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Grieve v. Commissioner – Tax Court Rejects IRS Gift Tax Valuation Approach

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In Determining Value of Nonvoting Interests in LLCs, Tax Court Repudiates IRS Valuations That Assumed the Voting Interest Would Also Be Acquired in the Same Willing-Buyer-Willing-Seller Transaction

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Synopsis

In *Grieve v. Commissioner*, T.C. Memo. 2020-28 (March 2, 2020), Judge Kerrigan upheld a donor's gift tax valuation of 99.8% nonvoting interests in two limited liability companies that he had given in 2013 to a GRAT and to another irrevocable trust. The assets held by the LLCs were largely cash, cash equivalents, and marketable securities. The donor's gift tax return applied entity-level discounts for lack of control and marketability totaling about 35%.

The Tax Court did not use an alternative approach the donor offered at trial that included discounting the value of interests in entities held by one of the LLCs being valued (resulting in "multiple-tiered discounts") and applying slightly different entity-level discounts. The court explained that it had found no justification for using a net value significantly lower than the value to which the taxpayer had previously admitted on the appraisal attached to the gift tax return (without any specific criticism of the multiple-tiered discounting approach).

The court firmly rejected a valuation offered by the IRS that assumed that a buyer of the 99.8% interest would start by seeking to buy the 0.2% controlling interest, which would have almost eliminated any entity-level discounts (leaving a discount of just over 1.4%).

Facts

1. **Background.** The donor, Pierson M. Grieve, resided in Florida when he filed his Tax Court petition, but from 1983 to 1996 he had been the chairman and chief executive officer of Ecolab, a public corporation headquartered in St. Paul, Minnesota. Ecolab stock was the underlying asset involved in the funding of the GRAT, and the Tax Court trial in March 2019 was held in St. Paul.

   Around 1990, Mr. Grieve established the Grieve Family Limited Partnership to preserve and manage his family wealth. The general partner of the limited partnership was the Pierson M. Grieve Management Corp. (PMG). In the early 2000s, Mr. Grieve's daughter Margaret became involved in helping Mr. Grieve manage the family wealth, and in 2008 she purchased PMG from Mr. Grieve for $6,200 and became its president.

   In 2012, Mr. Grieve created an irrevocable trust for the benefit of his children, with South Dakota Trust Co., LLC, as the trustee.

   The LLCs in question, Rabbit 1, LLC (Rabbit), and Angus MacDonald, LLC (Angus), were created under the law of Delaware in 2013 and 2012, respectively. PMG owned the Class A voting units in each LLC, comprising 0.2% of the ownership interests of the LLC, and PMG's owner, Margaret, was the chief manager of the LLCs. The Class B nonvoting LLC units, comprising 99.8% of the ownership interests, were owned by Mr. Grieve's revocable trust in the case of Rabbit and by Mr. Grieve himself in the case of Angus. Margaret was the trustee of the revocable trust.

   The assets of both LLCs were largely cash, cash equivalents, and marketable securities. The fair market values of those assets on the respective dates of transfer were $9,067,074 for Rabbit (as adjusted by stipulation in the Tax Court) and $31,970,683 for Angus.

   Under the LLC agreements, the holders of all Class A voting units had to consent to the transfer of any units to anyone other than a lineal descendant of Mr. Grieve or his wife (who died in 2012), or a trust for the exclusive benefit of any one or more such lineal descendants and/or their spouses, or, in the case of Rabbit, a charitable organization

2. **2013 Gifts.** On October 9, 2013, Mr. Grieve's revocable trust transferred its 99.8% nonvoting ownership interest in Rabbit to a two-year GRAT, with annuity payments defined as percentages of what the opinion describes as "the fair market value of assets transferred to the trust for Federal gift tax purposes." The percentage increased by slightly less than 20% from the first payment to the second payment, and the percentages were designed to "zero out" the GRAT – that is, to produce a gift tax value of the remainder equal to zero after applying the section 7520 rate of 2.4% for October 2013.

   On November 1, 2013, Mr. Grieve transferred his 99.8% nonvoting ownership interest in Angus to the 2012 irrevocable trust, in exchange for a single-life private annuity that on that date had a fair market value of $8,043,675. Thus, Mr. Grieve made a gift to the irrevocable trust in the amount by which the value of the 99.8% interest exceeded $8,043,675.

