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VALUATION ISSUES™

Klaris, Thomson & Schroeder, Inc. **2001-2**

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Estate of Albert Strangi v. Commissioner of Internal Revenue

by John A. Thomson ASA, MAI

The Strangi case is an interesting case involving family limited partnerships. We (Klaris, Thomson & Schroeder, Inc.) were the valuation experts for the IRS.

The case involved a Family Limited Partnership. The decedent, Mr. Albert Strangi, died October 14, 1994 and as of the date of death he owned a 99 percent limited partnership interest in the Strangi Family Limited Partnership (SFLP) and a 47.0 percent interest in the common stock of the corporation known as Stranco, Inc. Stranco, Inc. was the managing general partner of SFLP with a 1% general partnership interest. The partnership was formed on August 12, 1994. As of the date of formation, the Net Asset Value (NAV) of the partnership's assets was $9,933,262. The assets consisted of marketable securities, commercial and residential real property, general and limited partnership interests, promissory notes, life insurance, annuities and cash. Marketable securities represented approximately 72 percent of the NAV on the date of formation and 75 percent on the date of death. The NAV as of the decedent's death (sixty-three days after formation), October 14, 1994 had risen to $11,057,922.

> **"Apparently the IRS and the tax court looked at the partnership restriction for the 2703 issue."**

The 99.0 percent limited partnership interest held by the decedent was larger than the limited partnership interest percentage required to vote (required vote) on certain major events. Therefore, although still a minority interest (albeit large), the size of the interest was a factor. The decedent also owned a 47.0 percent shareholder interest in the managing general partner (Stranco, Inc.). The managing general partner only owned 1 percent of the partnership, but was in control, by agreement of the Partnership. There were only 4 other shareholders of Stranco, Inc. as of the date of formation, each holding 13.25 percent. As of the date of death, there were 5 shareholders in addition to Mr. Strangi the decedent (four holding 13.0 percent and one with 1.0 percent). Therefore, Mr. Strangi's (the decedent) block of stock, was by far the largest block of stock of the managing general partner. However, he did not have actual control, which in this case, subject to all the corporate and partnership restrictions, would have required 100 percent ownership of the corporate managing partner.[1] We believed the two decedent's interests should have been considered together as they are functionally related. A willing seller would want to sell both interests together to maximize his economic benefit, and a willing buyer would want to buy both interests to maximize his influence on the partnership. This was a factor we considered.

In determining our overall discount ,we looked both at the degree of the lack of control (minority discount) and the degree of illiquidity (lack of marketability) of both interests.

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[1]This is more restrictive than state corporate law. We believed that the 2703 issue (from a valuation perspective) was with the managing general partner, a corporation. Apparently, the IRS and the tax court looked at the partnership restrictions for the 2703 issue. Here, the partnership restrictions were not more restrictive than the state revised partnership act, and this is why 2703 was held not to apply to the partnership agreement.

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In determining our minority discount or discount for lack of control (degree of control), we used as our basic data, closed-end equity funds. In determining our marketability discount component of our overall discount, we looked both at certain restricted stock studies and certain initial public offerings (IPO studies).

Our overall discount for the partnership as of August 14, 1994 was 29.0 percent and as of October 14, 1994, the date of death, our overall discount was 31.0 percent. The difference was caused by a change in the underlying minority discount data (closed-end funds). In other words, a change in the market data from August 12 to October 14.

The August 12, 1994 date became irrelevant when the court ruled there was no gift on formation. The court made this ruling based on their belief that the decedent had effective control of the partnership and therefore, didn't give up anything of value at formation. We said the decedent had effective control in our separate 2703 report when the excessive corporate restrictions were disregarded. In that report, our discount on the two interests were 19.0 percent (for the 99 percent limited partnership interest) and 0 percent or no discount for the 47.0 percent corporate general partner interest.

