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UNDERSTANDING THE IMPLICATIONS OF *CECIL V. COMMISSIONER*

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In *Cecil v. Commissioner*, the U.S. Tax Court was faced with a dispute involving the valuation of a noncontrolling interest in a privately held S corporation. The valuation experts retained by the taxpayers and the Internal Revenue Service tax-affected the earnings of an S corporation and applied the S Corporation Economic Adjustment Multiple, even though both analyses had not been generally accepted by the Court. The ruling provides valuation analysts with guidance about valuing a noncontrolling interest in S corporation stock.

Introduction

On February 28, 2023, the U.S. Tax Court (the “Court”) released its long-awaited decision regarding *Cecil v. Commissioner*. William Cecil Sr. and Mary Cecil separately petitioned the Court to review a determination of a \$13,022,552 deficiency in their federal gift tax filings for 2010 by the Internal Revenue Service (“IRS”).¹

On November 18 and 19, 2010 (the “Valuation Dates”), Mr. Cecil transferred nonvoting Class B stock of the Biltmore Company (“TBC” or the “Company”) from his revocable trust to Mr. and Mrs. Cecil’s five grandchildren in two size blocks, one of 15.57 percent and one of 23.36 percent.² Meanwhile, Mrs. Cecil transferred voting Class A stock of TBC to Mr. and Mrs. Cecil’s two children (collectively, the “Subject Stock”).³

After the subsequent tax filing, the IRS contended that Mr. and Mrs. Cecil’s reported fair market values of the

transferred stock were too low. Conversely, Mr. and Mrs. Cecil argued at trial that (1) the reported values were too high and (2) they were owed a tax refund.⁴

The Court ultimately decided that Mr. and Mrs. Cecil’s valuation experts had provided the most appropriate fair market values for the Subject Stock. Further, because TBC is an S corporation, the Court’s decision in *Cecil* was a rare instance where the Court accepted tax-affecting the earnings of an S corporation and the use of the S Corporation Economic Adjustment Multiple (“SEAM”) to capture the tax benefit of S corporations. As a result, the Court’s decision in *Cecil* opens the door for valuation analysts to consider using both methods to value an S corporation under certain circumstances.

Case Background

TBC primarily operates in the travel and tourism or



historic hospitality industries.⁵ TBC is centered around the Biltmore House, a French Renaissance style chateau that is still the largest private home in the U.S.

George W. Vanderbilt constructed the Biltmore House between 1889 and 1895 in Asheville, North Carolina.⁶ Mr. Vanderbilt passed the Biltmore House and surrounding acreage (collectively, the “Biltmore Estate”) to his only child, Cornelia Cecil, upon his death in 1914.

THE COURT HAD TO DETERMINE WHETHER IT WAS APPROPRIATE TO TAX-AFFECT A PRIVATELY HELD S CORPORATION AND WHETHER IT WAS APPROPRIATE TO APPLY THE SEAM.

TBC was formed in 1932 as a Delaware corporation.⁷ That same year, the Biltmore Estate was contributed to TBC. In 1979, Mr. Cecil and his brother George, then the owners of TBC, had a falling out. The brothers divided TBC, with Mr. Cecil becoming the sole owner, while George Cecil walked away with the dairy operations of TBC. Three years later in 1982, TBC decided to be taxed as an S corporation.⁸

When TBC was formed, it offered tours of the Biltmore House. In 1995, TBC initiated a long-term plan to become a resort destination by expanding the Biltmore Estate to include hotels, restaurants, retail shops, and various outdoor activities.⁹

As of the Valuation Dates, TBC operated in 17 lines of business, had approximately 1,300 employees, and earned annual revenue of approximately \$70 million.¹⁰

Areas of Valuation Disputes

When Mr. and Mrs. Cecil filed their federal gift tax forms for 2010, they reported a value of \$3,308 per share of voting Class A TBC stock and \$2,236 per share of nonvoting Class B TBC stock, which totaled \$10,438,766 in taxable gifts.¹¹

However, the IRS believed that Mr. and Mrs. Cecil’s reported values were too low. In the notice of deficiency,

the IRS ignored the going-concern value of TBC, instead relying exclusively on the enterprise value of TBC based on the asset liquidation assumption.¹²

The Court had to determine whether it was appropriate to rely on an asset liquidation assumption when valuing the TBC stock. Although the valuation experts working for Mr. and Mrs. Cecil and the IRS disagreed on the use of the asset liquidation assumption, they agreed that it was appropriate to tax-affect the earnings of TBC and apply the SEAM. Consequently, the Court also had to determine (1) whether it was appropriate to tax-affect a privately held S corporation and (2) whether it was appropriate to apply the SEAM.

