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The Use of Subsequent Information in Tax Court Cases

A potential concern for taxpayers and advisors in gift and estate tax matters is how the Tax Court may interpret information occurring subsequent to the date of a valuation. To address this concern, one should rely on Internal Revenue Service rules and procedures as well as actual Tax Court cases.

In a speech to the American Society of Appraisers in June 1995, the Honorable David Laro stated, "For Federal gift tax purposes, fair market value is determined on the day of each gift, and, ordinarily, no consideration is given to any foreseeable future event that may have affected the value of the subject property" (Section 2512(a), I.R.C.; Section 25.2512-1, Gift Tax Regulations). However, application of the above statement by the Tax Court is sometimes mystifying.

For example, in *Saltzman v. Commissioner* (68 T.C. Memo 1544,1559 (1994)), the Tax Court ruled "The test to decide whether we may consider a later sale is not whether the sale is foreseeable, but

whether later events have materially changed the value of the property." This ruling seems to contradict an earlier ruling by the Tax Court in the *Estate of Jephson v. Commissioner* (81 T.C. 999 (1983)). In *Jephson* the Tax Court ruled that post-death events may not be considered in valuing estate assets; however, the Court went on to rule that subsequent events may be considered for the limited purposes of substantiating reasonable expectations.

Nevertheless, the Tax Court has generally allowed subsequent events to be used only when the event was reasonably knowable at the valuation date. A good example of applying subsequent information to substantiate reasonable expectations can be found in *Morris v. Commissioner* (761 F.2d 1195 (1985)), when the Tax Court determined that development of real estate owned by the decedent was a reasonable expectation at the date of death, and failure to have developed the property eight years after date of death was immaterial. Additionally, in *Gilford v. Commissioner* (88 T.C. 38), the Tax Court considered a merger that occurred six months after the valuation date and found

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Is an ESOP Appraisal an Open Book?

What the Courts and the Regulatory Authorities Say

What rights do ESOP participants have to documents related to the plan? Plan administrators, trustees and appraisers should be aware of Employee Retirement Income Security Act (ERISA) provisions that address this question, and should understand what is expected and required if this situation arises.

A recent court case speaks to this issue. In *Faircloth v. Lundy Packing Company* (4th Circuit, August 2, 1996) the plaintiffs were three employees of

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that "at the time of decedent's death, there was no reasonable or intelligent expectation that a merger would take place."

The Tax Court also considered a post-death merger in *Mueller v. Commissioner* (T.C. Memo 1992-284). The merger was being considered at the date of death and was consummated approximately 60 days later. The Tax Court utilized the merger price, but applied an arbitrage discount to the period elapsed. The Tax Court reasoned that the merger was knowable at the date of death, but a rational investor could not have been certain the merger would take place and would appropriately apply discounts for the uncertainty.

While the Tax Court is not always consistent in its application of post-death events, the trend appears to be that subsequent events or information are only considered when they are reasonably knowable at the valuation date. Given this fact, it is imperative for the business valuation professional to conduct thorough interviews with management when preparing appraisals which include discussions about significant matters affecting the value of the company. The business valuation professional should also look to documented evidence such as board minutes to determine whether a subsequent event was being considered at the valuation date. In addition, the appraiser should consider what other comparable companies are currently doing and have recently done to indicate what may be reasonably knowable.

One thing is certain: an appraiser does not know what will happen in the future. He or she must base valuation decisions upon facts that are known or can be reasonably anticipated at the valuation date. Another thing is certain: the Tax Court (and everyone else) will know what actually happened after the valuation date by the time a gift or estate tax matter is adjudicated years later. Whether the subsequent event(s) are considered by the Tax Court may ultimately hinge upon the documentation of an appraiser's investigation at the time of the original appraisal. ♦

Is an ESOP Appraisal an Open Book?

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Lundy Packing Company (Lundy) and also participants in the Lundy ESOP. They alleged that Lundy and the plan's trustees had violated ERISA provisions by refusing to furnish certain documents requested by the plaintiffs. The request came after issuance of the participants' plan statements in 1992, which reflected a 42% decline in the value of the company's stock and a resulting decline in their account balances.

Lundy's ESOP was typical in that it maintained an account for each participant and provided annual statements with an independent appraisal of the stock, which served as the basis for calculations of account balances. In this case, when statements were issued, employees turned to their union for help in determining why the value of the stock had declined.

