

**OFFICE OF TAX APPEALS
STATE OF CALIFORNIA**

In the Matter of the Appeal of:) OTA Case Number 21098630
W. GELPI)
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OPINION

Representing the Parties:

For Appellant: Michael G. Schinner, Attorney

For Respondent: Brian C. Miller, Attorney
Peter Kwok, Attorney

For Office of Tax Appeals: Tom Hudson, Attorney

C. AKIN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, W. Gelpi (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$161,238 and applicable interest for the 2017 tax year.

Office of Tax Appeals (OTA) Administrative Law Judges Cheryl L. Akin, Ovsep Akopchikyan, and Sheriene Anne Ridenour held an electronic oral hearing for this matter on August 17, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

ISSUE

Whether appellant has shown that FTB erred in disallowing a portion of appellant’s charitable contribution deduction.

FACTUAL FINDINGS

Background

1. Appellant was the co-founder and CEO of Rocket Games, Incorporated (RGI), which was a developer of online gaming applications that simulated casino games. Appellant owned

six million of RGI's 13,433,700 issued and outstanding shares. RGI's shares were not publicly traded on any stock exchange.

Appellant's Charitable Contribution of RGI Stock on July 21, 2016

2. On July 21, 2016, appellant donated 1.1 million shares of his RGI stock to Dechomai Asset Trust (Dechomai), a donor-advised Nevada public charity fund that works with donors and charities to facilitate charitable donations of noncash assets. The donation is evidenced by a Stock Transfer Agreement dated July 21, 2016, signed by appellant, RGI, and Dechomai.

Purchase of RGI Stock by Penn Interactive Ventures, LLC on July 28, 2016

3. One week later, on July 28, 2016, Penn Interactive Ventures, LLC, RGI, and RGI's shareholders, including appellant, entered into a Stock Purchase Agreement (Stock Purchase Agreement). Pursuant to the Stock Purchase Agreement, Penn Interactive Ventures, LLC, a third party unrelated to RGI or its shareholders, agreed to purchase all outstanding shares of RGI stock for an initial payment of \$60 million,¹ plus additional payments over the next two years if RGI met certain earnings before interest, taxes, depreciation, and amortization (EBITDA) thresholds (contingent earnout). The Stock Purchase Agreement capped the total purchase price at \$170 million, including the initial payment of \$60 million, if all contingencies were fully met. The maximum purchase price equaled \$12.65 per share (\$170 million divided by 13,433,700 outstanding shares), and the minimum purchase price if no contingencies were met equaled \$4.47 per share (\$60 million divided by 13,433,700 outstanding shares).
4. On September 30, 2016, Penn National Gaming, Inc., together with its subsidiary Penn Interactive Ventures, LLC (collectively, Penn), filed its Form 10-Q, Quarterly Report, with the U.S. Securities and Exchange Commission, reporting that it had acquired 100 percent of the outstanding RGI shares "for initial cash consideration of \$59.1 million" and "contingent consideration payments over the next two years." The Form 10-Q further stated, "The preliminary fair value of the contingent purchase price

¹ The \$60 million initial purchase price was subject to certain adjustments computed based on closing indebtedness, transaction expenses, the closing net working capital balance compared to the estimated closing net working capital balance, closing cash, and the exercise price for certain vested options.

was estimated to be \$56.0 million at the acquisition date [in addition to the initial payment] based on an income approach by applying an option pricing method to [Penn's] internal earning projections" If Penn had paid a total of \$115.1 million (\$59.1 million plus \$56.0 million) to purchase RGI, as estimated in Penn's Form 10-Q, the price per share would have been \$8.57 per share (\$115.1 million divided by 13,433,700 outstanding shares).

Equity Valuation of the Donated RGI Stock

5. On September 29, 2017, Allied Business Group, LLC (Allied) released an Equity Valuation of Multiple Shares of Common Stock (Appraisal) that estimated the fair market value of certain blocks of RGI stock as of June 30, 2016. The Appraisal stated that RGI hired Allied "to estimate the fair market value of multiple shares of common stock in [RGI], on a non-marketable, non-controlling basis, as of June 30, 2016, for charitable gift tax and gift tax purposes." The Appraisal indicated that it was prepared in accordance with the Uniform Standards of Professional Appraisal Practice and the Statement on Standards for Valuation Services of the American Institute of Certified Public Accountants. The Appraisal further stated that the analysis was prepared following the guidance of the IRS's Revenue Ruling 59-60, 1959-1 C.B. 237 (Rev. Rul. 59-60). The Appraisal noted three generally accepted approaches used when valuing a closely held business such as RGI: the cost approach; income approach; and market approach.
 - a. With respect to the cost approach, the Appraisal noted that the cost approach may not be appropriate where the subject company has significant cash flows from operations and/or significant value associated with intangible assets which may not be captured by the value of the underlying assets. Allied stated that it elected not to consider the cost approach to value the stock because it determined that RGI's best potential value was captured when considered as a going concern.
 - b. For the income approach, the Appraisal noted that this approach focuses on determining a forecast benefit stream that is reflective of RGI's most likely future performance, which is then discounted to present value based on the appropriate risk-adjusted discount rate. The Appraisal noted that it would use the discounted cash flow method, which uses a forecast benefit stream of multiple periods (as opposed to the capitalization of earnings method that uses a forecast benefit stream for a single

