

# TAX UPDATE

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North, to Alaska—Thompson, Valuation and Reasonable Cause  
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## Valuation Snag

The Second Circuit Court of Appeals took a look at two significant and one minor issue when it reviewed the Tax Court's opinion in the case of *Estate of Thompson* (TC Memorandum 2004-174). The Tax Court's decision on the proper valuation for the estate was generally accepted by the Court of Appeals, though all parties agreed there was a mechanical error in how the Tax Court had computed the valuation. The Court of Appeals also agreed that merely because the Tax Court rejected the IRS's valuation that it was bound to accept the taxpayer's valuation due to the burden of proof shift provisions of §7491.

However, the Second Circuit disagreed with the Tax Court's finding that there existed reasonable cause for the estate's undervaluation of the interest in question, based upon which the Tax Court had removed the penalty under §6662.

## **Background Facts**

The key asset in question in this case is the value of a 20% interest in a closely held company, Thomas Publishing, Inc., on May 2, 1998, the date of death of Josephine Thompson. The company published business to business manufacturing and industrial directories and publications. In the 1990s, the Company converted from being a paper based publisher of information to an electronic publisher, going to CD publication in 1993 and putting its directories on the Internet in 1995. By 1998, the date of Josephine's death, the company's website was, per the court, recognized as the sixth ranked business-to-business website in the United States. The company's revenues continued to increase in the years just prior to Josephine's death, though expenses grew at about the same rate—but the entity was consistently profitable. As well, revenues from paper products dropped during that period, but it more than made up for by online revenues.

However, following Josephine's death the fortunes of the company changed. As you may recall, initially there was a rush to create the "perfect portal" for vertical markets, on the theory that this was how people would access the internet. Those who are members of the AICPA likely remember that during this period the AICPA was touting their new "super portal" they were designing, CPA2Biz.

However, in September of 1998 Larry Page and Sergei Brin incorporated a new company that would change things rather dramatically—that company being Google. Google impacted the "perfect portal" theory (where a site would give a directory to a specialize area), replacing it with a more generic search engine based on a comprehensive index of information on the Internet hooked to a powerful search engine.

In the years following Josephine's death, revenues began to decline and expenses didn't drop at the same rate. In fact, by 2001 the company had gone from net income of over \$18 million to a net loss of nearly \$14 million, followed by a barely break even year in 2002. The consistent money machine that had been Thomas Publishing was no longer operating as smoothly.

## **Valuation and the Advisers**

At Josephine's death, the estate hired advisers to handle the valuation that were not at all geographically close—they hired an attorney and accountant from Alaska to value the enterprise. In its opinion, the Tax Court described both how the estate found Mr. Goerig (the Alaska attorney) and why they hired him:

The acknowledged reason the estate hired Goerig (to value the TPC stock owned by decedent and to represent the estate as administrator) was to have respondent's audit of decedent's Federal estate tax return conducted not by respondent's New York City office but by respondent's Alaska office, where Goerig believed and apparently represented to the estate's representative that he would be able to obtain for the estate a more favorable valuation of the estate's TPC stock.

Executors for the estate had learned about Goerig from an attorney for decedent's family who had met Goerig on a fishing trip.

Mr. Goerig retained the services of Paul M. Wichorek, an Alaska accountant, to assist him in valuing the interest in the entity. Both Mr. Goerig and Mr. Wichorek prepared the valuation report that was submitted with the estate tax return. When they had finished, they determined the value of Josephine's interest in Thomas Publishing was \$1,750,000. A key factor in their valuation was use of a capitalization rate of over 30% that included a 12% addition to the discount rate for "risks to TPC relating to the Internet and to technology and to the loss of advertising revenue that might be related thereto, including perceived risks in TPC's management structure."

The Tax Court had a number of problems with this valuation, beginning with the advisers themselves and their qualifications. The Tax Court noted:

Goerig is a lawyer with an audit and tax dispute resolution practice, and a tax return preparer, and he undertakes occasional valuations for small businesses and private individuals. From his resume, he appears to have attended limited appraisal courses, other than a few courses while working for respondent many years ago. Goerig also was appointed to act as administrator for the estate to handle the anticipated audit by respondent of the estate's Federal estate tax return, a role which we regard as somewhat in tension with his role as a purported independent valuation expert for the estate.

Wichorek provides accounting and tax preparation services, does business consulting, and undertakes occasional valuations for small businesses, generally in the context of divorce and property settlement disputes. He belongs to no professional organizations or associations relating to his appraisal or valuation work.

Although we admitted into evidence the estate's valuation reports and treated them as credible, we regard those reports and the testimony of the estate's experts to be only marginally credible. Goerig and Wichorek were barely qualified to value a highly successful and well-established New York City-based company with annual income in the millions of dollars.

The Court had a major problem with the technology risk discount, indicating that in 1998 it did not appear that anyone seemed to believe there was such a risk. While hindsight is 20/20, the valuation would need to be based in a willing buyer/willing seller analysis as of the date of Josephine's death. At that point, it seemed that, if anything, technology was primarily an income generator. The Tax Court noted:

The use by the estate's experts of a 12-percent technology-related risk factor, particularly in light of their failure to project any additional income to be produced from technology-related expenditures, seems to us inappropriate and unjustified.

