Recent Developments in Valuations

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STOUT

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About Stout

Overview of Stout

Stout is a global investment bank and advisory firm. Our clients and their advisors rely on our premier expertise, deep industry knowledge, and unparalleled responsiveness on complex matters.

Investment Banking

- M&A Advisory
- Private Financing of Debt & Equity
- Special Situations & Distressed M&A
- Strategic Alternative Assessments

Disputes, Compliance, & Investigations

- Contract Compliance
- Expert Testimony & Consulting
- Investigations
- Regulatory Compliance & Financial Crimes

Transaction Advisory

- Accounting & Reporting Advisory
- Financial Due Diligence
- IP Advisory & Transactions
- M&A Support Services
- Tax Services
- Transaction Opinions

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- Automotive Component Defect & Recall Consulting
- Digital & Data Analytics
- Legal Management Consulting
- Transformative Change Consulting

Valuation Advisory

- Corporate Tax Planning & Compliance
- ESOP & ERISA
- Financial Reporting
- Valuation Disputes
- Trust & Estate

Introductions

Oliver Warnke, ASA

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Notable Recent Court Cases

Estate of Miriam M. Warne v. Commissioner (T.C. Memo. 2021-17)

Quick Facts

- Judge Ronald L. Buch.
- DOD: February 20, 2014.
- Trial: September 11, 2019.
- Opinion issued February 18, 2021.
- Valuation of controlling interests with power to liquidate (magnitude of discounts).
- Is split charitable contribution of 100% interest subject to discounts?
- Valuation of leased-fee interests in underlying real property.
- Application of Section 6651(a)(1).

Overview

- Five entities: WRW Properties LLC (78.0%), Warne Ranch LLC (72.5%), VJK Properties LLC (86.3%), Warne Investments LLC (87.432%), and Royal Gardens LLC (100%).
- All five entities owned income-producing real property in California.
- Operating agreements granted the majority interest holder considerable power: could appoint and remove the manager and, together with the manager, elect to dissolve the LLC (i.e., “total control”).
- Royal Gardens interest was left 75/25 to two charities.

Estate of Miriam M. Warne v. Commissioner (T.C. Memo. 2021-17)

The Valuation

- Both experts applied DLOC and DLOM.

Taxpayer Expert

- Use of Mergerstat Control Premium study.
- Compared premiums paid for 50.1% to 89.9% interests vs. 90.0% to 100% interests.
- Difference in discount of 9.47%.
- Conclusion: 5% to 8% DLOC.

- Use of Stout Restricted Stock study.
- 714 transactions: average of 21.1%, median of 16.2%.
- Accounts for shorter holding period (estimated at 6 months).
- Conclusion: 5% to 10% DLOM.

- Combined total discount: 10%.

Estate of Miriam M. Warne v. Commissioner (T.C. Memo. 2021-17)

The Valuation

IRS Expert

- Use of closed-end real estate fund study.
- Discount range of 15.7% to premium of 3.8%, median of 11.9%.
- Conclusion: 2% DLOC.

- Use of Pluris DLOM database.
- 2,398 transactions: average of 21.4%, median of 18.6%.
- Conclusion: 2% DLOM.

- Combined total discount: 4%.

Estate of Miriam M. Warne v. Commissioner (T.C. Memo. 2021-17)

Conclusion

"When a majority interest holder exerts control similar to that which the Family Trust can exercise in the LLCs, we have held that no discount for lack of control applies."

- Nevertheless, Tax Court adopts 4% DLOC based on taxpayer's expert data, ignoring "risk of litigation."
- Taxpayer's DLOM analysis "was more credible."
- Tax Court concludes 5% DLOM at lower end of range.

- "Estate claims that, because 100% of Royal Gardens was included in the estate and the estate donated 100% of Royal Gardens to charities, the estate is entitled to a deduction of 100% of Royal Garden's value. **We disagree.**"

Estate of Miriam M. Warne v. Commissioner (T.C. Memo. 2021-17)

	Taxpayer	IRS	Tax Court
Lack of Control	5%	2%	4%
Lack of Marketability	5%	2%	5%
Total Discount	10%	4%	8.8%*

*Calculation

James C. Nelson v. Commissioner (T.C. Memo. 2020-81)

Quick Facts

- Judge Cary D. Pugh.
- Transfers on December 31, 2008, and January 2, 2009.
- Opinion issued June 10, 2020.
- Tiered discounts involving an FLP that owned a minority interest in an operating businesses.
- Were interests transferred fixed dollar amounts or percentage interests.

