… Valuation Developments

in Estate & Gift Taxation

Spring 2007

A discussion of recent U. S. Tax cases and IRS pronouncements from a valuation perspective.

John W. Hayes
Anchor Planning & Valuations, Ltd.
Email: anchorjwh@cs.com
Website: www.anchorplanning.com

1010 Jorie Blvd., Suite 380
Oak Brook, Illinois 60523
Phone (630) 573-7654
Fax (630) 573-9930

Non-Testifying Valuation Expert May Not Be Deposed Despite Earlier Designation as a Testifying Expert and Participation in Discovery

In the *Estate of Douglas L. Manship v. United States*, No. 04-C-91-M2 (M.D. La. Dec. 18, 2006), the U.S. District Court for the Middle District of Louisiana considered whether a non-testifying expert may be deposed when he was changed from a testifying to a non-testifying expert just before the deadline for the exchange of expert witness reports, where his report and testimony were not disclosed to the opposing party, and where the non-testifying expert participated in conference calls with that party's attorneys and testifying expert. The decedent owned interests in several closely held businesses. The value of the businesses for estate tax purposes is at issue in this refund suit.

The IRS initially listed two valuation experts as testifying experts on its witness disclosure list. Before the mandatory disclosure of expert witness reports, the IRS re-designated one of its valuation experts as a non-testifying expert. His report and the substance of his opinion have not been disclosed. This expert participated in telephone calls with the non-testifying expert, and the testifying expert included some information obtained from the non-testifying expert in forming his opinion.

The estate sought to depose the non-testifying expert. It claimed that since the testifying expert relied on some information provided by the non-testifying expert and participated in the conference calls with the testifying expert, it should be allowed to depose the non-testifying expert because he "likely assisted" in the preparation of the testifying expert's report. Further, it argued that information considered by the testifying expert in forming his opinion needed to be disclosed under Fed. R. Civ. P. 26(a)(2)(B). The IRS opposed the motion. The IRS claimed that the non-testifying expert was protected from discovery by Fed. R. Civ. P. 26(b)(4)(B) and the work product doctrine. Furthermore, it provided the court with an affidavit from its testifying expert, which swore that any information provided by the non-testifying expert and considered in the formation of his opinion was disclosed in his report.

The district court determined that the estate's position that the non-testifying expert "likely assisted" in the formation of the testifying expert's report and, thus, was discoverable under Fed. R. Civ. P. 26(a)(2)(B) was not supportable. It noted that the estate failed to support this assertion with anything other than time records that showed the two experts and counsel participated in a conference call. The estate made no showing of what, if any, information the non-testifying expert supplied that was considered by the testifying expert. Moreover, it noted that the IRS adequately rebutted this assertion with its expert's affidavit. In that sworn statement, the testifying expert stated that all information provided by the non-testifying expert and considered by him had been disclosed to the estate. Thus, the court denied the estate's argument that the deposition should be taken under Fed. R. Civ. P. 26(a)(2)(B).

The district court then considered whether the disposition should be granted due to the late re-designation of the expert from testifying to non-testifying. The court noted that there were two positions taken by various courts. Under the first line of cases, the deposition of a non-testifying expert is permitted so long as it is more probative than prejudicial (in compliance with Fed. R. Evid. 403) where the expert was initially designated as a testifying expert. The second line of cases considers whether there are exceptional circumstances such that essential information cannot be obtained from other sources without undue hardship. The district court noted that the Fifth Circuit has not adopted either test.

After a review of both lines of cases, the district court adopted the majority exceptional circumstances test. It found that where the expert is initially designated as a testifying expert and later re-designated as a non-testifying expert and participates in discovery, but does not issue a report or disclose his or her opinion; the expert's deposition may not be taken because it is protected by Fed. R. Civ. P. 26(b)(4)(B). The court noted that "mere designation … as testifying witnesses (a designation which the United States reserved the right to amend) and their involvement in discovery (which also could have occurred if they had originally been designated as consulting witnesses) constituted a permanent waiver of the work product protection that could not be revoked if the experts were later re-designated as non-testifying experts." The court further determined that its decision would not have changed had the expert issued his report or otherwise made his opinion known.