Positions of the Parties

1. **Gift Tax Return.** Mr. Grieve's 2013 gift tax return reported values for the 99.8% nonvoting interests that were based on appraisal reports prepared by Value Consulting Group (VCG), using a cost approach and adjusted net-asset method to determine the fair market value of the assets of the LLCs and applying lack of control discounts of 13.4% for Rabbit and 12.7% for Angus and lack of marketability discounts of 25% for each LLC. To determine these discounts, VCG looked at studies of closed-end mutual funds and closely held equity interests, including restricted stock studies. In the Tax Court, VCG's valuation of the Rabbit interest was adjusted slightly (from $9,102,757 to $9,067,074) by a stipulated change to the fair market value of Rabbit's assets as of the transfer date of October 9, 2013.

2. **Notice of Deficiency.** The IRS issued a notice of deficiency substantially increasing the values of the LLC interests. See the table below.

3. **Taxpayer's Position in the Tax Court.** In the Tax Court, Mr. Grieve offered additional valuation reports prepared by Will Frazier and others in the well-known valuation firm of Stout. These reports independently valued the assets held by the LLCs, including the application of minority interest and lack of marketability discounts to limited partnership interests and venture capital funds held by Angus (*i.e.*, employing multiple-tiered discounts) and determined combined values slightly less than the values VCG had used. The reports used a market approach and asset method similar to VCG's, but with different discounts for lack of control calculated separately for equity securities and for cash and short-term investments. The reports agreed with VCG's 25% lack of marketability discounts, supported by analysis that the Tax Court explicitly acknowledged "considered factors that we outlined in Mandelbaum v. Commissioner, T.C. Memo. 1995-255, aff'd, 91 F.3d 124 (3d Cir. 1996), [including] the holding period, the risk of the underlying assets, and the company's distribution policy." Finally, the Stout reports also introduced an income approach, which the court described as follows:

   > Mr. Frazier used the nonmarketable investment company evaluation (NICE) method which he developed as a valuation technique applicable to entities that hold a portfolio of investment assets. The NICE method determines a price that an investor would pay for the subject interest that lacks control and marketability by taking into consideration the investment risks and expected returns. In applying the NICE method, empirical studies were used to determine the incremental required rates of return in the light of information asymmetry (lack of control) and the cost of illiquidity (lack of marketability).

   Giving equal weight to those market and income approaches, the Stout reports determined fair market values of the transferred 99.8% interests on the transfer dates that were slightly less than the values VCG had determined, which had been used on the gift tax return.

4. **IRS's Position in the Tax Court.** In the Tax Court the IRS relied on the approach of Mark Mitchell, which has reportedly exasperated the appraisal community in other cases where the IRS has invoked it. The court described Mr. Mitchell's approach this way:

> In his valuation reports Mr. Mitchell sought the price at which a 99.8% noncontrolling interest would actually be bought or sold. According to Mr. Mitchell there was no empirical data on the sale of a 99.8% noncontrolling interest. His valuations were based upon the premise that the reasonable buyer of a 99.8% interest could be expected to seek to maximize his or her economic interest by consolidating ownership through the purchase of the 0.2% interest. Mr. Mitchell also contends that a willing buyer would consider the likelihood of purchasing the 0.2% interest.
>
> Mr. Mitchell determined that a hypothetical willing seller would seek first to acquire the class A [voting] units for a premium. According to his reports and testimony, purchasing the class A units would result in consolidated control and further maximize the value of the class B [nonvoting] units by reducing any discount sought by a hypothetical willing buyer.

Result in the Tax Court

The Tax Court totally rejected Mr. Mitchell's approach. Judge Kerrigan bluntly noted that "[w]e do not engage in imaginary scenarios as to who a purchaser might be," citing *Estate of Giustina v. Commissioner*, 586 F. App'x 417, 418 (9th Cir. 2014), *rev'g and rem'g* T.C. Memo. 2011-141. (In a similar context in *Estate of Jones v. Commissioner,* T.C. Memo. 2019-101, discussed **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**, Judge Pugh had also cited *Giustina*, in that case rejecting rather than affirming an asset-based approach.) In *Grieve*, Judge Kerrigan added:

> Mr. Mitchell's valuations relied on an additional action [that is, in addition to a hypothetical sale of the 99.8% class B units]. He concluded that to determine the value of what a willing buyer would pay and what a willing seller would seek for the class B [nonvoting] units, a premium to purchase the class A [voting] units has to be taken into account. Elements affecting the value that depend upon events within the realm of possibility should not be considered if the events are not shown to be reasonably probable [citing *Olson v. United States*, 292 U.S. 246, 257 (1934)]. The facts do not show that it is reasonably probable that a willing seller or a willing buyer of the class B units would also buy the class A units and that the class A units would be available to purchase. To determine the fair market values of the class B units we look at the willing buyer and willing seller of the class B units, and not the willing buyer and willing seller of the class A units.
>
> Neither respondent nor Mr. Mitchell provided evidence to show support for his valuations. His reports did not include empirical data which back up his calculation of the 5% premium to purchase the class A units of either entity. He provided no evidence showing that his methodology was subject to peer review. Respondent cited no caselaw in support of Mr. Mitchell's methodology. Accordingly, we reject Mr. Mitchell's valuations of the class B units of Rabbit and Angus. See Estate of Hall v. Commissioner, 92 T.C. at 340; Estate of Deputy v. Commissioner, T.C. Memo. 2003-176, slip op. at 20; Estate of Smith v. Commissioner, T.C. Memo. 1999-368, slip op. at 40.

In contrast, Judge Kerrigan did not criticize Mr. Frazier's reports, although she concluded that:

> We are not convinced that the higher discount for lack of control for Rabbit and lower values in the Frazier reports should be substituted for the values that the parties stipulated and the discounts petitioner provided in the VCG reports. See Estate of Hall v. Commissioner, 92 T.C. at 337-338; Estate of Deputy v. Commissioner, slip op. at 12 n.6.

As a result, undoubtedly reassured by the very similar results in the Stout reports, the court accepted the values that had been reported on the gift tax return, with the slight adjustment that had been stipulated in the fair market value of the underlying assets owned by Rabbit.

The following table summarizes the parties' positions and the court's conclusion:

Values Determined for the 99.8% Nonvoting LLC Interests Transferred (including the effective discount (rounded) from 99.8% of the value of the LLC's assets)					
LLC (including the value of the LLC's assets)	**Initial Positions**		**Positions in Tax Court**		**Tax Court's Conclusion**
	Gift Tax Return (VCG)	**IRS Notice of Deficiency**	**Taxpayer (Stout, Will Frazier)**	**IRS (Mark Mitchell)**	
Rabbit ($9,067,074)	$5,903,769 (35.0%*)	$9,048,866 (0.4%*)	$5,884,000 (35.0%)	$8,918,940 (1.4%)	$5,880,626 (35.0%)
Angus ($31,970,683)	$20,890,934 (34.5%)	$31,884,403 (0.1%)	$19,854,000 (37.8%)	$31,456,742 (1.4%)	$20,890,934 (34.5%)
* Based on the $9,102,757 estimated value of Rabbit's assets before the stipulated correction.					

As noted above, the taxable gift in the case of Angus was the excess of this amount over the $8,043,675 value of the annuity Mr. Grieve took back, in other words $20,890,934 minus $8,043,675, or $12,847,259. Because Mr. Grieve's wife died in 2012, it is possible that he had a DSUE amount from a portability election to apply against that gift. (According to the opinion, the IRS's notice of deficiency would have increased the value of the Angus interest transferred to the irrevocable trust by $10,993,469 (from $20,890,934 to $31,884,403), but, without explanation, would have increased the net value of the resulting gift by only $7,852,480 (from $9,966,659 to $17,819,139).

Analysis

1. **Apparently No Challenge of the LLCs Themselves.** The valuation discounts reflected in the IRS Notice of Deficiency – 0.4% for Rabbit and 0.1% for Angus – are tantamount to simply ignoring the LLCs altogether and simply treating the underlying assets of the LLCs as the subjects of the gifts. Yet there is no indication in the court's opinion that the IRS had encouraged the court to disregard the LLCs or to question, for example, whether the LLCs were formed for a "legitimate and significant nontax reason," which is the standard the Tax Court used in *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005) (reviewed by the Court) in the context of section 2036 (which does not necessarily apply in a gift tax context). Nor is there any indication that the IRS had asked the court to apply section 2703 or 2704.

2. **Apparently No Section 2036(a)(2) Exposure Under *Powell* and *Cahill*.** *Grieve* is a gift tax case, and Mr. Grieve was alive when the Tax Court decided the case. Therefore there was no occasion for the IRS or the court to raise or address the issue that the 99.8% nonvoting interests might have "the right, … in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom," under section 2036(a)(2) as applied in *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017) (reviewed by the Court), and *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84. In light of *Powell* and *Cahill*, however, it may be noted in passing that neither Mr. Grieve nor his revocable trust retained any interest in Rabbit and Angus, and that in any event the Rabbit and Angus nonvoting units, as the opinion notes, "could not vote on or participate in any proceedings in which the entity or its members took action."

