

Nelson v. Commissioner: Tax Court Opines on the Transfer of Fixed-Dollar Value Amounts and the Application of Multitier Discounts

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This discussion reviews the 2020 U.S. Tax Court decision, Nelson v. Commissioner. In particular, this discussion (1) summarizes the factual background of the case, (2) considers both the valuation and the taxation issues addressed in the judicial decision, and (3) examines the implications of this Tax Court judicial decisions with regard to taxpayers, tax counsel, and valuation analysts.

INTRODUCTION

Nelson v. Commissioner (the “Nelson case”)¹ was a significant U.S. Tax Court decision during 2020. In this judicial decision, the U.S. Tax Court (“Tax Court”) addressed two topics related to valuation.

The first topic concerned whether the two ownership interest transfers in the *Nelson* case represented (1) fixed percentages of partnership interests or (2) a dollar value that determined the amount of partnership interests transferred.

The second topic concerned the applied discounts for lack of control and lack of marketability at two organizational levels—for a limited partnership that had a multitier organizational structure.

This discussion reviews the *Nelson* decision. Specifically, this discussion describes the factual background of the *Nelson* case. This discussion examines the following:

1. The factual issues of the *Nelson* case

2. The conclusions reached by the Tax Court
3. The guidance that can be extracted from this judicial guidance for taxpayers, tax counsel, and valuation analysts (“analysts”)

In the *Nelson* decision, there are implications for multiple parties including the taxpayer, the tax counsel representing taxpayers on gift transactions, and the analyst.

Lastly, it is noteworthy that the *Nelson* decision is currently on appeal by James C. Nelson and Mary P. Nelson (collectively, the “Petitioners”).

BACKGROUND AND CASE SUMMARY

First, this discussion summarizes the subject companies involved in the *Nelson* case. Second, this discussion reviews the background of the transfers and of the dispute.

Subject Companies Involved in the Nelson Case

Background of Longspar, Ltd.

The *Nelson* case involves the transfers of limited partnership interests in Longspar, Ltd. (“Longspar”). Longspar was formed on October 1, 2008, as a Texas limited partnership and was headquartered in Midland, Texas. Longspar was formed (1) to consolidate and protect family assets and (2) to make gifts without fractionalizing the ownership interests in closely held family businesses.

Mr. and Mrs. Nelson were the sole owners of the Longspar general partnership interests. Together they held a 1.0 percent general partnership interest in Longspar.

The general partnership interest and the limited partnership interests in Longspar on December 31, 2008 (the “valuation date”), prior to the transfers, are summarized in Exhibit 1.

As of the valuation date, Longspar held various assets including cash, marketable securities, investments in private equity and venture capital funds, and receivables. The primary asset of Longspar, however, was an ownership interest in Warren Equipment Co. (“Warren Equipment”).

Longspar also held 65,837 common stock shares of Warren Equipment. The Longspar sole liability as

of the valuation date was an accounts payable balance of \$5,000.

The net assets of Longspar are summarized in Exhibit 2.

As presented in Exhibit 2, the fair market value of its investment in Warren Equipment represented nearly all of the assets held by Longspar.

What triggered the dispute with the Internal Revenue Service (the “Service”) was the transfer of limited partnership interests in Longspar. Because the Longspar investment in Warren Equipment represented approximately 99 percent of total assets, the valuation of Warren Equipment was contested in the *Nelson* decision. The following discussion describes Warren Equipment.

Background of Warren Equipment Co.

In 1971, Johnny Warren (“Mr. Warren,” the father of Mrs. Nelson) founded Compressor Systems, Inc. (“CSI”), with another family. In 1975, Mr. Warren and his brother-in-law purchased the other family’s ownership interest in CSI, making CSI wholly owned by the Warren family.

CSI manufactures, sells, and rents natural gas compressors and services, and it also provides servicing and financing for natural gas compressors.

