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# Value Matters™

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Issue No. 5, 2013

# 8 More Mistakes To Avoid in Valuations

## According to Tax Court Decisions

In this second part of a two-part series, we have collected eight examples of mistakes that valuation experts have made, as reported in federal courts tax decisions (see Value Matters™, Issues No. 4, 2013 for “16 Mistakes to Avoid in Valuations: According to the Tax Court.”) It is important to note that there are two sides to every story, and courts do not always get it right. For this reason, we do not name any valuers in this collection of mistakes to avoid.

### 1 Insufficient Due Diligence

In *Freeman Estate v. Commissioner* (T.C. Memo 1996-372), the taxpayer's valuator failed to ask the subject company's president whether he had plans for an IPO. In the Tax Court's opinion:

The corporation had an initial public offering of stock in June 1990, at a price of \$10 per share. The possibility of an initial public offering was discussed at a meeting of the board of directors of the corporation on August 24, 1989. In his report, [the valuator] states specifically that (1) during his interview with Bernard V. Vonderschmitt, president ... he did not inquire as to whether, on October 22, 1989, the corporation had any plans for a public offering of stock, and (2) he did not consider the potential for a public offering in carrying out his valuation assignment.

Petitioner has cited to us no authority prohibiting an inquiry into plans for a public offering. We assume that a potential purchaser would be interested in such plans and might pay a premium depending on her judgment of the likelihood of such an offering.

Likewise, in *Bennett Estate v. Commissioner* (T.C. Memo 1993-34), the Tax Court criticized a valuator for failing to investigate as would a hypothetical willing buyer:

Compounding this shortcoming is [the valuator's] exclusive reliance upon the numbers listed on Fairlawn's balance sheets with no further investigation or due diligence. [The valuator] himself acknowledged at trial that a hypothetical willing buyer would look behind the balance sheet numbers in evaluating their correctness

and in applying valuation methods. Although [the appraiser] stated that he was not able to obtain requested documents from Fairlawn, we feel that [he] did not perform sufficient due diligence in this matter.

It is imperative that the valuator document all due diligence efforts in the valuation report, because the valuator may not get a chance to do so on the witness stand. Include unsuccessful efforts to obtain important information, with a legitimate explanation of why the effort failed (See, e.g., *Winkler Estate v. Commissioner*, T.C. Memo 1989-231).

Another example of lack of due diligence, as well as incorrectly written descriptive report, is where the valuator failed to make relevant inquiries in *Ansan Tool and Manufacturing Co. v. Commissioner* (T.C. Memo 1992-121).

[The valuator] had not discussed Mario Anesi's departure from petitioner with management to determine whether customers would leave or stay with petitioner. It is also unclear how [he] determined that only 10 percent of sales would be lost if Mario Anesi competed against petitioner, nor why the 10 percent loss would be limited solely to the first year after he left petitioner.

### 2 Unforeseeable Subsequent Events

A dilemma inherent in retrospective valuations is that life and business carry on after the valuation date. Consequently, the post-valuation-date events and cycles become known to valuers during the valuation process. The uncertainties, economic or otherwise, that exist on the valuation date can be lost when subsequent reality becomes visible and measurable. The problem that occurs when future expectations blend into history is that events subsequent to the valuation date are not supposed to be considered in a valuation, except to the extent that such events and conditions could have been knowable or reasonably foreseen.

A valuator's observations and perspective could potentially be influenced by subsequent events. This can be equally true of the information and feedback provided by the various stakeholders to a valuation event. The question often becomes whether that information was knowable as of the valuation date. *Love Estate v. Commissioner* (T.C. Memo 1989-470) is instructive on this issue:

... after Mrs. Love's death, Praise was determined to be in foal. Surely, this increased her value considerably. Respondent's expert assumed for the purpose of his valuation that Praise was pregnant at the date of Mrs. Love's death, although it was impossible to ascertain pregnancy on that date. A hypothetical willing buyer would not have been aware that Praise was in foal. The report of respondent's expert, therefore, contravenes the regulations by making use of hindsight.

A tax valuation is made as of a certain date; for example, date of death or date of a gift. Generally, a valuator should only consider circumstances in existence on the valuation date and events occurring up to that date. The courts, however, have allowed evidence of subsequent events if those events were reasonably foreseeable as of the valuation date (*Spruill Estate v. Commissioner*, 88 T.C. 1197 (1987)).

