Business Valuation Review

Back to the Future, Part II

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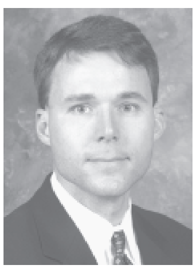
> *The future is ever a misted landscape,*
> *no man foreknows it.*
> *-Robinson Jeffers*

Introduction. Six years ago, this journal published my article, Back to the Future. In that article, I took the position that the use of subsequent information in a valuation report (i.e., "time traveling" into the future to consider data not known at the valuation date) is clear error. As support for my position, I cited the definition of fair market value, Revenue Ruling 59-60, business valuation standards as promulgated by the major business valuation organizations, case law, and common sense. Since that time, time travelers have continued to ply their wares with increasing frequency and volume albeit without a commensurate level of logic or reason. In this sequel, I will look at new developments in the time travel issue that have occurred in the interim, including a key change in one set of business valuation standards.



Michael Paschall

I will also attempt a more thorough legal analysis than currently exists in some textbooks and give particular attention to an important distinction in the case law commonly cited by time travelers. Because time travelers operate in direct opposition to the definition of fair market value, Revenue Ruling 59-60, business valuation standards as promulgated by the major business valuation organizations, and common sense, the only safe harbor for time travelers is a very slender thread of lower-court decisions that allow time travel. As discussed in this article, the security offered to time travelers by this "safe harbor" is highly suspect and my conclusion here is the same as before: time travel is best left to books and the movies and has no place in business valuation.

Rules and Definitions. There have been no changes to the commonly-accepted definition of fair market value and Revenue Ruling 59-60 since 2002, therefore, it is not necessary to revisit these items, both of which clearly prohibit the consideration of subsequent events in business valuation.

Business Valuation Standards. The four major credentialing bodies in business valuations in the United States include the American Society of Appraisers (ASA), the American Institute of Certified Public Accountants (AICPA), the National Association of Certified Valuation Analysts (NACVA), and the Institute of Business Appraisers (IBA). These bodies occasionally update their business valuation standards. Since 2002, there have been no changes to the ASA, or IBA standards as concerns their prohibition of the consideration of subsequent events. The NACVA standards are silent as to the subsequent events issue, however, the NACVA standards encourage the consideration of other business valuation guidelines by the IRS and the Uniform Standards of Professional Appraisal Practice (USPAP), both of which prohibit time travel.

AICPA Strengthens its Prohibition. In 2002, the AICPA issued a proposed draft of its Statement on Standards for Valuation Services. In this proposed draft, the AICPA addressed the subsequent events issue as follows:

> "The valuation date is the specific date at which the valuation analyst is to establish the value of the business interest. In performing the valuation, the valuation

(Continued on Page 2)

> analyst considers circumstances at the valuation date and events occurring up to the valuation date. Events that occur after the valuation date should not normally be taken into account in supporting the business valuation conclusion unless they were known, knowable or foreseeable."

After allowing for five years of comment, the AICPA finalized these business valuation standards in 2007. In Section 43 of its Statement on Standards for Valuation Services, the AICPA states:

> "The valuation date is the specific date at which the valuation analyst estimates the value of the subject interest and concludes on his or her estimation of value. Generally, the valuation analyst should consider only circumstances existing at the valuation date and events occurring up to the valuation date. An event that could affect the value may occur subsequent to the valuation date; such an occurrence is referred to as a subsequent event. **Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or conditions. Moreover, the valuation report would typically not include a discussion of those events or conditions because a valuation is performed as of a point in time—the valuation date—and the events described in this subparagraph, occurring subsequent to that date, are not relevant to the value determined as of that date.** In situations in which a valuation is meaningful to the intended user beyond the valuation date, the events may be of such nature and significance as to warrant disclosure (at the option of the valuation analyst) in a separate section of the report in order to keep users informed (paragraphs 52(p), 71(r), and 74). **Such disclosure should clearly indicate that information regarding the events is provided for informational purposes only and does not affect the determination of value as of the specified valuation date" (emphasis added).**

As seen above, the 2007 final version of the AICPA standards is considerably longer and more specific than the section in the 2002 proposed draft. Both versions limit appraisers to consider circumstances leading up to and including the valuation date. The 2002 draft allows consideration of subsequent events that were known, knowable, or foreseeable. The 2007 final standards allows the consideration of known or knowable subsequent events, however, foreseeable subsequent events are no longer eligible for consideration. The 2007 final standards also have clear prohibitions against the consideration of subsequent events, as noted in the bold type above. In comparing the 2002 proposed draft to the 2007 final version of the AICPA standards, it is clear that the AICPA felt that its treatment of subsequent events in the 2002 proposed draft was not strong enough and, as a result, a much stronger section on this issue was needed.

Textbooks. The issue of subsequent events continues to gain increasing attention from business valuation authors. In Business Valuation and Taxes (John Wiley & Sons, Inc., 2005), co-authors David Laro and Shannon Pratt dedicate an entire chapter to subsequent events. Likewise, in Standards of Value: Theory and Applications (John Wiley & Sons, Inc., 2007), co-authors Jay Fishman, Shannon Pratt, and William Morrison discuss the subsequent events issue in the context of the "reasonable knowledge of relevant facts" component of the definition of fair market value.

A Circus Tent. In Business Valuation and Taxes, co-authors Judge Laro (U.S. Tax Court) and Dr. Pratt conclude that "events subsequent to the valuation date should not be taken into consideration when valuing business interests, unless at least one of these five conditions is true:

1. The subsequent events were reasonably foreseeable as of the valuation date.

2. The subsequent events are relevant to the valuation, and appropriate adjustments are made to account for the differences between the valuation

(Continued on Page 3)

date and the date of such subsequent events.