Expert Opinions

Three valuation experts were retained to value the Subject Stock. Two experts were retained by Mr. and Mrs. Cecil (respectively, the “first Cecil expert” and the “second Cecil expert”; collectively, the “Cecils’ experts”), and one valuation expert was retained by the IRS (the “IRS expert”).

The First Cecil Expert

In valuing the TBC stock, the first Cecil expert relied on the discounted cash flow (“DCF”) method, the guideline publicly traded company (“GPTC”) method, and the similar transaction method.¹³ The first Cecil expert did not rely on the asset-based approach because (1) a holder of the Subject Stock could not force a liquidation of TBC and (2) the management of TBC did not intend to liquidate the Company.¹⁴

In his DCF method, the first Cecil expert selected a 15 percent weighted average cost of capital to apply to the projected cash flow of TBC, applied a 30 percent discount for lack of marketability (“DLOM”), and concluded a value of \$9,030,059 for TBC.¹⁵

In his GPTC method, the first Cecil expert selected five companies as guideline companies: Peak Resorts, Inc.; Pairi Daiza SA; Premier Exhibitions, Inc.; Vail Resorts, Inc.; and Whistler Blackcomb Holdings, Inc.¹⁶ He then calculated valuation multiples based on the size, growth, and liquidity of TBC and the comparable companies. The first Cecil expert applied a 15 percent discount to his valuation multiples to account for the lack of diversification of TBC, applied a 30 percent DLOM, and concluded a value of \$10,540,694 for TBC.¹⁷



The Biltmore House in Asheville, North Carolina, is the foundation of the Biltmore Company. A valuation of the Biltmore Company led to a dispute that was settled in February 2023 in U.S. Tax Court.

In his similar transactions method, the first Cecil expert selected six acquisitions: USJ Co., Ltd.; Paramount Canada’s Wonderland Park; Festival Fun Parks, LLC; American Golf Corp.; Northern Racing, PLC; and Sydney Attractions Group, Pty Ltd.¹⁸ He then calculated purchase price multiples based on revenue; earnings before interest, taxes, depreciation, and amortization (“EBITDA”); and earnings before interest and taxes.¹⁹ To reach his indicated value of \$12,161,048, the first Cecil expert applied a 20 percent discount for lack of control (“DLOC”) and a 30 percent DLOM.²⁰

In reaching his final concluded value for the Subject Stock, the first Cecil expert applied a 50 percent weighting to the DCF method and a 25 percent weighting each to the GPTC method and the similar transactions method.²¹ Because the Company was taxed as an S corporation, the first Cecil expert agreed that tax-affecting would be appropriate to ascertain the fair market value of TBC; however, he did not apply the SEAM. He determined that the Subject Shares had a fair market value of \$1,019.00 per share with tax-affecting and \$1,614.71 per share without tax-affecting.²²

The Second Cecil Expert

The second Cecil expert relied on the capitalization of net cash flow (“NCF”) and GPTC methods to value the Subject Stock.²³ Similar to the first Cecil expert, the second Cecil expert did not rely on the asset-based approach because the Subject Stock could not force a liquidation of the Company.²⁴

In his capitalization of NCF method, the second Cecil expert estimated that the Company had NCF of \$1,162,600 and a capitalization rate of 10.7 percent. To reach his equity value of \$10,865,400, the second Cecil expert divided the TBC NCF by the capitalization rate.²⁵ To conclude the fair market value of TBC as an S corporation, the second Cecil expert tax-affected TBC and applied the SEAM. Based on the second Cecil expert’s analyses, he concluded a 24.6 percent tax benefit associated with TBC being an S corporation and reached a fair market value of \$1,353.83 per share for the Subject Stock.²⁶

In his GPTC method, the second Cecil expert selected Cedar Fair, L.P. as his sole comparable company.²⁷ He



selected valuation multiples based on the market value of invested capital to EBITDA after analyzing the size, profitability, return on equity, growth, financial strength, and distributions of the two companies.²⁸ He applied these multiples to the TBC latest 12-month (“LTM”) EBITDA as of the Valuation Dates and the median EBITDA from 2006 to the LTM. The second Cecil expert then applied a 25 percent DLOM and a 2 percent discount for lack of voting rights (“DLOV”), which resulted in a fair market value of \$1,131 per share for the voting Class A stock and \$1,108 per share for the nonvoting Class B stock.²⁹

The IRS Expert

Contrary to the other experts, the IRS expert relied on the asset-based approach, specifically, the net asset value (“NAV”) method, as well as the discounted future benefits (“DFB”) method.³⁰

THE COURT’S OPINION REGARDING TAX-AFFECTING IS SIGNIFICANT BECAUSE IT WAS ONE OF THE FEW INSTANCES WHERE THE COURT ACCEPTED TAX-AFFECTING THE EARNINGS OF AN S CORPORATION AND THE APPLICATION OF THE SEAM.