Supporting our conclusion that TPC's risks relating to the Internet and technology do not support a 12-percent risk factor, we note that, during its 1998 fiscal year, TPC paid out cash dividends to its stockholders in excess of \$7 million, a significant increase over total cash dividends paid out to stockholders in prior years and inconsistent with any management perception that, as of May of 1998, or in the near future, TPC faced extraordinarily risky additional Internet- and technology-related expenditures.

TPC's 1998 cash dividends, particularly in light of the lower level of stockholder dividends that had been paid in prior years, are indicative of an optimistic management outlook for TPC as of May of 1998.

The IRS's experts determined a value for Josephine's interest of \$32 million—but the Tax Court wasn't terribly pleased with this valuation either. The Court tersely noted:

Turning to respondent's expert's valuation, respondent's expert appeared to be concerned with numbers only and did not appear to make an effort to base his valuation of TPC on a real company. His sterile approach is reflected both in his comparable public company analysis and in his discounted cashflow analysis.

The Tax Court found that the 11 “comparable” companies used by the IRS's expert “only in a broad sense, relate to TPC.” As well, the Court complained of significant errors in the cash flow analysis performed by the IRS expert, and the expert's claim that no minority discount was appropriate.

At the end of the day, the Tax Court made its own finding of the value of the interest, finding that the proper value was \$13,525,240. However, there was a mechanical error made in the Tax Court's own valuation, a mistake both litigants agreed existed in the valuation mechanics of the Tax Court, as noted by the Court of Appeals:

As set out in the prior paragraph, the Court treated \$68 million in short-term investments as non-operating assets, and therefore added \$68 million to the Company's capitalized income. But when the Court calculated the Company's projected income, it included the income produced by the \$68 million in its projection, thus factoring in the \$68 million twice. The Commissioner estimates that this error resulted in a \$1.2 million overstatement in the value of the Estate's shares; the Estate (which agrees that the error was made) does not attempt to quantify its effect.

The Second Circuit does note that the Tax Court will need to recompute the proper value when it again looks at this case—but it's coming back for another, more significant issue as well. And, unfortunately for the estate, the Second Circuit did not agree with their primary issue on appeal that would have rendered the whole “improper calculation” matter moot.

## Burden of Proof

The estate attempted to argue that §7491 required in this case that Tax Court adopt the estate's valuation once it rejected the IRS expert's valuation. Section 7491 provides:

### **Sec. 7491 Burden of proof**

(a) Burden shifts where taxpayer produces credible evidence

(1) General rule

If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.

(2) Limitations

Paragraph (1) shall apply with respect to an issue only if--

(A) the taxpayer has complied with the requirements under this title to substantiate any item;

(B) the taxpayer has maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews; and

(C) in the case of a partnership, corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii).

Subparagraph (C) shall not apply to any qualified revocable trust (as defined in section 645(b)(1)) with respect to liability for tax for any taxable year ending after the date of the decedent's death and before the applicable date (as defined in section 645(b)(2)).

(3) Coordination

Paragraph (1) shall not apply to any issue if any other provision of this title provides for a specific burden of proof with respect to such issue.

The question of valuation is a factual issue, and it appears the IRS did not dispute that the taxpayers had submitted credible evidence of value (even if the Tax Court appeared to grant that fact a bit grudgingly) and had otherwise met the requirements to shift the burden. The Second Circuit notes:

The Estate argues that the Commissioner necessarily failed to satisfy his burden. It contends that, under § 7491, the Tax Court's rejection of the valuation proffered by the Commissioner required the Court to adopt the Estate's competing valuation.

Unfortunately for the estate, the Second Circuit didn't agree with that view of the matter.

The Court noted:

Before the enactment of § 7491, "a deficiency determined by the Commissioner [was] presumptively correct and the taxpayer [bore] the burden of disproving it." Silverman, 538 F.2d at 930. Section 7491 reallocated the burden. However, this reallocation does not require the Tax Court to adopt the taxpayer's valuation, however erroneous, whenever the Court rejects the Commissioner's proposed value; the burden of disproving the taxpayer's valuation can be satisfied by evidence in the record that impeaches, undermines, or indicates error in the taxpayer's valuation.

The Court noted that such information did exist in the record that brought the taxpayer's valuation into question:

Here, the Commissioner not only presented evidence in support of his own valuation; he also cited record evidence to rebut the Estate's valuation, arguing that the Estate's profit projections were overly pessimistic, that it failed to properly account for non-operating assets, and that its assumptions about the Internet were inconsistent with the Company's investments in Internet-related projects. Notwithstanding the enactment of § 7491, it remains the case that (as we said in 1976) the "Tax Court is not bound by the formulas or opinions proffered by expert witnesses. It may reach a determination of value based upon its own analysis of all the evidence in the record."