3. The subsequent events are not used to arrive at the valuation, but to confirm the valuation already concluded.

4. The subsequent events relate to property that is comparable to the property being valued, and the subsequent events are probative of value.

5. Subsequent events may be evidence of value rather than as something that affects value."

In Estate of Noble v. Commissioner (T.C. Memo 2005-2), Judge Laro elaborated on the above conditions as follows:

> "An event occurring after a valuation date may affect the fair market value of property as of the valuation date if the event was reasonably foreseeable as of that earlier date…An event occurring after a valuation date, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller for the subject property as of the valuation date…Unforeseeable subsequent events which fall within this latter category include evidence, such as we have here, 'of actual sales prices received for property after the date [in question], so long as the sale occurred within a reasonable time…and no intervening events drastically changed the value of the property.'"

Based on the conditions above, there is virtually no situation where the consideration of a subsequent event could not be justified. According to the Laro/Pratt book, the doors through which a subsequent event can enter a valuation are numerous:

1. Reasonably foreseeable.
2. Unforeseeable but relevant to the value.
3. Unforeseeable but confirms the value.
4. Unforeseeable but probative of value.
5. Unforeseeable but evidence of value.

Furthermore, according to the Laro/Pratt book, only one of these conditions must be met for the subsequent event to enter. This is a circus tent so vast and expansive that nearly any subsequent event can come in. In fact, my above analogy of doors through which a subsequent event may enter is not accurate. In reality, there are no doors to this tent and subsequent events may enter at will and with virtually no opposition. In effect, the above "conditions" are really window-dressing. It would have the same effect for the Laro/Pratt book to state that any and all subsequent events are allowed.

Rain or Shine? It is Monday. I want to have a picnic this Saturday and need to reserve a spot at the park, invite my friends, start buying food and drinks, etc. I utilize the Laro/Pratt analysis as to whether I should go ahead with these plans:

1. Is it reasonably foreseeable that it will rain? Well, it certainly could rain but I don't know for sure. While meteorological forecasting is increasingly advanced, my picnic is five days out and too far into the future to know with complete certainty.

2. Is rain relevant to my desire to have a picnic? Yes. If I know it will rain, I will not plan a picnic.

3. Would rain confirm the fact that I would otherwise not plan a picnic? Yes.

4. Is rain probative of the fact that I would not have a picnic on Saturday? Yes.

5. Would the existence of rain be evidence that I would not have a picnic on Saturday? Yes.

(Continued on Page 4)

So what do I do? I go ahead and plan the picnic and take the risk of rain. Maybe I win this bet and maybe I don't. I do not, however, have the benefit of time traveling to Saturday, checking the weather in person, and then time traveling back to Monday to begin planning my picnic. Similarly, buyers and sellers transact on Monday without knowing whether it will "rain" on Saturday. They can guess at the weather but they do not know with certainty. In the Laro/Pratt universe, however, Saturday's weather is known with 100% certainty on Monday and plans are made or cancelled accordingly.

The New Math. In their attempt to assist business appraisers in allowing subsequent events to change the value as of the valuation date, the Laro/Pratt book offers the following formula as a starting point:

"Value at valuation date

\+ Inflation

+/- Industry changes, or changes in expectations regarding industry

+/- Changes in business component results if relevant in time and type

+/- Societal changes, such as changes in technology, macroeconomics, or tax laws

+/- The actual occurrence (or lack thereof) of an event included (excluded) from original valuation, if relevant in time and type

+/- The occurrence or nonoccurrence of any other events or facts that an arm's-length buyer could have reasonably foreseen had she purchased the business in the year of valuation

= Adjusted valuation"

Got all that? Although the Laro/Pratt book cautions that this formula is just a "starting point," it is hard to imagine a greater degree of subjectivity than is seen above. Furthermore, the only objective variable in the above formula (inflation) has been shown in a number of studies to have a minimal or even inverse relationship to changes in the value of a business (i.e., company values increase more during periods of low inflation and less during periods of high inflation, a completely reasonable expectation and exactly the opposite of what the above formula suggests). Therefore, even the inflation component in the above formula is suspect.

Legal Analysis. The Laro/Pratt book cites a number of cases in the course of its analysis of the subsequent events issue. Similarly, in the Fishman/Pratt/Morrison Standards of Value: Theory and Applications, the co-authors also cite a number of cases, primarily via the inclusion of a table of cases compiled by Michael Mard of the Financial Valuation Group. Mr. Mard's table includes 31 cases at all federal levels and ranging from 1929 to 2005. A breakdown of the 31 cases indicates two U.S. Supreme Court cites (although only one case, as is explained below) and six U.S. Court of Appeals cases. The remaining 23 cases are at lower federal levels including U.S. District Court, U.S. Tax Court, and U.S. Claims Court. We will examine the cases selected by Mr. Mard from the "bottom-up" in the following sections.

Lower Court Cases. There are a number of cases at the lower federal levels (primarily U.S. Tax Court) that allow time travel. The gold-standard case for time travelers is probably Cidulka (T.C. Memo 1996-149) as that case allowed for time travel of almost four years into the future to capture a subsequent transaction. In addition to the considerable temporal range of the Cidulka time machine, conditions between the valuation date and the time of the subsequent event were radically different with a stock market that had almost doubled and interest rates nearly half their level as of the valuation date. This did not matter to the Cidulka court which held that the transactions four years into the future had relevance as concerned the value at the valuation date. Cidulka is a prime example of the elasticity of the term relevance and its ability to be stretched and contorted to fit virtually any subsequent event.

