CHAPTER 1

Tax Valuation and the Necessity for Expert Appraisals

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SUMMARY

The appraisal profession, which includes specialized valuation determinations of real estate, businesses, interests in businesses, intangible assets, machinery and equipment, and private personal property, has made great strides in the last decade. With these advancements, appraisals have become increasingly technical. Attorneys, return preparers, and appraisers are finding that courts and regulators are much more inclined to scrutinize all aspects of the valuation and appraisal processes. In response, tax professionals increasingly rely upon expert valuators to support tax reporting positions in civil and criminal tax controversies with the IRS, the Tax Division of the U.S. Department of Justice, and state and local tax authorities.

Tax professionals who rely upon valuators, and valuators who provide support to tax professionals, must develop cross-disciplinary skills in valuation and tax to better serve their clients. This chapter summarizes the necessity of involving well-qualified and knowledgeable experts in all aspects of the appraisal process, especially since appraisals often involve significant valuation technicalities and many deal with major sums of money for the participants.

THE NEED FOR VALUATION EXPERTS

Valuation is pervasive in our tax system; complex valuation disputes have filled court dockets for centuries. Approximately 340 sections of the Internal Revenue Code require determinations of fair market value in order to accurately assess and report tax liabilities.[1] Indeed, valuation litigation is so frequent that it accounts for between

[1] As of the time of this writing, the term *fair market value* appears in 344 different sections of the Internal Revenue Code. Roughly 290 of these sections concern the calculations of income, estate and gift, employment, and excises taxes. The other 54 sections deal with valuation in procedural and administrative areas of the tax law, mostly as it relates to third-party reporting on information returns. One section relates to Coal Industry Health Benefits.

20 and 35 percent of all Tax Court cases in which the taxpayers are represented by counsel.[2]

Valuation methodology has become highly sophisticated, and valuation-related tax issues often perplex even the most experienced tax professionals. It is against this backdrop that knowledgeable valuators have become indispensable to the tax reporting and tax litigation processes. Following are the areas where valuation and tax are likely to overlap.

Valuation in Tax Reporting

As applied to tax reporting, the federal tax law generally *requires* taxpayers to hire a *qualified appraiser* to prepare a *qualified appraisal* in connection with:

- Claiming a charitable contribution deduction of more than $5,000 where the donated property is not cash, publicly traded securities, a qualifying vehicle, or certain intellectual property;[3]
- Valuing assets of charitable remainder trusts;[4]
- Valuing claims and counterclaims against an estate;[5] and
- Transferring property to a qualified settlement fund.[6]

Moreover, obtaining a qualified appraisal prepared by a qualified appraiser may help a taxpayer avoid accuracy-related penalties under section 6662 of the Internal Revenue Code.[7] The terms *qualified appraisal* and *qualified appraiser* are technically and specifically defined in the Internal Revenue Code and the federal Treasury Regulations. Chapter 2, *Qualified Appraisal*, and Chapter 3, *Qualified Appraiser*, analyze and discuss each of these terms in detail.

As applied to tax reporting, practitioners may hire expert valuators to accurately compute and report tax liabilities. A nonexclusive list of the areas where such expertise is typically utilized is:

1. Charitable contribution deductions, including, but not limited to, donations to real property, personal property, grants of air rights, development rights, and conservation easements;
2. Business formations;
3. Inventory valuations;

[2]The Tax Court published 422 opinions in 2014. Of these 422 opinions, 148 involved taxpayers represented by counsel and 274 involved taxpayers appearing *pro se* (i.e., unrepresented by counsel). Questions of valuation were resolved, in one form or another, in roughly 52 of the 148 cases involving taxpayers represented by counsel, which means that valuation was at issue in approximately 35.1% of cases in represented taxpayer cases in 2014. Similarly, the Tax Court published 443 opinions in 2013. Of these 443 total opinions, 98 involved taxpayers represented by counsel and 345 involved taxpayers proceeding *pro se*. Valuation issues of some sort were resolved in 20 of the 98 cases involving taxpayers represented by counsel, which means that valuation was at issue in approximately 20.4% of cases in which practitioners had entered an appearance for taxpayers.

[3]*See* I.R.C. § 170(f)(11)(A), (C), (D).

[4]*See* Treas. Reg. § 1.664-1(a)(7).

[5]*See* Treas. Reg. § 20.2053-4(b).

[6]*See* Treas. Reg. § 1.468B-3(b).

[7]*See* Treas. Reg. § 1.6664-4(h).