There is an interesting notation in the footnote attached to this paragraph that notes the Second Circuit is not considering what would happen if the Tax Court had rejected the entire IRS position:

Because the Tax Court adopted some of the Commissioner's arguments in opposition to the Estate's valuation, we have no occasion to decide whether § 7491 would require a court to adopt a taxpayer's valuation if the court rejected all arguments advanced by the Commissioner in opposition to that valuation, or if the Commissioner made no such arguments.

That question is left open to be decided another day.

## Valuation Penalty

Now the question arises about the penalty under §6662 for a substantial valuation understatement on the estate tax return. As the Second Circuit notes:

The Tax Court determined that the Estate's share of the Company was worth \$13.5 million; the Estate valued its share at \$1.75 million -- less than 15% of the value determined as correct by the Court.<sup>3</sup> Under the version of IRC § 6662 then in effect, if the claimed value of the Estate is not more than 25% of the amount determined to be correct, the taxpayer must pay an accuracy-related penalty equal

to 40% of its underpayment. See 26 U.S.C. § 6662(a), g(1), (h)(1), (h)(2)(C) (2006), amended by Pension Protection Act of 2006 § 1219, Pub. L. No. 109-280, 120 Stat. 780, 1083 (2006). With one exception, this penalty is mandatory. See *id.* § 6662(a) ("there shall be added to the tax an amount equal to [40] percent of the . . . underpayment" (emphasis added)). An exception is allowed if "it is shown that there was a reasonable cause for such [underpayment] and that the taxpayer acted in good faith with respect to such [underpayment]." *Id.* § 6664(c)(1).

The Tax Court had reasoned that the reasonable cause exception to the penalty applied in this case. The Tax Court decided this was a particularly difficult appraisal and noted:

The valuation herein of the estate's 20-percent stock interest in TPC was particularly difficult and unique. Companies comparable to TPC were not found. Valuation of the estate's 20-percent TPC stock interest under the capitalization of income and under the discounted cashflow methods involved a number of difficult judgment calls. We believe it noteworthy and relevant to the appropriateness of the section 6662 penalty that even respondent's expert made significant errors in his various calculations.

The Tax Court continued on with the following:

Certainly, the experts for the estate were aggressive in their relatively low valuation of TPC. Respondent's expert was aggressive in his relatively high valuation of TPC. We note that our valuation of TPC and of the estate's 20-percent interest in TPC is closer to the estate's valuation than to respondent's valuation.

On the record before us, we believe it inappropriate to impose the accuracy-related penalty. The estate is not liable for the accuracy-related penalty.

The Tax Court appears to have penalized the IRS, looking at this "battle of the experts" as ending up with two appraisals that were wildly different from what was finally decided upon.

The Second Circuit did not accept that the Tax Court had done enough to determine that no penalty was appropriate. The Second Circuit instead instructs the Tax Court to look at the *taxpayer's* actions. The appeals court first notes:

Under agency regulations, the existence of reasonable cause is determined "on a case-by-case basis, taking into account all pertinent facts and circumstances. . . . Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." 26 C.F.R. § 1.6664-4(b)(1). "Reliance on . . . an appraiser does not necessarily demonstrate reasonable cause and good faith," but such reliance does satisfy the reasonable cause exception if, "under all the circumstances, such reliance was reasonable and the taxpayer acted in good

faith." *Id.* Thus reliance on an expert's opinion "may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law." *Id.* § 1.6664-4(c)(1).

I would suspect the Second Circuit panel was especially concerned about the advisers the taxpayers had retained and the Tax Court's concern about their qualifications. The panel's opinion notes:

The (Tax) Court found that these experts "demonstrated no experience with . . . Internet- and technology-related companies," *id.* at \*11, and were "too inexperienced, accommodating, and biased in favor of the estate," *id.*

The Second Circuit did not find that the reasons the Tax Court gave were sufficient or, apparently, even relevant to the matter at hand.

The Tax Court's findings are insufficient to support a determination of reasonable cause under § 6664. The factors set out in the regulations search the good faith of the taxpayer -- either in assessing its own liability or in relying on an expert to do so. But the Tax Court made no finding as to whether the Estate's reliance on its experts was reasonable and in good faith, or whether the Estate knew or should have known that they lacked the expertise necessary to value the Company.

The Second Circuit instructs the Tax Court to specifically determine if the reliance on the Alaska attorney and accountant to provide this valuation was reasonable and in good faith.

## Consequences

The case outlines a couple of important points. First, it's important not to overestimate the usefulness of the burden shift under §7491. While we would prefer to have the shift take place, it doesn't put the IRS into an "all or nothing" situation with their position, just as when the burden doesn't shift the taxpayer isn't put into a similar position of being required to carry all points or lose in the entirety. The Second Circuit makes clear that the Tax Court continues to have the authority to make its own finding of fact on matters like this, rather than having to choose one or the other expert's final position.

Second, the case also emphasizes the importance of having qualified appraisers for the client. In this case, it appears the client selected the appraisers primarily based on (remote) geographic location—and then stopped all consideration of their qualifications. Even if we were to agree that it was important to have the matter considered by an office other than that of the IRS in New York (which I'll discuss next), it seems unlikely that the advisers had to have this limited a set of credentials—there are advisers with strong credentials outside of New York, and it seems likely that there are a number of such individuals in the far north of Alaska.