Time travelers need to be aware, however, that there also are a significant number of cases at the lower federal levels that do **not** allow time

(Continued on Page 5)

travel. Before venturing into the future, the prospective time traveler will want to take care to avoid the verbal spanking given by the Tax Court to a business appraiser who tried but failed to go only 67 days into the future in Mueller (T.C. Memo 1992-284):

> "Respondent's expert's report and testimony were result-oriented and biased, substantially diminishing their weight."
>
> "We are convinced [the expert] made erroneous assumptions at nearly every step of this part of its analysis."
>
> "In effect, respondent asks us to average two unreasonable assumptions and hope that we reach a reasonable result. This we decline to do."
>
> "We conclude that [the expert's] 'discounted effective merger price' methodology is flawed…because it relies on information (the exact day the deal would close) that could not have been known on the valuation date."
>
> "Having found [the expert's] analysis to be materially flawed…"
>
> "We believe that [the expert's] report was result-oriented and that this was reflected in [the expert's] testimony. As a result, [the expert's] report and testimony lacked…objectivity."
>
> "The conflict arose when [the expert] strayed from the standard of objectivity and 'cast aside his scholar's mantle and became a shill' for respondent."

A debate on time travel at the lower federal court level is futile as opponents would trade cases ad infinitum. Fortunately, the U.S. federal judicial system has higher courts. Even more fortunate is the logic, rationale, and consistency with accepted business valuation standards of those higher courts as concerns the issue of time travel where the valuation of closely-held businesses are concerned.

U.S. Court of Appeals Cases. Next up are the six Appellate Court cases listed in Mr. Mard's table. These cases are examined in chronological order, as follows:

Fitts v. Commissioner, 237 F.2d 729 (8th Cir. 1956). In Fitts, the decedent died on February 10, 1949. The estate valued the closely-held stock at $150 per share and the IRS countered with a $600 per share value. At the lower level (Fitts v. Commissioner, T.C. Memo 1955-269), the Tax Court opinion noted seven transactions in the company's stock. Five of these transactions occurred from three to seven years prior to the date of death. The other two transactions occurred five and six years after the date of death. The Tax Court ultimately decided that the fair market value of the stock was $375 per share.

As anyone who is vaguely familiar with business valuation knows, there are three major valuation methodologies: the income approach, the market approach, and the cost approach. The Fitts case is an excellent example of a fourth valuation methodology: the judicial approach. The judicial approach has the distinct benefit of being the easiest method to understand as it consists of adding the two opposing values together and dividing their sum by two. Or, in the case of Fitts: $600 + $150 = $750 ÷ 2 = $375. Fortunately, the popularity of the judicial approach has declined over time and its use has become less and less frequent. In 1955, however, the judicial approach was alive and well.

The Tax Court in Fitts supported its opinion of a value of $375 per share as follows:

> "Each case involving questions as to the value of the stock in a closely held corporation must rest on its own facts. Based on all pertinent factors shown by the stipulated facts and the oral testimony including the history of the corporation, its management, its dividends and earnings, the book value of its shares, the prices of stock in corporations characterized by the witnesses as 'comparable' to the corporation here involved, the size of the block of stock involved, and the fact that the stock of the Fitts Dry Goods Company was closely held and there were few sales that can be taken as an accurate criterion of its value, we have applied our best judgment and find that the

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> stock had a fair market value on the critical date, of $375 per share."

There is no mention of the consideration of subsequent events by the Tax Court other than the mysterious "there were few sales that can be taken as an accurate criterion of its value" statement. Does this statement mean that the seven noted transactions (five prior to the valuation date and two subsequent to the valuation date) were considered or not? It is impossible to tell. Fortunately, the estate in Fitts appealed to the U.S. Court of Appeals for the Eighth Circuit.

The Appellate Court started with a recitation of the facts and then noted the definition of fair market value as follows:

> "Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell. Treasury Regulations 105, § 81.10."

One interesting aspect about this definition is that it is pre-Revenue Ruling 59-60. In Section 2.02 of Revenue Ruling 59-60 (which was promulgated three years after the Fitts case), we see the familiar definition of fair market value which is basically the same definition noted by the Fitts court above with the addition of the key requirement that **both parties have reasonable knowledge of the relevant facts**. While no such requirement was in place prior to 1959, reasonable knowledge of the relevant facts (which cannot include future events that have not yet happened) apparently was an important enough requirement to be included in the new definition of fair market value.

Fortunately, the Appellate Court in Fitts clarifies the mystery surrounding the Tax Court's vague comments on the use of subsequent events:

> "A few small sales of Fitts Company stock were made between members of the Fitts family at prices ranging from $110 to $128 per share. The prior sales occurred three years or more before the basic date and the subsequent sales were five years after the basic date. Such sales were too remote to require the Tax Court legally to regard them as establishing value upon the basic date."

In other words, the Tax Court in Fitts did not consider any of the sales of stock that occurred subsequent to the valuation date. Therefore, no time travel occurred in Fitts at either the Tax Court or Appellate Court levels.

The Appellate Court in Fitts makes one additional decision concerning subsequent events. Another shareholder in Fitts Dry Goods Company died on September 9, 1949, or seven months after the date of death of the decedent in Fitts. As concerned the second estate, the IRS accepted a value of $200 per share for the closely-held stock, or almost one-half of the $375 per share value held by the Fitts courts. The estate in Fitts argued that the $200 value should also apply to its stock, however, the Appellate Court refused to consider the $200 value that was allowed by the IRS seven months later.

