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When Results Count

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Tax Valuation E-Flash

Estate of Trompeter, T.C. Memo 2004-27, February 4, 2004

On remand from the Ninth Circuit, Judge Laro explained how he calculated fair market value in T.C. Memo 1998-35, and made some adjustments to that original calculation.

The Ninth Circuit vacated and remanded T.C. Memo 1998-35 with instructions to explain the basis for arriving at the $4.5 million fair market value of assets fraudulently omitted from the estate, the reasoning and analysis for using a 4% discount rate in valuing cumulative preferred stock, and the "well accepted present value formulae" referenced and applied in the opinion.

This means the same jewelry item would have different fair market values for estate purposes depending on whether the decedent was a dealer or a consumer.

The $4.5 million of omitted assets included diamonds, jade, rugs, coins, cash, and similar assets. The opinion discusses the manner in which the fair market value of such assets is determined, i.e. based on the market in which the decedent would purchase the asset. For example, an individual would purchase estate jewelry at retail from a dealer, while the dealer would buy that jewelry at auction. This means the same jewelry item would have different fair market values for estate purposes depending on whether the decedent was a dealer or a consumer.

In the original case (Trompeter I), the Court determined the fair market value of the cumulative preferred stock using a 4% discount rate compounded daily. Upon remand (Trompeter II), the Court explained the calculation of present value, but concluded that annual compounding was more appropriate since the dividends were compounded annually. The Ninth Circuit had questioned whether a 4% discount rate adequately reflected the risk that the preferred stock would not be redeemed as provided by agreement. Judge Laro noted that the 4% did not reflect the risk that the stock would not be redeemed as required, but rather only the time value of money, noting "As to the risk that Sterling would not meet its contractual obligation to redeem

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its series A preferred stock, we believe that a hypothetical buyer would have demanded minimal additional compensation to accept such a risk under the facts herein."

In Trompeter II, Judge Laro did conclude that the 4% did not take into account the risk that,

> The Court also "…noted but (did) not rely upon…" the fact that the preferred shares were subsequently redeemed at a reduced price.

"Sterling would not redeem its series A preferred stock for the contractual amount…but would redeem those shares at a lesser amount." Based on that, Judge Laro increased the 4% discount in Trompeter I to 12.5% in Trompeter II. The Court also "…noted but [did] not rely upon…" the fact that the preferred shares were subsequently redeemed at a reduced price.

Also on remand, the estate argued that the value of preferred stock should be reduced by a discount for lack of marketability. Judge Laro disagreed, noting that his calculation of fair market value for the preferred shares was not the freely traded value of those shares, so a discount is not appropriate. The opinion does not explain why the value determined was not a freely traded value.