

---

---

# THE HEMPSTEAD LETTER

## Estate and Gift Tax Valuation Edition

---

---

Vol. XXIV, No. 2

### Tax Court Says “Ok” to 50% Valuation Discount

In a recent Tax Court case, a successful showing of “arm’s-length” transactions helped buttress taxpayers’ use of an appraisal featuring a 50% lack-of-marketability discount.

#### Background

Members of the Huber family made gifts of stock of J. M. Huber Corp. during the period 1997 to 2000. The IRS believed that the value of the stock was under reported on the gift tax returns. The result was a Tax Court case called *Huber, et al. v. Commissioner* (T.C. Memo. 2006-960), decided May 9, 2006.

J. M. Huber Corp. (Huber) is a privately-held diversified company based in Edison, New Jersey. The company at the time in question had annual sales of in

excess of \$500 million and approximately 250 shareholders. It is one of the largest family-owned companies in America.

#### Appraisal

The donors of the Huber stock valued the stock for gift tax purposes based on a report prepared by an independent appraiser. The company had engaged this appraiser since 1993 to prepare annual valuations of its stock. These valuations were used for a variety of purposes, including; (1) valuing gifts of Huber shares made to non-profit organizations, (2) valuing stock options granted to the company’s CEO, (3) fixing the compensation of Huber’s board members, (4) evaluating the performance of Huber as a whole, (5) valuing shares that are bought back by Huber from its shareholders, and (6) valuing shares in transactions between Huber shareholders.

#### Sub-S Corp Valuation Issues Addressed In Delaware Chancery Decision

Subchapter-S corporations present a special valuation challenge to business appraisers. The appraisal profession has in recent years been wrestling with the thorny question of how to treat the income tax status of Subchapter-S corporations when performing a business valuation. The issue is whether or not, or to what extent, one should include in a valuation an amount to reflect the fact that Sub-S corporations do not pay Federal corporate income taxes.

#### A Recent Case

Vice Chancellor Strine, of the Delaware Chancery Court, was faced with this issue recently in an appraisal/entire fairness action called *Delaware Open MRI Radiology Associates, P.A.* (Consolidated C.A. No. 275-N, April 26, 2006).

The case involved a group of eight radiologists that owned a company called Delaware Open MRI Radiology Associates, P.A. (Delaware Ra-

*continued on page 2*

---

**“... sales of Huber stock... demonstrate the best reference for the valuation of Huber shares...”**

---

The appraiser had used a consistent method for preparing its valuation. It compared Huber to comparable publicly-traded companies. It then applied a 50% lack-of-marketability discount from the freely-traded value of the shares to arrive at its valuation.

#### IRS Position

The IRS agreed with the freely-traded values of Huber shares established by the appraiser. They took issue, however, with the 50% lack-of-marketability discount. They proposed discounts ranging from 25% to 45% during the years in question.

The IRS also rejected the appraiser’s values on the grounds that sales at these values were not arm’s-length transactions.

#### Court Analysis

The Court began its analysis based on the following premise: “In determining the value of unlisted stocks, actual arm’s-length sales of the stock in the normal course

*continued on page 2*

---

---

## **Tax Court Says “Ok” to 50% Valuation Discount**

*continued from page 1*

of business within a reasonable time before or after the valuation date are the best criteria of market value.”

The Court then proceeded to examine some of the more than 90 transactions that had taken place in Huber stock from 1994 to 2000, all based on the appraiser’s value. It examined the relationships between the parties, the presence or lack of compulsion on the part of the seller, the reasonableness of the shareholders’ reliance on the appraiser’s value, and the intent of the parties with respect to the sales.

The Court concluded that while there were close family relationships between parties in some of the sales, this is neutralized by the fact that many of the transactions took place between parties that were hardly related or unrelated and who had fiduciary obligations to obtain the best price.

The Court also satisfied itself as to the lack of compulsion on the part of the sellers, their intent, and the degree to which they were informed of the appraiser’s opinion.