### 3 Improper Reliance on a Draft Valuation Report

Valuators sometimes have to rely on the work of other valuers whose work may be in progress at the same time. In *Cloutier Estate v. Commissioner* (T.C. Memo 1996-49), a valuator lost credibility for failing to follow up on a work-in-process:

[O]ne of the appraisals on which [the valuator] purported to rely was merely a draft of an appraisal, and [the valuator] never spoke to the author concerning the author's completion of that draft or about any of the information contained therein.

### 4 Ignoring Asset Appraisals in Other Disciplines

In *Ford Estate v. Commissioner* (T.C. Memo 1993-580), the taxpayer's expert used historic book value of assets in the net value approach, even though asset appraisals had been obtained and were available. The Tax Court said:

[P]etitioner's expert valued the assets of each company using unadjusted book value, thereby undervaluing the assets themselves. Petitioner's expert generally used historic book value as a factor in his formula, notwithstanding that petitioner

had obtained appraisals as of the valuation date for certain of the Ford companies' assets, namely, the real estate owned by Ford Mercantile and Ford Dodge, the securities issued by unrelated entities that were owned by Ford Mercantile, Ford Dodge, Ford Real Estate, and Ford Moving, as well as the cars, trucks, trailers, and securities issued by unrelated entities that were owned by Ford Van.

### 5 Use of Data with Caveats or Warnings

In *Haffner's Service Station, Inc. v. Commissioner* (T.C. Memo 2002-38), a valuator used data that was subject to an explicit warning by the publisher of the data:

[The valuator] acknowledged at trial that the general data was unreliable, he stated specifically that he knew that Robert Morris's publication warns readers explicitly that the data is not statistically accurate and should not be relied upon or used in a legal proceeding. [The valuator] attempted to rationalize his reliance on the Robert Morris compilation by stating: "Unfortunately, I had to use what was available. It was ... the best stuff around. I have to concede that they're flawed." We find this attempt unavailing.

### 6 Using an Ancient Comparable Sale

The market approach is premised on the use of sales that occur reasonably close to the valuation date. In *Hagerman Estate v. United States* (81 AFTR2d Par. 98-771 (C.D. Ill. 1998)), the court pointed out:

He relied particularly on Sale 2 finding the subject farm was of the same value. Unfortunately for Plaintiffs, the sale price for Sale 2 was as previously indicated 20 years outdated. Clearly, [the valuator's] valuation of Farm 4 is seriously flawed.

### 7 Neglecting to Identify an SIC

In *Jann Estate v. Commissioner* (T.C. Memo 1990-333), a valuator referred to a Standard Industrial Code in his report, but failed to identify what category that number referred to:

[The valuator's] report referred to comparable companies but did not identify them; did not state whether [he] 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 the price-earnings ratio of 9.8.

## 8 Failure to Proofread

The last mistake on this list, fittingly, is from *Hinz Estate v. Commissioner* (T.C. Memo 2000-6), in which the valuator apparently neglected to proofread his report, and the Tax Court socked it to him:

When asked why his expert witness report relies on a statute that had been repealed years earlier, [the valuator] replied as follows: "I think this is boilerplate that was put in by my secretary over the last—ever since 1992, and I have never taken it out."

Also, in some instances, the textual descriptions of properties in [the valuator's] written report did not match the properties listed in the accompanying matrix. It was as though [the valuator] had revised parts of a draft of his report but inadvertently kept parts of former drafts that no longer fit the revised draft.

## Conclusion

In this article, we presented eight mistakes made by valuation experts, as reported in federal courts in tax decisions. Just because one judge in one case calls something a mistake doesn't make it a mistake in all cases. But we think the above examples are indeed instructive in most valuation situations.