- period), since RGI's cash flows were expected to change over time before reaching a steady rate of growth.
- c. For the market approach, the Appraisal noted that it would use the guideline transaction method which involves identifying and selecting actual transactions, such as mergers, acquisitions, investments, sales, or licensing agreements that involve companies or assets with financial and operating characteristics similar to those of RGI. Allied noted that it found a sufficient sample of comparable transactions of privately held companies with models and financial characteristics similar to RGI and would consider the guideline transaction method in its valuation.
 - d. Using the discounted cash flow and guideline transaction methods, weighted at 75 and 25 percent, respectively, the Appraisal estimated RGI's enterprise value to be \$124,985,800. The Appraisal then allocated this enterprise value to the individual classes of equity in RGI. The Appraisal noted that it chose the option pricing method (over other methods such as the current value method and the probability-weighted expected return method) to allocate this enterprise value because RGI was "still negotiating with potential buyers in the near future." Using this method and applying a lack of control discount of 6 percent and a lack of marketability discount of 5 percent,² the Appraisal estimated the value of the 1.1 million shares of RGI stock donated by appellant to be \$7,715,000. This equals \$7.01 per share (\$7,715,000 divided by 1.1 million shares).

Events Occurring Subsequent to the Charitable Contribution and Penn's Acquisition of RGI

6. On March 15, 2017, nearly all of RGI's gaming applications were removed from Apple's App Store. Appellant provides samples of the automated notifications and emails Apple sent RGI regarding the removal of its applications from the App Store. The emails state: "Upon further review, we noticed your [application] is nearly identical to other [applications] you have submitted to the App Store with only minor differences. Submitting [applications] with common or identical feature sets is considered a form of spam and violates App Store Guideline 4.3. As a result, your [application] has been

² The Appraisal noted that "the time period between the stock transfer date . . . and the potential sale date of [RGI] is less than [15] days," and therefore concluded that "the [lack of marketability discount] should be lower due to the sale event on the horizon." Thus, the Appraisal used a lack of marketability discount of 5 percent instead of the more common 20 to 35 percent discount typically used for closely held businesses.

removed from the App Store.” During the hearing, appellant testified that Apple unilaterally removed RGI’s applications from the App Store, that RGI had not received any prior warnings or notice from Apple regarding the potential removal of its applications, and that the removal of its applications from the App Store was not foreseen or foreseeable at the time of the charitable contribution or sale to Penn in July 2016. Appellant further testified that he learned through subsequent conversations with Apple representatives that Apple wanted RGI to combine all of its applications together into one application and offer only one application on the App Store. Appellant provides sample emails RGI sent to Apple explaining the differences between its various applications and attempting to get its applications reinstated to the App Store. Appellant testified that RGI was able to get a couple of its largest games restored on the App Store, but that the majority were never restored, which resulted in about a 30 percent reduction in RGI’s revenue. Appellant testified that prior to the removal of its applications, RGI was on target to exceed the contingent earnout, but that after the removal, RGI’s revenue took a “dramatic change,” and RGI started to get closer to the contingent earnout minimums “which ultimately led to [a] dispute on the first anniversary of the sale.”

7. Appellant also testified that in 2017, after Penn had acquired RGI, Penn requested assistance from RGI to build Penn a digital platform for some of Penn’s other products. Appellant testified that this was not part of the original agreement when Penn acquired RGI, and that Penn verbally told appellant that RGI would be permitted to capitalize the expenditures associated with developing the digital platform so that the expenditures would not affect RGI’s EBITDA calculations for the contingent earnout. RGI built the digital platform for Penn in 2017. Subsequently, a dispute arose between RGI and Penn as to whether the platform development expenditures should be expensed or capitalized and whether RGI had met its contingent earnout threshold for the first year. Appellant testified that expensing the platform development costs reduced RGI’s 2017 EBITDA by approximately \$2 million without increasing RGI’s profitability or income for that year. Appellant further testified that RGI considered going to court over it but ultimately decided to instead settle by amending the Stock Purchase Agreement. Appellant testified that this dispute was unforeseen at the time of the charitable contribution and stock sale in July 2016, as RGI and Penn had not discussed the building of a digital platform for

- Penn at the time of the acquisition. Appellant testified that throughout the acquisition period it was his and RGI's understanding that RGI would be left completely independent for the first two years after the acquisition.
8. On September 12, 2017, Penn and RGI amended the Stock Purchase Agreement to eliminate the contingent earnout payments in return for a single payment of \$17.5 million on or before September 13, 2017 (Amendment). This resulted in a total purchase price of \$76.6 million (the \$59.1 million initial payment per Penn's Form 10-Q plus the \$17.5 million additional payment per the Amendment) for Penn's acquisition of RGI.
 9. In accordance with the Stock Purchase Agreement and the Amendment, Dechomai received a total of \$5,355,830 from the sale of its 1.1 million shares of RGI stock (donated to it by appellant) to Penn. Dechomai received \$3,637,207 in August 2016; \$1,214,144 in 2017; and \$504,479 in 2018. This equals \$4.87 per share (\$5,355,830 divided by 1.1 million shares).

