MERCER CAPITAL

Handout Material

11 ISSUES YOU SHOULD BE AWARE OF WHEN WORKING WITH BUSINESS APPRAISERS

Thursday Luncheon Presentation
October 24, 2013

Matthew R. Crow, ASA, CFA
President

Nicholas J. Heinz, ASA
Senior Vice President

MERCER CAPITAL
901.685.2120
www.mercercapital.com

Don't Miss This Mid-Day Presentation

Why isn't business valuation more user-friendly?	Why the bids you receive for business valuation projects make no sense?	Do business valuation credentials matter?	Can any one appraiser truly do anything you need?	Is an appraiser's track record in court something to be proud of?
What's the difference between a testifying expert and an expert testifier?	Audit rates are rising. Why is that important?	Do IRS appraiser penalties matter?	What is the importance of experience? How do you judge that?	What is the significance of the IRS DLOM Job Aid?
How do you judge the quality of a business appraisal?				

11 Issues

You Should Be Aware of When Working with Business Appraisers

OCT
24
12:15pm

Estate planners often need business appraisal services, yet vetting business appraisers and understanding their work product is often more difficult than it should be. This session lifts the veil on the business appraisal profession and addresses issues and questions important to estate planners and, ultimately, their clients.

Sponsored By

MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY

5100 Poplar Avenue, Suite 2600
Memphis, TN 38137
901.685.2120
www.mercercapital.com

Presenters:

Matthew R. Crow, ASA, CFA
President
Mercer Capital
crowm@mercercapital.com

Nicholas J. Heinz, ASA
Senior Vice President
Mercer Capital
heinzn@mercercapital.com

MATTHEW R. CROW, ASA, CFA

901.685.2120 // crowm@mercercapital.com

Matthew R. Crow is the President of Mercer Capital and a member of the board of directors.

Matt provides corporate valuation services related to corporate planning and reorganization, transactions, employee stock ownership plans, and tax issues. He is active in valuation related to asset management firms and telecommunications enterprises and has broad industry experience in agriculture, manufacturing, distribution, and technology companies.

In addition, Matt serves as a course developer for the American Society of Appraisers BV302 course on Advanced Topics in the Valuation of Intangible Assets. He also actively participates in the Appraisal Issues Task Force, a group that interacts with the SEC to address new and developing fair value issues.

NICHOLAS J. HEINZ, ASA

901.685.2120 // heinzn@mercercapital.com

Nicholas J. Heinz joined Mercer Capital in 2000 and serves as a senior vice president. Nick also leads Mercer Capital's Valuation Services Group.

Nick has extensive experience in providing valuation and corporate advisory services for purposes including estate and gift tax planning and compliance matters, mergers and acquisitions, fairness opinions, solvency opinions, employee stock ownership plans, buy-sell agreements, and corporate planning and reorganizations.

Nick is an active member of several professional organizations including the ESOP Association, the National Center for Employee Ownership, and the American Society of Appraisers. He serves as an officer in the New South Chapter of the ESOP Association.

MERCER CAPITAL

www.mercercapital.com

Mercer Capital is a national valuation and financial advisory firm. Clients include private and public companies, financial institutions, high-net worth families, and private equity/hedge funds. Industries served fall into three broad categories: Financial Institutions, Operating Companies, and Asset Holding Companies.

Our suite of services encompasses two integrated service areas: valuation advisory & opinions and financial advisory services. Valuation advisory and opinions services include tax compliance and reporting, corporate transactions, financial reporting, employee benefit plans, and litigation support. Financial advisory services include corporate and strategic advisory, mergers & acquisitions, and fairness opinions.

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 in connection with engagements involving their clients.

MERCER CAPITAL

BUSINESS VALUATION // FINANCIAL ADVISORY

Mercer Capital is known for uncommon professionalism, intellectual rigor, technical expertise, and superior client service. We provide business valuation and financial advisory services to public and private companies and financial institutions throughout the world.

Mercer Capital is one of the largest independent business valuation and financial advisory firms in the nation.

We offer a broad range of services, including corporate valuation, financial institution valuation, financial reporting valuation, gift and estate tax valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting.

Since 1982, we have provided thousands of valuation opinions for corporations of all sizes in a wide variety of industries.

Our valuation opinions are well-reasoned and thoroughly documented, and provide critical support for any potential transaction.

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 in connection with engagements involving their clients.

No matter the valuation or financial advisory situation, Mercer Capital has the experience and expertise to help you.

MERCER CAPITAL'S CORE SERVICES

- Corporate Valuation
- Litigation & Expert Testimony Consulting
- Employee Stock Ownership Plan Valuation
- Estate & Gift Tax Valuation
- Buy-Sell Agreement Valuation
- M&A Representation & Consulting
- Financial Statement Reporting Valuation
- Fairness Opinions
- Financial Institution Valuation

MERCER CAPITAL SENIOR PROFESSIONALS

Z. Christopher Mercer, ASA, CFA, ABAR
mercerc@mercercapital.com

Timothy R. Lee, ASA
leet@mercercapital.com

Andrew K. Gibbs, CFA, CPA/ABV
gibbsa@mercercapital.com

Nicholas J. Heinz, ASA
heinzn@mercercapital.com

Matthew R. Crow, ASA, CFA
crowm@mercercapital.com

Jeff K. Davis, CFA
jeffdavis@mercercapital.com

Travis W. Harms, CFA, CPA/ABV
harmst@mercercapital.com

MERCER CAPITAL
5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137
901.685.2120 (p)
www.mercercapital.com

Business Valuation Credentials

A Comparison of the Primary Requirements to Obtain & Maintain

Requirement	ASA (1)	ABV (2)	CBA (3)	CVA (4)	CFA (5)
Year Credential Instituted	1981	1997	1978	1991	1947
Education	College/Equiv.	College/Equiv.	College/Equiv.	College/Equiv.	College/Equiv.
Experience in Business Valuation	5 years or 2,000 hours	6 completed engagements	No Minimum	None	None
Qualifying Examination & Length of Exam	Proctored, closed book | 8 – 12 hours	Proctored, closed book | 8 hours	Proctored, closed book | 6 hours	Proctored, closed book | 5 hours	3 annual closed book
Submit reports to a qualifications review committee	1 report	None	2 reports	A case study or, in lieu of a case study, 1 BV report	None
Continuing Professional Education and Recertification	100 hours every 5 years	60 hours every 3 years	36 hours every 3 years	36 hours every 3 years	None
Organization has a body of professional business valuation standards	Yes	Yes	Yes	Yes	None
Approximate No. of Designees	1,200	2,600	400	5,100	100,000

Organizations Awarding Closely Held Business Valuation Credentials
Track to the footnote numbers following the above designations

(1) ASA	Accredited Senior Appraiser designation from the American Society of Appraisers
(2) ABV	Accredited in Business Valuation designation from the AICPA
(3) CBA	Certified Business Appraiser designation from the Institute of Business Appraisers
(4) CVA	Certified Valuation Analyst from the National Association of Certified Valuators and Analysts
(5) CFA	Chartered Financial Analyst designation from the Chartered Financial Analyst Institute

Comparative Chart of BV Report Writing Standards

By Donald P. Wisehart, ASA, CPA/ABV, CVA, MST

	REPORTING ON CONCLUSIONS OF VALUE							NONVALUATION REPORTS		
	(D) DETAIL (C) COMPREHENSIVE (F) FORMAL (A) APPRAISAL					SUMMARY				
Item was considered a reporting requirement if "shall" or "should" was used in the reporting standard sections	AICPA (D) *¶ 51; 68*	ASA (C) *BVS-VIII*	USPAP(1) (A) *Std 10(2)*	NACVA (D) *¶4.3.b*	IBA (F) *Standard 5*	AICPA *¶71*	NACVA *¶4.3.a*	AICPA (Calc) *¶76 (2)*	NACVA (Calc) *¶4.3.c*	IBA (Ltr) Standard 4
Engagement identification requirements										
Transmittal letter	51				5.6					
Table of contents	51									
Introduction	52 a - r									
Client	52.a	VIII-IV-G	(a) (i)		5.3.a	71.a				4.3.a
Identification, description of subject being valued	52.d,e; 68.a	VIII-IV-G	(a) (iii)	4.3.a.1	5.3.a	71.d,e	4.3.a.1	76.a,e	4.3.a.1	4.3.a **(10)**
Interest being valued	52.d,e; 68.b	VIII-IV-G	(a) (iii)	4.3.a.2	5.3.b	71.f	4.3.a.2	76.e	4.3.a.2	4.3.a
Valuation (or effective) or calculation date	52.g	VIII-IV-G	(a) (vii)	4.3.a.4	5.3.f	71.g	4.3.a.4	76.a	4.3.a.4	4.3.f
Intended use and/or users of the valuation	52.c; 65.d	VIII-IV-G	(a) (i)		5.4	71.c				4.3.d; 4.4
Report Date	52.h	VIII-IV-G	(a) (vii)	4.3.a.5	5.3.g	71.h	4.3.a.5	76.j	4.3.a.5	4.3.g
Type of report	52.i	USPAP	Section 10-2	4.3		71.i	4.3	73; 77;	4.3	
Premise of value	52.j	VIII-IV-G	(a) (vi) **(3)**	4.3.a.8	5.3.c	71.j	4.3.a.8		4.3.a.8	4.3.c
Standard of value defined	52.k	VIII-IV-G	(a) (vi) **(3)**	4.3.a.7	5.3.e	71.k	4.3.a.7		4.3.a.7	4.3.e
Purpose and intended use of the engagement/report	52.b; 68.b	VIII-IV-G	(a) (ii)	4.3.a.6	5.3	71.b	4.3.a.6	76.c	4.3.a.6	4.3.d
Sources of information disclosed	51; 53.a - j	VIII-V	(a) (ix)	4.3.a.15	5.3.i	71.l	4.3.a.15		4.3.a.15	
Interviewees	53.c				1.19.b					1.19.b
Site visit disclosure or lack of	53.a **(4)**				1.19.a					1.19.a
Analysis and development of value requirements			**(7)**	**(5)**			**(5)**			
Nature and history of business	57; *27* **(9)**	VIII-V **(8)**	(a) (iii)		5.3.j.i **(10)**					
Economic conditions, present, and outlook	57; 65.b	VIII-V	(a) (ix)		5.3.j.ii					
Past, current, and future prospects of business/industry	53; 58; *29*	VIII-V	(a) (ix)		5.3.j.iii					
Financial analysis of earnings/dividend capacity	58; *30*	VIII-VI	(a) (ix)							
Past sales of interest in the business being appraised	61.c	VIII-V	(a) (ix)		5.3.j.iv					
Market prices of similar businesses publicly traded	61.c	VIII-VII	(a) (ix)	4.3.b.6 **(6)**	5.3.j.v					
Similar business/interest sales	61.c	VIII-VII	(a) (ix)		5.3.j.iv					
Ownership, size, nature, restrictions, and agreements	52.f; 59-62	p20 VII	(a) (ix)		5.3.j.vii			76.e		4.3.b;.i
Extent the interest appraised contains control	52.f	VIII-IV	(a) (iv)		5.3.j.viii	71		76.e		4.3.b
Extent interest has or lacks elements of marketability	52.f	VIII-IV	(a) (v)		5.3.j.viii	71		76.e		
Nonoperating/excess operating assets	64	Major Assets		4.3.b.1**(6)**						
Valuation approaches and methods considered	59; *31*	USPAP	(a) (ix)	4.3.b.5 **(6)**	5.3.j.vi					1.16
Valuation approaches and methods used (or procedures)	60 - 62	VIII-VII	(a) (ix)	4.3.0.9 **(5)**	5.3.j.vi	71.q	4.3.a.9 **(5)**	76.a	4.3.a.9 **(5)**	
Valuation approaches and methods rejected		USPAP	(a) (ix)		5.3.j.vi					
Valuation adjustments (DLOC, DLOM, etc.)	58.a; 63	VIII-IV-G	(a) (ix)		5.3.j.viii					4.3.j
Calculation procedures purpose/performed								76.a,b,c	4.3.c.1	
Conclusion of value and signature	68.d;.f	VIII-II	(a) (ix);10-3	4.3	5.5	71	4.3	76	4.3	4.5
Reconciliation of estimates	68	VIII-VII	(a) (ix)			71.v				
Estimate, calculation, or opinion disclosure	68.d,f	I-VI	10-3 **(1)**	4.3		71.v	4.3	76.h	4.3.c.2	
Signature of primary appraiser	68.g	VIII-II	(a) (xi)	4.3.a.20	1.30	71.u	4.3.a.20	76.i	4.3.a.20	1.30

Calculation caveat statement								76.f,.g; 77	4.3.c.3	
Firm signature option	68.g	VIII-II			1.30	71.u		76.i		1.30
Financial information disclosure	54-56	VIII-VI	(a) (ix)		5.5					4.5
Historical financial statement (F/S) summaries	58	VIII-VI	(a) (ix)	4.3.a.10	5.3.j.iii		4.3.a.10		4.3.a.10	
Adjustments to historical F/S summaries	63	VIII-VI	(a) (ix)	4.3.b.2 **(6)**						
Adjusted F/S summaries	58	VIII-VI	(a) (ix)	4.3.b.3 **(6)**						
Projected/forecasted F/S including assumptions	58	VIII-VI	(a) (ix)	4.3.b.4 **(6)**	5.3.4.iii					
Tax return information	53									
If appropriate, financial comparison to industry		VIII-VI								
Limiting conditions and assumptions	15; 52.l; 65.a; 68 .e,g,l,m	VIII-III &	(a) (x)	4.3.a.11			4.3.a.11	73; 65.a	4.3.a.11	4.3.h
The scope of work of the appraisal incl. limitations		USPAP	(a) (viii)	4.3.a.11	5.3.h	71.m;.n	4.3.a.11		4.3.a.11	
Use of report limitations	52.l; 65.d; 68.b	VIII-IX	(a) (ii)	4.3.a.14			4.3.a.14		4.3.a.14	
Representations/Certifications Required	51; 65 a thru h	USPAP	(a) (xi);10-3		1.25	71.t				1.25
Subsequent events in certain circumstances	52.p; 43					71.r		74; *43*		
Jurisdictional exception application	52.q; 10	USPAP	Stated	4.3.a.13	1.1	71.s	4.3.a.13	74; *10*	4.3.a.13	1.1
Firm attestation engagement disclosure	54; 15									
Economic and industry data source disclaimer	65.b							73; 65.b		
Tax preparer/client relationship disclosure	55									
Appraisal based fees/contingent fees	65.e	USPAP	10-3 **(1)**	4.3.a.18	1.25.d			73; 65		
Hypothetical conditions if any	52.n;	VIII-IV-G	(a) (x)		1.22	71.o		74; 22		1.22
Extraordinary assumptions if any	*TNU*	VIII-IV-G	(a) (x)	*TNU*	*TNU*	*TNU*	*TNU*	*TNU*	*TNU*	*TNU*
Disclosure of not auditing, reviewing, or compiling F/S	56									
The reports scope limitations	52; 62.e		(a) (viii)	4.3.a.14		71	4.3.a.14		4.3.a.14	
Statement of independence		VIII-III	(a) (xi)	4.3.a.16			4.3.a.16		4.3.a.16	
If a specialist was used, a reliance use statement	15; 52.o; 65.f		(a) (xi)	4.3.a.12		71.p	4.3.a.12	74; *20*	4.3.a.12	
No obligation to update statement	65.g			4.3.a.17		71.w	4.3.a.17	76.k	4.3.a.17	
Conforms to organizations' standards	65.c; 68.c	VIII-II	(a) (xi)	4.3.d	1.25.e	77	4.3.d	76.d; 65.c	4.3.d	1.25.e
Disclosure/signature of dissenting opinion					1.23.a;.b					1.23.a;.b
Qualifications of the appraiser	67			4.3.a.19	1.26		4.3.a.19		4.3.a.19	1.26

NOTE: *TNU* = Term not used in the report writing standards sections

1. USPAP 10(a) the appraisal report; 10(b) the restricted use report. 10(a) requires the appraiser to "state" and "summarize" specific disclosures. 10(b) requires to only "state" specific disclosures. See item 7 below. Section 10-3 of USPAP discloses the required "Certification" signed by the appraiser.
2. General description of engagement and calculation procedures agreed upon.
3. USPAP requires a cite of standard and premise of value.
4. AICPA requires whether a site visit was made and to what extent.
5. NACVA refers to Revenue Ruling 59-60 tenets as "fundamental analysis".
6. NACVA: It is no longer required to disclose a description of the fundamental analysis in any reports. Further, these and other items reference in para. 4.3.b are optional.
7. USPAP 10(a)(ix) requires that the appraiser summarize the information analyzed, the appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions; exclusion of the market approach, asset-based (cost) approach, or income approach must be explained; 10(b)(ix) requires that the appraiser state the appraisal procedures followed, state the value opinion(s) and conclusion(s) reached, and reference the work file; exclusion of the market approach, asset-based (cost) approach, or income approach must be explained.
8. ASA includes form of organization, history, products and/or services, markets and customers, management, major assets, both tangible and intangible, and major liabilities, sensitivity to seasonal or cyclical factors, competition and "such other factors". In addition, the principal place of business location and the state or jurisdiction of incorporation must be disclosed.
9. AICPA refers to nature, background and history, facilities, organizational structure, management team, classes of equity ownership interest and rights attached thereto, products and/or services, geographical markets, key customers and suppliers, competition and business risks.
10. IBA includes the form of the organization and if incorporated, the state of incorporation, together with a description, adequate to the assignment, of all classes of securities outstanding and a list of shareholders whose interest should, in the appraiser's judgment, be specified. If a partnership, the type and the state of filing, together with a list of those partners, whether general or limited, whose interest should, in the appraiser's judgment, be specified.

A statement that the estimate of value resulting from a valuation engagement is expressed as a conclusion of value with WEBSITE

A Reviewer's Handbook to Business Valuation

Practical Guidance to the Use and Abuse of a Business Appraisal

L. Paul Hood, Jr.
Timothy R. Lee

A Reviewer's Handbook to Business Valuation

Practical Guidance to the Use and Abuse of a Business Appraisal

L. PAUL HOOD, JR.
TIMOTHY R. LEE

WILEY
John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

Hood, L. Paul, 1960-
A Reviewer's handbook to business valuation : practical guidance to the use and abuse of a business appraisal / L. Paul Hood and Timothy R. Lee.
p. cm.
Includes bibliographical references and index.
ISBN 978-0-470-60340-6 (cloth); ISBN 978-1-118-02561-1 (ebk);
ISBN 978-1-118-02562-8 (ebk); ISBN 978-1-118-02563-5 (ebk)
1. Business enterprises—Valuation. 2. Corporations—Valuation—Law and legislation—United States. 3. Corporations—Valuation—Accounting—Standards. I. Lee, Timothy R. II. Title. III. Title: Handbook to business valuation.
HF5681.V3H59 2011
658.15'22—dc22

2010045215

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Contents

PART III

Lessons from the Trenches

CHAPTER 17

Alleged Errors of Omission by Appraisers

This chapter highlights alleged errors that have appeared in reported federal tax court decisions. The purpose of identifying these errors (or alleged errors as the case may be) is to allow appraisers and appraisal report users alike an awareness of the controversies surrounding numerous alleged errors. An awareness of and a proactive recognition of the various appraisal methods, treatments, and adjustments allows appraisers and appraisal stakeholders the opportunity of assessing the ramifications of such court decisions. It is important to note that there are always two sides to every story, and courts do not always get it right. For this reason, we have made a conscious decision to not name any appraisers in this analysis. We did not want to single out any appraiser because the errors and the subject matter themselves are far more instructive. Lest we not add to the confusion or controversy, we use the courts' own words in many instances because they say it better than we could have.

