Mary P. Nelson	93.88
Mary P. Nelson, as Custodian for Carole A. Nelson under the Texas Uniform Transfers to Minors Act	1.83
Mary P. Nelson, as Custodian for Mary C. Nelson under the Texas Uniform Transfers to Minors Act	0.88
Mary P. Nelson, as Custodian for Paige F. Nelson under the Texas Uniform Transfers to Minors Act	0.88
Steven C. Lindgren, as Trustee of the Mary Catherine Nelson 2000 Trust	0.51
Steven C. Lindgren, as Trustee of the Paige Francis Nelson 2000 Trust	0.51
Steven C. Lindgren, as Trustee of the Sarah Elizabeth Nelson 2000 Trust	0.51
Total	100.00

Source: James C. Nelson v. Commissioner of Internal Revenue and Mary P. Nelson v. Commissioner of Internal Revenue, T.C. Memo 2020-81 (June 10, 2020).

Exhibit 2
Longspar, Ltd.
Fair Market Value of Net Assets
As of December 31, 2008

Net Assets	Fair Market Value ($)	
Cash	9,470	
Marketable Securities	158,344	
65,837 Common Stock Shares in Warren Equipment Corporation	60,060,014	[a]
Investments in Private Equity and Venture Capital Funds	446,153	
Notes Receivable	25,000	
Accounts Receivable	35,380	
Total Assets	60,734,361	
Accounts Payable	5,000	
Total Liabilities	5,000	
Net Asset Value	60,729,361	[a]

[a] Represents an estimate, based on the facts of the *Nelson* case.
Source: James C. Nelson v. Commissioner of Internal Revenue and Mary P. Nelson v. Commissioner of Internal Revenue, T.C. Memo 2020-81 (June 10, 2020).

expansion, Warren Equipment was organized on September 26, 1990, as a Delaware corporation.

As of the valuation date, Warren Equipment was comprised of seven wholly owned subsidiaries, including CSI. Additionally, CSI owned and operated three subsidiaries, holding 100 percent ownership interests in the following companies:

1. Pump Systems International, Inc.
2. Rotary Compressor Systems, Inc.
3. Engines, Parts & Service, Inc.

Warren Power & Machinery, LP ("Warren Cat"), was the largest subsidiary owned by Warren Equipment as of the valuation date. Warren Cat is a dealer of new and used Caterpillar, Inc., construction and heavy equipment in Texas and Oklahoma.

The following paragraphs present summary descriptions of the remaining five subsidiaries owned by Warren Equipment:

1. Warren Administration Co. ("Warren Administration") provides corporate management and administrative functions for Warren Equipment subsidiaries.
2. Ignition Systems and Controls, LP ("ISC"), is a regional dealer of ignition and control systems.
3. North American Power Systems, Inc. ("NAPS"), sells light towers and generators.
4. Perkins South Plains, Inc. ("PSP"), is a distributor of engines for industrial applications.
5. Warren Real Estate Holdings, Inc. ("Warren RE"), finances and holds all real estate property associated with the operations of Warren Equipment and its subsidiaries.

Figure 1 presents the organizational chart of Warren Equipment.

Longspar owned 65,837 common stock shares in Warren Equipment, out of 237,407 total shares outstanding, as of the valuation date.

As presented in Figure 1, the common stock shares held by Longspar represent an approximate 27 percent ownership interest in Warren Equipment as of the valuation date.