Appellant's Reporting per His 2016 and 2017 Tax Returns

10. Appellant timely filed a 2016 California Resident Income Tax Return. On the attached IRS Form 8283, Noncash Charitable Contributions, appellant reported \$7,715,000 as the fair market value of the RGI stock that he donated to Dechomai. Appellant also reported the donation of clothing and computers valued at \$740, resulting in total noncash charitable contributions of \$7,715,740.³ Appellant deducted \$4,662,433 in 2016,⁴ and carried forward the remainder because his deduction for noncash charitable contributions was limited to 30 percent of his reported federal adjusted gross income (AGI), in accordance with Internal Revenue Code (IRC) section 170(b)(1)(B).⁵

³ The \$740 noncash charitable contribution of clothing and computers is not at issue in this appeal.

⁴ Appellant's reported charitable deduction of \$4,662,433 on Schedule A, Itemized Deductions, for 2016, including \$231 in gifts to charity by cash or check, are not at issue in this appeal.

⁵ California conforms to IRC section 170 pursuant to R&TC section 17201(a).

11. Appellant timely filed a 2017 California Resident Income Tax Return. On Schedule A, Itemized Deductions, appellant reported a charitable contribution carryover of \$3,053,538. Appellant deducted \$1,916,550 in 2017 and carried forward the remainder.⁶

FTB's Audit and Appellant's Protest with FTB and Subsequent Appeal to OTA

12. FTB audited appellant's 2016 and 2017 tax returns. For the 2016 tax year, FTB reduced appellant's reported charitable contribution deduction for the donation of the RGI stock to Dechomai from \$7,715,000 to \$5,355,830, the amount that Dechomai ultimately received from the sale of the RGI stock to Penn. On November 15, 2019, FTB issued a letter indicating that there would be no change to appellant's 2016 California income tax return because FTB allowed appellant's claimed charitable contribution deduction of \$4,662,202. However, FTB reduced the amount of the deduction that could be carried forward from the reported amount of \$3,053,538 to \$693,628 to conform to the \$5,355,830 that Dechomai ultimately received for the donated stock.
13. For 2017, FTB reduced appellant's reported charitable contribution deduction from \$1,916,550 to \$704,236,⁷ a reduction of \$1,212,314. On March 10, 2020, FTB issued appellant a Notice of Proposed Assessment (NPA) proposing additional tax of \$161,238, plus applicable interest, for the 2017 tax year. The NPA also informed appellant that his charitable contribution carryover of \$1,147,416 was eliminated and appellant no longer had any charitable contributions to be carried forward after the 2017 tax year.
14. Appellant protested the NPA, and FTB issued a Notice of Action affirming the NPA. This timely appeal followed.
15. On appeal, FTB agreed to modify the 2017 proposed assessment from \$161,238 to \$161,139, plus applicable interest, to allow appellant's 2016 noncash charitable contribution unrelated to appellant's contribution of the RGI stock at issue in this appeal.

⁶ As with the prior year, appellant's deduction for noncash charitable contributions in 2017 was limited to 30 percent of his reported federal AGI, in accordance with IRC section 170(b)(1)(B). Appellant's reported charitable deduction of \$1,916,550 on Schedule A for 2017 included \$8,410 in gifts to charity by cash or check. Appellant also reported the donation of clothing and household goods valued at \$2,198 on IRS Form 8283. Only the carryover deduction for the RGI stock is at issue in this appeal.

⁷ This amount consists of the revised carryover from 2016 of \$693,628 per the FTB audit, plus appellant's 2017 cash and noncash charitable contributions of \$8,410 and \$2,198, respectively.

DISCUSSION

Burden of Proof

It is well established that a presumption of correctness attends FTB's determinations of fact, and that the taxpayer has the burden of proving that such determinations are erroneous. (*Appeal of Head and Feliciano*, 2020-OTA-127P.) Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence that he or she is entitled to the deduction claimed. (*Appeal of Vardell*, 2020-OTA-190P.) Except as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) A preponderance of the evidence means that the taxpayer must establish by documentation or other evidence that the circumstances the taxpayer asserts are more likely than not to be correct. (*Appeal of Black*, 2023-OTA-023P.) Unsupported assertions are not sufficient to satisfy the taxpayer's burden of proof. (*Appeal of Rios*, 2021-OTA-341P.) In the absence of credible, competent, and relevant evidence showing an error in FTB's determination, FTB's determination will be upheld. (*Ibid.*)

Deduction for Charitable Contributions

IRC section 170(a) provides a tax deduction for charitable contributions. Except as otherwise provided, California incorporates and conforms to IRC section 170 pursuant to R&TC section 17201(a). Charitable contributions that exceed certain income-based limits may be carried forward to be deducted in future tax years. (IRC, § 170(b)(1)(B).)