Overview

- Longspar Partners Ltd. (Texas LP) owned a 27% interest in Warren Equipment Co. (WEC).
- Underlying WEC stock accounted for 99% of the FLP's assets (a key consideration in other cases).
- The WEC interest was discounted 15% for lack of control & 30% for lack of marketability; the FLP was discounted 5% for lack of control & 28% for lack of marketability (a total discount of almost 60%).

James C. Nelson v. Commissioner (T.C. Memo. 2020-81)

	Taxpayer	IRS	Tax Court
Warren Equipment Co.			
Lack of Control	20%	0%	15%
Lack of Marketability	30%	30%	30%
Total Discount	44%*	30%*	40.5%*
Longspar Partners Ltd.			
Lack of Control	15%	5%	5%
Lack of Marketability	30%	25%	28%
Total Discount	40.5%*	28.75%*	31.6%*
Bottom-to-Top Discount	**66.7%***	**50.1%***	**59.3%***

*Calculation

Tax Proposal – Impact on Valuation

Tax Proposal – Impact on Valuation

Overview

- Source: The Tax Foundation (www.taxfoundation.org).
- Based on tax plan released before the election.

Plan

- Repeal the TCJA components for high-income filers.
- Raise taxes on individuals with income above $400,000, including income, capital gains, and payroll taxes.
  - Impose 12.4% social security tax evenly split between employers and employees.
  - Revert top individual income tax bracket from 37% to 39.6%.
  - Taxes long-term capital gains and qualified dividends at the ordinary income tax rate of 39.6% on income above $1 million and eliminates step-up in basis for capital gains taxation.
  - Limit itemized deductions.
- Raise corporate income tax rate from 21% to 28%.
- Impose corporate minimum book tax on book profits of $100 million or higher (15% alternative minimum tax).
- Doubles tax rate on Global Intangible Low Tax Income earned by foreign subsidiaries of U.S. firms from 10.5% to 21%.
- Establishes and expands various corporate tax credits.
- Temporarily increase child tax credit and dependent credit.
- Restore estate- and gift-tax rates and exemptions to 2009 levels (45% and $3.5 million).

Tax Proposal – Impact on Valuation

Effects

- Raise tax revenue by $3.3 trillion over 10 years (on conventional basis) or $2.8 trillion (accounting for macroeconomic feedback effects).
- Reduce GDP by 1.62% and GNP by 1.83% over the long term.
- Lead to about 7.7% less after-tax income for top 1% of taxpayers and about a 1.9% decline in after-tax income for all taxpayers (including top 1%) on average.

Provision	Long-Run Change in Economic Output
Apply a Social Security payroll tax of 12.4% to earnings above $400,000	-0.18%
Tax capital gains and dividends at 39.6% on income above $1 million and repeal step-up in basis	-0.02%
Restore estate and gift taxes to 2009 levels	-0.15%
Limit the tax benefit of itemized deductions at 28% of value for those earning over $400,000	-0.09%
Raise the corporate income tax to 28%	-0.97%
15% corporate minimum book tax	-0.21%
Total	**-1.62%**

Source: Tax Foundation General Equilibrium Model, October 2020.

Tax Proposal – Impact on Valuation

Hypothetical Example: Valuation of an Operating Company			
	Current Environment	Proposed Tax Changes	
Pretax Cash Flow$_0$	$ 1,000,000	$ 1,000,000	Impact of increased payroll rax for high earners.
Corporate Income Taxes	$ (210,000)	$ (280,000)	Increase in tax rate.
After-Tax Cash Flow$_0$	$ 790,000	$ 720,000	
Long-Term Growth Rate	4.0%	2.5%	Long-term effect on GDP.
Cash Flow$_1$	$ 821,600	$ 738,000	
Capitalization Rate	10.0%	11.5%	Change in growth rate affects cap rate.
Equity Value (C Corp.)	**$ 8,257,286**	**$ 6,445,415**	**-21.9%**
S Corp. (SEAM) Adjustment	1.005	1.311	S corp. benefit become valuable again.
Equity Value (S Corp.)	**$ 8,301,400**	**$ 8,450,655**	**1.8%**