Mr. Warren continued to expand CSI and acquired or founded new business ventures. To facilitate this

Exhibit 1 Longspar, Ltd. Ownership Schedule

Partners	Partnership Interest (%)
<u>General Partners:</u>	
James C. Nelson	0.50
Mary P. Nelson	0.50
<u>Limited Partners:</u>	
Mary P. Nelson	93.88
Mary P. Nelson, as Custodian for Carole A. Nelson under the Texas Uniform Transfers to Minors Act	1.83
Mary P. Nelson, as Custodian for Mary C. Nelson under the Texas Uniform Transfers to Minors Act	0.88
Mary P. Nelson, as Custodian for Paige F. Nelson under the Texas Uniform Transfers to Minors Act	0.88
Steven C. Lindgren, as Trustee of the Mary Catherine Nelson 2000 Trust	0.51
Steven C. Lindgren, as Trustee of the Paige Francis Nelson 2000 Trust	0.51
Steven C. Lindgren, as Trustee of the Sarah Elizabeth Nelson 2000 Trust	0.51
Total	100.00

Source: James C. Nelson v. Commissioner of Internal Revenue and Mary P. Nelson v. Commissioner of Internal Revenue, T.C. Memo 2020-81 (June 10, 2020).

Exhibit 2
Longspar, Ltd.
Fair Market Value of Net Assets
As of December 31, 2008

Net Assets	Fair Market Value (\$)
Cash	9,470
Marketable Securities	158,344
65,837 Common Stock Shares in Warren Equipment Corporation	60,060,014 [a]
Investments in Private Equity and Venture Capital Funds	446,153
Notes Receivable	25,000
Accounts Receivable	<u>35,380</u>
Total Assets	<u>60,734,361</u>
Accounts Payable	<u>5,000</u>
Total Liabilities	5,000
Net Asset Value	60,729,361 [a]

[a] Represents an estimate, based on the facts of the *Nelson* case.
 Source: James C. Nelson v. Commissioner of Internal Revenue and Mary P. Nelson v. Commissioner of Internal Revenue, T.C. Memo 2020-81 (June 10, 2020).

3. North American Power Systems, Inc. (“NAPS”), sells light towers and generators.
4. Perkins South Plains, Inc. (“PSP”), is a distributor of engines for industrial applications.
5. Warren Real Estate Holdings, Inc. (“Warren RE”), finances and holds all real estate property associated with the operations of Warren Equipment and its subsidiaries.

Figure 1 presents the organizational chart of Warren Equipment.

Longspar owned 65,837 common stock shares in Warren Equipment, out of 237,407 total shares outstanding, as of the valuation date.

As presented in Figure 1, the common stock shares held by Longspar represent

an approximate 27 percent ownership interest in Warren Equipment as of the valuation date.

expansion, Warren Equipment was organized on September 26, 1990, as a Delaware corporation.

As of the valuation date, Warren Equipment was comprised of seven wholly owned subsidiaries, including CSI. Additionally, CSI owned and operated three subsidiaries, holding 100 percent ownership interests in the following companies:

1. Pump Systems International, Inc.
2. Rotary Compressor Systems, Inc.
3. Engines, Parts & Service, Inc.

Warren Power & Machinery, LP (“Warren Cat”), was the largest subsidiary owned by Warren Equipment as of the valuation date. Warren Cat is a dealer of new and used Caterpillar, Inc., construction and heavy equipment in Texas and Oklahoma.

The following paragraphs present summary descriptions of the remaining five subsidiaries owned by Warren Equipment:

1. Warren Administration Co. (“Warren Administration”) provides corporate management and administrative functions for Warren Equipment subsidiaries.
2. Ignition Systems and Controls, LP (“ISC”), is a regional dealer of ignition and control systems.