Background of the Transfers and the Dispute

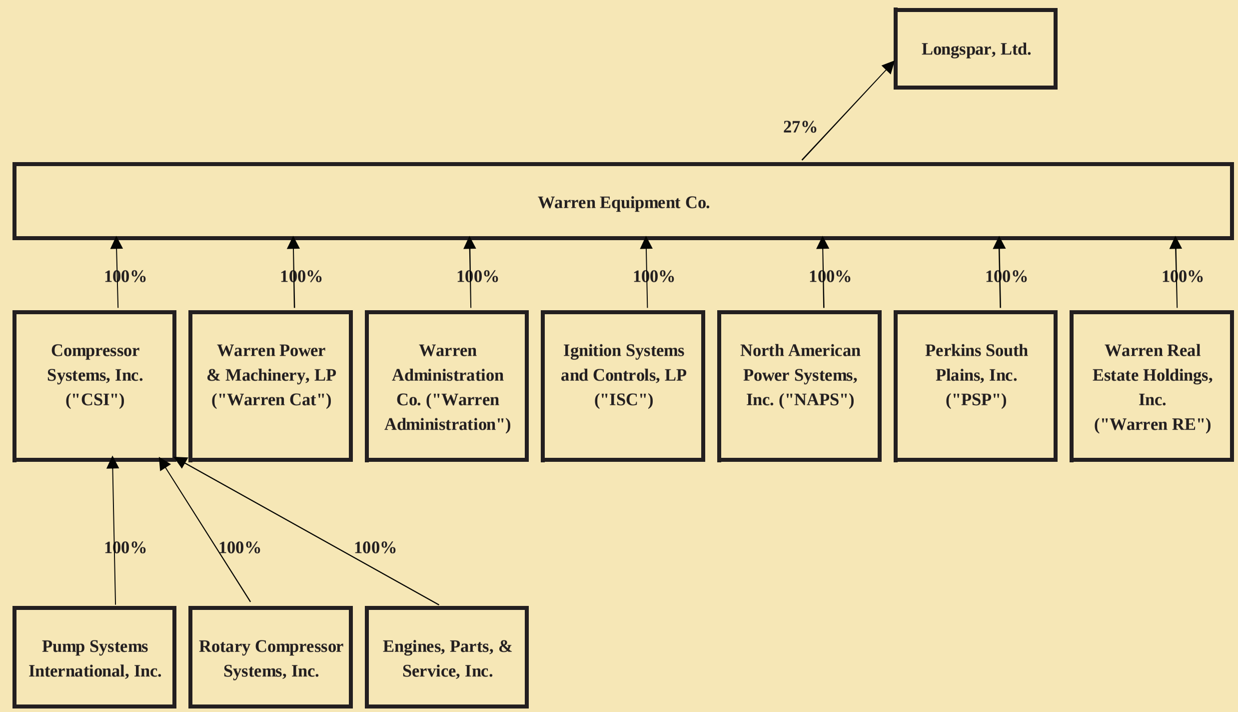
At issue in the *Nelson* case were two transfers of limited partnership interests in Longspar.

In December of 2008, the Petitioners formed the Nelson 2008 Descendants Trust (the "Nelson Trust"), which had Mrs. Nelson as settlor and Mr. Nelson as trustee. Mr. Nelson, and the four daughters of Mr. and Mrs. Nelson, were the beneficiaries of the Nelson Trust.

On December 31, 2008, Mrs. Nelson executed, as a gift, a transfer of a limited partnership interest in Longspar to the Nelson Trust. On January 2, 2009, Mrs. Nelson executed a second transfer, as a sale, of a limited partnership interest in Longspar to the Nelson Trust.

For the first transfer, in the Memorandum of Gift and Assignment of Limited Partner Interest (the "Gift Memorandum") that outlined the gift transfer, Mrs. Nelson structured the transaction as a gift of a limited partnership interest in Longspar with a fair market value of $2,096,000, to be determined by a qualified appraiser within 90 days.

Figure 1
Organizational Chart of Warren Equipment Co.
As of December 31, 2008



Source: Source: James C. Nelson, Petitioner v. Commissioner of Internal Revenue, Respondent and Mary P. Nelson, Petitioner v. Commissioner of Internal Revenue, Respondent, Tax Court Memo 2020-81 (June 10, 2020).

For the second transfer, in the Memorandum of Sale and Assignment of Limited Partner Interest (the "Sale Memorandum") that described the sale, Mrs. Nelson structured the transaction as the sale of a limited partnership interest in Longspar with a fair market value of $20,000,000, to be determined by a qualified appraiser within 90 days.

