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VALUE ADDED™

ROUTE TO:

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Common Reasons For Not Obtaining An Independent Appraisal – and Why They are Wrong

Over the years we have heard a number of reasons - some new, some time honored - for not obtaining independent appraisals to substantiate asserted values in tax-related situations. Several of these reasons are highlighted below and we offer some thoughts to suggest why we believe they are erroneous.

"The Estate Tax might be repealed, so I am waiting to see what happens before I do anything." As of the publication of this newsletter, Congress has voted to repeal the Estate Tax and President Clinton has yet to veto it (as he is expected to do). Whether the repeal of this tax is political posturing in an election year or an issue with true bipartisan support remains to be seen. We are unsure if the Estate Tax will indeed be abolished; possibly a compromise will be struck raising the exemption. Nevertheless, the huge accumulation of wealth since 1946 is unlikely to escape notice by the taxing authorities. Given the current situation, tax planning should continue to take place.

The best strategy for tax appraisals related to ownership of interests in closely held companies is to hire a qualified independent appraiser who will prepare a solidly documented, soundly reasoned and reasonable valuation report to substantiate your filing value

"An appraisal in the file or in existence just provides ammunition for the IRS." Appraisals used for planning purposes do not hurt. They help provide the basis for gifting programs, purchasing appropriate amounts of life insurance, and establishing realistic buy-sell agreement terms. Sound tax planning combined with good execution will almost inevitably lead to a more favorable result than leaving tax matters to chance.

"We will save money by avoiding an appraisal now and negotiating with an agent. We will get an appraisal only as a last resort." It may be possible to settle on small amounts from time to time, but, if larger dollar amounts are involved, the IRS is unlikely to settle without some concrete independent evidence of value. If the IRS gets an appraisal, whether internally or externally, you will likely spend the dollars anyway to get your own. You can only hope that your appraiser's result will support your original filing. If it does

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An Overview of Valuation Approaches

Theoretically, the value of a business interest is the present value of all future financial benefits originating from three sources:

- Earnings from the business
- Sale of the interest, and/or
- Liquidation or pledging of assets

While it may be easy to recognize the form of financial benefits, determining the value of these benefits is a different matter. For example, earnings could range from minimal to deficit, transactions in the interests do not occur with any regularity, and/or no sale of the underlying assets is planned. In this case, would an interest in the entity be worthless? Certainly not. However, de-

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not, you really have a problem. Even if the result supports your original filing, regardless of the appraiser's actual independence, the late appraisal may be prejudiced because you did not obtain an independent appraisal in the first place (see ***Estate of Berg***, TC Memo 1991-279, aff'd in part & revd in part 976 F.2d 1163 (8th Ct 1992)).

"Let's not make any gifts now, because all we can give is $20,000 per child, and that is not enough to do any good." The better plan is to engage in regular gifting, based upon an independent appraisal, paying some tax on gifts made each year. Every $20,000 of value shifted is $20,000 of value. That is about $11,000 of future tax deferrals at the current marginal estate tax rate. Further, if gifts are made and adequately documented by independent appraisal, the gift tax return is subject to a three-year review period, after which the IRS will be precluded from later challenging the gifts.

"I cannot justify paying an appraisal fee just to make some gifts." Making gifts of assets, rather than holding on to them for an eventual estate tax appraisal, makes sense for many clients. Essentially, when you make a gift now, you get that asset and its prospective appreciation out of your estate. Additionally, gifts made of Family Limited Partnership interests (or LLC interests) gain the benefit of transferring assets to another generation at discounts from the underlying net asset values. The fee paid for a properly documented appraisal report typically represents a small fraction of the implicit tax savings, and many clients will use a December appraisal to make gifts then, and the following January.

"Book value is a good estimate for the value of my business so I'll just use that." Book value used to be a reasonably good proxy for the value of a family business, but not any more. Business restructuring in the 1980s resulted in generally higher rates of return on capital, thereby enhancing the value based on an earnings approach, as well as the value based on a comparable, guideline company approach. Additionally, with the increasing number of Subchapter S corporations, which can pay out almost all of their earnings, book value is no longer a clear guide to value.