Now consider Mr. Mard's summary on Fitts: "It was determined in this case that actual sales made in reasonable amounts in arm's-length transactions, in the normal course of business, within a reasonable time frame after or before the date of value, are the best criteria of market value." This is a completely misleading summary of the events in Fitts. At no time in Fitts were any actual sales, prior or subsequent, used as the best criteria of market value. In fact, both of the subsequent events noted in Fitts (the two trades of stock occurring five and six years after the valuation date as well as the IRS acceptance of a different value on another estate seven months after the valuation date) were specifically excluded. **Any suggestion or implication that Fitts is a pro-time travel case is completely contrary to the facts and holding in that case.**

Tripp v. Commissioner, 337 F.2d 432 (7th Cir. 1964). Chester Tripp purchased five pieces of jewelry in April 1953 for a total purchase price of $15,000. In 1955, Mr. Tripp donated this jewelry to the University of Chicago and claimed a charitable deduction of $42,500. Although Mr. Tripp offered the testimony of an expert witness, the Tax Court did not find his testimony compelling and held that the allowable charitable deduction for Mr. Tripp

(Continued on Page 7)

was his 1953 purchase price of $15,000. The Court of Appeals upheld the Tax Court's decision.

Mr. Mard's summary on Tripp is as follows: "In this case, the court chose to use the purchase price of an antique jewelry collection (given to charity two and one-half years after the date of purchase) to establish value because it found 'no substantial evidence that any situation arose or development occurred in the interim which increased the value of the collection.'"

While the above summary on Tripp is accurate, a closer reading of this summary (as well as the actual case) shows **it has absolutely nothing to do with subsequent events or time travel**. The chronological order in Tripp was:

1953: purchase of jewelry.
1955: gift of jewelry.

The prior purchase price was used as the value of the gift 2.5 years later. Because the date of the gift is the valuation date, no subsequent events were used or considered in Tripp. The value used for the gift tax return was a purchase that had occurred 2.5 years **in the past**, not in the future. Mr. Mard's inclusion of the Tripp case in his table is at the least baffling and at the worst potentially misleading should a careless reader see the 2.5 year time lapse and believe that the Tripp court allowed time travel that far into the future. In fact, the exact opposite occurred as the Tripp court went 2.5 years into the past, a perfectly acceptable practice as the prior sale was certainly known or knowable as of the date of gift.

Foltz v. U.S. News and World Report, Inc., 760 F.2d 1300 (D.C. Cir 1985). In U.S. News (which actually includes several decisions at the district and appellate court levels), the issue involved the annual valuation of closely-held stock for Employee Stock Ownership Plan (ESOP) purposes. Retired ESOP participants sold their closely-held stock back to the ESOP at prices that gradually increased from $65 per share in 1969 to $152 per share in 1980. In 1981, the company announced a development plan on real estate owned by the company that had appreciated significantly and rapidly in recent years. As a result, the appraised value of company stock increased from $152 per share in 1980 to $470 per share in 1981. In 1984, the company agreed to be acquired for $2,842 per share. Naturally, those retiring shareholders who had sold their company stock in 1980 at $152 per share were somewhat upset to have missed out on the $470 per share value just one year later, not to mention the $2,842 per share value just three years later. Although there were a number of important issues in the case, the key issue was whether the business appraiser should have considered in his value events that occurred (in 1981 and 1984) after the annual valuation dates ranging from 1969 to 1980.

Mr. Mard's summary on U.S. News and World Report is accurate: "The court noted: 'The approach to be used is not retrospective, but prospective. One must look at the situation as of the time that each employee separated from the company. Therefore, the appropriate inquiry is whether the company was properly valued during the class period, not whether former employees became eligible for a greater share of benefits upon the contingency of a subsequent sale." In other words, the consideration of subsequent events was not allowed.

Interestingly, in the October 2005 issue of Shannon Pratt's Business Valuation Update, the lead article is a reflection by Dr. Pratt on the ten-year anniversary of the publication of the Update. In this interview, Dr. Pratt is asked what he believes to be "the most significant court case of which business appraisers should be most aware." His answer: "Foltz v. U.S. News and World Report, an 83-page opinion which addresses more valuation issues than any other case." As noted above, the key issue in this case was whether a subsequent event should be considered in the valuation of closely-held company stock. As seen above, the U.S. Court of Appeals clearly ruled that subsequent events cannot be considered.

Gross v. Commissioner, 272 F.3d 333 (6th Cir 2001). Although Gross is far better-known as the first S Corp "tax-affecting" case, a peripheral issue in the case involves the use of data that was not known as of the valuation date. In Gross, one of the taxpayer's objections was that the marketability discount data used by the government's expert

(Continued on Page 8)

included 79 (of a total of 157) transactions that had occurred after the valuation date. The Tax Court allowed the use of this subsequent data and the Appellate Court upheld the Tax Court. Despite the approval by both courts of the use of subsequent data, the government's expert realized his error and went back and recalculated his marketability discount data after removing the post-date transactions.

As with any holding, it is always beneficial to read the entire opinion to understand the Court's rationale for its decision. The Gross court's support for its consideration of subsequent events is bizarre at best:

1. The Gross court first cites Morris v. Commissioner, 761 F.2d 1195 (6th Cir. 1985): "subsequent events may only be considered if they were reasonably known on the date of valuation and also that such could be reasonably contemplated on that date." In Morris, the Appellate Court ruled that the Tax Court did not abuse its discretion in refusing to permit introduction of evidence concerning the state of development on decedent's property after the valuation date. In other words, the Morris court did not allow subsequent events. The fact that the Gross court first cites a case holding the opposite position is not unusual as many opinions cite both sides of an argument before selecting one particular position.