The transaction was financed with a promissory note to Longpsar issued by the Nelson Trust.

The Petitioners hired an appraiser to estimate the fair market value of a 1 percent limited partnership interest in Longspar as of the valuation date. The appraiser concluded that the fair market value was $341,000.

Therefore, the fair market value of the December 31, 2008, gift was equal to a 6.14 percent limited partnership interest in Longspar, while the fair market value of the sale that occurred on January 2, 2009, equated to a 58.65 percent limited partnership interest in Longspar.[2]

Mr. and Mrs. Nelson each filed separate gift tax returns for 2008, with the gift transfer being classified as a split gift. The 2009 transfer was not filed as a gift in 2009, as it was a sale of the limited partnership interest in Longspar to the Nelson Trust.

On May 21, 2012, the Service selected the 2008 and 2009 Forms 709 for the Petitioners for examination. On May 21, 2012, the Petitioners entered into the administrative appeal process with the Service. The Service and the Petitioners attempted to enter into a settlement agreement, but it was never completed.

On August 29, 2013, the Service issued notices of deficiency, determining that the Petitioners:

1. undervalued the split gifts in 2008 (the December 31, 2008, gift transfer) and
2. undervalued the transfer on January 2, 2009, which as a result was alleged to be partly a gift.

Issues of the Case

The Tax Court addressed the following two issues in the *Nelson* decision:

1. Whether Mr. and Mrs. Nelson transferred percentage interests or, alternatively, fixed dollar value amounts to the Trust
2. Whether the Petitioners' expert (the "Longspar expert") or the Service's expert correctly estimated the valuation discounts for lack of control and lack of marketability applicable to Longspar and Warren Equipment[3]

The following discussion considers theses two issues.

Transfers of Percentage Interests versus Fixed-Dollar Value Amounts

In the *Nelson* case, the Petitioners claimed that they transferred fixed-dollar value amounts of $2,096,000 for the gift transfer and $20,000,000 for the sale.

In contrast, the Service claimed that the two transfers were actually transfers of percentage interests—6.14 percent for the gift transfer and 58.65 percent for the sale—based on the Petitioners' appraisal of the fair market value of a 1 percent limited partnership interest in Longspar.

The Service claimed that the Petitioners' appraisal undervalued a 1 percent limited partnership interest in Longspar.

Based on this contention, the Service claimed that the Petitioners had (1) under-reported the gift transfer amount on their 2008 gift tax returns and (2) failed to report the excess value transferred in the sale (i.e., the excess value of the 58.65 percent Longspar limited partnership interest beyond the

$20,000,000 consideration paid by the Trust to Petitioners) on their 2009 gift tax returns.

Tax Court Opinion on the Transferred Interests

The Tax Court agreed with the Service and concluded that the executed transfers represented percentage interests. The Tax Court determined that the transfers were "saving clauses" and, therefore, represented transfers of percentage interests.

The Petitioners claimed that the transfers were more similar to "formula clauses," for which there is precedent for transferring dollar amounts. The Tax Court ultimately determined that this conclusion was based on the Petitioners' intent arising from subsequent settlement discussions with the Service.

Instead, the Tax Court arrived at its conclusion based on the language of the Gift Memorandum and the Sale Memorandum.

Discounts for Lack of Control and Lack of Marketability

Also at issue in the *Nelson* case were the valuation discounts for lack of control and lack of marketability applied to Warren Equipment and Longspar. Specifically, the Service's expert estimated a different discount for lack of control for Warren Equipment than did the Warren Equipment expert.

Additionally, the Service's expert estimated different discounts for lack of control and for lack of marketability for Longspar than did the Longspar expert.

The differences between the experts' estimated discounts for lack of control and for lack of marketability applicable to Warren Equipment and Longspar, and the Tax Court ultimate concluded discounts, are presented in Exhibit 3.