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*This article originally appeared in the September/October 2013 issue of The Value Examiner. It was adapted from Chapters 17-18 of A Reviewer's Handbook to Business Valuation by L. Paul Hood, Jr., and Timothy R. Lee, (John Wiley & Sons, New Jersey, 2011). For book details, see www.mercercapital.com or http://www.wiley.com/WileyCDA/WileyTitle/productCd-0470603402.html.*

## Upcoming Industry Events

*The senior staff of Mercer Capital attends and presents at numerous industry and professional conferences. If you are attending as well, please let us know so we can connect with you.*

### 2nd International OIV Conference on Business Valuation

November 26, 2013  
Milan, Italy

**Chris Mercer**, CEO, will be speaking on the topic of "The Integrated Theory" at this conference sponsored by the Organismo Italiano di Valutazione.  
mercerc@mercercapital.com

### Professional Member Forum of the ESOP Association

February 25, 2014  
New Orleans, LA

**Tim Lee**, Managing Director, will be attending this event.  
leet@mercercapital.com

### Heckerling Institute on Estate Planning

January 13 - 17, 2014  
Orlando, FL

**Tim Lee**, Managing Director, **Nick Heinz**, Senior Vice President and **Barbara Price**, Senior Vice President, will attend this event. Mercer Capital will also be exhibiting. Visit us at booth 408.

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Nick Heinz » heinzn@mercercapital.com  
Barbara Price » priceb@mercercapital.com

### Banks with ESOPs Seminar sponsored by the ESOP Association

February 26, 2014  
New Orleans, LA

**Tim Lee**, Managing Director, and **Andy Gibbs**, Senior Vice President will be attending and Tim will be speaking.

Tim Lee » leet@mercercapital.com  
Andy Gibbs » gibbsa@mercercapital.com

### Valuation Report Writing Basics Webinar

January 10, 2014  
Webinar sponsored by BV Resources

**Tim Lee**, Managing Director, will co-presenting with L. Paul Hood, Jr., Esq.  
leet@mercercapital.com

### NCEO 2014 Annual Conference

April 8 - 10, 2014  
Atlanta, GA

**Tim Lee**, Managing Director, and **Nick Heinz**, Senior Vice President, will be attending this event.

Tim Lee » leet@mercercapital.com  
Nick Heinz » heinzn@mercercapital.com

### Acquire or Be Acquired Conference

January 26 - 28, 2014  
Arizona Biltmore Resort, Phoenix, AZ

**Matt Crow**, President, **Jeff Davis**, Managing Director, and **Andy Gibbs**, Senior Vice President, will present the topic "Acquisitions of Non-Depositories by Banks" on January 27. Mercer Capital will also be exhibiting.

Matt Crow » crowm@mercercapital.com  
Jeff Davis » jeffdavis@mercercapital.com  
Andy Gibbs » gibbsa@mercercapital.com

### AICPA/AAML Conference on Divorce

April 24 - 25, 2014  
Las Vegas, NV

**Chris Mercer**, CEO, will be speaking in three sessions. He will present a general session on April 24 on "The Five Really Big Issues in Business Valuation." In addition, he will participate on the following panel discussions: "The Great Debate on the Future of Marketability Discounts" and "Hot Debate on the Hot Topics in Business Valuation."

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# Valuation Strategies for Dealing with the IRS

Business owners seldom think about a valuation strategy for dealing with the IRS on gift and estate tax matters. Many owners ignore the importance of estate tax planning, which can also be called lifetime planning. Lack of vision or short-sightedness on planning can be damaging to family wealth and succession.

## Things to Consider

There is a demographic bubble involving ownership of closely held business interests held by baby boomers. This will bring a huge amount of wealth into the estate tax pipeline over the next two decades. Business owners should contemplate three things:

1. The IRS is aware of the potential revenue from this demographic bubble.
2. If a business owner engages in the gifting of closely held stock during his/her lifetime, the need for an "IRS strategy" will be important.
3. The need for an "IRS strategy" will be critical for executors and heirs at the time of death.

The old strategy goes like this: "Let's try to value things as low as possible and with as little documentation as possible, thereby saving money. If questions are raised, we'll try to negotiate a reasonable settlement."

## IRS Strategy

This strategy often results in loggerhead positions that lead to protracted negotiations, Tax Court, or unreasonable settlements. At the very least, dealing with the IRS in this fashion is quite disruptive to families and businesses. A different strategy seems more appropriate in today's environment. Recognize first that if you own a successful closely held business, you, your heirs, and/or your advisors will be dealing with the IRS regarding estate tax matters. Therefore, your "IRS strategy" might be composed of the following:

### Mercer Capital's

## Gift, Estate, and Income Tax Compliance Services

**Valuations are a critical element of successful tax planning strategies. Objective third-party valuation opinions are vital.**

Mercer Capital has been providing objective valuations for tax compliance since 1982. Our opinions of value are well-reasoned and thoroughly documented.

