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IRS Reveals Seven Mistakes of Highly Unsuccessful Appraisals

In recent conferences sponsored by business appraisal professional organizations and industry associations, the IRS has made an effort to discuss, on an informal basis, the most common reasons for auditing a business appraisal associated with a gift or estate tax return. Most of the following "red flags" will not surprise estate and gift tax attorneys (or their financial advisors) so much as confirm the areas that require continued professional oversight and appraisal expertise:

Discounts. The reasonableness of valuation discounts used in estate and gift tax appraisals is still a primary focus for the IRS, which will often flag discount conclusions that are not supported by the data or that apply study averages without sufficient explanation.

Standard of value. Likewise, the IRS is still seeing valuation reports that apply the fair value standard instead of fair market value, or consider the perspective of only one person (either the hypothetical willing buyer or the seller) rather than both.

Tax-affecting. Valuation of S corporations is another problematic area, in which the courts, valuation experts, and IRS examiners have not always been consistent. Rather than focus on the case law, attorneys and appraisers would be well-advised to carefully consider the particular facts and circumstances of any case. Related issues are tax considerations in C to S corporation conversions and the valuation of embedded capital gains tax liability.

Factual errors. Appraisal inaccuracies will also get the attention of the IRS. More than mere mathematical errors, these include presenting false information or assuming facts related to the appraisal that do not exist.

Valuation errors. Unfortunately, the IRS is still finding appraisals of business interests that purposefully include or exclude valuation approaches; ignore strong market evidence; or disregard professional standards. Many of these mistakes are made by individuals without the appropriate training or experience, and can be avoided by using qualified appraisers.

Analytical errors. The IRS is also finding appraisals that lack a strong, consistent factual development; an income stream that's inadequately or inappropriately matched to any adjustments (discounts); an incomplete tax rate analysis. Appraisals that supply a good "analytical fit" to the facts of a case clearly show how the valuation conclusions were reached; what adjustments were made; what data were used; and what law was relied on.

Documentation errors. Also watch out for: exhibits and computations that fail to follow the analytical narrative or are incomplete; and failure to document according to all relevant professional standards.

Tax Court Adopts Discount for Embedded Capital Gains but Declines Dollar-for-Dollar Rule

***Estate of Jensen v. Commissioner*, 2010 WL 3199784 (U.S. Tax Ct.)(Aug. 10, 2010)**

A wealthy widow held the majority (82%) of a private C corporation, which owned and operated real estate and improvements. At her death, the estate's appraiser used the net asset approach to value the corporation at just over $4.2 million, minus $965,000 for built-in long-term capital gains tax (LTCG) liability, calculated on a dollar-for-dollar basis. After applying a 5% marketability discount, the appraiser valued the decedent's share at $2.55 million.

The IRS agreed with the net asset value approach and the 5% marketability discount, but calculated a $250,000 discount for LTCG liability and assessed a deficiency of just over $333,000. (Interestingly, the IRS did not explain how it determined the LTCG liability in its deficiency notice.) The estate appealed to the Tax Court, claiming a 100% LTCG discount applied not only because the net asset method presumes a sale of assets, but also because the U.S. Court of Appeals for the Second Circuit (the appellate forum in this case) would most likely follow recent decisions in both the 5th and 11th circuits that have a dollar-for-dollar discount.

The IRS argued that 2nd Circuit's decision in *Estate of Eisenberg* was still controlling, and permitted a discount for embedded capital gains tax based on the facts and circumstances of the case, taking into account the fair market value standard of willing buyer/seller. Accordingly, its expert began with the $4.2 million net asset value calculated by the estate's expert and then examined data from general closed-end funds. He found no direct correlation between a higher exposure to built-in capital gains tax liability beyond 41.5% of net asset value (NAV), and thus applied a dollar-for-dollar discount only to the portion of the unrealized capital gains beyond 41.5% of NAV in this case. This resulted in a LRCG liability of just over $415,000, or approximately 10% of net asset value.