This discussion considers the application of the discounts for lack of control and lack of marketability for Warren Equipment and Longspar in the following sections.

Application of the Discount for Lack of Control for Warren Equipment Co.

The Warren Equipment expert applied the asset-based approach to estimate the value of the common equity of Warren Equipment. The Warren Equipment expert concluded that her asset-based approach valuation analysis estimated a value of the common equity of Warren Equipment on a controlling, marketable ownership interest basis.

To adjust for this, the Warren Equipment expert then applied a discount for lack of control and a discount for lack of marketability to arrive at the value of the common equity of Warren Equipment on a noncontrolling, nonmarketable ownership interest basis.

Warren Equipment is a holding company that holds 100 percent ownership interests in various subsidiaries. As noted in the Tax Court opinion, the Warren Equipment expert estimated the fair market value of each operating subsidiary, deducted the liabilities of Warren Equipment, and subtracted the preferred equity to arrive at the value of the common equity.

Typically, the adjusted net asset value valuation method estimates a value of total equity on a controlling, marketable ownership interest basis.

The Warren Equipment expert estimated the value of the common equity of Warren Equipment, as of the valuation date, to be approximately $363.7 million to $1,532 per share—on a controlling, marketable ownership interest basis.

Exhibit 3
Comparison of Discounts for Lack of Control and Lack of Marketability for Warren Equipment Co. and Longspar, Ltd.

	Warren Equipment Expert (%)	Longspar Expert (%)	Service's Expert (%)	Tax Court (%)
Warren Equipment Co.				
Discount for Lack of Control	20	NA	-	15
Discount for Lack of Marketability	30	NA	30	30
Combined Discount [a]	44	NA	30	41
Longspar, Ltd.				
Discount for Lack of Control	NA	15	3	5
Discount for Lack of Marketability	NA	35	25	28
Combined Discount [a]	NA	45	27	32

[a] Calculated as 1-(1-discount for lack of control) × (1-discount for lack of marketability).
Source: James C. Nelson v. Commissioner of Internal Revenue and Mary P. Nelson v. Commissioner of Internal Revenue, T.C.\ Memo 2020-81 (June 10, 2020).

After applying valuation discounts for lack of control and for lack of marketability, the Warren Equipment expert estimated the fair market value per common share of Warren Equipment to be $860 per share on a noncontrolling, nonmarketable ownership interest basis.

The Service's expert did not dispute the indicated value of the common equity in the Warren Equipment expert's valuation analysis of $1,532 per share. Instead, he disputed the level of value basis that the Warren Equipment expert's valuation analysis had estimated.

In other words, the Service's expert claimed that the Warren expert's indicated value of common equity per share of $1,532 was already developed on a noncontrolling (rather than controlling), marketable ownership interest basis.

After applying the same 30 percent discount for lack of marketability as the Warren Equipment expert, the Service's expert estimated the fair market value of Warren Equipment to be approximately $1,072 per share.

Exhibit 4 summarizes the valuation methodology applied by the Warren Equipment expert. In the case of Warren Administration, the Warren Equipment expert did not estimate an indicated fair market value—presumably because the Warren Administration subsidiary had an indicated value that was de minimus or zero.

In the case of Warren RE, the Warren Equipment expert relied on a third-party valuation specialist.

The Service's expert made three arguments to support his conclusion that the value of common equity was estimated on a noncontrolling, marketable ownership interest basis.

The Service's expert made the following arguments:

1. In the cases of CSI, Pump Systems International, Inc., and NAPS, the application of the discounted cash flow method did not include specific assumptions that would estimate a value on a controlling, marketable basis. The Service's expert argued that the discounted cash flow method analysis failed to consider the impact of operating assumptions (e.g., ability to increase profits, capital structure) that would differentiate between a controlling interest and a noncontrolling interest.
2. In the cases of CSI and Pump Systems International, Inc., (a) the selection of low pricing multiples and (b) the application of a control price premium was unnecessary in the market approach, since the market approach (presumably the guideline publicly traded company method) estimates value on a noncontrolling, marketable ownership interest basis.
3. In the case of Warren Cat, the application of the adjusted net asset value method did not consider intangible assets. Therefore, the adjusted net asset value method estimated the fair market value of Warren Cat on a noncontrolling, marketable ownership interest level of value basis.

