View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Saint Louis University School of Law Research: Scholarship Commons

Saint Louis University School of Law

Scholarship Commons

All Faculty Scholarship

2014

Valuation Lessons From Estate of Adell

Kerry A. Ryan

Follow this and additional works at: https://scholarship.law.slu.edu/faculty

Part of the Estates and Trusts Commons, and the Tax Law Commons

(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Valuation Lessons From *Estate of Adell*

By Kerry A. Ryan

Kerry A. Ryan

Kerry A. Ryan is an associate professor at Saint Louis University School of Law.

In *Estate of Adell*, the Tax Court determined that the correct value of a decedent's interest in a closely held corporation was the figure reported on the original estate tax return. The court rejected alternative values as either using the incorrect valuation method or failing to account for the significant value of a key employee's personal goodwill.

Copyright 2014 Kerry A. Ryan.
All rights reserved.

At issue in *Estate of Adell*[1] was the fair market value of stock of STN.Com Inc. for estate tax purposes.[2] Franklin Adell died in 2006. His son Kevin Adell was the estate's temporary co-personal representative when the Tax Court petition was filed.

STN and The Word

STN.Com Inc. (STN) was a subchapter C corporation formed in 1999 with Franklin as its sole shareholder[3] and Kevin as its president.[4] STN's only business purpose was to broadcast an urban religious program called ''The Word Network'' (The Word). Kevin successfully pitched his idea for a 24-hour religious program channel to several prominent religious leaders in the Midwest and eventually to DirecTV. At the request of DirecTV, Kevin and Franklin organized The Word as a nonprofit entity.[5] The two men served as the company's officers and directors. According to its Form 1023, ''Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code,'' The Word was responsible for arranging all programming content, STN was responsible for uplinking The Word's signal to a satellite, and DirecTV agreed to extract the programs off the satellite and broadcast them nationally.

The Word and STN entered into a contract under which STN agreed to provide various services (management, technical, legal, etc.) to The Word. In return The Word agreed to pay a monthly programming fee to STN equal to ''the lesser of actual cost or ninety-five percent of net programming revenue received by'' The Word.[6] From its inception, The Word paid STN at least 95 percent of its revenue, contravening the contract stipulation that should have limited the programming fee to The Word's actual cost. The Word was STN's sole customer.

Competing Valuations

In 2007 the estate filed a Form 706 that valued the STN stock at \$9.3 million.[7] In 2010 the IRS issued a notice of deficiency to the estate that valued the STN stock at more than \$92.2 million.[8] At trial, the estate and the IRS argued the value of the STN stock on the date of Franklin's death, it was \$4.3 million and \$26.3 million, respectively.

Fair market value for estate tax purposes is the ''price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.''[9] The court focused on two questions to determine the proper value of the STN stock. First,

---

[1] *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155.

[2] A second issue was whether the substantial estate tax valuation understatement penalty (section 6662(h)(2)(C)) applied. Given its holding that the value reported on the original return was correct, the court did not need to address the penalty.

[3] Later Franklin transferred the stock to a trust that named his three children as equal beneficiaries.

[4] Franklin, Kevin, and a third party served as STN's board of directors.

[5] DirecTV required The Word to be a nonprofit in order to use available broadcast space.

[6] *Adell* at *9.

[7] The estate amended its estate tax return twice. The second amended return reported the value of the STN stock at zero. The court noted that ''the notice of deficiency did not reference the estate's second amended return . . . and it does not appear from the record that the second amended Form 706 was accepted.'' T.C. Memo. 2014-155 at *23, n.33.

[8] The IRS's valuation resulted in an estate tax deficiency of approximately \$40 million. The IRS also applied a substantial estate tax valuation understatement penalty (section 6662(h)(2)(C)) of about \$15 million.

[9] Reg. section 20.2031-1(b).

Electronic copy available at: http://ssrn.com/abstract=2506289

what was the proper valuation method for the business — the income approach or the asset approach? Second, what was the proper way to account for the value of Kevin's personal goodwill?

Proper Valuation Method

The first issue addressed by the court was whether STN should be valued using the income method or the asset method. In the valuation report attached to the estate's original tax return, one of the estate's experts, Jeffrey M. Risius, concluded that because STN was an operating entity with positive expected future cash flows, its value as a going concern exceeded the value of its assets in liquidation. Accordingly, he used an income-based technique (discounted cash flow) rather than an asset-based one to value STN's stock at $9.3 million.

In a second valuation report prepared for trial, Risius switched to the asset approach (adjusted book value) to value the STN stock at $4.3 million.[10] Risius justified the change in method (and the resulting lower value) by strictly interpreting the contract provision limiting STN's fee from The Word to the lesser of its cost or 95 percent of The Word's revenue. Because The Word was STN's sole customer, the limitation effectively prevented STN from generating a profit. Given the lack of projected positive cash flow, Risius determined that the income method of valuation used in his first report was inappropriate.