The Tax Court agreed that the broader factual inquiry of *Eisenberg* applied to this case, and it expressly declined to consider how the 2nd Circuit might interpret other federal circuit decisions. At the same time, the court rejected the IRS expert's analysis, because closed-end data were simply not comparable to the assets in this case. The expert also failed to account for the assets' appreciation, the time value of money, and how a hypothetical buyer could practically avoid LTCG liability. As a result, the court conducted its own present value calculations based on the fair market value of the improved property, multiplied by appreciation and compounded interest rates (over a 17-year holding period), plus a 40% effective tax rate to reach an LTCG tax liability of approximately $1.2 million. This amount was higher than the estate's appraised dollar-for-dollar discount, which led the court to adopt the same, "because although not precise, it is within the range of values that may be derived from the evidence (and the estate did not argue for a greater amount)." Having specifically declined to adopt a *per se* rule of 100% discount for LTCG liability, the Tax Court has left the issue ripe for appeal to the 2nd Circuit.

Non-Compete Is a Corporate Asset, for Income Tax Purposes

***Howard v. United States*, 2010 WL 3061626 (E.D.Wash.)(July 30, 2010)**

In 1980, a dentist incorporated his practice, becoming the sole shareholder, officer, and director. He also entered an agreement not to compete with his corporation (in effect, protecting the company from himself). The agreement did not address whether the dentist or the business owned the related professional goodwill.

When the dentist retired in 2002, he sold his practice for approximately $613,000, allocating $549,900 for personal goodwill and $16,000 for a covenant not to compete with the buyer. In filing his federal tax returns that year, the dentist reported just over $320,000 as long-term capital gain income resulting from the sale of goodwill. The IRS re-characterized the goodwill as a corporate asset, however, and treated the dentist's receipt of $320,000 as a dividend. After the dentist paid the deficiency, he sought a refund in district court, claiming the goodwill was personal.

In support of his arguments, the taxpayer pointed to state divorce law, which holds that professional goodwill "has value to the professional" and is included among the divisible assets. (Note: Washington, a community property state, follows the minority rule, finding no distinction between professional and enterprise goodwill; both are assets subject to disposition in divorce.) In particular, a 1979 divorce decision by the Washington Supreme Court held that the patients of the dentist are part of goodwill and have a real pecuniary value to a hypothetical buyer. The taxpayer also claimed that the sale agreement controlled the characterization of goodwill in this case and effectively terminated the original, 1980 non-compete agreement.

Covenant not to compete is controlling. The IRS relied on federal income tax law to argue that the goodwill of the dental practice was a corporate rather than personal asset. It cited *Martin Ice Cream Company v. Commissioner*, 110 T.C. 189 (1998) and *Norwalk v. Commissioner*, T.C. Memo. 1998-279 (1998) for the proposition that if a professional works for a corporation under a non-compete, then the corporation owns the associated goodwill. The IRS also argued the parties' asset purchase agreement was not dispositive, and that, even if it somehow terminated the 1980 covenant not to compete, it did not change the character of the goodwill that the dentist generated from 1980 through the sale of his practice in 2002. Finally, the IRS claimed the "economic reality" of the transaction should determine the outcome of the case.

The Tax Court sided with the IRS and its citation of law. The parties' asset purchase agreement did not control the ownership of goodwill, nor did it reflect the contractual relationship between the dentist and his corporation. The corporation was clearly the entity that earned, controlled, and reported the dentist's income from the time of incorporation through the sale, and the covenant not to compete reinforced the corporate control of the assets, including the dentist's earnings. On review, the federal district court (E.D. Wash.) confirmed the Tax Court's decision in all respects, and denied the taxpayer's claim for a refund.

Important Tax Court Reminder re: Small Firm ESOP Compliance

***Hollen v. Commissioner of Internal Revenue*, T.C. Memo. 2011-2, 2011 WL 13637 (U.S. Tax Ct.)(Jan. 4, 2011)**

A small, private dental practice began sponsoring an employee stock ownership plan (ESOP) in 1987. The dentist-owner served as ESOP administrator and trustee of its related trust. In 1989, the trust borrowed $420,000 to purchase roughly 131,000 shares of stock in the dental practice; the firm distributed $200,000 to the trust to repay a portion of the loan, and the trust allocated $200,000 of common stock to participants' accounts, including $150,000 to the owner.

Law requires independent appraisal. The ESOP retained a CPA to appraise the trust's stock in years 2001 through 2003. It also requested a determination from the IRS as to its qualified status, but withdrew the request in 2003. Five years later, the commissioner issued a final letter disqualifying the ESOP since its inception. The IRS also found the dentist was the primary beneficiary of the $200,000 "dividend" distributed to the trust, and recharacterized the $150,000 in "earnings" as an annual addition to the plan.

