

Valuing Claims: Is there a Methodology?

by

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Pan Am Flight 103 was Pan American World Airways' third daily scheduled transatlantic flight from Heathrow Airport to John F. Kennedy International Airport. On 21 December 1988, the aircraft flying this route, a Boeing 747-121, was destroyed by a bomb, killing all 243 passengers and 16 crew members with total fatalities of 270. Until 2003 Libya had never formally admitted carrying out the 1988 Lockerbie bombing. On 16 August 2003 Libya formally admitted responsibility (but did not admit guilt) for Pan Am Flight 103 in a letter presented to the president of the United Nations Security Council. On 29 May 2002, Libya offered up to \$2.7 billion to settle claims by the families of the 270 killed in the Lockerbie bombing, representing \$10 million per family. The Libyan offer was that:

- 40% would be released when United Nations sanctions, suspended in 1999, were cancelled;
- another 40% when US trade sanctions were lifted; and
- the final 20% when the US State Department removed Libya from its list of states sponsoring terrorism.

On October 31, 2008, President Bush signed Executive Order 13477 approving the removal of Libya from its list of states sponsoring terrorism.

Differing asset classes present different challenges in valuation. Valuation analysis can be thought of as a spectrum with assets having low risk and uncertainty such as cash, marketable securities, to asset classes that involve far greater risk and uncertainty. Your client, the surviving parent of one of the Pan Am passengers possesses a claim against a terrorist state, but dies prior to the payment of such claim. As part of your client's estate tax return, how would a claim against a sovereign nation which was a sponsor of a terrorist bombing be valued?

We are all familiar with real estate and business interests which are far harder to value. There are other types of assets which, under the statutory framework, must be valued. Examples of these types of interests are: trust interests, blocks of accounts receivable, disputed contractual claims, and claims which arise in the context of torts, such as, for example, wrongful death claims. Fortunately, there is a methodology for evaluating the valuation of these types of claims.

The framework for evaluating the includability and valuation of claims made by an estate are contained within Internal Revenue Code §§ 2031 and 2033 where a claim is classified as a chose in action, to be included in an estate. The relevant measure of the amount to be included is fair market value as of the date of death. Fair market value is defined as “the price at which a willing seller and a willing buyer, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts will choose to exchange the property.” IRC Treas. Reg. 20.2031-1(b); United States v. Cartwright, 411 U.S. 546, 551 (1973) In evaluating choses in action, there has been significant case law over some years, but the case law is not uniform with respect to the weight accorded to post-death events in valuing a claim at date of death.

Some courts have excluded post-death events in their analysis of the relevant facts, while in other cases the courts have included some post-death events as part of the relevant facts about

which the buyer and seller should be aware. It is also clear from the case law that the value of enforceable actions have been discounted for hazards of litigation, delays in collection and other uncertainties and that the analysis is very closely driven by the relevant facts.

With tort claims, the following basic facts need to be compared and contrasted with respect to two (2) potential valuation discounts. First, the possibility that there will be some significant delay in the payment of the claim; and second, uncertainty associated with whether the claim would in fact ever be paid. In evaluating the uncertainty associated with whether a claim will ever be paid, the facts and circumstances surrounding the claim and the responsible party will be paramount. A judgment is made which is qualitative in nature about the risks of collection, potential enforceability and other potential risks to the realization and conversion of this type of asset into cash and these qualitative factors need to be evaluated carefully in each case. A careful analysis of all the unique facts is necessary, but once the facts are understood, a comparative analysis can be done.

A close analysis of the relevant case law indicates that discounts with respect to potential timing of payments had been allowed by the courts in a number of instances and are generally related to the potential uncertainty in terms of when payments might be made. In addition, in cases where credible evidence was demonstrated with respect to the uncertainty of a payment of a claim, the courts have allowed discounts ranging from 29% to 70%, and in several cases have taken the position that by virtue of unique facts and circumstances, that the claim ought not to be included in the federal transfer taxable estate at all.