Mercer Capital's internal review and quality control processes are designed to generate expedited results that minimize common mistakes in process and analysis, particularly in situations where service and delivery needs are high. Mercer Capital also offers a diversity of services to its clients, including efficient fees for the valuation of partnership and LLC interests, as well as the most comprehensive services for complex entities and business models.

**Contact Nick Heinz ([heinz@mercercapital.com](mailto:heinz@mercercapital.com)) or Tim Lee ([leet@mercercapital.com](mailto:leet@mercercapital.com)) at 901.685.2120 to discuss your needs in confidence.**

- Obtaining a business valuation from a qualified independent appraiser as the basis for making substantial gifts, or for estate tax returns. Court cases have cited the importance of specific business valuation experience, credentials and training in the court's evaluation of the credibility of expert witnesses.
- Insuring that your business appraiser prepares a well-written, fully documented valuation report that explains the rationale for important valuation assumptions, or for the use of valuation premiums or discounts.
- Submitting the valuation report as an attachment to the gift or estate tax return. By doing so, you will increase the probability that your gift or estate tax matter is settled timely and fairly.

If your business appraiser's valuation report is well-supported and reasonable in its conclusion, you have little reason to negotiate with the IRS until credible evidence calling for a different conclusion is provided. An estate tax return for a substantial estate which is submitted without a supporting appraisal is an invitation for the IRS to negotiate for higher taxes.

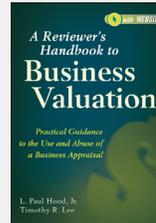
Absent the business valuation, you will have little basis to argue your original position. If you and the IRS reach an impasse and both sides then are required to obtain an appraisal, your appraiser's independence can be called in question, particularly if the conclusion is supportive of your original position. If the conclusion is not supportive, you have an entirely different set of problems. Further, rest assured that valuations prepared under the threat of immediate litigation tend to be more expensive than those prepared in the ordinary course of business. Finally, know with certainty that the negotiation process with the IRS is costly in terms of business time, personal time, and mental energy, not to mention valuation, legal, and accounting fees.

Remember the old adage, "It is always better to do things right the first time." Add to that, "It is always more expensive in terms of time, energy, and resources to fix what could have been done right the first time."

## Conclusion

If you own a business or serve as a professional advisor to business owners, engage a competent business appraiser when the need arises. Mercer Capital is one of the largest and most respected business valuation firms in the nation. Give us a call at 901.685.2120 to discuss your valuation issues in confidence.

## Mercer Capital's Books of Interest



### A Reviewer's Handbook to Business Valuation: Practical Guidance to the Use and Abuse of a Business Appraisal

Timothy R. Lee, ASA, Mercer Capital  
L. Paul Hood, Jr., Esq.

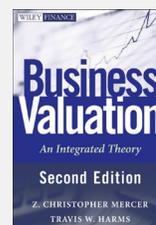
Focused on the practical aspects of business valuation that arise in the context of a tax valuation, this book provides a detailed analysis of the business valuation process. Discussion is included of various cases outlining errors that appraisers have made in appraisal reports, as well as in-depth examination of current appraisal industry issues that impact tax valuations.



### An Estate Planner's Guide to Revenue Ruling 59-60: Understand How Valuation Experts Utilize the Ruling in Income and Estate & Gift Tax Valuation Engagements

Mercer Capital

Revenue Ruling 59-60 is over 50 years old and it continues to be a foundational document for estate planning and business valuation professionals. This book is a non-technical resource that clearly explains how business appraisers attempt to translate the guidance found in the Ruling into actual valuation engagements.



### Business Valuation: An Integrated Theory - Second Edition

Z. Christopher Mercer, ASA, CFA, ABAR  
Travis W. Harms, CFA, CPA/ABV

Whether you are an accountant, auditor, financial planner, or attorney, *Business Valuation: An Integrated Theory, Second Edition* enables you to understand and correctly apply fundamental valuation concepts. Thoroughly revised and expanded, the *Second Edition* demystifies modern valuation theory, bringing together various valuation concepts to reveal a comprehensive picture of business valuation.