The amount of the deduction for noncash charitable contributions is equal to the property's fair market value at the time of the contribution. (Treas. Reg. § 1.170A-1(c)(1); *Cave Buttes, LLC v. Commissioner* (2016) 147 T.C. 338, 357.)⁸ 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 sell and both having reasonable knowledge of relevant facts. (Treas. Reg. § 1.170A-1(c)(2).) Fair market value is a question of fact to be determined from all relevant evidence. (*Cave Buttes, LLC v. Commissioner, supra*, at p. 357.) The taxpayer has the burden of proving that the valuation of donated property should have been higher than

⁸ When applying the IRC, California also applies the underlying Treasury Regulations to the extent they do not conflict with the R&TC or regulations issued by the FTB. (R&TC, § 17024.5(d).) Additionally, where federal and California law are the same, rulings and regulations dealing with the IRC are persuasive authority in interpreting the California statute. (See *J.H. McKnight Ranch, Inc. v. Franchise Tax Bd.* (2003) 110 Cal.App. 4th 978, fn. 1.)

allowed by the government. (*Ibid.*)

In general, “property is valued as of the valuation date ‘on the basis of market conditions and facts available on that date without regard to hindsight.’” (*Berquist v. Commissioner* (2008) 131 T.C. 8, 17.) Subsequent events are generally not considered to fix fair market value, except to the extent that they were reasonably foreseeable at the date of valuation. (*Ibid.*) Thus, federal courts have considered relevant subsequent events if they were reasonably foreseeable “because they would be foreseeable by a willing buyer and a willing seller, and they therefore would affect the valuation of the property.” (*Ibid.*)

Furthermore, an event occurring after a valuation date, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller for the subject property as of the valuation date. (*Estate of Noble v. Commissioner*, T.C. Memo. 2005-2 (*Noble*)). Unforeseeable subsequent events which fall within this category include evidence of the actual sales price received for property after the date in question, so long as the sale occurred within a reasonable time and no intervening events drastically changed the value of the property. (*Ibid.*) In determining fair market value, “little evidence could be more probative than the direct sale of the property in question.” (*Estate of Kaplin v. Commissioner* (6th Cir. 1984) 748 F.2d 1109, 1111 (*Kaplin*)). It is useful to keep in mind that valuation issues are inherently imprecise. (*Trust Services of America, Inc. v. U.S.* (9th Cir. 1989) 885 F.2d 561, 568.) The determination of value “almost always . . . involves a conjecture, a guess, a prediction, a prophecy.” (*Commissioner v. Marshall* (2nd Cir. 1942) 125 F.2d 943, 946.) “[T]he value is no less real . . . if later the prophecy turns out false” (*Ithaca Trust Co. v. U.S.* (1929) 279 U.S. 151, 155.)

Fair Market Value of Appellant’s Charitable Contribution of 1.1 Million Shares of RGI Stock

In this appeal, the only issue is the fair market value of the 1.1 million shares of RGI stock that appellant contributed to Dechomai on July 21, 2016. Quoting *Duncan Industries, Inc. v. Commissioner* (1979) 73 T.C. 266, 276, FTB notes that in determining the value of unlisted stocks, “actual sales made in reasonable amounts at arm’s length, in the normal course of business within a reasonable time before or after the valuation date are the best criteria of market value.” As a result, FTB contends that the best indicator of the fair market value of the RGI stock is the \$76.6 million that Penn ultimately paid to acquire the shares based on the

Amendment dated September 12, 2017. FTB indicates that this would result in a charitable contribution deduction of \$5,355,830, compared to \$7,715,000 as claimed by appellant.

Appellant contends that the stock must be valued at the time of the charitable contribution. Appellant asserts that the Amendment, which was executed 14 months after the charitable contribution, is not the best indicator of the value of the donated stock because material and unforeseen subsequent events occurred between the charitable contribution and Amendment which significantly impacted the value of the RGI stock. Appellant contends that the fair market value of the RGI stock should be based on the Appraisal which valued appellant's 1.1 million shares of RGI stock at \$7,715,000 as of June 30, 2016. For the reasons discussed below, OTA finds in favor of appellant.

OTA generally agrees with FTB that a subsequent sale of stock can be highly probative in determining the fair market value of an earlier contribution of the same stock. (See, e.g., *Noble, supra*; *Kaplin, supra*; and *Duncan Industries, Inc. v. Commissioner, supra*.) Here, while the RGI stock was sold to Penn only one week after appellant's charitable contribution of 1.1 million shares to Dechomai, the original Stock Purchase Agreement provides little help in valuing the donated RGI stock due to the contingent earnout. The Stock Purchase Agreement provided for an initial payment of \$60 million and potential additional payments contingent on RGI meeting certain EBITDA thresholds over the following two years. As a result, the sales price agreed upon by Penn, RGI, and RGI's shareholders potentially ranged from a minimum amount of \$60 million up to a maximum amount of \$170 million if the EBITDA thresholds were fully met. As a result, OTA must look for other indicators of the value of the RGI stock on the date of appellant's charitable contribution.