"We have an ESOP appraisal each year. We'll rely on that." An ESOP appraisal is tailored to the unique and special needs of the Trustee of the Employee Stock Ownership Plan. As such, it may be performed on a controlling or minority interest basis, and may or may not reflect a discount for lack of marketability. It is unlikely that the specific factors involved in the appraisal of shares subject to an ESOP Agreement will exactly match those of a client's gift of a nonmarketable minority interest for estate planning purposes.

"We have used a formula pricing mechanism for years, and that seems to suit all the family members." While a formula pricing mechanism may coincidentally tie to fair market value, the formula price itself will not be sufficient documentation if you need to prove your case in court. The court has looked beyond transactions among family members who were not considered to be sophisticated investors, or who did not rely upon, or reasonably pursue, an analysis of value to come to an appropriate investment decision.

What is the best strategy for tax-related appraisals? A simple conclusion:

> *The best strategy for tax appraisals related to ownership of interests in closely held companies, whether for gifting (estate planning or charitable gifts), estate taxes, or employee stock ownership plans, is to hire a "qualified independent appraiser" who will prepare a solidly documented, soundly reasoned and reasonable valuation report to substantiate your filing value. This strategy should minimize the risk of challenge and maximize the probability of successful defense in the event of a challenge.*

If you own or are advising the owner(s) of closely held securities of considerable value, it is critical that current planning decisions be made based upon current independent appraisal and that actual tax transactions, whether gifts or estate tax filings, be conducted with similar documentation. Give us a call to discuss your requirements. ◆

Valuation Approaches

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pending on the nature and operations of a business entity, appraisers will take different approaches in determining the value of that business, either in whole or in part.

There are three broad approaches to business valuation, and subdivisions within each approach:

- **Asset-based approaches** write up (or down) to fair market value or otherwise adjust the book value of the tangible and intangible assets of an enterprise.
- **Market approaches** compare performance data of the subject company with those of comparable public and privately held companies if and when information is available.
- **Income approaches** directly capitalize earnings, forecast future benefits and discounts earnings to the present.

Table 1 depicts these three basic approaches and includes various subdivisions.

Business valuation is an art and a science. Experienced appraisers will examine the various valuation methods, weighing their appropriateness for each particular assignment. The methodology chosen by the appraiser must match the purpose of the appraisal and the methodological approach(es) and weight(s) accorded each approach should result in a reliable indication of value.

Here are two examples that demonstrate different valuation approaches while highlighting the importance of choosing the methodology that considers the individual characteristics of the business interest under consideration.

(1) We are asked to value a 10% limited partner interest in ABC Limited Partnership. The sole asset of the LP is land, which is currently leased for 15 years (with two 15-year renewal options) to a national discount store chain, with all taxes, insurance and maintenance provided by the lessee.

The fair market value of the entire Partnership without regard to the specific benefits of a general or limited partner interest is the market value of the land in the Partnership. The value of the land is generally determined by a local real estate appraiser who takes into account the terms of the lease (an income-based approach), the prices paid for similar properties in the area (a market-based approach), and the cost of replacement (an asset-based approach).

The market value of the land, less any liabilities of the Partnership is the Net Asset Value ("NAV") of the Partnership. However, a 10% limited partner interest is not worth its pro rata share of NAV because a limited partner interest has no control in the management or operations of the business and there is no ready market for the interest. As a consequence, appropriate minority interest and marketability discounts would be applied to the limited partner's pro rata share of NAV depending on the facts and circumstances of the Partnership and the valuation.

(2) We are asked to determine the fair market value of 10% of the common stock of XYZ Corporation. XYZ Corporation is a privately held canning company with a heavy investment in fixed assets.

Theoretically, the value of a business interest is the present value of all future financial benefits . . . While it may be easy to recognize the form of financial benefits, determining the value of these benefits is a different matter

The fair market value of the common stock of XYZ could be determined by using all three approaches to value, if appropriate. The book value of the Company's assets would be written-up to fair market value (as determined by a qualified, independent equipment appraiser). This approach would be appropriate for a company that is heavily dependent on a fixed-asset base. In addition, a search for publicly traded companies in the same (or similar) line(s) of business would be conducted. If comparable companies are available, the appraiser might look at price/book or market value of total capital to revenue multiples (as two examples) as an indication of value.