We did state that under the market value standard, subject to all the restrictions, that the decedent still had significant influence over the partnership, and we considered this in our 31.0 percent overall discount. This was our discount for the 99 percent limited partner interest which the court referred to in their decision. Our discount for the decedent's 47.0 percent corporate general partner interest was 19.0 percent (which was not mentioned in the court decision because the interest was relatively small).

"Here is a good example where the courts do not always split the difference between the valuation experts."

We were pleased the court accepted our fair market value report in its entirety, saying, we were well documented and persuasive. We finally point out that the taxpayer's report was disregarded for not being well documented nor persuasive. Here is a good example where the courts do not always split the difference between the valuation experts.

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Substantial Voting Control Premium Reversed by the Ninth Circuit Court of Appeals

Estate of Simplot v. Commissioner (9th Circuit, May 14, 2001)

by Raynor J. Klaris, ASA

In our newsletter, *Valuation Issues*, 1999-1, KTS reviewed the stunning Tax Court ruling (Estate of Simplot v. Commissioner, 112 T.C. No. 13, 1999) where the tax court ruled in favor of the IRS. The major issue in the tax case was the fair market value of 18 class A voting shares (23.55 percent of the total of 76.445 class A voting shares) of the J.R. Simplot Co. held in the Estate of Richard R. Simplot.

The tax court affirmed a value of $215,539 per class A voting share and $3,586 per share for the class B non-voting shares. As we related in our prior newsletter, the voting control premium was huge relative to the number of voting shares. This appeared to us to be a preposterous premium for only a voting right, particularly since both the class A and class B common shares had all the same rights of economic benefits such as asset values, earnings, pro-rata buyout value in a sale or merger,etc. Neither shares had received any dividends. KTS has performed numerous empirical studies of the differential values of voting versus non-voting common shares in the public markets and has found the differential on average to be none, or marginal (3 to 5 percent).

On May 14, 2001, the Ninth Circuit Court of Appeals reversed the Tax Court's original decision and found in favor of the Estate on remand. The Ninth Circuit stated "the Tax Court erroneously attributed a premium to minority voting stock in the J.R. Simplot Co." KTS agrees with this appeal decision based on our research of public share trading data, and investor's investment decisions in valuing voting versus non-voting shares.

Essential facts

The basic background facts are that the J.R. Simplot Co. is one of the largest potato processing companies in the world, and is a private family-owned corporation. This is the Company that supplied shoestring potatoes to our beloved "McDonalds". The decedent, Richard R. Simplot, owned 18 shares (23.55 percent) of the outstanding 76.445 shares of the Class A voting stock and 3,942.048 shares (2.79

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Control Premium Reversed
(Cont.)

percent) of the outstanding 141,288.584 shares of Class B non-voting stock of the J.R. Simplot, Co. The ratio of voting to non-voting shares was 1/1,848, an unusually skewed ratio.

The remaining shares of the outstanding voting stock were owned by the decedent's three children. The voting stock was subject to a 360-day restriction on transferability or hypothecation. Both classes of stock were entitled to the same dividends (without preference) on a per share basis, if and when dividends were declared. The holders of the non-voting stock were entitled to a liquidating preference. The key issue in the original tax court case was the fair market value of the Class A voting stock held in the Estate.

> **"The original substantial premium by the tax court was reversed by the Ninth Circuit Court of Appeals."**

Tax Court Case

After correcting a major error by its appraiser, the petitioner said the fair market value of each share of Class A voting stock was $3,025. The same as the Class B non-voting stock per share. The IRS argued the voting shares had a fair market value of $801,994.83 per share and the non-voting stock was $3,585.50 per share. The Tax Court held the voting stock, after a 35 percent marketability discount, was $215,539.01 per share and the non-voting stock, after a 40 percent marketability discount, was $3,417.05 per share.