Tax Proposal – Impact on Valuation

S Corporation Equity Adjustment Multiple (For a Non-Service Company)

		Notes		Temporary Period	Permanent Period	Hypothetical Period
1	Individual Ordinary Income Tax Rate	[a]	ti	33.4%	43.4%	43.4%
2	Income Tax Rate on Capital Gains		tcg	23.8%	23.8%	43.4%
3	Dividend Payout Ratio	[b]	Dp	0.0%	0.0%	0.0%
4	C Corporation Income Tax Rate		tc	21.0%	21.0%	28.0%
5	Income Tax Rate on Dividends		td	23.8%	23.8%	43.4%
6	S Corporation Equity Adjustment			10.6%	-6.0%	38.9%
7	Multiple Conversion			1.000	1.000	1.000
8	**S Corporation Equity Adjustment Multiple**			**1.106**	**0.940**	**1.389**
9	Multiplied by: Weighting Based on Free Cash Flows	[c]		40%	60%	100%
10	**Wtd. S Corporation Equity Adjustment Multiple**				**1.007**	**1.389**
11	S Corporation Risk Adjustment Factor	[d]			-20.0%	-20.0%
12	**Modified Weighted S Corporation Equity Adjustment**				**1.005**	**1.311**

$$SEAM = 1 + \frac{(t_c + t_{cg} - t_i - t_c t_{cg} + D_p t_d - D_p t_{cg} - D_p t_c t_d + D_p t_c t_{cg})}{[1 - t_c - t_{cg} + t_c t_{cg} - D_p t_d + D_p t_{cg} + D_p t_c t_d - D_p t_c t_{cg}]}$$

QBI = Qualified Business Income

[a] Given that the Company operates as a non-service business, our calculation of the individual

[b] Not relevant when the income tax rates on capital gains and dividends are identical.

[c] Based on the impact relating to the Tax Cuts and Jobs Act, we weight the implied multiples based

[d] Based on the risk attributes of S corporations when compared to C corporations.

Absorption Discounts in Real Estate Valuations

Absorption Discounts in Real Estate Valuations

Absorption Discounts – How did we get here?

- Astleford v. Commissioner, T.C. Memo. 2008-128
- Estate of Rodgers v. Commissioner, T.C. Memo. 1999-129
- Carr v. Commissioner, T.C. Memo. 1985-19
- Estate of Grootemaat v. Commissioner, T.C. Memo. 1979-49

In Astleford, the real estate at issue was approximately 1,187 acres of farmland in Dakota County, Minnesota. The Taxpayer's expert valued the land at $3,100 per acre and applied an absorption discount of 41.3%, arguing that annual absorption in the County is far less than the subject's total acreage, and that the property would take for years to sell off.

The IRS's expert valued the real estate at $3,500 per acre and argued an absorption discount was not warranted due to the property being purchased as a single, large parcel, so it certainly could be sold as such.

The Court concluded the IRS expert "was particularly credible and highly experienced and possessed a unique knowledge of property located throughout Dakota County and the surrounding area" and accepted the IRS's $3,500 per acre value.

As it pertains to the absorption discount, the Court cited Rodgers, Carr, and Grootemaat that allowed an absorption discount in valuing large parcels of real estate where a sale over a short period of time would reduce value.

Absorption Discounts in Real Estate Valuations

The Court used the taxpayer's appraiser's assumption that the property would take four years to completely sell off but reduced the present value discount from 25% to 10%, which is close to the return on equity that farmers actually earned in the locality.

The court stated, "A present value discount rate is a function of the riskiness of a project, and the hypothetical project herein is not land development but the sale of farmland over four years." The court observed that there was a low level of risk **because 75% of the property had been leased, providing a source of income to a prospective purchaser**. They applied an absorption discount of 20.396%.