Lundy, who was also the plan administrator, received a request from the appellants for 15 documents related to the plan and its administration, including all appraisal reports of Lundy stock and any information supplied to the person or entity that prepared the appraisal reports.

The plaintiffs argued that they were entitled to all of the documents requested under three sections of ERISA: §104(b)(4), §404(a)(1)(A) and §404(a)(1)(D). ERISA §104(b)(4) provides: "The administrator shall, upon written request of any participant or beneficiary, furnish a copy of the latest updated summary plan description, plan description, and the latest annual report, any terminal report, the bargaining agreement, trust agreement, contract or other instruments under which the plan is established or operated." [emphasis added]

The court recognized its job as that of interpreting the meaning and scope of the ERISA provision, and whether the provision could be interpreted broadly enough to encompass the documents requested.

The appellants in the case addressed a number of the documents individually and cited particular precedent cases that were favorable to their position. The court agreed in some cases and did not in others, citing various reasons for each document requested. With respect to the appraisal reports and accompanying documentation, the majority in the opinion wrote: "The ESOP is not set up or managed under these documents. The appraisal report simply derives the value of Lundy stock, and the supporting documents included in this request provide the raw material from which the appraisal report is derived. Accordingly §104(b)(4) does not encompass the appraisal reports or their supporting documentation." The case also indicated the trustees had no fiduciary duty to distribute the reports under sections §404 (a)(1)(A) or (D).

A dissenting judge concurred with the majority opinion in part, but dissented from the majority's view that plan participants are not entitled to see the appraisal reports, noting that the plan administrator uses the appraisal report to determine the price at which shares are bought and sold, and it is thus an instrument under which the plan is operated. He also noted that plan participants have the right to know how the value of the shares is calculated, in order to assess whether their interests are being protected. He noted: "An independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled."

He further reasoned that the rights of plan participants to review appraisal reports is analogous to the rights of shareholders to inspect the documents and records of a corporation.

While *Faircloth* holds that plan participants are not necessarily entitled to review appraisal reports, a recent Department of Labor (DOL) Advisory Opinion also addresses this issue. Advisory Opinion 96-14 (July 1996) states that plan sponsors are required to disclose certain financial documents related to ERISA plans. The reasoning behind this opinion (which relates to welfare benefit plans) should also be considered in light of other types of plans and associated documents. The opinion notes: "The legislative history of ERISA suggests that plan participants and beneficiaries should have access to documents that directly affect their benefit entitlements under an employee benefit plan. Consistent with the Congressional intent, it is the view of the DOL that, for purposes of section 104(b)(2) and 104(b)(4), any document or instrument that specifies procedures, formulas, methodologies or schedules to be applied in determining or calculating a participant's or beneficiary's benefit entitlement under an employee benefit plan would constitute an instrument under which the Plan is established or operated." Clearly, the DOL intends to make its position on the interpretation of the ERISA provision more direct and specific.

While *Faircloth* is the most recent case to deal with the issue of plan participants' rights (in relation to appraisal reports), previous case law has also interpreted the ERISA language to encompass appraisal reports. Therefore, it is wise to consult legal counsel upon receipt of any request for documentation related to an employee benefit plan. As noted above, *Faircloth* contains court case references and addresses the interpretation of ERISA as it relates to other documents. For a copy of the case or to discuss an ESOP appraisal issue in confidence, please call. ♦

Case Law Update

Scanlan v. Commissioner

At issue in *Scanlan v. Commissioner* (T.C. Memo 1996-331, 1996-414) is the value of a minority interest in Eatelcorp, Inc. (Eatel) at the time of a gift made by Arthur and Ruth Scanlan on April 12, 1991, and the date of Arthur Scanlan's death on July 16, 1991. Figure 1 on Page 4 indicates the various values per share attributed to the estate's interest.

Background. Eatel is a telecommunications company that provides telephone services, telecommunications and electronic equipment sales, answering and secretarial services, and administrative services through its various subsidiaries. At the valuation dates noted above, the Scanlan family owned approximately 37.1% of the outstanding shares of Eatel. The Banker family owned approximately 35%, and the King family owned 14% of the outstanding shares.