4. Corporate mergers, acquisitions, and spinoffs;
5. Allocations of purchase price under section 1060 of the Internal Revenue Code;
6. Business liquidations or reorganizations;
7. Financings;
8. Initial public offerings;
9. Goodwill (both personal goodwill and business goodwill);
10. Intangibles, including valuation of intangibles for transfer pricing purposes;
11. Employee stock ownership plans;
12. Retirement plan actions;
13. Incentive stock options;
14. Compensation received as property;
15. Buy–sell agreements and related consequences;
16. Stockholder disputes and related consequences;
17. Mark-to-market valuations under section 475 of the Internal Revenue Code;
18. Exchanges of property;
19. Estate tax returns;
20. Gift tax returns;
21. Determinations of reasonable compensation;
22. Foreign account reporting (e.g., in connection with reporting Form 8938, *Statement of Specified Financial Assets*);
23. Collection cases, especially where an offer in compromise is requested (note, Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, and Form 433-B, *Collection Information Statement for Businesses,* require valuation of real estate and businesses); and
24. Marital dissolutions and related reporting.

Valuation in Tax Litigation

Valuation is often implicated in civil tax litigation, and occasionally arises in criminal tax matters. As applied to civil tax litigation where valuation is at issue, expert testimony is routinely sought and can be helpful to document and prove a client's tax reporting position. In addition to the areas identified earlier, which relate to substantive determinations of tax liability, valuation may be implicated in the following penalty-related areas:

1. Substantial valuation misstatement penalty cases; and
2. Gross valuation misstatement penalty cases.

Given the prevalence of valuation in tax, it is important to recognize when an expert valuator can assist in proving and documenting a client's position. It is generally appropriate, and often wise, to hire an expert in litigation whenever doing so will help the trier of fact (and/or the attorney) understand the evidence or decide a fact in issue. As discussed more fully in Chapter 7, *From Daubert to Boltar*, and Chapter 13, *Attorney Involvement*, Rule 702 of the Federal Rules of Evidence, provides:

> *A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:*
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> *(a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;*

(b) the testimony is based on sufficient facts or data;
(c) the testimony is the product of reliable principles and methods; and
(d) the expert has reliably applied those principles and methods to the facts of the case.

As applied to tax litigation, it may also be helpful to hire an expert, either in connection with determining value or, as may be relevant in a criminal tax case, establishing tax loss. There are four areas in which an expert valuator may be utilized in such matters:

1. Determining the actual tax loss;
2. Assisting with the cross-examination of the government's expert or summary witness;
3. Challenging the reliability and credibility of the government's expert or summary witness; and
4. Explaining the correct treatment of the defendant's tax positions.

Valuation in Business and Familial Matters

Valuation disputes frequently arise, and the appraisal process is increasingly scrutinized, in business transactions and familial matters, including estate planning and divorces. The following highlights the importance of the appraisal process in these prevalent modern-day matters:

1. *For Gift, Estate, and Income Tax (including charitable contribution deductions)*—Appraisals will be reviewed by the IRS and are likely to be reviewed by appropriate state and local tax authorities;
2. *For Employee Stock Ownership Plans (ESOPs)*—Appraisals are subject to attack by plan participants, the Department of Labor, and the IRS;
3. *For Buying or Selling*—Appraisals are subject to negotiation by sellers/buyers, and the results of one or more appraisals may dictate the purchase price between the parties in the context of, for example, a buy–sell agreement;
4. *For Dissenting or Oppressed Stockholder Actions*—Appraisals are subject to review and critique by the opposing stockholder's expert;
5. *For Property Taxes*—Appraisals are reviewed and certified by the taxing authority;
6. *For Liability Cases (including insurance reimbursements)*—Appraisals are subject to review and critique by opposing experts; and
7. *For Marital Dissolution Matters*—Tax and valuation is routinely implicated in divorces, where appraisal reports are subject to review and critique by the opposing spouse's expert.

VALUATION CALCULATION STANDARDS

Almost all appraisals must be conducted under the rubric of some valuation standard, which is to say that the subject property's value must be measured. The appropriate measure of value depends upon the purpose for which the valuation is obtained.

There are numerous measures of value that may be encountered in connection with a tax matter, including:

1. *Fair market value*, which is the appropriate measure of value for the overwhelming majority of tax matters;
2. *Market value*, which may be utilized by valuators who prepare an appraisal report in accordance with the Uniform Standards of Professional Appraisal Practice (sometimes referred to herein as "USPAP");
3. *Fair value*, which may apply under state statutes governing dissenting stockholder and minority oppression actions, as well as under generally accepted accounting principles ("GAAP");
4. *Quick sale value*, which may apply in connection with IRS collection matters;
5. *Salvage value*, which may be used to compute allowable depreciation for tax purposes; and
6. *Investment value*, which connotes value to a particular investor or owner.