As of November 30, 2010, TBC had reported assets of \$53,580,000 and liabilities of \$33,349,000, which resulted in a net book value of \$20,231,000.³¹ In his NAV method, the IRS expert applied valuation adjustments to the net book value of TBC to account for the Company’s real estate, art portfolio, installment note receivable, trademarks and trade names, and the workforce in place.³² As a result, the IRS expert concluded a NAV of \$146,587,000 for the Company on a controlling, marketable basis.³³ In order to conclude a NAV for TBC on a noncontrolling, marketable basis, the IRS expert analyzed sales of real estate limited partnerships and closed-end funds, which resulted in an adjusted NAV of \$92,000,000 for the Company.³⁴

In his DFB method, the IRS expert selected an after-tax NCF of \$1,773,000 and a discount rate of 16 percent.³⁵ Based on these variables, the future benefit stream of the Company had a present value of \$12,931,000.³⁶ Because TBC is an S corporation, the IRS expert believed it was appropriate to tax-affect the future earnings and apply the SEAM, which resulted in a 17.6 percent valuation premium for the Company.³⁷ After applying the premium to the present value of the future benefit stream of TBC and adding the nonoperating assets, the IRS expert arrived at a value of \$36,000,000 using the DFB method.³⁸

In reaching his concluded value for the Subject Stock, the IRS expert applied a 90 percent weighting to the DFB method and a 10 percent weighting to the NAV method.³⁹ The IRS expert selected DLOMs of 19 percent for the voting Class A stock, 22 percent for the smaller block of nonvoting Class B stock, and 27 percent for the larger block of nonvoting Class B stock, which resulted in fair market values of \$4,000 per share, \$3,276 per share, and \$3,066 per share, respectively.⁴⁰

The Court’s Opinion

After reviewing the experts’ analyses, the Court’s opinion focused on three key valuation issues. These issues included (1) the tax-affecting of the S corporation earnings and the use of the SEAM, (2) the appropriate application of the asset liquidation assumption when valuing a noncontrolling interest in a company, and (3) the selection of comparable companies and similar transactions.

Tax-Affecting the Earnings of an S Corporation and Applying the SEAM

The Court’s opinion regarding tax-affecting is significant because it was one of the few instances where the Court accepted tax-affecting the earnings of an S corporation and the application of the SEAM.

Cecil was not the first time that the Court had evaluated such analyses. In *Gross v. Commissioner* and *Wall v. Commissioner*, the Court completely disallowed the use of tax-affecting.⁴¹ That precedent shifted in *Estate of Jones v. Commissioner*, when the Court stated, “we do not hold that tax affecting is never called for. But our cases show how difficult a factual issue it is to demonstrate even a reasonable approximation of what that effect would be.”⁴² With that statement, the Court accepted the



tax-affecting of an S corporation but, at the same time, established a high standard that valuation experts would have to meet for their opinions to be accepted.

THE DISPUTE BETWEEN THE CECILS AND THE IRS ORIGINATED, IN PART, BECAUSE THE IRS VALUED TBC UNDER THE ASSET LIQUIDATION ASSUMPTION.

In *Cecil*, however, the Court accepted the tax-affecting of an S corporation's earnings and the application of the SEAM because valuation experts retained by both sides agreed that the two analyses were necessary.⁴³ Yet the Court was careful to note "that while we are applying tax affecting here, given the unique setting at hand, we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation."⁴⁴

With the precedent established in *Cecil*, valuation experts are free to consider tax-affecting the earnings of an S corporation and applying the SEAM, but they should first determine that the circumstances surrounding the subject company support the use of both.

Appropriate Application of the Asset Liquidation Assumption

Another takeaway from *Cecil* is that valuation experts should consider the possibility of liquidation when applying an asset-based approach to value a noncontrolling interest. The dispute between the Cecils and the IRS originated, in part, because the IRS valued TBC under the asset liquidation assumption.