The court's first objection to appraisals is an overarching concern that there are diminishing returns in extensive numerical analyses in the appraisal process and that, no matter how the appraisal is fashioned, it has many areas for subjective determination along the way, which culminates in a subjective opinion. Consider what the U.S. Fifth Circuit wrote in *Dunn Est. v. Comr.*:[1]

> *As the methodology we employ today may well be viewed . . . as unsophisticated, dogmatic, overly simplistic, or just plain wrong . . . on the end of the methodology opposite* oversimplification *lies* overengineering. *(emphasis by the court)*

Back in 1967, the Tax Court, in *Messing v. Comr.*,[2] expressed a thought that perhaps should be revisited in every valuation case:

> *Too often in valuation disputes the parties have convinced themselves of the unalterable correctness of their positions and have consequently failed successfully to conclude settlement negotiations—a process clearly more conducive to the proper disposition of disputes such as this. The result is an overzealous effort,*

[1] 301 F. 3d 339 (5th Cir. 2002).
[2] 48 T.C. 502, 512 (1967).

during the course of the ensuing litigation, to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement.

Courts have also been troubled by the relevance of complex valuation techniques in the rough and tumble Darwinian real world of negotiation between buyers and sellers. In *Mueller Est. v. Comr.*,[3] the Tax Court criticized the complex valuation approach of the IRS appraiser, noting:

In addition to our problems with the constituent elements, we question the validity of this equation as a valuation tool. We cannot imagine that any prospective buyer would use such an arbitrary, artificial, and subjective approach to formulate an initial offering price or to calculate a last best offer.

In *Reynolds Est. v. Comr.*,[4] Judge Forrester noted:

One expert admitted that his method of computation constituted "a highly theoretical exercise," and indeed, this honest characterization applied equally well to the valuation methods utilized by the three other experts.

In *Gross v. Comr.*,[5] the Tax Court had this to say about valuation for tax purposes:

Overall, the entire valuation process is a fiction—the purpose of which is to determine the price that the stock would change hands from a willing buyer and a willing seller. However, a court is not required to presume hypothetical, unlikely, or unreasonable facts in determining fair market value. . . . The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction.

Some errors that appraisers have made seem self-evident and should be easily avoided, yet the following errors have been chronicled in reported tax decisions. This chapter will focus on failures or omissions by appraisers.

Failure to Comply with USPAP

Some appraisers must comply with USPAP in all appraisals.[6] In *Kohler v. Comr.*,[7] the Tax Court determined that the IRS appraiser failed to comply with USPAP:

We have several significant concerns about the reliability of [the appraiser's] report. These concerns lead us to place no weight on [the appraiser's] report as

[3] T.C. Memo 1992-284.
[4] 55 T.C. 172 (1970).
[5] *Gross v. Comr.*, T.C. Memo 1999-254, aff'd., 272 F. 3d 333 (6th Cir. 2001).
[6] See, e.g., ASA BVS General Preamble (II).
[7] T.C. Memo 2006-152.

> *evidence of the value of the Kohler stock the estate held. We have previously discussed the lack of customary certification of [the appraiser's] report and that his report was not prepared in accordance with all USPAP standards. We also have already noted that [the appraiser] admitted that his original report submitted to the Court before trial overvalued the estate's Kohler stock by $11 million, or more than 7 percent of the value he finally decided was correct. This is not a minor mistake. When we doubt the judgment of an expert witness on one point, we become reluctant to accept the expert's conclusions on other points.* Brewer Quality Homes, Inc. v. Commissioner, *T.C. Memo. 2003–200, affd. 122 Fed. Appx. 88 (5th Cir. 2004).*

Valuation Credentials

In *Furman v. Comr.*,[8] the IRS appraiser put himself and the IRS into a bit of a tough spot concerning his appraisal credentials:[9]

> *[The appraiser] 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. [The appraiser's] report also suggests that he is a member of the American Society of Appraisers, to which he has never belonged.*

In *Ford Est. v. Comm.*,[10] the taxpayer's appraiser was not a full-time appraiser and was not a member of any appraisal organization, and the Tax Court ultimately held against the taxpayer.

Too Much Involvement by Counsel in the Appraisal Report Preparation

In *Noble Est. v. Comm.*, the Tax Court excluded from evidence a rebuttal report because the Tax Court, citing Daubert, felt that there was too much involvement in the preparation of the report by the taxpayer's counsel. It is imperative that the appraisal report be the sole work of the appraiser. However, we see a definite role for counsel in the fact-finding part of the appraisal engagement and in the review of a draft appraisal.

Standard of Value

Many estate and tax planners are aware of only one standard of value: fair market value. However, there are other standards of value, for example, fair value. Occasionally, an appraiser utilizes a standard that is either not fair market value or is a

[8] T.C. Memo 1998-297.
[9] IBA considers such behavior to be unethical. IBA Business Appraisal Standards Section 1.24.
[10] T.C. Memo 1993-580.

variation of fair market value that deviates from or conflicts with the classical definition of fair market value required for federal tax purposes.

In *Knight v. Comr.*,[11] the Tax Court summarily dismissed the IRS appraiser's use of the fair value standard of value, noting:

> *Respondent's expert, [the appraiser], testified about the "fair value" but not the "fair market value" of the partnership interests at issue in these cases. We have not considered his testimony in deciding the fair market value of the gifts.*

In *Bailey Est. v. Comr.*,[12] the Tax Court criticized the appraiser's deviation from the fair market value standard:

> *[The appraiser's] downward adjustment of the California motel's value on account of the alleged need of decedent's estate to make a "distress sale" to settle the estate (an otherwise unsubstantiated factual premise) is inconsistent with the concept of fair market value as determined by reference to a hypothetical willing buyer and willing seller.*

Valuation Date

Given that valuation for federal transfer tax purposes is made as of a specific date, it is axiomatic that an appraiser use the date of death, the alternate valuation date, or the date of transfer, whichever is applicable. Additionally, all of the applicable business appraisal standards require the appraiser to state an as-of date in the appraisal report.[13] Nevertheless, there are reported decisions in which this mistake has been made. This mistake actually can be made where the appraiser is not told of a decision to employ the alternate valuation date under IRC Sec. 2032 and instead sticks with the date of death as the valuation date.

In *Kaufman Est. v. Comr.*,[14] the court rejected the appraisal of an expert that was as of the date of another appraisal on which sales of interests in the subject entity were based (and on which the federal estate tax return valuation was based in part) because that was not the federal estate tax valuation date.

In *Magnin Est. v. Comr.*,[15] the Tax Court noted the following excuse for not using the correct valuation date, which the Tax Court ultimately rejected:

---

[11] 115 T.C. 506 (2000).

[12] T.C. Memo 2002-152.

[13] 2010-2011 USPAP Standards Rule 9-2(d), Standards Rule 10-2(a)(vii), the comment to Standards Rule 3-1(c) and Statement on Appraisal Standards No. 3; IBA Business Appraisal Standards Section 1.20; ASA BVS VI Section II.A; AICPA Statement on Standards for Valuation Services Paragraphs 12, 25, 43, 52 (calculations), 68, 69, 71 (summary reports), and 77 (calculations); NACVA Professional Standards Sections 3.3(c) and 4.3(a)(4); see also the definition of "valuation date" in the International Glossary of Business Valuation Terms that was adopted by the AICPA, ASA, CICBV, IBA, and NACVA.

[14] T.C. Memo 1999-119.

[15] T.C. Memo 2001-31.

[The appraiser] used a valuation date of January 31, 1952, instead of October 31, 1951, because he claims that he would have had to rely on information that was 9 months old.

Retrospective appraisals can be especially tricky in that some of "the future" will have already occurred by the time the appraiser starts his work. In *BTR Dunlop Holdings, Inc. v. Comr.*,[16] the Tax Court noted:

In addition, petitioner's experts made extensive adjustments based on hindsight as to matters occurring subsequent to the valuation date. Some of these adjustments were based on interviews with petitioner's employees and representatives 10 years after the valuation date and in anticipation of trial.

In *Titus Est. v. Comr.*,[17] the Tax Court pointed out a problem often encountered in rebuttal reports or in appraisals prepared in cases more contemporaneously than an initial appraisal:

We have afforded the Apr. 7, 1988, supplemental report little weight because of the extensive use of hindsight based upon information which clearly would not have been available to a buyer or seller on Apr. 18, 1983.

The Subject Property Interest

Like the valuation date, it seems implausible that an appraiser could err in the property to be valued. Appraisers are usually required to describe the subject property in the appraisal report.[18] Nevertheless, this mistake can arise in many different contexts and circumstances, as the following cases demonstrate. In *True Est. v. Comr.*,[19] the Tax Court stated:

Finally, we disagree with [the appraiser] that Dave True's 68.47-percent interest . . . should be treated as a noncontrolling interest.

In *True Est. v. Comr.*,[20] the Tax Court also noted:

Because Eighty-Eight Oil routinely allowed its partners to maintain disproportionate capital accounts, the two approaches are fundamentally inconsistent. To the extent that the partnership agreement defines the interest being transferred, we doubt that [the appraiser] has valued the correct interest.

[16] T.C. Memo 1999-377.
[17] T.C. Memo 1989-466.
[18] See, e.g., ASA BVS-I Section (II)(B)(1); NACVA Professional Standards Section 4.3(a)(2); AICPA Statement on Standards for Valuation Services Paragraph 52(3); IBA Professional Appraisal Standards Section 5.3(a).
[19] T.C. Memo 2001-167.
[20] T.C. Memo 2001-167.

In *Godley Est. v. Comr.*,[21] the Tax Court observed:

He failed to recognize that the hypothetical buyer investing in GMA would not merely be buying the accounts receivable on a particular date, but instead would be buying the income stream attributable to 10 percent of the rental income of each of the four housing partnerships, minus expenses associated with managing the housing partnerships.

Bias

The first rule of an expert witness is supposed to be that the expert witness, who offers no factual information such as documentation or eyewitness accounts that might be helpful to the trier of fact, offers a considered opinion that is based upon the facts as known or as reasonably knowable.[22] If a court suspects any expert witness of bias, such a suspicion can eviscerate or seriously erode the expert witness's credibility. Appraisers are supposed to be unbiased and are not supposed to be advocates.[23]

In *Hearst Corp. v. U.S.*,[24] the United States Court of Federal Claims articulated the following impression about the appraisers for both sides:

As is typical in litigation that involves battles by experts in analysis of complex matters, the information provided by the valuation witnesses of both parties was skewed to advance the objectives of their respective clients.

Even a competent appraiser can get lulled into the minefield of bias, especially when working for one side in a litigated matter. Appraisers who are brought in to defend or justify another appraiser's conclusion of value can easily be inclined, even subconsciously, to skew their conclusion of value toward that of the appraiser whose opinion they were hired to defend. In *Mueller Est. v. Comr.*,[25] the Tax Court had this to say about a preeminent business appraiser:

The conflict arose when [the appraiser] strayed from the standard of objectivity and "cast aside his scholar's mantle and became a shill" for respondent.

In *Auker Est. v. Comr.*,[26] the Tax Court wholly disregarded an appraiser's opinion concerning blockage, stating:

We decline to accept the opinion of a man whose only appearance in this case seems to be as a spokesman for the interests of his clients and the estate.

---

[21] T.C. Memo 200-242.
[22] FRE 702.
[23] IBA Business Appraisal Standards Sections 1.3 and 1.4; AICPA Statement on Standards for Appraisal Services Paragraph 14; ASA BVS VIII (III)(A); NACVA Professional Standards Section 1.2(j).
[24] 28 Fed. Cl. 202 (Cl. Ct. 1993), vacated, 36 F. 3d 1116 (Fed. Cir. 1994).
[25] T.C. Memo 1992-284.
[26] T.C. Memo 1998-185.

In *Knight v. Comr.*,[27] the Tax Court concluded that the appraiser was not objective:

> *We conclude that [the appraiser] was acting as an advocate and that his testimony was not objective.*

Sources of Data

Appraisers often are required to cite the sources of data in their reports.[28] It is important that these cited materials be complete, up to date, and objective. In *Lauder Est. v. Comr.*,[29] the Tax Court stated the following in a footnote:

> *It is worth noting that in analyzing the general economy, [the appraiser] represented that there were certain negative economic indicators by November of 1976 relying on an untitled "article" in the November 29, 1976, issue of Barron's. We found that the quote relied on came instead from an editorial commentary entitled "How's Business? Not as Bad as the Misleading Indicators Suggest." The editorial commentary does not provide sufficient information to support [the appraiser's] representation. Further, characterizing it as an article without providing us with a title appears to be misleading.*

In *Klauss Est. v. Comr.*,[30] the Tax Court rejected the IRS's sole reliance upon an article by Bajaj and Hakala, "Valuation for Smaller Capitalization Companies," published in *Financial Valuation: Businesses and Business Interests*, Chapter 12A (Hanan and Sheeler, ed. 1998) for the proposition that there is no small stock premium.

Appraisers are supposed to provide sources for the data that they utilize in valuation reports.[31] In *Klauss Est. v. Comr.*,[32] the court criticized the IRS appraiser for failing to include a source for an article:

> *Respondent attached to respondent's opening brief an appendix which shows that large capitalization stocks have outperformed small stocks since about 1988. We do not consider the information in the appendix because respondent provided no source for it.*

With respect to the increasing use of citations to web sites, a good valuation report will note the last time that the web site was checked. This is particularly important in areas of the report such as general economic conditions, and so forth.

---

[27] 115 T.C. 506 (2000).
[28] ASA BVS-I Sections (V) and VIII(V)(k); IBA Business Appraisal Standards Sections 1.18 and 5.3(I); AICPA Statement on Standards for Valuation Services Paragraph 44.
[29] T.C. Memo 1992-736.
[30] T.C. Memo 2000-191.
[31] IBA Business Appraisal Standards Section 1.18; AICPA Statement on Standards for Valuation Services Paragraph 53; NACVA Professional Standards Section 3.3(j); ASA BVS Section VIII (V)(K).
[32] T.C. Memo 2000-191.

Independence

It is self-evident that the work of appraisers must be independent.[33] Lack of independence is related to, but is not exactly the same as, the problem of bias. In *Anclote Psychiatric Center, Inc. v. Comr.*,[34] the Tax Court observed:

> *We think that [the appraiser's] report is more characteristic of the work of a revenue agent than of an impartial, disinterested appraiser. In this connection, we note that [the appraiser's] report was received and adjusted by respondent's National Office. We reject respondent's suggestion that we exclude [the appraiser's] objectionable comments and admit the balance of his report.*

Appraisers usually must certify that they are independent.[35] In *McCormick Est. v. Comr.*,[36] the Tax Court noted the following about an obvious lack of independence:

> *Petitioners' proffered "expert" was John McCormick III, son of petitioner.*

In *Hall Est. v. Comr.*,[37] the Tax Court expressed its concern about the independence of this appraiser:

> *Overall, we can only conclude that [the appraiser] was instructed to prepare and did prepare an analysis that led to an artificial and excessive value for the Hallmark stock.*

In *Cook Est. v. Comr.*,[38] the Tax Court disregarded testimony of a person who was obviously too close to the action:

> *[The appraiser's] valuation of the stock at issue is not persuasive because of his self-interest. [The appraiser] is a stockholder, president, and chief operating officer of Central Bancompany, Inc. Further, [the appraiser] is president of Central Trust Bank, a subsidiary of Central Bancompany, Inc. and the co-executor of Howard Winston Cook's estate.*

Pure Reliance on Case Law

Obviously, what constitutes the proper amount of a valuation discount is essentially an intensely factual issue. Indeed, valuation discounts can be factored in as an

[33] See, e.g., AICPA Statement on Standards for Valuation Services Paragraph 15; IBA Professional Appraisal Standards Sections 1.3 and 1.4; NACVA Professional Standards Section 1.2(j); and ASA BVS VIII Section (III)(A).
[34] T.C. Memo 1998-273.
[35] See, e.g., 2010-2011 USPAP Ethics Rule line 207; IBA Business Appraisal Standards Section 1.3; AICPA Statement on Standards for Valuation Services Paragraph 15; NACVA Professional Standards Section 1.2(k); and ASA BVS VIII Section (III)(A).
[36] T.C. Memo 1995-371.
[37] 92 T.C. 312 (1989).
[38] 86-2 USTC Par. 13,678 (D.C. W.D. Mo. 1986).

element of the discount rate (sometimes characterized as implicit treatment) or applied as direct adjustment(s) to value after the enterprise level value has been determined. As such, pure reliance upon case law for determination of valuation discounts is inadvisable, particularly when the economics, facts, and circumstances of the precedent case(s) do not reasonably parallel those of the subject interest in an appraisal. Nevertheless, some appraisers have resorted to reliance on case law for determination of valuation discounts. In *Berg Est. v. Comr.*,[39] the Tax Court was unimpressed with this practice:

> *The fact that petitioner found several cases which approve discounts approximately equal to those claimed in the instant case is irrelevant.*

See also *Pillsbury Est. v. Comr.*[40]

Site Visits and Management Interviews

Site visits and management interviews are required by the business valuation standards of some of the major business appraisal organizations.[41] In *Polack v. Comr.*,[42] the IRS appraiser interviewed the employee who was responsible for daily operations, and he relied on that information, while the taxpayer's appraiser had relied on information provided by the taxpayer, who owned the company. The Tax Court sided with the information provided by the employee as more credible.

In *Gloeckner Est. v. Comr.*,[43] the Tax Court was unimpressed with the IRS expert's effort:

> *[The appraiser] did not: (1) Make a site inspection of the company's premises, (2) interview the management of the company, (3) secure information about the company from potential outside sources such as suppliers, customers, competitors, or financial institutions, or (4) obtain information about the company's competitors.*

In *Litchfield Est. v. Comr.*,[44] the Tax Court ruled against the IRS appraiser, who did not bother to interview management or make a site visit.

In *Kohler v. Comr.*,[45] the Tax Court was unimpressed with the efforts of the IRS appraiser with respect to his investigation of the subject company:

---

[39] T.C. Memo 1991-279.
[40] T.C. Memo 1992-425.
[41] See, e.g., IBA Business Appraisal Standards Section 1.19; and AICPA Statement on Standards for Valuation Services Paragraph 53.
[42] T.C. Memo 2002-145.
[43] T.C. Memo 1996-148.
[44] T.C. Memo 2009-21.
[45] T.C. Memo 2006-152.

Moreover, we are convinced from his report and trial testimony that [the IRS appraiser] did not understand Kohler's business. He spent only 2–1/2 hours meeting with management. He decided the expense structure in the company's projections was wrong and decided to invent his own for his income approach analysis. He did not discuss his fabricated expense structure with management to test whether it was realistic. [The IRS appraiser] also decided to weight the operations plan model 80 percent and the management plan model only 20 percent under the income approach, despite the admonitions of management that the operations plan projections were only what could be created in a perfect environment while the management plan forecasted realistic, achievable targets.

Failure to Provide Sufficient Explanation

Appraisers sometimes forget that correctness in a conclusion of value often is not as important as explaining how the appraiser arrived at that conclusion. Another appraiser should be able to replicate the work of the appraiser by review of his work or workpapers.[46] This perhaps illustrates as well as any other point that perceived, defensible value indeed is everything. In *Winkler Est. v. Comr.*,[47] the Tax Court provided perhaps one of the best arguments for a free-standing, comprehensive appraisal report:

Respondent's expert appears to be extremely well qualified but he favored us with too little of his thought processes in his report. In another area, for example, his report briefly referred to the projected earnings approach, but the discussion was too abbreviated to be helpful. His testimony on the computer models he used, while unfortunately never developed by counsel, suggested that a lot of work had been done but simply not spelled out in his report. That may also be the case in his price-to-earnings computations, but the Court cannot simply accept his conclusions without some guide as to how he reached those conclusions.