In Estate of Baldwin v. C. I. R., T.C. Memo, 1961-89, that the value of a claim at the date of death was held to be equal to 69% of the fair market value of the actual property received by the estate post death. The court discussed the fair market value of the claim in light of the

hypothetical buyer and seller test of § 2031 and noted difficulty in fixing a value. The claim being valued was a pending against the decedent's brother, and the fair market value of the property received subsequent to the death of the decedent was an amount of \$87,400. A \$60,000 value of the claim was determined by the court. The court discussed the merits of the claim, the locale and the litigiousness of the surviving brother in assessing the uncertainty of whether the claim would ever be paid and held that a discount of 31% would apply. It is important to note that the court, in reaching its holding, assessed a 31% discount in this case even though the claim was clearly enforceable under United States law.

In Houston v. Commissioner of Internal Revenue, T.C. Memo 1982-362, 44 T.C.M., the value of a claim was held to be close to the amount of the actual settlement received, but different than the amount actually received. The claim was for wrongful death made by the surviving spouse on the death of her husband in an automobile accident. The total claim sought was approximately \$640,000, and a settlement of some \$132,500 was agreed to and paid out approximately 5.5 years after the wife's date of death, to be divided evenly between the wife's estate and her children. The court found the value of decedent's claim to be \$75,000, which was greater than the actual amount of \$66,250 ($\$132,500 \times 50\%$), and in evaluating the case the court took a close look at the facts at the time of death, as well as subsequent facts that established the uncertainty of the claim. The court cited Estate of Curry v. Commissioner, 74 T.C. 540 (1980) for the proposition that the court can look to events subsequent to the decedent's death to determine value because, in this case, the value of the claim was not fixed as of the date of death. The Houston case points out a trend which is apparent throughout the analysis of cases: valuation analysis has a tendency to be fact-driven and specific facts can have significant impacts on the court's decision.

In Rubenstein v. United States of America, 826 F.Supp. 448 (1993), the value of a claim was held to be equal to the net value of the actual property transferred in settlement of the claim. In Rubenstein the court noted that the taxpayer was unable to provide any evidence of fair market value and noted that the funds actually received were highly indicative of the value of the decedent's share of the claim. Citing United States v. Simmons, 346 F.2d 213 (1965), the court noted that the willing seller and willing buyer test required both parties to have a reasonable knowledge of the relevant facts and that settlement proceeds could be relevant. It is interesting to note and distinguish this case since the court clearly identifies in Rubenstein that the taxpayer proffered no evidence as to the uncertainties which would impinge on fair market value.

In Bary v. Commissioner, T.C. Memo 1965-322 (1965), the court held that the value of a claim against a foreign government was zero at the decedent's date of death, (15 years prior to legislation that would enable her estate to make a claim). The court reasoned that at the date of death there was no basis in the law to allow a claim to be brought, as the enabling legislation allowing the claim was not enacted until 15 years later. The Court held that the value of decedent's claim was zero at the date of death in 1940, because decedent did not have an enforceable claim until at least 1955 when Congress enacted legislation giving certain nationals of the United States enforceable rights against Russian assets held by the United States. Since the legislation did not exist at decedent's time of death, decedent had no claim which could be enforceable under United States law at the time.

Bary makes clear that the claim which arose out of the seizure of assets from the Union of Soviet Socialist Republics arose by actions taken by a sovereign state, over which the taxpayers had no control. It is also instructive in the sense that it acknowledges that sovereign

foreign governments were engaged in conduct for which there was no legal remedy under the laws of the United States. As against sovereign states, the only recourse, if such recourse is available, is through diplomatic and other means.