The Court decided that the liquidation of TBC was unlikely. According to the Court, for the owner of the Subject Stock to liquidate the Company, the owner would "need to (1) acquire additional shares in order to cause TBC's liquidation; (2) convince other shareholders to vote for a liquidation; or (3) wait until the shareholders or their heirs decide to liquidate, and we consider each of these three events unlikely to occur."⁴⁵ In addition, TBC had remained within the family since 1932, and several

current stockholders testified that they were unwilling to sell their stock or liquidate the Company. Therefore, the Court decided that the asset liquidation assumption was not appropriate when valuing the Subject Stock, and the Court assigned zero weight to the IRS expert's opinion on the fair market value of the Subject Stock. When valuing a noncontrolling interest, valuation experts would be wise to consider the guidance provided by the Court in *Cecil* regarding the asset liquidation assumption.

Examining the Selection of Comparable Companies and Similar Transactions

Finally, the opinion rendered in *Cecil* serves as a stark reminder to valuation experts of the importance of selecting quality comparable companies or similar transactions when relying on a market-based approach. As the Court discussed, the Cecils' experts did not sufficiently identify comparable companies or similar transactions when valuing TBC.

The Court's main fault with the second Cecil expert's GPTC method was the use of a single company to calculate valuation multiples. In *Estate of Hall v. Commissioner*, the Court declared "that it is inconceivable that a hypothetical buyer would consider only a single alternative comparable."⁴⁶ By ignoring the Court's guidance in *Estate of Hall*, the second Cecil expert should not have been surprised to hear that his GPTC method was viewed as suspect.

The first Cecil expert used more than one company and transaction in his GPTC and similar transactions methods, but the Court still faulted his methodology. First, the Court believed that Pairi Daiza SA and Premier Exhibitions, Inc. were not comparable to TBC. Specifically, Pairi Daiza SA "operates a park which houses thousands of animals, and it does so at a location (in Belgium) that is vastly different from western North Carolina."⁴⁷ In addition, Premier Exhibitions, Inc. "presents museum exhibitions outside the hospitality industry and does that worldwide while TBC's operation is limited to a single city, Asheville, and the surrounding area."⁴⁸ Second, the Court noted the first Cecil expert included two transactions that occurred during the Great Recession and included companies that were not in the hospitality industry.

The Court's opinion regarding the Cecils' experts' market-based approaches provides guidance to valuation experts on the degree of scrutiny they should apply



when determining whether a company is comparable to the subject company.

The Court’s Decision

The Court had to determine which valuation expert properly accounted for (1) the tax-affecting of the S corporation earnings and the use of the SEAM, (2) the appropriate application of the asset liquidation assumption when valuing a noncontrolling interest in a company, and (3) the selection of comparable companies and similar transactions.

Table 1, right, presents the concluded fair market values of the three experts. The Court ultimately accepted the valuation concluded by the first Cecil expert before tax-affecting and the application of any discounts. For the DLOC, the Court accepted the first Cecil expert’s 20 percent discount. For the DLOM, the Court accepted the IRS expert’s discounts of 19 percent for the voting Class A stock, 22 percent for the smaller block of the nonvoting Class B stock, and 27 percent for the larger block of nonvoting Class B stock. Additionally, the Court determined that a DLOV was not applicable to the nonvoting Class B stock.

Conclusion

Valuation experts eagerly awaited the Court’s decision

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<u>Class of Stock</u>	<u>First Cecil Expert</u>	<u>Second Cecil Expert</u>	<u>IRS Expert</u>
Class A Common	\$1,019.00	\$1,131	\$4,000
Class B Common (15.57% Block)	\$1,019.00 \$1,614.71 (non-tax-affected)	\$1,108	\$3,276
Class B Common (23.36% Block)	\$1,019.00 \$1,614.71 (non-tax-affected)	\$1,108	\$3,066

in *Cecil*. The significance of the Court’s decision stems from the fact that it was one of the few instances where the Court accepted tax-affecting an S corporation’s earnings and the application of the SEAM. As a result, valuation experts finally have guidance for valuing a noncontrolling interest in S corporation stock. In addition, *Cecil* provides further insight on the appropriate application of the asset liquidation assumption when dealing with noncontrolling interests and the selection of comparable companies or transactions when using a market-based approach.

Due to the precedents established in the case, *Cecil* is one of the most consequential Court decisions regarding S corporations in recent memory.



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