Eatel was known as DATA until August 31, 1989. DATA's net income rose from \$423,000 in 1984 to \$894,000 in 1986, before falling to \$369,000 in 1987. From 1988 through 1992, net income ranged from a high of \$6.6 million to a low of \$4 million. The court seemed to suggest that DATA, because of significant changes in its income levels, may have reorganized or acquired new operations rather than just changing its name. Eatel paid dividends of \$1 per share in 1990, \$2 per share in 1991, and \$2.50 per share in 1992. Neither Eatel nor DATA paid dividends before August 1989.

In September 1992, Eatel's board solicited offers to purchase the company. The offers ranged from \$65 to \$75 million. On August 30,

1993, the Scanlan family exercised their right of first refusal and caused Eatel to enter into an agreement wherein all other shareholders would sell their shares to the Scanlan family. This redemption was completed at a price of \$75.1555 per share, based on the offer received in March 1993 to purchase Eatel.

Valuation - The Estate. The Court was presented with testimony from the estate's expert, David Blackshear Hamilton Chaffe, III (Mr. Chaffe) of Chaffe & Associates (C&A). Both the estate's tax returns were based on reports signed by Mr. Chaffe. The value attributed to the minority interest for gift tax purposes was based on C&A's November

15, 1989 valuation of a nonmarketable minority interest in Eatel. This report updated a report prepared August 31, 1989. The gift return then made adjustments to reflect increases in book value in the subsequent two years.

Mr. Chaffe also signed a report dated October 21, 1991 which also relied heavily on the August 1989 report. The October 1991 report indicated C&A discussed Eatel's performance with its president and compared Eatel to nine publicly traded companies. Using median multiples from these companies, C&A determined a marketable minority interest value. A 35% marketability discount was applied, indicating a value of \$35.20 per share at the date of death.

Valuation - The IRS. The IRS' valuation conclusion was based on the redemption price, discounted by 4% for both minority and marketability discounts.

The Court's Conclusion. The Court concluded that the value at both the dates of gift and death should be \$50.51.

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[This case] indicates the importance of full analysis and documentation when reaching valuation conclusions

This is based on the redemption price of \$75.16 after the application of a 30% marketability and minority interest discount.

The Court rejected Mr. Chaffe's opinion because "the Company valued in 1989 (DATA) was not sufficiently similar to the company valued in 1991 (Eatel) to make reliance on the earlier valuation reasonable" and Mr. Chaffe made no indication that he attempted to independently verify whether Eatel's operations in 1991 were similar to DATA's in 1989. The Court also criticized Mr. Chaffe for failing to explain DATA's dramatic earnings increase and for failing to adequately account for a dividend payment. In addition, the court noted that the 1991 report did not explain the impact of certain events mentioned in the 1989 report. These included the disposition of a subsidiary and the effects of the incorporation of technology and changes in operation to the company's income.

The Court also criticized the IRS' valuation conclusion because a 4%

discount could not adequately account for both a marketability and minority interest discount.

Interestingly, the Court's analysis of its discount is quite limited. The Honorable David Laro presided in this case and did not seem inclined to apply an analysis of specific factors when determining appropriate discounts as he had

standards set forth in *Mandelbaum*. The Court reasoned that the purpose of a motion for reconsideration is to resolve substantial errors of fact or law and the petitioner's motion did not indicate any unusual circumstances or substantial errors.

The Court suggested an explanation for its reluctance to utilize a *Mandelbaum* analysis; it determined relevant values "in light of the imperfect record ... [And] Petitioner's frustration with our memorandum opinion is best attributed to its inability to build a better record from which we could have made a more precise determination."

This statement is significant for two reasons. First, it suggests that the *Mandelbaum* analysis is still good law. More importantly, it indicates the importance of full analysis and documentation when reaching valuation conclusions.

For a copy of the case or to discuss a valuation issue in confidence, please give us a call. ♦

Figure 1

Petitioner		Respondent		Court	
Value at Gift	Value at Death	Value at Gift	Value at Death	Value at Gift	Value at Death
\$34.84	\$35.20	\$72.15	\$72.15	\$50.51	\$50.51

done in *Mandelbaum (Mandelbaum v. Commissioner T.C. Memo 1995-255, affd. without published opinion 91 F.2d 124 (3d Cir. 1996))*.

This reluctance to incorporate the *Mandelbaum* analysis in its conclusion is supported by the fact that the Court denied the estate's motion for reconsideration based on the failure to account properly for minority and marketability discounts and the failure to apply the

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