# HOW TO READ AND CRITIQUE AN APPRAISER'S APPRAISAL

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**The Value of Valuation – A Litigator's Perspective on What Owners and the IRS Look for in Appraisals**

By Stephanie Loomis-Price, Esq.[1]

# I. INTRODUCTION:

## A. PURPOSE

This article is intended to aid estate planning attorneys in reading and commenting on an expert's valuation report, particularly as related to closely-held entities. It is intended to assist the reader in refining the report of a valuation expert to ensure that any gift, estate, or generation-skipping transfer tax return is prepared in a manner that is most defensible in audit, and in court, if need be.

## B. ROLE OF THE ADVISOR IN REVIEWING THE APPRAISAL REPORT IN DETAIL

Strong communication between the client, the client's advisors, and the appraiser should greatly improve the quality (and defensibility) of an appraisal. A high-quality appraisal, which is more often the product of such thorough communication, improves the odds that a case involving good legal facts will achieve the best result possible.

## C. FACTORS TO LOOK FOR

Depending on the terms of the entity governing agreement and the identity of the transferee, the interest transferred by the taxpayer may be a general partnership interest, a limited partnership interest, or an assignee interest in a partnership interest (and, depending on the terms of the partnership agreement, there may be classes within one or more of these types). It is important to identify the nature of the interest transferred, as each type carries with it specific rights and responsibilities that are likely to impact value.

If the transferred partnership interests include more than one class (*i.e.*, general partnership interests and limited partnership interests), be sure to clarify with the appraiser as to whether those interests should be aggregated for valuation purposes. For instance, if a general partnership interest and a limited partnership interest are transferred by the decedent, certain authority suggests that the interests should be aggregated.[2] If, however, the general partnership interest was held by the decedent, and the limited partnership interest is held in a marital trust created by the

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[1] These materials were originally jointly developed with Lance S. Hall, ASA, of FMV, Inc.

[2] *Estate of Curry v. United States*, 706 F.2d 1424 (7th Cir. 1983) ("Plainly, then, to meet the mandate of the Code, those shares are not to be . . . arbitrarily disaggregated under one possible subsequent transaction scenario."); *see also Ahmanson Foundation v. United States*, 674 F.2d 761, 768 (9th Cir. 1981) ("There is nothing in the statutes or in the case law that suggests that valuation of the gross estate should take into account that the assets will come to rest in several hands rather than one.").

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decedent's pre-deceasing spouse, the taxpayer may be able to take the position that the interests should not be aggregated.[3]

Depending on the nature of the asset transferred, two layers of discounts might be merited.[4] If the transferred asset is a minority interest in an entity that holds a minority interest in another entity, two sets of discounts could apply to each of the two separate entities.[5] However, where the transferred asset constitutes a significant portion of the parent entity's assets, or where the transferred asset is the parent entity's "principal operating subsidiary," the Service may argue that only one level of discounts should be applied.[6]

A readily defensible partnership valuation report does not arise by happenstance, but rather by the conscientious efforts of the appraiser, advisors, and the client. The more thorough the valuation report, the more defensible it likely will be should a dispute arise. The appraiser should conduct due diligence, discussing with the general partner issues such as the partnership's investment philosophy, asset allocation, and return targets. The appraiser should review and consider the appraisals of the partnership's underlying assets. The valuation report should be supported by empirical data that is clearly understood by the appraiser, such as restricted stock studies and discussion of comparables, and the comparative factors employed should be relevant and useful. The report should fully describe the partnership's assets and financial history. Throughout the valuation report, care must be taken to avoid typos and errors, as they may call into question the competence of the author of the report. Finally, a non-appraiser should be able to understand the analysis and conclusions of a valuation report, and it is critical that advisors reviewing draft appraisals provide their input (and their questions) to the appraisers conducting the valuation analysis.

In opining as to fair market value, the appraiser will likely take into account numerous partnership-specific facts, such as the terms of the governing partnership agreement, the fair market value of the partnership's underlying assets, cash flow to the partnership, and the distribution policy of partnership management. As a result, when reviewing the appraiser's conclusions, it is important to confirm that the appraiser has properly reflected these facts in his report, so that his valuation conclusions are not based on incorrect factual assumptions. It is also helpful to make sure that a copy of the partnership agreement is included with the final appraisal, perhaps as an exhibit.[7]

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[3] See, e.g., Estate of Bonner v. United States, 84 F.3d 196 (5th Cir. 1996); Estate of Bright v. United States, 658 F.2d 999, 1004 (5th Cir. 1981); Estate of Mellinger v. Comm'r, 112 T.C. 26, 37-38 (1999).

[4] *See, e.g.*, *Astleford v. Comm'r*, 95 T.C.M. (CCH) 1497, 1502 n.5 (2008).

[5] *Id.* (*citing Estate of Piper v. Comm'r*, 72 T.C. 1062, 1085 (1979); *Janda v. Comm'r*, 81 T.C.M. (CCH) 1100 (2001); *Gow v. Comm'r*, 79 T.C.M. (CCH) 1680, 1690-91 (2000), *aff'd*, 19 Fed. Appx. 90 (4th Cir. 2001); *Gallun v. Comm'r*, 33 T.C.M. (CCH) 1316, 1320-21 (1974)).

[6] Id. (citing Estate of O'Connell v. Comm'r, 37 T.C.M. (CCH) 822, 825, 833 (1978), aff'd on this point and rev'd on other grounds, 640 F.2d 249 (9th Cir. 1981)).

[7] *See Kohler v. Comm'r*, 92 T.C.M. (CCH) 48, 56 (2006) (declining to rely on IRS appraisal where expert "did not understand Kohler's business").


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Once the appraiser has completed his appraisal, it is helpful in defending his conclusions if, after the valuation date, the partnership is operated in the manner reported to the appraiser, for example, in such areas as the distribution policy, anticipated cash flow, etc. Arguably, post-valuation date facts are irrelevant to valuation conclusions. Nonetheless, the IRS may assert that deviation from the factual assumptions by the appraiser indicate that the appraiser's conclusions were faulty, especially if the partners anticipate at the time of the transfer that such an occurrence might take place. Living with the factual information provided to the appraiser may help avoid such assertions.

