Court Case Emphasizes Basic Foundations of Testimony

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Bradley J. Bergquist and Angela Kendrick, et al., Petitioners, Commissioner of Internal Revenue, respondent, 131 T.C. No. 2, United States Tax Court, Filed July 22, 2008.

This tax court case is rich in decisions concerning many different areas of valuation including:

- Going concern vs. liquidation premise of value
- Concept of the valuation date and what was known or knowable
- Proper valuation approaches
- Use of control premium studies for determining discounts for lack of control
- Use of restricted stock studies and IPO studies for determining discounts for lack of marketability
- The use of studies for discounts for non-voting vs. voting stock
- Charitable contributions
- Accuracy-related penalties

In terms of the valuation issues, the IRS was the clear hands-down winner. The facts also appeared to favor the IRS as well as damaging evidence countering the taxpayer's position, particularly as it relates to the premise of value– going concern vs. liquidation.

The tax court picked the Respondent's (IRS) expert's value of $37 per share for voting stock and $35 per share for non-voting stock vs. the petitioner's (taxpayer) expert's value of $401.79 per share. However, while the petitioner lost on the major issue of the premise of value, the rest of the decisions on the other areas seemed to make it easier for the court to opine in favor of the respondent. This was one of those decisions where the result for one side really looked ugly, but when you carefully read the case you see that there was one major issue that, had it gone the other way, could have been equally ugly for the other side. However, that's the way it can go in litigation and this was a big win for the IRS and the IRS's valuation expert.

Background

This case is simply about the value of stock in a medical professional service corporation, University Anesthesiologists, P.C. (UA), donated to a charitable professional service corporation. Petitioners were medical doctors who specialized in anesthesiology in Oregon. The UA provided medical services to patients of the Oregon Health & Science University Hospital (OHSU), a public teaching and research hospital in Portland. Petitioners were employed by the UA on month-to-month contracts. These contracts did not include noncompete or nonsolicitation clauses.

> Consistent with the typical management of medical professional service corporations, at the end of each year UA generally paid bonuses, salaries, and prepaid expenses that offset reported income. UA never declared or paid cash dividends to its stockholders. UA's only significant booked asset was its accounts receivable.

> In 1998 OHSU management formed the OHSU Medical Group (OHSUMG) as a section 501(c)(3) tax-exempt professional service corporation to serve as the single consolidated medical group into which all of the then-extant 30 different medical practice specialty groups whose doctors were affiliated with OHSU would be consolidated.

The doctors were to become employees of OHSUMG and leave their respective separate medical practices and their medical professional service corporations.

> In early 1999 [UA's CEO] attended a conference sponsored by the Medical Group Management Association. During a roundtable discussion at the conference, [UA's CEO] learned that for Federal income tax purposes some doctors throughout the country apparently were claiming substantial charitable contribution deductions relating to donations to academic-affiliated institutions of stock in their medical professional service corporations.

UA's attorney prepared a plan that …

> called for UA stockholders to donate their UA stock to OHSUMG in two stages. Before the consolidation they would donate to OHSUMG their newly created UA nonvoting stock and claim substantial charitable contribution deductions relating thereto. After the consolidation they would donate to OHSUMG their UA voting stock and possibly claim additional charitable contribution deductions relating thereto…Once the consolidation was completed, UA would have no doctors and no patients, and UA would not operate and would continue in existence for a period of time simply to collect accounts receivable outstanding as of the date of the consolidation. It was expected that after the consolidation UA's winding-down expenses would reduce UA's taxable income to zero.
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> On June 6, 2001, UA retained [P Expert] to value the UA stock to be donated. In a letter to [P Expert], the UA attorney described the planned consolidation and wrote that OHSUMG would "be the employer of all of the physicians, including the [UA] anesthesiologists, after the reorganization is completed…On approximately September 8, 2001, upon OHSUMG's request, UA staff began preparing pro forma cashflow projections. OHSUMG requested that the cashflow projections be prepared under the assumption that at the end of 2001 all UA anesthesiologists would move to OHSUMG and that UA would no longer operate. On September 10, 2001, the UA accountant, the UA attorney, and [one of the doctors] met to discuss the planned consolidation and the planned donation of UA stock to OHSUMG. The final decision made at the meeting was that the planned donation by the UA stockholder of their UA stock would go forward on September 14, 2001.
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> OHSUMG's executive management accepted the donation of UA stock as a professional courtesy to the UA stockholders. At the time of donation, OHSUMG's management did not expect to derive any economic benefit from the donated UA stock. OHSUMG management did not expect to receive and in fact did not receive from UA any dividends or distributions.

On October 5, 2001, [P Expert] appraised the donated UA voting and nonvoting stock as of August 31, 2001, at $401.79 per share…

There was a later meeting in 2001 to discuss whether there should be a second donation of stock in UA and the decision was not to proceed with the contribution. On Jan. 1, 2002, there was a consolidation of the various medical groups and doctors into OHSUMG, and the doctors became employees. "After the consolidation, UA no longer operated as a provider of anesthesiology services…"

Also, of all the doctors and medical groups that became part of OHSUMG only the UA doctors donated any pre-consolidation interests in their groups.