2. As expected, the Gross court then cites Estate of Gilford, 88 T.C. 38 (1987) as support that "the tax court has considered relevant subsequent events that took place less than one year from the valuation date due to its relevance." **The only problem with citing Gilford as support for the consideration of subsequent events is that the Gilford court held that the consideration of subsequent events is not allowed.**

   The decedent in Gilford died unexpectedly on November 17, 1979, owning a 22.9% interest in a company whose stock was actively traded in the over-the-counter market. The decedent was Chairman and CEO of the company. On November 27, 1979, the board of directors met and decided not to solicit any offers for the company. On January 2, 1980, the board hired an investment bank to investigate financial alternatives. During March 1980, the board considered selling the company and on May 30, 1980, the company was sold for $24 per share. The estate return used a value of $7.35 per share based on the actual trading price of the stock less a discount for blockage and the fact that the stock was restricted. The IRS claimed a value of $24 per share based on the May 1980 transaction, however, the Tax Court found no evidence that the subsequent transaction was foreseeable and held for the taxpayer:

> "In general, property is valued as of the valuation date on the basis of market conditions and fact available on that date without regard to hindsight. However, we have held that postmortem events can be considered by the Court for the 'limited purpose' of establishing what the willing buyer and seller's expectations were on the valuation date and whether these expectations were 'reasonable and intelligent.' The rule that has developed, and which we accept, is that subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable at the date of valuation."
>
> "On November 17, 1979, there was no reasonable or intelligent expectation that a merger of Gilford or a sale of petitioner's block of stock between a willing buyer and a willing seller for $24 per share would take place. The valuation of stock by hindsight analysis is especially inappropriate where there is an active market. To rule for respondent in this case would reject the few strands of clarity in this murky world of valuation. This we refuse to do."

(Continued on Page 9)

Gilford, in other words, **did not allow the consideration of the subsequent event as it was not reasonably foreseeable**.

Mr. Mard's summary on Gross is as follows: "The IRS expert utilized pre- and postvaluation date transactions to determine an appropriate lack of marketability discount. The Tax Court found that reliance on such figures was appropriate because they demonstrated more accurately than the flawed earlier studies what willing buyers and willing sellers were actually doing at the time of valuation."

While Mr. Mard's summary on Gross is accurate, it fails to drill down to examine the rationale for the decision. As seen above, the Gross court cites two cases (Morris and Gilford), **both of which did not allow subsequent events**, as support for its consideration of subsequent events.

Estate of McMorris v. Commissioner, 243 F.3d 1254 (10th Cir. 2001) and **Estate of O'Neal v. United States, 258 F.3d 1265 (11th Cir. 2001).** The McMorris and O'Neal cases were not valuation cases per se, but dealt rather with the deductibility of claims against the estate that were later impacted by subsequent events. This important distinction is discussed in more detail later in this article. Mr. Mard's summary on McMorris is as follows: "The Appeals Court ruled that the estate tax deduction for the decedent's income tax liabilities should not be reduced by the amount of an unexpected income tax refund that the estate received after the date of death (i.e., after the valuation date)." Mr. Mard's summary on O'Neal is as follows: "The Appeals Court ruled that the deduction (for claims against the estate) must be valued as of the date of Mrs. O'Neal's death. All events that have occurred after her death that may alter the value of the estate must be disregarded." In other words, in both cases, the consideration of subsequent events was not allowed.

Summary of Appellate Court Cases. As seen above, the holdings in the six U.S. Court of Appeals cases cited in Mr. Mard's table can be summarized as follows:

1. Fitts (Eighth Circuit, 1956). The consideration of subsequent events was not allowed. The consideration of actual sales of stock after the valuation date as well as an estate value accepted by the IRS seven months after the valuation date was not allowed.

2. Tripp (Seventh Circuit, 1964). Subsequent events were not evident or even contemplated in this case. The court used a value as of 2.5 years prior to the valuation date.

3. U.S. News and World Report (D.C. Circuit, 1985). The consideration of subsequent events was not allowed.

4. Gross (Sixth Circuit, 2001). The consideration of subsequent events was allowed based on the rationale of two cases that did **not** allow the consideration of subsequent events, including another U.S. Court of Appeals case, Morris (Sixth Circuit 1985).

5. McMorris (Tenth Circuit, 2001). The consideration of subsequent events was not allowed.

6. O'Neal (Eleventh Circuit, 2001). The consideration of subsequent events was not allowed.

As seen above, there are a total of seven U.S. Court of Appeals cases (including Morris), in Mr. Mard's table. Six of these cases clearly prohibited time travel. The seventh case (Gross) allowed time travel by basing its rationale on two cases that did not allow time travel.

Supreme Court Cases. Mr. Mard cites just two United States Supreme Court cases in his summary, however, as discussed below, one of Mr. Mard's Supreme Court cites was never a case.