### D. Appraiser and Return Preparer Penalties

1. Both appraisers and estate planners should be aware of the penalties imposed upon appraisers under § 6695A, which imposes a penalty on appraisers of the greater of 10 percent of the amount of any underpayment, $1,000, or 125 percent of the income received by the appraiser for the engagement, if an appraisal is filed with a return or claim for refund and the filing results in a substantial valuation misstatement.[8]

2. Interestingly, appraisers may also be subject to penalties applicable to a return preparer under § 6694, as a return preparer is "any person who prepares for compensation a tax return or claim for refund, or a substantial portion of a tax return or claim for refund, and is no longer limited to persons who prepare income tax returns."[9]

3. In addition, "[a] person who for compensation prepares any of the forms listed in this subsection, which form does not report a tax liability but affects an entry or entries on a tax return and constitutes a substantial portion of a tax return or claim for refund that does report a tax liability, is a tax return preparer who is subject to section 6694."[10]

4. Obviously, an appraiser could fit within that definition and thus could also be subject to the return preparer penalties. (Whether this is a realistic concern, however, is uncertain, because the return preparer penalties could be less than those for the appraiser, as they are imposed at the greater of $1,000 or 50 percent of the income derived by the preparer in the preparation of the return.[11]) Nonetheless, appraisers do seem to fit within the strict definition and therefore should be aware that the penalty can be imposed unless "there is or was substantial authority for the position." If the appraisal is filed in conjunction with a tax shelter or reportable transaction, then the position being taken by the preparer is held to an even higher standard, for the previous

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8 I.R.C. § 6695A.

9 I.R.S. Notice 2008-13 (Jan. 22, 2008); *see also* Rev. Proc. 2009-11.

10 Rev. Proc. 2009-11 § 3.03(2).

11 I.R.C. § 6694(a)(1).


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"realistic possibility" standard has been replaced by a "more likely than not" standard.[12] "More likely than not" is interpreted to mean a greater than 50 percent probability of being upheld, if challenged. Again, however, the more likely exposure of the appraiser for a faulty appraisal are the appraisal penalties of § 6695A.

### E. APPEALS SETTLEMENT GUIDELINES – FAMILY LIMITED PARTNERSHIPS AND FAMILY LIMITED LIABILITY CORPORATIONS:[13]

1. In early 2007, the IRS issued new settlement guidelines for matters involving limited partnerships. In those guidelines, the IRS explained that its goal is to promote consistency of approaches across different jurisdictions and that its primary modes of attack on partnerships would be the indirect gift theory and § 2036, in addition to valuation.[14]

2. As stated in Example 2, a penalty may be appropriate where an independent appraiser bases discounts on "an IPO approach which compares the private-market price of shares sold before a company goes public with the public-market price obtained in the initial public offering of shares . . . ."[15]

### F. PRESUMPTION OF CORRECTNESS:

1. "At the outset of a Tax Court proceeding to re-determine a tax deficiency, the Commissioner's determination is presumed to be correct. The burden of proof is thus placed upon the taxpayer to show that the Commissioner's determination is invalid."[16] Note that a taxpayer may be in a position to shift the burden of proof if all of the elements of § 7491 are met.

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[12] The Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, § 6694, 121 Stat. 112 (2007).

[13] *See* Settlement Guidelines, 07 No. 020 BNA Taxcore 25; http://www.irs.gov/pub/irs-utl/asg_penalties_family_limited_pships_finalredacted10_20_06.pdf.

[14] *See, e.g., Lappo v. Comm'r,* 86 T.C.M. (CCH) 333 (2003); *McCord v. Comm'r,* 120 T.C. 358 (2003), *rev'd,* 461 F.3d 614 (5th Cir. 2006); *Peracchio v. Comm'r,* 86 T.C.M. (CCH) 412 (2003).

[15] Settlement Guidelines, 07 No. 020 BNA Taxcore 25.

[16] *Estate of Mitchell v. Comm'r*, 250 F.3d 696, 701-02 (9th Cir. 2001).


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## II. FOUNDATION OF AN APPRAISAL REPORT:

From a litigator's perspective, the foundation of the appraisal report is found in various court opinions that have dealt with valuation reports and created valuation standards that reports should follow. And a reader's review should start with the nature of the transfer taxes imposed on the transfers of the property being appraised.

### A. NATURE OF ESTATE AND GIFT TAX

1. At the most basic, we are told that "[t]he Federal estate tax is a tax on the privilege of transferring property upon one's death."[17] Similarly, the term "gift tax" has been defined to mean "(1) the tax imposed by chapter 12 of [the Internal Revenue] Code, and (2) any tax imposed by a State (or the District of Columbia) on transfers by gifts." P.L. 98-369, § 1026. A more detailed definition has been enunciated – the gift tax is "an excise tax in that it was a tax on one of the powers incident to the ownership of property, *i.e.*, the power to give the property to another [without consideration]."[18]

### B. DEFINITION OF FAIR MARKET VALUE

1. Pursuant to Treasury Regulations defining the fair market value of a transfer, whether for estate tax purposes or for gift tax purposes, the definition of fair market value is, at its heart, "the price at which the property would change hands between a [hypothetical] willing buyer and a [hypothetical] willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[19]

2. Property to be Valued:

   a. Estate Tax:

      i. The courts have clarified this definition of fair market value to indicate that "the property to be valued for estate tax purposes is that which the decedent actually transfers at his death rather than the interest held by the decedent before death, or that held by the legatee after death."[20] Subsequent decisions have expanded and clarified this position.

      ii. "The value of the gross estate of the decedent shall be determined by including . . . the value at the time

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17 *Estate of Nowell v. Comm'r*, T.C. Memo. 1999-15, *5.

18 *In re King,* 19 B.R. 936 (Bkrtcy. Tenn., 1982).

19 Treas. Reg. § 20.2031-1(b) (emphasis added); *see also* Tres. Reg. § 25.2512-1.

20 *United States v. Mfg. Nat'l Bank of Detroit*, 363 U.S. 194, 198 (1960); *see also Estate of Nowell v. Comm'r,* 77 T.C.M. (CCH) 1239 (1999).