Most clients, and many tax practitioners for that matter, have never thought about the technical requirements with which an appraiser must comply when providing an appraisal under any given valuation standard. Choosing the proper valuation technique in a tax matter or an appraisal assignment is an important decision that should be thoughtfully undertaken by both the valuator and the tax practitioner.

Valuation standards for value determinations can be established by federal or state statute, case law, or agreement among the parties (e.g., buy–sell agreements). Although it is the tax practitioner's responsibility to identify the appropriate measure of value to be utilized in any given matter, it is also essential for the appraiser to assist the tax practitioner so as to create parity between the tax and valuation assignment. It is also imperative for the expert appraiser to be intimately familiar with the appropriate mechanism for determining value under the identified valuation standard.

By "standards" in this context, we mean definitions of value. These are not to be confused with rules for conducting and reporting appraisals, such as the USPAP, which are discussed in Chapter 9, *Expert Appraisal Reports*.

Set forth ahead in more detail are the most common measures of value applicable to appraisals. As will be seen, these valuation standards are often complex and can vary drastically, mandating the involvement of a qualified experienced professional appraiser. We emphasize fair market value over the other measures of value because fair market value is the measure of value generally required in federal tax matters.

Fair Market Value Defined

In the United States and Canada, the most commonly acknowledged standard of value is *fair market value*. It is this standard that applies to most U.S. federal and state tax issues relating to corporate, estate, gift, and individual income taxes, including, for example, valuation of property for estate and gift tax purposes and charitable contribution deductions. This is an important point to stress since some valuators fail to properly utilize a true fair market value as the appropriate measure of value in federal tax matters, even though they are required to do so.

The definition of *fair market value* is one of the most important definitions in tax. The U.S. Treasury Regulations define fair market value of property as "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."[8] Included within this definition are a number of implied assumptions.

Implied Assumptions

Within the tax valuation industry, there is a general consensus that fair market value presumes that an arm's-length transaction exists where both the buyer and the seller have the ability and the willingness to effectuate a cash transaction. Within this definition, *market* refers to all potential buyers and sellers of assets in a situation where neither party is being forced to buy or sell.

When determining fair market value, an appraiser must identify the hypothetical willing buyer and hypothetical willing seller, making sure the two individuals are dealing with one another at arm's-length in the hypothetical sale. And an appraiser should not allow her fair market value determinations to be set by a price with parties driven by motivations not present in the typical hypothetical seller and buyer. In Canada, however, fair market value may include the value of synergies with a particular buyer.[9]

Consistent with this rationale, the Tax Court has mandated using the following six principles for fair market value determinations:

1. Fair market value is the price that a willing buyer would pay a willing seller, both persons having reasonable knowledge of all relevant facts and neither person being under any compulsion to buy or to sell.
2. The willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the characteristics of these hypothetical persons are not necessarily the same as the personal characteristics of the actual seller or a particular buyer.
3. Fair market value is determined as of the valuation date, and no knowledge of unforeseeable future events which may have affected the value is given to the hypothetical persons.
4. Fair market value equals the highest and best use to which the property could be put on the valuation date, and fair market value takes into account special uses that are realistically available due to the property's adaptability to a particular business.
5. Fair market value is not affected by whether the owner has actually put the property to its highest and best use. The reasonable, realistic, and objective possible uses for the property in the near future control the valuation thereof.

[8] *See* Treas. Reg. §§ 1.170A-1(c)(2); 20.2031-3 (1992); *see also United States v. Cartwright*, 411 U.S. 546, 551 (1973); Rev. Rul. 59-60, 1959-1 C.B. 237.
[9] *See* Richard M. Wise, "The Effect of Special Interest Purchases on Fair Market Value in Canada," 22 *Bus. Valuation Rev*. 196, 196–203 (2003), for a thorough discussion of fair market value in Canada.

6. Elements affecting value that depend upon events or a combination of occurrences which, while within the realm of possibility, are not reasonably probable, are excluded from this consideration.[10]

It is important to remember that fair market value determinations are inherently factual in nature and that the trier of fact in any tax controversy "must weigh all relevant evidence of value and draw appropriate inferences."[11] Expert judgment is a critical part of this calculation. It is important that all evidence considered and all assumptions and inferences made be disclosed in the appraisal report.