In *Hinz Est. v. Comr.*,[48] the Tax Court stated:

The expert witness helps the trier of fact primarily by explaining so that the trier of fact follows and understands. The expert who issues pronouncements without detailing the supporting analysis does not properly satisfy this obligation and so is generally not a persuasive expert witness. [footnote omitted]

Disregard of Material Facts

An appraiser's conclusion of value should consider the impact of all material facts.[49] If an appraiser either disregards a material fact, purposefully or unintentionally, or

[46] See, e.g., IBA Business Appraisal Standards Section 1.8.
[47] T.C. Memo 1989-231.
[48] T.C. Memo 2000-6.
[49] See, e.g., IBA Business Appraisal Standards Sections 1.7 and 1.20; AICPA Statement on Standards for Valuation Services Paragraph 44; NACVA Professional Standards Section 1.2(f); and ASA BVS-1 Section I(III).

gives the impression of disregard by failing to mention a material fact, this usually impacts the courts' reliance upon that appraiser's report and testimony. In *Dunn Est. v. Comr.*,[50] the Tax Court concluded:

> *Respondent's approach would require us to disregard completely the significant operational aspects of the company in determining fair market value. But Dunn Equipment was a viable operating company as of the valuation date and earned a significant part of its revenues from selling services as well as renting equipment.*

In *Lakewood Associates v. Comr.*,[51] the Tax Court reasoned:

> *Despite the expert's opinion, we cannot ignore the agricultural zoning of the Elbow Lake property and Lakewood's failed attempt to rezone the property for residential purposes during the year in issue.*

In *O'Keefe Est. v. Comr.*,[52] the Tax Court noted:

> *Although each of the experts was qualified to express an opinion on the subject matter on which he or she was called to testify, each of them suffered from the same tendency to ignore relevant facts inconsistent with the position of the party employing the expert and to exaggerate facts consistent with the view espoused.*

In *Lehmann Est. v. Comr.*,[53] the Tax Court observed:

> *Respondent relies upon [the appraiser's] view that the highest and best use of the property is as office space rather than as a hotel. Respondent's contention ignores the fact that the property was encumbered by a long-term lease. . . . Consequently, it is unrealistic to contend that the value of the partnership's interest in the land is equivalent to the value of the land at its highest and best use as though the land were vacant.*

Failure to Find Available Information

Very few things look worse for an appraiser than when the appraiser cannot find information that the opposing appraiser finds. This happened to an appraiser in *Barnes v. Comr.*:[54]

> *[The appraiser] used the market or guideline company approach to estimate the value of Home and Rock Hill stock, but he excluded three companies that [the*

[50] T.C. Memo 2000-12.
[51] 109 T.C. 450 (1997).
[52] T.C. Memo 1992-210.
[53] T.C. Memo 1997-392.
[54] T.C. Memo 1998-413.

other appraiser] used as comparables because he did not have their market trading prices as of the valuation date. In contrast, [the other appraiser] apparently easily obtained the stock prices by contacting the companies. [footnote omitted]

Failure to Adequately Support Selection of Beta

In the Capital Asset Pricing Model, the development of the required rate of return on equity (also referred to as the cost of equity capital) requires that beta, a measure of systematic risk, be estimated. Given the limitations of calculating betas for closely held concerns, beta is typically estimated by reference to the stock of comparable (guideline) publicly traded companies. The grouping of such publicly traded companies may be broad and based upon the subject industry, or it may be more specific and based upon a defined group of comparable companies deemed directly relevant to the valuation of the subject business entity. When appraisers utilize a beta of 1.0 for a closely held company, the courts usually do not believe them or feel that they have not adequately explained that beta is properly 1.0. In *Hendrickson Est. v. Comr.*,[55] the Tax Court disregarded the IRS appraiser's selection of a 1.0 beta, noting:

[The appraiser] did not otherwise adequately support his selection of a beta of 1, a figure he admits is "approximately equal to the overall market average of 1 based on the S&P 500." That statement, if anything, suggests that [the appraiser's] beta is unreasonably low; using a beta greater than 1 would increase the discount rate used in the [the appraiser] analysis, thereby decreasing the value otherwise computed. We do not believe that an investment in Peoples, a small, single-location bank, whose earnings were susceptible to impending interest rate mismatches and sluggish local economic conditions, presents the same systematic risk as an investment in an index fund holding shares in 500 of the largest corporations in the United States. [footnote omitted]

In *Furman v. Comr.*,[56] the Tax Court stated:

Finding that Burger King was the number two fast food chain, [the appraiser] reasoned that Burger King would be no more or less volatile than the fast food industry as a whole, justifying a beta of 1.0 for FTC's common stock. In his report, [the appraiser] gave no further explanation of his choice of beta and did not provide evidence that he had investigated the betas of comparable public companies, or even of BKC, on which his selection of beta was based.

[55] T.C. Memo 1999-278.
[56] T.C. Memo 1999-157.

There are two types of risks: systematic (which can be minimized by diversification) and unsystematic (which cannot be reduced by diversification). In *Hendrickson Est. v. Comr.*,[57] the IRS appraiser forgot to factor unsystematic risk into the mix:

> *In calculating Peoples' discount rate, [the appraiser] followed the principles of CAPM and did not make any provision for Peoples' unsystematic risk, based on the assumption that such risk was diversifiable. Yet respondent and [the appraiser] have overlooked the difficulties in diversifying an investment in a block of stock they argued is worth approximately $8.94 million. Construction of a diversified portfolio that will eliminate most unsystematic risk requires from 10 to 20 securities of similar value. See Brealey and Myers,* supra *at 137–139. Thus, proper diversification of an investment in the Peoples shares owned by petitioner, as valued by respondent, would require a total capital investment of at least $89 million. We do not think the hypothetical buyer should be limited only to a person or entity that has the means to invest $89 million in Peoples and a portfolio of nine other securities.*

Improper Sampling Techniques

When the data set is so large that it cannot be feasibly analyzed, in certain situations, sampling is permitted. Such data sets may be characterized by various measures of central tendency, such as an average, median, or other measure. These measures may be employed directly in the valuation methodology or used anecdotally to support a given treatment, adjustment, or conclusion. However, it is imperative that data sampling be conducted in accordance with sound statistical principles and that employment of the data be used in a generally accepted and credible fashion.

In *Skripak v. Comr.*,[58] the Tax Court concluded:

> *[I]t is sufficient to state that we are adequately persuaded by respondent's rebuttal expert witness that [the appraiser's] conclusion is not statistically valid because of his failure to employ proper statistical techniques. Titles from certain BFL catalogs were oversampled, and titles from certain other BFL catalogs were undersampled.*

In *Mueller Est. v. Comr.*,[59] the Tax Court had this to say about the IRS appraiser's sampling:

> *[The appraiser's] hindsight method caused [the appraiser] to use a skewed statistical sample. The decedent died 3 days after the announcement of the proposed merger. [The appraiser], therefore, should have scoured its vast library for similar tender offers for comparable companies, and looked at the price of target companies a few days after those announcements. Instead, [the appraiser] looked only at deals that actually closed (rather than all deals that were announced) and counted back 67 days.*

[57] T.C. Memo 1999-278.
[58] 84 T.C. 285 (1985).
[59] T.C. Memo 1992-284.

[The appraiser's] sample universe of mergers that actually closed is not representative of the universe of tender offers. The sample was underinclusive because tender offers relating to deals that actually failed were not included. Assume that investors make an educated guess about the likelihood that a deal that was announced three days ago will eventually go through. If some potential investors are good predictors, they will be able to avoid investing in the stocks of targets that will not be acquired. The price of those stocks would reflect this belief, resulting in a comparatively large discount from the offer price. These large discounts (if they existed) were excluded from the [the appraiser's] analysis, inflating the supposed value of the Mueller Co. stock.

If [the appraiser] instead had looked at all comparable deals a few days after the deals were announced, as petitioner's expert [name omitted] did, the potential for bias would have been eliminated. We cannot be sure of the actual effect of [the appraiser's] sampling mistake. The correct sample and [the appraiser's] sample might coincidentally point to the same result, but we cannot jump to that conclusion any more than we can decide this case by rolling dice. We conclude that [the appraiser's]"discounted effective merger price" methodology is flawed not only because it relies on information (the exact day the deal would close) that could not have been known on the valuation date, but also because the methodology limited [the appraiser] to an inappropriate sample.

Off Financial Statement Items

Quite often, there are items that significantly affect value that are not reflected on the subject company's financial statements. In *First National Bank of Fort Smith v. U.S.*,[60] the Tax Court observed:

Although the valuation may have been a good faith effort to evaluate raw financial data, it was, in essence, prepared in a vacuum. By this, we mean that the government's expert arrived at his opinion of fair market value base almost solely upon financial data; he did little to incorporate those valuation factors which do not show up on a corporate balance sheet. We find it highly unlikely that any buyer would be willing to purchase WWL stock without careful analysis of industry-wide technological developments, threats to the company's traditional business, obsolescence, and future uncertainties as well as the broad range of current financial data.

Failure to Sufficiently Explain Assumptions

It is important that an appraiser explain any assumptions made in a valuation report.[61] In *Bailey Est. v. Comr.*,[62] the Tax Court criticized the appraiser for failing to explain assumptions:

[60] Docket No. 84-2255 (D.C. W.D. Ark. 1985).

[61] IBA Business Appraisal Standards Sections 2.2(b) and 3.2(b); NACVA Professional Standards Sections 3.3(g) and 4.3(b)(8); ASA BVS-VIII Section (III); and AICPA Proposed Statement on Standards for Valuation Services Paragraphs 18, 52(l), 68(g), and 71(m).

[62] T.C. Memo 2002-152.

[The appraiser] offered no explanation or support for any of the many assumptions that he utilized in the just-described analysis. Nor did he offer any explanation or support for his conclusion that the discount related to stock sale costs should be 6 percent. An expert report that is based on estimates and assumptions not supported by independent evidence or verification is of little probative value or assistance to the Court.

Insufficient Due Diligence

It is imperative that appraisers conduct sufficient due diligence.[63] In *Freeman Est. v. Comr.*,[64] the taxpayer's appraiser did not conduct sufficient due diligence 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 appraiser] states specifically that (1) during his interview with Bernard V. Vonderschmitt, president of the corporation, 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.

In *Bennett Est. v. Comr.*,[65] the Tax Court called down an appraiser for failing to investigate:

Compounding this shortcoming is [the appraiser's] exclusive reliance upon the numbers listed on Fairlawn's balance sheets with no further investigation or due diligence. [The appraiser] 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 [the appraiser] did not perform sufficient due diligence in this matter.

Failure to Make Inquiries with Significant Third Parties

Appraisers often must make inquiries with third parties on matters germane to the appraisal.[66] Sometimes they do not do so, and they get called down for it. In *Adams Est. v. Comr.*,[67] the Tax Court called down the IRS appraiser for failing to do so:

---

[63] See, e.g., IBA Business Appraisal Standards Section 1.15.
[64] T.C. Memo 1996-372.
[65] T.C. Memo 1993-34.
[66] See, e.g. Appendix A to Statement on Standards for Valuation Services No. 1, at 17.
[67] T.C. Memo 2002-80.

We believe that [the appraiser's] approach for estimating the value of WSA stock (before applying a discount for lack of marketability) was more thorough than [the other appraiser's]. [The other appraiser] did not speak with anyone from MCC or investigate the pending litigation. [The appraiser] did those things, and reasonably concluded that it was unlikely that WSA would survive without Gelder.

In *Ansan Tool and Manufacturing Co., Inc. v. Comr.*,[68] the Tax Court also had a problem with the appraiser's efforts in this regard:

Indeed, [the appraiser] 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 [the appraiser] 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.

Failure to List All Appraisers' Qualifications

Appraisers generally should list the appraisal qualifications of each appraiser who assisted in the preparation of the report.[69] That did not happen in *Crocker v. Comr.*[70]

Failure to Consider the Small-Stock Premium

In *Hendrickson Est. v. Comr.*,[71] according to the Tax Court, the IRS appraiser failed to consider the small stock premium:

Although [the appraiser] cited Ibbotson as his source for equity risk premium, in his initial report he ignored a crucial aspect of the Ibbotson approach to constructing a cost of capital—the small stock premium. In his rebuttal report, [the appraiser] unsuccessfully tried to persuade us that the small stock premium is not supported by financial theory, characterizing the risk associated with a firm's size as unsystematic risk, for which the market does not compensate. The relationship between firm size and return is well known. Size is not an unsystematic risk factor and cannot be eliminated through diversification. "On average, small companies have higher returns than large ones." Ibbotson at 125 (citing Banz, The Relationship Between Returns and Market Value of Common Stock, 9 J. Fin. Econ., 3–18 [1981]). We have already alluded to the likelihood that small stocks will have higher betas than larger stocks, because of greater risk. See Ibbotson at 126. However, it has been

[68] T.C. Memo 1992-121.

[69] See, e.g., NACVA Professional Standards Section 4.3(a)(19); AICPA Statement on Standards for Valuation Services Paragraph 67; and IBA Business Appraisal Standards Section 1.26. 2010–2011 USPAP does not contain any requirement that appraisers list their qualifications in the valuation report. See the answer to Question No. 235 in the 2010–2011 USPAP FAQs.

[70] T.C. Memo 1998-204.

[71] T.C. Memo 1999-278.

found that the greater risk of small stocks is not fully reflected by CAPM, in that actual returns may exceed those expected based on beta. See ibid. Consequently, when calculating a cost of capital under CAPM on a small stock . . . it is appropriate to add a small stock premium to the equity risk premium, to reflect the greater risk associated with an investment in a small stock in comparison to the large stocks from which the equity-risk premium is calculated. Based on Peoples' size, a micro-capitalization equity size premium of 3.6 percent should have been added. See Ibbotson at 161. Consequently, even if we accepted Mr. Fuller's beta of 1, which we do not, Peoples' cost of capital should have been at least 18 percent.

In *Klauss Est. v. Comr.*,[72] the Tax Court was skeptical, noting:

[The appraiser] stated that he selected the beta based on a review of comparable companies. However, he did not identify these comparable companies or otherwise give any reason for his use of a .7 beta. We believe [the appraiser's] use of a .7 beta improperly increased his estimate of the value of the Green Light stock.

Failure to Factor in Income Tax

It is axiomatic that income tax be factored into the mix. In *Anclote Psychiatric Center, Inc. v. Comr.*,[73] the Tax Court called down the IRS appraiser for failing to do so:

We are constrained to add that, even if we had decided to overrule petitioner's objections and admit [the appraiser's] report into evidence, we would have given it minimal weight because of [the appraiser's] inexperience at the time of his appraisal, the defects in the report, such as listing a claimed comparable sale as having taken place in 1983 instead of 1985, the value he ascribes to the impact of the change in the Medicare system in 1983, the failure to take into account the impact of income taxes on his projected income stream (only partially corrected by the subsequent adjustment of the report by respondent's National Office), the internal contradictions reflected in his analysis of projected profitability, and the seeming excessive value for goodwill.

Failure to Set Forth the Adjustments to Financial Statements in the Appraisal Report

Most business appraisal standards require that the adjustments to the financial statements of both the subject company as well as the guideline companies be set forth in the valuation report.[74] The court could not find these adjustments in *True Est. v. Comr.*[75]

[72] T.C. Memo 2000-191.
[73] T.C. Memo 1998-157.
[74] ASA BVS-II Section (III) and BVS-VIII Section (VI)(B); NACVA Professional Standards Section 4.3(b)(17); AICPA Statement on Standards for Valuation Services Paragraphs 40 and 51; IBA Business Appraisal Standards Section 5.3(j)(vi).
[75] T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).

Failure to Produce a Replicatable Report

An appraiser's work should be able to be replicated by another appraiser based upon the preparing appraiser's report and workfile.[76] This was not the case in *True Est. v. Comr.*[77]

Failure to Identify the Multiples Selected

In *True Est. v. Comr.*,[78] the Tax Court criticized the appraiser for failing to even identify the multiples selected in the market approach.

Failure to Discuss Weightings in the Appraisal Report

It is essential that an appraiser include a significant discussion in the valuation report of how he weighted products of various multiples in his conclusion of value. This did not happen in *True Est. v. Comr.*,[79] as the Tax Court pointed out:

> *The final [appraiser] report's guideline company analysis was even more questionable. It provided no data to support the calculations of EBDIT, EBIT, pretax earnings, and book value for either the comparable companies or True Oil. Further, [the appraiser] did not explain the relative weight placed on each factor. The [appraiser] report also applied market multiples to only one year's worth of financial data. We believe that using a five-year average of True Oil's financial fundamentals (as [another appraiser] did) would have provided more representative results. Without more data and explanations, we cannot rely on the final [appraiser] report's valuation conclusions using the guideline company method.*

Failure to Distinguish between Tax and Book Depreciation

Depreciation for book and tax purposes often is very different. Appraisers must adjust for this difference. In *True Est. v. Comr.*,[80] the appraiser failed to do so:

> *Third, contrary to the [appraiser] report's emphasis on the TBVIC multiple, we find that it is not a meaningful measure of value in this case. In general, book value of tangible assets would serve as a meaningful measure of value only if book value was close to market value on the valuation date. Thus, tangible asset values first should be adjusted to their respective fair market values to make price-to-asset-value ratios more relevant. Moreover, equipment varies from one company to another in*

[76] See, e.g., NACVA Professional Standards Section 4.3; IBA Business Appraisal Standards Section 1.8.
[77] T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).
[78] T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).
[79] T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).
[80] T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).

> *age, condition, and importance to the operations, so that price-to-asset-value measures are difficult to implement on a comparison basis and frequently are not helpful. See Pratt et al.,* Valuing a Business *217 (3d ed. 1996).*
>
> *Black Hills Trucking owned a variety of heavy specialized equipment that was purchased anywhere from 1 to 40 years before the valuation date. [The appraiser] calculated the fair market value of equipment (under the NAV method) to be $11.5 million as of December 31, 1993, while net book value was $2.5 million. Such a large disparity between book value and fair market value suggests that TBVIC is not an appropriate basis for valuing Black Hills Trucking.*

Failure to List Guideline Companies

Business appraisers usually are required to include the names of guideline companies in the valuation report.[81] This was not done in *Jann Est. v. Comr.*,[82] which the Tax Court pointed out:

> *Specifically, [the appraiser's] report referred to comparable companies but did not identify them; did not state whether [the appraiser] 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.*

Failing to Separate Operating and Nonoperating Aspects of a Company

Appraisers must separate operating and nonoperating aspects of a company under certain circumstances.[83] In *Ford Est. v. Comr.*,[84] the Tax Court pointed this out:

> *Petitioner's expert did not even attempt to separate the operating and nonoperating portions of Ford Moving for valuation purposes, as did respondent's expert.*

Failing to Lay Foundation for Small Stock Premium

The empirical evidence of a "small stock premium" is widely accepted by most of the valuation community.[85] However, although the courts have permitted the small-stock premium, the courts have disregarded the applicability of the small-stock

[81] AICPA Statement on Standards for Business Valuation Paragraph 61.
[82] T.C. Memo 1990-333.
[83] See, e.g., Laro and Pratt, *Business Valuation and Taxes* (Hoboken, NJ: John Wiley & Sons, 2005), 154–155; Pratt with Niculita, *Valuing a Business,* 5th ed. (New York: McGraw-Hill, 2008), 298; AICPA Statement on Standards for Valuation Services Paragraph 51.
[84] T.C. Memo 1993-580.
[85] *Estate of Hendrickson*, T.C. Memo 1999-278. See, also Pratt with Niculita, *Valuing a Business* 5th ed. (New York: McGraw-Hill, 2008), 193–198.

premium where the taxpayer's appraiser has failed to lay the foundation for the premium to be added.[86]

It is not enough that the appraiser exercise professional judgment in selecting data such as the small-stock premium. The appraiser should explain that choice in the written report. In *Hoffman Est. v. Comr.*,[87] the Tax Court stated:

> *[The appraiser's] report states that 5.3 percent is equivalent to the premium for investing in small company stocks as calculated by Ibbotson Associates, but [the appraiser] did not explain why such a figure is appropriate for WLI specifically.*

Failing to Justify Capitalization or Discount Rates

Appraisers cannot simply pull capitalization rates or discount rates out of thin air; these must be justified. This seems to have been the case in *Morton v. Comr.*:[88]

> *[The appraiser] testified that venture capitalists generally require between 30- and 60-percent return, and that his 35 percent discount rate was "conservative." However, [the appraiser] did not provide any objective support, either at trial or in his expert report, for selecting a discount rate in this range.*

Failure to Think Like an Investor

In *Newhouse Est. v. Comr.*,[89] the Tax Court concluded:

> *None of respondent's expert witnesses testified that they would have advised a willing buyer to use the subtraction method in deciding the value of the stock. None could testify that they had ever advised the use of the subtraction method in advising buyers or sellers of closely held stock in any comparable situation.*

In *Mueller Est. v. Comr.*,[90] the Tax Court observed:

> *In addition to our problems with the constituent elements, we question the validity of this equation as a valuation tool. We cannot imagine that any prospective buyer would use such an arbitrary, artificial, and subjective approach to formulate an initial offering price or to calculate a last best offer.*

[86] *Estate of Jung v. Comr.*, 101 T.C. 412 (1993); *Barnes v. Comr.*, T.C. Memo 1998-413.
[87] T.C. Memo 2001-109.
[88] T.C. Memo 1997-166.
[89] 94 T.C. 193 (1990).
[90] T.C. Memo 1992-284.