On appeal, the Tax Court found that the ESOP and its trust failed to comply with Sec. 401(a) IRC on four different grounds:

1. *Ineffective amendment.* The dental practice failed to amend the ESOP within the effective dates provided by statute and applicable to certain small businesses.

2. *Improper vesting schedules.* The ESOP also failed to vest according to its own schedule. "Petitioner offers no explanation . . . why the vesting schedules on the ESOP's books did not properly reflect the provisions of the plan document's vesting schedule," the court observed.

3. *Unsigned appraisal.* The petitioner claimed that its CPA was an independent, qualified appraiser of the ESOP's stock pursuant to IRC Sec. 401(a)(28)(c). But the ESOP failed to comply with at least two requirements of the regulations, the court pointed out. First, the appraisal letters covering the 2001 through 2003 plan years were unsigned. Second, the submitted appraisals failed to list the appraiser's background, experience, education, and membership in any professional appraisal organization. As a result, the trust's holdings were not valued by a "qualified appraiser," the court held

4. *Excess annual additions.* Finally, the court confirmed that the IRS properly recharacterized $150,000 of the $200,000 dividend as an annual addition to the owner's account, in excess of the limitations of Sec. 415(c) IRC. "Because the ESOP never took any action to correct this failure," the court held, "the ESOP was not qualified in plan years after that date [1989]."

Moreover, the court noted that the ESOP had been given an opportunity to amend its omissions through the IRS's "closing action program," but chose not to do so.

Test Case: Tax Court Uses *Daubert* to Reject 'Absurd' Appraisal

***Boltar LLC v. Commissioner*, 2011 WL 1314445 (U.S. Tax Ct.)(April 5, 2011)**

In its first published decision regarding a *Daubert* challenge to an expert appraisal of a conservation easement, the U.S. Tax court uses strong language that could very well carry over into its consideration of business appraisals prepared for gift and estate tax purposes. Certainly, the case establishes precedent for applying *Daubert* to valuation evidence in Tax Court.

Conservation easement worth $3 million or just $30,000? In this case, the taxpayer claimed a $3.24 million charitable deduction for the donation of a conservation easement in a 20-acre parcel, based on a fair market value appraisal by a large, national firm that concluded the property's "highest and best use" was a 174-unit residential condominium development.

On review, the IRS determined that the conservation easement was worth no more than $42,200, later reduced to roughly $31,000. Prior to trial, the government also moved to exclude the taxpayer's appraisal under Rule 702 of the Federal Rules of Evidence and the *Daubert* standard for failing to follow the "before and after" methodology and for positing a "hypothetical development" that was neither physically possible nor legally permissible. The taxpayer's appraisers had determined value "based on whatever use generates the largest profit," the government maintained, "without regard to whether such use is needed or likely to be needed in the reasonably foreseeable future."

In response, the taxpayer argued that the *Daubert* standard did not apply to bench trials and that its appraisers used a commonly accepted methodology. The U.S. Tax Court quickly dismissed the first argument, finding that the *Daubert* analysis applies to jury as well as bench trials. Based on the IRS's appraisal, the court also found that the property's best and highest use, both before and after the easement, was as single-family residential development. By contrast, the taxpayer's appraisal failed to value the property after the easement grant and failed to consider its residential use. In addition, the projected condominium development could not fit on the property and it ignored the effect of a pre-existing pipeline gas easement.

The court could have received the taxpayer's appraisal "for what it was worth" and then rejected it or adjusted it at trial (as has been the Tax Court's general past practice). But to do so would have undermined the court's gatekeeper function to bar expert evidence that disregards relevant facts or "exaggerates value to incredible levels," the court said. Moreover:

> In most cases, as in this one, there is no dispute about the qualifications of the appraisers. The problem is created by their willingness to use their resumes and their skills to advocate the position of the party who employs them without regard to objective and relevant facts, contrary to their professional obligations. [. . .] In addition, the cottage industry of experts who function primarily in the market for tax benefits should be discouraged. Each case, of course, will involve exercise of the discretion of the trial judge to admit or exclude evidence. In this case, in the view of the trial Judge, the expert report is so far beyond the realm of usefulness that admission is inappropriate and exclusion serves salutary purposes.

Justice may be blind, the court concluded, "but we need not blindly admit absurd expert opinions," and it rejected the appraisers' report.