Ithaca Trust v. U.S., 279 U.S. 151 (1929). The decedent in Ithaca Trust died on June 15, 1921, and

(Continued on Page 10)

left the residue of his estate to his wife for the duration of her life. Upon his wife's death, the remainder of the estate went to various charities. The estate was eligible to deduct a certain amount for the gifts made to charity, based on the life expectancy of the wife. When the wife died unexpectedly six months after the decedent's date of death, the value of the gifts to charity became much larger and the estate attempted to take a larger deduction for those gifts. The United States Supreme Court held that the known fact of the wife's unexpected death six months later was irrelevant and the allowable deduction for the estate must be based on the wife's expected mortality as of the date of death. Justice Oliver Wendell Holmes delivered the opinion of the Court:

> "The first impression is that it is absurd to resort to statistical probabilities when you know the fact. But this is due to inaccurate thinking. [T]he value of the thing to be taxed must be estimated as of the time when the act is done. But the value of property at a given time depends upon the relative intensity of the social desire for it at that time, expressed in the money that it would bring in the market. Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out false than when it comes out true. Tempting as it is to correct uncertain probabilities by the now certain fact, we are of opinion that it cannot be done, but that the value of the wife's life interest must be estimated by the mortality tables."

Justice Holmes' holding in Ithaca Trust is cited in numerous later cases for the proposition that it is inappropriate to consider subsequent data simply because that data was not available to a willing buyer and willing seller as of the valuation date. The logic of Justice Holmes is sound: "The value of the thing to be taxed must be estimated as of the time when the act is done. The value is no less real at that time if later the prophecy turns out false than when it comes out true." This is true even when the result is unfavorable for the taxpayer, as in Ithaca Trust.

Mr. Mard's summary on Ithaca Trust is as follows: "The value of the thing to be taxed must be estimated as of the time when the act is done. Like all values, as the world is used by the law, it depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out false than when it comes true." This is an accurate summary of the case. Ithaca Trust is nearly 80 years old and has never been overturned. The vote in the case was 9-0. In refusing to allow time travel in its 1999 Estate of Algerine Smith decision, the Fifth Circuit noted:

> "We note in passing that since Ithaca Trust, Congress has thrice reenacted the entire Internal Revenue Code and has made countless other modifications to the statute, but has never seen fit to overrule Ithaca Trust legislatively. We decline the Commissioner's invitation to rewrite the law ourselves."

Unfortunately, other courts have seen fit to rewrite the law on this issue.

Estate of David Smith v. Commissioner, 57 T.C. 650 (1972), affirmed, 510 F.2d 479 (2nd Cir. 1975), cert. denied, Lowe v. Commissioner, 423 U.S. 827 (1975). The decedent, David Smith, died on May 23, 1965. At the time of his death, Mr. Smith, a sculptor, owned 425 pieces of sculpture. There were two issues in the case: (1) the value of the sculptures at Mr. Smith's date of death, and (2) the deductibility of sales commissions related to the sale of sculptures after the date of death as expenses of the Estate.

As to the valuation of the sculptures, the Tax Court stated:

> "We have taken into account certain other elements involved in the valuation process as they existed at the moment of death. These include…the prices at which sales were made during the period immediately preceding and following death."

Thus we see the Tax Court considering subsequent events (i.e., sales after death). As discussed above, this is not an unfamiliar position of the Tax Court as

(Continued on Page 11)

there are a number of cases that consider subsequent events along with a number of cases that do not consider subsequent events. In supporting its position for considering subsequent events, the Tax Court cited the Fitts case summarized above. As seen above, however, there was no time travel in Fitts.

The second issue in the Smith case at the Tax Court level was the deductibility of expenses incurred by the Estate in the form of commissions paid to a broker for the sale of some of Mr. Smith's sculptures. Again we see the distinction between the valuation of an **asset of the estate** versus the determination of a **claim against the estate**. Following the date of death, Mr. Smith's estate paid about $1.6 million in commissions related to the sale of his sculptures. The Estate attempted to reduce the taxable estate by this amount, however, the Tax Court refused to allow this, instead allowing a smaller amount of commissions as deductible. The Tax Court stated:

> "The regulations appear to be directed toward safeguarding the integrity of the estate tax by making certain that administration expenses which are properly deductible will normally be limited to those which could be anticipated as being necessarily incurred and paid during the period of administration. To allow the commissions to the extent claimed by petitioner herein would seriously undermine the achievement of that sound objective. A similar result would obtain if deduction of commissions were allowed on the basis that they were claims against the estate, contingent and speculative at death but becoming a reality during the period of administration."

In other words, the Tax Court in Smith allowed for the deduction of a reasonably foreseeable amount of expenses but not the actual expenses incurred. The Smith case at the Tax Court level thus allowed the consideration of subsequent events as concerned the valuation issue but did not allow the consideration of subsequent events as concerned the deduction of estate expenses issue. The Smith court did not attempt any reconciliation of these directly opposite positions.

At the Court of Appeals level, the valuation issue (in which the Tax Court allowed the consideration of subsequent events) was not appealed. Therefore, the Court of Appeals in Smith had no opportunity to affirm or reverse the Tax Court on this issue. The only issue appealed to the Court of Appeals was the deduction issue. The Court of Appeals in Smith affirmed the Tax Court's holding on the deduction issue, namely that the consideration of subsequent events was not allowed. The Estate then petitioned the United States Supreme Court (under the name of Ira Lowe, one of the co-executors of the Estate), however, the Supreme Court refused to hear the case.

Mr. Mard's table notes this case two times with the Lowe Supreme Court cite and the Smith Tax Court case. The Smith Court of Appeals case is not cited in Mr. Mard's table. Mr. Mard's summary on Lowe is as follows: "Sales after the valuation date 'may be used to corroborate the ultimate determination of value.'" **This is dead wrong. As noted above, there is no Lowe opinion as the Supreme Court refused to hear the case. Furthermore, the valuation issue was not even appealed to the Court of Appeals – it was settled at the Tax Court level.** In fact, the only decision at the higher court (Court of Appeals) in Smith was to **prohibit** the consideration of subsequent events as to the deductibility of claims.