Failure to Define Capital Structure

The appraiser should define the subject company's capital structure in the valuation report.[91] In *Kaufman v. Comr.*,[92] the Tax Court stated:

> *He relied repeatedly on the unverified representations of Seminole's management, and we are unable to verify the accuracy or completeness of those representations. He also relied on faulty assumptions to arrive at his value, neglected to analyze key indicia of value (including Seminole's certificate of incorporation and bylaws), and assumed erroneously that the sales by Mr. Hoffman and Ms. Branch were at arm's length.*

Failure to Adequately Consider the "Willing Buyer"

The definition of fair market value considers both a willing buyer and a willing seller. Courts have repeatedly called down appraisers for failing to consider the willing buyer. *Smith Est. v. Comr.*,[93] *Cloutier Est. v. Comr.*,[94] and *Pabst Brewing Company v. Comr.*[95] See also *Hendrickson Est. v. Comr.*,[96] in which the Tax Court criticized the IRS appraiser:

> *Thus, proper diversification of an investment in the Peoples shares owned by petitioner, as valued by respondent, would require a total capital investment of at least $89 million. We do not think the hypothetical buyer should be limited only to a person or entity that has the means to invest $89 million in Peoples and a portfolio of nine other securities.*

Failure to Adequately Consider the Willing Seller

The definition of fair market value for tax purposes requires consideration of both a willing buyer and a willing seller. At times, the courts have also called down taxpayers' appraisers for a failure to consider the willing seller. See, for

[91] See, e.g., ASA BVS VIII Section (IV)(A); IBA Business Appraisal Standards Sections 4.2(b) and 5.3(b); NACVA Professional Standards Section 4.3(B)(2); AICPA Statement on Financial Services Paragraph 51.
[92] T.C. Memo 1999-119.
[93] T.C. Memo 1999-368.
[94] T.C. Memo 1996-49.
[95] T.C. Memo 1996-506.
[96] T.C. Memo. 1999-278 (citing *Estate of Curry v. United States*, 706 F.2d 1424, 1428-1429, 1431 [7th Cir. 1983]).

example, *Branson Est. v. Comr.*,[97] *Lehmann Est. v. Comr.*,[98] *Crocker v. Comr.*,[99] and *Moore v. Comr.*[100]

In *Mandelbaum v. Comr.*,[101] the Tax Court had this to say:

> *Ignoring the views of a willing seller is contrary to this well-established test. In this regard, [the appraiser] failed to consider any person who could be considered a hypothetical willing seller of Big M stock. He also did not consider whether such a seller would sell his or her Big M stock for at least 70 percent less than its freely traded value. We find incredible the proposition that any shareholder of Big M would be willing to sell his or her stock at such a large discount.*

Failure to Accurately Describe the Subject Property

Appraisers are required to accurately describe the property to be valued in the appraisal report.[102] This did not happen in *Frazee v. Comr.*:[103]

> *The major weakness in [the appraiser's] report is that the property was valued as though it was located within the agricultural preserve. However, the record establishes that the Carlsbad property was not within the agricultural preserve. Therefore, a fundamental premise underlying his appraisal was incorrect. As the record demonstrates, commercial and industrial properties were selling at a much higher price than residential properties and properties within the agricultural preserve. Therefore, [the appraiser's] incorrect presumption leads to a much lower value.*

Failure to Properly Classify the Subject Company

It is important that an appraiser properly characterize a subject company. In *Bennett Est. v. Comr.*,[104] the Tax Court felt that the IRS appraiser failed to do this:

> *Finally, we think that, in his report, [the appraiser] should have characterized Fairlawn as a corporation actively engaged in commercial real estate management rather than wholly as an investment or holding company.*

[97] T.C. Memo 1999-231.
[98] T.C. Memo 1997-392.
[99] T.C. Memo 1998-204.
[100] T.C. Memo 1991-546.
[101] T.C. Memo 1995-255.
[102] See, e.g., ASA BVS-I(II)(B); NACVA Professional Standards Section 3.3; AICPA Statement on Standards for Valuation Services Paragraph 52; IBA Business Appraisal Standards Section 4.3(a).
[103] 98 T.C. 554 (1992).
[104] T.C. Memo 1993-34.

Failure to Explain the Basis for a Valuation Discount

If an appraiser determines that a valuation discount is applicable to the subject interest, it is very important that the appraiser explain the basis for taking the discount. In *True Est. v. Comr.*,[105] the IRS appraiser failed to do so:

> *We find respondent's proposed 10-percent minority discounts for interests transferred by Dave and Jean True to be unsubstantiated and insufficient.*

Failure to Properly Consider the Subject Company's Growth Rate

It is essential that an appraiser consider the subject company's projected growth rate. In *Freeman Est. v. Comr.*,[106] the Tax Court called down the taxpayer's appraiser for failing to do so:

> *We are also concerned that in relying on his three approaches [the appraiser] ignored the dynamic state of the corporation, which had experienced exceptional growth in both revenues and earnings since its inception. We can find in neither [the appraiser's] identification of (1) market variables or (2) variables particular to the corporation (e.g., earnings) nor in his manipulation of those variables any recognition that* future *earnings and revenues might be any different than they were in 1989 (i.e., that earnings and revenues would continue to grow). Although, in the body of his report, [the appraiser] takes note of the growth since inception of both the corporation's earnings and revenues, and although an income statement for the first 6 months of 1990 was reasonably available to him, which showed continued growth in both earnings and revenues, [the appraiser] does not specifically acknowledge such growth (or any future growth) in any of the approaches that he adopted.*

Failure to Explain Market Multiples Selected for Guideline Companies

In *True Est. v. Comr.*,[107] the Tax Court criticized one of the taxpayer's appraisers, stating:

> *[The appraiser] provided no data showing: (1) How he computed the guideline company multiples or the Belle Fourche financial fundamentals, (2) which of three multiples he applied to Belle Fourche's fundamentals, or (3) how he weighed each resulting product. Without more information we cannot evaluate the reliability of [the appraiser's] results.*

[105] T.C. Memo 2001-167.
[106] T.C. Memo 1996-372.
[107] T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).

Failure to Explain Equal Weighting of Conclusions of Value

Where different valuation methods yield differing indications of value, appraisers must be very clear about what they do with these differing indications of value in arriving at a conclusion of value. It sometimes is tempting to simply weight the indications equally. However, what is more important is to have an explanation for the weighting of indications of value, whatever they might be.[108] In *Hendrickson Est. v. Comr.*,[109] the Tax Court criticized the work of an appraiser who simply gave the indications of value equal weight without bothering to explain why he did so.

Failure to Consider Differences between the Subject Company and the Guideline Companies

Given that even the smallest public guideline companies usually are larger than the subject company, there often are differences between the guideline companies and the subject company that ought to be addressed in the valuation report. This was not done in *Klauss Est. v. Comr.*[110]

Failure to Utilize Data from a Guideline Company That the Appraiser's Own Summary Chart Reflects Is Closest to the Subject Company

When a guideline company's comparison data is very close to that of the subject company, sometimes there is never a good enough excuse for failing to consider that company's performance measures. In *Lewis G. Hutchens Non-Marital Trust v. Comr.*,[111] the Tax Court turned aside an explanation by the taxpayer's appraiser that he had not considered the performance measures of the guideline company that was apparently easily identifiable on the expert's own charts as the most similar to the subject company, observing:

> *We believe that [the appraiser] should have incorporated Fruehauf's data in calculating a capitalization factor for HII. [The appraiser's] own charts reveal a similarity between HII and Fruehauf that is lacking in the other companies.*

Failure to Explain the Selection of the Range of Performance Ratios Selected

In the market approach, it is very important that the appraiser carefully describe the ranges of performance ratios selected and explain why a particular range was selected. The Tax Court criticized the appraiser for failing to do so in *Heck v. Comr.*[112]

[108] Pratt with Niculita, *Valuing a Business*, 5th ed. (New York: McGraw-Hill, 2008), 477–482.
[109] T.C. Memo 1999-278.
[110] T.C. Memo 2000-191.
[111] T.C. Memo 1993-600.
[112] T.C. Memo 2002-34.

Failure to Adequately Explain Why Companies Selected as Guideline Companies Are in Fact Comparable to the Subject Company

Picking guideline companies is not nearly as important as explaining how the guideline companies are in fact comparable to the subject company. In *Fleming Est. v. Comr.*,[113] the Tax Court called down an appraiser for failing to so explain.

Failure to Explain Why So Few Comparable Properties or Guideline Companies Were Selected

When an appraiser is unable to identify a sufficient population of guideline companies or comparable properties, the appraiser had better explain the potential shortcomings of using a narrowly defined guideline group as well as address the caveats and adjustments required to harvest reasonable, relevant valuation evidence from the data. Of course, this circumstance could suggest that the market approach is not a viable sole valuation method for the subject company.[114] This was the case in *Fleming Est. v. Comr.*:[115]

> *In applying his modified market multiple method, [the appraiser] selected three publicly traded companies (guideline companies) engaged to varying degrees in consumer lending that he determined were comparable or similar to B&W Longview. [The appraiser] did not explain in his report or adequately explain at trial why the three guideline companies that he chose were comparable to B&W Longview on the valuation date and why he selected only three publicly traded companies as guideline companies. For these reasons, we are not persuaded that the results that [the appraiser] reached under his modified market multiple method are reliable, and we shall not give any weight to those results in determining the fair market value on the valuation date of the stock interest in question.*

[113] T.C. Memo 1997-484.
[114] Pratt with Niculita, *Valuing a Business*, 5th ed. (New York: McGraw-Hill, 2008), 274.
[115] T.C. Memo 1997-484.

CHAPTER 18

Alleged Errors of Commission

This chapter focuses on affirmative actions by appraisers that courts ruled were mistakes, including at least one in which a trial court was called down by an appellate court for making a valuation mistake.

Retrospective Appraisals

A dilemma inherent in retrospective appraisals is that life and business carry on after the valuation date. Consequently, the events and cycles of a continuing, post-valuation date reality become known to appraisers as well as to other stakeholders to the valuation process. The essence of uncertainty, economic or otherwise, that envelopes any given point in time is lost when subsequent reality becomes visible and measurable. The issue with the evolution of future expectations into hindsight is that subsequent events to an appraisal valuation date are not supposed to be considered in an appraisal other than to the degree such events and conditions could have been reasonably expected to occur (i.e., an outcome among other outcomes within the horizon of reasonable probability). Not only are an appraiser's observations and perspective potentially influenced by subsequent events, so can the information and feedback provided by the various stakeholders to an appraisal event. The question often is whether that information was knowable as of the valuation date. *Love Est. v. Comr.*[1] is instructive on this issue:

> *Second, 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 appraisal is made as of a certain date; for example, date of death or alternate valuation date or as of the date of a gift. Generally, an appraiser should only consider circumstances in existence on the valuation date and events occurring up to the

[1] T.C. Memo 1989-470.

valuation date.[2] However, the courts have allowed evidence of subsequent events if those events were reasonably foreseeable as of the valuation date.[3] Taking subsequent events into account can happen easily, particularly in the context of retrospective appraisals. See, for example, *Mueller Est. v. Comr.*,[4] *Messing Est. v. Comr.*,[5] and *Gillett Est. v. Comr.*[6] In *Jung Est. v. Comr.*,[7] the Tax Court drew the following distinction:

> *A distinction may usefully be drawn between later-occurring events which affect fair market value as of the valuation date, and later-occurring events which may be taken into account as evidence of fair market value as of the valuation date. [Emphasis by the court]*

See also the reviewed opinion of the Tax Court in *Spruill Est. v. Comr.*[8]:

> *It is well settled that, in examining all the relevant facts and circumstances, events occurring subsequent to the valuation date are not considered in determining fair market value, except to the extent that such events were reasonably foreseeable on the valuation date. [Emphasis by the court]*

Use of Past Publications of an Appraiser against the Appraiser

In *Caracci v. Comr.*,[9] the Tax Court used the appraiser's past writings against him in the selection of a price-to-revenue multiple:

> *Moreover, in an article published in the spring of 1997, [the appraiser] indicated that for the prior 2 years, a standard market benchmark for valuing traditional visiting nursing agencies, such as the Sta-Home tax-exempt entities, was a price-to-revenue multiple of .55. [the appraiser] & Spieler, "Valuation of Home Health Care Companies," Intrinsic Value (Spring 1997). We fail to understand why the Sta-Home tax-exempt entities had a much lower multiple of .26.*

Using Untested Methodology

Given that valuation methodology has coalesced into specific methods as well as the gatekeeper requirements of *Daubert v. Merrill Dow Pharmaceuticals,*[10] it is

---

[2] See, e.g., AICPA Statement on Standards for Valuation Services Paragraph 43; *Ithaca Trust Co. v. U.S.*, 279 U.S. 15 (1929). But see the recently finalized regulations under IRC Sec. 2053.
[3] *Spruill Est. v. Comr.*, 88 T.C. 1197 (1987).
[4] T.C. Memo 1992-284.
[5] 48 T.C. 502 (1967).
[6] T.C. Memo 1985-394.
[7] 101 T.C. 412 (1993).
[8] 88 T.C. 1197, 1228 (1987).
[9] 118 T.C. 379 (2002), rev'd 456 F. 3d 444 (5th Cir. 2006).
[10] 507 U.S. 579 (1993).

imperative that appraisers stick to methods that have been subjected to peer review and acceptance.

In *Smith Est. v. Comr.*,[11] the Tax Court criticized the appraiser:

The notion that there is a premium associated with a minority interest contradicts this Court's precedents, the weight of expert commentary, and common sense . . . The fact that [the appraiser's] data reflects this trend suggests that there is something wrong with his data, his analysis, or both.

In *Newhouse Est. v. Comr.*,[12] the Tax Court cast aside the IRS expert's work, noting:

The other problem with [the appraiser's] report was his use of the subtraction method for valuing the Advance common stock. Although the subtraction method may on occasion be an appropriate valuation method, some foundation for applying the subtraction method to a corporation whose capital structure is as unusual and complicated as Advance's is necessary. Respondent had to establish that the subtraction method was appropriate to valuing Advance. While [the appraiser] was on the stand, respondent's counsel promised that two of his subsequent witnesses would testify that in their experience ([the appraiser] had no qualifying experience on this point), a willing buyer would use the subtraction method to value the common stock in Advance. In fact, their proffered testimony fell far short and was ultimately stricken from the record as irrelevant. As a result, [the appraiser's] employment of the subtraction method was not meaningful.

Improper Reliance on a Draft Appraisal

Appraisers frequently have to rely on the work of other appraisers, whose work may be ongoing at the same time as that of the appraiser.[13] Caution is required in such instances. In *Cloutier Est. v. Comr.*,[14] an appraiser lost credibility for failing to follow up on a work-in-process appraisal of another appraiser:

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

Conclusion of Value Offends Common Sense

Although clients often disagree with the conclusions of value reached by appraisers, it is prudent to run the conclusion of value past the client or officers of the company to ensure that some major aspect of value has not been

[11] T.C. Memo 1999-368.
[12] 94 T.C. 193 (1990).
[13] See, e.g., AICPA Statement on Standards in Valuation Services Paragraph 20; NACVA Professional Standards Section 3.8.
[14] T.C. Memo 1996-49.

overlooked or missed. Consider the comments of the Seventh Circuit Court of Appeals in *Van Zelst v. Comr.*:[15]

> *Van Zelst was not an armchair investor dependent on others for his knowledge of the land's value; he was himself an expert, who also knew the number of resorts in the area (zero), the price of copper (67 cents and falling), the number of corporations that had owned the Nelson Mine without figuring out how to make a profit (four), the number of years the claim had lain fallow since the patent issued (46), the number of producing copper mines near the Park (none), what the land sold for in 1983 ($30,000), the highest competing bid for the Nelson Mine (zero), and the highest bid Cooper had received for any of its other parcels (zero). He had to have known that the [appraiser's] estimate was hooey, the sort of number ginned up to put one over on the revenooers.*

Taxpayers cannot blindly rely upon experts, even appraisers.[16]

Mathematical Errors

Given the extent of mathematical computations that are latent within appraisal, and the humanity of the appraiser, it is not surprising that appraisal computational errors have made their way into reported decisions. This is despite the fact that computational errors should be preventable. See, for example, *Rabenhorst v. Comr.*,[17] *Simplot Est. v. Comr.*,[18] *Freeman Est. v. Comr.*,[19] and *Lehmann Est. v. Comr.*[20] (where the appraiser for the prevailing side in each case was the one who made the computational errors), and *True Est. v. Comr.*[21] In *Bell Est. v. Comr.*,[22] the Tax Court disregarded the taxpayer's expert report, lamenting:

> *Aside from arbitrary and result-oriented analysis, [the appraiser's] report had many errors. During the trial the Court found that a whole column of numbers was misplaced in the report and wrongly used by the expert. The stores owned by Bell Oil companies had to be reconsidered during the trial to determine the correct number of them. The Court also had to refigure the breakdown of gas sales and food sales for the Bell Oil corporations because of the expert's inaccuracy.*

[15] 100 F. 3d 1259 (7th Cir. 1996), writ. den., 118 S. Ct. 45 (1997).
[16] *Bergquist v. Comr.*, 131 T.C. No. 2 (2008).
[17] T.C. Memo 1996-92.
[18] 112 T.C. 130 (1999).
[19] T.C. Memo 1996-372.
[20] T.C. Memo 1997-332.
[21] T.C. Memo 2001-167.
[22] T.C. Memo 1987-576.