Key Takeaways

- **Court recognized the validity of absorption discounts**
- **Court recognized that the riskiness of the property in question directly affects the discount rate**
    - **Income can impact discount rate**
- **In their analysis, the court reduced the projected cash flows for sales expenses and property taxes. They did not include income being generated by the farms.**
- **Court also allowed discount for Lack of Marketability at the entity level**

Absorption Discounts in Real Estate Valuations

Case Study #1

- Client contacted Stout to perform a discount analysis based on appraisals they'd already commissioned from a local appraiser.
- Estate owned majority of a master planned resort island off the East Coast.
- After review of appraisals provided, we noted several areas of deficiency. The appraiser had concluded to an overall sum value of the properties of approximately $105 million based on poor comp selection, improper methodologies, and an overall lack of understanding of market conditions coming out of the Great Recession on the resort residential market.
- Client contracted us to perform new appraisals along with the absorption discount analysis.
- We concluded to a sum of the individual values of approximately $65 million with a 20% discount, bringing the total value to approximately $53 million.
- After IRS review, our underlying values were accepted without any additional discussion and a 10% absorption discount was offered as acceptable.
- We submitted additional support for the original 20% discount, which was accepted as reasonable.

Absorption Discounts in Real Estate Valuations

Case Study #2

- Stout was retained to perform a review of the valuation of an estate after the IRS rejected the concluded discounts applied to the sum of the individual real property values.
- Portfolio included a total of 120 properties near St Louis, MO including mainly office, retail, and vacant land parcels.
- Original appraiser had concluded to a sum value of the portfolio of approximately $270 million and applied a portfolio discount of nearly 50% based primarily on an article written by Joseph Torzewski, MAI for the Stout Journal in 2010.
- Upon review several deficiencies were noted in the valuations and we were retained to revalue the portfolio and provide a defensible portfolio discount.
- We concluded to a sum value of the underlying assets of approximately $180 million, which was discounted based on a weighted average discount for the underlying properties comprising the portfolio to $146 million (22%).
- We provided a rebuttal letter along with our report explaining the deficiencies in the prior valuations and how those were cured within our analyses.
- The IRS did not challenge our valuations or discount conclusion and did not request any additional support.

Case Study #3

- Stout was retained to perform a valuation of approximately 4,000 acres of raw land in 20 developments throughout the Houston, Texas Metro area for estate tax purposes.
- Properties were being held for future phases of existing developments and were valued as bulk.
- Although all of the properties were in the Houston Metro area, we did a thorough investigation into the demographics and trends that affect each development and concluded to a total sum value for the land of approximately $45 million.
- We completed a detailed demand analysis for the subject land and determined an absorption period based on market conditions at that time.
- We concluded to a 15% discount based on the absorption analysis.
- The IRS did not challenge our work and never requested additional support.

Absorption Discounts in Real Estate Valuations

Case Study #4

- Stout was retained to perform a valuation of 90 retail properties near Dallas, Texas as part of partnership buyout.
- The portfolio included several Class A, net lease assets as well as assets considered “unwanted” by parties to the transaction.
- We performed a detailed valuation of each of the underlying assets, taking into consideration all factors that contribute to the values on an individual basis.
- The total sum value of the individual properties was approximately $880 million, which was discounted 30% for absorption.
- After review by all parties to the transaction, it was agreed our valuations were accurate based on market conditions at that time and underlying property characteristics. Moreover, both parties agreed the 30% discount was reasonable based on the support presented within our report.

Conservation Easements

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What is a Conservation Easement?

- A conservation easement is a voluntary, legal agreement that permanently limits uses of the land in order to protect its conservation values.
- Typically, a landowner voluntarily agrees to sell or donate certain rights associated with their property, often the right to subdivide, mine, or develop.
- All conservation easements must provide public benefits, such as water quality, farm and ranch land preservation, scenic views, wildlife habitat, outdoor recreation, education, and historic preservation.

What is the Benefit of a Conservation Easement?

- Can result in significant tax benefits if it meets the requirements of federal law. It may lower federal income tax, as you can claim the value of the easement as a tax-deductible charitable donation.
- May also lower your state income tax, depending on your state laws.
- Typically lowers the property's value for federal estate tax purposes and may decrease estate tax liability.
- May help heirs avoid being forced to sell off land to pay estate taxes and enable land to stay in the family.
  - A few conservation programs use temporary easements -- but only permanent conservation easements qualify for income and estate tax benefits.