BACKGROUND OF THE TRANSFERS AND THE DISPUTE

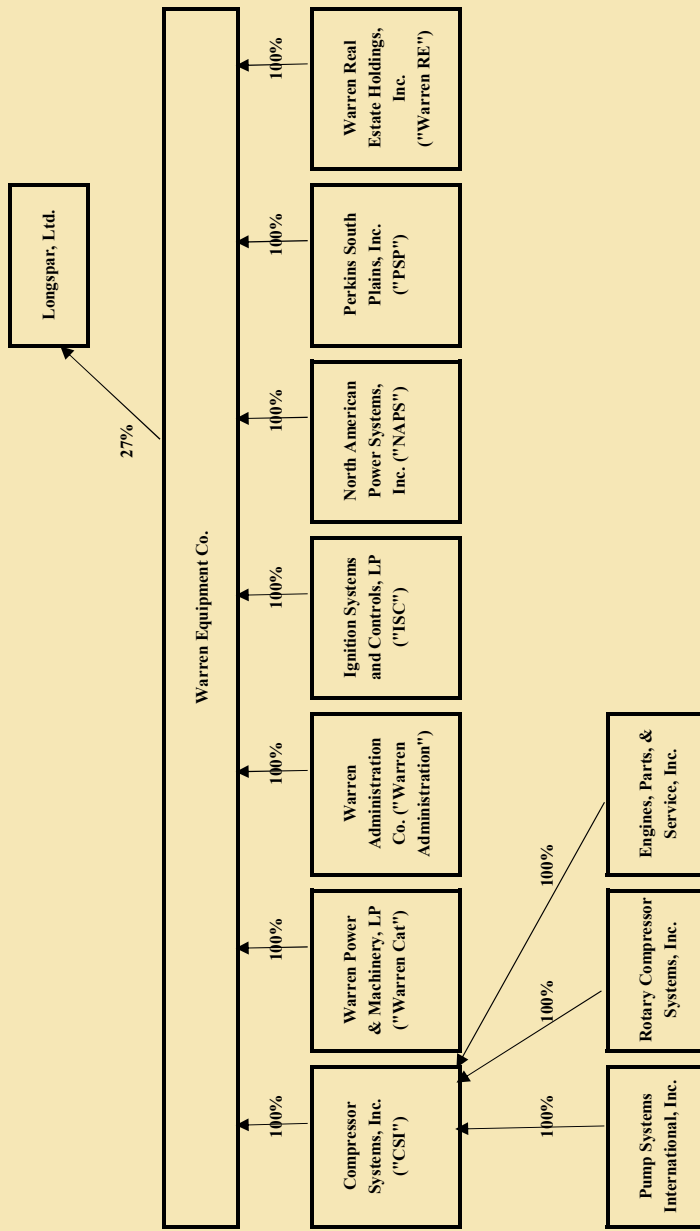
At issue in the *Nelson* case were two transfers of limited partnership interests in Longspar.

In December of 2008, the Petitioners formed the Nelson 2008 Descendants Trust (the “Nelson Trust”), which had Mrs. Nelson as settlor and Mr. Nelson as trustee. Mr. Nelson, and the four daughters of Mr. and Mrs. Nelson, were the beneficiaries of the Nelson Trust.

On December 31, 2008, Mrs. Nelson executed, as a gift, a transfer of a limited partnership interest in Longspar to the Nelson Trust. On January 2, 2009, Mrs. Nelson executed a second transfer, as a sale, of a limited partnership interest in Longspar to the Nelson Trust.

For the first transfer, in the Memorandum of Gift and Assignment of Limited Partner Interest (the “Gift Memorandum”) that outlined the gift transfer, Mrs. Nelson structured the transaction as a gift of a limited partnership interest in Longspar with a fair market value of \$2,096,000, to be determined by a qualified appraiser within 90 days.

Figure 1
Organizational Chart of Warren Equipment Co.
As of December 31, 2008



Source: James C. Nelson, Petitioner v. Commissioner of Internal Revenue, Respondent and Mary P. Nelson, Petitioner v. Commissioner of Internal Revenue, Respondent, Tax Court Memo 2020-81 (June 10, 2020).