Mr. Mard's summary on Smith (Tax Court only) is as follows: "The dissenting Tax Court judge stated that more weight should be given to the actual sales of a sculptor's art both before and after his death as uncontested evidence of value." This is true but totally irrelevant. A dissenting opinion has no weight or authority whatsoever. As seen above, the Tax Court allowed for the consideration of subsequent events in the valuation issue, a position that has been taken by other lower courts. The Tax Court did not allow for the consideration of subsequent events in the claims issue, a holding that was upheld by the Second Circuit.

Scorecard. In summary, therefore, the accurate scorecard for Mr. Mard's table is as follows:

(Continued on Page 12)

Supreme Court	
Time Travel Not Allowed:	1
Time Travel Allowed:	0
Nonexistent Case:	1
U.S. Court of Appeals	
Time Travel Not Allowed:	6
Time Travel Allowed (rational):	0
Time Travel Allowed (bizarre):	1

While Mr. Mard's table in the Fishman/Pratt/Morrison book serves as a good starting point in identifying some of the key cases in the time travel issue, it unfortunately is misleading both in the presentation of some of the data as well as the conclusions that should be drawn from the table by a reader. First, some of the case summaries in the table are clearly wrong and imply the acceptance of time travel where a careful reading of the case does not. Secondly, the rationale for allowing time travel in some of the cases is clearly flawed upon a closer reading of both the particular case as well as those cases cited by the particular case.

The primary danger with Mr. Mard's table in the Fishman/Pratt/Morrison book is that a reader of the table may come away with the impression that time travel cases are all over the board and time travel can therefore be used or not used at the discretion of the appraiser. This is a dangerous and incorrect conclusion. While lower federal court cases certainly are all over the board on the issue, a careful appraiser will look at the totality of the cases to determine whether or not time travel is a prudent exercise. A careful reader of the cases in Mr. Mard's table will note that once a case rises above the free-for-all at the lower court level, it is almost unanimous at the United States Supreme Court and Court of Appeals levels that time travel is prohibited. As seen above, the only business valuation case at an upper level that allowed time travel (Gross) was based on faulty reasoning. Also, there is only one U.S. Supreme Court case on this issue. As seen above, this case prohibited time travel by a 9-0 vote and has not been overruled for nearly 80 years.

A Key Distinction. It is important to make a distinction among the various cases involving time travel. Most of the above cases dealt with the valuation of a **"thing to be taxed"** (citing Ithaca Trust) as of a particular valuation date and the question as to whether subsequent events should impact the value of that thing as of the date of death. These cases include: Fitts (closely-held stock), Tripp (jewelry), Foltz (closely-held stock), Morris (real estate), Gilford (closely-held stock), Ithaca Trust (charitable remainder), and Estate of David Smith (at the Tax Court level only: sculptures). The Gross case was somewhat related to these cases in that the subsequent event issue involved the use of post-date marketability data to value closely-held stock. In contrast to these cases, the other cases noted above involved the issue of whether subsequent events should impact the valuation of a **claim against the estate**. These cases include McMorris, O'Neal, and the Estate of David Smith (Appellate Court level only).

This distinction between the valuation of a **thing to be taxed** and the valuation of a **claim against the estate** is important as it points back to the two cases from which the two schools of thought as to time travel arise. As noted above, the Ithaca Trust case is the archetypal case for the proposition that time travel is not allowed. Similarly, **Jacobs v. Commissioner, 34 F.2d 233 (8th Cir. 1929)** is the seminal case supporting time travel. Jacobs, decided only a few months after Ithaca Trust, distinguished itself from Ithaca Trust based on a different set of facts.

In Jacobs, the husband-decedent gave his wife the option (at his death) of: (1) $75,000 in cash or (2) the right to the net income from $250,000 placed in trust for the rest of her life. The decedent died on July 27, 1923. On September 17, 1924, the widow notified the executors that she was selecting option (2) above. On September 24, 1924, the executors deducted $75,000 from the value of decedent's gross estate. The IRS disallowed the deduction and was sustained by the Board of Tax Appeals.

The Eighth Circuit upheld the Board of Tax Appeals in a 2-1 decision. Cognizant of the very recent Ithaca Trust Supreme Court case which held that valuation was to be determined on the date of death, the Jacobs court distinguished its fact pattern by drawing the distinction between valuing an asset

(Continued on Page 13)

in an estate and valuing potential claims against an estate. The Jacobs court first cited Section 403 of the Revenue Act of 1921 which distinguishes between the value of the gross estate and claims against the estate:

> "That for the purpose of the tax the value of the net estate shall be determined (a) in the case of a resident, by deducting from the value of the gross estate (1) such amounts for funeral expenses, administration expenses, claims against the estate, unpaid mortgages upon, or any indebtedness in respect to, property, etc."