In *Renier Est. v. Comr.*,[23] an appraiser transposed his figures. In *Magnin Est. v. Comr.*,[24] the Tax Court noted:

> *After trial, [the appraiser] corrected his error of not subtracting projected capital expenditures in his original report, but it is troubling that such a large mistake was made in the first place.*

Inconsistency

Appraisers frequently use more than one valuation approach. It is important that the assumptions used in each valuation method be consistent. This was not the case in *Bell Est. v. Comr.*:[25]

> *Furthermore, the rates of return applied by [the appraiser] in the excess earnings method bore no relationship to the capitalization rate [the appraiser] used in the capitalization of income stream method. We believe his choice of varying rates indicates a result-oriented analysis. An appropriate capitalization rate is determined by the comparable investment yield in the market not by the choice of a valuation method. [The appraiser] made little effort to identify comparable investments.*

Any significant discrepancy between an appraiser's report and that appraiser's testimony can significantly compromise the appraiser's credibility, as the Tax Court demonstrated in *Moore v. Comr.*:[26]

> *We have several problems with [the appraiser's] valuation. First, his report and trial testimony are inconsistent in that they indicate different methodologies for valuing the partnership interests. The report indicates that he valued the interests by discounting the fair market value of the business to reflect the lack of control and illiquidity associated with the minority interests. His trial testimony indicates that he valued the partnership interests under the procedure prescribed in Rev. Rul. 59–60, 1959–1 C.B. 237.*

Double Counting

Double counting can arise in many different contexts in an appraisal, both directly and indirectly. In *Renier Est. v. Comr.*,[27] the Tax Court called down the IRS appraiser for a double counting infraction:

[23] T.C. Memo 2000-298.
[24] T.C. Memo 2001-31.
[25] T.C. Memo 1987-576.
[26] T.C. Memo 1991-546.
[27] T.C. Memo 2000-298.

Although [the appraiser] recognized he had double counted a liability of $137,038, he did not modify his computations to correct for this error.

Conflicting Conclusions of Value

Where an appraiser values the same interest at or around the same valuation date and that appraiser arrives at significantly different conclusions of value, the appraiser probably cannot explain too much. In *Freeman Est. v. Comr.*,[28] the Tax Court exposed the appraiser who had fallen into this trap:

[The appraiser] had prepared an earlier report valuing the shares, which was appended to the estate tax return filed by petitioner. In that earlier report, [the appraiser] listed eight publicly traded companies that he considered comparable to the corporation. Seven of those eight companies were omitted from the report received as [the appraiser's] testimony. One company (Altera Corp.) is mentioned, but no analysis of that company to support [the appraiser's] valuation methods is provided.

In *Turner Outdoor Advertising, Inc. v. Comr.*,[29] the Tax Court pointed out:

[The appraiser] prepared two appraisal reports, one in 1991 and one in 1994, in preparation for the trial in this case. The appraisals were of the same property, as of the same time. The 1994 report is the primary support for respondent's position. Both of the reports appear to be based upon the same appraisal methodologies and assumptions used by petitioner's experts, but the total fair market value in the first report is half the amount in the second report. [The appraiser], however, could not provide the Court with an adequate explanation as to why the values differed in the two reports.

Sole Reliance on a Valuation Model

Courts are troubled when an appraiser relies heavily upon a valuation formula or model, especially where slight variations in the model inputs produce dramatically different results. In *Weinberg Est. v. Comr.*,[30] the Tax Court concluded:

We disagree with the discount computed by [the appraiser] on the basis of the QMDM model because slight variations in the assumptions used in the model produce dramatic differences in the results. For example, if the holding period for the investment were extended from 10 to 15 years, the period assumed by [the appraiser], to 15 to 20 years, and the required holding period return were increased to 20 percent from the return assumed by [the appraiser] of between 16

[28] T.C. Memo 1996-372.
[29] T.C. Memo 1995-227.
[30] T.C. Memo 2000-51.

to 18 percent, the QMDM table produces a 30-percent discount, twice the amount of the discount produced using [the appraiser's] assumptions.

In *Morton v. Comr.*,[31] the Tax Court reasoned:

Changing the discount rate just 2 percentage points, from 35 to 33 percent, leaving all other variables the same and applying a 7 percent growth rate, causes an increase in the overall valuation from, by our calculation, $47.33 per share to $1,161 per share. A discount rate of 30 percent produces a final value of $3,551 per share. Once again, the volatile nature of [the appraiser's] valuation model, along with the lack of objective support for his assumptions, causes us concern about the accuracy of his final calculation.

Rev. Rul. 59–60 counsels against reliance on a single valuation method. In *Bennett Est. v. Comr.*,[32] the Tax Court expressed concern about this:

Although [the appraiser's] credentials are impressive, and we have put great weight on many of his valuations in this case, the Court is troubled by his reliance on only one method of valuation, the asset-accumulation method, without further adjustments or discounts.

In *Mellinger Est. v. Comr.*,[33] the Tax Court had this to say about an appraiser's reliance upon a single valuation method:

[The appraiser] relied on a single method, and we are not persuaded that his method is the only one that would be considered by hypothetical buyers and sellers.

In *True Est. v. Comr.*,[34] the Tax Court said the following about the use of a single valuation method in the valuation of an oil company:

We find it unreasonable to assume that a hypothetical willing buyer would rely entirely on public company multiples to compute the purchase price of a closely held family business [footnote omitted] that derived all its value from its ability to discover and exploit oil and gas reserves. See Zukin, Financial Valuation: Businesses and Business Interests, *par. 19.2[6] at 19–9, par. 19.2[8] at 19–13 (1990). If a company is primarily in the business of selling its assets, then hypothetical buyers most likely would be interested in the company's net asset value. See* Ward v. Commissioner, *87 T.C. at 102 (citing* Harwood v. Commissioner, *82 T.C. 239, 265 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986)(concerning company engaged in selling timber); see also* Estate of Jameson v. Commissioner, *T.C. Memo. 1999–43.*

[31] T.C. Memo 1997-166.
[32] T.C. Memo 1993-34.
[33] 112 T.C. 26 (1999).
[34] T.C. Memo 2001-167.

Incorrect Usage of Discounted Cash Flow Method

Hutchens Non-Marital Trust v. Comr.[35] contains a few examples of the incorrect usage of the DCF method:

> *[The appraiser] also relied upon a discounted cash flow analysis in valuing the company. He admitted, however, that in arriving at a value under this method, he should have deducted some $817,000 of short-term debt and other long-term liabilities.*

Also in *Hutchens Non-Marital Trust v. Comr.,*[36] the Tax Court observed:

> *In addition, [the appraiser] computed HII's cost of capital as if its debt component were 25 percent of its capital structure. In reality, debt comprised only 12 percent of HII's capital structure. These errors resulted in an overvaluation of the company.*

In *Hall Est. v. Comr.,*[37] the Tax Court determined that the appraiser had incorrectly defined cash flow:

> *In its application of the discounted future cash flow valuation, [the appraiser] incorrectly defined cash flow as net income plus depreciation, omitting consideration of deferred taxes, capital expenditures, and increases in working capital.*

Skewed Assumptions

It is axiomatic that the assumptions relied upon by the appraiser be accurate and complete. It is easy to have cascading assumptions that lead the appraiser astray. The Tax Court felt that this happened to the IRS appraiser in *Mueller Est. v. Comr.,*[38] and wrote the following:

> *We are convinced [the appraiser] made erroneous assumptions at nearly every step of its analysis.*

Overemphasis on Buy-Sell Restrictions among Related Parties

IRC Sec. 2703 makes it clear today that appraisers should disregard buy-sell restrictions in agreements dated after October 8, 1990, between "applicable family members" for purposes of determining fair market value. However, even though the

---

[35] T.C. Memo 1993-600.
[36] Ibid.
[37] 92 T.C. 312 (1989).
[38] T.C. Memo 1992-284. See also *Hearst Corp. v. U.S.*, 28 Fed. Cl. 202 (Cl. Ct. 1993), vacated, 36 F. 3d 1116 (Fed. Cir. 1994).

agreements in question predated IRC Sec. 2703, an appraiser attempted to do this in *True Est. v. Comr.* but was chastised for it under prior jurisprudence.[39]

Using Historic Book Value of Assets in Net Asset Value Approach, Even Though Asset Appraisals Had Been Obtained

Business appraisers frequently have to utilize appraisers from other disciplines, for example, real estate and oil and gas, and so on. In *Ford Est. v. Comr.*,[40] the Tax Court called down the taxpayer's expert for failing to consider appraisals of assets that were available:

> *[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.*

Misapplication of Pre- and Post-Tax Figures

Appraisers are cautioned to be consistent in their use of pre- and post-tax figures.[41] In *Dockery v. Comr.*,[42] the appraiser failed to do just that:

> *[The appraiser] misapplied the price/earnings capitalization rate of five used in Estate of Feldmar to convert Crossroads' weighted average earnings in that the Court in Estate of Feldmar applied the capitalization rate to post-tax earnings and [the appraiser] applied it to pretax earnings.*

Ignoring the Hypothetical Nature of the Willing Buyer or Willing Seller

The buyer and seller in the fair market value calculus must be hypothetical. In *Simplot v. Comr.*,[43] the Ninth Circuit called down the Tax Court for failing to adhere to this standard, noting:

> *The Tax Court in its opinion accurately stated the law: "The standard is objective, using a purely hypothetical willing buyer and willing* seller. . . . *The* hypothetical *persons are not specific individuals or entities." The Commissioner*

[39] T.C. Memo 2001-167.
[40] T.C. Memo 1993-580.
[41] See, e.g., ASA BVS-Section IV(IV)(D).
[42] T.C. Memo 1998-114.
[43] 249 F. 3d 1191 (9th Cir. 2001).

himself in his brief concedes that it is improper to assume that the buyer would be an outsider. The Tax Court, however, departed from this standard apparently because it believed that "the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect value." Obviously the facts that determine value must be considered.

The facts supplied by the Tax Court were imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with Simplot children or grandchildren and what improvements in management of a highly successful company an outsider purchaser might suggest. "All of these factors," that is, all of these imagined facts, are what the Tax Court based its 3 percent premium upon. In violation of the law the Tax Court constructed particular possible purchasers. [Emphasis by the court.]

Inconsistent Use of Commercially Available Data

Appraisers must be consistent in their use of commercially available data. In *Klauss Est. v. Comr.*,[44] the Tax Court determined that this was not the case with one appraiser:

[The appraiser] testified that it is appropriate to use the Ibbotson Associates data from the 1978–92 period rather than from the 1926–92 period because small stocks did not consistently outperform large stocks during the 1980s and 1990s. We give little weight to [the appraiser's] analysis. [The appraiser] appeared to selectively use data that favored his conclusion. He did not consistently use Ibbotson Associates data from the 1978–92 period; he relied on data from 1978–92 to support his theory that there is no small-stock premium but used an equity risk premium of 7.3 percent from the 1926–92 data (rather than the equity risk premium of 10.9 percent from the 1978–92 period).

Use of Commercially Available Data That Warns of Statistical Inaccuracy

Haffner's Service Station, Inc. v. Comr.[45] points out the perils of utilizing data that is subject to caveats and limitations without considering those caveats and limitations:

In addition to the fact that [the appraiser] 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 appraiser] attempted to rationalize his reliance on the Robert Morris compilation by stating: "Unfortunately, I had to use what was available. It was that and the—were the best stuff around. I have to concede that they're flawed." We find this attempt unavailing.

[44] T.C. Memo 2000-191.
[45] T.C. Memo 2002-38.

Misstatement of Methodology Employed by Appraisers on Whose Work the Appraiser Has Relied

If an appraiser errs in describing the valuation methodology of appraisers on which that appraiser relies, the courts' confidence in the appraiser can be compromised. That happened in *Auker Est. v. Comr.*:[46]

> *[H]e assumed incorrectly that the appraisers valued the subject property by a "market comparable method." The appraisers valued the apartment complexes on the basis of an income capitalization method, and they valued the remaining parcels of real estate on the basis of an assortment of methods, one of which was a sales comparison method.*

Undue Reliance on the Work of Another Appraiser

It is not unusual for a business appraiser to rely in part on the efforts of another appraiser, often a real estate or other personal/intangible property appraiser. Unfortunately, the relying appraiser cannot blindly rely on the work of other appraisers and must make some baseline assessment of the accuracy and completeness of the other appraiser's work.[47] In *Northern Trust Co. v. Comr.*,[48] the Tax Court criticized the opinion of an appraiser, noting:

> *[The appraiser] explained that he relied on the opinion of several local real estate appraisers . . . [The appraiser] admitted, however, that the appraisers never viewed the property prior to determining the appropriate adjustments. Indeed, the record contains no evidence explaining the basis of these adjustments.*

Using a Valuation Method without Laying a Foundation That It Is a Legitimate Method (for Example, the Business Broker Method Using Data from the IBA Market Database)

The business appraisal standards of the major business appraisal organizations caution one relative to so-called rules of thumb.[49] In *Renier Est. v. Comr.*,[50] the Tax Court totally disregarded the appraisal offered by one of the taxpayer's appraisers, who had utilized two market approaches and four rules of thumb, stating:

---

[46] T.C. Memo 1998-185.

[47] See, e.g., AICPA Statement on Standards for Valuation Services Paragraphs 20 and 52(o) and NACVA Professional Standards Section 3.8.

[48] 87 T.C. 349, aff'd. sub nom. *Citizen's Bank & Trust Co. v. Comr.*, 839 F. 2d 1249 (7th Cir. 1988).

[49] See, e.g., AICPA Statement on Standards for Valuation Services Paragraphs 39 and 62; ASA BVS-Section V(V); IBA Business Appraisal Standards Section 1.1; and NACVA Professional Standards Section 3.8.

[50] T.C. Memo 2000-298.

> *His report contains no explanation of, or analytical support for, the various "rules of thumb" employed in reaching several of its valuation estimates. Thus, we are largely unable to assess the merits of [the appraiser's] conclusions. See Rule 143(f)(1). To the extent we are able to form a judgment, we find his analysis unpersuasive. One of his market approach calculations and three of his rules of thumb used gross revenue as the primary determinative factor, without taking profitability into account. This raises doubts about the basis for his conclusions, given that Renier's profitability was high in relation to the industry average. Furthermore, while [the appraiser's] second market approach calculation used Renier's earnings and one of his rules of thumb used Renier's cash-flow, [the appraiser] provided no justification for the earnings and cash-flow figures he used.*

Improper Reliance on a Study That Does Not Completely Provide All Relevant Data

An appraiser has a duty to investigate or otherwise inquire about information on which the appraiser relies.[51] In *Kraft, Inc. v. Comr.*,[52] the court criticized the appraiser for using incomplete data:

> *Foremost is that the data used by [the appraiser] from Table No. 58 of the Pitcher Report, included in Exhibit 208, and used in the "Knutson formula," cannot reasonably be construed to represent conditions in milk markets elsewhere in the United States, or even within the New York City Metropolitan area. It is true that the Pitcher Report was a detailed study of the milk market in New York State, rich with anecdotal stories and complex analyses of a very troubled industry crying for help from its elected and appointed government officials. Nonetheless, the data used by [the appraiser] was only for the New York City Metropolitan area; it did not include data gathered from dairies statewide, from other New York State cities, and from the larger NYC Metropolitan area dairies. The failure to include data from the larger dairies is significant.*

Failure to Apply Discussion of Economic Factors to the Subject Company

It is of little value to discuss outside facts such as economic conditions without applying that discussion to the valuation of the subject company. In *Anderson Est. v. Comr.*,[53] the Tax Court noted:

> *[The appraiser] devotes several pages of his report to an analysis of economic conditions as of May 1982 without any specific application of this analysis to the Holding Company, the Operating Companies or their customers.*

[51] See, e.g., IBA Business Appraisal Standards Section 1.15(a).
[52] 94-1 USTC Par. 50,080 (Cl. Ct. 1994).
[53] T.C. Memo 1988-511.

Using Commercially Available Data in a Manner Contrary to How the Data Source Says the Data Should Be Used

In *Friedberg Est. v. Comr.*,[54] the Tax Court criticized the IRS appraiser's use of Standard & Poor's investment rating as an indicator of future performance, as the Standard & Poor's materials themselves so warn.

Failure to Proofread Report Prior to Issuance

The appraiser in *Hinz Est. v. Comr.*[55] failed to properly proofread his appraisal report to excise unnecessary boilerplate, and the Tax Court put it to him:

> *When asked why his expert witness report relies on a statute that had been repealed years earlier, [the appraiser] 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."*

More than one final conclusion of value reflected in an appraisal report also usually spells doom to an appraiser. In *Hinz Est. v. Comr.*,[56] this happened:

> *[The appraiser's] report, too, evinced failure to review before issuing. For example, [the appraiser's] report included more than one final value for the Lafayette Property and the Parker Property. [The appraiser] report showed final values for the Lafayette Property of $3,417,000, $3,960,000, and $3,618,000, and for the Parker Property of $1,468,000 and $1,240,000.*
>
> . . .
>
> *Also, in some instances, the textual descriptions of properties in [the appraiser's] written report did not match the properties listed in the accompanying matrix. It was as though [the appraiser] had revised parts of a draft of his report but inadvertently kept parts of former drafts that no longer fit the revised draft.*

Apparently Conflicting Assumptions Used for the Same General Purposes without Sufficient Explanation

Appraisers often must make assumptions.[57] However, the appraiser should exercise caution to ensure that he is consistent in his usage of assumptions. In *Hutchens*

[54] T.C. Memo 1992-310.
[55] T.C. Memo 2000-6.
[56] T.C. Memo 2000-6.
[57] AICPA Statement on Standards for Valuation Services Paragraph 18; NACVA Professional Standards Section 3.3(i); IBA Business Appraisal Standards Section 4.3(h); ASA-BVS Section VIII(III).

Non-Marital Trust v. Comr.,[58] the Tax Court determined that the appraiser had not been consistent in his assumptions:

> *[The appraiser] viewed HII's earning potential through a pessimistic lens, by evaluating the company in its 1982 posture—that is, in the trough of its five-year business cycle. However, the assumptions regarding HII's financial strength that [the appraiser] used in valuing decedent's pre-recapitalization common stock contrast with those that he used in determining the post-recapitalization value of decedent's preferred stock. For the latter purpose, he made optimistic estimates of future earnings and dividends. Therefore, his approach tends to stress lower values for the pre-recapitalization common stock and higher values for the post-recapitalization preferred stock.*

Use of Different Valuation Methods in Valuing the Same Interest in Valuation Reports Offered at Different Times without Adequate Explanation

Even though there may be legitimate bases for valuing the same interests utilizing different methods in sequentially issued reports, there is a risk that the second method will be perceived as a result-oriented report that is merely offered to support the first report.

In *True Est. v. Comr.*,[59] the Tax Court found that the appraiser was inconsistent in his application of valuation methodology:

> *Second, the final [appraiser] report calculated the equity value of Dave True's 68.47-percent interest in Belle Fourche on a fully marketable noncontrolling basis without first valuing the company as a whole. This significantly departed from the initial [appraiser] report's guideline company approach, which first valued the company on a marketable controlling basis, and then applied a 40-percent marketability discount. Even though both reports used the guideline company method, we believe the approaches were substantially different and find it remarkable that both reports arrived at the same ultimate value of roughly $4,100,000 for Dave True's interest. This suggests that the final [appraiser] report was result-oriented.*

Making Improper Adjustments to Financial Statements

In *Hess v. Comr.*,[60] the Tax Court found that the taxpayer's appraiser's upward adjustment to the subject company's cost of goods sold was improper and served to understate income, noting:

[58] T.C. Memo 1993-600.
[59] T.C. Memo 2001-167.
[60] T.C. Memo 2003-251.

