THE SPOTLIGHT

BROUGHT TO YOU BY ROBINS KAPLAN LLP'S
WEALTH PLANNING, ADMINISTRATION, AND DISPUTES GROUP

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WHEN IT'S A MATTER OF VALUE

ROBINS KAPLAN LLP

WELCOME TO THE SPOTLIGHT

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The Spotlight is the result of ongoing collaboration between our national trial practice and estate planning groups, with the goal of providing a forum to discuss the latest news and other issues impacting the trusts and estates community. Whether you are a trustee, beneficiary, trust officer, attorney, financial advisor, or other professional in this area, we hope that you will find this newsletter interesting, informative, and perhaps at times even a bit entertaining.

As leaders and teachers in the field of wealth planning and administration, our attorneys have built a reputation for excellence in meeting the needs of individuals and organizations from basic to complex testamentary planning. We counsel individuals and business owners in all aspects of estate planning and business succession, providing them with peace of mind and reassurance that their legacy is in the best of hands.

Furthermore, should a conflict arise, our wealth disputes attorneys are well positioned to resolve the matter with thoughtfulness, creativity, and compassion. Our national reputation for litigation excellence includes wins in the fiduciary arena for trustees and fiduciaries, personal representatives, beneficiaries, guardians, and conservators. Whether litigating fiduciary matters, inheritance issues, or contested charitable donations, we help clients cut through confusion to find a path to resolution.

Is there a topic affecting your practice that you would like us to discuss in an upcoming issue of the Spotlight? Let us know at TPentelovitch@RobinsKaplan.com.

– Denise S. Rahne and Steven K. Orloff

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VALUATION: THE "EYE OF THE BEHOLDER" CAUSES DISPUTES

BY ANNE M. LOCKNER AND RICHARD R. ZABEL

The need to value closely held corporations and associated real estate frequently arises in the context of estate administration. The value of such assets, however, is often fogged by the differing perceptions of the various estate stakeholders. Further, valuation of closely held family businesses often entwines valuation techniques with family dynamics and statutory dictates that complicate determination of the "value" of stakeholders' interests. In addition, the real estate of a closely held business may be held in other legal entities likely established for various tax, liability, and cash-flow purposes. Disputes in valuation of these assets often occur due to differing perceptions about how to value the business and the "eye of the beholder" of different stakeholders.

VALUATION

Valuations of closely held business utilize three general approaches – cost/asset approach, market approach, and income approach – each with its own strengths and weaknesses. The three approaches may produce significantly different values that can be difficult to reconcile. Finally, all valuations have an element of opinion. Disputes arise when the valuation results are not reconciled or contrasting opinions produce disparate results based on the perceptions of the various stakeholders.

COST/ASSET APPROACH

The cost/asset approach values the business based on the cost to build or the expected replacement cost of the business assets. All assets – receivables, inventory, machinery, buildings, and land (if owned by the legal business entity) – are adjusted to their fair market value and the total value of the assets is the "value" of the business. The main problem with the cost/asset approach is that the business' income-producing capabilities may greatly exceed the value of its assets. There are also issues with establishing the fair market value of certain assets, including the value of all assets combined in an operating business rather than measured individually.

MARKET APPROACH

The market approach is a form of relative valuation based on comparable transactions for similar businesses or comparable results of operations that measure certain valuation metrics. The main challenges with this method are finding comparable businesses and lack of access to sufficient information on other business sales and operations.

INCOME APPROACH

The income approach, also known as the discounted-cash-flow approach, is a form of intrinsic valuation in which future cash flows for the business are forecast and these future cash flows are discounted to present value. The main issue with this approach is the ability to project the future operations of the business, i.e., "the crystal ball challenge," which may create a wide dispersion of values based on the "eye of the beholder" and their visions for the business.

Each of the three valuation methodologies are fraught with subjective opinions on the measure of the business's value. Consequently, each of these valuation techniques may provide a range of values before the considerations of individualistic issues for a stakeholder such as discounts for marketability and minority discounts for certain potential stakeholders.

One common issue is the application of Minn. Stat. Section 302A.751 for minority stakeholders that uses a measure of "fair value" versus "fair market value." Fair value is the value of the business before the application of certain discounts to determine the fair market value of the business—usually to account for the lack of a public market for the stock of the company. Differing stakeholders may wish to apply one versus the other based on their role and interest in the business.

Variations in valuations can become particularly acute when one family member runs the business and other family members are passive owners with no management responsibilities. For example, the individual whose entire career has been spent building and growing the business may value the company more than those who have not. Other family dynamics such as divorce, large families, and multiple generations may add another layer of complexity to the determination of the "value" of the business and who will potentially benefit from the transfer or sale of the business in an estate.