Exhibit 4
Valuation Approaches Relied on by Warren Equipment Co. Expert by Warren Equipment Co. Subsidiary

	Valuation Approach Relied on by Warren Equipment Expert		
Warren Equipment Co. Subsidiary	Asset-Based Approach	Income Approach	Market Approach
CSI		✓	✓
Pump Systems International, Inc.		✓	✓
Rotary Compressor Systems, Inc.	NA	NA	NA
Engines, Parts & Service, Inc.	NA	NA	NA
Warren Cat	✓		
Warren Administration	NM	NM	NM
ISC	✓		
NAPS		✓	
PSP	✓		
Warren RE	NM	NM	NM

NA = Not Available
NM = Not Meaningful
Source: James C. Nelson v. Commissioner of Internal Revenue and Mary P. Nelson v. Commissioner of Internal Revenue, T.C. Memo 2020-81 (June 10, 2020).

Tax Court Opinion on the Warren Equipment Discount for Lack of Control

The Tax Court's opinion included components of both arguments set forth by the Service's expert and the Warren Equipment expert.

The Tax Court accepted the Service's expert argument that the income approach method performed by the Warren Expert did not address certain assumptions in its income approach analysis that would differentiate between a noncontrolling interest or a controlling interest.

Ultimately, however, the Tax Court concluded that all the operating subsidiaries possessed at least some control elements and, therefore, the Warren Equipment expert was correct in applying a discount for lack of control to Warren Equipment.

After examining the discount for lack of control estimated by the Warren Equipment expert, the Tax Court rejected the Warren Equipment expert's 20 percent discount for lack of control—and concluded that the appropriate discount should be 15 percent.

Application of the Discount for Lack of Control and Lack of Marketability for Longspar, Ltd.

In contrast to Warren Equipment, there was no dispute as to whether discounts for lack of control and lack of marketability should be applied in the valuation of a 1 percent limited partnership interest in Longspar. Instead, the level of the selected discounts was disputed.

The Longspar expert applied the adjusted net asset value method to estimate the equity value of Longspar on a controlling, marketable ownership interest basis. Then, the Longspar expert subtracted the 1 percent general partnership interest held by Mr. and Mrs. Nelson and applied a discount for lack of control and a discount for lack of marketability.

The Longspar expert estimated a discount for lack of control of 15 percent and a discount for lack of marketability of 35 percent. The fair market value of a 1 percent limited partnership in Longspar, according to the Longspar expert, was $341,000 as of the valuation date.

The Service's expert also applied the adjusted net asset value method to estimate the fair market value of Longspar. The Service's expert estimated a discount for lack of control of 3 percent and a lack of marketability of 25 percent, for Longspar.

In estimating the discount for lack of control, the Longspar expert relied on a 2008 report that contained closed-end fund data for 43 closed-end funds. The Longspar expert selected three closed-end funds from the dataset that were similar to Longspar. Specifically, the selected closed-end funds had long-term appreciation investment strategies.

The Longspar expert noted that the three selected closed-end funds lacked sufficient comparability based on (1) size and (2) the assets the selected closed-end funds held.

Based on the differences between these funds, the Longspar expert adjusted his analysis to conclude a discount for lack of control for Longspar of 15 percent.

The Longspar expert also concluded a discount for lack of marketability, and relied on (1) restricted stock studies and (2) pre-initial public offering ("pre-IPO") studies.

The Longspar expert estimated a discount for lack of marketability for Longspar of 30 percent based on (1) an average of various restricted stock studies and (2) an indicated range of 40 to 45 percent from the pre-IPO studies.