> *For HII's 1995 fiscal year, [the appraiser] adjusted HII's cost of sales upward and thus its earnings figures downward by approximately $2.5 million. He used this adjusted cost of sales in developing his cost of sales assumption for his discounted cashflow analysis and the adjusted earnings amount in his market comparable analysis. This adjustment was made on the basis of information contained in a 1997 memorandum from personnel at HII to [the appraiser] regarding a purported overstatement of 1995 income attributable to an alleged understatement of reserves for expenses associated with machine construction projects for 1995. We cannot agree that [the appraiser] properly adjusted earnings to account for the alleged understatement.*
>
> *Petitioners have not established the existence of an understatement of reserves for 1995, the nature of the understatement, or its amount. We cannot conclude from the evidence presented that a hypothetical buyer or seller would have discovered, or even considered, the understatement of reserves in 1995, at the time of the gift.*

Reliance on the Pre-IPO Studies and the Restricted Stock Studies to Determine the Discount for Lack of Marketability for a Controlling Interest

When an appraiser is valuing a controlling interest, the determination of the discount for lack of marketability can be a bit more difficult if using the benchmark analysis because all the studies to date have included only noncontrolling interests. In *True Est. v. Comr.*,[61] the Tax Court was very critical of the taxpayer's appraiser in this regard in one case, even though that court had accepted that methodology in other decisions:

> *We also find that the restricted shares and pre-IPO studies referenced by [the appraiser] are not useful in determining marketability discounts applicable to controlling interests, because those studies analyzed marketability of noncontrolling interests.*

Misreading or Failing to Properly Consider Revenue Ruling 59–60

The eight factors set forth in Rev. Rul. 59–60 need not be given equal weight, as the Tax Court pointed out in *Ford Est. v. Comr.*[62] In *Mueller Est. v. Comr.*,[63] the Tax Court criticized the IRS appraiser for only looking at three years of income statements when Rev. Rul. 59–60 suggests that five years of income statements be used.

[61] T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).
[62] T.C. Memo 1993-580.
[63] T.C. Memo 1992-284.

Failure to Accurately State the Number of Shares Outstanding in the Subject Company

The business appraisal standards of some of the appraisal organizations make it clear that appraisal reports must set forth the subject company's capital structure.[64] In *Simplot v. Comr.*,[65] the Tax Court castigated the taxpayer's appraiser for failing to have accurately done so:

> *The total number of outstanding shares of J.R. Simplot Co. used by [the appraiser] in its appraisal erroneously included treasury shares held by J.R. Simplot Co.*

Inconsistency in Valuation Methodology Expressed in Testimony versus the Appraiser's Methodology as Expressed in Another Writing

An appraiser should be consistent in both appraisal report and his testimony. The Tax Court found that an appraiser was inconsistent in *Hunt & Sons, Inc. v. Comr.*,[66] noting that the taxpayer's appraiser was inconsistent between his report and a letter that he had written to the IRS.

Unreasonably Low Projections

In *Wright Est. v. Comr.*,[67] the Tax Court called down an appraiser for making unreasonably low projections.

Failure to Add Back Depreciation Included in Costs-of-Goods-Sold Computation in the Computation of EBDIT

In *True Est. v. Comr.*,[68] the Tax Court noted that one of the taxpayer's experts failed to add back depreciation that had been included in cost of goods sold in the computation of EBDIT.

Combining the Discount for Lack of Control with the Discount for Lack of Marketability

Most appraisers recognize these discounts as separate and distinct, although some appraisers do combine the discounts in particular situations. Nevertheless, the Tax Court was not buying it in *True Est. v. Comr.*[69]

---

[64] See, e.g., ASA BVS-I Section (III)(A) and IBA Business Appraisal Standard Sections 4.3(b) and 5.3(b).
[65] 112 T.C. 130 (1999).
[66] T.C. Memo 2002-65.
[67] T.C. Memo 1997-53.
[68] T.C. Memo 2001-167.
[69] T.C. Memo 2001-167.

> *[W]e cannot evaluate the reasonableness of the final [appraiser] report's minority discount relative to [the appraiser's], because of [another appraiser's] combined discount approach. We are not convinced that using a combined discount is appropriate, inasmuch as marketability and minority discounts are conceptually distinct.*

Utilizing an Assumed Income Tax Rate That Differed from the Actual Past Tax Rates of the Subject Company

It is important that the appraiser use the actual facts when making assumptions in an appraisal. The IRS appraiser made a large error in this regard relative to corporate tax rates in *Furman v. Comr.*:[70]

> *Finally, we question [the appraiser's] use of a 40 percent marginal tax rate in computing WACC, when the marginal tax rates derived from FIC's income statements for FY 1979, FY 1980, and FY 1981 are 4.96 percent, 1.25 percent, and 31.69 percent, respectively.*

Disconnect between Assumption about When Revenues or Expenses Would Be Received or Incurred and When Those Items Were Actually Received or Incurred

Appraisers often assume that revenues or expenses will be incurred or received on the last day of a period, although they often use what is called a mid-year convention, in which the items are recognized as occurring in the middle of the year. However, where appropriate, the revenues and expenses should be estimated when actually received or incurred. That was the case in *Lehmann Est. v. Comr.*:[71]

> *In addition, [the appraiser] treated the net cash flows arising from the lease as being received upon the last day of the year. The lease agreement, however, specifically provides that the lessee is to pay the rent on the first of each month. Further, the partnership had a cash balance of $64,339 as of the valuation date. [The appraiser's] analysis does not provide adequate support or explanation of treatment of that cash or his assumptions regarding the projected interest income.*

Error in Computing Terminal Value When Using the Income Approach

It is noteworthy that in most appraisals that utilize a discounted cash flow or present value of income approach, the bulk of the value may well be in computing the terminal value, that is, the present value of the cash or income streams after a certain number of years out into the future. In *Freeman Est. v. Comr.*,[72] the taxpayer's appraiser made an error in computing the terminal value of the subject company that resulted

[70] T.C. Memo 1998-157.
[71] T.C. Memo 1997-392.
[72] T.C. Memo 1996-49.

in a 17 percent correction of the conclusion of value of the stock per share (from $4.94 to $4.20).

Discounting an Income Stream Only at or Close to the Risk-Free Rate

Whether an appraiser uses a build-up method in the income approach or uses WACC, the appraiser must compare his capitalization or discount rate to the then-current risk-free rate. In *Bennett Est. v. Comr.*,[73] appraisers for both sides failed to do so:

> *An 11-percent discount rate was used by both [the appraiser] and [the other appraiser] to determine the present value of the ground lease. However, as the Estate's counsel pointed out at trial, this rate is only 0.2 percent higher than the then-current rate on 30-year Treasury bonds, which are normally considered to be risk-free investments. Thus, we have concluded that a higher rate, which more accurately reflects the risks associated with receiving the rent payments and the difficulties experienced by the Mall, is appropriate in this case.*

In *Furman v. Comr.*,[74] the appraiser used WACC and failed to perform a sanity check of his result:

> *First, [the appraiser] modified the WACC formula by weighting FIC's debt and equity based on book value, rather than market value, to arrive at a WACC of 11.0 percent. Considering that the parties have stipulated risk-free rates of 11.86 percent and 14.4 percent in 1980 and 1981, respectively, it is obvious that [the appraiser's] result is incorrect.*

In *Bell Est. v. Comr.*,[75] the same thing happened:

> *The mean average of U.S. Treasury bonds and notes at the time was 12.33 percent according to the expert. This represents the rate of return an investor would expect on risk-free, intermediate, and long-term investments generating taxable income. The expert gave no explanation for why the rates applied in his excess earnings method were lower than the U.S. Treasury bond and note rates despite the comparatively higher risk that investment in Bell companies' stock presented.*

Modifying or Abandoning Positions Taken in the Written Appraisal Report during the Appraiser's Testimony

Courts become suspicious of appraisers who, during their testimony, abandon or significantly modify a position taken in the valuation report. This happened in

[73] T.C. Memo 1993-34.
[74] T.C. Memo 1998-157.
[75] T.C. Memo 1987-576.

Fleming Est. v. Comr.[76] to appraisers for both sides, causing the Tax Court to have problems with the work of both appraisers:

> *At trial, [the appraiser] and [the other appraiser] modified and/or abandoned portions of their respective expert reports, as follows: In applying the market approach to valuing the stock interest in question, petitioner's expert modified his application of the market multiple method (modified market multiple method), and respondent's expert modified his application of the transaction method (modified transaction method) and abandoned his determination of value under the market multiple method. Consequently, both experts modified their respective opinions of the fair market value on the valuation date of decedent's 50 percent stock interest in B&W Longview. We have problems with the opinions of both experts.*

Referring to a Standard Industrial Code in the Appraisal Report without Identifying That Number in the Report

It is imperative that an appraiser identify significant information in the appraisal report. In *Jann Est. v. Comr.*,[77] the appraiser failed to do that:

> *Specifically, [the appraiser's] report referred to comparable companies but did not identify them; did not state whether [the appraiser] 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.*

Relying upon Guideline Companies That Were Not Comparable to the Subject Company

Unlike many other terms in appraising, the term *guideline company* is not defined, which means that whether a company is a guideline company is really part of the appraiser's professional judgment. Rev. Rul. 59–60 gives relatively little guidance about what a comparable or guideline company is, except "companies engaged in the same or similar line of business are selling in a free and open market." Rev. Rul. 59–60 merely gives two examples of what would *not* be considered a guideline company:

> *Corporation having one or more issues of preferred stock, bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.*

[76] T.C. Memo 1997-484.
[77] T.C. Memo 1990-333.

What, then, makes a company a guideline company? The ASA requires that there must be a "reasonable basis for comparison"[78] to the subject company. The AICPA Statement on Standards for Valuation Services encourages appraisers to include a description of the process used in the selection of guideline companies in the valuation report.[79] In many respects, the appraiser's process of selecting guideline companies and inclusion of a description of that process in the valuation report is what is most important to taxpayers and their advisors.

The Tax Court has observed that there are "guideposts in determining comparability,"[80] including capital structure, credit status, depth of management, personnel experience, nature of competition, and maturity of the business.

Courts have disregarded appraisers' selections of guideline companies due to:

1. Size: *Knight v. Comr.*,[81] *Hendrickson Est. v. Comr.*[82]
2. Profitability and asset makeup: *Luton Est. v. Comr.*,[83] *Knight v. Comr.*, supra.
3. Operating characteristics: *Hendrickson Est. v. Comr.*, supra.
4. Product mix: *Zaiger Est. v. Comr.*[84]
5. Significant sales in markets other than that engaged in by the subject company: *Brookshire Est. v. Comr.*[85] In *Ansan Tool & Manufacturing Co., Inc. v. Comr.*,[86] the Tax Court observed:

> *Mindful of [the appraiser's] admonition that "not every firm in the sample will be identical to the subject firm [petitioner]," it appears that the corporations were selected merely because they all had the same Standard Industrial Classification code numbers.*

Preparing and Utilizing Earnings Projections That Vary Significantly from the Earnings Projections Prepared by the Subject Company

Given that the income approach is a forward-looking measure, appraisers inquire about whether a subject company has prepared income projections. Where an appraiser has obtained income projections from a subject company, the appraiser either needs to use those projections as is or explain very carefully why those projections were either disregarded or altered. This happened in *Wall v. Comr.*:[87]

[78] ASA BVS-V Section (III)(A).
[79] AICPA Statement on Standards for Valuation Services Paragraph 61.
[80] *Tallichet v. Comr.*, T.C. Memo 1974-255.
[81] 115 T.C. 506 (2000).
[82] T.C. Memo 1999-278.
[83] T.C. Memo 1994-539.
[84] 64 T.C. 927 (1975).
[85] T.C. Memo 1998-365.
[86] T.C. Memo 1992-121.
[87] T.C. Memo 2001-75.

> *If the 1992 EBIT and earnings actually projected by Demco were substituted for the erroneous amounts used by Ms. Walker, then Ms. Walker's appraisal of the Demco stock under her forecasted earnings approach would have been approximately $289 per share, approximately $77 per share higher than the forecasted earnings value set forth in her original report. The record does not disclose Demco's projected EBDIT for 1992.*

Use of Only One Year's Worth of Guideline Company Data

In order to have confidence in a conclusion of value based on a guideline company method, it is important to have sufficient data points. The Tax Court found one year's worth of data to have been insufficient in *True Est. v. Comr.*[88] Although the determination of the number of years of data is a matter of appraiser's professional judgment, we caution against sole reliance on this method when there is less than three years of guideline-company data.

Inappropriate Employment of a Discount to Make a Conclusion of One Valuation Approach Appear More in Line with Another

A significant example of this can be found in *Magnin Est. v. Comr.*:[89]

> *[The appraiser] testified that he applied a minority discount in this situation because if he did not then his market approach generally yielded a value higher than the value determined under his DCF approach. We do not find [the appraiser's] explanation for applying a minority discount in this situation to be satisfactory because it is not based on valuation standards, but rather on the fact that he is adjusting his valuation simply to yield a result closer to that produced under his DCF approach.*

Failing to Properly Calculate a Valuation Discount

Applying a valuation discount to less than all of the enterprise level value is problematic, as the Tax Court pointed out in *Wall Est. v. Comr.*:[90]

> *Nevertheless, we still conclude that [the appraiser's] market-based appraisal somewhat overstated Demco's value, in part because it did not apply a minority discount to the media note . . .*

[88] T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).
[89] T.C. Memo 2001-31.
[90] T.C. Memo 2001-75.

Inappropriate Use of a Price-to-Asset Multiple Where the Difference between Book Value and Asset Fair Market Value Is Not Close

One type of valuation multiple is a price-to-asset multiple, where the price of a guideline public company is a function of the book value of the company's assets. Appraisers must employ caution and professional judgment in the use of this multiple in valuing operating concerns. In *True Est. v. Comr.*,[91] the Tax Court disregarded an appraiser's use of this multiple.

Selection of Too Few Guideline Companies or Comparable Properties

In the market approach, it is suggested that, when an appraiser can find only a few guideline companies, use of the market approach may be contraindicated.[92] The Tax Court disregarded an appraiser's use of a market approach when the appraiser relied on a small number of guideline companies or comparable properties:

1. *Klukwan, Inc. v. Comr.*[93] (one guideline property)
2. *Hall Est. v. Comr.*[94] (one guideline company)
3. *Hunt & Sons, Inc. v. Comr.*[95] (one comparable property)
4. In *Heck Est. v. Comr.*[96] (two guideline companies selected but only one was used), the Tax Court stated:

> *[The appraiser] discussed the similarities and differences between both Mondavi and Canandaigua and Korbel, and he computed price to earnings and price to operating cashflow multiples for both Mondavi and Canandaigua. Nevertheless, when he applied those multiples to Korbel, he referred only to Mondavi, and he adjusted downward from the Mondavi figures. We fail to see how Canandaigua influenced [the appraiser's] guideline analysis. It appears to us that [the appraiser], himself, effectively disregarded Canandaigua as a guideline company.*

Selection of Too Few Performance Measures in the Guideline Company Method

In the market approach, it is as important to find a sufficient number of performance measures, that is, data points, as it is to find a sufficient number of guideline companies. In *Wall v. Comr.*,[97] the Tax Court observed:

[91] T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).
[92] Pratt with Niculita, *Valuing a Business*, 5th ed. (New York: McGraw-Hill, 2008), 274.
[93] T.C. Memo 1994-402.
[94] 92 T.C. 312 (1989).
[95] T.C. Memo 2002-65.
[96] T.C. Memo 2002-34.
[97] T.C. Memo 2001-75.

> *However, [the appraiser] used only four performance measures and three guideline companies to derive Demco's value; this is far fewer than the 12 measures and seven companies used by [the other appraiser] . . . Moreover, we note that [the appraiser] used only four performance measures; the multiples he used seemed to vary greatly from company to company, and his choice of multiples was not very well explained.*

Cherry Picking Valuation Multiples

In *Wall v. Comr.*,[98] the Tax Court had the following problem with the appraiser's selection of multiples:

> *Third, it did not use all the guideline company multiples but instead picked and chose among the lowest . . . [The appraiser's] use of the two or three lower multiple companies is inconsistent with the conclusion expressed elsewhere in her report that, even after the decline in Demco's earnings had been taken into account, Demco's profitability and risk levels were close to or at the industry norm. It also may be inconsistent with her conclusion that the seven companies she identified as comparable were in fact comparable to Demco.*

In *Gallo Est. v. Comr.*,[99] the Tax Court was even more pointed in its cherry-picking criticism:

> *In valuing Gallo under each of the five methods based on comparables that he used, [the appraiser] assigned to Gallo ratios that would result in the highest possible valuations. [The appraiser's] method was pervasive and absolute: he made no real attempt to compare Gallo with any of the individual comparables. Even if Gallo were an above-average company, which it was not when ranked among the comparables, it would be unreasonable to expect Gallo to be most attractive with respect to each and every ratio. None of the 16 comparables was so positioned.*

Using an Inexcusably Old Comparable Sale

The market approach is premised upon the use of sales that occur reasonably close in time to the valuation date. In *Hagerman Est. v. U.S.*,[100] 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 appraiser's] valuation of Farm 4 is seriously flawed.*

[98] T.C. Memo 2001-75
[99] T.C. Memo 1985-363.
[100] 81 AFTR2d Par. 98-771(C.D. Ill. 1998).

Inappropriate Reliance on Governance Document Restrictions in Establishment of Valuation Multiples

In *True Est. v. Comr.*,[101] the Tax Court rejected attempts by both of the taxpayer's appraisers to reduce the multiples selected under the guideline company approach for the depressing effect of the buy-sell agreement.

Stating the Wrong Date from a Comparable Sale

In *Anclote Psychiatric Center, Inc. v. Comr.*,[102] the Tax Court disregarded the IRS appraiser's work, in part because of defects in his appraisal report, which included characterizing a sale as having occurred in 1983 instead of 1985.

Mismatching the Valuation Dates of the Guideline Companies and the Subject Company in Computing Price Multiples

The price ratios of guideline companies do have significant date relevance.[103] In other words, the dates of the financial statement ratios of the guideline companies should closely mirror those of the subject company. In *Hall Est. v. Comr.*,[104] the Tax Court noted this:

> *In deriving a price-to-earnings ratio for Hallmark, PCA considered American Greetings' earnings for the five-year period ended February 28, 1982, approximately eight months before the valuation date and 10 months before the period ended December 31, 1982, which was used for Hallmark's earnings. [the appraiser] testified that if he had used American Greetings' earnings for the five-year period ended February 28, 1983, a period more comparable to the five calendar year period 1978 through 1982 used for Hallmark, his "functional relationship" would have produced substantial discounts for Hallmark's price-to-earnings ratio when compared to American Greetings.*

However, in *Hess v. Comr.*,[105] while the Tax Court determined that the mismatch was a mistake, it did not render the appraisal ineffective, stating:

> *The P/E ratios for the guideline companies that [the IRS appraiser] selected were based on those companies' earnings for the two most recent quarterly filings and the forecasts of the earnings for the next two cycles.[37] The P/E ratio for HII, however, was based on that company's financial information for the fiscal year ending July 31, 1995. Petitioners claim that good appraisal practice requires use of*

[101] T.C. Memo 2001-167, 390 F. 3d 1210 (10th Cir. 2004).
[102] T.C. Memo 1998-157.
[103] Pratt with Niculita, *Valuing a Business*, 5th ed. (New York: McGraw-Hill, 2008), 275.
[104] 89 T.C. No. 19 (1989).
[105] T.C. Memo 2003-251.