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of his death of all property, real or personal, tangible or intangible, wherever situated."[21]

iii. "[V]alue is to be measured at the instant before transfer, so that the amount of tax depends on the value of the transferred property in the hands of the transferor rather than its value in the hands of the transferee."[22]

b. Gift Tax:

i. "Similarly, the Seventh Circuit has explained that the "gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon the ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable."[23]

3. Price:

The Courts also have provided specific guidance as to the relevant price to be determined for transfer tax purposes:

a. "The fair market value of property must reflect the highest and best use of that property on the relevant valuation date."[24]

b. "Fair market value takes into account special uses that are realistically available due to the property's adaptability to a particular business. Fair market value is not affected by whether the owner has actually put the property to its highest and best use. The reasonable and objective possible uses for the property control the valuation thereof."[25]

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21 *Estate of Andrews v. United States*, 850 F. Supp. 1279, 1288-89 (E.D. Va. 1994), *quoting* I.R.C. § 2031(a).

22 *Citizens Bank & Trust Co. v. Comm'r*, 839 F.2d 1249, 1251 (7th Cir. 1988) (emphasis added).

23 *Estate of Stinson v. United States*, 1998 WL 796775, at *7 (D.C. N.D. Ind. 1998), *aff'd* 214 F.3d 846 (7th Cir. 2000).

24 *Estate of Feuchter v. Comm'r*, 63 T.C.M. (CCH) 2104, 2109 (1992).

25 *Estate of Trenchard v. Comm'r*, 69 T.C.M. (CCH) 2164, 2169 (1995).


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c. "The best method to value a corporation's stock is to rely on actual arm's-length sales of the stock within a reasonable period of the valuation date."[26]

d. "In the absence of arm's-length sales, fair market value represents the price that a hypothetical willing buyer would pay a hypothetical willing seller, both persons having reasonable knowledge of all relevant facts and neither person compelled to buy or sell."[27]

e. "Nor is the fair market value of property to be determined by the sale price of the property in a market other than that in which such property is most commonly sold to the public."[28]

f. "The value of a particular kind of property is not the price that a forced sale of the property would produce."[29]

g. "[T]he fair market value of the non-voting stock in the hands of an estate with sufficient shares of voting stock to ensure the estate's control of a corporation cannot be less than the value of the voting stock."[30]

4. Willing Buyer/Willing Seller:

a. "Court opinions also have given clarity to the willing buyer/willing seller referred to in the Regulations. Thus, the Tax Court has indicated that "[t]he hypothetical willing buyer and seller are presumed to be dedicated to achieving the maximum economic advantage, which advantage must be achieved in the context of market conditions, the constraints of the economy, and, assuming shares of stock are to be valued, the financial and business experience of the subject corporation existing on the valuation date."[31] Other Tax Court opinions have further expanded on this point.

b. "The willing buyer and the willing seller are hypothetical persons, instead of specific individuals or entities, and the characteristics of these hypothetical persons are not

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[26] *Estate of Renier v. Comm'r*, 80 T.C.M. (CCH) 401, 404 (2000).

[27] *Estate of Deputy v. Comm'r*, 85 T.C.M. (CCH) 1497 (2003).

[28] *Estate of Frank v. Comm'r*, 69 T.C.M. (CCH) 2255, 2260 (1995); *see also* Treas. Reg. § 25.2512-1 ("Nor is the fair market value of an item of property the sale price in 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.").

[29] Treas. Reg. § 25.2512-1.

[30] *Estate of Curry v. United States*, 706 F.2d 1424, 1427 & n.2 (7th Cir. 1983).

[31] *Estate of Heck v. Comm'r*, 83 T.C.M. (CCH) 1181, 1184-85 (2002).


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necessarily the same as the personal characteristics of the actual seller or a particular buyer."[32]

c. "Focusing too much on the view of one hypothetical person, to the neglect of the view of the other, is contrary to a determination of fair market value."[33]

d. "The willing buyer and willing seller standard renders irrelevant the actual buyer and actual seller; however, the other stockholders are not irrelevant under the standard."[34]

e. "Emotional factors may preclude a redemption price from representing fair market value."[35]

5. Knowledge of Relevant Facts: The appraiser clearly must be apprised of all relevant facts regarding the asset being appraised, and indicate that such knowledge has been considered in the report. A number of opinions from both the Tax Court and courts of appeal reflect the importance of ensuring that the appraiser is given all relevant facts and addresses them in the report.

a. "In valuing shares of stock in a corporation whose shares are not publicly traded, the factors we take into account include net worth, prospective earning power and dividend paying capacity, and other relevant factors, including the economic outlook for the particular industry, the company's position in the industry, the company's management, the degree of corporate control represented in the block of stock to be valued, and the value of publicly traded stock or securities of corporations engaged in the same or similar lines of business."[36]

b. The general rule is "relevant facts for purposes of setting value on the date of death [are]…those that the hypothetical willing buyer and seller could reasonably have been expected to know at that time."[37]

c. "The Court of Appeals for the Fifth Circuit held that Exxon's claim must be valued as of the decedent's date of death and, thus, must be appraised on information known or available up to (but not after) that date."[38]

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32 *Estate of Cloutier v. Comm'r*, 71 T.C.M. (CCH) 2001, 2002 (1996).
33 *Estate of Kaufman v. Comm'r*, 77 T.C.M. (CCH) 1779, 1783 (1999), *rev'd on other grounds by Morrissey v. Comm'r*, 243 F.3d 1145 (9th Cir. 2001).
34 *Estate of Magnin v. Comm'r*, 81 T.C.M. (CCH) 1126, 1139 (2001).
35 *Estate of DiSanto v. Comm'r*, 78 T.C.M. (CCH) 1220, 1224 (1999).
36 *Estate of Heck*, 83 T.C.M. (CCH) at 1185; *see also* I.R.C. § 2031(b); Treas. Reg. § 20.2031-2(f)(2); Rev. Rul. 59-60, 1959-1 C.B. 237, 238-242.
37 *Estate of Andrews v. United States*, 850 F. Supp. 1279 (E.D. Va. 1994).
38 *Estate of Smith v. Comm'r*, 82 T.C.M. (CCH) 909, 912-13 (2001), *aff'd*, 54 Fed. Appx. 413 (5th Cir. 2002).