The Service's expert also relied on closed-end fund data to estimate a discount for lack of control for Longspar. The Service's expert used a broader set of 30 U.S. general equity closed-end funds, but then argued that the closed-end fund data was insufficiently comparable to Longspar.

After evaluating Longspar, the Service's expert concluded there was almost no possibility of lack of control disadvantages for Longspar, applied a discount for lack of control of 5 percent, and adjusted the indicated discount for lack of control downwards to 3 percent.

The Service's expert concluded a discount for lack of marketability for Longspar of 25 percent. The Service's expert applied (1) quantitative models and (2) restricted stock studies and pre-IPO studies that relied on recent data.

The Service's expert relied on an approximate range of 20 percent to 35 percent based on his analysis, and selected the approximate median of this indicated range of 25 percent.

Tax Court Opinion on the Warren Equipment Discount for Lack of Control

Again, the Tax Court's opinion included components of both arguments set forth by the Service's expert and the Longspar expert.

In the case of the Longspar discount for lack of control, the Tax Court agreed with both experts in determining that a discount for lack of control was justified. However, the Tax Court disagreed with both experts on the application of the closed-end fund data in estimating the Longspar discount for lack of control.

Instead, the Tax Court determined a discount for lack of control of 5 percent based on the acknowledgement of the Service's expert that "the possibility of a lack of control disadvantage for a minority owner is remote."

In the case of the Longspar discount for lack of marketability, the Tax Court rejected the Longspar expert and accepted the discount for lack of marketability analysis of the Service's expert.

However, the Tax Court concluded a discount for lack of marketability of 28 percent, which reflected a more precise calculation of the median of the indicated range of discount for lack of marketability.

Conclusions and Implications

The Tax Court decision in the *Nelson* case has numerous implications for various parties, including taxpayers, tax counsel representing taxpayers in gift transactions, and analysts. The following discussion summarizes the broad implications arising from the *Nelson* case:

1. The Tax Court rejected the treatment of the transfers in the *Nelson* case as defined dollar amounts based on indicated values subsequently estimated by appraisers.

   However, the Tax Court rejected this interpretation of defined dollar amount transfers ("defined value") in the *Nelson* case based on the wording of the Gift Memorandum and the Sale Memorandum. In other words, the Tax Court rejected the interpretation of the transfers as defined value transfers in the *Nelson* case based on the facts of the case, not as a rejection of defined value transfers more generally.

   A takeaway for counsel representing taxpayers on gift transactions would be to ensure that the proper, exact clauses are included in the language of the transfer documents.

   In the *Nelson* case, the Tax Court rejected subsequent evidence that revealed the intent of the Petitioners and instead relied on the language of the Gift Memorandum and the Sale Memorandum.

2. The Tax Court acknowledged that discounts, for both lack of control and lack of marketability, were justified at multiple organizational levels. As presented in the *Nelson* case, these multitier discounts for lack of marketability and control were appropriate at the Warren Equipment entity level and at the Longspar entity level.

   One takeaway for the analyst from the *Nelson* case is that based on the unique facts of the subject interest valuation analysis, in some instances, multitier discounts are justified and appropriate. And, depending on the specific facts of the subject interest valuation analysis, the appropriate valuation discounts may be large.

Notes:

1. Nelson v. Commissioner, T.C. Memo 2020-81 (June 10, 2020).
2. Petitioners relied on the appraisal of a 1 percent limited partnership interest in Longspar as of December 31, 2008, for the fair market value of the January 2, 2009, sale.
3. The Petitioners relied on an expert witness who performed the appraisal of Longspar. The Longspar expert relied on a separate appraisal for Warren Equipment. The appraiser who performed the appraisal of Warren Equipment also performed expert testimony services in the Nelson Case. We refer to this expert as the Warren Equipment expert. We refer to the expert for the Service as the Service's expert.

George Haramaras is an associate in our Chicago practice office. George can be reached at (773) 399-4315 or at ghharamaras@willamette.com.