> *the same period of time for the guideline companies and the subject company. We agree with petitioners that the preferable comparison of historical and/or projected earnings should be made using consistent time periods. However, petitioners do not explain how the use of consistent time periods in the instant case would change [the IRS appraiser's] conclusions. Although this flaw in [the IRS appraiser's] analysis leads us to question its persuasiveness, we are not convinced that it renders his analysis wholly erroneous.*

Defining "Guideline Company" Too Narrowly

As we discussed earlier, there is relatively little guidance about what is a guideline company. However, the Tax Court determined that the IRS appraiser defined the term too narrowly in *Heck Est. v. Comr.*[106]

> *[The appraiser] argues that only companies that are "primarily champagne/sparkling wine producers like Korbel" constitute permissible guideline companies. Because no such publicly traded company existed, Dr. Bajaj rejected the market approach. We find [the appraiser's] approach to be unduly narrow (in theory), in light of the case law cited in the text.*

[106] T.C. Memo 2002-34.

CHAPTER 20

Random Practical Valuation Tips and Thoughts

This chapter contains a panoply of seemingly unrelated, yet invaluable, information that did not, considering each item, constitute enough material to warrant individual separate chapters in and of themselves. The topics covered in this chapter range from an introduction to the five main business appraiser organizations to practical tips that we offer based upon our combined 40 years of experience, which admittedly comes from different vantage points, which is, one from the standpoint of a business appraiser and the other from the standpoint of an estate planning attorney.

Discovery and Privileges

Although the areas of discovery and assertion of applicable privileges are the province of the lawyer, the business appraiser needs a working knowledge of these items because it may well be, and often is, that the appraiser is asked directly by the government to produce documents. Hence, an introduction to discovery and privilege is warranted. Moreover, this discussion will serve as a good introduction of these areas even to estate planning lawyers who are not litigators and accountants. Caution: This is only intended to be a very rudimentary introduction to discovery and privileges. The reader will, as they say, know enough to be dangerous!

There is a golden rule in file maintenance: Don't put anything (and we mean anything) in your file that you would not want to see on the front page of the *New York Times* or in a Tax Court opinion. It's as simple as that. One must remain very vigilant about the contents of a file, because it can be very embarrassing if extraneous materials, such as even misfiled information, come out in discovery or, worse yet, in court, because it can impact the credibility of the appraiser. This applies to all forms of correspondence, memos to a file, and phone notes.

Discovery is usually very broad, with fairly few limitations, for example, a fishing expedition[1] or assertion of a privilege, the latter of which we will discuss later in this

[1] See, e.g., *Missouri Pacific Railroad Co. v. United States,* 168 Ct.Cl. 86, 338 F.2d 668, 670 (1964).

section of this chapter. In fact, there is a strong legal presumption in favor of discovery. The bottom line is that most things can be discovered, especially when one is a party to an action, even if the action might not be susceptible to introduction into evidence under the evidentiary rules.

In tax matters, one also must contend with the extremely broad subpoena powers of the IRS. The source of this broad power is set forth in IRC Sec. 7602(a), which provides as follows:

> *For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized—*
>
> 1. *To examine any **books, papers, records, or other data which may be relevant or material** to such inquiry;*
> 2. *To **summon** the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and*
> 3. ***To take such testimony of the person concerned**, under oath, as may be relevant or material to such inquiry. [Emphasis added]*

As a simple read of this provision reveals, not only may the IRS examine relevant or material information, it may summon the person to testify under oath. The IRS power to summon is subject to all applicable privileges.[2] However, one of the key takeaways from this chapter should be that privileges are pretty limited in scope, much more so than the IRS powers to examine and summon, and privileges must be timely asserted by the right person. Not just anyone has the right to assert a privilege, and it is fairly easy to be deemed to have waived a privilege.

Just because the IRS summons a person to appear before it does not always mean that the person must comply. The IRS must show that the summons (1) was legitimately issued, (2) seeks relevant information that the IRS does not have, and (3) satisfies all administrative steps required by the United States Code.[3] Because the information sought must only be relevant, as opposed to being capable of introduction in a court of law, it usually is very easy for the IRS to meet this standard.

There are several relevant privileges that possibly come into play with respect to a tax audit or tax litigation. These privileges are the attorney-client privilege, the attorney work product privilege, and the tax practitioner privilege under IRC Sec. 7525(a). Of interest to business appraisers is that, at least in the Tax Court, there generally is no

---

[2] *U.S. v. Euge*, 444 U.S. 707 (1980).
[3] *U.S. v. Powell*, 379 U.S. 48 (1964).

appraiser-client privilege.[4] As we discuss later in this chapter, appraisers should assume that every appraisal will be subject to contest in the Tax Court, because that is the most conservative position that one can take.

The Tax Court's rationale in *Halas Est. v. Comr.* was principally buttressed by the fact that, at that time, Sec. 3.6 of the ASA Code of Ethics provided:

> *Since the general public welfare is often involved in the execution of valuation assignments, the appraiser has an obligation and responsibility to the general public that supersedes the appraiser's obligation to his client.*

Though we are aware of no discussion on this point, even though Sec. 3.6 is no longer in the ASA Code of Ethics, the damage has been done, at least in the Tax Court. Query whether someone could make an argument for an appraiser-client privilege in either the Claims Court or a federal district court. We think that this would be a steep uphill battle. In *Halas Est. v. Comr.*, the Tax Court analogized the duty of the appraiser to that of a Certified Public Accountant (CPA). There is no confidential accountant-client privilege in federal law.[5] Since many CPAs also are appraisers, the likelihood of a CPA appraiser successfully asserting such a privilege seems remote. It also strikes us as almost as remote for a non-CPA appraiser to successfully assert such a privilege.

Attorney-Client Privilege

Many lawyers naively believe that this privilege covers the waterfront and protects the lawyer from having to disclose any client information. That's not quite the way that it works. For starters, the privilege does not belong to the lawyer; it belongs to the client. It is the client who must assert the privilege in a timely manner.

The second general misconception that most nonlitigators have about the attorney-client privilege is exactly what it covers. Generally, the attorney-client privilege only covers confidential communications between a lawyer and his client that were made for the purpose of the rendering of legal advice.[6] The purpose of the attorney-client privilege is to encourage clients to make complete and frank disclosures to the attorney to facilitate the rendering of accurate and proper legal advice.[7] Therefore, if the communication was not for the purpose of rendering legal advice, it is not covered.

What communications between the lawyer and a third party, for example, a CPA and business appraiser, are covered? The only communications with third parties that are covered by the privilege are those that are made in confidence to assist the lawyer in rendering legal advice to the client.[8] Thus, communications with third parties that are not made in confidence are not covered. Suppose that

[4] *Halas Est. v. Comr.*, 94 T.C. 570 (1990).

[5] *United States v. Arthur Young*, 465 U.S. 805 (1984).

[6] See, e.g., *Swidler & Berlin* and *James Hamilton v. United States*, 524 U.S. 399 (1998).

[7] See, e.g., *Upjohn Co. v. United States*, 449 U.S. 383 (1981).

[8] See, e.g., *United States v. Adlman*, 68 F. 3rd 1495 (2nd Cir. 1995).

the client hired the business appraiser directly, and that the client's lawyer communicated with the client's business appraiser. In this situation, the attorney-client privilege arguably would not apply because the business appraiser was hired by the client, not by the lawyer, and further that there was no reasonable expectation of privacy for the client in such a situation. The moral of the story: have the lawyer hire the appraiser.

The big problem with the attorney-client privilege is that it is very fragile and can easily be deemed to have been waived. Suppose the same fact pattern as earlier. Suppose further that there is a meeting attended by the client, the business appraiser, the lawyer, and the client's CPA for the purpose of conducting due diligence for the appraisal. In this scenario, the presence of the third party, the client's CPA, might give rise to a claim of waiver because the primary purpose of the meeting for the appraiser's benefit and was not solely for the purpose of, and was necessary to, the lawyer providing legal advice to the client. Tread very carefully here and with all third-party communications.

Attorney Work Product Privilege

The scope of the attorney work product privilege (also known as the attorney work product doctrine) is usually even less understood by nonlitigators than the attorney-client privilege. And it is a lot less broad in one important respect. The work product privilege only applies to documents that are prepared "in anticipation of litigation."[9] Query: Could one take the position that every estate or tax planning document is prepared in anticipation of eventual litigation with the IRS or other taxing authority? It is very doubtful that one could successfully assert this position.[10] Additionally, most appraisal engagement agreements stipulate that the work product is for a given specific purpose and that testimony to defend the report is not part of the engagement; rather, testimony is a separate process that the client acknowledges is not part of the fee arrangement for the appraisal. This type of engagement qualification suggests that the appraisal was not intended for litigation. Counter to the presumption that all tax appraisals are subject to eventual litigation is the posture that a well-crafted appraisal will keep one out of court.

In one important respect, the attorney work product privilege is broader than the attorney-client privilege. The attorney work product privilege covers documents prepared by third parties, which is, not just those documents prepared by the lawyer. Thus, if a lawyer hired the business appraiser to appraise a client's business in connection with a tax dispute, and that appraiser prepared a draft valuation report that the IRS wants in either response to a summons/request for documents or a discovery

[9] Fed. R. Civ. P. 26(b)(3).

[10] See, e.g., *United States v. Adlman*, 96-2 USTC ¶ 50,493 (S.D.N.Y. 1996), which, in denying assertion of the attorney work product privilege involving a tax matter, determined that the subject documents were prepared not in anticipation of litigation but in connection with whether or not to engage in a transaction.

request made in ongoing tax litigation, that draft report should be shielded from discovery through the attorney work product privilege.[11] The moral of the story: have the lawyer hire the appraiser.

Another potential problem with the codified attorney work product privilege is that it is not absolute. If a litigation opponent can successfully demonstrate a "substantial need," the court can order that the subject documents be provided to the opposition even if the attorney work product privilege otherwise applies.[12]

Tax Practitioner Privilege

Somewhat in response to the broad ruling in favor of the IRS in *United States v. Arthur Young*,[13] Congress enacted IRC Sec. 7525, which provides a limited tax-practitioner privilege for tax advice given to a client by a person who is authorized to practice before the IRS in matters not involving criminal activity[14] or tax shelters.[15] Unfortunately, this privilege does not apply to tax return preparation advice.[16] This privilege does not include a work product privilege, too.[17] Again, watch waiver here.[18]

A Free Standing, Complete Report, or a Mere Letter or Restricted Use Appraisal Report?

Estate and tax planning should be conservative unless clients are willing to be guinea pigs and possibly subject themselves to opportunity costs due to other techniques not used as well as possible interest and penalties. In order to be conservative, clients and appraisers must assume that the IRS will attack *every* tax appraisal. And if attacked, clients and appraisers must conservatively assume that the matter will wind up in court.

There are three possible forums in which tax matters are litigated: two refund forums that require full payment of the contested taxes, penalty, and interest; and the Tax Court, where prepayment is not required. Proposed audit adjustments involving valuation are often very large.[19] One should conservatively assume that

[11] Fed. R. Civ. P. 26(b) and 28. However, see *McKay v. U.S.*, 372 F. 2d 174 (5th Cir. 1967); *Brown v. U.S.*, 478 F. 2d 1038 (7th Cir. 1973); and *U.S. v. Meyer*, 398 F. 2d 66 (9th Cir. 1968).
[12] Fed. R. Civ. P. 26(b)(3).
[13] 465 U.S. 805 (1984).
[14] IRC Sec. 7525(a)(2).
[15] IRC Sec. 7525(b).
[16] See, e.g., *U.S. v. BDO Seidman*, 337 F. 3rd 802 (7th Cir. 2003).
[17] See, e.g., *U.S. v. KMPG, LLP*, 237 F. Supp. 2d 35 (D.C. D.C. 2002).
[18] See, e.g., *Evergreen Trading, LLC v. U.S.*, No. 06-123T (Cl. Ct. 2007).
[19] See, e.g., *Newhouse Est. v. Comr.*, 94 T.C. 193 (1990), where there was more than $1 billion at issue considering proposed additions to tax, together with penalties and interest.

the taxpayer will lack the cash to prepay the tax, penalties, and interest at the time of the litigation, so the matter will get litigated in the Tax Court because one does not have to pay to play. Therefore, the most conservative least common denominator for a valuation report is to assume that the Tax Court rules will ultimately apply.

Like all other courts, the Tax Court has some procedural rules that are intended to streamline litigation. One such rule is Tax Court Rule 143(g)(1), which provides in pertinent part as follows:

> *Unless otherwise permitted by the Court upon timely request, any party who calls an expert witness shall cause that witness to prepare a written report for submission to the Court and to the opposing party. The report shall set forth the qualifications of the expert witness and shall state the witness's opinion and the facts or data on which that opinion is based.* ***The report shall*** *set forth in detail the reasons for the conclusion, and it will* ***be*** *marked as an exhibit, identified by the witness, and received in evidence as* ***the direct testimony of the expert witness****, unless the Court determines that the witness is not qualified as an expert.* ***Additional direct testimony with respect to the report may be allowed to clarify or emphasize matters in the report, to cover matters arising after the preparation of the report, or otherwise at the discretion of the Court.*** *[Emphasis added]*

As one can plainly see, the Tax Court almost always restricts the ability of an expert witness to supplement his or her report on direct testimony, and it rarely permits supplementation.[20] Compounding this limitation is the fact that appraisals may lie dormant for a very long period of time, particularly with respect to estate and gift tax cases, although this is certainly not limited to estate and gift tax cases.

A whole host of things can happen between the time that the business appraisal is conducted and the time that the appraisal is attacked. In the interim, something may happen to the appraiser before the matter is brought to trial. Data may be lost. Indeed, entire files of a business appraiser may either be lost or destroyed, even in the ordinary course of business.[21] Therefore, the safest and most conservative type of business appraisal report is the wholly contained, full and complete business appraisal report since a well-written business appraisal report will contain and preserve all the data necessary to replicate the results and thinking of the business appraiser.[22] Obviously, sometimes clients only want a summary or letter report. As a result, for purposes of file retention, business appraisers should view these appraisal files as different from files for complete reports and perhaps should keep the workpapers for these files for a longer period of time.

[20] See, e.g., *Whitehouse Hotel Limited Partnership v. Comr.*, 131 T.C. No. 112 (2008), rev. and rem. No. 09-60085 (5th Cir. August 10, 2010).

[21] See, e.g., *Lawton v. Bank of America Corp.*, No. 2010 WL 1508922 (D.R.I. April 14, 2010).

[22] See, e.g., IBA Business Appraisal Standard 1.8 and NACVA Professional Standard 4.3.

Those Business Appraisers Must Be Identified in Time

Courts are increasingly procedurally complex these days. When a judge dictates the time for appraisers to either be identified or to have their expert reports in, that judge almost always means it.[23] Generally, the penalty for tardiness is draconian: exclusion of the appraiser's report from evidence and even a prohibition against the appraiser even testifying. Although a business appraiser does not have to be bothered with such procedural issues, that being the province of the lawyer, the business appraiser nevertheless should inquire about the deadlines because they could impact the due date of the appraisal to be performed.

Should a Business Appraiser Always Follow USPAP?

There are no commonly agreed to generally accepted appraisal standards, such as GAAP. As we have discussed in Chapter 11, ASA appraisers must generally follow USPAP, whereas other business appraiser organizations do not always have to do so. Assume that a business appraisal is prepared for tax purposes. What guidance is there for estate planners and business appraisers to follow in tax law relative to valuation standards?

IRC Sec 170(f)(11)(E)(i)(II) makes a reference to "generally accepted appraisal standards," which is to be defined by regulations. Notice 2006–96, 2006–46 IRB 1 provides temporary guidance pending the issuance of regulations (which have not been issued to date), defining "generally accepted appraisal standards" as "consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP)." The regulations under IRC Sec. 4942 make reference to "commonly accepted methods of valuation" and then deem the valuation principles expressed in Treas. Reg. Sec. 20.2031 "acceptable" (Treas. Reg. Secs. 53.4942[a]-2[c][4][b] and [c]). See also the reference to "generally accepted real property valuation rules" in Treas. Reg. Sec. 20.2032A-4(d).

Therefore, for tax purposes, business appraisal reports for taxpayers, but not the IRS,[24] must comply with USPAP even if the business appraiser is not otherwise required to comply with USPAP. It is imperative that the business appraisal report prepared for tax purposes comply with USPAP.

---

[23] See, e.g., *Fisher v. U.S.*, No. 06-351 T (CL. Ct. 2007) (taxpayer's appraiser's report was excluded); and *Kolczynski Est. v. Comr.*, T.C. Memo 2005-217 (taxpayer's appraiser's report was excluded).

[24] See, e.g., *Whitehouse Hotel Limited Partnership v. Comr.*, 131 T.C. No. 112 (2008), rev. and rem. No. 09-60085 (5th Cir. August 10, 2010); and *Schwartz v. Comr.*, No. 08-3171 (not precedential) (3rd Cir. 2009). But see *Kohler v. Comr.*, T.C. Memo 1996-152, where the IRS appraiser did not use USPAP, and the Tax Court essentially disregarded that appraiser's analysis.

How Much Input Can a Client's Advisor Have in the Preparation of a Business Appraisal Report?

It is axiomatic that the work of the business appraiser be solely the work of the appraisers who sign the valuation report.[25] This means that neither a client nor client's counsel or CPA can have significant input in the analysis or conclusions of the report. Indeed, the Tax Court has excluded appraisal reports from evidence on the basis of overly involved counsel.[26] With this as a backdrop, we tackle the question.

We believe that both clients and advisors must play a key role in the business appraisal process. This is particularly true in the fact-gathering and due-diligence phases of a business appraisal engagement. We have all encountered clients who are not always forthcoming with all of the requested information, whether that information would have (often in the client's mind) either a positive or negative impact upon the ultimate conclusion of value. Advisors often act well as a go-between the business appraiser and the client in the information-gathering phase and sometimes have to coerce and cajole the client to turn over the requested information. Sometimes, it is a matter of the client not understanding why the business appraiser must have certain information. In this situation, the advisor, whose relationship with the client is almost always closer than that of the business appraiser can play an invaluable role in explaining, sometimes delicately, the need for certain requested information to the client.

Advisors also can, and often do, play a key role in reviewing draft business-appraisal reports for accuracy and possibly even provide guidance on legal or accounting questions that are germane to the business appraisal report. Attorneys can also play a key role in the draft review phase by reviewing the report for consistency and errors. The best way for an advisor to handle this phase, when corrections are perhaps needed, is to make written suggestions to the business appraiser and make it clear that the final call is up to the business appraiser. It is perhaps best to memorialize those suggestions in writing and to refrain from suggesting particular language to include in the appraisal report if the advisor's role is ever questioned by the other side or by the court.

If the lawyer is the one who hired the business appraiser, then the lawyer can play a key role in facilitating the communications that transpire in connection with the appraisal engagement.

Types of Appraisers; Appraisal Associations

The appraisal profession has become very specialized. Significant increases in the number of recognized specialty designations have been created by appraisal trade associations in just the past few years. Appraisers tend to fall into three

[25] See, e.g., 2010-11 USPAP Standards Rule 10-3; IBA Business Appraisal Standard 1.25(b); AICPA SSVS Paragraph 65(a); ASA BVS VIII(II); and NACVA Professional Standard 4.3(a)(20).

[26] *Bank One v. Comr.* 120 T.C. 174 (2003) (taxpayer's business appraisal report); and *Noble Est. v. Comr.*, T.C. Memo 2005-2 (the IRS's business appraisal report).

main categories: (1) real estate, (2) business, and (3) personal property; although there are obviously subcategories within the main categories. With one exception discussed later, most appraisal trade associations tend to involve only one of the valuation subcategories. The number of appraisal trade associations also has grown in recent years.

The business valuation profession is one that can still be most accurately described as in its embryonic state. The first business valuation professionals were real estate appraisers and securities analysts.