How is the Value of a Conservation Easement Determined?

- The before/after methodology, similar to that used in condemnation
  - Value of the property prior to the easement with no restriction to development other than zoning and use restrictions.
    - Thorough highest and best use and feasibility analyses must be performed to prove value of alternate development.
      - Often, multiple experts are retained
  - Value of the property after the easement with restrictions in place
    - Does placing the easement on your property enhance the value of other properties you own in the market? If so, offset to easement value.

  - Difference between before and after value is value of easement

What are the Potential Pitfalls of an Easement Valuation?

- Many legal aspects need to be understood
  - Content of valuation report
  - Timely filing of appropriate paperwork with the IRS
  - Excessive administrative responsibilities not typical in valuation assignments – must be very organized
- High likelihood of audit
  - The IRS hates conservation easements
  - Particularly cracking down on "Syndicates" which pool investor money into a partnership, purchase properties and put easements on them so that all members can take advantage of tax benefits.
    - Tax avoidance v. Well intended preservation
  - Original property owner (farmer, rancher, etc.) is less likely to get audited as long as valuations are considered reasonable.
- IRS is getting aggressive on imposing penalties on appraisers for faulty or misleading work

Key Takeaways – Conservation Easements

- The appraisal can make or break the case
  - Make sure you are using a “Qualified Appraiser” as detailed in IRS guidelines.
    - Have they performed this type of work before?
    - Have they been through audit?
    - What sort of testimony experience does the appraiser have?
    - Have they generally worked for Taxpayers or IRS, both?
    - Do they have a PTIN #?
  - Make sure appraisal meets the standards of “Qualified Appraisal”
  - Don’t cheap out when hiring an appraiser
  - Make sure appraiser is detail oriented and can provide support for all assumptions.
  - Be certain up front that the appraiser is willing to sign and submit a Declaration of Appraiser

Select Professionals

Biographies

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Accredited Senior Appraiser (ASA)

Practice Areas

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Industry Focus

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Energy & Utilities
Real Estate, Lodging & Leisure

Oliver Warnke is a Director in the Valuation Advisory group. He has over 15 years of experience providing valuations primarily for estate-, gift-, and income-tax requirements, as well as fairness opinions, mergers and acquisitions, financial reporting, and employee stock ownership plans.

Mr. Warnke serves a wide range of industries including oil and gas, beverage distribution, asset management, real estate, manufacturing, construction, and farming. Mr. Warnke also specializes in the valuation of fractional interests in family limited partnerships, private equity funds, and hedge funds.

Prior to joining Stout, Mr. Warnke was a Vice President at HFBE where he participated in financial analysis and valuation of corporate securities and partnership interests of private and closely held companies as well as publicly traded corporations.

Professional Memberships

- Houston Estate and Financial Forum
- Houston Business and Estate Planning Council

Biographies

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Industry Focus

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Energy & Utilities
Real Estate, Lodging & Leisure
Metals & Mining

Joseph L. Torzewski is a Managing Director in the Real Estate practice within the Valuation Advisory group. He has over 18 years of specialized commercial real estate valuation experience covering a broad spectrum of property types and purposes both nationally and internationally. He is responsible for management, client liaison, and appraisal production.

Mr. Torzewski has been qualified as an expert witness and has testified numerous times throughout the U.S. in multiple Federal and District Courts, U.S. Tax Court, and multiple Commissioner's Hearings for a wide range of commercial real estate engagements including property tax appeal, bankruptcy, shareholder dispute, family law, eminent domain, and diminution of value determinations due to environmental contamination and construction defects. In addition, he has been named as the expert on numerous other disputes.

Mr. Torzewski also has extensive experience in the valuation of rural properties, including ranches, farmland, and orchards. He has appraised over two million acres of agricultural land across the U.S.

Mr. Torzewski holds permanent licenses in numerous states and has appraised properties across 47 states and five continents.

Professional Memberships

- Appraisal Institute
- The Great Lakes Chapter of the Appraisal Institute, Past President
- Institute for Professionals in Taxation (IPT)
- American Society of Farm Managers and Rural Appraisers (ASFMRA)
- Head of Stout's Philanthropy Board