TREATMENT OF DONATION

By letter dated January 8, 2002, OHSUMG's president notified [a UA doctor] that on its books OHSUMG would enter a value of zero for donated UA stock that it received…

STOCKHOLDER MEETING

At the January 29, 2002, UA stockholders meeting the UA stockholders discussed how they should report and claim on their 2001 federal income tax returns charitable contribution deductions with respect to the donation of their UA stock....UA's attorney and accountant advised the UA stockholders not to attract respondent's attention by deviating from the amounts reported on the Forms 8283 and not to discuss the donations with respondent if contacted.

At the January 29, 2002, stockholders meeting UA's attorney and accountant further advised the UA stockholders not to show to their own tax advisers the minutes from the UA stockholders meetings or the January 8, 2002, letter from OHSUMG's president. The trial evidence suggests that petitioners complied with this advice and further that petitioners apparently, with respect to the donations, did not consult with any attorney or accountant who was truly independent and not involved with the planned donation of UA stock.

Of the 28 stockholders, 26 filed a charitable contribution deduction on their income tax returns for 2001, based on [P Expert's] value.

IRS AUDIT AND POSITION

The IRS audited the returns of each of the petitioners and UA owners and determined no value for the donated interests as of September 14, 2001 and disallowed the charitable contribution deductions. Before trial and on the basis of an expert appraisal, respondent agreed that the UA stock had a value of $37 per voting share and $35 per nonvoting share and that charitable contribution deductions were allowable to petitioners to that extent.

Subsequent Events

Subsequent events are not considered to fix fair market value, except to the extent that they were reasonably foreseeable at the date of valuation.

> … Thus, courts may consider relevant subsequent events if they are reasonably foreseeable "because they would be foreseeable by a willing buyer and a willing seller, and they therefore would affect the valuation of the property.
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> **Premise of Value and Known or Knowable**
> The dramatic difference between petitioner's experts' and respondent's expert's appraised value for the UA stock stems largely from the experts' respective conclusions as to the proper valuation premise—whether to value UA as a going concern.
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> At trial, in addition to the [P Expert], petitioners presented expert testimony and an expert report from another expert witness who valued the UA stock at $326 per voting share and $323 per nonvoting share.

This was the key issue as, again, all the other issues would be decided dependent in large part on the resolution of the premise of value.

> Petitioners' experts valued UA as of September 14, 2001, as a going concern because they viewed the scheduled January 1, 2002, consolidation of UA into OHSUMG as uncertain.
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> In their expert reports neither of petitioners' experts explain why or how they selected a going concern premise of value, and they conveniently and incredibly make no mention of the scheduled Jan. 1, 2002, consolidation.
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> After careful consideration of the trial testimony and other evidence (including letters, e-mails, minutes of meetings, financial statements, and handwritten notes), we conclude that as of September 14, 2001, UA should not be valued as a going concern. The donation of UA stock was driven by the imminent consolidation of UA (along with the other medical groups) into OHSUMG. On the evidence, it is beyond any reasonable question that petitioners would not have donated their UA stock to OHSUMG had there existed any realistic possibility that the consolidation would not occur by year end 2001 or soon thereafter.

The court opined that it was "highly likely" that the planned January 1, 2002 consolidation would take place and that:

> The evidence does not indicate that UA management or petitioners at any time expressed to anyone that petitioners and other UA anesthesiologists had any reservations about the planned consolidation or might decline to participate in the consolidation.
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> On the facts before us, a reasonably informed and willing buyer or seller certainly would have known about and would have taken into account the fact that as of September 14, 2001, there was an extremely high likelihood that by early 2002 UA would no longer be an operating entity.

No Reliance on Taxpayer's Expert Analysis and Report
The court opined that [P Expert] should not have valued UA under the premise of value of going concern and, as such, decided not to rely upon their report in determining the value of the donated UA interests.

Hypothetical Willing Buyer and Seller

> Petitioners argue that regardless of the certainty of the planned consolidation, as of Sept. 14, 2001, a hypothetical willing buyer should be treated as not knowing what everyone else in fact knew of and anticipated (i.e., the planned and imminent consolidation), and a hypothetical willing buyer would make an offer to buy UA stock only on the condition that UA anesthesiologists sign long-term employment contracts and noncompete agreements with UA. While the willing buyer and the willing seller are hypothetical persons who are "presumed to be dedicated to achieving the maximum economic advantage"…" petitioners' experts fail to take into account that the economic "advantage must be achieved in the context of market conditions"… and that for valuation purposes the "positing of transactions which are unlikely" is frowned upon…
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> After UA's incorporation, UA employment agreements were month-to-month and did not contain noncompete agreements. Given the clear movement and momentum to consolidate and the UA history of no long-term employment agreements, we find it most improbable and highly unlikely that the UA anesthesiologists would have been willing to enter into any such contracts, and any hypothetical buyer must be deemed to know of that fact during the course of his or her hypothetical negotiations to buy UA.
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> **IRS' Expert's Use of the Asset Approach to Value**
> Respondent's expert valued UA as an assemblage of assets because, in his opinion, it was known or knowable on September 14, 2001, that on January 1, 2002, UA very likely would no longer be operating.