For the second transfer, in the Memorandum of Sale and Assignment of Limited Partner Interest (the “Sale Memorandum”) that described the sale, Mrs. Nelson structured the transaction as the sale of a limited partnership interest in Longspar with a fair market value of \$20,000,000, to be determined by a qualified appraiser within 90 days.

The transaction was financed with a promissory note to Longspar issued by the Nelson Trust.

The Petitioners hired an appraiser to estimate the fair market value of a 1 percent limited partnership interest in Longspar as of the valuation date. The appraiser concluded that the fair market value was \$341,000.

Therefore, the fair market value of the December 31, 2008, gift was equal to a 6.14 percent limited partnership interest in Longspar, while the fair market value of the sale that occurred on January 2, 2009, equated to a 58.65 percent limited partnership interest in Longspar.²

Mr. and Mrs. Nelson each filed separate gift tax returns for 2008, with the gift transfer being classified as a split gift. The 2009 transfer was not filed as a gift in 2009, as it was a sale of the limited partnership interest in Longspar to the Nelson Trust.

On May 21, 2012, the Service selected the 2008 and 2009 Forms 709 for the Petitioners for examination. On May 21, 2012, the Petitioners entered into the administrative appeal process with the Service. The Service and the Petitioners attempted to enter into a settlement agreement, but it was never completed.

On August 29, 2013, the Service issued notices of deficiency, determining that the Petitioners:

1. undervalued the split gifts in 2008 (the December 31, 2008, gift transfer) and
2. undervalued the transfer on January 2, 2009, which as a result was alleged to be partly a gift.

ISSUES OF THE CASE

The Tax Court addressed the following two issues in the *Nelson* decision:

1. Whether Mr. and Mrs. Nelson transferred percentage interests or, alternatively, fixed dollar value amounts to the Trust
2. Whether the Petitioners’ expert (the “Longspar expert”) or the Service’s expert correctly estimated the valuation discounts for lack of control and lack of marketability applicable to Longspar and Warren Equipment³

The following discussion considers these two issues.

Transfers of Percentage Interests versus Fixed-Dollar Value Amounts

In the *Nelson* case, the Petitioners claimed that they transferred fixed-dollar value amounts of \$2,096,000 for the gift transfer and \$20,000,000 for the sale.

In contrast, the Service claimed that the two transfers were actually transfers of percentage interests—6.14 percent for the gift transfer and 58.65 percent for the sale—based on the Petitioners’ appraisal of the fair market value of a 1 percent limited partnership interest in Longspar.

The Service claimed that the Petitioners’ appraisal undervalued a 1 percent limited partnership interest in Longspar.

Based on this contention, the Service claimed that the Petitioners had (1) under-reported the gift transfer amount on their 2008 gift tax returns and (2) failed to report the excess value transferred in the sale (i.e., the excess value of the 58.65 percent Longspar limited partnership interest beyond the

\$20,000,000 consideration paid by the Trust to Petitioners) on their 2009 gift tax returns.

Tax Court Opinion on the Transferred Interests

The Tax Court agreed with the Service and concluded that the executed transfers represented percentage interests. The Tax Court determined that the transfers were “saving clauses” and, therefore, represented transfers of percentage interests.

The Petitioners claimed that the transfers were more similar to “formula clauses,” for which there is precedent for transferring dollar amounts. The Tax Court ultimately determined that this conclusion was based on the Petitioners’ intent arising from subsequent settlement discussions with the Service.

Instead, the Tax Court arrived at its conclusion based on the language of the Gift Memorandum and the Sale Memorandum.

Discounts for Lack of Control and Lack of Marketability

Also at issue in the *Nelson* case were the valuation discounts for lack of control and lack of marketability applied to Warren Equipment and Longspar. Specifically, the Service’s expert estimated a different discount for lack of control for Warren Equipment than did the Warren Equipment expert.

Additionally, the Service’s expert estimated different discounts for lack of control and for lack of marketability for Longspar than did the Longspar expert.