The unusual facts of the tax court case were: (l) there was a significant disparity in the number of voting versus non-voting shares; (2) there were only four shareholders of the Class A voting shares with no owner having control, with the largest block being 29.36 percent and the remaining three blocks having 23.55 percent each; and (3) the appraisers on both sides were criticized by the judge, but the appraiser for the petitioner apparently made two major errors which did not have the judge thinking very kindly of his opinions. The disparity of the percentage ownership of the voting shares was an important fact in this case. The Tax Court allowed a substantial premium for what was essentially a minority voting share ownership.

The huge premium by the Tax Court needs to be put in perspective: (l) it is only three percent when applied to the aggregate minority equity of the entire Company at $830 million, or $24.9 million; (2) however, this innocuous premium at the total equity level, when applied to such an unusually low number of voting shares, skews the voting share indicated value upward in a dramatic stratospheric spike.

We note that the one area of unanimity was that the appraisers and the Tax Court all concluded at a 35 percent marketability discount for the subject block of voting shares and a 40 percent marketability discount for the subject block of non-voting shares.

In our original review of this Tax Court case, we conjectured on whether this was a good decision. Our rhetorical question was: "Would a willing and prudent buyer pay a $5.86 million premium for a 23.55 percent voting interest worth $105,684 on a pro rata basis, when he clearly owns a minority interest in a company that had never paid dividends." **The Ninth Circuit** has answered our rhetorical question!

Ninth Circuit Summary

The Ninth Circuit concluded that the Tax Court erred in the following areas: (l) the Tax Court departed from the willing buyer/willing seller fair market value standard; and (2) erred in the calculation and treatment of the premium when it applied the premium to all of the voting shares when only a portion of the voting shares were at issue.

The Ninth Circuit in its finality noted " In Richard Simplot's hands at the time of transfer his stock was worth what a willing buyer would have paid for the economic benefits presently attached to the stock. By this standard, a minority holding Class A share was worth no more than a Class B share."

Family Limited Partnerships- Remain Effective for Estate Planning

by Raynor J. Klaris, ASA

As noted in the July 6, 2001 issue of *The Kiplinger Tax Letter*, "Continue using family limited partnerships. Donors can leverage the $1-million exemption...can effectively give away more than $1 million because they can use minority interest discounts for gifts of small shares in these entities. Another hedge against a reversal of estate tax repeal."

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KTS CALENDAR

RECENT AND UPCOMING SEMINARS AND SPEAKING ENGAGEMENTS

5/24/01	Presentation—St. Louis Area CPA's, CPE Session—"Business Valuation"
6/26/01	Presentation—Montgomery County Bar Association—"Valuation Terms and Concepts Including an Overview of the Davis and Strangi Case"
8/8/01	Presentation—IRS - LMSB Engineering CPE Session, St. Louis, MO.—"Common Errors, Misconceptions, and Fallacies of Business Valuation"
9/24/01	Presentation—Pinellas County Estate Planning Council—"Overview of Strangi and Knight Cases"
10/26/01	Presentation—20th Annual Advanced Business Valuation Conference, Seattle, Washington
11/01/01	Presentation—Manatee County Estate Planning Council—"Valuation Concepts From the Davis Case"

KTS RECENT ENGAGEMENTS

* Valuation of a large industrial property in Mexico City for a multi-national firm for financial accounting.
* Valuation of an international garden products company for financing.
* Valuation of a grape root stock supplier to the vineyard/wine industry for financing.
* Valuation of a stevedore company in Alaska for estate tax.
* ESOP valuation for a machinery equipment distributor for bankruptcy court.
* Valuation of trucking company for possible sale.
* Valuation of an asphalt paving company for estate tax purposes.

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is a full service valuation and consulting company specializing in business valuations, financial consulting, expert testimony and litigation support. In addition, we also perform real estate valuations, machinery and equipment valuations, and international transfer pricing analyses.

For more information or a free valuation seminar for your firm or professional group, please call John Thomson at (562) 597-0821, or e-mail your request to info@ktsvaluation.com.

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Valuation Issues

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Quarterly Quote:

"Whatever is worth doing at all is worth doing well."
- Phillip Stanhope