Finally, an analysis of XYZ's earnings (both historical and projected) would be conducted. Here the appraiser could apply some multiple (a capitalization factor) to a measure of earnings to obtain an indication of value, or as previously discussed, the value of the business could be determined by determining the present value of future cash flows. After consideration for the different methodologies are applied, a marketable minority level value is determined. If the particular circumstances of the engagement warrant a marketability discount, the marketable minority value will be reduced appropriately.

The primary determinants when choosing valuation approaches are the legal organization of the entity (partnership, limited liability company, or corporation), and the nature of the business operations (asset-based or earnings-based). The relevant facts will vary with each appraisal. ◆

Table 1
Approaches to Business Valuation

Asset Based	Market Based	Income Based
Net Asset Value	Public Company Information	Capitalization of Earnings
	Mergers & Acquisition Data	Discounted Future Benefits
	Transactions Data	Discounted Cash Flow

A View from One U.S. Tax Court Judge

At the Spring 2000 annual meeting of the American College of Trust and Estate Counsel in Scottsdale, Arizona, U.S. Tax Court Judge David Laro addressed the audience on the issue of business valuation. Judge Laro is, at least among business appraisers, one of the best known judges on the U.S. Tax Court, and has written some widely read and discussed opinions addressing issues fundamental to business appraisers.

His outline summary touches on some of the fundamental issues before the Court today. It is important to note that Judge Laro prefaced his remarks

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by stating that these comments were his personal views and were not intended to represent the views of his colleagues on the U.S. Tax Court.

A Summary of Judge Laro's Comments. From Judge Laro's perspective, anyone approaching the subject of valuation should be aware of certain truisms as a frame of reference, such as: 1) each valuation case is unique; 2) in valuation, there are no absolutes; 3) there is no irrefutable "right" answer; 4) experts will and do differ; and 5) there are available methods that are generally recognized and accepted by the appraisal profession and the courts.

Judge Laro noted that the standard of value in tax court cases is fair market value. Fair market value is determined on the valuation date and, ordinarily, no consideration is given to any unforeseen future event that may affect the value of the subject property. The definition is familiar: "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." The failure to focus on the totality of the definition may lead to an inaccurate or incomplete definition.

Judge Laro recognizes that there are both strategic and financial buyers in the marketplace, and that strategic buyers will often pay a premium over the amount that typical financial buyers will pay, due to the special synergies with the unique buyer. He also recognizes that hypothetical buyers and sellers are not specific buyers and sellers.

Regarding the "weighting" of various factors presented in a valuation report, Judge Laro believes that one should consider carefully all relevant factors, but should not assign weights to such factors. Since the circumstances of each case are different, it is practically impossible to prescribe a single standard or formula that must be applied; reasonableness and flexibility are necessary to arrive at an appropriate valuation. However, Judge Laro does appreciate an appraisal report pointing out factors that are critical, influential or controlling in the appraisal. A report may highlight a critical factor without assigning it a weight as part of a formula. [Remember that these comments are Judge Laro's personal views. In fact, many business appraisers weight various factors in their appraisal reports.]

And finally, when considering prospective discounts, Judge Laro believes one must be careful not to confuse the minority discount with the marketability discount. A minority discount reflects the fact that a minority shareholder usually cannot control the policy and operations of the corporation. A minority discount also reflects the fact that an investor will usually pay more for a block of stock that represents control. Accordingly, the minority discount is rooted in a shareholder's lack of control over company policy.

Our Comments. Judge Laro has advanced the business appraisal profession by addressing issues of importance to business appraisers, and urging appraisal professionals to prepare cogent, well-reasoned and credible valuation reports, with conclusions that are arrived at as objectively and reliably as possible. As business appraisal professionals, we applaud Judge Laro's efforts to define the parameters of reasonably acceptable valuation issues. ◆

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BUSINESS VALUATION

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