The differences between the experts’ estimated discounts for lack of control and for lack of marketability applicable to Warren Equipment and Longspar, and the Tax Court ultimate concluded discounts, are presented in Exhibit 3.

This discussion considers the application of the discounts for lack of control and lack of marketability for Warren Equipment and Longspar in the following sections.

Application of the Discount for Lack of Control for Warren Equipment Co.

The Warren Equipment expert applied the asset-based approach to estimate the value of the common equity of Warren Equipment. The Warren Equipment expert concluded that her asset-based approach valuation analysis estimated a value of the common equity of Warren Equipment on a controlling, marketable ownership interest basis.

To adjust for this, the Warren Equipment expert then applied a discount for lack of control and a discount for lack of marketability to arrive at the value of the common equity of Warren Equipment on a noncontrolling, nonmarketable ownership interest basis.

Warren Equipment is a holding company that holds 100 percent ownership interests in various subsidiaries. As noted in the Tax Court opinion, the Warren Equipment expert estimated the fair market value of each operating subsidiary, deducted the liabilities of Warren Equipment, and subtracted the preferred equity to arrive at the value of the common equity.

Typically, the adjusted net asset value valuation method estimates a value of total equity on a controlling, marketable ownership interest basis.

The Warren Equipment expert estimated the value of the common equity of Warren Equipment, as of the valuation date, to be approximately \$363.7 million to \$1,532 per share—on a controlling, marketable ownership interest basis.

Exhibit 3 Comparison of Discounts for Lack of Control and Lack of Marketability for Warren Equipment Co. and Longspar, Ltd.

	Warren Equipment Expert (%)	Longspar Expert (%)	Service's Expert (%)	Tax Court (%)
Warren Equipment Co.				
Discount for Lack of Control	20	NA	-	15
Discount for Lack of Marketability	30	NA	30	30
Combined Discount [a]	44	NA	30	41
Longspar, Ltd.				
Discount for Lack of Control	NA	15	3	5
Discount for Lack of Marketability	NA	35	25	28
Combined Discount [a]	NA	45	27	32

[a] Calculated as 1-(1-discount for lack of control) × (1-discount for lack of marketability).

Source: James C. Nelson v. Commissioner of Internal Revenue and Mary P. Nelson v. Commissioner of Internal Revenue, T.C. Memo 2020-81 (June 10, 2020).

After applying valuation discounts for lack of control and for lack of marketability, the Warren Equipment expert estimated the fair market value per common share of Warren Equipment to be \$860 per share on a noncontrolling, nonmarketable ownership interest basis.

The Service's expert did not dispute the indicated value of the common equity in the Warren Equipment expert's valuation analysis of \$1,532 per share. Instead, he disputed the level of value basis that the Warren Equipment expert's valuation analysis had estimated.

In other words, the Service's expert claimed that the Warren expert's indicated value of common equity per share of \$1,532 was already developed on a noncontrolling (rather than controlling), marketable ownership interest basis.

After applying the same 30 percent discount for lack of marketability as the Warren Equipment expert, the Service's expert estimated the fair market value of Warren Equipment to be approximately \$1,072 per share.

Exhibit 4 summarizes the valuation methodology applied by the Warren Equipment expert. In the case of Warren Administration, the Warren Equipment expert did not estimate an indicated fair market value—presumably because the Warren Administration subsidiary had an indicated value that was de minimus or zero.

In the case of Warren RE, the Warren Equipment expert relied on a third-party valuation specialist.

The Service's expert made three arguments to support his conclusion that the value of common equity was estimated on a noncontrolling, marketable ownership interest basis.