3. **Concurrent Testimony of Experts.** In a footnote to her opinion, Judge Kerrigan stated that "[w]ith agreement of the parties we directed the expert witnesses to testify concurrently. The procedure was implemented in substantially the same way as in Rovakat, LLC v. Commissioner, T.C. Memo. 2011-225 [affirmed, 529 Fed. Appx. 124 (3d Cir. 2013)]."

   In *Rovakat*, Judge Laro had explained:

   > To implement the concurrent testimony, the Court sat at a large table in the middle of the courtroom with all three experts, each of whom was under oath. The parties' counsel sat a few feet away. The Court then engaged the experts in a three-way conversation about ultimate issues of fact. Counsel could, but did not, object to any of the experts' testimony. When necessary, the Court directed the discussion and focused on matters that the Court considered important to resolve. By engaging in this conversational testimony, the experts were able and allowed to speak to each other, to ask questions, and to probe weaknesses in any other expert's testimony. The discussion that followed was highly focused, highly structured, and directed by the Court.

   The engagement of expert witnesses around a table like this has been referred to colloquially as "hot tubbing," and Judge Laro actually cited an article titled "Experts in the Tub" (21 Antitrust 95, 97 (2007)).

4. **Formula Clause for GRAT Annuity Payments.** As noted above, for the GRAT to which Mr. Grieve's revocable trust contributed the nonvoting Rabbit units, the annuity payments were defined as percentages of what the opinion describes as "the fair market value of assets transferred to the trust for Federal gift tax purposes." As the court noted in a footnote:

   > The parties stipulated that petitioner will not owe additional gift tax if we determine that he understated the initial fair market value of assets transferred to the GRAT if, within a reasonable time, the GRAT pays to petitioner, or to his personal representative in the event of his passing, an amount equal to the difference of the properly payable annuity and the annuity actually paid.

   Thus the formula clause worked, even though the GRAT was designed to produce a taxable gift of zero, which could have made the "final determination" of federal gift tax value less obvious. The formula clause used in *Grieve*, of course, is specifically authorized by Reg. §25.2702-3(b)(1)(ii)(B). Even so, for the IRS to force the formula clause to be respected, in this case by entering into the stipulation with the donor, is somewhat comparable to what we might have observed in the recent settlement of cases involving defined value clauses in the broader gift tax context. *See Estate of Donald Woelbing v. Commissioner* (Tax Court Docket No. 30261-13) and *Estate of Marion Woelbing v. Commissioner* (Tax Court Docket No. 30260-13) (petitions filed Dec. 26, 2013; stipulated decisions entered March 25 and 28, 2016); *Karen S. True v. Commissioner* (Tax Court Docket No. 21896-16) and *H.A. True III v. Commissioner* (Tax Court Docket No. 21897-16) (petitions filed Oct. 11, 2016; stipulated decisions entered July 9 and 6, 2018).

   As such, *Grieve*, along with *Woelbing* and *True*, might provide a template for the resolution of cases involving defined value clauses, even as the IRS is probably still searching for a case in which it might successfully challenge the effectiveness of such a clause, standing alone, to prevent, defeat, or diminish a valuation challenge.

   It also did not seem to matter in *Grieve* that the annuity payments determined by formula were, as the court put it, "to be paid within 105 days of [the respective anniversaries of the funding of the GRAT]." Specifically, neither the IRS nor the court seemed to be concerned that the explicit reference to the 105-day grace period of Reg. §25.2702-3(b)(3) even though it is not a governing instrument requirement might require valuation of the remainder for gift tax purposes to be based on the later permissible payment dates.

It is also interesting, as in Chief Counsel Advice (CCA) 201939002, discussed **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**, that the IRS is auditing GRATs at all, although in this case it is easier to understand in a context where clearly Mr. Grieve's other transfer to an irrevocable trust in 2013 produced a taxable gift. The stipulation described in the court's footnote might provide an explanation of why such audits make sense. If, to settle a case, the IRS requires the grantor of a GRAT to explicitly confirm an increase in the annuity payments, more value presumably will be brought back into the grantor's estate to be taxed in the future, and the IRS is given one more tool to use in tracking and enforcing those annuity payments.