Each book is available at [www.mercercapital.com](http://www.mercercapital.com)

# Information of Interest From Around the Web

## Business Appraisers Withstand Daubert Challenges Better Than Other Experts Per PWC Study

Among all types of financial experts, appraisers fare best at surviving a Daubert challenge, reveals the newest PricewaterhouseCoopers' survey, *Daubert Challenges to Financial Experts* (<http://mer.cr/10hd7v>).

The year 2012 marked the 13th anniversary of the U.S. Supreme Court's *Kumho Tire* decision, which expanded Daubert's reach to financial expert witnesses. The annual PwC study analyzes challenges to financial expert witnesses under the Daubert standards in the years following *Kumho* (2000-2012). Highlights include:

- The number of challenges to financial expert witnesses rose to the highest level in the last 13 years, while the rate of successful challenges (45%) remained consistent with the historical average (46%).
- Challenges were concentrated in the 2nd, 5th, 6th, 7th, and 9th Circuits, which heard more than half (57%) of all challenges. The 2nd Circuit accounted for the highest percentage (15%) of the total challenges.

- In 2012, lack of relevance emerged as the most prevalent reason that a financial expert opinion was excluded. In the previous 12 years, lack of reliability was the top reason.
- Economists and accountants are the most frequently challenged financial expert witnesses. But in 2012, appraisers were the most likely to survive a challenge, while economists were the least likely to survive.
- Of all financial expert witnesses, intellectual property experts experience the highest exclusion rate.
- Exclusions more commonly result from the misuse of accepted methodologies than from the introduction of unusual or untested analytical methods.

Excerpted from **BVWire News Blog** (BV Resources) :: <http://mer.cr/1eiUcbh>

## IRS Loses in E&G Tax Case

The Tax Court recently denied an IRS motion for summary judgment in an estate and gift tax case where an elderly mother made gifts to her daughters, while requiring them to pay all tax liabilities due if she happened to die within three years of making the gifts. In the calculation for gift tax purposes, the mother reduced the value of the gifts by the estimated tax liability. This reduction was denied by the IRS. For the full details on this fascinating case, visit the *Journal of Accountancy* website (<http://mer.cr/17Mvkt0>).

Excerpted from **NACVA's Quick Read Blog** :: <http://mer.cr/1f1WyQkB>

## Do You Subscribe to Mercer Capital's Industry Quarterlies?

Having built a substantial client base in various industries, we have formalized our research efforts to provide a regular, detailed overview of pertinent issues and relevant current events. These industry newsletters offer a quarterly perspective on valuation issues pertinent to various industry groups and sectors. Each issue includes a segment focus, market overview, mergers and acquisitions review, and more.



### FinTech Industry

FinTech Watch focuses on one Fin-Tech segment each quarter, including payment processors, technology, and solutions companies.

Each issue examines general economic and industry trends as well as a summary of M&A and venture capital activity for the segment.



### Insurance Industry

This quarterly provides perspective on valuation issues pertinent to insurance agencies, brokerages, and underwriters. Market segments: 1st quarter: Insurance Brokerages, 2nd quarter: Property and Casualty Underwriters, 3rd quarter: Life Insurance Underwriters, and 4th quarter: Health Insurance Underwriters.

**To subscribe to these or other industry quarterlies, click here.**

# Mercer Capital

Mercer Capital's ability to understand and determine the value of a company has been the cornerstone of the firm's services and its core expertise since its founding.

Mercer Capital is a national business valuation and financial advisory firm founded in 1982. We offer a broad range of valuation services, including corporate valuation, gift, estate, and income tax valuation, buy-sell agreement valuation, financial reporting valuation, ESOP and ERISA valuation services, and litigation and expert testimony consulting. In addition, Mercer Capital assists with transaction-related needs, including M&A advisory, fairness opinions, and strategic alternatives assessment.

We have provided thousands of valuation opinions for corporations of all sizes in a variety of industries. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement. Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation on behalf of their clients.

Contact a Mercer Capital professional to discuss your needs in confidence.

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