On Our Website

Recent Articles and Presentations

Lisa Tran, a vice president in our Portland office, and Travis Royce, an associate in our Portland office, authored an article that was published in the May 12, 2021, issue of *QuickRead.* The title of Lisa and Travis's article is "Application of the Tax Amortization Benefit Valuation Adjustment."

The so-called tax amortization benefit (TAB) adjustment represents the present value of the federal income tax savings resulting from the tax amortization of an acquired intangible asset over a statutory period. Internal Revenue Code Section 197 allows the cost of certain acquired intangible assets to be amortized for federal income tax purposes. However, not all acquired intangible assets are subject to such amortization tax deductions. Analysts should apply the so-called TAB adjustment to an intangible asset valuation analysis only when it is appropriate. Lisa and Travis's article summarizes what analysts should know before applying the TAB adjustment to an intangible asset valuation analysis.

Robert F. Reilly, a managing director of our firm, authored an article that was published in the February 2021 issue of *Practical Tax Strategies.* The title of Robert's article is "Functional Analysis as Part of a Valuation, Damages, or Transfer Price Analysis."

A functional analysis is one important component of a transfer price analysis. This analysis is often applied for purposes of assessing the comparability of the subject entity to selected guideline entities. Robert examines the reasons for performing such a functional analysis. He discusses the impact of the analysis on valuation estimates, on damages measurements, and on transfer price determinations. Robert summarizes the 12 steps of a functional analysis. Finally, he discusses proper documentation of a functional analysis.

Tim Meinhart, a managing director of our firm, and Nate Novak, a vice president in our Chicago office, delivered a presentation at a webinar presented by Business Valuation Resources on March 31, 2021. The title of Tim and Nate's presentation is "Evaluating and Applying Control Premiums."

Tim and Nate begin their presentation with an introduction to acquisition premiums and control premiums and discuss the differences between these two terms. They go on to explore empirical data sources for both acquisition premiums and control premiums. They summarize the issue of prerogatives of control. Tim and Nate compare equity-based premiums to invested capital premiums. Finally, they discuss the application of equity premiums and invested capital premiums in the valuation analysis.

Connor Thurman, a senior associate in our Portland office, and Robert Reilly, a managing director of our firm, authored an article that was published in the January 2021 issue of *Journal of Multistate Taxation and Incentives*. The title of Connor and Robert's article is "Benchmarks to Estimate the Property-Specific Risk Premium in Unit Principle Valuations."

This is the second part of the article "Property-Specific Risk Premiums and Unit Principle Valuations." Connor and Robert's article focuses primarily on market-derived, empirical data sources that an analyst may consider as a proxy in the quantitative estimate of a property-specific risk premium. The article also summarizes one procedure that affects both the qualitative and the quantitative assessment of the property-specific risk premium: the functional analysis of the taxpayer property considered in the unit principle valuation.

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Communiqué

In Print

Robert Reilly, firm managing director, had an article reprinted in the April 2021 issue of the *Journal of Taxation*. The article originally appeared in the January 2021 issue of *Practical Tax Strategies*, and the title of that article is "Due Diligence regarding Shareholder Agreements in S Corporation M&A Transactions."

Robert Reilly also had an article published in the online publication sponsored by the National Association of Certified Valuators and Analysts at www.quickreadbuzz.com on April 15, 2021. The title of that article was "Analyst Considerations in the Valuation of a Tax Loss Target Company Acquisition."

Robert Reilly also had an article published in the March/April 2021 issue of *Corporate Taxation*. The title of that article was "Functional Analysis as Part of a Valuation, Damages, or Transfer Price Analysis."

Robert Reilly also had an article published in the April 2021 issue of *Journal of Taxation*. The title of that article was "Due Diligence regarding Shareholder Agreements in S Corporation M&A Transactions."

