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Tanenblatt v. Commissioner: Valuation Methods in Real Estate

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Tanenblatt v. Commissioner (Estate of Diane Tanenblatt v. Commissioner, T. C. Memo 2013-263), filed on November 18, 2013, involved the fair market value (FMV) of a 16.67 percent minority membership interest in a New York LLC whose principal holding was a commercial building on East 18th Street in the historic Ladies’ Mile district of Manhattan. The resulting decision has important implications for the valuation—and taxation—of real estate and the use of experts.

The LLC was owned by three families whose members participated in its management and control. The LLC’s operating agreement called for dissolution of the LLC upon the death of any member unless a majority of the other members agreed to its continuation. Tax Court averred that because the decedent had transferred her interest to a trust, her death would not trigger dissolution. No other reference appeared on the record as to any possible immediate termination of the LLC or sale of the property. Furthermore, there was no indication that the minority interest conveyed any controlling factors. (A noncontrolling interest is one for which the holder cannot exercise prerogatives of control such as determining policies, effecting a change in management, or selling the underlying real estate.)

In Tanenblatt, the IRS determined that the subject interest’s FMV had been underreported. The petitioner subsequently engaged a second expert valuator, who submitted a valuation report but refused to testify due to a fee dispute. As a result, the court would not permit her report to be admitted into evidence, even though it adhered more closely to Tax Court precedents. Commentators have questioned the rationale of expending the effort and cost of a trial without ensuring the expert’s participation. Even the petitioner’s counsel commented to the court that apparently “ *counsel’s time is less dear than was* [the second expert’s].

A more fundamental question was the need for a second expert. In this matter, the petitioner contended the initial expert “ *failed to utilize the proper method of valuation and failed to properly classify the interest*.”

Generally, appraisal organizations and professional literature recognize three approaches in valuing businesses, real estate, and other investments:

1. The asset or cost-based approach.
2. The income approach.
3. The market approach.

The asset-based approach focuses primarily on the net assets of the business, while the income approach principally involves the use of earnings or cash flows to estimate value. Finally, direct comparisons with other transactions are used in the market approach. Professional standards require business valuators to consider all three approaches in every business valuation, although they may apply only the most appropriate approaches in each assignment.

In this case, the petitioner' s first expert and the respondent' s expert both applied only the net asset value (NAV) method, which is a form of the asset approach. The method computes the total value of the holding company's assets, including the appraised value of real estate, cash and other assets less liabilities. NAV is generally considered to be the net value that could be realized by a controlling interest excluding liquidation cost. When valuing a noncontrolling interest, business valuators have simply applied discounts to the NAV to account for the interest' s lack of control and marketability.

In this matter, neither the petitioner nor the IRS questioned the value of the underlying real estate concluded by the real estate appraiser. However, the petitioner did criticize his own business valuation expert, claiming that the exclusive reliance on NAV was inappropriate because:

> *" [T]he LLC is at least in part an operating company that should be valued giving some weight to the LLC[' s] earnings and/or distributions."*

In valuing closely held real estate holding companies that are involved in the operation and management of the property, Tax Court precedent is to apply a weighting approach using both the NAV method and an income capitalization approach so that the entities cannot be characterized for valuation purposes as solely investment companies or solely operating companies. Since investors in a noncontrolling interest cannot exercise prerogatives of control, they generally would expect value in the form of distributions from the real estate cash flows. Under the income approach, generally one of two methods would be employed: the capitalization of income or the discounted cash flow method. The capitalization of income method identifies a stream of income and then capitalizes it using the apposite rate of return. The discounted cash flow (DCF) method anticipates future earnings or cash flows and then discounts them to present value.

In the case *Andrews v. Commissioner*, the decedent owned an approximately 20 percent interest in each of four separate companies primarily involved in the ownership and active management of commercial real estate properties. The court reasoned that unlike many industrial companies, where the value of the manufacturing equipment and plant is tied to the nature of the manufacturing operation, the value of the underlying real estate will retain most of its inherent value even if the entity is not effective in securing a stream of rental income. The court opined:

> *" ..the degree to which the corporation is actively engaged in producing income rather than merely holding property for investment should influence the weight to be given to the values arrived at under the different approaches..."*

In *Andrews*, the court applied a weighting between the asset and income approaches. Furthermore, in two subsequent decisions the court followed a similar path as in Weinberg v. Commissioner, where the decedent possessed a general power of appointment over a marital deduction trust containing a 25.235 percent limited partnership interest that owned and operated a residential apartment building. In Giustina v. Commissioner, the decedent' s estate included a trust that owned a 41.128 percent LP interest in a company primarily consisting of operating timberlands. In both these cases, the court applied a weighting between income and NAV methods of 75 percent and 25 percent, respectively. In *Giustina*, Tax Court opined:

> *" ..the cash flow method is appropriate to reflect the value of the partnership if it is operated as a timber company and the asset method [NAV method] is appropriate to reflect the value of the partnership if its assets are sold. Accordingly, the percentage weight to be accorded the cash flow method should be equal to the probability that the partnership would continue to be operated as a timber company."*

In *Tanenblatt*, the court did not ignore the income approach entirely. The court observed that the real estate appraiser' s analysis was exclusively based on an income approach applying a DCF analysis. It should be noted that generally if a DCF analysis is prepared by a business valuator, it will usually differ from the analysis by the real estate appraiser because the inputs usually vary, yielding different valuation conclusions. Real estate appraisers consider the revenues and expenses from the vantage point of the underlying property itself, whereas the business valuator considers these amounts from company operations. To a real estate appraiser, stabilized revenues and expenses are those that a buyer of the property would expect assuming full control, without synergies. The revenues and expenses used by business appraisers assume continued operations as the willing purchaser of a noncontrolling interest does not have the authority to change policies or to change the capital structure of the holding company entity. The buyer of a noncontrolling interest is a very dissimilar purchaser with very dissimilar rights.

In *Tanenblatt*, the court reasoned that no evidence was admitted explicitly suggesting a business valuator would have reached a different conclusion. Despite the fact that the report from the petitioner’ s second expert more closely adhered to Tax Court’ s precedent for weighting real estate companies that are partially considered operating, which led to a lower concluded value, her report was barred from being entered as evidence. She applied a weighting of the income and asset approaches of 80 percent and 20 percent, respectively and she also considered the interest as an assignee interest rather than a membership interest, which did not appear to weigh into the court’ s value of the interest. In this case, the court concluded that while the petitioner disagreed with the respondent’ s expert discounts, no expert testimony was provided from which the court might draw *“ different, greater value* [for discounts] *in those technical areas of analysis.”*

One blogger observed that the moral of the story is to pay your experts. In fact, the lesson for us is that the expert can best be of assistance to the client when he or she can provide the most accurate and thorough information to the trier of fact. It usually can mean providing several methods supporting a conclusion for the court to consider. It appears when the expert limits his or her analysis, the court may have not any alterative, but to make assumptions, which as in this matter differ from the expectations of the petitioner. Furthermore, frequently if an expert offers positions are unsupported and/or appears to be serving as an “ advocate,” the expert may no longer be of the most assistance to the client or the court. A limited analysis can lead to limited options.

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