It Isn't Easy Being Green: Henson Estate Denied Deductions from Value of Stock

In *Albert Gottesman, Executor of the Estate of James M. Henson v. United States*, No. 05 Civ. 8212 (S.D.N.Y. Jan. 12, 2007), the U.S. District Court for the Southern District of New York considered whether an estate could make a deduction from the value of closely held stock for amounts allegedly due under a marital separation agreement that were secured by that stock. The decedent created and produced children's television shows and movies, including the Muppets, through a closely held business.

In 1987, Henson divorced. Under the separation agreement, one-third of the stock in Henson's business was placed into escrow. The escrow secured his obligations to make annual payments to his ex-wife through 1996. The agreement also allowed the ex-wife to share in the proceeds of any sale or merger of the business received by the husband or his estate.

Henson died in May 1990. His will left his stock to his children. The estate tax of $20 million was paid, which included tax arising on the value of his business stock. The escrow agreement remained in effect thereafter until 2000. No evidence indicated that the separation agreement was not fully complied with throughout the post-death period.

In 2000, Henson's children sought to sell the company. Concerned that the escrow agreement clouded their title to the stock, they executed a settlement agreement with Henson's ex-wife. Under this agreement, the children paid the ex-wife $10.6 million to release the Henson estate from any obligation arising under the 1987 separation including obligations related to the escrowed stock. Thereafter, the sale of stock was completed.

In 2002, the estate sought a refund of $4.1 million in estate taxes. It claimed that the estate should have taken a deduction under § 2053 from the value of the gross estate because the ex-wife had a valid claim against the estate in the amount of the settlement agreement. Alternatively, the estate claimed that it was entitled to offset the value of the business' stock by the amount of the settlement agreement. It claimed, "the value of the shares, like any property subject to a non-recourse obligation, must be reduced to reflect the Estate's liability" to

IRS Circular 230 Disclaimer: To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that any U.S. Federal Tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of (1) avoiding tax-related penalties, (2) promoting, marketing or recommending any federal tax transaction or matter, and (3) any taxpayer should seek specific advice from an independent tax advisor with respect to any federal tax transaction or matter discussed in this newsletter.

the ex-wife under the separation agreement, which permitted her to share in the proceeds of a sale of the business. Treas. Reg. § 20.2031-2(g); § 20.2053-7. The IRS denied the refund and the matter proceeded to trial.

The district court agreed with the IRS that a deduction was not warranted under either § 2053 or § 2031. The court determined that the separation agreement required that Henson or his estate pay the ex-wife a share of the sale or merger proceeds if it owned the shares and the sale or merger occurred during her life. It found that the shares were transferred from the estate to Henson's children by operation of the will. Therefore, it held that since the estate did not own the stock, no liability under either § 2053 or setoff under § 2031 could arise as a result of the separation agreement.

The court additionally found that the ex-wife did not hold an interest in the escrowed stock. It found that the escrow was designed to secure Henson's and his estate's obligations to make specific payments under the separation agreement. The court stated, "The shares remaining in escrow served as protection for [ex-wife] in case the Estate defaulted on this or any other of its outstanding obligations to her, but it did not provide [her] with a minimum share in the proceeds from <u>any</u> subsequent sale of the Company, no matter who received the proceeds." (Emphasis in original.) Therefore, the court held that since the ex-wife had no interest in the escrowed stock and the sale provisions of the 1987 separation agreement were not triggered, the estate was not entitled to a deduction under § 2053 or § 2031.