The Service's expert made the following arguments:

1. In the cases of CSI, Pump Systems International, Inc., and NAPS, the application of the discounted cash flow method did not include specific assumptions that would estimate a value on a controlling, marketable basis. The Service's expert argued that the discounted cash flow method analysis failed to consider the impact of operating assumptions (e.g., ability to increase profits, capital structure) that would differentiate between a controlling interest and a noncontrolling interest.
2. In the cases of CSI and Pump Systems International, Inc., (a) the selection of low pricing multiples and (b) the application of a control price premium was unnecessary in the market approach, since the market approach (presumably the guideline publicly traded company method) estimates value on a noncontrolling, marketable ownership interest basis.
3. In the case of Warren Cat, the application of the adjusted net asset value method did not consider intangible assets. Therefore, the adjusted net asset value method estimated the fair market value of Warren Cat on a noncontrolling, marketable ownership interest level of value basis.

Warren Equipment Co. Subsidiary	Valuation Approach Relied on by Warren Equipment Expert		
	Asset-Based Approach	Income Approach	Market Approach
CSI		✓	✓
Pump Systems International, Inc.		✓	✓
Rotary Compressor Systems, Inc.	NA	NA	NA
Engines, Parts & Service, Inc.	NA	NA	NA
Warren Cat	✓		
Warren Administration	NM	NM	NM
ISC	✓		
NAPS		✓	
PSP	✓		
Warren RE	NM	NM	NM

NA = Not Available
 NM = Not Meaningful
 Source: James C. Nelson v. Commissioner of Internal Revenue and Mary P. Nelson v. Commissioner of Internal Revenue, T.C. Memo 2020-81 (June 10, 2020).

Tax Court Opinion on the Warren Equipment Discount for Lack of Control

The Tax Court's opinion included components of both arguments set forth by the Service's expert and the Warren Equipment expert.

The Tax Court accepted the Service's expert argument that the income approach method performed by the Warren Expert did not address certain assumptions in its income approach analysis that would differentiate between a noncontrolling interest or a controlling interest.

Ultimately, however, the Tax Court concluded that all the operating subsidiaries possessed at least some control elements and, therefore, the Warren Equipment expert was correct in applying a discount for lack of control to Warren Equipment.

After examining the discount for lack of control estimated by the Warren Equipment expert, the Tax Court rejected the Warren Equipment expert's 20 percent discount for lack of control—and concluded that the appropriate discount should be 15 percent.

Application of the Discount for Lack of Control and Lack of Marketability for Longspar, Ltd.

In contrast to Warren Equipment, there was no dispute as to whether discounts for lack of control and lack of marketability should be applied in the valuation of a 1 percent limited partnership interest in Longspar. Instead, the level of the selected discounts was disputed.

The Longspar expert applied the adjusted net asset value method to estimate the equity value of Longspar on a controlling, marketable ownership interest basis. Then, the Longspar expert subtracted the 1 percent general partnership interest held by Mr. and Mrs. Nelson and applied a discount for lack of control and a discount for lack of marketability.

The Longspar expert estimated a discount for lack of control of 15 percent and a discount for lack of marketability of 35 percent. The fair market value of a 1 percent limited partnership in Longspar, according to the Longspar expert, was \$341,000 as of the valuation date.

The Service's expert also applied the adjusted net asset value method to estimate the fair market



value of Longspar. The Service's expert estimated a discount for lack of control of 3 percent and a lack of marketability of 25 percent, for Longspar.

In estimating the discount for lack of control, the Longspar expert relied on a 2008 report that contained closed-end fund data for 43 closed-end funds. The Longspar expert selected three closed-end funds from the dataset that were similar to Longspar. Specifically, the selected closed-end funds had long-term appreciation investment strategies.

The Longspar expert noted that the three selected closed-end funds lacked sufficient comparability based on (1) size and (2) the assets the selected closed-end funds held.

Based on the differences between these funds, the Longspar expert adjusted his analysis to conclude a discount for lack of control for Longspar of 15 percent.

The Longspar expert also concluded a discount for lack of marketability, and relied on (1) restricted stock studies and (2) pre-initial public offering ("pre-IPO") studies.

The Longspar expert estimated a discount for lack of marketability for Longspar of 30 percent based on (1) an average of various restricted stock studies and (2) an indicated range of 40 to 45 percent from the pre-IPO studies.