As such he dismissed the income and market approaches to value. Respondent's [R Expert] valued the equity of UA through the asset approach and valued UA's assets net of liabilities. As often done, UA's balance sheet was the starting point for the analysis where book values were adjusted to fair market values. The net asset value was $1,458,387 before discounts.

Discounts for Lack of Control, Marketability and Non-Voting
[R Expert] applied a discount for lack of control (DLOC) of 35 percent and a discount for lack of marketability (DLOM) of 45 percent as follows:

$1,458,387	Pre-discount value
$ 510,435	Less: DLOC of 35%
$ 947,952	
$ 426,578	Less: DLOM of 45%
$ 521,373	Discounted equity fair market value (Rounding difference)
14,000	Divided by: UA shares outstanding
$ 37	Voting per share value rounded
$ 2	Less: Discount for non-voting stock of 5% (rounded)
$ 35	Non-voting per share value (rounded)

Respondent's expert derived the 35 percent lack of control discount from a study of mergers and acquisitions of publicly traded companies in the health care industry which compared the difference in an entity's share price just before an announced acquisition to the price paid per share by the acquiring business. The study demonstrated that in 1999 and 2000 share prices of stock in health care companies before a merger traded at an average discount of approximately 35 percent relative to their postacquisition share prices—a discount respondent's expert attributes to lack of control.

Respondent's expert derived his 45 percent lack of marketability discount from a study of restricted stock health care companies and from a study of initial public offerings (IPOs). The restricted stock study compared prices of freely traded stock in public companies with those of restricted but otherwise similar stock. The study demonstrated that from 1983 to 2000 restricted stock of health care companies traded at a mean and median discount of approximately 39 percent relative to their unrestricted counterparts—a discount respondent's expert attributed to lack of marketability. The IPO study compared the private-market price of stock sold before a company went public with the public-market price obtained for the stock shortly after the IPO. The study demonstrated that from 1975 to 1997 pre-IPO stock traded at mean and median discounts of approximately 44 and 46 percent, respectively, relative to the post-IPO stock prices—a discount respondent's expert attributed to lack of marketability. Respondent's expert then divided the discounted UA equity value of $521,373 by 14,000 (the number of UA stock shares outstanding) to arrive at a per-share value of $37 for voting UA stock. On the basis of several studies, respondent's expert then applied an additional 5 percent discount to account for the lack of voting rights of the nonvoting UA stock, resulting in a value of $35 per share for the nonvoting UA stock.

Court's Conclusion of Value

The court selected the IRS's expert's opinion of value of $37 and $35 per share for voting and non-voting stock, respectively, and allowed only those values for determining the charitable contributions. This was vastly different from the $401.79 per share value of the taxpayer's expert.

Penalties

> Respondent argues that petitioners did not act in good faith and did not make a good faith investigation of the value of the donated UA stock. We agree with respondent. From the beginning, the plan to donate UA stock on the brink of the January 1, 2002, consolidation was presented to UA stockholders as a way to reap a potential "150K" windfall. Petitioners are well educated and surely were cognizant of the imprudence of valuing the UA stock at such a high value given the likelihood that by 2002 UA would no longer be an operating entity.
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> Petitioners were aware of the January 8, 2002, letter from OHSUMG's president stating that OHSUMG had decided to book the donated stock at zero; and while the value of property in the hands of the donee is generally not determinative of FMV…petitioners should have at least questioned the difference in reporting by OHSUMG and by themselves. Furthermore, the fact that petitioners were advised not to bring their own tax advisers to the January 29, 2002, UA stockholders meeting and were directed to withhold information from their own tax advisers should have put petitioners on notice as to the inaccuracy of the claimed donations.
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> We note that under section 1.6664-4(c)(1)(ii), Income Tax Regs., a taxpayer will not be considered to have reasonably relied in good faith on advice from an adviser if the advice is based on an "unreasonable" assumption the "taxpayer knows, or has reason to know, is unlikely to be true". This would appear to be particularly applicable where no adviser is sought out who is truly independent of the planned transaction. We conclude that petitioners did not make a good faith investigation as to the value of their donated UA stock and did not act in good faith…
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> In view of the evidence before us, we conclude that petitioners were negligent and that petitioners' underpayments were attributable to their negligence. We hold that to the extent petitioners are not liable for the 40-percent penalty under section 6662(h) (because their underpayments do not exceed $5,000 under the Rule 155 calculation), petitioners are liable for the 20-percent penalty under section 6662(b)(1).

Conclusion

As you can see things starting falling apart for the taxpayer based on two things: (1) bad facts and support and (2) the court's determination, based in large part on those bad facts, that the asset approach based on liquidation values was the appropriate way to value the equity vs. going concern values based on other approaches to values. The premise of value is a "foundation" of any valuation analysis, and this case emphasizes how important that foundation is.