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d. "[A]ny knowledge of future events not known or reasonably anticipated on the valuation date that might affect the value of the stock cannot be attributed to the willing seller or buyer." [39]

e. "The only legitimate use of hindsight is for the limited purpose of establishing what a reasonably well-informed investor might have believed on the valuation date."[40]

f. "Subsequent events affecting the character or quality of the property to be valued should be distinguished from subsequent market activity which can provide helpful comparable sales."[41]

g. "Sales occurring after the date of decedent's death are relevant and do not fall within the normal proscription against consideration of events subsequent to the valuation date."[42]

6. A Moment in Time:

a. Finally, the appraisal of the property is made as of the date of the transfer, so the facts and the resulting values are determined as of a specific moment in time. This is clearly the focus in the estate tax area, where the estate tax is imposed upon "the value of all property to the extent of the interest therein of the decedent at the time of his death."[43] This was made very clear in the famous *Land* case, quoted immediately below.

b. "Brief as is the instant of death, the court must pinpoint its valuation at this instant – the moment of truth, when the ownership of the decedent ends and the ownership of the successors begins."[44]

c. When gift tax is involved, valuation is made as of the date of gift. How tricky that can be is addressed in a case in which the donors were 18 percent shareholders and members of the board of directors of a publicly traded corporation [XYZ]. A tender offer and merger agreement were entered into for a purchase price of $22.50 per [XYZ] share, in cash, on July 28. The merger agreement was approved of by the [XYZ] board of directors, who recommended acceptance of the tender offer to [XYZ]

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[39] *Estate of Luton v. Comm'r*, 68 T.C.M. (CCH) 1044, 1047 (1994), *opin. suppl.* 71 T.C.M. (CCH) 2772 (1996).
[40] *Estate of Mueller v. Comm'r*, 63 T.C.M. (CCH) 3027, (1992).
[41] *Estate of Newhouse v. Comm'r*, 94 T.C. 193, 218, n.15 (1990).
[42] *Estate of Jung v. Comm'r*, 58 T.C.M. (CCH) 1127, 1128 (1990).
[43] I.R.C. § 2033 (emphasis added).
[44] *United States v. Land*, 303 F.2d 170, 172 (5th Cir. 1962), *cited in Estate of Schwan v. Comm'r*, 82 T.C.M. (CCH) 168, 172 (2001).


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shareholders. The merger agreement was conditioned upon [XYZ] shareholders tendering 85 percent of their shares. The Donors began the process of donating [XYZ] stock to their church in mid-August, but because of delays at the brokerage house, the gifts were not completed until September 9. On September 12, the acquirer announced it had received over 95 percent of the shares of [XYZ]. Accordingly, the Court framed the issue before it, as follows:

> The key issue here is whether the [Donors] had completed their contributions of the appreciated [XYZ] stock before it had ripened from an interest in a viable corporation into a fixed right to receive cash. If the [Donors] had done so, then they cannot be taxed on the gain realized when the stock ripened; if they had not, then they can.

The Court ruled that on August 31, more than 50 percent of the [XYZ] shares had been tendered, and thus, "the receipt of cash . . . was practically certain to occur, [and, therefore, the Donors'] stock had ripened by that date."[45]

## C. Appraiser Qualifications

To minimize IRS attack, the taxpayer should select an appraiser who will provide an independent and qualified appraisal of the fair market value of the transferred interest. In that regard, consider whether the selected appraiser is independent from the taxpayer, is credible, is experienced in appraising the type of property being valued, as well as having the appropriate certifications. In addition, attaching an appraisal to a tax return can be a way to satisfy adequate disclosure requirements and to start the running of statutes of limitations. Perhaps most importantly, the appraiser should not act as an advocate for the taxpayer.

The Tax Reform Act of 1984 was fairly elementary, providing that a qualified appraiser is one who "holds himself or herself out to the public as an appraiser."[46] The 2006 Pension Protection Act expanded the definition to define a qualified appraiser as:

> an individual who has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary; regularly performs appraisal for which the individual receives compensation; and meets such other

[45] *Ferguson v. Comm'r*, 174 F.3d 997, 1005 (9th Cir. 1999).

[46] Treas. Reg. § 1.170A-13(c)(5)(i)(A); *see also* IRS Publication 561 and Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

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requirements as may be prescribed by the Secretary in regulations or other guidance.[47]

There are a number of recognized professional appraiser organizations, but those most often focused on entity appraisers and the certification that each offers are:

a. American Society of Appraisers (ASA);

b. National Association of Certified Valuation Analysts (NACVA); and

c. Institute of Business Appraisers (CBA).

Planning attorneys should engage credentialed appraisers, as courts often evaluate opinion evidence in the light of the "qualifications of the expert and all other evidence of value."[48] For example,

a. "[P]etitioner did not provide respondent with information regarding the identity, qualifications, and credentials of the individual who prepared the Touche appraisal. . . . Further, petitioner did not attach a resume of Mr. Stone to the Stone report so that respondent could evaluate Mr. Stone's credentials."[49]

b. "[W]e give little weight to [son's] appraisal because, as the son of the decedent, he has a personal interest in having the . . . property valued at a low amount."[50]

c. "In the expert report submitted by respondent, Mr. Shelton represents that he has certain qualifications and credentials to perform business valuations that he does not in fact have, including courses on valuation that he has not successfully completed. Mr. Shelton's report also suggests that he is a member of the American Society of Appraisers, to which he has never belonged. Since Mr. Shelton has not demonstrated that he is qualified to perform a business valuation, we will evaluate his opinion accordingly."[51]

d. "We conclude that Conklin was acting as an advocate and that his testimony was not objective."[52]

The 2006 Pension Protection Act further delved into bureaucratic lingo by making reference to qualified appraisals. Predictably, under the statute, a

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47 Pension Protection Act of 2006, Pub. L. No. 108-280, § 1219(c)(1)(E)(ii), 119 Stat. 1937.
48 *Parker v. Comm'r*, 86 T.C. 547, 561 (1986).
49 *Estate of Levy v. Comm'r*, 63 T.C.M. (CCH) 1739, 1740 (1992).
50 *Estate of Dougherty v. Comm'r*, 59 T.C.M. (CCH) 772, 778 (1990).
51 *Furman v. Comm'r*, 75 T.C.M. (CCH) 2206, 2213 (1998).
52 *Knight v. Comm'r*, 115 T.C. 506, 519 (2000).