### **Conclusion**

Having satisfied itself on these matters, the Court expressed itself as follows; “We conclude that the sales of Huber stock established in the record are arm’s-length sales that demonstrate the best reference for the valuation of Huber shares on petitioners’ gift tax returns.” ■

### **Mark Penny Elected Regional Governor of the American Society of Appraisers**

Hempstead & Co. Managing Director Mark Penny, ASA has been elected Regional Governor of the Mid-Atlantic and New England Region of The American Society of Appraisers. As Regional Governor, he will represent his region in the governance of the ASA.

The ASA, founded in 1936, is the leading professional association of appraisers in the field of business valuation and other appraisal disciplines. It awards the ASA designation to appraisers who meet its rigorous educational, testing and experience requirements.

Mark has been an active business appraiser for more than 20 years. He is a graduate of the University of Pennsylvania, and holds an MBA degree from Temple University. He testifies frequently in state and Federal court as an expert in business valuation. ■

---

---

## **Sub-S Corp Valuation Issues Addressed In Delaware Chancery Decision**

*continued from page 1*

diology). The company performs MRI scans. A radiology practice owned by the eight radiologists, called Fox Chase Medical Center Radiology Associates, P.C. (Fox Chase) performed the diagnostic “reads” of the scans made by Delaware Radiology.

All eight doctors were originally together in one practice. In 1999, however, three of the eight partners left Fox Chase to start a new practice. This created a number of problems which ultimately led the five remaining Fox Chase doctors, who collectively owned 62.5% of the Delaware Radiology shares, to decide to effect a squeeze-out merger of the three minority shareholders of the company.

---

***“The opposing valuation experts took utterly differing positions on the issue of the proper treatment of Sub-S taxation.”***

---

The terms of the merger, which took effect on January 20, 2004, provided for a payment to the minority shareholders of \$16,229 per share (equivalent to a valuation of \$6.5 million for the company in its entirety). The minority shareholders, unhappy with this valuation, submitted a demand for an appraisal. Their appraisal expert valued the company at \$66,074 per share (equivalent to \$26.4 million for the whole company).

### **Subchapter-S Tax Issue**

There were a number of issues involved in this litigation. For purposes of this discussion, however, we will confine ourselves to a consideration of the Court’s treatment of the Subchapter-S tax issue.

The opposing valuation experts took utterly differing positions on the issue of the proper treatment of Sub-S taxation (or lack of taxation). The appraiser for the majority shareholders treated the company as if it were a normal or C corporation for valuation purposes. He applied a 40% corporate tax rate to the earnings of the company. The argument that supports this approach is that if the most likely buyer of the company is a C corporation, the buyer will, after the acquisition, be faced with paying corporate income taxes on the earnings of the acquired company. If the buyer will receive no benefit from the acquired company’s S-Corp. sta-

*continued on next page*

---

---

## *Sub-S Corp Valuation Issues Addressed In Delaware Chancery Decision*

*continued*

tus, it will analyze the company's earnings as if the company did pay corporate income taxes. In other words, the buyer will "tax affect" the target company's earnings by an amount which corresponds to normal C corporation taxes.

The appraiser for the minority shareholders, on the other hand, asserted the proposition that because Delaware Radiology is an S corporation, it faced no corporate-level income taxes. Any taxes, he reasoned, would be paid at the stockholder level and should not be considered in valuing Delaware Radiology as an entity. Accordingly, he did not tax affect its earnings at all in performing his valuation.

### *The Court's Analysis*

The Court had problems with both approaches. The Judge described his problem with the majority approach this way; "Delaware Radiology is a very small entity. The record reveals no set of circumstances in which it is likely that Delaware Radiology will convert to C corporation status. . . . The S corporation tax status is a highly valuable attribute to the shareholders of Delaware Radiology. . . an appraisal petitioner is entitled to be paid for that which has been taken from him. . . As a matter of fairness, the merger price had to take into account these (S-Corp.) benefits and provide fair compensation for the (minority group's) loss. (The majority group's) approach denied the (minority group) members the value they would have received as continuing S corporation stockholders in Delaware Radiology and, therefore, ensured that the merger price was lower than fair value."