The estate planner should have a working knowledge of the various appraisal trade associations and the designations offered by each organization in order to be able to evaluate potential appraisers and to cross-examine opposing appraisers. The professional training and credentials of an appraiser are important to courts, and since perceived defensible value is the ultimate goal, the credentials of those giving such opinions has never been more important.

General Appraisal Professional Organizations

AMERICAN SOCIETY OF APPRAISERS Founded in 1936, the American Society of Appraisers (ASA) is a multi-appraiser discipline association that provides accreditation in several appraisal subspecialties: (1) business valuation, (2) gems and jewelry, (3) machinery and technical specialties, (4) personal property, (5) real property, and (6) appraisal review, generally at two different experience levels: associate member (AM) and accredited senior appraiser (ASA as well). Additionally, the ASA offers a designation of Master Gemologist Appraiser. The ASA also offers subspecialties within some of the categories, such as personal property-artwork, with which the appraiser's ASA or AM designation is associated.

In order to qualify for the AM designation, a candidate must have a college degree, two years of appraisal experience, completed four courses and a qualifying exam, together with peer review of an appraisal report prepared by the AM candidate. The ASA designation candidate must become an AM and then obtain an additional three years of appraisal experience prior to attaining ASA status. The ASA also confers the prestigious FASA designation upon an ASA who has been voted into the College of Fellows based on the ASA's leadership and professional contributions to the appraisal profession. The ASA maintains a Principles of Appraisal Practice and Code of Ethics and is headquartered in Herndon, Virginia.[27] Members of the ASA are subject to USPAP.[28]

APPRAISAL INSTITUTE Founded in 1932, the Appraisal Institute is an organization of real estate appraisal professionals. The Appraisal Institute offers three separate and distinct designations: Member, Appraisal Institute (MAI); Senior Real Property Appraiser (SPRA); and Senior Residential Appraiser (SRA). However, all three designations are subject to peer review and must comply with the Appraisal Institute's Code of Professional Ethics.

[27] For more information on the ASA, go to www.appraisers.org.
[28] ASA BVS General Preamble (II).

BUSINESS APPRAISAL PROFESSIONAL ASSOCIATIONS The most significant business appraisal professional associations are the ASA, Institute of Business Appraisers (IBA), National Association of Certified Valuation Analysts (NACVA), the CFA Institute (CFA), American Institute of Certified Public Accountants (AICPA) and Canadian Institute of Chartered Business Valuators (CICBV).

ASA The ASA offers the designations in business appraisal that were discussed in the preceding section. In addition to its Standards of Practice and Code of Ethics, the Business Valuation Committee of ASA publishes *Business Valuation Review*, a quarterly publication, as well as Business Valuation Standards, which are included in this book. As noted earlier, members of the ASA who specialize in business valuation are subject to USPAP.

IBA Founded in 1978, the IBA offers four primary designations: Certified Business Appraiser (CBA), Master Certified Business Appraiser (MCBA), Accredited by IBA (AIBA), Business Valuator Accredited for Litigation (BVAL), and Accredited in Business Appraisal Review (ABAR). The CBA requires a four-year college degree, completion of 24 hours of IBA coursework, successful completion of an examination, successful review of two business appraisal reports prepared by the candidates, personal references, and five years of full-time active experience as a business appraiser.

The MCBA must have held the CBA designation for at least five years, have a two-year postgraduate degree, and must possess at least ten years' experience as a business appraiser. Additionally, the MCBA must also "hold a journeyman level professional designation awarded by one or more compeer professional business appraisal societies."[29] AIBA, BVAL, and ABAR are fairly new designations.[30]

The IBA does not require its certified members to comply with USPAP, but many members of IBA are required to comply with USPAP with virtue of holding certifications of other organizations, for example, ASA, that do require their members to comply with USPAP. Like the ASA, the IBA also has a fellow designation (FIBA) for members who have been voted into its College of Fellows on the basis of technical leadership and contributions to the appraisal profession.

NACVA Founded in 1991, NACVA offers three designations: Certified Valuation Analyst (CVA), Accredited Valuation Analyst (AVA), and Certified Forensic Financial Analyst (CFFA). The CVA requires a valid and unrevoked CPA license, completion of a five-day training program, and successful passage of an examination. The AVA does not require a CPA license but does require at least two years of business valuation experience and completion of 10 or more business valuation engagements in which the candidate's involvement was referenced in the report, completion of a five-day course, and successful passage of an examination. NACVA has Professional Standards, and NACVA certified appraisers "may also find it necessary to consider guidelines and standards established by others, such as the Department of Labor, the IRS,

[29] The designations expressly referenced as considered are ASA, CVA of NACVA, and ABV of AICPA.

[30] Complete details about all four designations offered by IBA are set forth on the IBA web site: www.instbusapp.org.

state laws, and USPAP."[31] The ABV has recertification and continuing professional education requirements. NACVA publishes *The Value Examiner*, a bimonthly professional journal.

AICPA Tracing its history back to 1887, the AICPA offers the Accredited in Business Valuation (ABV) designation only to members of AICPA who hold CPA licenses, and a CPA may hold himself out as an ABV as long as he is a member in good standing of the AICPA. The AICPA also offers a Certified in Financial Forensics (CFF) designation. ABV candidates must have passed an examination and have performed significant services in connection with at least 10 valuations. The ABV has recertification and continuing professional education requirements.[32] The AICPA publishes *The CPA Expert*, a quarterly publication.

CFA INSTITUTE Tracing its lineage back to 1947, the CFA Institute (formerly the Association for Investment Management and Research), is an association of investment/securities analysts and awards the Chartered Financial Analyst (CFA) designation. The business valuation discipline is finding increased relevance in a wide variety of investment and compliance related applications. As such, investment professionals are performing more valuation services, and noninvestment professionals are seeking the educational and benefits of the CFA Institute's program. CFA holders must pass a three-part examination and adhere to the CFA Institute standards and regulations.[33]

CANADIAN INSTITUTE OF CHARTERED BUSINESS VALUATORS Founded in 1971, the Canadian Institute of Chartered Business Valuators (CICBV) is the Canadian association of business appraisers. The CICBV offers one designation, the Chartered Business Valuator (CBV). In order to obtain the CBV designation, an individual must possess a degree from a postsecondary academic institution or university, complete six courses, achieve a passing grade on a membership entrance exam, and have accumulated 1,500 hours of business and securities valuation experience, as attested to by a sponsor.[34] The CICBV publishes the *Journal of Business Valuation*, a semi-annual publication and the *Business Valuation Law Review*, an annual publication. The CBV has continuing education requirements.

Random Strategy Tips

The following strategy tips consist of a combination of our experience and our opinions. There is never only one way to go about a particular task. However, we have learned the hard way on many of the following tips, so we offer them for consideration.

[31] Information about NACVA, including its designations and its Professional Standards are on the NACVA web site. www.nacva.com.

[32] Information about ABV is set out on the AICPA web site. www.aicpa.org.

[33] For more information about the CFA Institute, go to the organization's web site, www.cfainstitute.org.

[34] For more information about CICBV, go to the organization's web site, www.cicbv.ca.

Hire a Separate Rebuttal Appraiser to Protect the Independence of Your Main Appraiser

Many clients want the return or trial appraiser to do double duty, which is, not only testify on direct about his appraisal but rebut the testimony of the opponent's appraiser, in order to save costs. We think that this can be a big mistake as it potentially compromises the main appraiser in the eyes of the court because that appraiser is in essence forced into the role of advocate, which is, criticizing the other party's appraisal.[35] If the court determines that an appraiser is too active in the defense of a party, that appraiser's credibility and the force of the main appraisal will be eroded or even wholly disregarded.[36] In many modest litigated matters the likelihood of a separate rebuttal expert is admittedly remote. Therefore, appraisal experts should be keenly aware of holding their own work to the same level of accuracy and reasonableness charged of an opposing expert. Additionally, in direct testimony an expert should present a posture of objective balance when it comes to critical valuation assumptions and treatments (obviously such balance must come from the substance of the opinion rather than the form of the appraiser's testifying demeanor). At the end of the day, the expert providing the court with the most complete and balanced information will carry more credibility. This is simply harder to carry off when providing both direct and rebuttal testimony.

Watch Very Carefully What Ends Up in An Appraiser's Workfiles Because It Could Well Be Discovered

See *Nick Hughes v. Comr.*,[37] where, when referring to an appraisal pertaining to a conservation easement deduction, the words "Nick [the taxpayer] wants it Bigger!" ended up in the appraiser's workfiles and made its way into a footnote in the court's opinion. Such statements can give rise to a claim that the appraiser simply was doing the client's bidding and not acting independently.

Differences in Appraisal Reports Issued by the Same Appraiser of Interests in the Same Subject Company That Are Fairly Close in Time to One Another Should Be Well Explained[38]

One must assume that all appraisal reports will be discovered and plan in advance to explain these differences in detail. If there are significant differences in methodology or valuation approach used by the same appraiser to value an interest in the subject company, the opposition, for example, IRS, could argue that the results were predetermined. Therefore, it is imperative that these differences be well explained. One should assume that the opposition will attempt to exploit those differences and take preemptive action to explain them in detail before they are called into question.

[35] See, e.g., *Gross v. Comr.*, T.C. Memo 1999-254 aff'd 272 F. 3d 333 (6th Cir. 2001); *Litchfield Est. v. Comr.*, T.C. Memo 2009-21.
[36] See, e.g., *Laureys v. Comr.*, 92 T.C. 101 (1989); *Mueller Est. v. Comr.*, T.C. Memo 1992-284.
[37] T.C. Memo 2009-94.
[38] See, e.g., *Mosher Est. v. Comr.*, T.C. Memo 1988-24.

The existence of secondary or recent appraisal work product from a given appraiser regarding a given subject interest is rising given the recent USPAP disclosure requirements.

Differences in Appraisal Reports of Interests in the Same Subject Company Issued by Different Appraisers That Are Fairly Close in Time Should Be Well Explained

Although you might not know that other business appraisers have appraised interests in the same subject company, this must be a part of the due diligence. If there are significant differences in methodology or approach, for example, a prior appraisal disregarded a guideline company approach because the appraiser could not find any suitable guideline companies, while the subsequent appraisal relies upon a guideline company approach and cites several guideline companies. This is a significant difference that must be explained.

Appraisal Reports of Valuations of Interests in the Same Subject Company That Are Issued by Different Appraisers at the Same Time or Fairly Close in Time with One Another Should Be Explained and Coordinated

Again, a business appraiser must inquire in the due diligence phase as to prior and even ongoing appraisals and must explain any significant differences in methodology, particularly if the IRS has accepted the prior appraisal methodology for interests in the subject company in the past. This can happen in any number of different contexts, for example, an annual valuation engagement or an appraiser retiring or dying.

How Long Should an Appraiser Maintain a File and Workpapers?

The answer is, "It depends." With respect to gift tax appraisals, the appraiser should maintain this file and associated workpapers arguably until the owner of the subject interest dies and his or her estate tax return is accepted with no changes by the IRS. Why? This is because gifts can be revalued for estate tax purposes, even after the gift tax statute of limitations has tolled. For estate tax and income tax appraisals, we believe that the minimum time that appraisals that were filed with a tax return and associated workpapers should be retained for at least six years after the return is filed, which is the statute of limitations period for the IRS to raise a substantial omission of items leading to additional amounts of tax.[39]

With respect to appraisals that are prepared in connection with an audit or with litigation, the file should be retained until a judgment becomes final and nonappealable or is settled. For other appraisals, there really is no specific recommended period of time, but the applicable valuation standards should be treated as the *minimum* amount of time that a file should be retained. The answer to the original question posed is that business appraisers should spend more time evaluating how much time a file and workpapers for a particular appraisal should be retained and do

[39] IRC Sec. 6501(e).

it on an appraisal-by-appraisal basis. Slavish following of a one-size-fits-all document-retention policy probably should be avoided.

For example, if the client requests less than a full report, the workpapers for these engagements probably should be retained for a longer period of time since the workpapers will be necessary to refresh the appraiser's recollection of the facts and the data.

Should a Business Appraiser Ever Issue an Updated Report, as Opposed to a New Complete, Free-Standing Report?

Business appraisers should be very cautious about issuing mere updated reports in lieu of a new, complete report.[40] There is a great temptation to do this for reasons of cost to the client, for example, appraisals that are used for annual exclusion gifts or done annually. However, it's not the client's reputation on the line; it's the appraiser's reputation that stands to be sullied, especially if that mere update is the appraisal report that is used, as opposed to the original report being filed or used with the update. Query whether mere updated reports even qualify under USPAP and the various business valuation standards. For cases in which an update letter or report is issued, it seems virtually compulsory that the appraiser incorporate by reference the most recent full documented, free-standing report. Additionally, the appraiser should cite any relevant changes and additions to the previous opinion that impact the updated valuation analysis and conclusion. It is likely necessary that the updated report should contain all the functional exhibits and financial analysis to substantiate the updated opinion. Lastly, update reports should likely be avoided when the original, free-standing opinion becomes dated enough that an update is not suitable. The $64,000 question is when an appraisal report becomes "dated." One should conservatively assume that an appraisal has a fairly short shelf life absent some strong evidence to the contrary.

How Does One Go about Selecting a Business Appraiser?

In today's world, it is imperative that a business appraiser be both qualified and competent. How do we know if an appraiser is qualified? The tax law gives us some guidance in this regard. Treas. Reg. Sec. 1.170A-13(c)(5) defines the term "qualified appraiser" to include the following criteria:

- The appraiser must hold himself or herself out to the public as an appraiser or perform appraisals on a *regular* basis.
- The appraiser must be *qualified* to appraise the property in question.
- The appraiser must be *independent*.[41]
- The appraiser must *understand* that he or she can be subject to a civil penalty under IRC Sec. 6701 and may have appraisals disregarded.

[40] See, e.g., *Scanlan Est. v. Comr.*, T.C. Memo 1996-414.
[41] See also Treas. Reg. Sec. 301.6501(c)-1(f)(3).

This definition looks circular because of the requirement that an appraiser be qualified to appraise the subject property, which is an element of the definition of the term *qualified appraiser*. How does one determine whether an appraiser is *qualified*? In valuation, as in lots of things, *perception is everything*. Courts and the IRS are evaluating the work of business appraisers for taxpayers and looking for weaknesses. One identified weakness has been lack of experience. But another is lack of valuation credentials. Another big area of weaknesses is mistakes in the appraisal report.

So who should the attorney or client hire for the business appraisal engagement? For starters, one should hire a business appraiser who is certified by at least one of the big-five business appraisal organizations that we identified earlier in this chapter. Why? These organizations have applicable standards, codes of ethics, and rigorous certification and continuing education requirements. Although these requirements do not always necessarily equate to competence to handle a particular engagement, it is one of the best ways found so far to ensure quality because it demonstrates that the prospective appraiser has taken steps to remain current in the ever-changing world of business valuation theory. The Tax Court has recognized the importance of certification for appraisers.[42] Although there is no doubt that there are competent business appraisers who are not credentialed by one of the big five, the trend is decidedly in the direction of being credentialed.

How does a client or lawyer find an appraiser who is qualified to handle a *particular* engagement? What follows are some questions that a lawyer or client can ask a prospective appraiser:

- Has the prospective appraiser ever been subjected to disciplinary sanctions under Notice 85–18, debarred from practice before the IRS, or ever subjected to penalties under IRC Secs. 6695A or 6701?
- From what business appraisal organizations does the prospective appraiser have credentials, and what are those credentials?
- Has the prospective appraiser ever been retained by the IRS or served as a result of a court appointment?
- How often is the prospective appraiser's work relied upon in *real* transactions, which is, not just hypothetical tax matters?
- What is the expected turnaround time for receiving a draft report in the proposed assignment?
- Would the prospective appraiser have any problem with communicating a conclusion of value orally first?
- What is the prospective appraiser's estimate of a range for the expected costs of the appraisal?
- How would the prospective appraiser staff the proposed assignment?
- Does the prospective appraiser have experience or expertise with the particular industry in which the subject company operates?[43]

---

[42] See, e.g., *Ford Est. v. Comr.*, T.C. Memo 1993-580.

[43] See, e.g., *Cloutier v. Commissioner*, T.C. Memo 1996-49, where the Tax Court criticized the work of an appraiser who had little familiarity with the industry of the subject company.

- What methodologies would the prospective appraiser consider appropriate for the proposed assignment?
- Has the prospective appraiser ever testified before the IRS in tax matters? Has the prospective appraiser ever been qualified as an expert witness? If yes, in what courts? What was the final result in those matters? Has the prospective appraiser ever been denied expert status in court? If yes, why?
- Has the prospective appraiser ever been subjected to a successful Daubert objection? If so, what were the circumstances?
- What kinds of resources does the prospective appraiser have?
- Is the prospective appraiser's work going to be consistent with his or her past publications[44] or testimony?[45]

[44] See, e.g., *Caracci v. Comr.*, 118 T.C. 379 (2002), rev. 456 F. 3d 444 (5th Cir. 2006).
[45] See also *Mandelbaum v. Comr.*, T.C. Memo 1995-255, aff'd., 91 F.3d 124 (3rd Cir. 1996), in which Judge Laro criticized the taxpayer's expert for having taken contrary positions in other cases.

Praise for

A Reviewer's Handbook to Business Valuation

"In business valuation, you don't know what you don't know. What a business owner and their advisors should know about business valuations could fill a book. Fortunately, Paul Hood and Tim Lee have written it! In one place, you'll find the questions to ask, real-word guidance, the best, most understandable, primer on business valuation that you'll find anywhere, and a list of mistakes that others have made—so that you won't make them. Don't even think of authorizing anyone to start or work with you on a business appraisal—until you've read this book (and I'd insist all the professionals involved read it too)!"

—Stephan R. Leimberg, Publisher
Leimberg Information Services Inc.

"In 1999, Kumho Tire Co. brought business valuation into the realm of scientific evidence and under the requirements of Daubert. And yet, courts continue to struggle with their 'concerns about the reliability of [the appraiser's report]' (*Kohler v Commr.*, 2006) as much today as they did with this 'highly theoretical exercise' (*Reynolds v Commr.*, 1970) forty years ago. Has the business appraisal profession made any progress? Have we gotten any more 'scientific?' Never before has such a complete work been assembled to address the courts' concerns in this regard. *A Reviewer's Handbook to Business Valuation* is a powerful new resource instructing not only reviewers of business valuation as to how to identify issues—it is also a preparer's "must-have" checklist for reviewing their own work."

—Nancy J. Fannon, ASA, CPA/ABV, MCBA
Fannon Valuation Group

"Recalling the trite adage that one cannot learn to ride a bike by reading a book, Tim Lee successfully conveys complexities of the business valuation profession that can only be offered by someone with years of experience riding the business appraisal bicycle. Leveraging his career as a tax attorney, Paul Hood then takes Tim's contribution to the next level and bridges the chasm between providers and users of business appraisal services. Readers won't finish the book and then magically be able to ride the business appraisal bicycle. However, they will better understand the complexities and subtleties of the profession. More importantly, readers will be able to use the information to better serve their legal, accounting, and financial planning clients."

—Chris D. Treharne, ASA, MCBA, BVAL
Gibraltar Business Appraisals, Inc.

"Whether you are a business valuation professional or someone who works with valuation practitioners (attorneys, estate planners, CPAs), this book is for you. *A Reviewer's Handbook to Business Valuation* provides an overview of valuation processes and methodology and in-depth review of the prevailing business valuation standards. What I found most compelling were the chapters regarding alleged errors, as well as the practical tips and thoughts. As a seasoned valuation practitioner, it gives me a lot to ponder and many things to consider when I perform my next engagement."

—Linda B. Trugman, CPA/ABV, MCBA, ASA, MBA
Trugman Valuation Associates, Inc.

ISBN 978-0-470-60340-6
59500
9 780470 603406