Cash Value and Market Value

The terms *cash value* and *market value* are occasionally used interchangeably with *fair market value*. Indeed, real estate appraisers generally use the term *market value* in an attempt to denote the concepts of fair market value. An independent board of the Appraisal Foundation provides, through USPAP Advisory Opinion 22, the following definition of *market value*:

> *[T]he most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition are the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:*
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> 1. *The buyer and the seller are typically motivated;*
> 2. *Both parties are well informed or well advised and acting in what they consider their best interests;*
> 3. *A reasonable time is allowed for exposure in the open market;*
> 4. *Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and*
> 5. *The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.*[12]

The Appraisal Foundation emphasizes that the definition of *market value* connotes an exchange that occurs for cash or cash equivalents.[13]

COMPUTING FAIR MARKET VALUE

A complete discussion of the various approaches to calculate fair market value is outside the scope of this book, but practitioners should understand the basic principles by which fair market value is computed.

[10] *Pabst Brewing Co. v. Comm'r*, T.C. Memo. 1996-506, 72 T.C.M. (CCH) 1236 (1996).
[11] *See Pabst Brewing Co. v. Comm'r*, T.C. Memo. 1996-506, 72 T.C.M. (CCH) 1236 (1996).
[12] USPAP Advisory Opinion 22 (2014–2015).
[13] USPAP U-3, 98-111 (2014).

The value of any property (real, tangible, intangible, and personal) can be calculated in a two-step process. Under step 1, valuators compute the subject property's net asset value. Under step 2, valuators apply appropriate valuation discounts and premiums to adjust the net asset value.

Step 1: Calculating Net Asset Value

This first step employs the three most common approaches to determine net asset value: the market approach, the income approach, and the asset-based approach.

The *market approach* assumes that the value of property can be determined by reference to the value of comparable properties for which values are known as a result of recent sales or quotes on a readily tradable market. Under the market approach, the valuator compares the subject property to similar comparable properties that were sold in an arm's-length transaction reasonably proximate to the valuation date. The value of the subject property is determined by taking into account the sales prices of comparable properties that were sold proximate to the valuation date and adjusting the value of each comparable property for features unique to the subject property, but not possessed by the comparable property. The market approach is most appropriately used when comparable properties have qualities substantially similar to those of the subject property.

The *income approach* assumes that the value of the subject property can be determined by computing the present value of the estimated future cash flows that may be realized with respect to that property. Within the income approach, there are at least two accepted methods: the *discounted cash flow method*, which typically uses a static growth rate assumption to estimate future cash flows; and the *income capitalization method*, which typically uses a variable growth rate assumption to estimate future cash flows.

The *asset-based approach* (also known as the *cost approach*) generally assumes that the value of property can be determined by calculating the cost to reproduce it, less any applicable depreciation or depletion. The approach is slightly more nuanced in business valuations. In that situation, valuators generally value the business or business interest by determining the cost to reproduce it and focusing on the company's net asset value (i.e., the fair market value of its total assets minus its total liabilities). In practice, the fair market value of assets (e.g., marketable securities or real estate valuation) is substituted for the respective book values on the balance sheet of the company being valued.

Valuators typically do not value property under just one approach. Rather, property is often valued under each of the above-referenced approaches, and the indicated value in each approach is weighted to derive a final opinion of value. In addition to containing the items discussed in Chapter 9, *Expert Appraisal Reports*, an appraisal report should:

1. Reconcile the different conclusions of value derived from the various approaches;
2. Explain the weighting of each valuation approach in determining a final opinion of value;
3. Disclose any assumptions that were made in valuing the property; and
4. Provide sufficient details and explanations about how the final opinion of value was derived so that another valuator can replicate this work after reviewing the report of related workpapers.

Step 2: Applying Discounts and Premiums

The second step in determining fair market value is to apply appropriate discounts and premiums. There are numerous types of valuation discounts and premiums, some of which are appropriate at the owner level, some of which are appropriate at the entity level, and some of which apply principally to property that can be jointly held (e.g., real estate, art, and collectibles). Among the types of valuation discounts and premiums are:

1. Discount for lack of marketability;
2. Blockage or market absorption discounts;
3. Lack of control discount;
4. Lack of voting rights discount;
5. Control premium/minority interest discount;
6. Discount for built-in capital gain;
7. Key person discount;
8. Discount for contingent liabilities;
9. Portfolio discount;
10. S corporation premiums; and
11. Fractional interest or partition discounts.

The fair market value of property can generally be computed by adding and subtracting appropriate premiums and discounts from the property's net asset value.

COMMON TAX APPRAISAL REPORTS

The valuation process, including any assumptions, is generally documented in a written report. The contents of the report will depend upon the purposes for which the report was procured.