Finally, current general financial conditions affect business valuations. This may include conditions such as COVID-19 limitations or changes in operations, technology advancements, and incorporation of technology into the business' operations, and "disrupters" of the business' market. Each of these items needs to be factored into the valuation analysis and affects the lens through which a valuation is created.

A WORD ABOUT REAL ESTATE

Another potential complication lies in the fact that the underlying real estate of a business may be held in another entity and the estate may want to separate the business from its real estate to achieve alternative goals. For instance, certain stakeholders, generally the older generation, may want the business to continue to pay rent to the entity that owns the real estate as a means to financially support the older generation – this holds true for both businesses sold to family members as well as non-family members.

If the location of the property has seen extreme valuation increases due to the real estate being held a long time or in a now-more-valuable location, the value of the real estate may be the major assets and may even exceed the value of the business that operates on the real estate. Ultimately, the highest and best use of the real estate, an assumption that is part of valuing real estate, may be to sell the real estate and separate it from the business. How to deal with the underlying real estate may also create disputes, not only over value, but also over the ultimate use of the property.

THE IRS SAYS "NICE TRY." CASE ILLUSTRATIONS OF UNSUCCESSFUL VALUATION EFFORTS

BY BRENDAN JOHNSON AND ENA KOVACEVIC

In the context of valuation, legal professionals have at times utilized creative efforts to shield clients from tax exposure. It is perhaps unsurprising therefore that whether the focus involves art, a business, or a charitable donation, some of the most common valuation disputes intersect with taxing authorities. As the cases below illustrate, the IRS is not easily impressed.

In Estate of *Kollsman v. Commissioner*, the decedent owned two 17th-century Old-Master paintings. The estate's expert cumulatively valued the paintings at $600,000 while the IRS's expert cumulatively valued the paintings at $2,600,000. The discrepancy in price resulted from a discount the estate's expert applied due to the paintings' dirtiness and the risk involved in cleaning them. In the battle of appraisers, the IRS expert came out on top. The Tax Court agreed with the IRS expert's valuation and valued the paintings at the price at which property would change hands between a willing buyer and a willing seller. The Court rejected the estate expert's valuation for several reasons, including the expert's failure to obtain "reasonable knowledge of the relevant facts" that the dirt was not embedded and that the risk of cleaning the paintings was minimal. The Ninth Circuit affirmed. *Estate of Kollsman v. Commissioner of Internal Revenue*, 777 Fed. App'x 870 (June 21, 2019).

In *Streightoff v. Commissioner*, the estate of Frank Streightoff argued against a deficiency determination based on an allegedly undervalued limited liability partnership formed during his lifetime and funded by decedent's assets. The decedent owned 88.99% of the LLP. On the same day the decedent formed the LLP, he established the Frank D. Streighoff Revocable Trust and assigned all his interest in the LLP to the revocable trust. An assignment of interest was executed. The decedent's daughter was the manager of the LLP's general partner, trustee, and executor of the estate. His estate valued his LLP interest by applying discounts for lack of marketability, lack of control, and lack of liquidity. The Tax Court upheld the IRS determination and found that the purported assignment of interest was in name only and the decedent transferred a limited partnership interest solely for estate tax and valuation purposes. The Fifth Circuit affirmed. *Estate of Streightoff v. Commissioner of Internal Revenue*, 954 F.3d 713 (5th Cir. 2020).

In *Dieringer v. Commissioner of Internal Revenue*, the decedent's family owned a closely held corporation. The decedent was vice president and chair of the board and a shareholder. Before the decedent died, the corporation discussed purchasing the decedent's shares and appraised her shares at $14 million. The decedent died before she sold her shares. After her death, the value of the decedent's shares was appraised at a lower value than the first appraisal. The second appraiser appraised the shares as if she were a minority interest holder (even though she was a majority interest holder) and included discounts for lack of control and lack of marketability (at a son's instructions). The corporation decided not to purchase the decedent's shares, which were then transferred to the family's foundation pursuant to the decedent's estate plan. The foundation reported in its tax return that it received a contribution of $1.4 million in shares (based on the second appraisal), but the estate claimed a date-of-death charitable deduction of $18 million (based upon the first appraisal). The court held that the value of the charitable deduction is limited to the value actually received by the foundation and reduced the value that the estate could claim for the charitable deduction. The Ninth Circuit affirmed. *Dieringer v. Commissioner of Internal Revenue*, 917 F.3d 1135 (9th Cir. 2019).

FROM THE TRENCHES: A SPOTLIGHT INTERVIEW WITH LARRY FARESE

The Spotlight had a chance to sit down with longtime Robins Kaplan trial attorney and mediator Larry Farese for a good old-fashioned story telling session.

THE SPOTLIGHT: Larry, you have, as they say, "seen a few things." What is the strangest "asset" you have seen beneficiaries fight over and if it got resolved, how did that happen?