The Service's expert also relied on closed-end fund data to estimate a discount for lack of control for Longspar. The Service's expert used a broader set of 30 U.S. general equity closed-end funds, but then argued that the closed-end fund data was insufficiently comparable to Longspar.

After evaluating Longspar, the Service's expert concluded there was almost no possibility of lack of control disadvantages for Longspar, applied a discount for lack of control of 5 percent, and adjusted the indicated discount for lack of control downwards to 3 percent.

The Service's expert concluded a discount for lack of marketability for Longspar of 25 percent. The Service's expert applied (1) quantitative models and (2) restricted stock studies and pre-IPO studies that relied on recent data.

The Service's expert relied on an approximate range of 20 percent to 35 percent based on his analysis, and selected the approximate median of this indicated range of 25 percent.

Tax Court Opinion on the Warren Equipment Discount for Lack of Control

Again, the Tax Court's opinion included components of both arguments set forth by the Service's expert and the Longspar expert.

In the case of the Longspar discount for lack of control, the Tax Court agreed with both experts in determining that a discount for lack of control was justified. However, the Tax Court disagreed with both experts on the application of the closed-end fund data in estimating the Longspar discount for lack of control.

Instead, the Tax Court determined a discount for lack of control of 5 percent based on the acknowledgement of the Service's expert that "the possibility of a lack of control disadvantage for a minority owner is remote."

In the case of the Longspar discount for lack of marketability, the Tax Court rejected the Longspar expert and accepted the discount for lack of marketability analysis of the Service's expert.

However, the Tax Court concluded a discount for lack of marketability of 28 percent, which reflected a more precise calculation of the median of the indicated range of discount for lack of marketability.

CONCLUSIONS AND IMPLICATIONS

The Tax Court decision in the *Nelson* case has numerous implications for various parties, including taxpayers, tax counsel representing taxpayers in gift transactions, and analysts. The following discussion summarizes the broad implications arising from the *Nelson* case:

1. The Tax Court rejected the treatment of the transfers in the *Nelson* case as defined dollar amounts based on indicated values subsequently estimated by appraisers.

However, the Tax Court rejected this interpretation of defined dollar amount transfers ("defined value") in the *Nelson* case based on the wording of the Gift Memorandum and the Sale Memorandum. In other words, the Tax Court rejected the interpretation of the transfers as defined value transfers in the *Nelson* case based on the facts of the case, not as a rejection of defined value transfers more generally.

A takeaway for counsel representing taxpayers on gift transactions would be to ensure that the proper, exact clauses are included in the language of the transfer documents.

In the *Nelson* case, the Tax Court rejected subsequent evidence that revealed the intent of the Petitioners and instead relied on the language of the Gift Memorandum and the Sale Memorandum.

2. The Tax Court acknowledged that discounts, for both lack of control and lack of marketability, were justified at multiple organizational levels. As presented in the *Nelson* case, these multitier discounts for lack of marketability and control were appropriate at the Warren Equipment entity level and at the Longspar entity level.

One takeaway for the analyst from the *Nelson* case is that based on the unique facts of the subject interest valuation analysis, in some instances, multitier discounts are justified and appropriate. And, depending on the specific facts of the subject interest valuation analysis, the appropriate valuation discounts may be large.

Notes:

1. *Nelson v. Commissioner*, T.C. Memo 2020-81 (June 10, 2020).
2. Petitioners relied on the appraisal of a 1 percent limited partnership interest in Longspar as of December 31, 2008, for the fair market value of the January 2, 2009, sale.
3. The Petitioners relied on an expert witness who performed the appraisal of Longspar. The Longspar expert relied on a separate appraisal for Warren Equipment. The appraiser who performed the appraisal of Warren Equipment also performed expert testimony services in the *Nelson* Case. We refer to this expert as the Warren Equipment expert. We refer to the expert for the Service as the Service's expert.

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