FTB asserts that the Amendment, which eliminated the contingent earnout payments in return for a single additional payment of \$17.5 million, is the best indicator of the fair market value of the donated RGI stock. FTB notes that in *Kaplin* and *Noble*, subsequent sales after the relevant valuation dates were used to establish the fair market value of property as of the valuation dates. In *Kaplin*, a sale of property two years after the charitable contribution was used to determine the fair market value of the contribution. Similarly in *Noble*, a sale 14 months after the applicable valuation date was used to determine the fair market value of the stock on the valuation date. However, unlike the facts here, in both *Kaplin* and *Noble*, there were no

subsequent intervening events which occurred between the valuation dates and subsequent sales which materially impacted the values of the property in question.

In *Kaplin*, the Sixth Circuit Court of Appeals expressly found that no changes had been made to the property (land and associated improvements) during the time between the charitable contribution and the subsequent sale by the donee two years later: “The record demonstrates . . . that the City of Toledo did not improve the property during this period but only watched over it. If anything, the property would have decreased in value during this period because little attention was given to it.” (*Kaplin, supra*, at p. 1111.) Similarly, in *Noble*, the U.S. Tax Court noted that the actual sales price received for property after the date in question may be relevant “so long as the sale occurred within a reasonable time . . . and no intervening events drastically changed the value of the property.” In *Noble*, the U.S. Tax Court specifically noted that the record did “not reveal any material change in circumstances that occurred between [the valuation] date and the date of the [] sale that would have affected the fair market value of the subject shares.”

The same is not true here. While the Amendment set a fixed \$76.6 million price for Penn’s purchase of the RGI stock, this fixed price is not necessarily representative of the value of the RGI stock 14 months earlier on the charitable contribution date of July 21, 2016. Here, the evidence in the record establishes that RGI’s profitability and related contingent earnout payments were negatively impacted by two significant unforeseen events occurring between the charitable contribution and original sale in July 2016, and the date of the Amendment 14 months later on September 12, 2017. These two unforeseen, intervening events are: (1) Penn’s decision subsequent to the acquisition to have RGI develop a digital gaming platform for it,⁹ and the resulting impact of the development on RGI’s EBITDA for purposes of computing the contingent earnout; and (2) the removal of RGI’s gaming applications from Apple’s App Store.

Development of a digital gaming platform for Penn required RGI to shift efforts and resources from its core revenue producing activities (i.e., development of new games and improvements and/or updates to its existing games) to the building of the platform for Penn which appellant testified was not expected to generate “any revenue for [RGI] or [Penn] in the first year.” Appellant also testified that RGI ultimately was not permitted to capitalize the costs

⁹ Appellant indicates that prior to the acquisition, Penn had no in-house software development capabilities and was licensing a digital gaming platform from a third-party business partner in order to deliver a digital gaming experience to Penn’s customers. Appellant indicates that at the time of the acquisition, Penn was in the process of renegotiating the licensing terms and was concerned that it was vulnerable to the deal falling through.

associated with the development of the platform which reduced RGI's EBITDA by approximately \$2 million in 2017 and impacted the contingent earnout payment for that year.¹⁰ Appellant credibly testified that development of the digital gaming platform and the subsequent dispute over the accounting for the associated costs was not discussed by the parties or foreseen at the time of the Penn acquisition, or at the time of appellant's charitable contribution of stock to Dechomai a week prior to the acquisition.

Appellant also provided evidence showing that Apple removed a large number of RGI's gaming applications from the App Store on March 15, 2017. Appellant credibly testified that the removal of RGI's games from the App Store was both unforeseen and had a significant negative impact on RGI's revenue and profitability. Appellant testified that overnight, following the removal of the games from the App Store, RGI's revenues decreased approximately 50 percent. Appellant noted that while RGI was able to get a couple of its largest games reinstated on the App Store, Apple did not reinstate the majority of appellant's games, which resulted in an approximately 30 percent reduction to RGI's revenues. Appellant also credibly testified that this action was taken unilaterally by Apple, that RGI had not received any prior warnings or notification from Apple regarding the potential removal of its games, and that this event was unforeseen and unforeseeable at the time of the charitable contribution and stock sale in July 2016.

Unlike the situations in *Kaplin* and *Noble*, OTA finds that there were significant unforeseen events occurring between the applicable valuation date of July 21, 2016, and the subsequent Amendment on September 12, 2017, which significantly impacted the value of the RGI stock and caused the parties to agree to amend the original Stock Purchase Agreement.¹¹ Neither *Kaplin* nor *Noble* involved a situation where an agreement to sell property was

¹⁰ Treating the costs associated with the development of the digital platform as current expenses reduced RGI's EBITDA for 2017 because the expenses were deducted from RGI's 2017 revenues to arrive at earnings or net income (before deductions for interest, taxes, depreciation, and amortization). Capitalizing the costs would not have the same impact on RGI's EBITDA for 2017 because the costs would be treated as creating an asset with a useful life extending beyond the 2017 year in which the expenses were incurred, which would be depreciated or amortized (i.e., expensed) ratably over future years.