FARESE: Although a corpse should hardly be considered an "asset," I have handled at least two cases where family members fought over the body of a loved one. In one the children of the decedent wanted access to their father's corpse in order to have a private autopsy to prove that their father had advanced-stage Alzheimer's that resulted in an invalidated offending will. The surviving second spouse initially resisted out of respect for her deceased husband, but ultimately agreed, believing that the results would prove a negative. Her gamble failed miserably and the case settled shortly after the results were obtained.

On another occasion, the decedent's children refused to sign a consent form to transport their mother's body from a hospital's morgue to a funeral home for cremation. Instead, they intentionally left their mother decomposing in the hospital's morgue and refused to consent to the removal unless and until the hospital admitted to its own malpractice in causing the death of the mother. The hospital rightfully refused. I filed suit against the family to obtain a mandatory injunction ordering the family to

abate the private nuisance by consenting to have the body removed. The family signed the consent form immediately after the injunction hearing to avoid incarceration for contempt.

THE SPOTLIGHT: Why is it that sometimes the assets that are lowest in value create the greatest degree of difficulty in finding a path to resolution?

FARESE: Two reasons. First "sentimental value," an emotionally charged but very real concept devoid of rational thinking. An estate beneficiary may be inclined to delay probate administration and engage in disproportionate litigation and expense to obtain the cherished family heirloom that is equally coveted by other siblings. While obstinance might work and cause the more reasonable siblings to give in rather than continue to waste their inheritance on legal fees, the strategy often backfires. Which leads me to reason number two: revenge. Armed with the knowledge that one sibling is blinded by the emotional attachment to a valueless heirloom, other siblings are happy to weaponize the object and use it as leverage to obtain what they really want - more money.

THE SPOTLIGHT: You are a longtime litigator turned mediator. Did your approach to dealing with "clients" in the context of hard-to-value assets differ depending upon which hat you were wearing?

FARESE: Yes and no. Even as a full-time litigator, my approach was always to seek an amicable resolution as early as possible if one could be achieved on reasonable terms. However, clients often view the litigator as a gladiator who should be willing to fight to the death regardless of the amount in controversy. How often have we all heard the client say: "I don't care what it costs. I would rather pay you than them. I don't care if I spend all of my inheritance on legal fees. It is the principle of the thing." This leaves the litigator with the difficult task of properly advising the client on the cost-benefit analysis of continued litigation and the risk of loss without appearing too "weak" and prompting the question: "Whose side are you on anyway?" As a litigator I often called on the mediator to do my bidding and beat sense into my client. Now, in my role as a full-time mediator, the tables are turned. I consider it my job to bring both sides back to reality. As I see it, it is better for the clients to be mad at me for pushing back against their unrealistic expectations than to be mad at their own lawyers.

THE SPOTLIGHT: What is your view on experts when it comes to ascertaining a meaningful valuation of a hard to value asset?

FARESE: Experts can be useful as a reference point when valuing hard-to-value assets, but parties in dispute rarely agree on the opinion of one expert as a basis for resolution. An ownership interest in a closely held business is a prime example. A business valuation expert can provide an opinion on a total enterprise value of the business as a going concern based on "comparable market data," which may or may not be comparable in the eye of the beholder. Even with a reasonable enterprise valuation as a starting point, valuing a partial ownership interest in the venture, particularly a minority position, becomes very subjective when applying appropriate discounts for lack of marketability, lack of control, etc. Because there is no objective data to prove or disprove the expert's hypothesis of the value, expert opinions are of limited use when attempting to achieve an agreement on a purchase and sale price between business partners.

As a mediator of disputes between business partners, I prefer to rely on the parties themselves to set the value of their business by negotiating an after-the-fact buy/sell agreement, where, for example, one partner sets a per-share price for her interest, and the other has the option of either buying the partner out at the offered price or selling her shares at the same price per share. I find these types of practical techniques more useful than an expert's hypothetical opinion of value.

THE SPOTLIGHT: Do you have a success story as a practitioner or mediator in terms of getting to resolution on an asset or class of assets on which the interested parties were stuck?

FARESE: Often in probate, disputes items of tangible personal property have no market value, other than "yard sale value" as I call it. Nevertheless, heirs are happy to fight about it. I once mediated a case in which three brothers could not agree on an equal division of personal property. To solve the dispute, the parties agreed to my suggestion that one brother, who was the personal representative, would divide the property into three lots that he felt were equal. Each lot contained some of the decedent's coins, artwork, jewelry, family photos, etc. The brother who was causing most of the problems was given the first choice to pick a lot, the other brother chose second, and the personal representative got the leftover lot. After the three lots were chosen, the brothers were free to make trades of items if they so desired, but of course by that time no one was speaking to the others. In the end, everybody was unhappy, but the case got resolved.

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