In Lennon v. Commissioner, T.C. Memo 1191-360 (1991), the court valued a claim at a 29% discount from the net settlement received by the estate. The discounts claimed by the taxpayer's experts, which were greater than 40%, were deemed excessive by the court. However, the court also noted that the IRS placed undue weight on the actual settlement amount. The Internal Revenue Service argued for 2 valuations; first, the decedent's interest in the total \$7.75 million judgment, or second, the decedent's interest in the net settlement received. The court stated "We believe \$1.75 million for the date-of-death fair market value of decedent's interest in the judgment reflects, among other things, the risk that the circuit court judgment would be modified on appeal and the delay the appeal would cause in the receipt of the award." The court noted the taxpayer's valuation disregarded the possibility of a substantial settlement and the possibility of recovering under maritime law.

The court in Lennon cited Gilford v. Commissioner, 88 T.C. 38, 52 (1987) stating: "This court has adopted the rule that generally 'subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable at the date of valuation.'" The court also ruled that attorney's fees are an appropriate reduction in the amount of the claim as the payment of the claim requires the payment of attorney's fees.

In Davis v. Commissioner, T.C. Memo 1993-155 (1993), the court valued a claim at about 30% of the net settlement received by the estate, creating an effective 70% discount. The taxpayer's expert witnesses testified to the value of the claim, and the court used a highly technical analysis to value the compensatory claim involved. For federal estate tax purposes the

value of the gross estate is determined by including the value at the time of death of all property in which decedent has an interest, real or personal, tangible or intangible. The value of the property is the fair market value on the date of death. After reciting Treas. Reg. 20.2032-1(b), the court went on to state:

Having set forth these rather familiar principles for determining fair market value, we must admit that the valuation of a lawsuit continues to be a unique and abstract endeavor. A lawsuit is not the type of asset, either tangible or intangible, which readily fits within the categories of things regularly traded in commerce. Furthermore, the valuation process for lawsuits does not appear to be as objectively achievable as other types of assets. The concepts underlying lawsuits for punitive damages make valuation questions even more elusive and difficult to ascertain with a high degree of certainty.”

In this case, the court’s valuation included a 10% discount weighed to account for the time delay in receipt of the claim and applied this 10% per year discount for each of 2 years in reducing the value of the claim.

In American National Bank & Trust Company v. United States, 594 F.2d 1141 (1979), the court specifically noted that it is appropriate to adjust fair market value for the time delay under which a payment might be received, and that actual settlement proceeds are not determinative of value. The court in its analysis argued that, notwithstanding some delay in the payment, the government’s position that the amount subsequently paid must be the value of the claim was inherently unreasonable. The court noted that such a result would entail a harsh and seemingly irrational taxing policy, requiring an estate to pay tax on the full amount receivable in these cases, regardless of when, or if, such amount were received. The court stated no specific

provision exists in the Internal Revenue Code or Regulations to provide for recovery of taxes paid in such a situation and, therefore, the estate would bear the potentially insurmountable task of advancing money to pay taxes on funds not yet in the estate. The court remanded the case, with instructions to determine an appropriate discount with respect to the date of death value of an accident claim, and rejected the use of actual settlement proceeds as value.

In Biagioni v. Commissioner, T.C. Memo 1981-660, the court valued a claim at an amount greater than the actual settlement received by the estate 4 years later. The court noted that the taxpayer failed to introduce evidence of value, and found that a claim of \$235,925 had a fair market value of \$105,000. While the claim value was held to be greater than the settlement subsequently received, note the court still discounted the face value of the claim by more than 50% of \$235,925.

In Bull v. Commissioner, T.C. Memo 2001-92, the court held the value of decedent's rights in certain insurance reimbursements, as of the date of death was equal to zero, because the decedent's rights were unenforceable at the date of death due to conditions precedent. The case is instructive because it stands for the proposition that factual impediments to payment should be recognized by the law as reducing the value of a claim potentially even to zero. The case reaffirms that fair market value, as of the date of death, and based on all relevant facts known at that time is the appropriate measure for value.