¹¹ FTB contends that the events identified by appellant were not unforeseeable at the time of the charitable contribution. However, FTB does not provide any evidence to establish that these events were in fact foreseen or foreseeable by appellant, RGI, and/or Penn, and fails to provide any explanation for why the Amendment was needed if the events identified by appellant were in fact foreseeable by the parties at the time the original Stock Purchase Agreement was executed. The Amendment itself is evidence that tends to show some significant and unforeseen event(s) occurred which caused the parties to subsequently agree to revise the original Stock Purchase Agreement.

subsequently amended, and FTB has not pointed to any authority where a subsequent sale of property was later amended and the amended, rather than original, purchase price was used to value an earlier contribution of property, as FTB seeks to do here. While the \$76.6 million modified sales price per the Amendment may be reflective of the value of RGI's stock as of September 2017, given the significant, unforeseen events occurring between the charitable contribution and the Amendment, OTA is not convinced based on the facts and evidence in this appeal that the modified sales price per the Amendment was representative of the value of the stock as of appellant's charitable contribution 14 months earlier on July 21, 2016. Thus, OTA rejects FTB's contention that the sales price per the Amendment was the best indicator of the fair market value of appellant's charitable contribution and will instead consider the reasonableness of the appellant's Appraisal.

Fair Market Value per the Appraisal

As previously noted, appellant computed the amount of his charitable contribution deduction based upon the Appraisal performed by Allied, which valued appellant's 1.1 million shares of RGI stock at \$7,715,000 as of June 30, 2016. In the case of non-publicly traded stock, the value of which cannot be determined by relevant arm's-length sales, fair market value is generally determined using one or a combination of three approaches: the income approach; the market approach; and the asset-based (cost) approach. (*Appeal of Housman and Pena*, 2022-OTA-375P, citing *Noble, supra.*) Additionally, Rev. Rul. 59-60 has been widely accepted as setting forth the appropriate criteria to consider in determining the fair market value of stock of a closely held business. These criteria include: (1) the nature of the business and the history of the enterprise from its inception; (2) the economic outlook in general and the condition and outlook of the specific industry in particular; (3) the book value of the stock and the financial condition of the business; (4) the earning capacity of the company; (5) the company's dividend paying capacity; (6) whether or not the enterprise has goodwill or other intangible value; (7) sales of stock and the size of the block of stock to be valued; and (8) the market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter. (Rev. Rul. 59-60; see also *Appeal of Housman and Pena, supra.*)

OTA finds the Appraisal prepared by Allied to be reasonable and the best estimate of the fair market value of appellant's donated shares at the time of the charitable contribution. The

Appraisal indicates that it was prepared in accordance with Rev. Rul. 59-60 and both the Uniform Standards of Professional Appraisal Practice and the Statement on Standards for Valuation Services of the American Institute of Certified Public Accountants. The Appraisal is thorough and comprehensive in its analysis of the various factors provided in Rev. Ruling 59-60 and in its consideration of the three standard approaches typically used for valuing closely held businesses (i.e., the income approach, the market approach, and the cost approach). While the appraisal only utilized the income and market approaches to value the RGI stock, it thoroughly discussed all three methods and persuasively explained its reason for not using the cost approach – i.e., because the cost approach may not be appropriate where the subject company has significant cash flows from operations and/or intangible assets and because Allied determined that RGI’s best potential value was captured by valuing RGI as a going concern. There is no fixed formula for applying the factors that are to be considered in determining the fair market value of unlisted stock and the weight to be given to the various factors in arriving at fair market value depends on the facts of each case. (*Appeal of Housman and Pena, supra*, citing *Estate of Davis v. Commissioner* (1998) 110 T.C. 530, 536-537.)

OTA also finds the Appraisal and the appraised value of appellant’s 1.1 million shares of RGI stock to be reasonable, based on all of the facts and circumstances which were known and/or reasonably foreseeable as of the date of appellant’s charitable contribution on July 21, 2016, and based on the evidence in the record. The Appraisal estimated an enterprise value of \$124,985,800 for RGI. OTA notes that this enterprise value is consistent with the Stock Purchase Agreement executed one week after appellant’s charitable contribution, which fixed the sales price for the RGI stock as an amount between a minimum of \$60 million and a maximum of \$170 million.¹² This estimated enterprise value is also consistent with the reporting of the acquisition of RGI by Penn in its Form 10-Q, which found the “fair value” of the contingent

¹² FTB refers to the July 28, 2016 Stock Purchase Agreement as a “partial agreement,” suggesting that the subsequent Amendment merely completed or clarified that original agreement. However, the Stock Purchase Agreement was the complete and entire agreement of the parties at the time of its execution. While FTB is correct that the Stock Purchase Agreement provided a wide price range for Penn’s acquisition of RGI, any suggestion by FTB that the subsequent Amendment merely completed or clarified the Stock Purchase Agreement by providing a “fixed” or “concrete” purchase price in place of the contingent earnout ignores the fact that the Amendment significantly modified the terms of the Stock Purchase Agreement, and most likely resulted from subsequent, unforeseen events occurring after execution of the original Stock Purchase Agreement. There is nothing in the record to suggest that the parties anticipated amending the original Stock Purchase Agreement at the time that agreement was executed.

payments to be \$56.0 million based on an income approach, resulting in a total estimated purchase price for the RGI stock of \$115.1 million.