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qualified appraisal is one "conducted by a qualified appraiser in accordance with generally accepted appraisal standards."[53] Because the statute has referenced appraisal standards, it is important that the appraiser follow the Uniform Standards of Professional Appraisal Practice. These standards were originally focused on real estate appraisals, so Standards Rule 1 – 8 cover real estate appraisals, and Standards Rule 9 & 10 cover business valuation. The current version runs 370 pages (including introduction, statements, advisory opinions, and frequently asked questions sections), and according to the Appraisal Standard Board, "[t]he goal of the *Uniform Standards of Professional Appraisal Practice* is to promote and maintain a high level of public trust in appraisal practice by establishing requirements for appraisers."[54]

## D. SPECIAL VALUATION PROVISIONS IN THE CODE

In addition to various government pronouncements, the appraiser of certain transferred interests must be aware of the special valuation rules found in Chapter 14 governing the valuation of transfers of entity interests to family members, and in some instances the Special Use Valuation statute in Section 2032A governing the valuation of certain farm and real property. These rules deal more with how the transferred interest is measured for tax purposes. Chapter 14 is composed of I.R.C. §§ 2701-2704 and was enacted in the wake of the retroactive repeal of I.R.C. § 2036(c), which attempted (albeit unsuccessfully) to address estate freeze transactions.

a. Section 2701 applies when a transferor makes a transfer to a family member of an interest in an entity, but retains one or more enumerated rights, such as a liquidation, put, call, or conversion right ("extraordinary payment rights"), or a distribution right, if the transferor and family members control the entity. Section 2701, if applicable, requires that the value of the gift be determined by subtracting the retained interest's special value under § 2701 from the property's fair market value immediately prior to the transfer.[55]

b. Section 2702 provides special valuation rules governing transfers of interests in trusts such as GRATs, GRUTs, and QPRTs.

c. Section 2703, in the absence of its exceptions, applies to disregard for valuation purposes any right or restriction relating to (for our purposes) an entity interest (such as an option or agreement to acquire or use the property for less than full market value). Under the exception detailed in § 2703(b), however, such rights/restrictions will not be

[53] Pension Protection Act of 2006 § 1219(c)(1)(E)(i)(II).

[54] Appraisal Standards Board Summary of Actions Related to Proposed Changes (Apr. 3, 2009), at 1, *available at* www.appraisalfoundation.org/s_appraisal/sec.asp?CID=60&DID=89.

[55] I.R.C. § 2701; Treas. Reg. § 25.2701-1.

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disregarded if: (1) those rights/restrictions are bona fide business arrangements; (2) the rights/restrictions are not a device to transfer the entity interest to a decedent's family for less than full and adequate consideration; ***and*** (3) the terms of the rights/restrictions are comparable to those found in similar, third-party transactions.[56]

d. Finally, Section 2704(a) causes a taxable transfer to occur upon the lapse of any voting or liquidation right in a corporation or partnership if the holder of the right and members of the holder's family controlled the entity before and after the lapse.[57] Further, § 2704(b) provides that any liquidation restriction more restrictive than applicable state law is to be disregarded for purposes of determining the fair market value of a transferred entity interest, if the interest is transferred to a family member and the entity is controlled by the transferor and her family immediately before the transfer.[58]

There are other statutory valuation rules in the special use valuation area, such as those found in Section 2032A(e)(7) relating to qualified woodlands and Section 2032A(e)(8) relating to pastureland. Again, appraisers of these types of interests should be very familiar with these statutes and their Regulations.

## E. GOVERNMENT PRONOUNCEMENTS:

As part of following the Standards, the appraiser must be conversant with various government pronouncements. Thus, the attorney should ensure that the appraiser being retained understands the relevant authority applicable to a particular kind of property being appraised. Otherwise, the persuasiveness of the appraiser and the appraisal report may be weakened, as noted by the Tax Court in the *Rabenhorst* case:

> We recognize that [the expert] has respectable credentials, but we are troubled by his unfamiliarity with relevant Treasury regulations and revenue rulings. While such unfamiliarity does not in and of itself convince us that [the expert] was incapable of rendering an accurate valuation, it does raise some suspicion.[59]

At a minimum, such understanding should go to any applicable statutes, Regulations, or other pronouncements by the IRS. Certainly, the appraiser needs to know the general valuation rules, statutes, and Regulations under § 2031 for estate tax and § 2512 for gift tax.

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[56] I.R.C. § 2703; Treas. Reg. § 25.2703-1.
[57] I.R.C. § 2704(a); Treas. Reg. § 25.2704-1.
[58] I.R.C. § 2704(b); Treas. Reg. § 25.2704-1.
[59] *Rabenhorst v. Comm'r*, 71 T.C.M. (CCH) 2271, 2275 (1996).


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1. Revenue Rulings:

a. RR 59-60. In addition to statutory and Regulatory provisions, the appraiser also needs to follow the various Revenue Rulings on valuation that have been issued over the years. By far, the most important in this area is Rev. Rul. 59-60, which provides :

> The following factors, although not all-inclusive are fundamental and require careful analysis in each case. Other important rulings include:
>
> i. The nature of the business and the history of the enterprise from its inception.
>
> ii. The economic outlook in general and the condition and outlook of the specific industry in particular.
>
> iii. The book value of the stock and the financial condition of the business.
>
> iv. The earning capacity of the company.
>
> v. The dividend-paying capacity of the company.
>
> vi. Whether or not the enterprise has goodwill or other intangible value.
>
> vii. Sales of stock and the size of the block of stock to be valued.
>
> viii. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.[60]

While the above factors are prescribed, Revenue Ruling 59-60 also clarifies, "A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."[61]