In Cobb v. Commissioner, T.C. Memo 1982-571, the court discounted the value of a claim with respect to the husband's estate and specifically noted the difficulty in valuing a claim and in determining a discount for both litigation hazards, and for delay in receiving the funds. The case further states that a prospective purchaser of an estate's interest in a claim would consider both the delay in receiving the funds as well as any other hazards or contingencies.

In Crossmore v. Commissioner, T.C. Memo 1988-494, the court gave a nominal 5% discount in valuing a decedent's interest in another's estate, stating that an undue influence claim that could bar decedent's recovery was unlikely to be successful and did not garner a deep discount. The asset in question was an interest in the estate of another arising from a will that was not even probated at the decedent's death. The decedent was left the entire estate of her aunt by will, who died 2 months before the decedent, but whose will had not been probated at the decedent's death. The total value of the aunt's estate was about \$285,000. The decedent's estate received most of these funds after expenses. The decedent's executor valued this interest at \$50,000 discounted for the possibility of an undue influence case, which could have barred decedent's recovery. The IRS valued the interest at \$279,000, the total cash in the estate less a \$5,000 settlement payment. The court found decedent's attorney too aggressive with discounts. The court noted that the decedent's attorney himself admitted that most undue influence claims were not successful.

Ultimately, the court determined the probability was minimal that the decedent's recovery would be barred by an undue influence claim, and any discount should reflect only a nuisance value of potential litigation. The court therefore provided a \$15,500 discount on a \$285,000 claim. The court noted that events after death are not controlling, and it carefully went through the merits of a potential undue influence claim before determining that only a minor discount was appropriate. That discount was approximately equal to 5.5%. The Crossmore case illustrates how fact specific the court's inquiry must be and how specific facts illustrate uncertainties which are reflected in the discount.

This heavy dependence on factual analysis is further illustrated by a series of cases regarding other interests where the court considered various risk factors. See the following table:

<u>Case</u>	<u>Type of claim</u>	<u>Discount for delay</u>	<u>Discount for uncertainty</u>
Livermore v. Commissioner T.C. Memo 1988-503	Production by oil wells	-	40%
Gokey v. Commissioner T.C. Memo 1984-665	Trust Remainder interest	-	75%
McGlue v. Commissioner 41 B.T.A. 1199 (1940)	Right to receive executor's commission	0%	0%
Skinker v. Commissioner T.C. Memo 13 B.T.A. 846 (1928)	Contracts regarding contingent refunds	-	99%
Duffield v. United States 136 F. Supp 944 (1955)	Fee contracts owned by Attorney's Estate	Uncertain – summary judgment – Important for rationale	Uncertain – summary judgment – Important for rationale
Aldrich v. Commissioner T.C. Memo 1983-543	Contingent fee arrangement owned by decedents' estate	Unstated reduction possible	Unstated reduction possible
Curry v. Commissioner 74 T.C. 540 (1980)	Deceased Attorney's contingent fees	15%/year	-

The reasoning in Curry v. Commissioner is particularly helpful.

The court indicated that the appropriate standard for valuation is fair market value as of the date of death. The court stated that §2031 provides that the value of the gross estate shall be determined by including the value of all property, real or personal, tangible or intangible.

Section 2033 provides that the value of the gross estate include the value of all property to the extent of the interest therein of the decedent. As used in the statute, the term property

encompasses all choses in action, including claims for services performed. The court pointed out that:

As a matter of law, the inclusion of an interest in the decedent's gross estate at its fair market value does not command that the value of an estate be fixed at any specific amount. Rather, the (Fair Market) value of an asset must be determined in order to assess the tax. The value of every item of property includable in a decedent's gross estate under §§ 2031-2044, is its fair market value at the time of decedent's death. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller; neither being under any compulsion to buy or to sell and both having reasonable knowledge of the facts. The fair market value of a particular item or property is not to be determined by a for sale price, nor is the fair market value of an item or property to be determined by the sales price of the item at a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate . . . uncertainties and difficulties in determining value have never been considered justifications for obviating the necessary task of determining fair market value. *Id.*

Uncertainties provide no excuse for failing to value such assets. As the court said "Inexactitude is often a by-product of estimating claims or assets which do not have an established market and, therefore, the qualitative evaluation of such items is of necessity what must be done to obtain fair market value."