In line with Risius's original interpretation, the IRS's expert, Francis X. Burns, assumed that The Word would continue its practice of paying STN according to its revenues rather than STN's actual costs. Under that assumption, STN's sales were projected to reach between $18.5 million and $26 million. Applying the income method of valuation, Burns valued the STN stock at $26.3 million.[11]

In the opinion, Judge Elizabeth Crewson Paris agreed with the IRS that STN was a profitable company before Franklin's death and that its profitability was reasonably expected to continue. The court noted that in the five years leading up to Franklin's death, The Word paid 95 percent of its revenues to STN.[12] As a result, STN's gross receipts increased from $7.8 million to $15.9 million. Also, none of the evidence suggested that The Word would limit the programming fee to STN's costs after Franklin's death. The court gave particular weight to Kevin's post-death indications to Risius that STN's sales would increase and that additional capital expenditures would be made.[13]

Kevin's Goodwill

The second issue the court addressed was how to properly adjust STN's value to reflect Kevin's personal goodwill. Both the IRS and Risius recognized that the success of STN depended on Kevin's relationships with the ministers providing content to The Word; however, they each accounted for it differently. Risius applied an economic charge for Kevin's personal goodwill that ranged from 37.2 percent to 43.4 percent of sales over the historical period and 43.7 percent to 44.1 percent of sales over the projection period. The IRS's expert did not apply an economic charge. Rather, he concluded that a hypothetical investor would be able to retain Kevin for a salary equal to 8.1 percent of sales.

According to the court, Kevin owned his goodwill. He never transferred it to STN through a covenant not to compete or other employment agreement.[14] As a result, Kevin was free to leave STN at any time and take his goodwill with him to a competitor.[15] In Judge Paris's opinion, Risius's economic charge of $8 million to $12 million was sufficient to account for the significant value of Kevin's contacts, whereas Burns's salary estimate to retain Kevin was too low.[16]

Court's Holding

The court considered the reported value of the STN stock on the original estate tax return as an admission by the estate, and found that the estate failed to provide "cogent proof that the reported value was erroneous."[17] Judge Paris considered Mr. Risius's first valuation report the most "creditable because it properly accounted for Kevin's personal goodwill and appropriately used the . . . income approach to value the STN stock."[18]

---

[10]A second valuation for trial was submitted by Alex W. Howard, an employee of the same company that employed Risius. Using the net asset method, Howard also concluded that the value of STN was $4.3 million.

[11]Burns also made valuation adjustments to reflect the market rate of officer compensation and to account for Kevin's personal goodwill.

[12]The court noted that The Word did not enforce the cost of services cap on the programming fee for four years after Franklin's death.

[13]The discussion between Kevin and Risius occurred in the course of preparing Risius's first appraisal. The court gave extra weight to these statements because Kevin controlled The Word.

[14]Howard also cited STN's lack of an employment agreement with Kevin as a reason to use the net asset approach rather than the income approach to value the stock.

[15]After being sued in probate court by his sisters, Kevin resigned from STN and created a new company to provide uplinking services to STN, taking with him all but one of STN's employees.

[16]The court noted that after Franklin's death, Kevin effectively stepped into his father's shoes. *Id.* Before his death, Franklin collected a salary ranging from $2 million to $7 million.

[17]T.C. Memo. 2014-155 at *45.

[18]*Id.* at *55.

(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Electronic copy available at: http://ssrn.com/abstract=2506289

Valuation Lessons

The first lesson is that courts may go beyond an agreement's terms and analyze the parties' course of conduct to determine a company's value. This is especially true when the contracting entities are related, as in *Adell*. A discrepancy between the actual and stated terms of a contract can have a significant effect on value. In *Estate of Adell*, the $5 million difference between Risius's first and second STN appraisals reflected the disparity in the value of the contractual programming fee in practice as compared to on paper.

The second lesson is that the characterization of goodwill as personally owned rather than as a business asset can have important tax implications. At least since *Martin Ice Cream*,[19] tax planners recognized that certain income tax advantages can be realized in an asset sale of a corporation when all or a portion of the goodwill is treated as being transferred by the selling shareholder rather than by the entity.[20] *Adell* reminds estate planners that personal goodwill exists, it can be valued, and its value can be significant. This can be a sword or a shield depending on whose goodwill is at issue and in what context. Here, separating Kevin's goodwill from that of the business significantly reduced the value of STN for estate tax purposes.

---

[19]*Martin Ice Cream Co. v. Commissioner*, 110 T.C. 188 (1998).

[20]The major tax benefit to the seller is that only one level of tax levied at capital gains rates is imposed on transferred personal goodwill. *See generally* Darian M. Ibrahim, "The Unique Benefits of Treating Personal Goodwill as Property in Corporate Acquisitions," 30 *Del. J. Corp. L.* 1 (2005).

Let the news find you.

Customized e-mail alerts. Let the tax news and analysis you need find you fast with our customized e-mail alerts. Simply profile your needs, by code section, jurisdiction, document type, subject, search terms, and more, and we'll get you what you want, when you want it. It's one part of a great personalized service.

Visit **taxanalysts.com** today.

taxanalysts®

Tax Notes Today® ▲ State Tax Today® ▲ Worldwide Tax Daily®

(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.