OTCBB Stock May Be "Qualified Appreciated Stock" for Charitable Deduction Purposes

In LTR 200702031 (released Jan. 12, 2007), the Internal Revenue Service determined that stock traded on the Over The Counter Bulletin Board (OTCBB) could be treated as qualified appreciated stock for charitable deduction purposes. The taxpayer held stock in a company that was traded on the OTCBB. The stock was held for longer than one year and during that time it had appreciated. The taxpayer wanted to donate it to a charitable foundation and take a charitable deduction.

A taxpayer is entitled to a deduction for charitable donations to qualified organizations. I.R.C. § 170 (a). Non-cash donations are valued at fair market value on the date of the contribution. Treas. Reg. § 1.170A-1(c)(1). If the donation is appreciated stock, the taxpayer's deduction is limited to the taxpayer's basis in the stock unless the stock is qualified appreciated stock. I.R.C. §170(e)(1)(B)(ii); § 170(e)(5)(A). In order to be qualified appreciated stock, the stock (1) must be traded on an established market for which market quotations are readily available on the date of the contribution, and (2) must be long-term capital gain property. § 170(e)(5)(A).

The New York Stock Exchange, the American Stock Exchange, and the NASDAQ exchange are generally acknowledged to be "established market[s]" within the meaning of § 170(e)(5)(A). The OTCBB was created by the Securities and Exchange Commission (SEC) in 1990 after § 170(e)(5)(A) became effective. Stock listed on the OTCBB is required to comply with SEC, banking and insurance laws as well as NASDAQ requirements. The NASDAQ operates and oversees the OTCBB.

The Internal Revenue Service (IRS) determined that the OTCBB was an "established market" and market quotations were "readily available." In reaching its decision on this taxpayer's questions, the IRS focused on Congress's legislative purpose in enacting the qualified stock exception: The minimization of overvaluation and other abuses when appreciated stock is donated to private non-operating foundations. The IRS determined that the legislative purpose would not be thwarted if OTCBB stock was treated as qualified appreciated stock because daily and historical market quotes were readily available through the internet at no cost and without registration obligations at various websites including www.otcbb.com. Furthermore, one of the websites contained historical trading data (daily high, low, and median price as well as volume) dating from the early 1990s. Thus, it found that the market quotation information was readily available over the internet even though it was not available in any nationally distributed daily newspaper. The IRS further found that the OTCBB was an established market because it was created

Qualified Appreciated Stock
Cont. from p. 3

by the SEC under an act of Congress; the listed stock was subject to SEC, banking and insurance laws and regulations; and the market was regularly updated and policed by the NASDAQ. Therefore, the IRS permitted the stock to be treated as qualified appreciated stock provided (1) the stock remained regularly traded on the OTCBB on the date of contribution; (2) the taxpayer retained daily trading data on the stock for at least one year prior to the date of contribution; and (3) the historical and daily trading data remained readily available without cost through the internet.

The brief summaries in this publication discuss only some valuation aspects of the subject cases and pronouncements. The reader is referred to the actual documents for additional details. This publication does not constitute legal, tax, accounting, or valuation advice, and it is offered as an informational service only. Those seeking specific advice should contact a professional advisor. No liability whatsoever is assumed in connection with the use of this newsletter. Copyright © 2007

This newsletter is provided by Anchor Planning & Valuations, Ltd. and John W. Hayes, a Managing Director in the firm. Mr. Hayes is a Certified Valuation Analyst and is Accredited in Business Valuation by the American Institute of CPAs. He specializes in the valuation of businesses, business ownership interests, and in financial litigation support. He has performed work for a variety of businesses for purposes including estate and gift taxation, and has experience in the defense of these valuations and analyses. For copies of this newsletter, please call or write the address below:

John W. Hayes
Anchor Planning & Valuations, Ltd.
1010 Jorie Blvd., Suite 380
Oak Brook, Illinois 60523
Phone (630) 573-7654
Fax (630) 573-9930
Email: anchorjwh@cs.com

Anchor Planning & Valuations, Ltd.
1010 Jorie Blvd., Suite 380
Oak Brook, Illinois 60523