Robert Reilly and Connor Thurman, Portland office senior associate, had an article published in the March/April 2021 issue of *Construction Accounting and Taxation*. The title of their article was "Empirical Benchmarks to Estimate the Company-Specific Risk Premium."

Robert Reilly and Connor Thurman also had an article published in the May 2021 issue of *The Practical Tax Lawyer*. The title of their article was "What Tax Lawyers Need to Know about the Measurement of Functional and Economic Obsolescence in the Industrial or Commercial Property Valuation (Part 2). Part 1 of that article appeared in the November 2020 issue of *The Practical Tax Lawyer*.

Robert Reilly and Nate Novak, Chicago office vice president, were the authors of a new Forensic & Valuation Services Practice Aid issued by the American Institute of Certified Published Accountants ("AICPA"). The topic of that AICPA Practice Aid is "Best Practices in Intangible Asset Valuation—Cost Approach Methods and Procedures." That Practice Aid was released in April 2021. That Practice Aid provides nonbinding but authoritative professional guidance to CPAs—and to all other valuation analysts—with regard to the valuation of intangible assets.

In Person

Tim Meinhart, firm managing director, and Nate Novak, Chicago office vice president, delivered a presentation at a Business Valuation Resources webinar on March 31, 2021. The title of their presentation was "Evaluating and Applying Control Premiums."

Curtis Kimball, Atlanta office managing director, will deliver a virtual presentation to the ALI CLE Estate Planning for the Family Business Owner seminar on November 2021. The topic of Curt's presentation will include an illustrative valuation case study.

Kyle Wishing, Atlanta office vice president, delivered a presentation at a webinar sponsored by Willamette Management Associates on May 14, 2021. The title of that presentation was "Introduction to ESOPs for Business Owners."

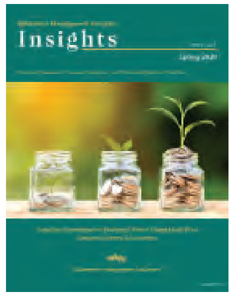
Robert Reilly will deliver a presentation at the 2021 Wichita State University annual property tax conference. The conference will be presented on July 27 and 28, 2021. This year, the conference will be presented virtually. The title of Robert's presentation is "Selecting Unit Principle Valuation Variables in a COVID-Affected Economic Environment." Robert will deliver this conference presentation on Tuesday, July 27, 2021.

Robert Reilly will deliver a presentation at the Texas CPA Society annual valuation and forensic services conference. This conference will be presented on July 29 and 30, 2021. This year, the conference will be presented virtually. The title of Robert's presentation is "Intangible Asset Valuations for Litigation Purposes or Fair Value Measurements." Robert will deliver this conference presentation on July 29, 2021.

Insights Thought Leadership Archives

❑ Spring Issue 2021

Thought Leadership in Fair Value Measurements



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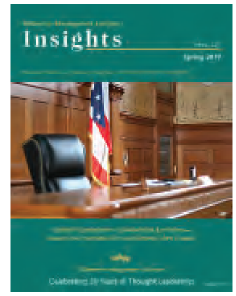

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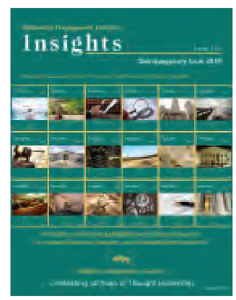

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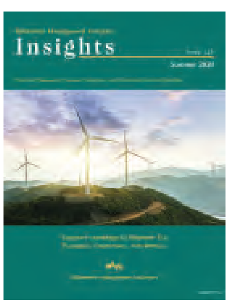

❑ Summer Issue 2020

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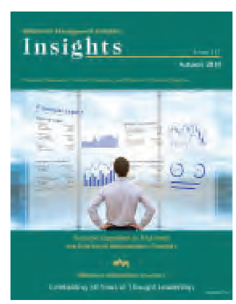
❑ Summer Issue 2019

Thought Leadership in Estate and Gift Tax Planning, Compliance, and Controversies



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