---

***"[t]he Judge developed an approach that he felt properly captured the value of the company's S status."***

---

The Court found the minority approach to be "equally flawed," in that it "overstates the value fairly belonging to the (minority group)." He pointed out that if the universe of buyers is principally composed of C corporations, it would be highly misleading to do a market-based comparable acquisition valuation of an S corporation using sales of C corporations to C corporations and then to assume that an S corporation would be sold at a higher price because of its tax status.

He summarized the dilemma as follows; "I am not

trying to quantify the value at which Delaware Radiology would sell to a C corporation; I am trying to quantify the value of Delaware Radiology as a going concern with an S corporation structure and award the (minority group) their pro rata share of that value."

### *The Court's Conclusion*

After due consideration, the Judge developed an approach that he felt properly captured the value of the company's S status without overstating it, as he felt would be the case if the minority group approach were adopted. For purposes of analysis, he assumed a hypothetical corporation that had \$100 of pretax earnings, and paid out all of its after-tax earnings to its shareholders. He then calculated how much of this \$100 would remain with the shareholder after all taxes had been paid. He made the calculation twice, once assuming that the company was a C corporation, and once assuming that it was an S corporation. He then compared the amount retained by the shareholder after all taxes. Using a corporate and personal income tax rate of 40%, and a dividend tax rate of 15%, he found that the C corporation shareholder would retain \$51 out of the \$100, and the S corporation shareholder would retain \$60 out of the \$100.

He then calculated a hypothetical corporate tax rate which, if applied, would leave a C corporation shareholder with the same after-tax earnings that he would have if the company were an S corporation. That rate is 29.4%, as is shown in the last column of the table below:

	<u>C Corp</u>	<u>S Corp</u>	<u>S Corp Valuation</u>
Income Before Tax	\$100	\$100	\$100
Corporate Tax Rate	40%	—	29.4%
Available Earnings	\$60	\$100	\$70.60
Dividend or Personal Income Tax Rate	15%	40%	15%
Available After Dividends	\$51	\$60	\$60

The Court then applied this tax rate of 29.4% to the pretax earnings of the company for purposes of calculating its value in order "to measure with the greatest practicable precision the fair value of the (minority group's) interest in the going concern value of Delaware Radiology." ■

---

---

## –Subscribe to our E-Letter –

Keep up with developments in the field of business valuation by subscribing to our free e-letter, “*Business Valuation Notes.*”

Simply go to our web site, [www.hempsteadco.com](http://www.hempsteadco.com) and fill in the box.

---

*The material presented in the Hempstead Letter should not be construed as definitive legal, accounting, financial, or business advice nor should it be acted upon without consultation with legal or other professional counsel.*

*To ensure compliance with requirements imposed by the IRS, we inform you that any US federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (a) avoiding penalties under the Internal Revenue Code or (b) promoting, marketing or recommending any transaction or matter addressed herein.*

*Hempstead & Co. is a financial consulting firm providing services in the following areas:*

- *Valuations of Businesses and Corporate Securities*
- *Fairness Opinions*
- *Valuations of Stock Options*
- *Valuations of Intangible Assets*
- *Loss of Business Damage Analysis*
- *Mergers & Acquisitions*
- *Purchase Price Allocations*
- *Goodwill Impairment Testing*

*Professional designations of our staff include Accredited Senior Appraiser, American Society of Appraisers (ASA), and Chartered Financial Analyst (CFA). We welcome the opportunity to serve you. Please call Mark Penny at (800)541-3323 or contact him via e-mail at [jmpenny@hempsteadco.com](mailto:jmpenny@hempsteadco.com).*

---

***We'd like to hear from you!*** Please contact us regarding information found in *The Hempstead Letter*, or with any mailing address updates.

---



***Hempstead & Co. Inc.***

807 Haddon Ave.

Haddonfield, NJ 08033

ADDRESS SERVICE REQUESTED

***IN THIS ISSUE:***

- ***Tax Court Okays 50% Valuation Discount***
- ***Sub-S Corp Valuation Issues***