[60] Rev. Rul. 59-60.
[61] *Id.*

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b. RR 77-287: "Guidelines are set forth for the valuation, for Federal tax purposes, of securities that cannot be immediately resold because they are restricted from resale pursuant to Federal securities laws…"[62]

c. RR 81-253: "It is the position of the Service that ordinarily no minority discount will be allowed with respect to transfers of shares of stock among family members where, at the time of transfer, control (either majority voting control or de facto control) of the corporation exists in the family."[63]

d. RR 93-12: "[I]n the case of a corporation with a single class of stock, notwithstanding the family relationship of the donor, the donee, and other shareholders, the shares of other family members will not be aggregated with the transferred shares to determine whether the transferred shares should be valued as part of a controlling interest."[64]

Although the Service has issued TAMs that attempt to restrict Revenue Ruling 93-12's approach to situations in which each gift will be considered separately, the Courts are not as restrictive, noting that "[t]his unity of ownership argument is inconsistent with the willing buyer-willing seller rule."[65]

2. Technical Advice Memoranda: TAMs are guidance issued by the office of Chief Counsel to a requesting IRS area director or appeals officer related to a closed transaction, related to procedural or technical questions that arise during the review of a tax return. Although the TAM is conclusive as to the Service's position in the matter at hand, it has no precedential value in other cases.

3. Private Letter Rulings: PLRs are guidance issued to requesting taxpayers related to a proposed transaction, interpreting and applying tax laws to the taxpayer's specific set of facts, thereby allowing the taxpayer to understand the tax consequences of a transaction before engaging in it. If the taxpayer fully and accurately discloses all relevant facts in the PLR request, the PLR is binding on the Service with regard to that taxpayer's transaction. As with TAMs, PLRs may not be relied upon in other matters by the Service or by taxpayers. Thus, the Tax Court has observed that:

[62] Rev. Rul. 77-287.
[63] Rev. Rul. 81-253.
[64] Rev. Rul. 93-12.
[65] *Estate of Pillsbury v. Comm'r*, 64 T.C.M. (CCH) 284, 286 (1992).


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We note that petitioner cites IRS private letter rulings in his petition with regard to this issue. These rulings have no precedential force.[66]

4. Actions on Decision:

   a. An Action on Decision will be issued at the discretion of the Service only on unappealed issues decided adverse to the government. Generally, an Action on Decision is issued where its guidance would be helpful to Service personnel working with the same or similar issues. Unlike a Treasury Regulation or a Revenue Ruling, an Action on Decision is not an affirmative statement of Service position. It is not intended to serve as public guidance and may not be cited as precedent.

      Actions on Decisions shall be relied upon within the Service only as conclusions applying the law to the facts in the particular case at the time the Action on Decision was issued. Caution should be exercised in extending the recommendation of the Action on Decision to similar cases where the facts are different. Moreover, the recommendation in the Action on Decision may be superseded by new legislation, regulations, rulings, cases, or [subsequent] Actions on Decisions.[67]

## III. THE REPORT:

### A. IRS REVENUE RULING 59–60 – FACTORS TO CONSIDER

1. Nature of business & history of operation
2. Economic and industry outlook
3. Entity's:
   a. financial condition
   b. earning capacity
   c. dividend-paying capacity of the company
4. Sales of stock in subject entity
5. Market price of stocks engaged in similar lines of business

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66 *Estate of Jalkut v. Comm'r*, 96 T.C. 675, 684 (1991).
67 I.R.B. 2007-40 (Oct. 1, 2007).

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### B. *MANDELBAUM*[68] – FACTORS TO CONSIDER

1. Existence of put rights
2. Likelihood of dividend payments
3. Prospect of public offering
4. Restrictions on sale of interest
5. Size of interest

### C. COVER LETTER (EXECUTIVE SUMMARY):

1. Retaining Party and Other Intended Users
2. Standard of Value Definition and Source (Fair Market Value)
3. "As of" or "Effective" Date of Value
4. Purpose of Value and Intended Use
5. Type of Asset and Interest Being Valued
6. Summary of Interest's Rights to Control
7. Summary of Interest's Access to Liquidity
8. Summary of the Scope of Work
9. Summary of Information Considered
10. Summary of Methodologies Utilized
11. Caveats or Hypothetical Conditions
12. Value Conclusion
13. Appraiser's Signature

[68] *Mandelbaum v. Comm'r*, 69 T.C.M. (CCH) 2852 (1995).

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## D. BODY OF REPORT:

1. Standard of Value

2. Purpose of Value

3. Interest being Valued

4. Prior Transactions

5. Caveats or Hypothetical Conditions:

   a. "[C]learly and accurately disclose all assumptions, extraordinary assumptions, hypothetical conditions, and limiting conditions used in the assignment."[69]

6. Rights, Preferences, and Privileges of Interest Being Valued

   a. Description of all Interests (Debt and Equity)

   b. Specific Rights, Preferences, and Privileges of Interest

      i. Statutory

         (a) "The discount should reflect that restrictions are placed on the land as a result of the Williamson Act and that the assets of the corporation are not liquid."[70]

         (b) "[W]e find respondent's argument persuasive, in that a holder of a one-third interest in a California corporation is protected under California corporate law, the right to force a liquidation is not unfettered; grounds are required. Thus, although we believe that a potential investor would apply some discount to a one-third interest in Dune Lakes, Ltd., for lack of control, we believe the safeguards afforded under California corporate law would mitigate the impact."[71]

      ii. Contractual:

         (a) Articles of Incorporation

         (b) Company By-Laws

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69 Uniform Standards of Professional Appraisal Practice ("USPAP"), Standards Rule 10-1(c), *available at* www.appraisalfoundation.org/s_appraisal/sec.asp?CID=68&DID=97.

70 *Estate of Luton*, 68 T.C.M. (CCH) at 1051.

71 *Id*. at 1053 (citations omitted).