In valuing a claim or chose in action held by an estate, an integral part of the analysis should be the extent to which, and the factual connection to, costs of attempting to collect the claim are present and relevant. These costs would include attorney's fees among other potential

expenses, and therefore, in many instances the logical construction of valuing the assets would include an analysis of what expenses might reasonably be incurred. The net realizable value of the asset would also be part of the valuation analysis. Relevant to valuation of expenses incurred in collecting a claim, are the contractual obligations the estate faces, for example, fee agreements, in collecting a chose in action on which an estate is proceeding in attempts to collect the same. Different conclusions regarding value will arise depending on whether the costs associated are contingent upon the collection of the claim or whether those costs are incurred on some other basis and are therefore tied indirectly or not at all to the probability of collecting the underlying claim.

Courts must value claims against an estate using a date of death value. This is consistent with the valuation analysis used for claims held by estates, as demonstrated by the previously cited cases. Courts have attempted to determine a claim's date of death value and may regard, but not consider dispositive, the claim's "face value" at the date of death or the actual amount paid out or received by the estate subsequent to the date of death. See Propstra v. U.S., 680 F. 2d 1248 (1982), Van Horne v. Comm., 78 TC 728 (1982), and Smith v. Comm., 198 F. 3d 515 (1999). In each of these cases, the courts attempted to determine the value of a claim against an estate using a date of death value. At least one other factual similarity exists; in all of them the face value of the enforceable claim at date of death was significantly greater than the settled claim amount after death (\$596,000 as compared to \$35,000, \$2,400,000 as compared to \$680,000, and \$202,423 as compared to \$134,826 Van Horne, Smith, and Propstra, respectively). In all of these cases the court attempted to determine the date of death value and did not base its decision solely on the settled value.

In analyzing the cases which evaluate intangible property several logical constructs emerge. First, it is clear that courts have recognized that in the case of intangible assets, where an enforceable contract exists with respect to an expense driven by those assets, that the courts have and will allow these expenses to reduce the value of the assets to be valued.

Second, in the case of intangible claims which will be paid subsequently, the courts have recognized that a delay in time with respect to payments, apart from any uncertainty as to whether payment would occur, is valid and should be recognized. In fact, the time value of money concepts, which recognize that a \$1 paid at some time in the future is worth less than \$1 paid today, are replete throughout the Internal Revenue Code. The valuation of uncertainty in when a potential claim might be paid is by its nature subject to less precision than the mechanical provisions within the Internal Revenue Code, but courts have recognized that such a discount is nonetheless valid. In the cases analyzed in this article, discounts with respect to the timing of payment have ranged between 5% and 15%.

Finally, with respect to discounts for uncertainty as to whether a claim exists (or is legally enforceable) and/or events which have yet to take place, conditions precedent and other contingencies have clearly been allowed by the courts. The analysis of these cases indicates that specific evidence with respect to all the facts and circumstances are an important underpinning of any decision, and where facts have been presented via testimony of qualified experts, or otherwise, that effective discounts ranging from 10% to 100%, have been adjudicated by the courts.

A methodology exists which enables the valuation of these less commonly encountered and intrinsically hard-to-value assets. That analysis, by its very nature, must be qualitative. A

close comparison to existing cases, which make qualitative judgments about uncertainties leading to substantial discounts are instructive and permits taxpayers to take positions that have substantial authority resulting in substantial discounts being allowed by the Internal Revenue Service.

****Legal notes are not legal advice. Because legal problems are factually intensive, the reader must always consult their counsel before acting on any legal matter.**