Appraisal Reports to Support Tax Reporting Positions

An appraisal report is sometimes required to support a tax reporting position. For example, federal tax law generally *requires* taxpayers to hire a *qualified appraiser* to prepare a *qualified appraisal* in connection with:

- Claiming a charitable contribution deduction of more than $5,000 where the donated property is not cash, publicly traded securities, a qualifying vehicle, or certain intellectual property;
- Valuing assets of charitable remainder trusts;
- Valuing claims and counterclaims against an estate; and
- Transferring property to a qualified settlement fund.

The requirements of a qualified appraisal are discussed in Chapter 2, *Qualified Appraisal*, and the requirements of a qualified appraiser are discussed in Chapter 3, *Qualified Appraiser*.

In other cases, even though a qualified appraisal is not required, clients or practitioners may desire to obtain an appraisal report to support a tax reporting position.

We discuss best practices with respect to such appraisal reports in Chapter 9, *Expert Appraisal Reports*.

Appraisal Reports to Support Tax Litigation

Expert witness reports, which differ from appraisal reports used to support a tax reporting position, may be advisable where the question of value is to be litigated. The requirements for such reports are technically and specifically defined in applicable court rules. The requirements for appraisal reports to support litigation are discussed in Chapter 13, *Attorney Involvement*.

PROLIFERATION OF LITIGATION

In the past decade, courts have increasingly scrutinized appraisals and the underlying mechanics of such appraisals. Litigation is especially prominent in the area of qualified appraisals required to support a charitable contribution deduction. As a general matter, courts are becoming more sophisticated with respect to all types of appraisals. The degree of sophistication, however, varies among the courts and even among judges in the same court.

It is incumbent upon the lawyer and the valuation expert to explain to the court and the trier of fact, whether sophisticated or not, why the submitted appraisal best meets the applicable valuation methodology. An expert can be technically qualified and still not be a good expert in a litigation setting. Thus, unless the expert can adequately explain her appraisal methodology and how her appraisal fits into the particular valuation context at hand, the judge and/or finder of fact may very well find fault with the appraisal. In all situations, the appraiser must be a good communicator, with the ability to teach the judge and the trier of fact complex concepts of finance that may be outside their realm of knowledge; this is especially true in the areas of valuing businesses, business interests, and intangible assets.

Knowledgeable judges are not shy about criticizing unreliable work by appraisers. For example, one court excluded the report of the taxpayer's real estate appraiser as unreliable and inadmissible per rule 702 of the Federal Rules of Evidence, *Daubert v. Merrell Dow Pharmaceuticals, Inc.*,[14] and United States Tax Court Rule 143(g) because the expert made no effort to determine the highest and best use of property after the grant of a conservation easement.[15] Similarly, in *Kohler v. Commissioner*,[16] the Tax Court gave no weight to a stock valuation opinion of the IRS's expert where the expert spent little time with the company's management, invented his own expense structure for his income approach analysis, and decided not to use an unreliable dividend-based method despite the fact that the company had historically paid large dividends. In giving the expert's opinion no weight, the Court noted the lack of customary certification of the expert's report and that his report was not prepared in accordance with all USPAP standards. The Court also placed no weight on the expert's report in *Estate of Renier v. Commissioner*,[17] where the report contained

[14] *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 597 (1993).
[15] *Boltar, L.L.C. v. Comm'r*, 136 T.C. 326 (2011).
[16] *Kohler v. Comm'r*, T.C. Memo. 2006-152, 92 T.C.M. (CCH) 48 (2006).
[17] *Estate of Renier v. Comm'r*, T.C. Memo. 2000-298, 80 T.C.M. (CCH) 401 (2000).

no explanation of, or analytical support for, the various rules of thumb employed in reaching several of his valuation estimates, thus making it almost impossible for the Court to assess the merits of his conclusions.

Therefore, regardless of whether a qualified appraisal prepared by a qualified appraiser is required in connection with a tax reporting position, it is beneficial to retain an appraiser who is not only "qualified," but also *well-qualified*. These court-driven criticisms of expert appraisers can be avoided by careful expert selection and thorough and thoughtful preparation. Selection and preparation of appraisers is the subject of Chapter 6, *The Practicalities of Selection and Preparation of Experts*.

CONCLUSION

Expert valuators and tax practitioners must develop cross-disciplinary skills in valuation and in tax. This cross-disciplinary approach first requires valuators and tax practitioners to recognize that fair market value is the proper standard of value for federal tax purposes, and then to understand how fair market value is computed. Within the cross-disciplinary approach, it is important for all professionals to appreciate: the gambit of appraisal reports that may be required; how valuators will prepare those reports; how practitioners will use those reports and what penalties may apply for faulty appraisals; and what judges look for in deciding a valuation case.