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(c) Operating/Partnership Agreement

(d) Right of First Refusal:

(1) A right of first refusal "would add some uncertainty and a chilling effect to the transaction . . . ."[72]

(e) Buy/Sell Agreement:

(1) "[I]t has long been recognized that a buy-sell agreement in effect at the date of a decedent's death may fix the value of the stock of a closely held corporation if: (1) It is an enforceable agreement, (2) it applied to the stock during the lifetime of the decedent as well as at his death, and (3) it had a bona fide business purpose rather than being testamentary in nature."[73]

iii. Economic:

(a) Key Person

(b) Blockage/Market Absorption

(c) Black-Out Provisions

(d) Sub-S Tax Benefit

(e) Influence

(1) "Before a control premium may be applied, however, something more than 'substantial influence' is required."[74]

(f) Lack of Control

(1) "The value for control is separate from, and independent of, any discount that may apply for a lack of marketability."[75]

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[72] *Estate of Borgatello v. Comm'r*, 80 T.C.M. (CCH) 260, 269 (2000).
[73] *Estate of Carpenter v. Comm'r*, 64 T.C.M. (CCH) 1274, 1280 (1992).
[74] *Estate of Wright v. Comm'r*, 73 T.C.M. (CCH) 1863, 1867 (1997).
[75] *Estate of Trenchard*, 69 T.C.M. (CCH) at 2173.

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(2) "The bottom line is, irrespective of whether it is a 1% or 99% interest, if you do not have control over the assets, then we are talking about a minority interest for these purposes."[76]

(3) "[T]he fair market value of the non-voting stock in the hands of an estate with sufficient shares of voting stock to ensure the estate's control of a corporation cannot be less than the value of the voting stock."[77]

(g) Lack of Marketability/Liquidity

(1) "A bare assertion that a discount is appropriate, however, with no evidence to support it cannot be upheld."[78]

7. Economic Overview:

a. Overall General Economy

b. Industry Specific

c. Summary and Conclusions

8. Company Specific Information:

a. "[N]ature and history of the business enterprise or intangible asset"[79]

b. Financial Observations

i. Income Statement

ii. Balance Sheet

iii. Summary and Conclusions

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76 *Succession of Helis v. Comm'r*, 2001 WL 871301, at *3 (Fed. Cl. 2001).
77 *Estate of Curry*, 706 F.2d at 1427 & n.2.
78 *Estate of Pillsbury*, 64 T.C.M. (CCH) at 287.
79 USPAP, Standards Rule 9-4.

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9. Methodologies Used to Determine Fair Market Value

a. Summary of Methodologies:

i. Which Are Used and Why

(a) "Respondent offered no evidence of the value of MD&F stock other than the redemption price in 1995, which we do not consider."[80]

ii. Which Are Not Used and Why

b. Methodologies:

i. "[C]ourts should not restrict consideration to only one approach to valuation, such as capitalization of earnings or net asset values. Certainly, the degree to which the corporation is actively engaged in producing income rather than merely holding property for investment should influence the weight to be given to the values arrived at under the different approaches but it should not dictate the use of one approach to the exclusion of all others."[81]

ii. Market:

(a) "In general, a market-based appraisal concentrates on a company's historical performance measures and, by reference to guideline public company multiples, attempts to determine the price at which the stock of a company with those performance measures would trade."[82]

(b) Guideline Public Company Approach:

(1) "A proper valuation report must contain enough data on each similar corporation to allow the Court to make an informed, independent decision as to [w]hether the corporations are sufficiently similar

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[80] *Estate of DiSanto v. Comm'r*, 78 T.C.M. (CCH) 1220, 1225 (1999).

[81] *Estate of Smith v. Comm'r*, 78 T.C.M. (CCH) 745, 748 (1999), *quoting Estate of Andrews v. United States*, 850 F. Supp. 1279 (E.D. Va. 1994).

[82] *Wall v. Comm'r*, 81 T.C.M. (CCH) 1425, 1432 (2001).

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to the subject corporation to perform a proper valuation analysis."[83]

(2) "We rejected the valuation report submitted by the Commissioner's expert in light of his reliance on a single comparable company in employing the market approach."[84]

(3) "We believe that the use of a single comparable can be problematic, and we prefer the approach of respondent's expert in using a number of comparables."[85]

iii. Income:

(a) "An income-based appraisal, by contrast, is more forward looking; it attempts to predict, and then determine the present value of, all future returns an investor could expect to receive from an investment in the subject company."[86]

(b) "Because an income-based approach attempts to value directly the future cash-flows that will be generated by an investment in the subject company, it will produce accurate results only if an accurate forecast of the company's future earnings is available."[87]

(c) "WACC [weighted average cost of capital] is an improper analytical tool to value a 'small, closely held corporation with little possibility of going public.'"[88]

iv. Asset:

(a) "It is well established that, in general, an asset-based method of valuation applies in the case of corporations that are essentially holding corporations, while an earnings-

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83 *Estate of Kaufman*, 77 T.C.M. (CCH) at 1786.
84 *Estate of Heck*, 83 T.C.M. (CCH) at 1187.
85 *Estate of Weinberg v. Comm'r*, 79 T.C.M. (CCH) 1507, 1515 (2000).
86 *Wall*, 81 T.C.M. (CCH) at 1432.
87 *Id*.
88 *Gallagher v. Comm'r*, 101 T.C.M. (CCH) 1702 (2011).

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based method applies for corporations that are going concerns."[89]

(b) "[W]e do not agree that we should focus on the company's historical earnings to the virtual exclusion of its net asset value, simply because the corporation was engaged in some business activities on the valuation date."[90]

(c) Liquidation:

(1) "[W]e find no merit to applying reductions for selling costs when the prospect of liquidation is remote."[91]

v. Impact of Net Asset Value Approach

(a) Discounts for Lack of Control, Lack of Marketability

vi. Special Situations:

(a) Sub-Chapter S Corporations:

(1) "The owners expect to save money [by electing Sub-S status], and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation."[92]

(b) Built-In Capital Gains Tax:

(1) "We are convinced on the record in this case, and we find, that, even though no liquidation of [the corporation] or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took

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89 *Estate of Smith,* 78 T.C.M. (CCH) at 748.
90 *Estate of Campbell v. Comm'r*, 62 T.C.M. (CCH) 1514, 1521 (1991).
91 *Estate of Luton*, 68 T.C.M. (CCH) at 1050.
92 *Gross v. Comm'r*, 78 T.C.M. (CCH) 201, 209, *aff'd*, 272 F.3d 333 (6th Cir. 2001).