The Jacobs court noted that the valuation of certain items are limited to the facts known at the date of death. The Jacobs court then distinguished claims against the estate as items that could not be determined until after the date of death:

> "Of course there are deductions which are determined as claimed by the executors by the facts and conditions existing at the date of death. The Supreme Court of the United States, in Ithaca Trust has held that the value of gifts to charity which were subject to the life estate of the widow should be determined by the use of mortuary tables notwithstanding the death of the widow before the tax in fact was ascertained…Of course, we accept without reservation the definition of the tax and the rules governing its assessment stated by the Supreme Court in these cases. But that court has not said that the deductions authorized by paragraph (1) of section 403 must be determined solely by the facts and conditions existing on the day of the death, and we are confident that court will never say so in view of the provisions of paragraph (1). Paragraph (1) not only allows as deductions claims against the estate – which it is true are liabilities of the estate at least potentially at the moment of the death – but also allows as deductions funeral and administration expenses, which have no existence until after the death. All these, funeral expenses, administration expenses, and claims against the estate, under this paragraph, were intended by Congress to be determined in the course of an orderly administration of the estate in and by the state courts."

The Jacobs court therefore draws a distinction between the valuation of assets in an estate and the determination of claims against an estate. As to the valuation of assets in an estate, the Jacobs court defers to the holding in Ithaca Trust in that valuation is made as of the date of death and subsequent events are not considered. As to the determination of claims against an estate, however, the Jacobs court holds that time travel is necessary to determine the exact amount of these claims.

As noted above, Jacobs was decided by a 2-1 margin. The dissenting judge in Jacobs took the Ithaca Trust position that time travel in the determination of the amount of claims against the estate was improper practice. As support for this position, the dissenting judge cited the intent of the Treasury Department in article 39 of its regulations:

> "Claims against the Estates. The amounts that may be deducted under this heading are such only as represent personal obligations of the decedent existing at the time of his death, whether matured or not."

The dissenting judge in Jacobs also addressed the lack of common sense in the majority's holding. As noted above, the widow elected the life interest option instead of the cash option. However, no deduction at all was allowed to the estate for this. Assuming annual interest earnings of 5% on the $250,000 principal would net the widow $12,500 per year. Assuming a 20-year life expectancy for the widow, the present value of the annual payments at a 10% discount rate is $106,420. This is an even higher deduction than the $75,000 initially attempted by the estate. Yet no deduction at all was allowed by the IRS or the courts. This makes no sense as the beneficiaries of the estate are certainly disadvantaged in that they do not enjoy the benefits of $250,000 of estate assets as those assets are tied up in trust for the remainder of the widow's life. Furthermore, it is logical that the widow would have selected the option that was most beneficial to her.

(Continued on Page 14)

In this case, she believed the life interest option was better than the cash option. In that respect, the $75,000 deduction attempted by the estate was the better option as concerned the IRS as an accurate valuation of the life interest would likely have resulted in a higher deduction and less estate tax paid. In any event, allowing no deduction to the estate for the life interest makes no sense.

The distinction between Ithaca Trust and Jacobs is an important one. As noted above, Ithaca Trust prohibited time travel in the context of valuing a "**thing to be taxed**." Ithaca Trust was not concerned with a claim against the estate. **An interest in a closely-held business is clearly a "thing to be taxed" and is not a claim against the estate.** The business valuation cases that have followed Ithaca Trust have properly applied the Supreme Court's holding that time travel is not allowed. Any business valuation case that has followed the Jacobs strategy of allowing time travel is effectively using an orange to value an apple.

There is a split among the courts as to whether Ithaca Trust or Jacobs is to be followed in the determination of a claim against an estate. A partial listing of Appellate Court estate claim cases that followed Ithaca Trust (i.e., time travel not allowed) is as follows:

1. Estate of McMorris v. Commissioner, 243 F.3d 1254 (10th Cir. 2001)
2. Okerlund v. United States, 365 F.3d 1044 (Fed. Cir. 2004).
3. Estate of O'Neal v. United States, 258 F.3d 1265 (11th Cir. 2001).
4. Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982).
5. Estate of Algerine Smith v. Commissioner, 198 F.3d 515 (5th Cir. 1999).
6. Estate of David Smith v. Commissioner, 510 F.2d 479 (2nd Cir. 1975).
7. Estate of Van Horne v. Commissioner, 720 F.2d 1114 (9th Cir. 1983).

A partial listing of estate claim cases that followed Jacobs (i.e., time travel allowed) is as follows:

1. First National Bank v. United States, 763 F.2d 891 (7th Cir. 1985).
2. Krapf v. United States, 977 F.2d 1454 (Fed. Cir. 1992).
3. Estate of Sachs v. Commissioner, 856 F.2d 1158 (8th Cir. 1988).
4. Estate of Shedd v. Commissioner, 320 F.2d 638 (9th Cir. 1963).
5. Commissioner v. Estate of Shively, 276 F.2d 372 (2nd Cir. 1960).

Whether Ithaca Trust or Jacobs is to be followed in the determination of a claim against an estate is beyond the scope of this article. However, it is clear that Ithaca Trust is the proper course for business appraisals (which involve a "thing to be taxed" and not a claim against the estate) and time travel is not allowed.

Summary. As seen above, time travelers in business valuation are hanging by a very slender thread. The overwhelming evidence in the field, including definitions, regulations, business valuation standards, case law, and common sense, all prohibit time travel. The only significant change in any business valuation standard addressing subsequent events in the past six years was a clear strengthening of the prohibition against time travel by the AICPA. Nearly all of the other definitions, regulations, and business valuation standards continue to clearly prohibit time travel. This leaves prospective time travelers nowhere to turn but the courts in the hopes of finding sympathetic judges who will legislate time travel from the bench. Even then, the best that time travelers can do is a few ill-reasoned lower court decisions that draw largely from a case that dealt with the claims against an estate as opposed to the valuation of assets in an estate. Time travelers are free to live in this straw house if they so choose, but careful business appraisers will continue to prefer the solid masonry of Ithaca Trust and its progeny. ♦

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