FTB argues that the reported amount per Penn's Form 10-Q does not state a certain fair market value for RGI. Instead, FTB asserts that the language of the Form 10-Q contains contingent language which indicates only that Penn and RGI did not have a firm purchase price. FTB further asserts that the reported value per the Form 10-Q is "fair value" which FTB contends reflects at best "book value, not a market value," for RGI.

However, because the July 28, 2016 Stock Purchase Agreement did not provide a fixed or firm purchase price (and instead provided for contingent earnout payments), appellant needed an appraisal to value his 1.1 million shares of RGI stock he donated to Dechomai and Penn needed to estimate the value of the RGI acquisition for its financial reporting. FTB is correct that "fair value" is an accounting term which generally means the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See Statement of Financial Accounting Standards No. 157, September 2006.) However, the definition of "fair value" for financial accounting purposes and fair market value for charitable contribution deduction purposes are sufficiently similar that OTA finds Penn's valuation of its acquisition of RGI for financial accounting purposes to be relevant evidence supporting the reasonableness of the value as determined by the Appraisal. Additionally, the fact that Penn estimated the value of the contingent earnout to be \$56.0 million suggests that at the time the Form 10-Q was filed on September 30, 2016, Penn also did not foresee the subsequent Amendment which eliminated the contingent earnout in return for a single payment of \$17.5 million.

Penn's estimated "fair value" of \$115.1 million as of the acquisition date is much closer to the Appraisal's estimated enterprise value of \$124,985,800 than it is to the \$76.6 million modified sales price per the Amendment.¹³ The Appraisal then allocated this enterprise value to individual classes of equity in RGI and applied lack of control and lack of marketability discounts to arrive at an estimated value of \$7,715,000 for appellant's 1.1 million shares of RGI stock, which further highlights the reasonableness of the appraised value per the Appraisal. It is useful to keep in mind that valuation issues are inherently imprecise. (*Trust Services of America*,

¹³ A difference of approximately \$9.9 million (\$124,985,800 minus \$115.1 million) versus a difference of approximately \$38.5 million (\$115.1 million - \$76.6 million).

Inc. v. U.S., *supra*, at p. 568.) The determination of value often requires conjecture, guess work, predictions, or prophecy, and a value is no less real or valid if, later, such prediction or prophecy turns out to be incorrect. (See *Commissioner v. Marshall*, *supra*, at p. 946; *Ithaca Trust Co. v. U.S.*, *supra*, at p. 155.) As such, OTA declines to conclude that the appraised value is unreasonable simply because the later Amendment resulted in a lesser amount ultimately being paid to Dechomai. Rather, the appraisal appears to be reasonable in light of the known or reasonably foreseeable facts and circumstances at the time of the charitable contribution.

FTB's Arguments with Respect to the Appraisal

FTB identifies what it believes to be two significant flaws or issues with the Appraisal, which FTB contends makes the Appraisal unreliable. First, FTB contends that the Appraisal failed to evaluate Rev. Rul. 59-60's factor (g), "sales of stock and the size of the block of stock to be valued," because the Appraisal did not consider the subsequent sale of the RGI stock to Penn. However, a careful examination of the Appraisal reveals that Allied was both aware of the sale to Penn and considered it in the Appraisal. The "Company Overview" section of the Appraisal expressly noted, "As of the Valuation Date, [RGI] is in active discussions with several buyers regarding the potential sale of [RGI]." The "Financial Overview – Income Statement" section noted that, in order to normalize the reported income, certain airfare expenses "were added back because they are travel costs related to preparing [RGI] for sale." In the "Discount for Lack of Marketability" section, the Appraisal expressly noted that "the time period between the stock transfer date . . . and the potential sale date of [RGI] is less than fifteen days" and "[s]ince [RGI] is about to be sold to potential investors in the near future, holder of the [RGI] shares] is expecting to be compensated accordingly at the sale date." As a result of this anticipated sale, the Appraisal indicated that it would use a lower lack of marketability discount rate of 5 percent, instead of the more common 20 to 35 percent discount rate typically used for closely held ownership interests.

FTB contends that the Appraisal "simply ignores the actual sale of RGI stock"; however, as illustrated above, this is not the case. It appears that FTB is actually arguing that, because the ultimate sales price for the RGI stock was known to Allied (based on the September 12, 2017 Amendment), Allied should not only have considered the subsequent sale to Penn but also should have used the modified sales price per the Amendment to value the stock, instead of utilizing the discounted cash flow method (an income approach) and the guideline transaction

method (a market approach) to value the RGI stock. However, it is important to remember that while the Appraisal was completed on September 29, 2017 (after both the original Stock Sale Agreement and the Amendment were executed), it was valuing the RGI stock as of June 30, 2016.¹⁴ As of the June 30, 2016 valuation date, and the July 21, 2016 charitable contribution date, the sale of the RGI stock to Penn was likely, but had not yet been finalized and was not yet certain to occur.