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no account of [the corporation's] built-in capital gains tax."[93]

(2) Assumption of liquidation carries with it dollar-for-dollar credit for built in gains.[94]

(c) Post-Valuation Date Events:

(1) Events that "occur after the date of death may be taken into account in making the valuation decision. When considered together, these principles governing consideration of events occurring subsequent to death have become a rule of relevance which precludes, as irrelevant, information that the hypothetical willing buyer could not have known and permits, as relevant, evidence of the actual price received after the date of death 'so long as the sale occurred within a reasonable time after death and no intervening events drastically changed the value of the property.'"[95]

10. Reconciliation:

a. "The Court has attempted to make sense out of both parties' approaches, but without success. It appears that both sides are using appraisals, which either make incorrect assumptions or describe considerations without demonstrating how those considerations entered into the appraiser's final conclusion. Both sides have mixed and matched before and after numbers, which may mix but do not match. The arguments of both sides are so full of apple and orange comparisons that the Court is forced to chart its own course through the maze which passes for a record in this case."[96]

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[93] *Estate of Davis v. Comm'r*, 110 T.C. 530, 550 (1998).

[94] *Estate of Jameson v. Comm'r,* 267 F.3d 366 (5th Cir. 2001); *see also Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002); *Estate of Jelke v. Comm'r*, 507 F.3d 1317 (11th Cir. 2007); *Estate of Jensen v. Comm'r*, 100 T.C.M. (CCH) 138 (2010). *But see Estate of Richmond v. Comm'r*, 107 T.C.M. (CCH) 1135 (2014) (holding discount for built-in gains appropriate, but not at dollar-for-dollar level).

[95] *Estate of Andrews v. United States*, 850 F. Supp. 1279 (E.D. Va. 1994); *see also, e.g., Estate of Noble v. Comm'r*, 89 T.C.M. (CCH) 649 (2005); *Estate of Smith v. Comm'r*, 198 F.3d 515 (5th Cir. 1999); *Estate of Saunders v. Comm'r*, 136 T.C. 406 (2011); *Estate of Foster v. Comm'r*, 101 T.C.M. (CCH) 1444 (2011).

[96] *Estate of Bruce v. Comm'r*, 65 T.C.M. (CCH) 2848, 2851 (1993).

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11. Valuation Conclusion:

    a. "The value conclusion is the result of the appraiser's judgment and not necessarily the result of a mathematical process."[97]

12. Signed Certification in Accordance with USPAP Standards Rule 10-3.

    a. "A signed certification is an integral part of the appraisal report. An appraiser who signs any part of the appraisal report, including a letter of transmittal, must also sign this certification."[98]

13. Statement of Qualifications

14. Exhibits:

    a. Financial

    b. Guideline Company

    c. Ratio Comparisons

    d. Valuation Mathematics

## E. EXAMPLES:

1. "At the time Tankersley's (Taxpayer's expert) report was offered into evidence by petitioner, respondent's counsel objected on the ground that the report did not comply with the requirement of Rule 143(f) that an expert's report set forth in detail the reasons for the conclusion of the expert witness. Specifically, Tankersley's report referred to comparable companies but did not identify them; did not state whether Tankersley used average earnings or a weighted average earnings in his analysis; referred to a standard industrial classification number but did not identify it; and did not explain how he arrived at the price-earnings ratio of 9.8. The Court agreed with the criticism of Tankersley's report and indicated that a timely motion in limine might have been granted if made earlier, when the defect in the report could have been cured, but overruled the objection because sustaining it when the witness began his testimony would have precluded petitioner's presentation of its case.

   "Tankersley's testimony and his report merely reiterated the factors set forth in section 2031(b), in the regulation quoted above, and in <u>Rev. Rul. 59-60</u> and asserted his conclusion. Tankersley

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[97] USPAP, Standards Rule 9-5 (cmt.).

[98] USPAP, Standards Rule 10-3 (cmt.) (A person "who signs a certification accepts full responsibility for all elements of the certification, for the assignment results, and for the contents of the appraisal report").

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gave us no reason to believe that the fortunes of the corporation would rise and fall with the companies that he used, and his failure to identify any of those companies prior to cross-examination during trial precluded verification of the ratios that he claimed to have derived from them. He did not explain how he calculated the numbers used or otherwise justify his result. It appeared from his testimony on cross-examination that he had arbitrarily picked a ratio and had erroneously compared average earnings over a 5-year period of the corporation being valued to current earnings of the other companies. Under the circumstances, Tankersley's opinion is unreliable and cannot satisfy petitioner's burden of proving that respondent's determination in the statutory notice was erroneous.

"Petitioner argues that we should accept Tankersley's testimony because he 'specifically states compliance with' section 2031(b), and respondent's expert witness report does not. We cannot, however, accept petitioner's expert's unsupported assertion that, applying the legal standards, the value of the common stock is $800 per share. Notwithstanding Tankersley's credentials, his unreasoned expert opinion cannot be relied on by the Court.

"Krug's opinion, by contrast, provided the information necessary for us to make a reasoned judgment as to the correctness of his approach. In the absence of more than one comparable company engaged in the same line of business, he was correct in comparing the corporation to companies engaged in a similar line of business, *i.e.*, other original automobile equipment manufacturers."[99]

2. "His report and testimony are unhelpful to the Court, and we find both to be unpersuasive. In contrast to the detailed reports that we typically see with respect to an expert's opinion of valuation, [taxpayer's expert's] report is three pages long and consists mainly of bald assertions. . . ."[100]

## IV. SUMMARY AND CONDITIONS

A defensible valuation report results from the conscientious efforts of the appraiser, advisors, and the client. The more thorough the review by the client and his advisors, the more defensible the report likely will be. Keep in mind that the appraiser, while an expert in valuation, is not and cannot be an expert with regard to the client's factual situation. A critical read-through by both the client and his legal advisor is critical to ensuring that the valuation report is as clear and accurate as possible.

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99 *Estate of Jann v. Comm'r*, 60 T.C.M. (CCH) 23, 26 (1990).
100 *Estate of Cloutier*, 71 T.C.M. (CCH) at 2003.


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