More importantly, as discussed in detail above, while the \$76.6 million modified sales price per the Amendment was reflective of the value of RGI's stock as of September 2017, given the significant, unforeseen events occurring between the original Stock Purchase Agreement and the subsequent Amendment, OTA does not find the Amendment to be representative of the value at the time of appellant's earlier charitable contribution on July 21, 2016. Thus, the Appraisal properly considered the likely future sale of RGI, but not the subsequent Amendment replacing the contingent earnout with a fixed amount which was not foreseeable at the valuation date. As such, OTA disagrees with FTB's assertion that "the [A]ppraisal was not conducted in compliance with Revenue Ruling 59-60, which diminishes the [A]ppraisal's probative value."

At the hearing, FTB also asserted that OTA should give the Appraisal little evidentiary weight because the Appraisal stated that it was prepared for "gift tax purposes," and this is an income tax case. FTB explains that the gift tax and personal income tax are found in separate and distinct chapters of the IRC,¹⁵ and that California has not had a gift tax since it was repealed in California in 1982. FTB notes that the Appraisal expressly stated that it is invalid if used for any other purpose, and that such "other purpose" would include valuing appellant's charitable contribution of stock for personal income tax purposes as opposed to gift tax purposes.

However, the Appraisal explicitly states that it was being prepared "for charitable gift tax and gift tax purposes," rather than just for "gift tax purposes." While the wording "charitable

¹⁴ While appellant should have acquired a valuation of the fair market value of the 1.1 million shares of RGI stock as of the charitable contribution date of July 21, 2016. Appellant explains that a June 30, 2016 valuation date was used because June was the final full month of financial data that a prospective buyer would have to consider before the charitable contribution. Appellant states that there were no material changes in the business between the June 30, 2016 valuation date, and the charitable contribution on July 21, 2016, and that preliminary data available in July 2016 indicated a continuation of RGI's growth trajectory. Because there is nothing in the record to establish that any material changes or events occurred between June 30, 2016, and July 21, 2016, which would significantly impact the value of the stock during this period, OTA continues to find the Appraisal to be the most persuasive evidence of the value of appellant's 1.1 million shares of RGI stock as of the charitable contribution date.

¹⁵ The personal income tax is found within Subtitle A, Chapter 1 of the IRC, while the gift tax is found in Subtitle A, Chapter 12 of the IRC.

gift tax” could have been clearer, OTA finds that the Appraisal’s use of this terminology was likely intended to include appellant’s charitable contribution. The gift tax generally does not apply to qualifying charitable contributions. (See IRC, §§ 2503 [defining taxable gifts to mean the total amount of gifts made during the calendar year less the deductions provided in IRC section 2522], 2522 [allowing an unlimited gift tax deduction for gratuitous transfers of money or property to or for the use of certain charitable entities].) Because the gift tax is not generally imposed on charitable contributions, such as appellant’s charitable contribution of RGI stock, the Appraisal’s use of the term “charitable gift tax. . . . purposes” was most likely intended to mean charitable contribution deduction purposes. This is further supported by the Appraisal’s inclusion of both the “charitable gift tax” *and* “gift tax.” The Appraisal was valuing not only appellant’s 1.1 million shares of RGI stock which were contributed to Dechomai, but also additional blocks of 120,000, 39,000, and 180,000 shares of RGI stock which were contributed to charities and/or gifted to family/friends by RGI’s shareholders. If the Appraisal was only intended to value these shares for gift tax purposes, it simply could have stated “for gift tax purposes,” instead of using the language “for charitable gift *and* gift tax purposes.” (Italics added.)

Further, in most cases, “there should be no distinction between the measure of fair market value for estate and gift tax and charitable contribution purposes.” (*Anselmo v. Commissioner* (11th Cir. 1985) 757 F.2d 1208, 1214.) Here, the Appraisal stated that it was determining the fair market value for the shares, which the Appraisal defined based on Rev. Rul. 59-60 as: “The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, [and] both parties [have] reasonable knowledge of the relevant facts.” This is the same definition of fair market value that is used for charitable contribution deduction purposes and provided in Treasury Regulation section 1.170A-1(c)(2). The Appraisal used the proper definition of fair market value, thoroughly and comprehensively analyzed the appropriate factors identified in Rev. Rul 59-60, used two well recognized approaches (i.e., the income and market approaches) to value appellant’s RGI stock, and explained why the third recognized approach (i.e., the asset-based or cost approach) was inappropriate in this case. As such, OTA does not agree with FTB’s assertion that the Appraisal should be given little evidentiary weight because the Appraisal states that it was prepared for gift rather than income tax purposes.

HOLDING

Appellant has shown that FTB erred in disallowing a portion of appellant’s charitable contribution deduction.

DISPOSITION

FTB’s action, as modified on appeal, proposing additional tax of \$161,139, plus applicable interest, for the 2017 tax year is reversed. FTB’s action disallowing appellant’s 2017 charitable contribution carryover of \$1,147,416 is also reversed.

DocuSigned by:
Cheryl Akin
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Cheryl L. Akin
Administrative Law Judge

We concur:

DocuSigned by:
Ovsep Akopchikyan
88F35E2A835348D...
Ovsep Akopchikyan
Administrative Law Judge

DocuSigned by:
Sheriene Anne Ridenour
67E043D83EF547C...
Sheriene Anne Ridenour
Administrative Law Judge

Date Issued: 11/20/2023